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# Corporate Governance: Still Broke, No Fix in Sight

George W. Dent, Jr.\*

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## I. INTRODUCTION

Dissatisfaction with the governance of public companies is as old as the public company itself, but public concern about corporate governance is spasmodic. When the stock market booms, as in the 1990s, investors are merrily engrossed counting their profits and don't fret about governance. When stocks crash amid an epidemic of corporate scandals, as in 2001, public fury erupts and demands change. To calm the storm, Congress, the Securities and Exchange Commission (SEC), and the stock exchanges make elaborate pretenses to effect bold solutions. With luck, stock prices revive and investors relax until the next crash. By then, the old troupe of legislators and regulators has been replaced by a new cast.

The crash and scandals of 2001 show that prior reforms did not cure the ills of corporate governance, and there is little reason to think that the recent spate of reforms will be any more effective. Despite a partial recovery of stock prices, many symptoms of the underlying disease persist, including excessive executive compensation, empire building by managements, and entrenchment of incumbents against unwanted takeovers. Unfortunately, investors seem to have been mollified by the recent reforms, and even these inadequate measures may be emasculated by the management lobby.

The fundamental problem of corporate governance remains what it has always been: the separation of ownership and control. No reform can succeed unless it overcomes this contradiction. Corporate executives are determined to preserve their privileges and a number of scholars deny this claim; in effect, these Panglosses consider the status quo the best of all possible worlds. Others recognize that corporate governance is broken and that initiatives recently instituted or proposed are inadequate. Several have proposed changes, some of which would be beneficial, but none promises to eliminate the separation of ownership and control.

The stakes in the corporate governance conflict are high. The loss in equity values from separation of ownership and control is hard to gauge but certainly amount to trillions of dollars.<sup>1</sup> This waste discourages public ownership. Robert Monks estimates that excessive executive compensation alone effectively imposes a 10% tax on shareholders and that this cost is spurring investors to flee into private equity.<sup>2</sup> The losses borne by employees and customers are even harder to calculate. However, employment and wages tend to grow faster and prices tend to be lower at more profitable firms, so the costs of inefficient corporate governance to these other constituencies are certainly substantial.

The problems of corporate governance should not be overstated:

Despite the alleged flaws in its governance system, the U.S. economy has

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1. The loss in equity values from staggered boards alone has been estimated at \$350 billion. *See infra* note 44.

2. Symposium on Corporate Elections 17 (Lucian A. Bebchuck ed., Ctr. For Law, Econ. & Bus., Discussion Paper No. 448, 2003), available at <http://ssrn.com/abstract=471640> (comments of Robert Monks); *see also* Michael Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61 (claiming that "[t]he 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").

performed very well, both on an absolute basis and particularly relative to other countries. 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, including the period since the scandals broke. In other words, the broad evidence is not consistent with a failed system. If anything, it suggests a system that is well above average.<sup>3</sup>

Nonetheless, we should not be complacent. The threat to the American economy from poor corporate governance is greater now than ever. Formerly, capital flows were obstructed by national barriers, and only a few industrialized countries offered an attractive investment climate. Financial markets are now global and many formerly undeveloped third-world nations compete for capital. If American companies are wasteful, investors will ship their money elsewhere, with dire consequences to employment and economic growth in America.

Part II of this article describes the corporate governance debate. Part III explains why the separation of ownership and control is the problem of corporate governance and why past reforms have failed. Part IV discusses the reforms instituted and proposed after the recent scandals and why they too will fail. Part V urges a means of finally solving the problem of corporate governance.

## II. THE PROBLEM OF CORPORATE GOVERNANCE

The debate over corporate governance waxes and wanes counter to the fortunes of the stock market. The bull market of the 1920s abruptly ended with the crash of 1929, which ushered in the Great Depression. Congress adopted the Securities Act of 1933 and the Securities Exchange Act of 1934, which forbade fraud and required broad disclosure in securities trading and proxy solicitations by public companies.<sup>4</sup> Although these laws influenced corporate governance, direct regulation was left to the states. Subsequent market breaks triggered new federal laws, but the core of corporate law remained the preserve of the states. Federal law did not, and was not designed to, end the separation of ownership and control.

With general prosperity after 1945 investors lost interest in corporate governance. The economic stagnation of the 1970s and early 1980s revived their concern. A loose consensus emerged in support of the monitoring model of governance, which posited that separation of ownership and control can be remedied by installing a board of independent outside directors to choose the best managers, give them compensation with incentives to perform well, prevent self-serving conduct by management, and replace managers who do not pan out.<sup>5</sup> Although the monitoring model was largely precatory, not legally mandated, it gradually exerted great influence. Most public companies now have boards

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3. Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 15 J. APP. CORP. FIN. 8, 8 (2003).

4. See generally Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77zz-3); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78nn).

5. See MELVIN EISENBERG, *THE STRUCTURE OF THE CORPORATION* 162-70 (1976) (offering an early plug for the monitoring model); AM. LAW. INST. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Am. Law Inst. 1992) (generally advocating a monitoring model).

with majorities of outside directors and several “overview” committees comprised primarily of outside directors to deal with the firm audit, executive compensation, and director nominations.

The market boom of the 1990s kept investors happily busy counting their money; perhaps the corporate governance problem was solved. In 2001, though, the stock market plummeted. Most share prices fell, especially in technology stocks, but investor fury focused on a few corporate scandals involving shocking misconduct. Congress, the stock exchanges, and the SEC all responded to investor outrage with new regulations designed to prevent such fiascos rather than alter the general rules of corporate governance.

Congress enacted the Public Company Accounting Reform and Investor Protection Act of 2002, popularly referred to as the Sarbanes-Oxley Act (SOX).<sup>6</sup> Because many recent scandals involved false financial statements, Congress required CEOs and CFOs to certify the accuracy of financial statements to their best knowledge.<sup>7</sup> Because corporate lawyers and auditors had failed to detect or divulge the shenanigans, SOX imposed rules to strengthen auditor independence and to demand more assertive action by lawyers who learn of corporate misconduct.<sup>8</sup> The most direct intrusion into corporate governance is the requirement that certain actions be approved by an audit committee of the corporate board consisting entirely of independent directors.<sup>9</sup> The New York Stock Exchange (NYSE) and the NASDAQ also adopted rules giving a greater role to independent directors of listed companies.<sup>10</sup>

The stock market bottomed out and the economy’s recession ended in 2002; both have since managed modest recoveries, although share prices remain well below their pre-crash highs. Once again there is hope that the corporate governance problem has been conquered.<sup>11</sup> Sober analysis suggests, however, that while the symptoms of defective corporate governance have moderated, the disease has not been cured. As Paul MacAvoy and Ira Millstein have put it: “there is a governance mechanism in the engine of the corporation that is broken . . . [T]he board was not functioning as agent for investors.”<sup>12</sup>

### III. THE SEPARATION OF OWNERSHIP AND CONTROL

#### A. Managerial Domination

In 1932 Adolph Berle and Gardiner Means proclaimed in their groundbreaking *The Modern Corporation and Private Property*<sup>13</sup> that a major problem of capitalism was the

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6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

7. *Id.* § 404 (requiring CEOs and CFOs to certify certain 1934 Act filings).

