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ARTICLE

ACADEMICS IN WONDERLAND: THE TEAM PRODUCTION AND DIRECTOR PRIMACY MODELS OF CORPORATE GOVERNANCE

*George W. Dent, Jr.**

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I. INTRODUCTION

Corporate governance has been controversial in America since 1932, when Adolf Berle and Gardiner Means charged that most public companies are run not in the interests of their supposed owners, the shareholders, but of the companies' own managers.[1] Of course, corporate executives and their operatives (like corporate lawyers) liked this arrangement. Most academics did not. Their critiques varied but generally fell into two camps. One denounced the failure of public companies to maximize shareholder interests; the other (the "progressives") decried their failure to serve other corporate constituencies (like employees and consumers) and the public interest (as they defined it).[2] Each camp offered diverse solutions to the problem it perceived.

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1. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 124 (1932).

2. *See* Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667, 669–70, 672–75 (2002) (introducing the distinction between the shareholder wealth maximization form of corporate governance and the more

Of late the debate has shifted. Although two factions remain, one devoted to shareholder interests, the second to other constituencies and the public, many academics in each camp now defend the status quo as an effective means to the ends it favors. The supposed champions of shareholders call the dominant corporate governance mode "director primacy";[3] progressives dub it the "team production"[4] (or "mediating") model. This astonishing concurrence of ancient foes prompts the obvious question of whether both can be right. More fundamentally, with the memory of Enron, Tyco, and other scandals still fresh, and with widespread complaints about executive compensation, can it be that the status quo is truly Nirvana, the best of all possible corporate governance worlds?

This Article probes both theories and finds them deluded. Berle and Means are still right: the status quo is not director primacy, shareholder primacy, or team production, but CEO primacy—governance by managers largely for their own benefit. The interests not only of shareholders but of other constituencies and the public would fare better with shareholder primacy. "Shareholder voice is an idea that hasn't been tried, not one that has failed."[5]

Part I describes the director primacy and team production models and explains why they are incompatible and false accounts of current reality. Part II shows the reality of CEO primacy and its costs, especially to shareholders. Part III offers a different and, it is submitted, more accurate description of how the market has shaped the current state of corporate governance. Part IV discusses trends that are weakening managerial domination and may lead to shareholder primacy and the social consequences of those trends. Part V concludes.

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broad community and constituent focus of the progressive governance model); *see also infra* notes 47, 53, 105–07, 348–51 and accompanying text. This Article will refer to the progressives' concept of the public interest without quotation marks, but it should be understood that the meaning of the term is controversial. *See* Kostant, *supra*, at 674–75 (noting the lack of uniformity among progressive scholars and the distracting nature of labels).

3. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1735 (2006) (defining the "director primacy" model).

4. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253–54 (1999) (comparing the progressive model to that of the "team production" or "mediating" model); Kostant, *supra* note 2, at 667–68 (calling the "team production model" a progressive idea).

5. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 608 (1990).

II. THE TEAM PRODUCTION AND DIRECTOR PRIMACY MODELS

Under statutes in all states, business corporations are managed by or under the direction of a board of directors elected by their shareholders.[6] Directors are fiduciaries of the shareholders and, in theory, charged with promoting their interests.[7] Proponents of the director primacy model (DPM) deny that directors are really chosen by the shareholders.[8] Indeed, they claim that to serve shareholder interests, boards must be largely free of shareholder interference.[9] Advocates of the team production (or mediating) model (TPM) concur that directors are not chosen by shareholders.[10] However, they claim that boards do not act solely for the benefit of shareholders but balance the interests of various corporate constituencies and of the public; TPM advocates further claim that this is as it should be.[11]

A. The Director Primacy Model

1. The Efficient Market for Corporate Governance Hypothesis. According to the Efficient Capital Market Hypothesis (ECMH), markets efficiently price securities at the present value of all expected future returns.[12] The relationship between shareholders and directors entails "agency costs" in the form of benefits (or "rents") appropriated by the directors as agents for the shareholders.[13] As a corollary of the ECMH, supporters of the DPM develop an "efficient market for corporate governance" hypothesis (EMCGH). The EMCGH posits that the agency costs of corporate governance are factored into stock prices. If agency

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6. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); DEL. CODE ANN. tit. 8, § 211(b) (2001) ("[A]n annual meeting of stockholders shall be held for the election of directors.").

7. *See* FRANKLIN A. GEVURTZ, CORPORATION LAW, § 4.1.5, at 305 (2000) (setting forth that courts typically "say that directors owe their duty to the corporation and its shareholders"); *see also* Blair & Stout, *supra* note 4, at 291 ("[C]orporate directors are a unique form of fiduciary . . . .").

8. *See infra* note 32 and accompanying text.

9. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605 (2003) (addressing the superior role of the director in the director primacy model of corporate governance).

10. *See infra* notes 40–39 and accompanying text.

11. *See infra* Part I.B.

12. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 347–70 (7th ed. 2003) (describing and documenting the ECMH).

13. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–09 (1976).

costs were substantial, a corporation would be "more vulnerable to bankruptcy or hostile takeover."[14] Further, "[b]y increasing the value of the firm, [managers] would do themselves a favor (most managers' compensation is linked to the stock market, and they own stock too)."[15] Accordingly: "If investors truly believed greater shareholder control meant better corporate performance, they could 'vote with their wallets' by preferring shares in firms that give shareholders more control."[16] Since they do not, "we may conclude investors do not value these rights."[17] The status quo must be Nirvana for shareholders.[18]

This reasoning has obvious flaws for companies that are already public. First, it ignores the serious and growing objections to the ECMH.[19] Further, the alleged market constraints on managers are often feeble. The threats of bankruptcy and of hostile takeover do not eliminate rents, which for most firms are large, but only keep them low enough for the firm to avoid insolvency or a successful raid.[20] That agency costs reduce managers' compensation and the value of their shares is hardly a constraint at all. A self-interested manager will not desist from grabbing one dollar from the corporate till just because, as a shareholder, she owns a fraction (typically minuscule) of that dollar. If she owns one percent of the stock, one penny of each dollar she appropriates is her own; the other ninety-nine cents come from the pockets of other shareholders.

Because of these weaknesses, EMCGH theorists rely heavily on initial public offerings (IPOs).[21] Managers of IPO firms are major shareholders, so they suffer substantial loss if poor corporate governance reduces the IPO's share price.[22] Further,

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14. Bainbridge, *supra* note 3, at 1736.

15. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 205 (1991).

16. Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 802 (2007). Likewise, "if shareholder empowerment is as value-enhancing as [opponents to EMCGH] claim[], why do we not already see it in the marketplace?" Bainbridge, *supra* note 3, at 1736.

17. Bainbridge, *supra* note 3, at 1737.

18. *See* Stout, *supra* note 16, at 803 (maintaining that shareholders themselves "prefer weak shareholder rights").

19. *See infra* Part III.A.3 (addressing the imperfect nature of information that influences market decisions). Michael Jensen himself has questioned the ECMH after concluding that mispricing of securities is common and can persist. Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5, 6–7 (2005).

20. *See* Bainbridge, *supra* note 3, at 1736 (discussing how "[c]orporate managers therefore have strong incentives to offer investors attractive governance arrangements" to reduce its vulnerability to bankruptcy or hostile takeover).

21. *See infra* note 255 and accompanying text.

22. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV.

most IPO firms have directors who represent major nonmanagement shareholders (like venture capitalists) who also suffer if the IPO price is suboptimal, so they also would demand that the firm adopt ideal corporate governance rules.[23]

One problem with the EMCGH for both IPOs and companies already public is that the transaction costs of adopting optimal corporate governance rules and then explaining their value to investors are substantial.[24] Accordingly, EMCGH theorists also point that state corporate laws are off-the-rack sets of rules; corporate constituents need to negotiate their own governance rules only to the extent that state law dissatisfies them. Business executives, then, are motivated to incorporate in the state with the best corporate law. To attract corporate franchise fees states compete in a "race to the top" to offer the best corporate law.[25]

Nor is this competition limited to the fifty states. Bainbridge argues that if critics of the corporate governance status quo were right, "U.S. corporate governance would be largely dysfunctional. It is not."[26] If some foreign corporate laws were more efficient than America's, capital would flow abroad. Foreign corporations would then enjoy a lower cost of capital than American companies, leading foreign firms and their nations to higher productivity and economic growth than America's. In other words, in addition to a domestic race to the top there is also an international race to the top. However, in economic growth and productivity gains, America has consistently exceeded other industrialized nations,[27] and America remains the most attractive locus for capital investment. We are winning the international race to the top, so our corporate governance laws must not be "dysfunctional."

The EMCGH is tidy, appealing, and in some respects true, but the market for corporate governance is more complex and less efficient than EMCGH allows.[28] Until recently, flaws in the

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1559, 1569 (2002) (noting that managers own a majority of IPO firm shares).

23. *Id.*

24. *See infra* notes 238–51 and accompanying text (discussing the high costs to investors of obtaining, processing, and benefiting from information).

25. This thesis was first proposed in Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 275–76 (1977).

26. Bainbridge, *supra* note 3, at 1739.

27. *Id.* at 1739–40 (quoting Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 1 (European Corporate Governance Inst., Finance Working Paper No. 23/2003, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441100).

28. *See* Oren Bar-Gill et al., *The Market for Corporate Law*, 162 J. INST. & THEORETICAL ECON. 134, 134 (2006) ("[C]ompetition among states . . . produce[s] optimal rules with respect to issues that do not have a substantial effect on management's private

market for corporate governance persisted because there was no clearly superior model of corporate governance; now there is.[29] Moreover, international competition for capital is heating up. Other countries are gaining on us by improving their laws. Countries like China and India that once offered few investment opportunities have now joined this race.[30] Thus, inefficiencies in our corporate governance do not merely shave investors' profits a little; they now threaten America's appeal to investors and, accordingly, the health of our economy.

2. *Director Primacy as the Efficient Solution.* An organization arises when a task cannot be done by one person or by several people interacting through contracts. Organizations delegate authority to agents. Citing the organizational theories of Kenneth Arrow, Steve Bainbridge says:

> Authority-based decisionmaking structures, which are characterized by a central agency empowered to make decisions binding on the firm as a whole, tend to arise when the firm's constituencies face information asymmetries and have differing interests. Because the corporation demonstrably satisfies those conditions, vesting the power of fiat in a central decisionmaker is the essential characteristic of its governance.[31]

According to the DPM, a business with many owners must delegate not only day-to-day control but plenary authority to a largely self-perpetuating board of directors; the shareholder–owners simply cannot inform themselves about the firm's operations and coordinate among themselves to control or even choose the board.[32] They need directors to serve as "Platonic guardians."[33]

This theory defies rational economic behavior. Contracting parties do submit disputes to third parties; they must do so because the law permits litigation over contract disputes. However, shareholders do not surrender control of a business to someone with little stake in its success. To do that would violate

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benefits but not with respect to issues [such as takeover regulation] that have [an effect on management's private benefits].").

29. *See infra* note 353 and accompanying text.

30. George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 74 (2005).

31. Bainbridge, *supra* note 3, at 1745 (citing KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–69 (1974)).

32. *See* Bainbridge, *supra* note 9, at 558–59.

33. *Id.* at 550–51.

an economic axiom—that an activity is usually handled most efficiently by those with the biggest stake in its success.[34]

Bainbridge's argument for director primacy also contradicts his own defense of the EMCGH: if shareholders suffer from "information asymmetries"—they can't evaluate management decisions—how can capital markets be efficient, especially with respect to corporate governance rules? The solution to this dilemma is that his justification for director primacy is false. Principals (including shareholders) never have all the information or skills of expert agents (including business managers)—that's why experts are hired. But wise principals do not abandon all control, including power to fire the agent, leaving the agent to do as he wishes for whatever compensation he chooses.

Likewise, the DPM is not necessitated by "differing interests" of "the firm's constituencies." Presumably, by "constituencies" Bainbridge means the shareholders because he himself says,

> [S]areholders are the only corporate constituency with a residual, unfixed, ex post claim on corporate assets and earnings . . . . [Therefore] shareholders have the strongest economic incentive to care about the size of the residual claim, which means that they have the greatest incentive to elect directors committed to maximizing firm profitability.[35]

The statement clearly imports a unity of shareholder interest. Here, Bainbridge has it right.[36]

B. *The Team Production (or Mediating) Model*

Advocates of the TPM agree with the DPM theory that boards operate largely free of shareholder control, but they claim that this autonomy benefits several corporate constituencies.[37] The TPM posits that firms need nonshareholder constituents (often called "stakeholders") to make commitments that would expose them to exploitation if shareholders controlled the firm.[38] Some stakeholders

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34. "[S]hareholders, as residual claimants, have the greatest incentive to maximize the value of the firm." Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1267–68 (1999). As a result, "shareholders will place a higher value on being the beneficiaries of director fiduciary duties than will nonshareholder constituencies." STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 421 (2002).

35. Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 613 (2006)

36. *See infra* notes 115–24 and accompanying text.

37. *See* Blair & Stout, *supra* note 4, at 253.

38. *See* Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 685–86 (2003); *see also* Martin Lipton & Steven A. Rosenblum, *Election Contests in the*

(especially employees) are particularly vulnerable because, unlike shareholders, they cannot diversify their investment of (human) capital or easily shift to another investment as individual shareholders can by selling their stock. To secure these commitments, firms must promise to treat stakeholders decently. However, because performance on each side is so complex and lasts indefinitely, the mutual commitments cannot be fully specified in contracts; shareholders could only promise to treat stakeholders "fairly." Since this commitment is too vague to be legally enforceable, the shareholders could easily renege; the stakeholders cannot trust them.[39]

To overcome this problem, shareholders cede control to disinterested directors who act as "mediating hierarchs" to balance the interests of shareholders and stakeholders.[40] Indeed, shareholders tie their hands by agreeing to rules that make it difficult or impossible to replace directors.[41] But, shareholders could still renege by selling the firm.[42] If this were easily done, stakeholders would not trust the firm and refuse to make the commitments it needs. Fortunately for shareholders, the law and firm-level antitakeover devices make it hard for them to sell the business. Thus, separation of ownership and control is the best of all possible worlds for investors; shareholders should welcome their weakness.[43] The team production model makes corporations more profitable.[44]

Company's Proxy: An Idea Whose Time Has Not Come, 59 BUS. LAW. 67, 79 (2003) (alleging "the need to have a body that balances a wide array of competing interests, both among the shareholders themselves and between shareholders and other constituencies").

39. *See* Stout, *supra* note 16, at 805 (stating that investors may make "opportunistic attempts to increase 'shareholder value' by changing the corporate rules in the middle of the game").

40. *See id.* at 797 ("Stakeholders contemplating making specific investments in relationships with corporations put more faith in firms run by boards than in firms run by powerful and possibly opportunistic shareholders."); *see also* Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 956 (1993) (proposing that directors be "neutral referees" for the various corporate constituencies).

41. *See* Stout, *supra* note 38, at 686. The argument is bolstered by a claim that the corporation became the dominant form of business entity in the nineteenth century because it locked in capital. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 392–93 (2003); Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY. BUS. L.J. 1, 4–5 (2004). This claim is demolished by Larry E. Ribstein, *Should History Lock In Lock-In?*, 41 TULSA L. REV. 523, 524 (2006).

42. *See* Stout, *supra* note 38, at 705.

43. *See* Bainbridge, *supra* note 35, at 624 ("[S]hareholders will prefer to irrevocably delegate decisionmaking authority to some smaller group, as, in the long run, this will maximize shareholder wealth.").

44. *See* Kostant, *supra* note 2, at 671. Some commentators share the ideals of the TPM's fans but feel that corporations do not now adequately consider the interests of

C. *Problems of the Team Production and Director Primacy Models*

1. *The Incompatibility of the Two Models and Their Internal Inconsistencies.* The DPM and the TPM are incompatible: the DPM posits that the current corporate governance regime maximizes shareholder welfare; the TPM claims that it balances shareholder and stakeholder interests. Some contend that the two do not conflict because stakeholder and shareholder interests coincide.[45] It is true that market forces compel firms to treat stakeholders well in order to maximize share price,[46] but that does not mean the interests of the two groups are identical.[47] Employees, for example, benefit if they get all firm income above the costs of goods and outside services, leaving nothing for shareholders. In European companies with two-tiered boards, one of which includes employee representatives (called "co-determination"), the two groups often clash.[48] Two-tiered boards seem to reduce shareholder value.[49] Not surprisingly, then, Germany is now

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nonshareholder stakeholders; they would give these interests greater weight, but they do not all agree (or, for some writers, have any idea) how to achieve this goal. *See* Kent Greenfield, *Saving the World With Corporate Law?* 28 (Boston Coll. Law Legal Studies, Research Paper Series No. 130, 2007) *available at* http://ssrn.com/abstract=978242 ("The specifics [of implementation] do not matter as much as does the notion that the board itself should be a place where more than just a shareholder perspective will be heard.").

45. *See* Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 46–48 (2004); S. Ramakrishna Velamuri & S. Venkataraman, *Why Stakeholder and Stockholder Theories Are Not Necessarily Contradictory: A Knightian Insight*, 61 J. BUS. ETHICS 249, 259 (2005) (positing that, "[i]n the absense of extensive legislation or detailed corporate codes of conduct," ethical values can bridge the gap between the normative stakeholder theory (TPM) and the investor centered model (DPM) when requiring a difficult decision such as the closing of a factory).

46. *See* Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 38 (1999) (postulating that "wealth-maximizing stakeholders at the time the firm is formed would agree that managers should run the firm so as to maximize the value of the firm's residual claim or common stock").

47. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 745 (2005) (doubting that the interests of the two groups always coincide).

48. *See* Detlev F. Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 53 (1966) (stating that on such boards "members have special preoccupations and perspectives of their own"); *see also* Olubunmi Faleye et al., *When Labor Has a Voice in Corporate Governance* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 11254, 2005), *available at* http://www.nber.org/papers/w11254 (finding that labor interests conflict with share value maximization).

49. *See* Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 J. EUR. ECON. ASS'N 863, 895 (2004) (concluding that firms that employ two-tiered boards trade at a significant discount compared to those which

weakening co-determination.[50] There is also evidence that increased "corporate social responsibility" reduces shareholder wealth.[51]

A variation on the compatibility theme is that the TPM and DPM differ only in their rhetoric about commitment to stakeholders.[52] Again, though, shareholder primacy theory posits fair treatment of stakeholders so as to maximize share price, and it makes sense to publicize this fact. It is unclear, though, whether the claims about rhetoric are true—firms do not proclaim their shareholders' impotence to stakeholders.

No evidence is offered that business *behavior* has changed, and corporate concern for the public interest does not seem to have grown. Indeed, increasing stakeholder rhetoric may "represent[] a temporary public relations response to the negative press generated by corporate scandals."[53] Pay for most workers has stagnated.[54] The environment and consumers seem no better served than before. Corporate manipulation of Congress and state legislatures with pots of money seems to have reached new heights (or, more accurately, depths). If there is any trend away from shareholder primacy, it is in favor of CEOs, not other stakeholders.