8. *Id.* § 307.

9. *Id.* §§ 204, 301.

10. See NYSE, Inc., Listed Company Manual § 303(A)(3) (2005), available at <http://www.nyse.com/frameset.html?displayPage=/listed/1022221393251.html>; NASD, Inc. Manual Rule 4350(c) (2006), available at <http://nasd.complinet.com/nasd/display/index.html>.

11. For example, the Business Roundtable, the mouthpiece of the corporate establishment, trumpets the growing number of companies that follow “best practices” in corporate governance. *Business Roundtable Reports Progress in Governance*, 8 Corp. Governance Rep. (BNA) 42 (Apr. 4, 2005).

12. PAUL W. MACAVOY & IRA M. MILLSTEIN, *THE RECURRENT CRISIS IN CORPORATE GOVERNANCE* 7, 9 (2003).

13. See ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE*

separation of ownership and control: that is, public companies were not controlled by their owners, the shareholders, but by the managers, the supposed agents of the shareholders. Managers often exerted their control to benefit themselves, not shareholders. Business executives and their minions often deny this thesis. They have resisted all recent reform initiatives by declaring that corporate governance is fundamentally sound; only minor tinkering is needed, and corporations are doing this on their own.<sup>14</sup> This claim is untenable.

First, CEOs influence, if not dominate, the composition and operations of corporate boards. New directors are typically chosen on the CEO's recommendation.<sup>15</sup> Most CEOs can at least veto nominations to the board, and they exclude anyone who might "rock the boat."<sup>16</sup> Directors so chosen naturally feel beholden to the CEO who approved them.<sup>17</sup> Most outside directors come from a small elite of current or former CEOs of other companies.<sup>18</sup> As outside directors they tend to give the CEO the same deference that they want from outside directors on their own boards.<sup>19</sup> They are wealthy, so they don't need the compensation, and fighting lonely and futile battles against a CEO is not most people's idea of a good time. Accordingly, if perchance an invitation is issued to someone who does not expect to go along with the CEO, the candidate will probably decline the offer.

If independently inclined directors nonetheless sneak onto the board, the traditions and atmosphere of the board discourage those inclinations and encourage "groupthink." Warren Buffett criticizes the prevalence of "an excessively cozy 'boardroom atmosphere.'"<sup>20</sup> As one director put it: "Being on a board was like having a merit badge.

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PROPERTY (1932).

14. See *Business Roundtable Reports Progress in Governance*, supra note 11, at 42 (painting a rosy picture of the state of corporate governance); David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1028-29 (2000) (stating that corporate governance is working for investors now). Others make the similar argument that no further changes should be made until recent reforms have been given time to work. See *infra* note 61 and accompanying text.

15. See ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 178 (2d ed. 2001); Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1835 (1999) (finding direct CEO involvement in selection of directors in 47% of corporations studied); James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60, 77 (1995).

16. See Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95, 100 (2003) ("Even a nominating committee composed entirely of independent directors is not likely to choose a candidate put forward by shareholders . . . unless the candidate is already known personally . . . as someone . . . who would 'not rock the boat.'").

17. See Nell Minow & Kit Bingham, *The Ideal Board*, in ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 496, 497 (1995) ("Even the ablest and most honorable directors are inevitably influenced by the 'dance with the one who brought you' syndrome. 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.").

18. See Gerald F. Davis et al., *The Small World of the American Corporate Elite, 1982-2001*, 1 STRATEGIC ORG. 301 (2003).

19. See Allen Kaufman et al., *The Managerial Power Thesis Revised: CEO Compensation and the Independence of Independent CEO Directors* (unpublished manuscript) (Mar. 3, 2005), available at <http://ssrn.com/abstract=678381>.

20. Letter from Warren Buffett, CEO of Berkshire Hathaway, to Berkshire Hathaway Shareholders (Feb. 21, 2003), available at <http://www.berkshirehathaway.com/message.html>. See also James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*,

You'd fly in for a dinner, pat the CEO on the butt and fly out."<sup>21</sup> Outside directors fear that they must go along with management in order to be re-nominated.<sup>22</sup> And, in any case, a director who does not enjoy backing the CEO will probably resign.

Most boards meet about once a month and do not have their own staff. Accordingly, management sets the agenda; the board does not initiate, it only reacts. Even in its monitoring function the board is hampered by its limited time and information.<sup>23</sup> Outside directors cannot match the managers' knowledge of the firm, and in reviewing management proposals the board must rely on the information management deigns to give. These conditions led Peter Drucker, dean of business management theorists, to dismiss outside directors as figureheads.<sup>24</sup>

Some argue that the states seek corporate franchise fees by offering the best corporate law. This incentive creates a "race to the top" among the states that guarantee optimal treatment of investors.<sup>25</sup> However, this market has serious barriers to entry, so it is doubtful that other states try very hard to challenge Delaware's dominance.<sup>26</sup> Certainly it is naive to assume that the abundant evidence of serious problems with corporate governance must be illusory because of a hypothetical but unconfirmed race to the top.

CEO domination of corporate boards may have eased somewhat in the 1980s because of the proliferation of successful tender offers.<sup>27</sup> However, as SEC Chairman William H. Donaldson has declared:

Over the past decade or more, the chief executive position has steadily increased in power and influence. In some cases, the CEO has become more of a monarch than a manager. Many boards have become gradually more deferential to the opinions, judgments and decision of the CEO and senior

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L. & CONTEMP. PROBS., Summer 1985, at 83, 99-108; Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, 38 WAKE FOREST L. REV. 911, 930 (2003) (quoting the Warren Buffett letter); Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 37-49 (1981).

21. PATRICK A. REARDON, *HARD LESSONS FOR MANAGEMENT, DIRECTORS AND PROFESSIONALS* 130 (2003) (quoting Robert H. Campbell, former chairman and CEO of Sunoco).

22. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 874-75 (1991).

23. See MELVIN EISENBERG, *THE STRUCTURE OF THE CORPORATION* 141-43 (1976).

24. PETER 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).

25. See Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 30; Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

26. See Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 563, 570-71, 581 (2002); see also Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Top/Bottom* (Univ. of Utah, Leg. Stud. Paper No. 05-09, 2005), available at <http://ssrn.com/abstract=662261> (questioning whether there is a race to either the top or the bottom).

27. This is suggested by an increase in CEO turnover and in the hiring of new CEOs from outside the firm between 1971 and 1994. See Mark R. Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265 (2001). Some believe that turnover has further accelerated recently and infer an "increase in the board's power vis-à-vis the CEO." Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for Compensation: Discussion and Analysis*, 30 J. CORP. L. 695 (2005).

management team.<sup>28</sup>

### B. The Effects of Managerial Domination

Despite the foregoing, some still deny that managers dominate corporate boards. More important, even if management domination exists, it is not necessarily a problem. Perhaps public corporations strive to serve shareholders by maximizing share value. However, there is abundant evidence that corporations often operate for the benefit of their managers, not their shareholders.

For one, executive compensation has exploded since 1990<sup>29</sup> and is now frequently excessive and poorly designed to motivate executives to maximize share value, as recently documented by Lucian Bebchuk and Jesse Fried in *Pay without Performance*.<sup>30</sup> Some defended the meteoric rise of executive compensation in the 1990s on the ground that equity values had also mushroomed and that executive pay had become more tightly tied to performance.<sup>31</sup> However, when profits and equity prices fell from 2001 to 2003, executive compensation continued to grow. Moreover, as Bebchuk and Fried show, in many companies executive compensation is not tied to performance.<sup>32</sup> One study actually finds a *negative* correlation between compensation and managerial performance

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28. William H. Donaldson, Chairman, SEC, Remarks at the 2003 Washington Economic Policy Conference (Mar. 24, 2003), available at <http://www.sec.gov/news/speech/spch032403whd.htm>; see also Holmstrom & Kaplan, *supra* note 3, at 17 (stating that the earlier decline of CEO entrenchment may have been reversed since 1994 by the institution of takeover defenses); Millon, *supra* note 14, at 1023 (stating that outside directors tend to defer to the CEO); Troy A. Paredes, *Enron: The Board, Corporate Governance and Some Thoughts on the Role of Congress*, in ENRON: CORPORATE FIASCOES AND THEIR IMPLICATIONS 495, 504-05 (Nancy B. Rapaport & Bala G. Dharan eds., 2004) [hereinafter CORPORATE FIASCOES] (stating that “the CEO has assumed an ever-dominant role in the corporation, culminating in what people have begun to refer to as the ‘imperial’ CEO”); D. Quinn Mills, *Paradigm Lost: The Imperial CEO*, DIRECTORS & BOARDS, June 22, 2003, at 41 (exhorting boards to curb the power of CEOs); Allen Kaufman et al., *A Team Production Model of Corporate Governance Revisited* 6 (George Wash. Univ., SMPP Working Paper No. 03-03, 2003), available at <http://ssrn.com/abstract=410080> (stating that CEOs have become more powerful).

29. See John E. Core et al., *Is U.S. CEO Compensation Insufficient Pay Without Performance?* 44-45 (Vand. L. & Econ. Research Paper No. 05-05, 2004), available at <http://ssrn.com/abstract=648648> (giving data on growth of CEO compensation); see also Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL’Y. 283 (2005).

30. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004). See also MACAVOY & MILLSTEIN, *supra* note 12, at 75 (stating that executive compensation was “out of line” by the end of the 1990s); Lucian Arye Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits* (Harvard Law & Econ. Discussion Paper No. 487, 2004), available at <http://ssrn.com/abstract=583861> (stating that many companies camouflage deferred compensation so that investors have difficulty calculating actual compensation); M.P. Narayanan & Hasan Nejat Seyhun, *Do Managers Influence Their Pay? Evidence from Stock Price Reversals Around Executive Stock Options Grants* (Jan. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=649804> (showing that some firms issue stock options on a back-date basis, picking a past date with a lower stock price than that on the decision date).

31. See Holmstrom & Kaplan, *supra* note 3 (based on statistics through 2001). Holmstrom and Kaplan concede, however, some problems with executive compensation: growing stock and stock option ownership encourages managers to manipulate accounting numbers; much executive compensation is too liquid; and “the size of some of the option grants has been far greater than what is necessary to retain and motivate.” *Id.* at 12-13.

32. BEBCHUK & FRIED, *supra* note 30, chs. 10-14.



in large firms with no large shareholders!<sup>33</sup> Excessive compensation also correlates with weak shareholder rights.<sup>34</sup>

Self-dealing by executives is also common and is damaging to their corporations.<sup>35</sup> Public companies provide more sumptuous executive perquisites, like luxurious facilities, large support staffs, and corporate jets, than do comparable non-public firms.<sup>36</sup> Some perquisites are difficult to recognize at all. For example, when corporate headquarters are relocated they are usually moved closer to the CEO's home despite some evidence that these moves impair corporate performance.<sup>37</sup>

In economic theory corporate funds should be distributed to shareholders unless the company can invest them with a reasonable expectation of a market rate of return or better. In practice, though, managers reinvest corporate funds even when they lack promising projects.<sup>38</sup> Thus returns on reinvested earnings are low; some studies find that they approach zero.<sup>39</sup> Managers even support double taxation of corporate earnings, despite its high costs to investors, because ending double taxation would fuel demands that earnings be paid out unless managers had promising projects to finance.<sup>40</sup> Managers are more risk-averse than shareholders so they capitalize companies conservatively. Despite the favorable tax treatment of debt, managers assume no more debt than the firm can handle. This furthers the managers' goal of corporate growth. Growth increases prestige and is used to justify higher compensation and perquisites.<sup>41</sup> It allows the CEO

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33. Robert Daines et al., *The Good, the Bad, and the Lucky: CEO Pay and Skill* (Aug. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=622223> (stating that some former defenders of the levels of executive compensation now believe that "the governance system itself is corrupted and tilted in the direction of management in a way that will almost inevitably lead to excesses in executive pay levels"). See also Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 20-21 (Harvard NOM Working Paper No. 04-28, 2004), available at <http://ssrn.com/abstract=561305>.

34. Porsnit Jiraporn et al., *CEO Compensation, Shareholder Rights, and Corporate Governance*, 29 J. ECON. & FIN. 242 (2005).

35. See Elizabeth A. Gordon et al., *Related Party Transactions: Associations with Corporate Governance and Firm Value* (Aug. 2004) (European Fin. Ass'n 2004 Maastricht Meetings Paper No. 4377), available at <http://ssrn.com/abstract=558983> (finding that self-dealing is common and harmful, especially where corporate governance is weak).