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have single-tiered boards).

50. *See* Ehud Kamar, *Beyond Competition for Incorporations*, 94 GEO. L.J. 1725, 1754 (2006) (referring to "the recent push in Germany to relax the so-called codetermination rights entitling employee representatives to half of the supervisory board seats in large companies").

51. *See* Leonardo Becchetti et al., *Corporate Social Responsibility and Corporate Performance: Evidence from a Panel of U.S. Listed Companies* 15 (Ctr. for Int'l Studies on Econ. Growth, Working Paper No. 78, 2005), *available at* http://papers.ssrn.com/abstract=871402 ("[Social responsibility] seems consistent with the shift in focus from wealth maximization to a multistakeholders welfare approach."). *But see* Lee E. Preston & Douglas P. O'Bannon, *The Corporate Social–Financial Performance Relationship: A Typology and Analysis*, 36 BUS. & SOC'Y 419, 428 (1997) ("[E]mploying the largest longitudinal database used to date in this type of research, we find overwhelming evidence of a positive relationship between social and financial performance indicators in a sample of large and important U.S. corporations—a finding broadly consistent with the stakeholder theory of the corporation.").

52. *See* Margaret M. Blair, *Directors' Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 899–900 (2003); Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 702 (2006).

53. Fairfax, *supra* note 52, at 698 (declining also "to address the extent to which the rhetoric can, and likely will, have an impact on corporate conduct"); *see also* Brian Grow, *The Debate over Doing Good*, BUS. WK., Aug. 15, 2005, at 76–77 ("There's no doubt that a surge in community outreach and do-good deeds is, in large part, a gussied-up bid for good favor.").

54. DEAN BAKER, CTR. FOR ECON. & POLICY RESEARCH, THE PRODUCTIVITY GAP: WHAT THE DATA SHOW 3 (2007) ("The real hourly wage of a typical worker is only slightly higher in 2006 than it was in the seventies."), *available at* http://www.cepr.net/documents/publications/growth_failure_04_2007.pdf.

If the TPM were important to stakeholders, we should observe a disadvantage of private companies that cannot deploy such rhetoric. No evidence of this is tendered. Quite the contrary, private ownership is surging.[55] Indeed, the TPM's fans contradict themselves. They say "shareholders in close corporations are often tempted to use their managerial powers opportunistically."[56] Yet, they also purport that in close corporations, "because there are fewer individuals involved, and these individuals often interact with each other, reputation and interpersonal trust can play a larger role in protecting against opportunism."[57]

Another contradiction: It is said that "board governance offers important advantages in terms of efficient and informed decisionmaking."[58] However, we also hear that "the existence of a mediating hierarchy may heighten incentives for team members to work out conflicts among themselves because the alternative is kicking the problem upstairs to a disinterested—but potentially erratic or ill-informed—hierarch."[59] Thus the board is depicted as both "efficient and informed" and as "erratic or ill-informed."

The interests of various stakeholders conflict with each other as well as with those of the shareholders. There is not even an agreed definition of "stakeholders."[60] Employees of a plant could clash with the plant's neighbors over whether to close the plant because of pollution it emits. Even employees, usually considered the primary stakeholder group, do not all have identical interests. Younger workers, for example, care more about a firm's longterm performance than do older employees.[61]

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55. *See, e.g.*, Tom Lauricella, *Mutual Funds Get Mad*, WALL ST. J., Oct. 2, 2007, at R1 (noting the some fund managers' complaints about the upsurge of management buyouts).

56. Blair & Stout, *supra* note 4, at 302 (stating that this opportunism leads to the "exploit[ation of] their fellow shareholders"). However, no reason is stated why shareholders would not also exploit stakeholders.

57. Stout, *supra* note 16, at 796 n.18.

58. *Id.* at 792.

59. Blair & Stout, *supra* note 4, at 282.

60. *See* R. Edward Freeman et al., *Stakeholder Theory and "The Corporate Objective Revisited"*, 15 ORG. SCI. 364, 365 (2004) ("[S]takeholder theory can be many things to many people."); Ronald K. Mitchell et al., *Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts*, 22 ACAD. MGMT. REV. 853, 858 (1997) (finding twenty-seven different definitions of "stakeholder").

61. *Cf.* Sarah Pierce, *Gen Y Myths Debunked*, ENTREPENEUR.COM, June 1, 2007, http://www.entrepreneur.com/humanresources/managingemployees/article179200.html ("[Younger] employees want to have a long-term relationship with a company . . . .").

2. *Dubious Premises.* Many arguments for shareholder primacy use stock prices as evidence.[62] Displaying a curious ambivalence about stock market efficiency, DPM/TPM theorists often deny the significance of share price. First, they claim that market price does not reflect fundamental value.[63] This is ascribed partly to investors' irrationality; they are "often driven by emotion and cognitive bias."[64] Similarly, they discount the event studies on which many arguments about corporate governance rely.[65] This is puzzling because the same writers premise claims of investor contentment with the status quo in part on the efficiency of the stock market in valuing corporate governance and initial public offerings.

Unfortunately, they seem to be wrong in every case. On one hand, the market is not very efficient in pricing corporate governance features, especially with regard to IPOs.[66] In general, though, stock pricing is quite efficient. Although share prices do not exactly match fundamental value, no measure is better.[67]

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62. One example is the loss of share value caused by having a staggered board. *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410–11 (2005) (discussing the negative correlation between the presence of staggered boards and firm value); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 936–39 (2002) (contending that staggered boards provide the directors too much power to remain independent from the shareholders, resulting in negative target shareholder value after a hostile bid); Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501, 501 (2007) ("[C]lassified boards destroy value by entrenching management and reducing director effectiveness."); Michael D. Frakes, *Classified Boards and Firm Value*, 32 DEL. J. CORP. L. 113, 150–51 (2007) (recognizing negative effects of classified boards). Similarly, destaggering the board increases share price. *See* Faleye, *supra*, at 514; Mira Ganor, *Why Do Managers Dismantle Staggered Boards?* 40–43 (1st Annual Conference on Empirical Legal Studies Paper, 2006), *available at* http://ssrn.com/abstract=908668.

63. *See* Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435, 1439–40 (2005) (claiming that the relationship between the two is "extremely loose").

64. *Id.* at 1443; *see also* HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 3 (2004) ("[T]he primary emotions that determine risk-taking behavior are not greed and fear, but *hope* and fear."); Jon E. Hilsenrath, *As Two Economists Debate Markets, the Tide Shifts: Belief in Efficient Valuation Yields Ground to Role of Irrational Investors*, WALL ST. J., Oct. 18, 2004, at A1 (comparing the irrationality of investors and the efficient market theory).

65. *See* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 656 (2003) (listing several criticisms of event studies).

66. *See infra* notes 238–51 and accompanying text (discussing the high costs to investors of obtaining, processing, and benefiting from information); *see also infra* notes 261–73 and accompanying text (discussing inefficiencies in the IPO market).

67.

> The public's valuation of a company in the marketplace has unique value, because it is the only judgment that cannot be manipulated. Various notions of

Investors are human and therefore not always perfectly rational, but critics of share price do not show that this affects corporate governance. Investors have strong incentives to maximize fundamental value, and evidence indicates that on corporate governance issues shareholders do so act.[68]

If objections to share price were sound, how could we gauge the success of the mediating board? Its proponents offer no alternative.[69] Without some yardstick, and without even loose accountability to any constituency, boards under the DPM/TPM are, in effect, unconstrained.[70] Moreover, if directors should serve many constituencies and investors are irrational, why have shareholders elect boards at all? Would it not be better to neuter shareholders and make boards officially self-perpetuating? Likewise, if the DPM/TPM is right that shareholders eschew control, they should not only be passive but also should oppose any activism by other shareholders. Assertiveness by some shareholders should be feared by others as a grab for special benefits. In fact, though, shareholder activism is growing, and

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> value based on concepts like earnings per share, book value, rate of return on reinvested capital, and the like are based on accounting principles that are so highly flexible that they have limited significance.

ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 55 (1995); *see also* Henry Manne, *Remarks on the Lewis & Clark Law School Business Law Forum: Behavioral Analysis of Corporate Law: Instruction or Distraction?*, 10 LEWIS & CLARK L. REV. 169, 172, 175 (2006) ("[C]ritics like Professor Stout are simply claiming too much. . . . [M]ere 'irrationality' on the part of some stock market participants cannot foil an otherwise efficient market."); Jeffrey N. Gordon, *Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm* 70–90 (Columbia Law & Econ., Working Paper No. 301, 2006), *available at* http://ssrn.com/abstract=928100 (stating that stock prices have become more "informative" in recent years).

68. *See infra* notes 116, 128–57 and accompanying text.

69. *See, e.g.*, Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 661 (2006) ("A major drawback to stakeholder theory is that it lacks a specific maximand to guide managerial discretion. To the extent that the interests of different stakeholders conflict, the stakeholder model offers no principled basis for choosing among them."); Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 9 (2001) (arguing that the lack of a corporate objective is likely to result in "confusion, conflict, [and] inefficiency"). *See generally* Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 ORG. SCI. 350, 350, 353–56 (2004) (arguing that shareholder value versus stakeholder value should be the preferred corporate objective).

70. Berle recognized this situation as a consequence of separation of ownership and control. *See* Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932) ("The point is that [corporate managers] need recognize no other."); *see also* JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER 34 (2004) (noting that if directors are responsible to several constituencies, they play them off against each other); Giovanni Cespa & Giacinta Cestone, *Corporate Social Responsibility and Managerial Entrenchment*, 16 J. ECON. & MGMT. STRATEGY 741, 743 (2007) ("CEOs who can rely on anti-takeover defenses and dominated boards do not need stakeholders' support to buttress their positions.").

even passive shareholders welcome the efforts of others.[71] Contrary to claims that investors tie their own hands, shareholder votes are significantly related to firm performance.[72] In sum, the DPM/TPM never has accorded with reality and does so even less as time passes.

DPM/TPM scholars refuse to view shareholders as owners of the corporation for whom directors are agents: "the way corporate law actually works in practice is consistent with the notion that directors are independent hierarchs whose fiduciary obligations run to the corporate entity itself and only instrumentally to any of its participants."[73] Directors are not agents because "they are not subject to direct control or supervision by *anyone*, including the firm's shareholders."[74] They are, instead, "a unique form of fiduciary who, to the extent they resemble any other form, perhaps most closely resemble trustees."[75] Further, "American law . . . grants directors tremendous discretion to sacrifice shareholders' interests in favor of management, employees, and creditors . . . ."[76] Statutes in over half the states expressly allow boards to weigh nonshareholder interests.[77]

True, directors are not precisely agents of the shareholders, but the claim that they enjoy "tremendous discretion to sacrifice shareholders' interests in favor of" other stakeholders is grossly misleading. As suggested by their own characterization of directors as resembling trustees for the shareholders, directors are fiduciaries of the shareholders and no one else. Most constituency statutes apply only to a takeover attempt, a rarity for any company and one most never face.[78] And these laws are absent in nearly half the states, including Delaware, the kingpin.[79]

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71. *See infra* notes 300–36 and accompanying text.

72. *See generally* Jie Cai et al., Electing Directors 3, 13, 15 (May 2007) (working paper), *available at* http://ssrn.com/abstract=910548 (confirming the hypothesis that shareholder voting is related to firm performance); *see also infra* notes 287–90 and accompanying text.

73. Blair & Stout, *supra* note 4, at 289.

74. *Id.* at 290.

75. *Id.* at 291.

76. *Id.*

77. *See id.* at 303 n.144 (stating that twenty-eight states allow directors to consider nonshareholder interests); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 579 n.1, 587 n.33 (1992) (listing statutes).

78. *See, e.g.*, N.Y. BUS. CORP. LAW § 717(b) (McKinney 2003) (outlining New York's constituency statute).

79. *See* Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 27–28 (1992) (noting that although twenty-nine states have constituency statutes, Delaware is not among them).

True also, the legal devices by which shareholders can call the board to account—specifically election and removal of directors and derivative suit—are imperfect, especially when the directors' acts are not self-interested.[80] In legal doctrine, however, directors are fiduciaries of the shareholders only.[81] Occasionally, directors are held to have breached their duties without any conflict of interest.[82] More important, the law often proclaims shareholder primacy. A key purpose of the Securities Exchange Act was to realize shareholder democracy.[83] Delaware courts recognize that the shareholder franchise is the linchpin of corporate legitimacy.[84]

The looseness of the directors' duties and restrictions on derivative suits are defended on the theory that tighter standards would breed excessive caution in directors fearful of personal liability and deter the best candidates from serving on boards. This reasoning is pure speculation, though; there is no evidence of its truth, and experience seems to show that an insistence on minimal care and competence does not empty a field of qualified practitioners.

It is true that not every step taken to increase shareholder power has produced benefits. That only shows, however, that the best means of implementing shareholder primacy are still unclear. Many enhancements of shareholder influence do generate gains.[85] Shareholder democracy is a work in progress. The Declaration of Independence proclaimed that governments "deriv[e] their just powers from the consent of the governed."[86]

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80. *See* Blair & Stout, *supra* note 4, at 292–315 (analyzing derivative suits and voting rights under the "mediating hierarchy model" and determining that such shareholder powers are "so weak as to be virtually meaningless").

81. *E.g.*, Newby v. Enron Corp., 188 F. Supp. 2d 684, 704 & n. 10 (S.D. Tex. 2002) (noting the fiduciary duty owed to shareholders by directors).

82. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986) (forbidding the board to weigh nonshareholder interests in a takeover bid except to benefit shareholders); Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (holding board liable for breach of the duty of care when it accepted a takeover bid); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (forbidding the board to withhold dividends and devote corporate funds to the public interest).

83. "Fair corporate suffrage is an important right that should attach to every equity security . . . ." H.R. REP. NO. 73-1383, at 13 (1934). The goal was to prevent "the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders." *Id.* at 14, *quoted in* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 381 (1970), *and* J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964); *see also* S. REP. NO. 73-1455, at 73–77 (1934) (observing the importance of stockholder knowledge in relation to proxy voting).

84. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

85. *See infra* notes 282–86 and accompanying text.

86. THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776).

Yet, it took over 100 years before women obtained the right to vote and nearly 200 years before African-Americans were really able to vote in many states.[87] Shareholder democracy has not been realized, but it is widely recognized as the holy grail of corporate governance, and changes in the law and in actual corporate behavior are bringing us closer to that ideal.[88]

3. The Team Production Model Does Not Benefit Stakeholders. A board of "mediating hierarchs" is not necessary to win stakeholder loyalty. To induce employees or suppliers to make firm-specific investments, the firm can pay their out-of-pocket costs[89] or offer rewards for making the investments.[90] Employees care not only about material rewards, but also (maybe even more) about procedural fairness.[91] But a mediating board is not needed to achieve this; investors seeking maximum share value have an incentive to maximize the efficiency of employees and to provide fair procedures that promote it.[92]

Some claim that the TPM prevents takeovers by an acquirer who will fire employees or curtail their pay or perquisites. However, most acquirers do not cut employment or compensation.[93] That is not surprising—an acquirer striving to maximize share value has as much incentive as any equity owner to treat employees well. Indeed, better management or synergies

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87. U.S. CONST. amend. XIV. *See generally* McKen Carrington, Book Review, 26 T. MARSHALL L. REV. 107, 110 n.11 (2000) (reviewing MERLINE PITRE, IN STRUGGLE AGAINST JIM CROW: LULU WHITE AND THE NAACP 1900–1957 (1998)).

88. *See infra* notes 300–36 and accompanying text.

89. *See* Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. ECON. 9, 18 (1962) (discussing the costs and benefits of specific investments in employees); Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 548–49 (2006).

90. *See* Lee, *supra* note 89, at 549 (mentioning profit-sharing formulas and performance standards as possible inducements).

91. *See* Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 615–16 (2002) (discussing findings of behavioral psychologist Tom Tyler). Significantly, Tyler does not say that employees care about the composition of the board; they care about how they are treated, not who makes the decisions.

92. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 863 (1992) ("In the long run, shareholders can't systematically exploit other 'stakeholders' in the corporate enterprise" because doing so would damage the shareholders' own interests.). *See generally* Olubunmi Faleye & Emery Trahan, Is What's Best for Employees Best for Shareholders 7, 13, 24 (May 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=888180 ("It appears that the benefits of creating an employee-friendly environment significantly outweigh the costs and that what is best for employees is, at least, good for shareholders.").

93. *See* U.S. DEP'T OF LABOR BUREAU OF LABOR STATISTICS, ANNUAL REPORT ON MASS LAYOFFS IN 1988, at 2 (1989) (finding that fewer than 5% of major layoffs resulted from changes in firm ownership).

stemming from a merger often benefit the acquired firm's employees.[94] Thus, when management thwarts a takeover, it is as likely to be hurting other employees as helping them. On the other side, managers of the acquired company often receive side payments in mergers.[95]

A mediating board is not just unnecessary to protect stakeholders but is also a dubious way to do it. There is no reason to think that independent directors care about stakeholders more than shareholders do.[96] Entrenched managers may pay their employees more,[97] but the excessive compensation of autocratic executives alienates workers.[98] Consider also Enron, WorldCom, and Tyco, whose boards slept while mismanagement destroyed their companies.[99] The losses suffered by shareholders were huge, but few had their lives destroyed as did many employees. These boards were not unusually insensible; they were quite typical.[100] Directors often play along with auctions of financially troubled companies that favor insiders to the detriment of creditors.[101] "Mediating"

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94. Charles Brown & James L. Medoff, *The Impact of Firm Acquisitions on Labor*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 9, 11, 23 (Alan J. Auerbach, ed., 1988) ("In general, we find small (and sometimes positive) changes in wages and employment following an acquisition.")

95. *See* GEVURTZ *supra* note 7, § 7.1.1(c), at 637.

96. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 59 (2003) ("The interests of directors and executives are even less aligned with the interest of stakeholders than they are aligned with the interests of shareholders. . . . [T]here is no reason to expect that reduced accountability to shareholders would translate into increased attention to stakeholders.").

97. *See* Henrik Cronqvist et al., *Do Entrenched Managers Pay Their Workers More?* 12, 24 (Fisher Coll. of Bus., Working Paper No. 2007-03-010, 2007), *available at* http://ssrn/com/abstract= 845844 (reporting the results of an empirical study).

98. *See* James D. Cox, *Fair Play for Chief Executive Officers*, *in* LAW AND CLASS IN AMERICA: TRENDS SINCE THE COLD WAR 99, 114 (P.D. Carrington & T. Jones eds., 2006); *see also infra* note 198 and accompanying text.

99. *See* DAVID SKEEL, ICARUS IN THE BOARDROOM 163–65, 183–84 (2005) (describing the inaction of the directors as their companies collapsed).