36. See WILLIAM A. MCEACHERN, *MANAGERIAL CONTROL AND PERFORMANCE* 65-66, 80, 86-87 (1975) (reviewing prior literature).

37. See WILLIAM H. WHYTE, *CITY: REDISCOVERING THE CENTER* 287-97 (1989) (noting that of 38 firms that left New York City in the period studied, 31 moved within eight miles of the CEO's home, but those firms lagged in economic performance behind those that stayed).

38. See Diane K. Denis, *Twenty-Five Years of Corporate Governance . . . and Counting*, 10 REV. FIN. ECON. 191, 195 (2001) (discussing management's incentive to make bad investment decisions); William J. Rafael F. La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1168 (2002) (concluding that "poor shareholder protection is penalized with lower violations").

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

40. See Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 336 (1995) (stating that "managers may prefer to lobby for other tax measures . . . that may be less advantageous to shareholders").

41. See Richard A. Lambert et al., *The Structure of Organizational Incentives*, 38 ADMIN. SCI. Q. 438, 441-42 (1993) (empirically verifying the ability of many CEOs to inflate their own compensation); Rudiger

to reward loyal underlings with promotions.<sup>42</sup> An egregious aspect of this “empire building” is unprofitable acquisitions: on average, purchasers realize no profit from acquisitions.<sup>43</sup> Finally, corporations deploy takeover defenses despite the damage they do to share values. The harm from staggered boards and poison pills has been documented.<sup>44</sup> In general, managerial entrenchment is associated with lower firm value<sup>45</sup> and higher CEO compensation.<sup>46</sup> Most firms retain their takeover defenses even when shareholders vote to request their removal.<sup>47</sup>

The foregoing claims are sometimes construed as a charge of managers’ bad faith; the alleged charge is then denied. Self-serving behavior does not necessarily stem from venality, though. Most people are optimistic and think well of themselves.<sup>48</sup> Managers are no exception.<sup>49</sup> Even when acting in good faith they are likely to exaggerate the benefits of growth and of their own value to the company.

The most touted evidence of persistent problems with corporate governance is the

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Fahlenbrach, *Shareholder Rights and CEO Compensation* (Univ. of Pa. Inst. for Law & Econ., Research Paper 03-05, 2004), available at <http://ssrn.com/abstract=390144> (demonstrating that weak shareholder rights correlate with higher CEO compensation and faster increases in CEO compensation).

42. See WILLIAM J. BAUMOL, *ECONOMIC THEORY AND OPERATIONS ANALYSIS* 383-85 (4th ed. 1977); GORDON DONALDSON, *MANAGING CORPORATE WEALTH: THE OPERATION OF A COMPREHENSIVE FINANCIAL GOALS SYSTEM* 37 (1984); OLIVER WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

43. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 614 n.5 (2002) (stating that “studies of acquiring companies stock performance report results ranging from no statistically significant stock price effect to statistically significant losses” (citation omitted)); 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.

44. See Lucian Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 430 (2005) (finding that staggered boards are associated with significantly reduced firm value). See generally Lucian Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003); Kenneth A. Borokhovich, et al., *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495 (1997) (showing that takeover defenses are associated with higher subsequent agency costs and poor performance).

45. Lucian Arye Bebchuk et al., *What Matters in Corporate Governance?* (Harvard Law Sch. John M. Olin Ctr., Discussion Paper No. 491, 2004), available at <http://ssrn.com/abstract=593423> (showing that a six-factor entrenchment index is associated with significantly lower firm value).

46. BEBCHUK & FRIED, *supra* note 30, at 85-86. See also Marianne Bertrand & Sendhil Mallainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND. J. ECON. 535 (1999); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 144-45 (2003).

47. In 2003, 84 shareholder proposals seeking rescission of, or shareholder approval for, poison pills came to a vote; 63 received majority support. In 2004, as of October 29, 48 such proposals had come to a vote; 41 received majority support. Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 26-27 (2004).

48. See generally CHOICES, VALUES, AND FRAMES (Daniel Kahneman & Amos Tversky eds. 2000); HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT (Thomas Gilovich et al., eds. 2002); Simon Gervais & Terence Odean, *Learning To Be Overconfident*, 14 REV. FIN. STUD. 1 (2001); J.B. Heaton, *Managerial Optimism and Corporate Finance*, 31 FIN. MGMT. 33 (2002); Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, 60 J. FIN. 2661 (2005); Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

49. See generally Laurie Larwood & William Whittaker, *Managerial Myopia: Self-Serving Biases in Organizational Planning*, 62 J. APPLIED PSYCH. 194 (1977); James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk-Taking*, 33 MGMT. SCI. 324 (1987).

spate of corporate scandals that exploded early in this decade: Enron,<sup>50</sup> WorldCom, Tyco, Adelphia, and ImClone. Defenders of the status quo treat these disasters as aberrations, not evidence of need for general corporate reform. However, the governance of the companies rocked by scandals does not seem to have been atypical. In both the composition and operation of their boards they seem to have followed the accepted “best practices.”<sup>51</sup>

In sum, there is overwhelming evidence that managers of public companies often can and do obtain corporate action that inures to their benefit and to the detriment of shareholders. Moreover, although it is impossible to quantify shareholder rights precisely, they seem to have diminished since 1985.<sup>52</sup>

### C. The Failure of Past Reforms: The Monitoring Model and the “Independent” Board

This state of affairs exposes the failure of past reforms. For over 20 years champions of greater corporate accountability to shareholders have succeeded in instituting rules and instilling attitudes in favor of corporate boards dominated by outside and independent directors. SEC rules require each company to disclose whether its directors are independent and whether its board has various oversight committees with majorities of independent directors.<sup>53</sup> Further, rules of the NYSE and NASDAQ now demand some elements of director independence.<sup>54</sup> As a result, most large public companies now have independent majorities on the full board and on standard oversight committees.

However, these changes have not produced greater accountability to shareholders. Numerous studies have failed to detect any positive correlation between board independence and corporate financial performance;<sup>55</sup> one study actually found a *negative*

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50. For descriptions of the events at Enron, see Jeffrey D. Van Niel, *Enron—The Primer*, in CORPORATE FIASCOES, *supra* note 28, at 3. For discussion of the legal implications of Enron, see generally CORPORATE FIASCOES; AFTERSHOCK: THE PUBLIC POLICY LESSONS FROM THE COLLAPSE OF ENRON AND OTHER MAJOR CORPORATIONS (Christopher L. Cull & William A. Niskanen eds., 2002). See also William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); John C. Coffee, Jr., *What Caused Enron: A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004).