100. *See* PATRICK A. REARDON, HARD LESSONS FOR MANAGEMENT, DIRECTORS AND PROFESSIONALS 71–72 (2003) (extolling the qualifications of Enron's Audit and Compliance Committee members); William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1333–34 (2002) (stating that Enron's board followed widely accepted "good governance practice"); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reactions*, 69 U. CHI. L. REV. 1233, 1241 (2002) (noting how Enron had "a splendid board on paper"); Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495, 504–05 (Nancy B. Rapoport & Bala G. Dharan eds., 2004) ("[T]he Enron board was on the scene and, for the most part, taking most of the steps we ask a board to take.").

101. *See* Gretchen Morgenson, *'For Sale' May Mean 'You Lose,'* N.Y. TIMES, Apr. 15, 2007, § 3, at 1; *see also* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*,

directors are less watchdogs for stakeholders than lapdogs for management.

If reassurance of stakeholders is a real problem, a contract seems a better solution than the "mediating" board. A promise of decent treatment cannot be fully specified, but many commitments can be spelled out, as they are in collective bargaining agreements. When this method of protection is impractical, it may be wise to vest discretion in a third party, but a traditional arbitrator or mediator seems better for this than the modern board. These arrangements are common not only in labor agreements but also in all kinds of relational contracts.[102] Their frequent use suggests that a need to reassure stakeholders is not the reason for shareholder impotence.

The TPM is also alleged to improve corporate compliance with law and social responsibility.[103] Unaffiliated directors are supposedly less likely to break the law since they will not profit from illegal acts.[104] However, champions of the TPM offer no evidence that nonpublic, shareholder-controlled companies are less law-abiding than director primacy companies.

As for other aspects of "social responsibility," a glaring difficulty is that the concept is hopelessly vague. Beyond obeying the law, how should a board balance such competing concerns as the environment, philanthropy, employees, and consumers? In a democracy, pursuit of goals outside the market with other people's money is supposed to be handled by elected officials. Directors eschewing profit maximization do not pursue the same goals Americans would choose democratically. Now, most boards are dominated by the CEO, so corporate philanthropy favors the pet charities of CEOs.[105] Corporate gifts come from the pockets of

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106 MICH. L. REV. 1, 32–34 (2007) (discussing possible explanations for below-market sales, including personal incentives to company insiders like CEOs).

102. *See, e.g.*, George Dent, *Lawyers and Trust in Business Alliances*, 58 BUS. LAW. 45, 74–75 (2002) (describing the use of arbitration and mediation in strategic business alliances).

103. *See* Kostant, *supra* note 2, at 684–703.

104. Peter Kostant claims that mediating directors are more likely to obey the law because they are less dominated by the CEO. *See id.* at 684, 688. It is not clear to what he is comparing the TPM. However, he admits that the TPM is "a dubious model" if this assumption is not true. *Id.* at 684. In fact, it is not true. *See infra* note 347 and accompanying text.

105. *See* W.O. Brown et. al., *Corporate Philanthropic Practices*, 12 J. CORP. FIN. 855, 855–57 (2006); J. Robert Brown, Jr., *Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 72, 78 (2006–07) [hereinafter Brown, *Disloyalty Without Limits*]; Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195, 1205 (1999); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44

taxpayers as well as shareholders because gifts are tax deductible and reduce corporate taxes.

When America wants corporations to pursue goals other than profit, it can pass laws (environmental laws, for example) dictating such goals or raise corporate taxes. The problem for progressives is that American democracy rejects their program. They hope the TPM will sneak that program in through the back door.[106] It is ironic that progressives despair of democracy and yet favor unelected, unaccountable elite. It is also a false hope to grant social power to CEO-dominated boards with, as Adolf Berle put it, no more than a "pious wish" that something good will come of it.[107] Reducing incentives for efficiency will not advance the progressive goals.

Most directors now have little personal stake in firm performance, but shareholders have a keen incentive to maximize profits and share price. In a market economy, the "invisible hand" guides those seeking personal profit also to benefit others[108] in many ways, including better jobs, better quality and price of goods and services, and higher tax receipts. At least when the firm is solvent, "profit maximization benefits all participants in the corporate venture and promotes societal welfare."[109] Much of the innovation and employment growth in America comes from nonpublic companies.[110] The efficiency of shareholder primacy helps explain this phenomenon.

UCLA L. REV. 579, 591 (1997) (claiming that "in most public corporations senior executive officers still exert extraordinary influence over . . . the selection of beneficiary organizations").

106. *See* Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1271 (1982) (stating that progressives seek to change corporate governance laws because they have "largely failed in implementing their objectives through the political processes"); Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6, at 33.

107. Berle, *supra* note 70, at 1368.

108. *See* ADAM SMITH, THE WEALTH OF NATIONS 485 (Modern Library 2000) (1776) (the individual "intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention"); Jeffrey G. McIntosh, *The End of Corporate Existence: Should Boards Act as Mediating Hierarchs? A Comment on Yalden*, *in* THE CORPORATION IN THE 21ST CENTURY 37, 72 (Anita I. Anand & William F. Flanagan eds., 2003) (stating that following the mediating model would reduce innovation and risk-taking); Sundaram & Inkpen, *supra* note 69, at 353 ("Only residual cash flow claimants have the incentive to maximize the total value of the firm.").

109. Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1497 (1993).

110. "[S]mall businesses generate 60 to 80 percent of the net new jobs added each year, employ half of all private sector employees, and pay 44.3 percent of the total U.S. private payroll." DEMOCRATIC STAFF, H. COMM. ON SMALL BUSINESS, 108TH CONG., SMALL BUSINESS RECORD REPORT 1 (2004), *available at* http://www.house.gov/smbiz/democrats/2004yearendreport%20docFINAL.pdf.

In a global economy with mobile capital, profit maximization is desirable not only for these benefits of the "invisible hand" but also because it draws capital investment to the nation. The importance of this draw is evidenced by the faster economic growth in America than in other countries.[111] However, many countries are now making themselves more attractive to investors; the United States cannot smugly assume continued superiority.[112]

In Conan Doyle's story, *Silver Blaze*, Sherlock Holmes solves a crime in part by noting the dog that didn't bark.[113] If the TPM were valid, stakeholders would be treated better by public firms hewing to that model than by private firms with shareholder-chosen boards. Likewise, employees would suffer when a public company goes private in a leveraged buyout. Employees, then, should flee such companies. No evidence of this is offered. Nor is there evidence that private firms are less solicitous of customers, suppliers, the environment, or the communities in which they operate. Like the dog that didn't bark, this absence is telling; it belies the TPM.

4. The Lack of Intra-Shareholder Conflicts and Investor Myopia. Some claim that an autonomous board is needed to mediate conflicts not only between shareholders and other constituents but also among the shareholders themselves.[114] The concern is grossly exaggerated. Investors do vary in many

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111. *See* Bainbridge, *supra* note 3, at 1739–40 ("U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades." (quoting Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 1 (European Corporate Governance Inst., Finance Working Paper No. 23/2003, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441100)).

112. *See infra* notes 342–45 and accompanying text.

113. When Holmes refers to "the curious incident of the dog in the night-time," Inspector Gregory says, "The dog did nothing in the night-time." Holmes replies: "That was the curious incident." ARTHUR CONAN DOYLE, *Silver Blaze*, *in* 1 THE COMPLETE SHERLOCK HOLMES § 1, at 1, 23 (Doubleday, Doran & Co. 1930) (1893).

114. *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577–93 (2006) (claiming various conflicts of interests among shareholders); Bainbridge, *supra* note 3, at 1751, 1754–57 (alleging danger of special interest shareholders); Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 368–70 (1991) (noting shareholder differences over time horizons, risk preferences, and expectations for the future); Lipton & Rosenblum, *supra* note 38, at 78 ("[M]any institutional investors and other activist investors have competing interests that may conflict with the best interests of the public corporation and its shareholder body and other constituencies taken as a whole."); Stout, *supra* note 16, at 794 ("Board power . . . protect[s] shareholders from *each other*."); *see also* Stout, *supra* note 63, at 1447–49 (claiming that highly diversified shareholders may oppose share-price maximization in some firms because of their interests in others).

ways,[115] but nearly all shareholders want to maximize firm value.[116]

More specifically, some allege that large shareholders extract special benefits—or would do so under a regime of shareholder primacy.[117] However, a large shareholder has financial incentives to monitor firm performance and to work to optimize it, and institutional investors have the sophistication to perform these functions.[118] Any large shareholder that sought special benefits would be checked by other large shareholders.[119] Again, *Silver Blaze* is instructive.[120] If shareholders were as divided as public voters, shareholder meetings would be as contentious as political elections and corporations (like political, religious, and civic organizations) would pursue varying goals. Major institutional shareholders and

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115. *See, e.g.*, Fisch, *supra* note 69, at 661 ("[I]nvestors vary considerably among such dimensions as the time frame over which they invest, the extent to which they trade versus passively holding the corporation's stock, their degree of diversification, the extent to which they hold non-equity interests in the issuer, any option or other hedging positions that they hold, and so forth.").

116. "Although a wide range of precatory resolutions are put forward [for shareholder vote], the ones that obtain majority support are those . . . that are widely viewed by financial institutions as serving shareholder interests." Lucian A. Bebchuk, *Reply*: *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1799 (2006); *see also* BAINBRIDGE, *supra* note 34, at 469 n.16 ("Although investors have somewhat different preferences on issues such as dividends and the like, they are generally united by a desire to maximize share value."); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 466 (1991) (stating that "the potential for conflict between large and small shareholders will likely be minimal"). Some diversified shareholders may care less how an act by a firm in which they are invested will affect itself than how it will affect another firm in which they are invested, but the overall impact of such concerns is small. *See* Jarrad Harford et al., *Conflicts of Interests Among Shareholders: The Case of Corporate Acquisitions* 1, 4–5 (MIT Sloan Sch. of Mgmt., Working Paper No. 4653-07, 2007), *available at* http://ssrn.com/abstract=1000421 (discussing cares and concerns of "shareholder cross-holdings"). Existence of even a small impact is rather speculative. Direct evidence of shareholders opposing value-maximizing acts in a firm because of their interests in other firms is extremely rare.

117. *See* Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal* 12–13 (UCLA School of Law, Law & Econ. Research Paper Series, Research Paper No. 03-22, 2003), *available at* http://ssrn.com/abstract=470121 ("[I]nstitutional investors may abuse their control by self-dealing and other forms of over-reaching. . . . If the board becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors.").

118. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 14 (1991) ("If an owner could take 25% stock positions in a few firms, it might find it worthwhile to assemble a staff with expertise to monitor effectively."); *see also* Laura L. Frieder & Avanidhar Subrahmanyam, Executive Compensation and Investor Clientele 5 (Oct. 2006) (unpublished working paper), *available at* http://ssrn.com/abstract=937115 (stating that empirical tests show that indirect executive compensation is lower in companies with more large investors).

119. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 244–45 (1994) (stating that multiple intermediaries can form "countercoalition[s]").

120. *See supra* text accompanying note 113.

shareholder advisory services would be addressing the issue and the business press would be discussing it. In fact there is no evidence for any of this.[121]

Shareholders' behavior confirms their common purpose. In this way they resemble baseball fans. Fans have varied political, religious, and social attitudes, but at a game they table their differences and unite to root for their team. They often display great camaraderie with people with whom they otherwise have little in common. Among shareholders, even hedge funds, which are sometimes portrayed as threats to other investors,[122] are actually welcomed.[123] If institution of real shareholder primacy did expose particular conflicts of interest, these could be handled by narrowly focused rules rather than by scrapping shareholder primacy altogether.[124]

Some charge that shareholders, including institutional investors, focus unduly on short-term results.[125] This obsession with

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121. *See, e.g.*, Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1043 (1996) ("[S]hareholders do not have the kinds of disputes one would expect if they were a diverse group of Americans engaged in a struggle to make corporations in their images . . . ."). Most shareholder disputes that do occur are initiated by special interest shareholders whose motions are overwhelmingly rejected. *See supra* note 116 (quoting Lucian Bebchuk on shareholder voting).

122. *See* Andrew M. Kulpa & Butzel Long, *The Wolf in Shareholder's Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control and Governance*, 6 U.C. DAVIS BUS. L.J. 4, 4 (2005); Memorandum from Martin Lipton et al. to Clients, Be Prepared for Attacks by Hedge Funds (Dec. 21, 2005), *available at* http://www.realcorporatelawyer.com/pdfs/wlrk122205-02.pdf.

123. *See* Chris Young, *Hedge Funds to the Rescue*, BUS. WK., July 31, 2006, at 86 (stating that hedge funds have become "the catalyst" for proxy fights, leading shareholders in opposing value-impairing deals); Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* 1 (Eur. Corporate Governance Inst., Finance Working Paper No. 139/2006, 2006), *available at* http://ssrn.com/abstract=948907 ("The market reacts favorably to hedge fund activism, as the abnormal return upon announcement of potential activism is in the range of 5–7 percent, with no apparent reversal in the subsequent year."); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* 53 (Univ. of Pa. Inst. for Law & Econ., Research Paper No. 06-16, 2006), *available at* http://ssrn.com/abstract=919881 (stating that traditional institutions are happy to "tag along" with activist hedge funds). Further, "target firms see moderate improvement in operational performance and considerably higher CEO turnover after activism." Brav, *supra*, at 1.

124. For example, some board seats are held by banks that are major lenders to the company and that also control the voting of many company shares through their trust departments. *See* Joao A.C. Santos & Adrienne S. Rumble, *The American Keiretsu and Universal Banks: Investing, Voting and Sitting on Nonfinancials' Corporate Boards*, 80 J. FIN. ECON. 419, 436 (2006) (discussing banks' ability to vote stock held in trust). If these banks are shown to misuse their board seats, they could be barred from boards.

125. *See* Lipton & Rosenblum, *supra* note 38, at 78 (stating that some investors "may seek to push the corporation into steps designed to create a short-term pop in the company's share price"); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119

short-term results creates a conflict between current shareholders, who profit from "earnings manipulation," and future shareholders.[126] Director primacy, then, insulates managers from "short-termism," freeing them to build long-term value.

The charge of short-termism raises four questions. First, is it true? "[F]or all the anecdotal evidence of short-termism and its effects, there is not a lot of empirical data to back it up."[127] "[N]o one has *demonstrated* that the long/short phenomenon exists."[128] Although some institutions do turn over their portfolios rapidly, there is no theoretical reason or empirical evidence that this makes their attitudes on corporate strategy any different from those of long-term shareholders.[129] No evidence is offered that profitable long-term business opportunities go begging, as should happen if myopia were rampant. The accusations first surfaced during the 1970s and early 1980s when America's economy was stagnant and Japan, Germany, and other countries seemed to be performing better.[130] However, for some years now America has outpaced its economic rivals, so the whole claim seems dubious.[131]

Second, if there is a problem, does it stem from defective corporate governance? Some charge that American companies pass up business opportunities promising returns that foreign firms accept. The reason, however, may be that the cost of capital is

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HARV. L. REV. 1759, 1764 (2006).

126. *See* Patrick Bolton et al., *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 725 (2005).

127. Joe Nocera, *A Defense of Short-Termism*, N.Y. TIMES, July 29, 2006, at C1. "Baruch Lev, the well-known accounting professor at New York University . . . scoffs at the notion that short-termism is even a problem." *Id.* Iman Anabtawi points to efforts of hedge-fund managers to have MCI, Inc. sold to Qwest Communications, the highest bidder, rather than to merge with Verizon Communications, which the board believed "offered MCI shareholders better long-term synergies." Anabtawi, *supra* note 114, at 582–83. However, Anabtawi offers no evidence that the board was right and the hedge funds wrong.

128. Roe, *supra* note 118, at 13.

129. "If a governance provision does not serve long-term shareholder value, its adoption will likely reduce short-term prices (which reflect expectations about long-term value) . . . ." Bebchuk, *supra* note 116, at 1802; *see also* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 532 (2002) ("Under elementary principles of finance, even short-term investors have an incentive to maximize the firm's long-term value . . . ."); Roe, *supra* note 118, at 13 ("The long/short controversy posits a market failure. After all, institutions should know how to discount long-term value to present value.").

130. *See* MICHAEL T. JACOBS, SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA 1–4 (1991) (discussing the United States's declining competitiveness in the 1970s and 1980s compared to Japan and Germany).

131. *See* Bainbridge, *supra* note 3, at 1739–40 (quoting Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 1 (European Corporate Governance Inst., Finance Working Paper No. 23/2003, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441100.

higher for American firms (which is not necessarily bad).[132] If so, the causes may lie outside corporate governance, such as government tax and fiscal policies and Americans' propensity to spend much and save little.[133]

Third, if short-termism exists and stems at least partly from defective corporate governance, is the defect pressure from short-term shareholders? Despite charges by CEOs of shareholder obsession with quarterly earnings, high institutional ownership is not associated with lower research and development (R&D) investment.[134] Share prices rise when companies increase R&D.[135] Share prices do not react positively to accounting changes that increase reported earnings but not cash flow.[136] Price to earnings ratios vary widely; obviously, investors consider factors other than current earnings. This is also evident from the successful public offerings by firms with little or no history of profits. Strong shareholder rights are associated with higher share, bond, and asset values, higher levels of investment, and higher firm valuation.[137] Even the Business Roundtable seems to concede excessive shareholder power does not cause corporate myopia.[138]

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132. *See* JACOBS, *supra* note 130, at 11 (alleging a "higher cost of capital in the United States" which "explain[s] a lot about short-term business behavior"). Cheap capital is generally desirable; it allows more investment, which creates more jobs and wealth. However, in countries with weak shareholder rights, returns on investment may be less than the cost of capital. *See* Klaus Gugler et al., *Corporate Governance and the Returns on Investment*, 47 J.L. & ECON. 589, 591–92 (2004). In that case, too much investment may be detrimental to investors. That would be troubling in a country like America where investment in securities is widespread and an important source of income for a growing number of retirees. *See* Patricia E. Dilley, *Hope We Die Before We Get Old: The Attack on Retirement*, 12 ELDER L.J. 245, 270–75 (2004) (discussing the dangers of retirees' increasing reliance on stock investments).

133. *But see* JACOBS, *supra* note 130, at 14 (arguing that these causes have negligible impact on costs of capital face by competing firms in the same market).

134. *See* OFFICE OF THE CHIEF ECONOMIST, SEC. & EXCH. COMM'N, INSTITUTIONAL OWNERSHIP, TENDER OFFERS, AND LONG-TERM INVESTMENTS (1985).

135. *See* Randall Woolridge, *Competitive Decline and Corporate Restructuring: Is a Myopic Stock Market to Blame?*, 1 J. APPLIED. CORP. FIN. 26, 26–36 (1988). *See generally* John J. McConnell & Chris J. Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*, 14 J. FIN. ECON. 399, 415 (1985) (comparing the effect of budget increases and decreases in several areas, including research and development).

136. *See* Robert S. Kaplan & Richard Roll, *Investor Evaluation of Accounting Information: Some Empirical Evidence*, 45 J. BUS. 225, 245 (1972) (finding accounting changes to have no statistically significant effect upon share prices and concluding, "Earnings manipulation may be fun, but its profitability is doubtful").

137. *See infra* notes 282–86 and accompanying text.

138. DAN KREHMEYER ET AL., CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORPORATE ETHICS, BREAKING THE SHORT-TERM CYCLE: DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET MANAGERS, INVESTORS, AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE 2 (2006), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2006.n1.4194 (recommending several

If myopia is the problem, powerful executives rather than shareholders may be its source. Insulation from shareholder pressure does not seem to produce the long-term focus that the short-term theory would predict. Companies that adopt takeover defenses actually reduce R&D.[139] "[L]ess monitoring by owners makes managers invest less rather than more in order to enjoy the quiet life."[140] The higher cost of capital to American companies may stem in part from an aversion of American executives to debt, which is cheaper than equity.[141]

Equity may be more costly in the United States partly because of the separation of ownership and control. "Sometimes [myopic behavior] occurs when managers hold little stock in their companies and are compensated in ways that motivate them to take actions to increase accounting earnings rather than the value of the firm."[142] Small ownership is typical: "The average CEO of a *Fortune* 500 company owns about one-fourth of [one] percent of his company's stock."[143] A CEO may inflate the firm's stock price by false disclosures and then dump his own shares before the truth emerges.[144] This is but one of many forms of self-serving behavior by CEOs.[145] Thus, some label CEOs' claims of managing for the long term "bogus."[146]

The fourth question: If short-term shareholders are indeed a problem, is director primacy the solution? If shareholders are

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changes, including aligning executive compensation with long-term goals and ending the practice of issuing quarterly earnings guidance, none of which would weaken shareholder influence).

139. *See* JACOBS, *supra* note 130, at 249 n.4 (citing a study by the SEC's Office of Economic Analysis).

140. *See* Øyvind Bøhren et al., Corporate Governance and Real Investment Decisions 3 (2007) (unpublished EFA 2007 Ljubljana Meetings Paper), *available at* http://ssrn.com/abstract=891060 (citing their own empirical findings and Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1047 (2003)).

141. *See* JACOBS, *supra* note 130, at 192 ("Contrary to popular belief, American companies are actually *underleveraged* by international standards.").

142. Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS, AND TARGET: THE IMPACT OF THE HOSTILE TAKEOVER 314, 320 (John C. Coffee, Jr., Louis Lowenstein, Susan Rose-Ackerman eds., 1988); *see also* JACOBS, *supra* note 130, at 194–96.

143. JACOBS, *supra* note 130, at 64.

144. *See infra* note 195 and accompanying text.

145. *See generally infra* notes 183–207 and accompanying text (discussing the detriments of CEO domination).

146. Nocera, *supra* note 127; *see also* MATTEO TONELLO, REVISITING STOCK MARKET SHORT-TERMISM 8 (2006) (reporting that "most business managers stated that they would rather forgo an investment promising a positive return on capital than miss the quarterly earnings expectations of their analysts and financiers"); John R. Graham et al., *The Economic Implications of Corporate Financial Reporting* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 10550, 2004).

obsessed with the short term, it may be because they lack information about and control over the long term.[147] Director primacy may be more a cause of than a cure for short-termism. Shareholder power may actually counter managerial myopia.[148] As for conflicting interests among shareholders, even assuming that holders of a small fraction of a firm's stock could profit from manipulating reported earnings and then dumping their stock at an inflated price, this course of action could not work for holders of large blocks.[149]

Some commentators have trumpeted one horror story.[150] The proposed acquisition of King Pharmaceuticals by Mylan Laboratories was opposed by a shareholder who had voting rights in many shares of Mylan but had hedged away all economic interest in those shares and held a big equity stake in King.[151] The specter conjured is that "pure" shareholders would be outvoted by investors with a conflicting interest. However, such ploys are rare[152] and likely to remain so because the amount of stock available for such gambits is limited.[153] More important, because a borrower of shares "must pay a 'rebate'" to the lender, the lenders know the risks of lending and charge for them.[154] In short, "stock lending is, to an important degree, self-policing."[155] Voting rules for a few ploys like short sales and record date capture trades may need to be

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147. *See* JACOBS, *supra* note 130, at 10 ("Lack of communication prevents investors from understanding management's long-term goals and objectives."); *id.* at 36 ("The problem lies in the quality of information the market uses to value companies, not in the greediness or impatience of investors.").

148. *See* Alex Edmans, Blockholders, Market Efficiency, and Managerial Myopia 29 (Mar. 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=946669.

149. Bolton et al. posit that some investors are irrational and, in particular, overconfident. Bolton et al., *supra* note 126, at 726–28. The number and holdings of such investors must be small, though. Their behavior may explain the few "bubbles" featured by Bolton et al., but they cannot significantly influence stock prices generally. Large net sales would quickly decimate a company's stock price. Thus earnings manipulation cannot succeed for more than a few small shareholders, and it is unlikely that a few small shareholders could exert much influence under a regime of shareholder primacy. *See infra* notes 353–54 and accompanying text (describing a proposal to institute shareholder primacy).

150. *See* Anabtawi, *supra* note 114, at 591–92; Stout, *supra* note 16, at 794–95.

151. High River Ltd. v. Mylan Labs., Inc., 353 F. Supp. 2d 487, 490 (M.D. Pa. 2005).

152. *See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 721 (2007).

153. *See* Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 25–26 (2006) ("[O]nly a small percentage of most common stock is available to be borrowed and an investor will be limited inherently by the supply.").

154. *Id.* at 27–28.

155. *Id.* at 25.

tweaked,[156] but the problem is far too small to justify defanging shareholders.

Shareholder control would not be perfect—no system dependent on human beings can be—but it would be far better than the CEO-dominated boards we have now. In corporate governance, shareholder control may be, as Churchill said of democracy, "the worst form of Government except all those other forms that have been tried from time to time."[157]

III. REALITY: CEO DOMINATION AND ITS COSTS

A. *The Reality: Not Director Primacy but CEO Domination*

Despite the claims for the DPM/TPM, the evidence is overwhelming that most boards are passive, dominated by CEOs who exert their power in their own interests.[158] This insight is far from novel. In addition to Berle and Means, seventy years ago William O. Douglas published an article titled *Directors Who Do Not Direct*.[159] He later characterized most outside directors as "business colonels of the honorary type—honorary colonels who are ornamental in parade but fairly useless in battle."[160] That passivity persists today.[161]

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156. *See* Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation* 50–51 (Vanderbilt Univ. Law Sch., Law & Econ. Working Paper No. 06-21, 2006), *available at* http://ssrn.com/abstract=931254 (describing some problem situations); *see also* Briggs, *supra* note 152, at 706–08 (urging higher disclosure requirements). These problems arise only because "hedge funds are . . . reacting to the failure of other institutions to exercise their franchise for the benefit of all shareholders." Partnoy & Thomas, *supra* at 52.

157. THE OXFORD DICTIONARY OF QUOTATIONS 202 (4th ed. 1992) (quoting Winston Churchill).

158. "The most significant problem facing corporate America today is the management-dominated, passive board of directors." Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127 (1996). *See generally* Glyn A. Holton, *Investor Suffrage Movement*, 62 FIN. ANALYSTS J. 15, 19 (2006) (stating that "[r]ecent market crashes and financial scandals are symptomatic of a capitalism in which shareholders have lost control over the corporations they own" and urging steps to make shareholder voting more effective); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 898–903, 913–17 (1996) (cataloging the many ways that CEOs dominate outside directors). Sophisticated investors realize this. *See* Rachel McTague, *Advisers, High-Net-Worth Investors Think Boards Serve Executives, Survey Says*, 39 BNA SEC. REG. & L. REP. 1662, 1662 (2007) ("A survey of more than 200 investment advisers and high-net-worth investors found that the respondents clearly perceive that corporate boards primarily answer to management, rather than shareholders.").

159. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

160. WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 46 (1940).

161. *See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 847 (1999) ("Both

Boards are passive for many reasons. Most board openings are filled on recommendation of the CEO.[162] Of course, they don't pick anyone expected to rock the boat. The most popular choice is other CEOs.[163] They enhance a board's prestige and exude independence: presumably one CEO will not kowtow to another. Reality is otherwise. A CEO wants directors on "his" (rarely "her") board to defer to him, so when he serves as an outside director he defers to that firm's CEO.[164] The incentive to do so is stronger when, as often happens, that firm's CEO is also an outside director on "his" board.[165] Also, directors naturally feel beholden to the person responsible for their selection.[166]

If the selection process errs and chooses someone unwilling to knuckle under, the board will probably not be much affected. First, the candidate may well decline the offer; to be a constant board dissenter is not most people's idea of a good time. If the offer is accepted, an atmosphere of "groupthink," in which members of a group "adopt[] the goals and methods of the group uncritically," pervades most boards and makes it awkward to

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theoretical and empirical reasons exist to believe that boards of a substantial minority, and perhaps a substantial majority, of U.S. public corporations are dominated by managers."); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 136 (2006) (stating that board passivity "has continued at many U.S. companies").

162. MONKS & MINOW, *supra* note 67, at 193 (noting that, in 1991, 82% of vacancies were filled on recommendation of the chairman, who is usually also the CEO); *see also* Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 34 (1993) (finding in a small survey of the 500 largest companies in 1989 that "the CEO initially recommended 90–100% of all directorial nominees"); Kevin F. Hallock, *Reciprocally Interlocking Boards of Directors and Executive Compensation*, 32 J. FIN. & QUANTITATIVE ANALYSIS 331, 332 (1997) (stating that CEOs often choose new directors); Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, 96–97 (1998) (stating that CEOs choose or approve of board nominees).

163. CEOs of other companies comprise about 63% of outside directors. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991).

164. *See id.* ("These directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards.").

165. *See* Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935, 952 (2003) (asserting that "mutually interlocking directorships . . . are prevalent"); Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1852 (1999). Interlocking boards are associated with higher CEO compensation. Fich & White, *supra* at 947–48.

166. "As long as a director is brought in by the CEO, he will naturally feel that it is to the CEO that he owes his loyalty." MONKS & MINOW, *supra* note 67, at 497.

step out of line.[167] It's easier to resign. A stubborn gadfly may not be renominated.[168]

Repeated regulatory efforts to increase board independence have proved futile or even counterproductive. By rules of the SEC, NYSE, and NASDAQ, most large public companies now have a majority of "independent" directors on the full board and on several oversight committees,[169] but these changes have not improved board performance.[170] One reason is that "independence" is, and probably must be, defined as a lack of certain affiliations with the company and its managers.[171] However, many outside directors still have "soft" conflicts of interest that are not caught by these definitions of independence.

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167. Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 124 (2006); *see also* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 83–84, 99–108 (1985) (describing bases of ingroup bias among directors); Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 37–43 (1981); Jones, *supra* note 161, at 139–41 (discussing board conformity). Put another way, "the very things that make people likely to join a board—connections, business experience, sociability—are also the things that make them less effective once they do." James Surowiecki, *The Sky-High Club*, NEW YORKER, Jan. 22, 2007, at 32.

168. *See* Gilson & Kraakman, *supra* note 163, at 874–75.

169. *See* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers, Too*, 22 GA. ST. U. L. REV. 251, 282–88 (2006) (describing the NYSE requirements); George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 48 (2005) (listing the relevant rules).

170. Several studies have found no correlation between corporate performance and board "independence" as defined by regulations. *See, e.g.*, Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002); Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 51–58 (2007); Gordon, *supra* note 67, at 34–43 (discussing the empirical literature); David F. Larcker et al., How Important Is Corporate Governance? 20–33 (2005) (unpublished working paper), *available at* http://ssrn.com/abstract=595821 (finding little correlation between firm performance and several common measures of corporate governance quality). Some studies find a *positive* impact from increased board independence. *See, e.g.*, Catherine M. Daily & Dan R. Dalton, *Board of Directors Leadership and Structure: Control and Performance Implications*, 17 ENTREPRENEURSHIP: THEORY AND PRACTICE 65, 75 (1993). Some studies find a *negative* impact from increased board independence. *See* Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. FIN. & QUANTITATIVE ANALYSIS 377, 394 (1996); Allen Kaufman et al., *The Managerial Power Thesis Revised: CEO Compensation and the Independence of Independent CEO Directors* 6 EMP. BENEFITS COMPENSATION & PENSION L.J. (2005), http://ssrn.com/abstract=678381 (finding that after some point a greater number of outside directors is associated with worse firm performance); April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 300–01 (1998) (finding negative correlation between firm performance and absence of insiders on a board's finance and investment committees).

171. Bhagat & Black, *supra* note 170, at 266 (discussing the failure of purportedly independent directors to fall within the "customary definition of independence").

These conflicts correlate with board performance.[172] If, against all odds, a rebel faction forms, it faces huge obstacles.[173] Most boards meet about once a month, too little time to match the managers' knowledge about the firm.[174] Directors also lack independent sources of information; they know only what they are told by the managers, the very people they are supposed to oversee.

Conflicts of interest are intrinsic to all boards. Directors set their own compensation, and the CEO influences the board, so each has a motive to be generous to the other.[175] CEOs can increase conflicts, in effect buying a director's loyalty, by arranging company gifts to a charity with which the director is connected, with consulting and other business ties, and through personal and social contacts.[176] When Michael Ovitz asked CEO Michael Eisner whether Disney's board would approve the lavish contract Eisner proposed for Ovitz, "Eisner laughed, ticking off the various ways that board members were beholden to him, and assuring Ovitz that they would do what he wanted."[177] Obsession with board "independence" even may be counterproductive. A veneer of board independence gives CEOs cover to feather their nests even more aggressively. This may help explain why CEO compensation has exploded in recent years while board independence supposedly increased.[178]

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172. *See* David F. Larcker et al., *Back Door Links Between Directors and Executive Compensation* 27 (2005) (unpublished working paper), *available at* http://ssrn.com/abstract=671063 (finding that even remote links between the CEO and outside directors are associated with higher CEO compensation). Such conflicts seem also to have been common at firms subject to recent scandals. *See* SKEEL, *supra* note 99, at 164–65 (referencing conflicts on Enron's board). *See generally* Fich & White, *supra* note 165 (discussing the implications of "mutual interlock" relationships within boards).

173. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 141–48 (1976) (discussing the various obstacles faced by outside boards).

174. *See id.* at 141–43. One study reported that outside directors devoted, on average, only 122 hours per year to their positions. Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 609 n.38 (1982) (citing KORN/FERRY INT'L, BOARD OF DIRECTORS: EIGHTH ANNUAL STUDY 20 (1981)).

175. Although their compensation is a small part of the earnings of most directors, the amounts are not trivial. Five years ago, compensation at *Fortune* 200 companies was reported to average $152,000 per year. Gary Strauss, *Companies Pony Up to Keep Directors; Board Seats Have Become Hot Seats*, U.S.A. TODAY, Nov. 21, 2002, at B1. The figure is undoubtedly higher now, and it does not include fringe benefits like life and medical insurance.

176. *See* Brown, *Disloyalty Without Limits*, *supra* note 105, at 79–80 (describing a corporate gift to a museum for which one of the company's outside directors served as president and a trustee); Paredes, *supra* note 100, at 510–11 (discussing the financial, social, and personal pressures directors face in their relationships with company officers).

177. James B. Stewart, *Partners: Eisner, Ovitz, and the Disney Wars*, NEW YORKER, Jan. 10, 2005, at 46.

178. Some studies find that a larger number of outside directors correlates to *higher* executive compensation. *See* John E. Core et al., *Corporate Governance, Chief Executive*

In sum, corporate governance today features not director primacy but director servility. Boards routinely approve classified (staggered) boards, poison pills, golden parachutes, and supermajority voting requirements, despite their notorious destruction of firm value.[179] Some directors acknowledge their passivity.[180] Peter Drucker, long the premier expert of business management, disparaged outside directors as figureheads.[181] Even more telling is the treatment of the business press. Discussions of corporate strategy and performance typically focus on the CEO; outside directors are routinely ignored. Higher standards of independence will not change this: "no definition of independence will ever assure that an independent director will indeed act as such."[182]

B. *The Costs of CEO Domination*

CEO-dominated boards impose great costs on investors. The notorious excesses of executive compensation[183] belie the DPM/TPM. Compensation committees comprised entirely of "independent" directors retain expert consultants to recommend a compensation package, but the consultants themselves are far from disinterested; they are compromised by numerous

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Compensation, and Firm Performance, 51 J. FIN. ECON. 371, 388 (1999); Richard M. Cyert et al., *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence*, 48 MGMT. SCI. 453, 466 (2002); *see also infra* notes 183–94 and accompanying text (describing the growth and current excesses of executive compensation).

179. *See* Frakes, *supra* note 62, at 150–51; Lucian Bebchuk et al., *What Matters in Corporate Governance* 16–22 (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Discussion Paper No. 491, 2004), *available at* http://papers.ssrn.com/abstract-id=593423 (study showing that these features lower share value).

180. *See* Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong*, 15 J. APPLIED CORP. FIN. 8, 15 (2003) (discussing a 2002 study by Korn/Ferry International finding that most directors wanted their boards to be more assertive).

181. PETER F. DRUCKER, CONCEPT OF THE CORPORATION 92 (rev. ed. 1972); *see also* Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255, 263–69 (2005) (reviewing literature on CEO power).

182. Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, 38 WAKE FOREST L. REV. 911, 927 (2003).

183. The literature is immense and grows daily. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1 (2004) [hereinafter BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE]; Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 648–49 (2005) (responding to criticisms of BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra*); John C. Bogle, *The Executive Compensation System Is Broken*, 30 J. CORP. L. 761, 763 (2005). The escalation of executive compensation is disproportionally concentrated in CEOs. *See* Lucian Arye Bebchuk et al., *Pay Distribution in the Top Executive Team* (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Discussion Paper No. 574, 2007), *available at* http://ssrn.com/abstract=954609.

incentives to inflate executive pay.[184] Executive perquisites, like luxurious offices and recreational facilities, large support staffs, and private jets, are more lavish in public companies than in comparable private firms[185] and can be quite costly.[186] Self-dealing is also common.[187]

Even more troubling than the gross amounts of executive pay are the many glaring design flaws. Often companies do not tie compensation to performance.[188] Plans that are performance-based are rarely indexed, so executives reap windfalls if their industry, or the market generally, just hits good times.[189] Executives can also circumvent performance conditions by "exercising options, selling shares, or using derivatives to hedge their positions."[190] One study found a *negative* correlation between executive compensation and performance in firms with no large shareholders.[191] Over 2,000 companies issued backdated options so that executives could profit even if the company's stock price languished.[192] This activity is especially offensive because its costs to shareholders far exceed its benefits to the favored executives.[193] In both size and design, executive pay schemes

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184. *See* Gretchen Morgenson, *Corporate America's Pay Pal*, N.Y TIMES, Oct. 15, 2006, § 3, at 1 (chronicling how one consulting firm repeatedly boosted executive compensation for over 1,800 clients); Gretchen Morgenson, *Outside Advice on Boss's Pay May Not Be So Independent*, N.Y. TIMES, Apr. 10, 2006, at A1 (discussing the "long and lucrative relationship" between one executive-compensation consulting firm and its client); *see also* Cox, *supra* note 98, at 106 ("The role of the compensation consultant is fraught with conflicting interests . . . ."); Fogel & Geier, *supra* note 170, at 63–64 ("[M]anagers use the compensation consultants as 'camouflage' to extract premium rents from the compensation committee.").