51. See REARDON, *supra* note 21, at 71-72 (stating that under widely accepted criteria Enron had excellent outside directors); Bratton, *supra* note 50, at 1333-34 (stating that Enron’s board followed widely accepted “best practices”); Paredes, *supra* note 28, at 504-05 (“[T]he Enron board was on the scene and, for the most part, taking most of the steps we ask a board to take”). Enron’s directors also owned substantial amounts of its stock. Outside directors on the audit committee owned on average 18,000 shares each. At Enron’s peak share price of about \$83, 18,000 shares were worth over \$1,500,000. See Yaniv Grinstein, *Complementary Perspectives on “Efficient Capital Markets, Corporate Disclosure, and Enron,”* 89 CORNELL L. REV. 503, 507-08 (2004) (providing share ownership figures from Enron’s 2001 proxy statement).

52. See Henry Huang, *Shareholder Rights and the Cost of Equity Capital 3* (Aug. 2004) (unpublished manuscript, on file with author) (stating that “the last two decades have witnessed a trend of restricting shareholder rights at the firm level in the U.S.”). An index of shareholder rights comprising 24 factors has been constructed in Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

53. See SEC Regulation S-K, Items 401(a),(d), 404(a),(b), 17 C.F.R. §§ 229.401(a),(d), 404(a),(b) (2005).

54. See *supra* note 10 and accompanying text.

55. See Lucian Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 63-64 (2003) (discussing empirical literature); Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); David F. Larcker et al., *How Important Is Corporate Governance?* (May 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=595821> (finding little correlation between corporate performance and several common measures of corporate governance quality); Kaufman et al., *supra* note 19, at 8 (stating that after some point a greater number of

correlation. Many directors still have “soft” conflicts of interest despite tightening definitions of “independence.”<sup>56</sup> When Michael Ovitz asked whether the Disney board would approve the lavish contract that CEO Michael Eisner proposed for him, “Eisner laughed, ticking off the various ways that board members were beholden to him, and assuring Ovitz that they would do what he wanted.”<sup>57</sup> And while rules defining independence may be too porous, allowing many conflicts of interest to seep through, they may also be too tight in some ways, barring the best candidates because of relatively minor affiliations.<sup>58</sup>

The lack of progress in corporate governance despite the growing number of independent directors persuaded some that reforms just had not gone far enough. Accordingly, definitions of “independence” were repeatedly tightened and requirements for board independence repeatedly ratcheted up. This effort has continued with the imposition of new requirements in the Sarbanes-Oxley Act.<sup>59</sup> Some argue for further steps in this direction.<sup>60</sup> Others oppose further reform now so that the recent changes have time to work.<sup>61</sup>

This approach is doomed to fail. The fatal flaw is that “independence” can be defined only as absence of affiliation between a director and corporate management. No definition or rule can make directors act zealously for shareholders,<sup>62</sup> and in current

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outside directors is associated with reduced firm performance); Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277, 284-90 (1996). See also Alton B. Harris & Andrea S. Kramer, *Corporate Governance*, in CORPORATE AFTERSHOCK: THE PUBLIC POLICY LESSONS FROM THE COLLAPSE OF ENRON AND OTHER MAJOR CORPORATIONS 49, 76 (Christopher L. Culp & William A. Niskanen eds., 2002) (stating that repeated increases in board independence have not worked).

56. See Paredes, *supra* note 28, at 510-11 (noting that independence is sometimes undermined by corporate charitable contributions to an institution with which a director is affiliated, consulting and other business arrangements between the company and its directors, or personal and social ties). For example, even remote links in board membership between a CEO and outside directors are associated with higher compensation for the CEO. David F. Larcker et al., *Back Door Links Between Directors and Executive Compensation* (Feb. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=671063>. Such soft conflicts seem to have existed at firms recently rocked by scandals. See DAVID SKEEL, *ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM* 164-65 (2005). See generally Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935 (2003).

57. James B. Stewart, *Partners: Eisner, Ovitz, and the Disney Wars*, NEW YORKER, Jan. 10, 2005, at 46, 48.

58. For example, SOX treats Warren Buffett as a “conflicted” member of the audit committee of the board of Coca-Cola, Inc. because he controls companies that do business with Coke. See Edward Iwata, *Businesses Say Corporate Governance Can Go Too Far*, USA TODAY, June 24, 2004, at 1B.

59. See Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

60. See Paredes, *supra* note 28, at 522 (“[T]here are still gaps in the tightened definition of independence in Sarbanes-Oxley.”); J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 376-79 (2004) (proposing tighter federal regulation of self-dealing and a federal mandate for independent nominating committees).

61. See Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 89-90 (2003) (“[I]t seems only prudent to take the time to assess the impact of the far-reaching reforms that have just been adopted.”); Task Force on S’holder Proposals of the Comm. on Fed. Reg. of Sec., Section of Bus. Law of the Am. Bar Ass’n, *Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors*, 59 BUS. LAW. 109 (2003) [hereinafter *ABA Task Force Report*] (*semble*).

62. See MACAVOY & MILLSTEIN, *supra* note 12, at 33 (stating that lack of affiliation is not enough to

circumstances they are unlikely to do so. “Independent” directors cannot know the firm as insiders do. They rarely own much company stock, so they have little personal stake in the stock’s value. To quarrel with management is unpleasant. Going along with the CEO and ignoring share value has no disagreeable consequences, and management has more influence than shareholders over the outside directors’ renomination and reelection.

Similarly, tackling managerial self-dealing with prohibitions is inevitably flawed because definitions of self-dealing are always both under-inclusive and over-inclusive. As an example of the latter, SOX forbids companies to make loans to executives,<sup>63</sup> but loans can be a useful element of compensation. Moreover, SOX has had some absurd consequences. For example, the ban on loans literally bars advances of travel expenses.

Likewise, although takeover defenses are now harmful to shareholders,<sup>64</sup> to ban all shark repellants would be unwise. If directors were truly independent and competent, poison pills might give them time to seek higher bids. Some form of job protection for executives may also benefit shareholders.<sup>65</sup> To get effective boards we need a new approach that gives directors incentives to be zealous and the discretion to adopt wise policies.