185. *See* WILLIAM A. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE 65–66, 80, 86–87 (1975) (reviewing empirical studies).

186. *See* David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211, 213 (2006) (showing that personal CEO use of company planes is associated with average shareholder returns that "underperform market benchmarks by more than 4% . . . per year").

187. *See* Elizabeth A. Gordon et al., *Related Party Transactions: Associations with Corporate Governance and Firm Value* 4–5 (EFA Maastricht Meetings Paper No. 4377, 2004), *available at* http://ssrn.com/abstract=558983.

188. *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 183, at 121. The percentage of profits going to top executives nearly doubled between 1993 and 2003. Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 287 (2005).

189. Holmstrom & Kaplan, *supra* note 180, at 13.

190. *Id.*

191. *See* Robert Daines et al., *The Good, the Bad, and the Lucky: CEO Pay and Skill* 17 (N.Y. Univ. Law & Econ. Research Paper Series, Working Paper No. 04-035, 2005), *available at* http://ssrn.com/abstract=622223.

192. *See* Stephanie Saul, *Study Finds Backdating of Options Widespread*, N.Y. TIMES, July 17, 2006, at C1.

193. *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1600–01 (2007) (finding that the average loss per

stink of control by management—not by independent directors bent on optimizing firm performance. Thus, Warren Buffett has called compensation committees "tail-wagging puppy dogs."[194]

Compensation plans also distort disclosure. Managers doctor share prices by withholding or falsifying information, then trade in the company's stock at prices they know are wrong. In "pump and dump" schemes managers inflate the firm's stock price by releasing false good news and suppressing bad news. They then sell their own stock at inflated prices, often after exercising stock options that had no value until the market was fixed.[195] Directors responsive to shareholders would police such misconduct, but most CEO-dominated boards don't even try. In the many recent scandals involving fraudulent disclosures, boards made little effort to detect or deter the fraud or to discipline guilty officers who were caught by others.[196]

Even if they don't break the law, CEOs often enrich themselves by their choices within the broad discretion offered by generally accepted accounting principles. Executive pay is often tied to reported earnings, and many managers choose accounting methods that increase reported earnings instead of the shareholders' preferred goal of maximizing share price.[197] Although some claim the TPM benefits employees, wage disparities between CEOs and average workers have soared in recent years. These extreme disparities "result in greater

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firm to shareholders was around $380 million but the potential gain to all the executives benefited in each firm averaged under $500,000).

194. *See* Surowiecki, *supra* note 167, at 32.

195. *See generally* ROBERT H. TILLMAN & MICHAEL L. INDERGAARD, PUMP AND DUMP: THE RANCID RULES OF THE NEW ECONOMY (2005); Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667, 703–04 (2007); John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ* 6–8 (Ctr. for Law & Econ. Studies, Working Paper No. 274, 2005), *available at* http://ssrn.com/abstract=694581 (noting that an industry-wide shift to equity-based compensation created incentives for market and accounting manipulation). Managers also time corporate disclosures to maximize their profits on stock options. *See* David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73, 74 (2000); Keith Chauvin & Catherine Shenoy, *Stock Price Decreases Prior to Executive Stock Option Grants*, 7 J. CORP. FIN. 53, 59 (2001); Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 802 (2005); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449, 449–50 (1997).

196. *See, e.g.*, Carrie Johnson & Ben White, *Opportunity for Corporate Fraud Has Shrunk—But It's Still There*, WASHINGTON POST, Jan. 26, 2006, at D1 (recalling the wake of Enron and noting how "[b]oards of directors . . . turned a blind eye to overly aggressive business practices").

197. David I. Walker, *Financial Accounting and Corporate Behavior* 14–15 (Boston Univ. Sch. of Law Working Paper Series, Law & Econ., Working Paper No. 06-05, 2006), *available at* http://ssrn.com/abstract=894002.

personnel turnover, lower employee morale, poorer product quality, and lower productivity."[198]

Some CEOs use their power to pursue growth, or "empire building." They reinvest retained earnings even if they have no promising investment opportunities.[199] They are often rewarded for increasing firm size independent of profits.[200] As a result, returns on reinvested profits tend to be low.[201] Unprofitable acquisitions are common.[202] Other CEOs do the opposite—leading the "quiet life" through *under*investment.[203] This does not mean that they maximize dividends, however. They may finance with retained earnings rather than incurring debt or even use profits to reduce debt, despite the lower cost and tax advantages of debt. In so doing, they avoid the discipline debt imposes on managers.[204]

The discretion managers enjoy from the separation of ownership and control itself introduces uncertainties that impede market efficiency. Skillful managers may earn high profits, but investors cannot be sure when or how much of those profits will

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198. Cox, *supra* note 98, at 114.

199. This misuse of earnings lowers dividend payouts. *See* D. Denis, *Twenty-Five Years of Corporate Governance Research and Counting*, 10 REV. FIN. ECON. 191, 195 (2001) (noting managers' preference to "hold on to cash flow and/or invest it in negative NPV projects rather than return it to shareholders"); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1148–49 (2002).

200. *See* Bebchuk & Grinstein, *supra* note 188, at 287 (asserting that 60% of average CEO compensation increases over a ten year period were not explained by changes in firm size and performance).

201. William J. Baumol et al., *Efficiency of Corporate Investment: Reply*, 55 REV. ECON. & STATISTICS 128, 130 (1973); *see also* William J. Baumol et al., *Earnings Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STATISTICS 345, 354 (1970) (showing that firms that issued little equity had returns on reinvestment of retained earnings that approached zero).

202. *See* BAINBRIDGE, *supra* note 34, at 614 (stating that "studies of acquiring company stock performance report results ranging from no statistically significant stock price effect to statistically significant losses"); RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 300–02 (2d ed. 1995). Further, "[a]cquiring firms appear to suffer negative abnormal returns in the several years following the transaction." *Id.* at 309. The highest prices tend to be paid by publicly traded acquirers whose managers own the least amount of their companies' stock. Leonce Bargeron et al., *Why Do Private Acquirers Pay So Little Compared to Public Acquirers?*, 20–23 (Fisher Coll. of Bus., Ohio St. Univ., Working Paper No. 2007-03-011, 2007), *available at* http://ssrn.com/abstract=980066.

203. *See supra* text accompanying note 140 (quoting Øyvind Bøhren); *see also* Kose John et al., Corporate Governance and Risk-Taking 1 (Apr. 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=979413 ("When . . . private benefits are large, insiders may undertake sub-optimally conservative investment decisions to preserve them. Better investor protection reduces these private benefits and may therefore induce riskier but value enhancing investment policy.").

204. *See* Jensen, *supra* note 142, at 321–23 (discussing how debt disciplines managers).

be paid to them rather than appropriated by the managers.[205] If managers are incompetent or greedy, investors cannot know how soon those managers will retire or die and whom they will choose to succeed them.

Boards strive to entrench themselves and the CEO. Many firms have staggered boards, poison pills, golden parachutes, and supermajority voting requirements. Boards loyal to shareholders could use these devices to prevent a raider from exploiting the shareholders' disorganization to grab the company at a suboptimal price. In practice, though, these devices are used to block attractive takeover bids, as evidenced by the damage that adoption of these devices does to share value.[206] When a firm thwarts a bid and stays independent, its stock price typically falls to pre-offer levels; stockholders simply lose the chance for a big premium.[207]

Because those who control a company can abuse their power to benefit themselves at the expense of shareholders, corporate law developed derivative suits as a means for courts to scrutinize alleged breaches of fiduciary duties.[208] However, the law also requires that, before filing a derivative suit, a shareholder must make a demand on the board to correct the alleged breach, unless demand is futile because wrongdoers dominate the board.[209] This requirement supposedly allows the board to protect the corporation from wasteful litigation.[210]

To see how absurd this rule is, imagine the reaction if the defendant in any other type of litigation proposed to have a group of her business associates, chosen by her, decide whether the plaintiff's suit against her should be allowed to proceed. The problems inherent in this approach are obvious. I do not know of

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205. *See* Jensen, *supra* note 19, at 10 (arguing that waste of free cash flow helps explains the apparent under-pricing of some public companies); *see also* Lucian A. Bebchuk et al., CEO Centrality (Harvard Law and Econ. Discussion Paper No. 601, Nov. 2007), *available at* http://ssrn.com/abstract=1030107 (asserting that greater CEO dominance is associated with, *inter alia*, lower firm value, profitability, and stock returns).

206. *See* Bebchuk et al., *supra* note 179, at 2–3 (showing that a six-factor entrenchment index is associated with significantly lower firm value). The presence of antitakeover devices is associated with higher CEO compensation. BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 183, at 84.

207. *See* Michael Bradley et al., *The Rationale Behind Interfirm Tender Offers: Information Or Synergy?*, 11 J. FIN. ECON. 183 (1983); Richard S. Ruback, *Do Target Shareholders Lose in Unsuccessful Control Contests?*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 137, 137 (Alan J. Auerbach ed., 1988).

208. *See* ROBERT C. CLARK, CORPORATE LAW 639–40 (1986).

209. *See id.* at 640–49.

210. *See, e.g.*, Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1681 (2002).

a single case where a board reacted to a shareholder demand by saying, "Gosh! We had no idea of this misconduct. Thanks for telling us," and then promptly rectified the wrong.

This account of boards' kowtowing to CEOs is severely abridged. It could be much longer, but the facts have been elaborated by others, and the point, I hope, has been made: Contrary to the claims of the TPM/DPM, boards of most public companies are not independent mediators of conflicting interests among shareholders, or between shareholders and stakeholders. Most boards are dominated by their CEO and serve *his* interests, at great cost to shareholders and with considerable loss of efficiency, to the detriment of society in general.

What is needed is "an external corrective mechanism."[211] The most effective corrective is shareholder power. "Firms with strong shareholder rights and high institutional ownership are found to earn abnormal returns and have higher accounting profitability."[212] Executive compensation is more reasonable in companies with strong shareholder rights[213] and correlates more closely with firm performance in companies with one or more shareholders large enough to exert some influence.[214] These facts also refute claims that executive compensation in companies with CEO-dominated boards is reasonable and efficient. If the lower compensation more closely attuned to performance in companies with strong shareholders was inadequate, their performance should be worse. In fact, it is superior.

IV. THE MARKET FOR CORPORATE GOVERNANCE

Champions of the DPM/TPM claim that market forces have brought corporate governance to Nirvana, to maximum efficiency. This claim is laughable. Markets operate within the law; misguided laws impair market efficiency. Further, markets

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211. Jones, *supra* note 161, at 139.

212. Reena Aggarwal & Rohan Williamson, Did New Regulations Target the Relevant Corporate Governance Attributes? 6 (Feb. 12, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=859264; *see also* Vidhi Chhaochharia & Luc Laeven, *The Invisible Hand in Corporate Governance* 4 (Eur. Corp. Governance Inst., Finance Working Paper No. 165/2007, 2007), *available at* http://ssrn.com/abstract=965733 (finding that "governance provisions adopted beyond those imposed by the 'norms' in the country have a strong, positive effect on firm valuation").

213. Pornsit Jiraporn et al., *CEO Compensation, Shareholder Rights, and Corporate Governance: An Empirical Investigation*, 29 J. ECON. & FIN. 242, 243 (2005).

214. *See* Daines et al., *supra* note 191, at 17; *see also* Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 75–76 (Harvard Bus. Sch., Negotiations, Orgs., & Markets Research Paper, Working Paper No. 04-28, 2004), *available at* http://ssrn.com/abstract=561305 (arguing that corporations should externalize performance-based standards).

are not frictionless. *Inter alia*, transaction costs and information asymmetries affect markets. Markets also take time; they do not work instantaneously. Corporate governance has not reached perfection; it is still evolving.[215] However, market forces are altering corporate governance in ways that erode the DPM/TPM and foster shareholder primacy.

A. *The Governance of Public Companies*

1. Legal Obstacles to Shareholder Primacy. One obstacle to shareholder power is that poor managers can be ousted only by a proxy fight or when someone new purchases control of the company. Both options are difficult and expensive. In proxy fights, incumbents enjoy huge advantages; the firm pays their expenses, but insurgents must bear their own costs.[216] Collective action problems and other obstacles hinder shareholders from waging effective proxy insurgencies.[217] The problems would be smaller if a few institutions owned large blocks of a company's stock, but there are economic limits on such holdings.[218] The law

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215. Henry Hansmann and Reinier Kraakman have argued that the "standard shareholder-oriented model" of corporate governance was "the most attractive social ideal for the organization of large-scale enterprise," as well as "the most efficient way to organize large-scale industry," and that "practice and law are, as a matter of fact, converging on" this model. Henry Hansmann, *How Close Is the End of History?*, 31 J. CORP. L. 745, 746–48 (2006) (discussing Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001)). They did not predict that this would happen promptly; they "carefully avoided offering any timeframe for future convergence." *Id.* at 748. The rise of the "shareholder-oriented model," or shareholder primacy, could encounter "interruptions." *Id.* at 749. However, "convergence in fact has proceeded quite quickly" in recent years. *Id.* at 748; *see also* Gianni de Nicolo et al., *Corporate Governance Quality: Trends and Real Effects* 5 (Int'l Monetary Fund, Working Paper No. 06/293, 2006), *available at* http://ssrn.com/abstract=956757; Mathias M. Siems, Shareholder Protection Around the World 1 (June 29, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=991092 (finding that "in general there has been a convergence in the last decade" in international standards of shareholder protection).

216. Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. (SUPP.) 317, 337 (1998) (explaining why proxy fights are rarely successful).

217. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688–94 (2007) (discussing impediments to electoral challenges); Black, *supra* note 5, at 536 (discussing the burdens the proxy rules place on shareholders); *see also infra* notes 234–37 and accompanying text (discussing shareholders' collective action problems). Management also has superior access to information about voting outcomes and can engage in vote buying and selective vote counting so that it almost "always wins the close ones." Yair Listokin, *Management Always Wins the Close Ones* 4 (John M. Olin Center for Studies in Law, Econ. & Pub. Policy, Research Paper No. 348), *available at* http://ssrn.com/abstract=980695.

218.

> [An investor] may often be impeded by limitations on her capital; limitations on her borrowing ability; regulatory and practical limits on some kinds of trading

also discourages large accumulations.[219] And there are "social constraints and *fear*: fear that a successful effort at control [by financial institutions] will trigger a political reaction."[220] As a result, serious proxy fights are rare, especially in larger public companies.[221] Through a friendly acquisition a buyer can eliminate the agency costs of director primacy, but incumbent managers can and do demand personal benefits (in effect, bribes) in return for approving the deal.[222]

Hostile takeovers avoid this problem. They benefit shareholders and the whole economy by removing poor managements.[223] Hostile acquisitions are hindered, though, by high transaction costs and, more important, by antitakeover devices like poison pills and staggered boards.[224] If a hostile takeover is possible at all, the raider usually must offer target shareholders a premium of at least thirty-five percent over its

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> (for example, short selling); the necessity of bearing risk; and a need to meet short-term goals and metrics that makes it impossible to exploit mispricing that cannot be counted upon to disappear very quickly.

Stout, *supra* note 63, at 1441.

219. Large shareholders are subject to special disclosure rules. Securities Exchange Act, 15 U.S.C. § 78m (2000). They are also subject to insider trading and short-swing profit rules. 17 C.F.R. §§ 240.10b-5, 240.14e-3, & 240.16a-1 to 240.16b-8 (2007); *see also* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 712–13 (1995). Large shareholders who work together could also trigger a company's poison pill. *See* GILSON & BLACK, *supra* note 202, at 1434–35.

220. Roe, *supra* note 118, at 30; *see also id.* at 31–53 (discussing the history of hostility to large shareholder influence in America).

221. Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 559 (2005).

222. *See* GEVURTZ, *supra* note 7, § 4.2.6, at 360 (stating that side payments to insiders are permitted if ostensibly given for valid consideration and not as a bribe).

223. *See* JACOBS, *supra* note 130, at 112 (citing study showing that "target companies had underperformed their peers by 45 percent in return on equity, by 73 percent in growth rate, and by 25 percent in market-to-book value"). Critics of this claim note that acquirers do not seek out poorly managed companies; many prefer well managed companies. LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 134–35 (1988); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV.1145, 1211–12 (1984) (citing surveys of bidders). The latter claim is partly true, but does not contradict the former. Acquirers seek firms whose stock price is far below intrinsic value. This can happen when a company is *operationally* efficient but wastes cash flow or seems likely to do so in the future. *See* Jensen, *supra* note 19, at 13–14.

224. *See* Bebchuk & Cohen, *supra* note 62, at 430 (reporting study finding that staggered boards are associated with significantly reduced firm value); Lucian Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 714 (2003); Kenneth A. Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495, 1515 (1997) (showing that takeover defenses are associated with higher agency costs and poor performance); Ronald W. Masulis et al., *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1854 (2007) (showing negative correlation between the strength of a firm's antitakeover provisions and profitability of its acquisitions).

pre-offer stock price.[225] Thus incumbents can waste at least twenty-five percent of profits before they risk a hostile raid. As a result, hostile tender offers are almost as rare as serious proxy fights.[226] Some protest that boards generally reject only inadequate takeover bids.[227] The evidence is to the contrary: "When incumbents defeat offers, shareholders experience on average a significant decline in stock value . . . ."[228]

Rarely can shareholders use litigation to call directors to account. Courts will not intervene unless the board's conduct is so bad that it evinces "intentional dereliction of duty, a conscious disregard for one's responsibilities."[229] Stricter scrutiny applies when directors are self-interested, but this scrutiny can be evaded by delegating a decision to fellow directors with no personal stake in the matter, even though those directors have ties to the interested directors that would clearly disqualify them in other situations, such as judge and litigant.[230] Actions with no direct financial dealing between the firm and directors, but that cement the incumbents' control, are reviewed less rigorously.[231] Finally, most suits to hold directors accountable must be brought as derivative suits, which face many procedural obstacles, especially a requirement to show that the board is dominated by persons directly monetarily threatened by the suit.[232] As a result, only crude or clumsy looting can be challenged by shareholder suits.