#### D. Support for Managerial Domination

##### 1. Traditional Managerialism

Some applaud the separation of ownership and control. In the 1930s Merrick Dodd argued that corporations should serve the public as well as shareholders; accordingly, managers should have discretion to serve the interests of other constituencies and not be beholden to investors alone.<sup>66</sup> As Berle and Means showed, managerialism was an accurate model of how corporate governance actually worked, but its normative appeal was always limited. In response to Dodd, Berle criticized the lack of accountability of managers in the managerialist model. It was unwise, he insisted, to grant managers immense power with little constraint beyond a “pious wish” that something good come of

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assure good director performance); Bebchuk, *supra* note 55, at 49 (“[I]ndependence of directors from the firm’s executives does not imply that the directors are dependent on shareholders or otherwise induced to focus solely on shareholder interests.”); Bratton, *supra* note 50, at 1334 (stating that no standard of independence can guarantee effective effort by directors); Enriques, *supra* note 20, at 927 (arguing that “no definition of independence will ever assure that an independent director will indeed act as such”); Pozen, *supra* note 16, at 98-99 (stating that “formal affiliation to the company” is not what determines the quality of a director).

63. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §402, 116 Stat. 745.

64. See *supra* note 44 and accompanying text.

65. See Sudheer Chava et al., *Do Shareholder Rights Affect the Cost of Bank Loans?* (European Fin. Ass’n, 2004 Maastricht Meetings Paper No. 5061, 2005), available at <http://ssrn.com/abstract=495853> (showing that weak shareholder rights are associated with lower interests rates on bank loans); 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 (2006) (showing that shareholders may benefit from job protections for executives).

66. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). See also Gordon Donaldson, *Financial Goals: Management vs. Stockholders*, HARV. BUS. REV., May-June 1963, at 116; Bayless Manning, *Book Review*, 67 YALE L.J. 1477, 1477 (1958) (reviewing J.A. LIVINGSTON, THE AMERICAN STOCK HOLDER (1952)).

it.<sup>67</sup> Even the American Law Institute eventually embraced the view that the goal of corporate governance was “enhancing corporate profit and shareholder gain.”<sup>68</sup>

## 2. *The Team Production (or Mediating) Model*

A modern variation on managerialism is the team production (or mediating) model of corporate governance.<sup>69</sup> It is sometimes called the director primacy model,<sup>70</sup> but this label is misleading because directors as such do not, and probably cannot, exercise much control.<sup>71</sup> Like the old managerialists, team production theorists argue that boards should mediate among the corporation’s various constituencies.<sup>72</sup> However, the old managerialism stemmed from socio-political concerns: it favored managerial control in order to achieve a socially desirable division between shareholders and other constituencies of the benefits flowing from the corporation. The team production model places more weight on economics.

First, team production theory posits that corporations need non-shareholder constituencies (often called “stakeholders”)<sup>73</sup> to make commitments that would expose them to exploitation by shareholder dominated boards.<sup>74</sup> Unlike shareholders, stakeholders are not diversified; if mistreated, they cannot simply withdraw their commitments as shareholders can by selling their stock.<sup>75</sup> Accordingly, these stakeholders need protection through a corporate governance system that leaves directors broad discretion rather than slavishly pursuing the goal of maximization of share value.

In fact, stakeholders need not fear exploitation by shareholders. Both shareholders and stakeholders generally benefit from the maximization of share price. The most profitable companies tend to offer the best employee compensation and opportunities for promotion.<sup>76</sup> And firms that “contract with their stakeholders on the basis of mutual trust

67. Adolph A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1368 (1932).

68. AM. LAW INST., *supra* note 5, § 2.01.

69. Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm*, in EMPLOYEES AND CORPORATE GOVERNANCE 58, 87 (Margaret M. Blair & Mark J. Roe eds., 1999) (discussing the need to protect the firm from predation by any constituency); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Governance*, 85 VA. L. REV. 247 (1999); Kaufman et al., *supra* note 19.

70. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

71. See *supra* notes 55-62 and accompanying text.

72. See Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 715 (2004) (referring to directors as “mediating hierarchs”).

73. The very definition of the term is problematic. See R. Edward Freeman et al., *Stakeholder Theory and “The Corporate Objective Revisited,”* 15 ORG. SCI. 364, 365 (2002) (“[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 (1997) (finding 27 different definitions of “stakeholder”).

74. See *infra* note 90 and accompanying text.

75. Interestingly, the frequent claim of team production theorists that shareholders are less vulnerable than other stakeholders—because they can withdraw their investment in the company by selling their stock—is contradicted by some team production theorists who defend the corporate form (including the separation of ownership and control) on the ground that it locks in shareholders by preventing them from withdrawing their capital without board action. See *infra* note 209 and accompanying text.

76. See Olubunmi Faleye et al., *When Labor Has a Voice in Corporate Governance* (Nat’l Bureau of

and cooperation . . . will have a competitive advantage.”<sup>77</sup> To mistreat employees, customers, or suppliers would be to impair the shareholders’ own interests.<sup>78</sup> If such exploitation did result from shareholder control, we would see evidence of it after takeovers. However, blue collar employment and wages do not decline after takeovers.<sup>79</sup>

Some team production theorists concede that in both the team production and the shareholder primacy models the goal of corporate governance is the same: to maximize firm value.<sup>80</sup> The only difference is semantic, but “language matters” because it sends “social signals” that induce essential cooperation from stakeholders and also enhance the ethics of team members.<sup>81</sup> It seems doubtful that language matters enough to warrant the major differences in the locus of corporate control that the two theories posit. More important, this analysis begs the question of why shareholders and (manager-dominated) boards clash over executive compensation and disposition of free cash flow. Clearly, investors dislike the status quo defended by team production theorists in ways that go beyond rhetoric.

Contrary to team production theory, shareholders have more reason to fear exploitation than do employees and other stakeholders. Employees have contracts specifying their compensation. True, employees make a commitment to the firm that can reduce the value of their human capital (i.e., their labor) outside the firm, thus exposing themselves to opportunism.<sup>82</sup> However, most employees retain substantial market value for their labor. Indeed, the job skills they acquire often enhance their market value. That is why employers often need non-competition clauses to limit the freedom of employees to switch jobs.<sup>83</sup> Even workers who lack a better alternative opportunity are not defenseless; they can simply slacken in their work. All employers know that a sullen and resentful workforce is less productive and profitable.

Suppliers, customers, and lenders also have ample protections from exploitation.

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Econ. Research, Working Paper No. W11254, 2005), available at <http://ssrn.com/abstract=697179> (stating that labor-controlled public firms grow more slowly and create fewer new jobs than other public firms). See BAINBRIDGE, *supra* note 43, at 420-21 (stating that “pursuit of shareholder wealth maximization often redounds to the benefit of nonshareholder constituencies” and that in a hypothetical bargain among all corporate stakeholders “we would expect a bargain to be struck in which shareholder wealth maximization is the chosen norm”).

77. Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 ORG. SCI. 350, 353 (2002).

78. 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.).