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225. *See* Bebchuk et al., *supra* note 62, at 934–36 (giving data on takeover premiums).

226. *See id.* at 925 (study showing that, from January 1996 to December 2000, only ninety-two of 2421 (3.8%) large public companies received an unfriendly takeover bid). In only twenty-three of these bids was the target ultimately acquired by the initial bidder. *Id.* at 933.

227. *See* Stout, *supra* note 63, at 1439.

228. Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 1004 (2002); *see also supra* note 206 and accompanying text.

229. *In re* Walt Disney Co., 906 A.2d 27, 64 (Del. 2006). Some argue that this leeway is necessary so that managers can sacrifice profits in the interests of shareholders. *See* Elhauge, *supra* note 47, at 770–71. Where sacrificing short term profits enhances share value, it should be supported by shareholders at least as much as by managers.

230. *See* DEL. CODE ANN. tit. 8 § 144 (2001) (allowing interested transactions if approved by a majority of disinterested directors); Brown, *supra* note 105, at 55–56, 77, 83 (criticizing Delaware courts' disregard of connections between interested and "non-interested" directors); *id.* at 70 (stating that this approach "has been labeled by some as an abject failure").

231. *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 954–55 (Del. 1985) (applying a standard somewhere between the business judgment test and the strict scrutiny standard to takeover defenses).

232. *See* Aronson v. Lewis, 473 A.2d 805, 815–16 (Del. 1984) (requiring particularized fact allegations of corporate direction of improper conduct), *overruled on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

2. The Shareholders' Collective Action Problem and Management Pressure. Shareholders suffer from a collective action problem. A shareholder who wins a proxy fight and raises the firm's equity value gets only a pro rata part of the increase but cannot compel other shareholders to share the proxy costs; they can "free ride" on the effort of the insurgent.[233] An institutional investor who bore all these costs would suffer a cost disadvantage vis-à-vis competing institutions;[234] thus, passivity pays.[235] Many institutional investors are also vulnerable to management pressure when they vote.[236] Nonetheless, antitakeover devices so damage shareholders' interests that opposition to them is now widespread and often succeeds.[237]

3. Problems of Information. The widely accepted "semi-strong" version of the efficient capital markets hypothesis posits that capital markets quickly impound all public information.[238] However, corporate managers can and often do distort share prices by deceptive publicity.[239] Such deception violates the federal securities laws[240] but is difficult to detect and prove.

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233. Black, *supra* note 5, at 527–28.

234. Because of competition, most institutional investors are cost-conscious. *See* Rock, *supra* note 116, at 460–63, 473–74.

235. *See* ROBERT A.G. MONKS & A. SYKES, CAPITALISM WITHOUT OWNERS WILL FAIL: A POLICYMAKER'S GUIDE TO REFORM 14 (2002) ("Passive institutions gain 95% or more of the benefit from any successful shareholder action at *no cost*—and with a real chance of winning business away from the more activist group."); Shann Turnbull, *Invigorating Capitalism* 4 (Sixth Int'l Conference on Corporate Governance & Bd. Leadership Paper, 2003), *available at* http://ssrn.com/abstract=437981 (indicating that cost-benefit analysis, free-riders, and uncertain outcomes prompt "institutional shareholders to be 'reluctant,' apathetic or negligent in exercising their ownership rights"). This situation may be changing. *See infra* notes 300–36 and accompanying text (describing growing shareholder activism and its effects).

236. *See* JACOBS, *supra* note 130, at 52 (stating that CEOs pressure pension fund managers to vote with management); Dent, *supra* note 169, at 55 n.98. For a good case study, see Gretchen Morgenson, *Investors vs. Pfizer: Guess Who Has the Guns?*, N.Y. TIMES, Apr. 32, 2006, § 3, at 1.

237. *See* Michael D. Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 757–62 (2003) (giving figures on shareholder opposition to various antitakeover devices); Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 369, 377–78 (2007) (documenting growing support for shareholder proposals, especially those opposing antitakeover devices).

238. *See* BREALEY & MYERS, *supra* note 12, at 351.

239. *See supra* note 195 and accompanying text.

240. *See* 17 C.F.R. § 240.10b-5 (2007) (forbidding manipulation and deception in connection with the sale or purchase of securities).

Even if public information is accurate, investors have limited capacity to process it. Investors act with bounded rationality; that is, they expend resources to analyze information only to the point at which it seems that the profits from analysis exceed the costs.[241] As one result, the choice of corporate governance rules is

> influenced by "network externalities." It is advantageous for a company to offer an arrangement that is familiar to institutional investors, that facilitates pricing relative to other companies, that is backed by a developed body of precedents and judges familiar with the arrangement. Conversely, companies are discouraged from adopting arrangements that are unconventional and radically different from those in other companies.[242]

Even a large institutional investor trading the securities of, or casting proxy votes for, a large issuer generally does not find it worthwhile to conduct extensive research into the quality of the issuer's corporate governance system or to speculate about the value of novel charter terms.[243] As a result, charters of public companies are remarkably uniform.[244]

Until recently, most institutions relied on rating and advisory services to evaluate corporate governance,[245] and these services generally used a single template rather than judging the unique circumstances of each issuer.[246] Even an investor who knew that antitakeover devices harm firm value also knew that the market did not factor such devices into stock prices.[247] The

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241. *See* Choi, *supra* note 167, at 112–13. *See generally* David M. Kreps, *Bounded Rationality*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 168, 172 (Peter Newman ed., 1998) ("[H]igh levels of analysis will not be undertaken for small stakes . . . .").

242. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 890 (2005) (footnote omitted).

243. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value?: Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 113 (2001) ("Perhaps governance terms are expensive for investors to price at the time of the IPO. This would allow management to get protection at low (or no) cost.").

244. *See* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 784–91 (2006).

245. *See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 889–90, 897 (2007) (describing extensive use of advisory services by institutional investors); *id.* at 907–16 (describing "one-size-fits-all" approach and extensive use of "rules of thumb" by advisory services).

246. *See id.* at 908.

247. In effect, this is a networking problem. *See* Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 483 (1998) (noting that network externalities arise "where purchasers find a good more valuable as additional purchasers buy the same good").

investor could profit from its insight only by buying stock of firms without antitakeover provisions and holding them until they were acquired. Few investors can wait that long. Rating and advisory services are growing more sophisticated in analyzing corporate governance, though, with the result that institutional investors are becoming more assertive about governance issues.[248]

The information problems of investors are exacerbated by conflicts of interest among financial advisors. In several recent cases, analysts defrauded their own clients by advising them to buy a stock that the analyst himself was selling.[249] Many analysts' employers coerce them to recommend companies with which the employer does business.[250] Employers also pressure advisors to generate commissions by encouraging clients to trade more than they should. Accordingly, even though markets are not perfectly efficient, many investors decide it is not worth the costs and risks to try to beat the market; they prefer to index.[251]

4. Markets Take Time. The investor's difficulty is escalated by the fact that the correction of a stock mispricing may take a long time. The longer the correction takes, the greater the deviation must be to promise an adequate rate of return. A long wait also exacerbates investors' doubts about whether an analyst's claim of mispricing is true. Even if the analyst is right, clients may lose faith and bail out before the correction occurs.

This problem plagues mutual funds. A fund that underperforms for several quarters can proclaim that its strategy is sound and just needs time to bear fruit, but it is hard for investors to validate such claims. Many will move their money elsewhere. Because funds realize economies of scale, funds suffering large redemptions are at a disadvantage to competitors even if they have a superior investment strategy.[252] Thus it is safer for a fund not to bank on long-term profits.

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248. *See infra* notes 314–21 and accompanying text.

249. *See* Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 57, 58, 60–64 (2006) (cataloging analyst conflicts of interest that lead to biased reports and recommendations).

250. *See* Lily Fang & Ayako Yasuda, *Analyst Reputation, Underwriting Pressure and Forecast Accuracy* 4, 24 (The Wharton Sch., Univ. of Pa., Working Paper No. 24-04, 2005), *available at* http://finance.wharton.upenn.edu/~rlwctr/papers/0507.pdf ("Conflict of interest is expected to be more severe in top-tier banks because these banks have a strong tradition to reward analysts for the generation of underwriting business.").

251. *See* JOHN C. BOGLE, JOHN BOGLE ON INVESTING: THE FIRST 50 YEARS 41–42 (2000) (describing the theory and practice of indexing).

252. *See* Rock, *supra* note 116, at 480 (debating why pension fund managers pursue strong governance matters with greater zeal than private mutual fund managers).

Superior returns should then be available to investors who will absorb the high cost of finding mispriced stocks and make large enough investments to cover these costs, then wait as long as necessary for prices to be corrected. In theory, that is the role of arbitrageurs, but their activity is hampered by limited capital and borrowing capacity and by legal restraints on some kinds of trading (like short selling). As a result, most are unwilling or unable to make large, long-term investments in supposedly mispriced issues.[253]

In sum, there are many impediments, both legal and economic, that hinder the creation of optimal corporate governance arrangements.[254]

B. *Initial Public Offerings*

Some defenders of the DPM/TPM acknowledge problems with the EMCGH for firms that are already public, so they focus instead on IPOs. They argue that companies going public offer the most attractive corporate governance rules in order to fetch the highest possible price for their stock in the IPO.[255] However, empirical studies cast grave doubt on whether antitakeover provisions (ATPs), for example, benefit public shareholders.[256] Of course, selling shareholders may

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253. For discussions of the limits of arbitrage, see generally Gordon Gemmil & Dylan C. Thomas, *Noise Trading, Costly Arbitrage, and Asset Prices: Evidence from Closed End Funds*, 57 J. FIN. 2571, 2590 (2002); Andrei Shleifer & Robert Vishney, *The Limits of Arbitrage*, 52 J. FIN. 35, 35–37 (1997); Jeremy C. Stein, *Why Are Most Funds Open-End? Competition and the Limits of Arbitrage*, 119 Q.J. ECON. 247, 247–48 (2005), Daniel A. Cohen et al., *Earnings Announcement Premia and the Limits to Arbitrage* 27–31 (2004) (unpublished working paper), *available at* http://ssrn.com/abstract=642045.

254. *See* Klausner, *supra* note 244, at 797 ("[T]ransaction costs that stem from learning and network externalities, and perhaps other market imperfections, impede [legally binding corporate governance agreements] and instead drive firms en masse towards incorporating in Delaware and adopting charters comprised of a limited and familiar set of highly standardized terms.").

255. *See* Bainbridge, *supra* note 3, at 1737; Gordon, *supra* note 114, at 358 (positing that "entrepreneurs selling stock to the public would bear the cost" of suboptimal corporate governance provisions); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 502 (2003) ("[W]e continue to believe that the IPO charter terms provide substantial evidence of appropriate governance structures."); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 853–56 (2002) ("Shareholders *act as if* they value corporate governance rules that insulate boards from hostile takeovers.").

256. *See* Daines & Klausner, *supra* note 243, at 97–106; Julian Atanassov, *Quiet Life or Managerial Myopia: Is the Threat of Hostile Takeovers Beneficial for Technological Innovation* (EFA 2007 Ljubljana Meetings Paper Aug. 2007), *available at* http://ssrn.com/abstract=967421 (concluding that executives take advantage of antitakeover laws to lead a "quiet life" rather than to overcome the detriments of investor myopia).

consciously accept a lower offering price in exchange for retaining the perquisites of control; that is legitimate. However, there are always minority shareholders who must also live with the lower stock price but do not share in control. Further, there may be benefits to controlling shareholders in this exchange.[257]

Venture capital firms may also accept a suboptimal IPO price in exchange for retaining a voice in control. A low offering price reduces returns to the fund managed by the venture capital firm and thus largely reduces benefits to the limited partners who are the fund's passive investors.[258] The partners in the venture capital firm, however, hold board seats from which they personally benefit through both direct compensation and access to inside information.[259] By acceding to managers in an IPO, venture capitalists also preserve a reputation for cooperating with entrepreneurs, a reputation that benefits other funds the firm manages.[260]

Further, the IPO market may not be efficient. IPOs depend heavily on underwriters' marketing to irrational "sentiment" or "noise" investors[261] who may be vulnerable to the inflated earnings reports common to IPO firms.[262] Many IPO underwriters

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257. *See* Bebchuk, *supra* note 224, at 716 (noting that those who "will continue to run the firm after the IPO . . . will fully capture the benefits of [ATPs] and will bear only part of the cost of reduced IPO share price"). In about one-third of IPOs from 1996 to 2000, executives received stock options at an exercise price equal to the IPO offer price. *See* Michelle Lowry & Kevin J. Murphy, *Executive Stock Options and IPO Underpricing*, 85 J. FIN. ECON. 39, 40 (2007). In one study over half these executives realized a net profit from underpricing of the IPO. *Id.* at 43–45. There are also tax benefits to ATPs. By retaining control, insiders can extract tangible benefits (like luxurious offices and expense accounts) and intangible benefits (like the prestige of autocracy) that are not taxed at all. *Cf.* Daines & Klausner, *supra* note 243, at 85 (hypothesizing that ATPs may be used at the IPO stage to protect incumbents' large private benefits). In effect, the U.S. Treasury bears some of the agency costs of the separation of ownership and control.

258. *See* Graeme Camp et al., *Incentives to Underprice*, 46 ACCT. & FIN. 537, 539 (2006) (stating that underpricing of an offering may "generate compensatory benefits in the aftermarket"); *see also* JOSEPH SHADE, BUSINESS ASSOCIATIONS IN A NUTSHELL 33–35 (2d ed. 2006) (describing, *inter alia*, limited partnerships and their use in venture capital firms).

259. *See* Douglas Cumming & Jeffrey MacIntosh, *Boom, Bust, and Litigation in Venture Capital Finance*, 40 WILLAMETTE L. REV. 867, 892–93 (2004) (discussing ways in which venture capital firms may favor themselves over the funds they advise).

260. *See* Klausner, *supra* note 237, at 770–71 ("[A]n important concern . . . is whether the fund's reputation for working well with management is at risk.").

261. *See* François Derrien, *IPO Pricing in "Hot" Market Conditions: Who Leaves Money on the Table?*, 60 J. FIN. 487, 497–98 (2005); Alexander P. Ljungqvist et al., *Hot Markets, Investor Sentiment, and IPO Pricing* 31, 34–36 (AFA San Diego Meetings, Nov. 6 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=282293.

262. *See* Bolton et al., *supra* note 126, at 733 (discussing earnings manipulation by pre-IPO firms); François DeGeorges & Richard Zeckhauser, *The Reverse LBO Decision*

require customers to buy the stock in the aftermarket in return for IPO allocations ("tie-in" agreements), a practice that distorts prices in the aftermarket.[263] In effect, the managers of IPO firms, their largest outside shareholders (often venture capital firms), and the underwriters create complex distributions in which they all profit at the expense of small investors.[264] As a result, IPOs tend to be overpriced.[265] ATPs and other corporate governance features that benefit the managers at the expense of the purchasers in the IPO may be part of the benefits the managers realize from these market distortions.

Sales of IPOs are abetted by the underwriter's securities analysts. They rate IPO issues underwritten by affiliated investment bankers more favorably than do unaffiliated analysts.[266] That practice may now end because investors have caught on, or because of new laws and regulatory pressure against such behavior, or both.[267] Even if the practice has diminished, though, the ability of investment banks to indulge in such behavior for many years illustrates the imperfection of the IPO market.

It makes little sense for investors to try to price novel corporate governance features for transactions as small as the

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and Firm Performance: Theory and Evidence, 48 J. FIN. 1323, 1324–30 (1993) (finding frequent earnings manipulation by LBO firms prior to going public again). Asymmetric risk may also motivate underwriters to set low prices in IPOs. *See* Atanu Saha & Allen Ferrell, *An Asymmetric Payoff-Based Explanation of IPO "Underpricing"* 2, 12 (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Discussion Paper No. 587, 2007), *available at* http://ssrn.com/abstract=991917. However, setting low prices may offset the disadvantages of the issuer's inefficient corporate governance to investors.

263. *See* Rajesh K. Aggarwal et al., *Underwriter Manipulation in Initial Public Offerings* 7–9 (Dec. 19, 2005), *available at* http://ssrn.com/abstract=686252 (providing examples of recent tie-in agreements).

264. *See* Gerard Hoberg & H. Nejat Seyhun, Do Underwriters Collaborate with Venture Capitalists in IPOs? Implications and Evidence 6–7 (Apr. 26, 2005) (unpublished comment), *available at* http://ssrn.com/abstract=690421 (describing arrangements).

265. *See* Olaf Ehrhardt & Henry Lahr, *Private Benefits and the Decision to Go Public* 9, 56–57 (Feb. 15, 2006), *available at* http://ssrn.com/abstract=885721 (noting that some "argue that investors are too optimistic [and t]herefore, IPOs are overpriced"); *see also* Tim Loughran & Jay R. Ritter, *The New Issues Puzzle*, 50 J. FIN. 23, 23, 28–29 (1995) (showing abnormally low post-IPO stock price performance).

266. *See* Patricia M. Dechow et al., *The Relation Between Analysts' Forecasts of Long-Term Growth and Stock Price Performance Following Equity Offerings*, CONTEMP. ACCT. RES. 1, 17 (2000) ("[A]ffiliated analysts make the most overly optimistic forecasts."); Roni Michaely & Kent L. Womack, *Conflicts of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. FIN. STUD. 653, 653–55 (1999).

267. *See* Maureen F. McNichols et al., *That Ship Has Sailed: Unaffiliated Analysts' Recommendation Performance for IPO Firms* 2–3 (March 2006), *available at* http://ssrn.com/abstract=892633 (describing legal and regulatory changes and reporting no difference between affiliated and unaffiliated analysts' recommendations between 1994 and 2001).

typical investment in an IPO.[268] Any effort by an underwriter or issuer to inform buyers about the value of unique governance features would be suspect as self-serving. Independent analysts do not evaluate corporate governance. There are no recognized independent experts who could be hired to certify the value of an unusual governance feature. It would be difficult for a would-be expert to establish a track record since the value of an attractive corporate governance regime will typically not be realized for many years.

The need to educate would not end with the IPO; to keep the benefit of a governance feature in its stock price in the aftermarket, the issuer would have to inform investors continually about that feature. Further, the issuer is a one-time player. It would bear all the costs of verifying the value of the feature; later issuers could free-ride on this effort. The underwriter is a repeat player and so might have an incentive to provide credible certification of the value of a corporate governance plan. To do so, however, would be awkward because it would tacitly devalue the underwriter's other clients who lack such a plan.