79. See GILSON & BLACK, *supra* note 43, at 625 (citing studies showing that “wages and employment of blue collar workers in plants subject to takeovers declined relative to non-takeover plants prior to the takeover, but grew more quickly after the takeover”). White collar employment may decline after takeovers. See *id.* However, this is probably a result not of mistreatment by the acquirer but of overstaffing as part of the empire building of pre-acquisition management.

80. Margaret M. Blair, *Directors’ Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 900 (2003).

81. *Id.* at 900-08.

82. See Kaufman et al., *supra* note 19, at 13 (noting that since “each member’s skills remain valuable only within the context of the team (and the firm and industry), individuals cannot threaten to quit and join another effort”).

83. See 2 MELVIN F. JAGER, TRADE SECRETS LAW § 13.4 (2005) (discussing the use of covenants by employees not to compete so as to protect the employer from a diversion of confidential information).

Suppliers and customers can demand contractual protection and simply refuse to deal with a company that behaves improperly. Suppliers can also charge more for their inputs. Both can injure a company's reputation—a crucial asset for most firms—by public criticism. Lenders (at least of private debt) insist on “elaborate covenants that give them a large role in the affairs of the corporation.”<sup>84</sup>

Shareholders' exposure is much greater. They have no contractual right to fixed payouts; they get only the residue (if any) that those in control generate and deign to distribute. Only stockholders have “the perspective of the aggregate.”<sup>85</sup> Moreover, the shareholders' input is complete once they buy the firm's stock. An employee can withdraw her input by quitting the firm, but shareholders can't withdraw their capital.<sup>86</sup> That is why equity owners alone elect the firm's directors. If the team production model was valid, employees and perhaps other stakeholders would share that right either by statute or by contract. In fact, they do not.

Team production theory also maintains that shareholders tie their own hands by ceding control to autonomous boards of directors in order to assure other constituencies that they will not be exploited.<sup>87</sup> This is far-fetched. If ceding control were necessary to corporate success, companies with controlling shareholders would not be viable unless those shareholders renounced control and walled themselves off from takeover bids with poison pills. That does not happen. Shareholders who own enough shares to exercise control do so.<sup>88</sup>

Neither do public shareholders voluntarily forswear influence. In particular, they actively fight antitakeover provisions. Team production theorists deny that this behavior belies their claims. They argue that investors welcome poison pills and other “shark repellants” when companies go public.<sup>89</sup> Efforts to remove antitakeover devices, they

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84. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance* 1 (Vanderbilt Law & Econ. Research Paper No. 05-08, 2005), available at <http://ssrn.com/abstract=692023>. See also *id.* at 8 (“These loan agreements define defaults in ways that give creditors as much control over the board and its decisions as shareholders.”).

85. Bayless Manning, *Thinking Straight About Corporate Law Reform*, 41 LAW & CONTEMP. PROBS. 3, 20-23 (1977). See also BAINBRIDGE, *supra* note 43, at 469-70. “[S]hareholders 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.” *Id.* (footnotes omitted).

86. See BAINBRIDGE, *supra* note 43, at 471 (stating that “job mobility” gives some protection to employees). An individual shareholder or the body of shareholders can disinvest by selling their stock to another investor, but the price paid reflects the purchaser's expectations of future payouts. More important, neither individual nor aggregate sales of stock withdraw capital from the company; they simply change the identity of the stockholders.

87. See Bainbridge, *supra* note 70, at 547 (stating that shareholders realize that corporate governance would suffer if they exerted control); 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). Some who do not espouse the team production theory still share its views about the role of the board. See Lipton & Rosenblum, *supra* note 61, at 79 (trumpeting “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”).

88. Institutional investors, especially hedge funds, are increasingly demanding board representation on public companies. See Mara Der Hovanesian, *Attack of the Hungry Hedge Funds*, BUS. WK., Feb. 20, 2006, at 72.

89. See Stout, *supra* note 87, at 698-702.



claim, are simply attempts to renege on the promises implicitly made to other stakeholders.<sup>90</sup> If this thesis were true, shareholders would attack poison pills only after a takeover bid is made. To rescind a pill sooner would cause stakeholders to abandon their commitment to the firm, thereby damaging the firm's share price. In fact, though, investors do battle poison pills even when there is no bid. When they succeed, share price does not fall, and I know of no evidence that rescission causes stakeholders to reduce their commitment to the firm. Investors have reasons to oppose antitakeover provisions apart from exploitation of stakeholders. Companies with strong antitakeover provisions are, for example, more likely to make unprofitable acquisitions.<sup>91</sup>

It is also argued that shareholders tie their own hands in order to avoid fighting among themselves over their conflicting interests and goals. This too is wrong; in fact, the interests of shareholders are remarkably uniform.<sup>92</sup> Claims that investors promote detrimental "short-termism" are also ill-founded.<sup>93</sup> A powerful shareholder presence is actually associated with better corporate financial performance in several respects.<sup>94</sup> Others maintain that institutional investors lack incentives to seek influence in corporate governance.<sup>95</sup> However, investors value shareholder rights, as evidenced by the impact of these rights on share prices.<sup>96</sup> These claims are further belied by the increasing

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90. *Id.* at 705.

91. See Ronald W. Masulis et al., *Corporate Governance and Acquirer Returns* (European Corporate Governance Inst., Working Paper No. 116/2006, 2005), available at <http://ssrn.com/abstract=697501> (reporting an empirical study); see also *supra* note 44 and accompanying text (discussing damage from takeover defenses).

92. See *infra* note 201 and accompanying text.

93. See Ronald J. Gilson, *Separation and the Function of Corporate Law* 9-10 (Stanford Law & Econ. Olin Working Paper No. 307, 2005), available at <http://ssrn.com/abstract=732832> ("[C]ompetition among investors who do not suffer from a short-term bias will drive stock price toward an unbiased level.").

94. See MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 237-38 (1994) (stating that the presence of large block holders often improves corporate performance); Paul Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. ECON. 229 (2001) (finding higher stock returns for companies with large institutional ownership); Thomas Moeller, *Let's Make a Deal: How Shareholder Control Impacts Merger Payoffs*, 76 J. FIN. ECON. 167, 167 (2005) (presenting study showing that "the presence of large outside blockholders . . . is positively correlated with takeover premiums"); Robert Daines et al., *supra* note 33 (showing that firms with large shareholders and high incentive pay tend to perform better); ROE, *supra* (stating that the available evidence strongly suggests that institutional investors are not systematically myopic; investors react favorably to increased firm spending on research and development, and institutional investors hold more than their pro rata share of stocks of R&D-intensive firms). On the other hand, antitakeover devices and other indicia of management entrenchment are associated with poor corporate performance. See Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999) (showing that stringent antitakeover laws weaken managements' incentive to control labor costs); Core et al., *supra* note 65 (describing a study finding that firms with stronger antitakeover provisions have poorer operating performance); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519, 520 (1999) (stating that antitakeover laws "allow managers to pursue goals other than maximizing shareholder wealth"); Masulis et al., *supra* note 91 (study showing negative correlation between the strength of a firm's antitakeover provisions and profitability of its acquisitions).