In most IPOs the issuer's officers and its venture capital investors retain a majority of the shares after the offering.[269] Accordingly, they would not only have to persuade purchasers of the value of their governance structure but also pledge not to change it after the IPO. They could do this with a charter clause requiring a supermajority shareholder vote to amend the structure.[270] This would complicate and increase the cost of both corporate planning and of the explanation effort. It would also lock the firm into rules that might have unexpected consequences. Moreover, the forms ATPs take are varied and constantly evolving, so a commitment precluding just one set of ATPs would be of little value. Finally, takeovers, even if relatively unimpeded, are only a partial cure for the ills of separation of ownership and control. Devices to commit to

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268. *See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 733–36 (1997) (describing network externalities that encourage standardization in corporate contracts). In particular, the value sacrificed by ATPs varies among companies, and it would be costly to calculate separately the amount lost in each IPO. *See* Klausner, *supra* note 237, at 776–77.

269. *But see* Daines, *supra* note 22, at 1560 (suggesting that "an IPO cuts managers' ownership by roughly 50%," and that this reduction therefore decrease the managers' incentive to improve corporate governance).

270. *See* DEL. CODE ANN. tit. 8, § 216 (2001 & Supp. 2006) (permitting provision in certificate of incorporation requiring supermajority board or shareholder vote for stipulated matters).

shareholder control may be on the horizon, but they do not exist yet.

The recent growth of governance ratings agencies and proxy advisors is making investors better informed about each issuer's governance.[271] In time, this trend may change the governance of IPO firms. Until recently, "institutional investors were apparently unaware of the fact that companies were going public with takeover defenses in their charters."[272] This fact is now getting more attention. As awareness dawns, investors are registering dissatisfaction with it.[273] For now, however, the governance of IPO firms is far from optimal.

C. *The Market for State Law*

The argument that states compete to offer the most investor-friendly corporate law is also fatally flawed. The "market" for corporate law has major barriers to entry that keep other states from challenging Delaware's dominance.[274] If another state adopted a law appealing enough to attract many companies to incorporate there, Delaware could just copy the attractive features.[275] It is also unclear what features are appealing in this market. Since CEOs now dominate most public companies, any competition among the states may just cater to CEOs.[276]

Any constraint on Delaware corporate law from other jurisdictions probably stems less from other states than from the

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271. *See infra* notes 314–21 and accompanying text.

272. Klausner, *supra* note 237, at 764; *see also* Bebchuk, *supra* note 224, at 740–42 (discussing the role of bounded rationality in IPO pricing).

273. *See* Klausner, *supra* note 237, at 765–68.

274. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 563, 568–71 (2002); *see also* Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 382 (2005) (questioning whether there is a race to either the top or the bottom). Delaware is chosen by 95% of firms that incorporate outside their home state. Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1563 (2002).

275. *See* Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. ON REG. 139, 164 (2003).

276. *See* Lucian Arye Bebchuk et al., *The Market for Corporate Law*, 162 J. INST'L & THEORETICAL ECON. 134 (2006) (finding that state competition produces optimal governance rules only to the extent they preserve managers' private benefits). This hypothesis is supported by evidence that incorporation in Delaware is not associated with higher firm value, as one would expect if Delaware law were better for investors. Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1788–90 (2002); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 41, 46 (2004) (finding no evidence of such a correlation in the 1990s except for firms with small market value).

threat of federal regulation.[277] This threat may help to explain the wild fluctuations in Delaware law. When the federal government shows interest in increasing corporate governance regulation, Delaware courts move to obviate it by tightening their standards. When the heat abates, they revert to their usual laxity. When federal action loomed in the 1980s, the Delaware Supreme Court ratcheted up the duty of care—or seemed to do so—by holding directors liable in *Smith v. Van Gorkom*,[278] even though their behavior was well within normal practices. Once the danger passed, state courts forgot *Van Gorkom*; no director was careless enough to be held liable.[279] When Enron and other scandals provoked demands that directors be required to exercise at least a little oversight, the Delaware Supreme Court again made some noise (albeit only in dictum) about a more stringent duty of care.[280] This pattern belies claims that courts are better than legislatures or the market at protecting shareholders.[281]

D. Counter-Evidence: Shareholder Influence and Share Prices

Companies with strong shareholder protections have higher share prices than companies with weak shareholder rights.[282] The former also have superior operating performance.[283] They invest

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277. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 591–92 (2003).

278. Smith v. Van Gorkom, 488 A.2d 858, 873–74 (Del. 1985).

279. In 1999, the Delaware Supreme Court said that directors breach the duty of care only if their conduct is "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1246 (Del. 1999) (quoting *In re* J.P. Stevens & Co., Inc., 542 A.2d 770, 780–81 (Del. Ch. 1988)); *see also* E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics, and Federalism*, 152 U. PA. L. REV. 1007, 1010 (2003) ("If the board's decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, lack of good faith may, in some circumstances, be inferred.").

280. Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) ("[D]irectors' decisions will be respected by courts unless the directors act in a manner that cannot be attributed to a rational business purpose . . . .").

281. *See* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1072 (2000) (finding courts limited by their reluctance to respond to political changes, their inability to set their own agendas, and their constraints on justiciability).

282. For example, companies that opted out of Pennsylvania's extreme antitakeover law were valued in the market at a multiple on cash flows 25% higher than companies that did not opt out. *See* JACOBS, *supra* note 130, at 250 n.5 (citing John Pound, *On Motives for Choosing a Corporate Governance Structure: A Study of Corporate Reaction to the Pennsylvania Takeover Law*, 8 J.L. ECON. & ORG. 656, 668–69 (1992)).

283. *See* Lin, *supra* note 158, at 922 (citing empirical evidence that appointment of outside directors positively impacts stock prices); Tod Perry & Anil Shivdasani, *Do Boards Affect Performance? Evidence from Corporate Restructuring*, 78 J. BUS. 1403, 1418–20 (2005) (finding that firms without a majority of outside directors are more likely to

more with more efficiency.[284] They have lower CEO compensation.[285] Further, countries with corporate laws that do not protect shareholders tend to have weak stock markets. This suggests that shareholder protections reduce agency costs.[286]

When large shareholders do exert influence, they do not usurp benefits for themselves; all shareholders gain from the activism of large shareholders. Initiatives undertaken by CalPERS, for instance, have generated superior market returns.[287] The presence of large block holders often improves firm performance.[288] High

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initiate asset restructurings and employee layoffs and that the reduction in the scale of operations is larger for these firms than for other firms and that such firms are more likely to improve performance after a restructuring); Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Operating Performance 13 (Mar. 20, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=814205 (finding that several proshareholder governance criteria are associated with higher returns on equity and on assets); Henry Huang, Shareholder Rights and the Cost of Equity Capital 29 (Aug. 2004) (unpublished manuscript, on file with the author) ("My findings indicate that the level of shareholder rights is significantly associated with the cost of equity capital. Investors perceive the weak shareholder rights as an important source of potential agency costs and demand higher rates of return accordingly."); *see also* John E. Core et al., *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. FIN. 655, 659–61 (2006) (stating that securities analysts weigh shareholder rights when making earnings forecasts).

284. *See* Bøhren et al., *supra* note 140, at 2, 3, 18 ("[B]etter governance improves investment efficiency by mitigating the underinvestment problem [and] the overinvestment problem . . . relative to the first best solution . . . .").

285. *See* Jiraporn et al., *supra* note 213, at 248 ("[W]eaker shareholder rights (more suppressive governance) are related to higher executive pay.").

286. There is some question whether strong (or weak) governance causes superior (or inferior) performance. "It is also possible that the results are driven by some unobservable firm characteristic." Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 145 (2003). A recent empirical study suggests that is the case. N.K. Chidambaran et al., Does Better Corporate Governance "Cause" Better Firm Performance? 43–44 (March 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=891556. Laws that protect investors are associated with higher national economic growth. Rui Castro et al., *Investor Protection, Optimal Incentives, and Economic Growth*, 119 Q.J. ECON. 1131, 1131–35, 1166–67 (2004).

287. *See* MONKS & MINOW, *supra* note 67, at 157 (citing Stephen L. Nesbitt, Long Term Rewards from Corporate Governance, Wilshire Assocs. (Jan. 5, 1994)); Mark Anson et al., *The Shareholder Wealth Effects of CalPERS Focus List*, 15 J. APPLIED CORP. FIN. 102, 103–05 (2003); Brad M. Barber, Monitoring the Monitor: Evaluating CalPERS' Shareholder Activism 2 (Nov. 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=890321 (finding that CalPERS's activism resulted in total wealth creation of $3.1 billion between 1992 and 2005); *see also* MONKS & MINOW, *supra* note 67, at 157 (discussing other examples of similar increase in shareholder value from actions at Sears, Roebuck, and Honeywell); *Meet the Friendly Corporate Raiders*, BUS. WK., Sept. 20, 2004, at 102 (describing success of Relational Investing fund in pressuring underperforming companies to change).

288. *See* ROE, *supra* note 119, at 237–38 (arguing that block-holders' presence personifies the shareholders, which spurs executive performance, promotes "loyalty," and discourages "shirking"); Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. ECON. 229, 229–30 (2001) (finding higher stock returns between 1980 and 1996 for companies with large institutional ownership).

institutional stock ownership is not associated with decreases in R&D.[289] Strong shareholders may even benefit bondholders.[290]

E. Counter-Evidence: Leveraged Buyouts and Acquisitions

There is much debate about the source of premiums in acquisitions,[291] but most commentators believe that some or most of them stem from eliminating the large agency costs of the separation of ownership and control.[292] In leveraged buyouts ("LBOs") a private group acquires a public company, typically paying a large premium for its stock.[293] Neither the direct costs of being a public company (like the costs of proxy statements and SEC filings) nor the tax savings of high leverage explain these premiums.[294] What does? Michael Jensen posits that going private removes huge agency costs that beset public firms.[295] On one hand, the high debt of LBO firms poses a threat of default that deters managers from the waste that plagues many public companies.[296] On the other hand, managers of LBO firms usually own a large share of the equity, which gives them strong incentives to increase share value.[297] As a result, LBOs improve efficiency.[298]

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289. *See* OFFICE OF THE CHIEF ECONOMIST OF THE SEC. & EXCH. COMM'N, INSTITUTIONAL OWNERSHIP, TENDER OFFERS, AND LONG-TERM INVESTMENTS 6–7 (1985).

290. *See* Angie Low et al., The Impact of Shareholder Power on Bondholders: Evidence from Mergers and Acquisitions 9, 37–38 (Mar. 13, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=891683 (showing that high institutional ownership is positively related to bondholder returns of the acquiring company in acquisitions).

291. *See* Bainbridge, *supra* note 9, at 617–22 (noting that there is no unified theory on the source of high premiums in merger and acquisition transactions).

292. *See id.* at 617–20.

293. *See* DALE A. OESTERLE, MERGERS AND ACQUISITIONS IN A NUTSHELL 27–28 (2d ed. 2006) (describing method for performing a leveraged buyout).

294. *See* GILSON & BLACK, *supra* note 202, at 404–06.

295. *See* Michael Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61 ("The publicly held corporation . . . has outlived its usefulness in many sectors of the economy . . . [because of] the central weakness of the public corporation—the conflict between owners and managers over the control and use of corporate resources . . . ."). Although public ownership will not disappear, the LBO trend continues. *Id.* at 62–66.

296. *See* Jensen, *supra* note 142, at 322–23.

297. Managers of LBO firms often own 15–20% of the equity. *Id.* at 323. This contrasts with the one-fourth of 1% of the equity owned by the average CEO of a *Fortune* 500 company. *See supra* note 143 and accompanying text.

298. *See* Frank R. Lichtenberg & Donald Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior*, 27 J. FIN. ECON. 165, 165–67, 184–93 (1990) (finding higher productivity after an LBO and that this result was not attributable to reduced research and development, wages, capital investment, or layoffs of blue collar workers); *see also* Richard Harris et al., *Assessing the Impact of Management Buyouts on Economic Efficiency: Plant-Level Evidence from the United Kingdom*, 87 REV. ECON. &

The existence of acquisitions (including LBOs) also helps to explain why the market has not demanded shareholder primacy. Unlike public shareholders, an acquirer has no collective action problem; it captures all the gains from improving corporate governance. Accordingly, it makes sense that a sophisticated investor who sees inefficient governance would not wage a proxy fight for control of public companies or seek IPOs by companies with better governance. By those steps, the investor would incur large costs (of investigation in the case of IPOs, or of a proxy solicitation) but reap little gain. It makes more sense for shareholders to wait for an offer of a premium by an acquirer who can take control and keep all the remaining gains.[299]

V. GOTTERDAMMERUNG: TRENDS ERODING DIRECTOR PRIMACY

A. *Growing Shareholder Activism*

Economic and legal trends are increasing shareholder power.[300] *Pace* the DPM theorists, shareholders did not choose impotence; it was forced on them.[301] Now they are gaining power, albeit slowly.[302] High-profile merger disasters and corporate

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STAT. 148, 152–53 (2005) (making similar findings in the U.K.); Shaker A. Zahra, *Corporate Entrepreneurship and Financial Performance: The Case of Management and Leveraged Buyouts*, 10 J. BUS. VENTURING 225, 238 (1995) (finding significant increases in new product development and other aspects of corporate entrepreneurship after LBOs).

299. This is not to say that LBOs entirely solve the problem of CEO domination.

> [M]aybe it's that [LBOs] are often done with the help of the acquired entity, where the managers know exactly how to change the company and make it worth more, but want to put that knowledge to work only if they can reap immense rewards from the repair job. That often seems to be what's happening.

Ben Stein, *What Is This Thing Called Private Equity?*, N.Y. TIMES, July 1, 2007, § 3, at 6.

300. *See* William T. Allen & Leo E. Strine, Jr., *When the Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton's Vision of the Corporate Law*, 60 BUS. LAW. 1383, 1395 (2005) (stating that increasing product competition and the growing power of institutional investors and securities markets are forcing changes in corporate governance).

301. *See supra* note 184 and accompanying text (concerning executive compensation consultants); *supra* notes 208–43 and accompanying text (describing obstacles to shareholder control).

302. *See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 175 (2001) ("Institutional investors have, in the past decade, increasingly engaged in corporate governance activities . . . ."). Shareholder proposals are gaining greater support. With growing frequency managements substantially accept them. For example, rules requiring a majority (rather than a plurality) shareholder vote for the election of directors are being adopted at "breathtaking speed." *See* Denise F. Brown, *Study Shows Majority Voting Continue to Gain Momentum*, 5 BNA CORP. ACCOUNTABILITY REP'T 190, 190 (Feb. 23, 2007). This shows that "in the battle between owners and managers . . . investors are gaining power." Jena McGregor, *Activist Investors Get More Respect*, BUS. WK., June 11, 2007, at 34.

scandals "have made shareholders more cynical about the decision-making process of boards of directors."[303] The SEC's 1992 proxy rule changes also made it easier for institutional investors to communicate and cooperate.[304] A recent court decision may foster further shareholder involvement in board elections.[305] There is continuing growth in the fraction of public stocks held by institutional investors generally and by public pension funds and other institutions that are less subject to pressure from corporate managers.[306]

Hedge funds have grown, and their activism in corporate governance is more intense and goes further than that of other institutional investors.[307] Hedge funds band together and recruit other institutional investors for group action.[308] They often "try to persuade managers to change the capital structure of the company (typically to pay substantial dividends, repurchase shares, or take on additional debt) in ways the hedge funds believe will maximize the value of shares."[309] They have been so successful as to "support[] the proposition that they have shifted the balance of corporate power in the direction of outside shareholders and their financial agendas . . . [perhaps heralding] a modification of the prevailing description of a separation of ownership and control . . . ."[310]

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303. Young, *supra* note 123.

304. *See* Briggs, *supra* note 152, at 686–89.

305. *See* Am. Fed. of State, County & Mun. Employees v. Am. Int'l Group, Inc., 462 F.3d 121, 125, 129–30 (2d Cir. 2006) (ordering inclusion on company's proxy statement of shareholder proposals relating to elections of directors generally).

306. In 1965, institutional investors held 16% of U.S. equities; by 2001 they held 61%. *See* SEC. INDUS. ASS'N, SECURITIES INDUSTRY FACTBOOK 2002, at 66 (2002).

307. *See* Kahan & Rock, *supra* note 123, at 4–18. This is a result of different economic incentives and lower regulatory constraints and conflicts of interest. *Id.* at 19–25; *see also* Partnoy & Thomas, *supra* note 156, at 43 (stating that "hedge fund corporate governance activism is more robust"); Young, *supra* note 123 (describing growing leadership by hedge funds to oppose value-impairing deals in proxy votes and noting that, because of their fee structures, hedge fund managers "maintain a laser focus on shareholder value").

308. *See* Briggs, *supra* note 152, at 690–92, 697–98 (describing "wolf pack tactics").

309. Partnoy & Thomas, *supra* note 156, at 35.

310. William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1409 (2007); *see also* Briggs, *supra* note 152, at 721 ("[H]edge funds with significant shareholdings have been able to use wolf-pack tactics against companies to achieve at least some of their aims.").

Investor sophistication is rising,[311] making it easier for shareholders to coordinate and raising the payoff to activism by increasing the power they can exert if they do cooperate. Investors and regulators are paying more attention to proxy voting by fiduciaries. "Today, institutional shareholders who consistently defer to management (the modus operandi of the past) may be accused of abdicating their fiduciary duties."[312] It is now harder for managers to intimidate shareholders who vote against them. In sum, the incentives for shareholder initiative are growing. This rising activism has already benefited firms' performance and share values;[313] as the trend continues, the benefits should also grow.

Both a cause and an effect of mounting shareholder energy is the growth of shareholder advisory organizations and lobbying groups. The foremost is Institutional Shareholder Services (ISS), which may guide over a third of the shareholder votes.[314] A similar organization, International Corporate Governance Network (ICGN), now operates transnationally.[315] These advisors have a significant impact on proxy votes.[316]

ISS has also created its Corporate Governance Quotient, which rates the corporate governance systems of public companies.[317] The Council of Institutional Investors also

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311. *See* Angela Morgan et al., *The Evolution of Shareholder Voting for Executive Compensation Schemes*, 21 J. CORP. FIN. 715, 715, 723 (2006) (concluding that "shareholders have become more sensitive to potentially harmful [executive compensation] plan provisions"); Rock, *supra* note 116, at 447–51 (describing examples of informed activism by institutional shareholders).

312. Young, *supra* note 123.

313. *See supra* notes 282–89 and accompanying text; *see also* Romano, *supra* note 302, at 183 (stating that institutional investors have targeted poorly performing corporations).

314. *See* Dean Starkman, *A Proxy Adviser's Two Sides: Some Question Work of ISS for Companies It Scrutinizes*, WASH. POST, Jan. 23, 2006, at D1. According to its president, 15–20% of ISS clients automatically vote according to ISS recommendations. *Id.*; *see also* Briggs, *supra* note 152, at 692–93, 698–99 (describing the operations and effectiveness of ISS). Glass, Lewis & Co. also offers research and advice to institutional investors. *See* Glass, Lewis & Co., Board Accountability Index, http://www.glasslewis.com/solutions/bai.php (last visited Oct. 19, 2007); *see also* Rose, *supra* note 245, at 904 (describing services offered by Glass, Lewis, & Co. and explaining the functions of the Board Accountability Index).

315. *See* Rose, *supra* note 245, at 897.

316. *See* Jennifer E. Bethel & Stuart L. Gillan, *The Impact of Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. J. 29, 30, 34 (2002); *see also* TONELLO, *supra* note 146, at 24 ("Recently, these organizations have focused increasing attention on what they consider to be unjustified and excessive compensation, thereby contributing to raising the 'best practice' bar.").

317. *See* Rose, *supra* note 245, at 900–03; Institutional Shareholder Services, Rating Criteria, http://www.isscgq.com/RatingCriteria.htm (last visited Oct. 19, 2007) (listing sixty-one rating criteria used in the CGQ). An index of twenty-four of these features

publishes corporate governance guidelines.[318] Governance Metrics International (GMI) and the Corporate Library (CL) also rate the governance structures of public companies.[319] Going farther, some institutional investors are joining forces to participate directly in corporate governance.[320] Shareholder activism will be facilitated by organizations like the new Investors for Director Accountability, which plans to coordinate institutional shareholders in order to "press directors to act in the interests of the stockholders."[321]

Some objections are leveled at these organizations. One is that ISS has a conflict of interest because, in addition to the foregoing activities, it offers advice to public companies, "which creates a concern that ISS'[s] recommendations in a proxy matter may be affected by whether or not the subject company purchases other services from ISS, such as governance advice."[322] It is also charged that the ratings of these organizations "do not reliably predict firm performance."[323]

These concerns are not fanciful. Conflicts of interest are ubiquitous in corporate governance, infecting not only directors, but also accountants, investment advisors, compensation advisors, and institutional investors themselves.[324] It would almost be surprising to find an aspect of corporate governance in which there are no conflicts of

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relating to shareholder power has been found to be positively associated with several measures of superior corporate performance. *See* Gompers et al., *supra* note 286, at 145–50.

318. *See* COUNCIL OF INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE POLICIES (2006), http://www.cii.org/policies/Current%20CII%20Corporate%20Governance%20 Policies%2003-20-07.pdf.

319. *See* GovernanceMetrics International, Overview, http://www.gmiratings.com /hgwaa055h0jyiu55scbird45)/About.aspx#top (last visited Oct. 19, 2007); *see also* Rose, *supra* note 245, at 903–04 (discussing GMI and CL).

320. *See* Mara Der Hovanesian, *Attack of the Hungry Hedge Funds*, BUS. WK., Feb. 20, 2006, at 72 (describing coordinated efforts, including the seeking of board seats). In some cases shareholders have formed groups to help explain the complex, abstruse financial information disclosed by public companies. *See* Gretchen Morgenson, *Hear Ye, Hear Ye: Corralling Executive Pay*, N.Y. TIMES, June 17, 2007, § 3, at 1 (describing formation of group of Verizon Communications shareholders).

321. Gretchen Morgenson, *Fund Manager, It's Time to Pick a Side*, N.Y. TIMES, Mar. 26, 2006, § 3, at 1.

322. Rose, *supra* note 245, at 906.

323. *Id.* at 908; *see also* Jeffrey Sonnenfeld, *Good Governance and the Misleading Myths of Bad Metrics*, ACAD. OF MGMT. EXEC., Feb. 2004, at 108, 108 (claiming that ratings are based on "Wall Street superstitions" and "cliches and myths, rather than on genuine research").

324. *See supra* notes 249–50, 266 and accompanying text (concerning investment advisors).

interest. However, recent studies find a significant correlation between at least some of these agencies' ratings factors and corporate performance.[325] No doubt further research can improve these correlations. There is room for disagreement about the criterion by which correlation should be sought.[326] However, the widespread use of the services of these organizations by institutional investors indicates powerfully that they find the services beneficial.

The market is already addressing these conflicts of interest.[327] If the market cannot solve the problems, regulation may be needed,[328] although regulation is always costly and not always beneficial. Given the recent effectiveness of ratings and advisory services in aiding shareholders, nothing should be done to hamper their continued growth.

More shareholder proposals are gaining majority shareholder support.[329] Boards once routinely ignored them.[330] Now they pay more heed and implement more shareholder-approved proposals.[331] "Vote No" campaigns in which disgruntled shareholders withhold their votes for some or all board nominees increase the odds of CEO turnover (which usually raises share price), even though these campaigns do not directly alter board composition.[332] Shareholder pressure to declassify boards and to remove poison pills is increasingly successful.[333] New regulations

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325. *See supra* notes 212, 282 and accompanying text.

326. Various studies have used return on equity, return on assets, accounting profitability, and cost of capital. *See supra* notes 212–14, 223–25 and accompanying text (referring to various measures of corporate performance).

327. Rose, *supra* note 245, at 907 ("[L]arge, institutional investors . . . have raised concerns and, in some cases, switched advisors over conflicts issue.").

328. *See id.* at 919–26 (discussing the possibility of regulation).

329. *See supra* note 237 and accompanying text (noting the growing success of shareholder opposition to antitakeover devices).

330. *See* Thomas & Cotter, *supra* note 237, at 370–71.

331. *See id.* at 369.

332. *See* Diane Del Guercio et al., Do Boards Pay Attention When Institutional Investors 'Just Vote No'?: CEO and Director Turnover Associated with Shareholder Activism 1–2, 23 (2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=575242.

333. *See* Thomas & Cotter, *supra* note 237, at 377–79 ("The number of [poison] pill redemptions and board declassifications increased substantially in 2004."). One study found that, of fifty companies that had approved a (precatory) shareholder proposal to declassify the board between 2004 and 2005, fifteen (30%) did so. Ganor, *supra* note 62, at 14. More boards are responding to shareholder pressure to remove poison pills despite management opposition to removal. *See* Ali C. Akyol & Carolyn A. Carroll, Removing Poison Pills: A Case of Shareholder Activism 9–13 (Sept. 2006) (unpublished manuscript), *available at* http://ssrn.com/abstrct=935950.

that enhance board oversight seem to have caused a reduction in CEO compensation.[334]

More shareholders are proposing by-law amendments.[335] Hitherto shareholders typically braved only precatory proposals, which boards regularly disregarded. By-law amendments are still imperfect tools; by-laws cannot achieve many protections investors need, and some companies require unattainable supermajority votes to amend the by-laws.[336] Still, this tactic allows investors to take one more step forward. If they are again frustrated, they will seek other means to defend themselves.

B. Growing Competition for Capital

"[I]n order to compete for capital, corporations will have to give investors more of a role in governance."[337] In America, the huge advantage that public equities once enjoyed over other investments is shrinking, and that trend is likely to continue. One growing competitor is private equity.[338] DPM/TPM advocates are so baffled by this development that they offer stunningly obtuse explanations for it. Lynn Stout says, "The recent boom in private equity buyouts suggests that the modern trend toward greater shareholder power and protection has already gone too far."[339] "[P]ublic shareholders may have made themselves so bothersome that many corporate managers simply do not want to deal with them."[340] It's unclear whether the recognition that the managers, not the directors, are calling the shots is a conscious confession or a slip of the pen.

In any case, a much more persuasive explanation for the trend is available: Through venture capital and leveraged buyouts, large investors can escape the abuse they suffer in

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334. *See* Vidhi Chhaochharia & Yaniv Grinstein, CEO Compensation and Board Structure 19 (Oct. 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=901642 (finding that firms that had not previously complied with the new rules decreased their CEO compensation by 20–25% upon compliance compared to firms that were already complying).

335. *See* Mark Maremont & Erin White, *Stock Activism's Latest Weapon*, WALL ST. J., Apr. 4, 2006, at C1.

336. *See id.*

337. MONKS & MINOW, *supra* note 67, at 156.

338. *See* William J. Holstein, *The Rising Role Of Private Equity*, N.Y. TIMES, July 16, 2006, § 3, at 9 (interviewing Robert F. Bruner, Dean of the Darden School of Business at the University of Virginia, about the role of private equity firms in merger and acquisition transactions).

339. Lynn A. Stout, *Democracy by Proxy*, WALL ST. J., March 8, 2007, at A16.

340. Lynn A. Stout, *Investors Who Are Too Bolshy for Their Own Good*, FIN. TIMES, Apr. 22, 2007, at 9.

public companies and exert real control. This is a primary motive for the growth of private equity.[341]

Foreign firms and securities markets are also becoming more competitive. America still compares favorably to other countries as a place to invest. "In fact, the U.S. [stock] market has generated returns at least as high as those of the European and Pacific markets" in every five-year period in the last twenty-five years.[342] However, we cannot be complacent. Better shareholder protection is making many countries more appealing to investors.[343] Now, "the law on shareholder protection in the US is weaker than the law [of several other countries]."[344] Americans are investing more of their money overseas.[345]

C. Stakeholders and Social Responsibility Under Shareholder Primacy

Increasing shareholder power poses no threat to stakeholders (other than CEOs). Pursuit of profit motivates shareholders to treat

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341. *See* Lucian Arye Bebchuk, *Symposium on Corporate Elections* 17 (Nat'l Center of Econ. Res., Harvard Law Sch., Discussion Paper No. 448, Nov. 2003), *available at* http://ssrn.com/abstact=471640 (claiming that excessive executive compensation in public companies in effect imposes a 10% annual tax on shareholder and offering this as an explanation for the growth of private equity).

342. Holmstrom & Kaplan, *supra* note 180, at 9. The performance was not limited to financial markets: from 1992 to 2000, "growth in GDP per capita was greater in the U.S. than in France, Germany, Great Britain, or Japan." *Id.* at 10.

343. *See* Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUD. 17, 30–33, 43 (2007) (concluding, through the use of "leximetrics," that Germany, France, United Kingdom, and India have stronger shareholder protection laws than the United States); Eric Pan, *Why the World No Longer Puts Its Stock in Us* 1–3, 11–12 (Benjamin N. Cardozo Sch. of Law, Working Paper No. 176, 2006), *available at* http://ssrn.com/abstract=951705 (stating that U.S. markets are no longer unique; foreign competition is growing and fewer foreign companies are using U.S. equity markets). In general, there is a world-wide trend toward the shareholder primacy model. *See* Marc Goergen et al., *Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe*, 21 OXFORD REV. ECON. POL'Y 243, 243–44 (2005); Kamar, *supra* note 50, at 1757–58 (describing a "trend toward shareholder protection" in the European Union).

344. Lele & Siems, *supra* note 343, at 43 (comparing the law of the United States, the United Kingdom, Germany, France, and India). Colin S. Melvin, director of corporate governance for a large British money manager, says that "the U.S. is probably one of the most difficult environments" for shareholders "to work with companies to improve corporate governance." Gretchen Morgenson, *Belated Apologies in Proxy Land*, N.Y. TIMES, Aug. 20, 2006, § 3, at 1. By measures developed by the World Bank, the United States now ranks below average in investor protection. *See* SIMEON DJANKOV ET. AL, THE LAW AND ECONOMICS OF SELF-DEALING 52–80 (2006), *available at* http://www.doingbusiness.org/documents/Protecting-Investors-Self-Dealing.pdf; *see also No Deomocracy, Please, We're Shareholders*, THE ECONOMIST, May 1, 2004, at 13 (stating that shareholder democracy is weaker in the United States than in the United Kingdom).

345. *See* Pan, *supra* note 343, at 9–11.

employees fairly.[346] Shareholder primacy would not increase corporate lawbreaking.[347] Shareholder primacy could reduce corporate philanthropy as directors become less free with the shareholders' money. However, the decline should be minor—"independent" boards tend to serve CEOs, not the public interest.

In fact, shareholder primacy will benefit society generally. Rising corporate profits and dividends mean higher tax receipts. Greater business efficiency and innovation will be pursued for the benefit of shareholders, but through the "invisible hand" this will expand the economy, bringing higher wages and better goods and services at lower prices.[348] Peter Kostant, a fan of the TPM, discusses corporate governance in terms of Rawls's concept of fairness.[349] Standing behind Rawls's "veil of ignorance," a rational person would choose shareholder primacy over other governance models because it benefits everyone (except CEOs). Kostant decries the excessive political power of CEOs[350] and praises the TPM's potential to curb CEOs.[351] In fact, "independent" boards do not curb but magnify CEO power. Even progressives should prefer shareholder primacy, which really reins in CEOs.

D. *Shareholder Nominating Committees*

A principal obstacle to shareholder primacy is that a corporation's "official" nominees for election to the board are chosen by a committee of incumbent directors.[352] Since most boards are dominated by the CEO, most committees choose nominees who, like themselves, accept CEO primacy. In this system, legislation cannot create true board independence but only reduce formal contacts.

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346. *See supra* note 118 and accompanying text.

347. There are a growing number of large private companies in which the board is chosen by one or a few dominant shareholders. *See supra* note 338 and accompanying text. Nonetheless, all the recent scandals over false financials and back-dating and spring-loading of executive stock options have involved public companies with a majority of "independent" directors. *See supra* note 100. Director "independence" obviously does not reduce law-breaking, and may increase it. *See supra* notes 158–82 and accompanying text.

348. *See* Michael Bradley et al., *The Purpose and Accountability of the Corporation in Contemporary Society*, 62 LAW & CONTEMP. PROBS. 9, 36–38 (1999) ("[M]aximizing the residual claim of a public corporation in turn maximizes the claims of all stakeholders . . . ."); McIntosh, *supra* note 108, at 68 (stating that shareholder wealth maximization is the goal that is "likely, *in the greatest number of cases* to result in global wealth maximization").

349. Kostant, *supra* note 2, at 698–99.

350. *Id.* at 680, 695.

351. *Id.* at 671.

352. *See* Cai et al., *supra* note 72, at 6 n.8 ("Under NYSE rules after SOX, the nomination committee, comprised entirely of outside directors, is charged with identifying qualified board candidates.")

The best way to make directors responsive to shareholders is to have them chosen *by* the shareholders. Accordingly, I have proposed that official nominees for the board be chosen by a committee comprising the ten to twenty largest shareholders.[353] I will not repeat my prior argument for this proposal, but merely address concerns about it that might be intensified by the growing power and activism of institutional investors. First, the need to gain a majority vote on this committee for any nominee would virtually preclude the selection of nominees expected to serve the special wishes of one or a few shareholders (like a union or state pension fund).

Could committee members plot a pump-and-dump scheme in which their lackeys on the board have the firm spread misleading news so as to raise its stock price and allow committee members to sell their stock at an inflated price? This would require cooperation from dozens of directors and officers risking severe civil and criminal penalties, all of whom would presumably demand rich compensation. Small incidents of insider trading often go undetected, but a campaign of this magnitude would be almost impossible to execute without discovery. Knowing that only one conspirator would have to blow their cover to inculpate all, prudent people would refuse to help. More generally, the only corporate goal likely to command support from a majority of the members of the committee would be maximization of share price.

Individual committee members might hope to profit from self-dealing. However, the interest of any director in a transaction must be disclosed to the other directors.[354] Apart from concerns about legality, directors would resist any action that would injure their reputations and chances for more or better directorships. In the current reign of CEO primacy, directors polish their reputations by toadying to the CEO. Under shareholder primacy, directors would cultivate a reputation for serving investors by maximizing share value. Efforts of committee members to extract inside information from directors would fail for similar reasons.

Of course, corruption infects every system that relies on fallible humans. With shareholder nominating committees, however, self-dealing, insider trading, and stock manipulation should be no greater than they are now, if only because the logistics would be more complicated for committee members

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353. *See* Dent, *supra* note 169, at 67–75.

354. *See* CLARK, *supra* note 208, at 171–72 (stating that director must disclose at least the underlying facts of a self-interested transaction).

than they are for the inside officers who now dominate corporations. Other problems, like excessive, poorly designed executive compensation, perquisites, and management slack should shrink under shareholder nominating committees. In sum, the proposal offers to investors higher share prices and to the overall economy greater efficiency and international attraction of more capital.

VI. CONCLUSION

The director primacy and team production models of corporate governance offer false descriptions of current reality—independent boards do not control most public corporations now, CEOs do. CEO domination exacts a huge toll on stock values. Some of this lost wealth is diverted to executives; much of it is simply lost through inefficiency. Little or none of it trickles down to other stakeholders.

The impotence of outside directors does not stem from personal failings or from legislative neglect. Over many decades laws have been amended repeatedly in an effort to increase board independence, but these efforts have only removed formal affiliations between managers and outside directors; they have increased board independence little or not at all. Further amendments are unlikely to be more successful. Accordingly, we can either resign ourselves to CEO domination or transfer power to shareholders. Shareholders want to maximize share value, a goal that generally coincides with maximizing industrial efficiency. Pursuit of that goal will generally benefit other corporate constituencies and society as a whole. Certainly, it will not make stakeholders worse off than they are now.

How can shareholder primacy be realized? We should at least revise rules that hinder cooperation among shareholders and accumulation of large blocks of stock.[355] Directors should be more readily held accountable in shareholder litigation.[356] Good directors will not be deterred from serving on boards or from taking rational risks by rules expecting them to act with minimal care and competence. Any legitimate concerns about frightening them can be addressed by limiting the personal liability of directors or eschewing it altogether and resorting to equitable relief.

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355. *See supra* notes 217–20 and accompanying text.

356. *See supra* notes 229–32 and accompanying text (discussing current hindrances to shareholder suits).

Ultimately, shareholders should have a major, if not dominant, role in choosing the board. I have urged that nominees for the board of each public company be chosen by a committee comprising its largest shareholders.[357] Others have suggested reforms that are more modest but point in the same direction.[358] For now, there should be a consensus to increase shareholder influence. We cannot be certain of our final destination, the precise recipe for optimal corporate governance, but we know the general direction in which we should head.

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357. *See supra* note 353 and accompanying text.

358. *See* MONKS & MINOW, *supra* note 67, at 168 (urging the creation of shareholder committees to "exercise control over the board's priorities and composition"); Bratton, *supra* note 100, at 1337 (arguing there is a need for independently nominated directors); William B. Chandler, III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 999–1000 (2003) (urging access to corporate proxy machinery for insurgents with significant support); Gordon, *supra* note 100, at 1243 (proposing a new category of "trustee directors" for audit committees and certain other roles); Rock, *supra* note 116, at 490–504 (describing and praising past use of shareholder advisory committees). It is unclear, however, how effective more modest reforms are likely to be. *See* Michael S. Weisbach, *Optimal Executive Compensation vs. Managerial Power: A Review of Lucian Bebchuk and Jesse Fried's Pay Without Performance: The Unfulfilled Promise of Executive Compensation* 14 (Nov. 14, 2006) (unpublished working paper), *available at* http://ssrn.com/abstract=939785 (disagreeing with Bebchuk and Fried's argument that "managers effectively set their own pay subject to an outrage constraint").