95. See Gilson & Kraakman, *supra* note 22, at 866 (claiming that diversified investors care only about their total portfolios, not about individual companies); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 474 (1991) (arguing that index funds compete by powering costs and therefore avoid the costs of participating in corporate governance).

96. See Huang, *supra* note 52, at 29 (presenting a study showing that "the level of shareholder rights is significantly associated with the cost of equity capital. Investors perceive the weak shareholder rights as an

activism of institutional investors and the growing support for shareholder proposals to limit antitakeover devices.<sup>97</sup> The activism of institutional investors, though limited, is impressive given the many obstacles it encounters. First, assertive shareholders can provoke CEOs who are jealous of their power and can punish unruly institutions.<sup>98</sup> Second, activism incurs out-of-pocket costs. Since even huge institutions typically own an infinitesimal fraction of the portfolio company's stock, the institutions can hope to cover these costs by increasing the value of the portfolio company's stock only on matters of exceptional financial importance.<sup>99</sup>

The law further hinders shareholder participation in corporate governance. The federal proxy rules treat anything more than de minimis contacts among shareholders as proxy solicitations,<sup>100</sup> which require a filing with the SEC and detailed disclosures.<sup>101</sup> Shareholders who collaborate may incur further duties and liabilities. If they own an aggregate of more than 5% of a company's stock, they may be deemed to be "act[ing] as a . . . group for the purpose of acquiring, holding, or disposing of securities" of the company<sup>102</sup> and therefore required to file disclosure documents with the SEC.<sup>103</sup> They may also become subject to liability as "controlling persons"<sup>104</sup> or as "insiders."<sup>105</sup> They

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important source of potential agency costs and demand higher rates of return accordingly." See also Core et al., *supra* note 65 (showing that analysts weigh shareholder rights in making earnings forecasts).

97. See Randall S. Thomas & James F. Cotter, *Shareholder Proposals Post-Enron: What's Changed, What's the Same?* (Vanderbilt Law & Econ. Research Paper No. 05-30, 2005), available at <http://ssrn.com/abstract=868652> (documenting growing support for shareholder proposals, especially those opposing antitakeover devices).

98. For example, the CEO can withhold information and management fees for the company's pension plan from disfavored institutions. See Pozen, *supra* note 16, at 97; see also Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 826 (1992) (stating that money managers that vote against management "are likely to lose any business that they conduct with the company"); Gerald F. Davis & E. Han Kim, *Would Mutual Funds Bite the Hand That Feeds Them? Business Ties and Proxy Voting* (Feb. 15, 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=667625> (presenting study showing that mutual funds that manage a large volume of pension funds are less likely to vote against management).

99. See Pozen, *supra* note 16, at 96-97 (detailing costs of shareholder activism to investors in terms of money and managerial time).

100. SEC rule 14a-1(l)(1)(iii) defines "solicitation" to include any "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." 17 C.F.R. § 240.14-a1(l)(1)(iii) (2005). There are several exemptions, including Rule 14a-2(b)(2): "any solicitation made otherwise than on behalf of the registrant where the total number of persons solicited is not more than ten." *Id.* § 240.14-a2(b)(2).

101. *Id.* § 240.14a-4 (prescribing the form of proxies); *id.* § 240.14a-6 (prescribing filing requirements). See Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 536-56 (1990) (discussing burdens of proxy rules on shareholder communications); Gilson & Kraakman, *supra* note 22, at 894 (*semble*); ROE, *supra* note 94, at 274 (*semble*).

102. Securities Exchange Act of 1934 § 13(d)(3) (codified as amended at 15 U.S.C. § 78m(d)(3) (2000)).

103. *Id.* § 13(d)(1) (requiring initial filing); *id.* § 13(d)(2) (requiring additional filings "[i]f any material change occurs in the facts set forth in the [previously filed] statements").

104. Securities Act of 1933 ch. 38, 48 Stat. 74, § 15, (codified as amended at 15 U.S.C. § 77o (2000)); Securities Exchange Act of 1934, § 20, (codified as amended at 15 U.S.C. § 78t (2000)).

105. Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (2000) (imposing liability for short-swing trading profits by insiders); and Securities Exchange Act § 20A, 15 U.S.C. § 78t(A) (2000); *id.* § 21A, 15 U.S.C. § 78u(A) (2000); 17 C.F.R. §§ 240.10b-5, 240.10b5-1, 240.10b5-2 (2005) (forbidding trading by insiders on material non-public information).

can also trigger disabilities and liability under poison pills and state antitakeover laws.<sup>106</sup> Nonetheless, there is evidence that, when it occurs, shareholder activism is beneficial to firm performance.<sup>107</sup>

Other Pollyannas make the contradictory claim that investors are content because they already have ample power.<sup>108</sup> This claim is also false, as demonstrated by the support of investors for proposed SEC rule 14a-11.<sup>109</sup> Proxy fights for control are rare, especially in larger public companies.<sup>110</sup> Defenders of the status quo also argue that investors have no cause for complaint because if they are dissatisfied with management of a firm they can sell its stock.<sup>111</sup> The sale price, however, reflects the quality of management. If management is poor, the investor will get a low price.

To the extent that investors accede to management domination it less likely reflects a calculation of their own interests than a concession to the awkwardness and futility of seeking fundamental change. Again, even minor increases in shareholder influence have been hard to obtain, impossible except in times of public outcry triggered by a corporate crisis. Further, although investors do not identify with managers, they do both play in the same business game, a game with age-old rules. To seek more than minor changes in these rules is frowned upon by all the competing teams in this league. Indeed, it is always hard even to think about fundamental changes in habits that have acquired a thick patina of tradition over decades or centuries.

Team production theory champions the “director primacy” of an independent board, but independent directors do not dominate corporate boards now and never have.<sup>112</sup> When managers dominate boards, the team production theory is unworkable. Team production theorists posit that directors will behave altruistically.<sup>113</sup> However, there is no reason to think that managers would exert their power for the benefit of constituencies other than themselves, and there is no empirical evidence that they do so.<sup>114</sup> Team

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106. See Black, *supra* note 101, at 550-51, 556-59.

107. See Christopher Palmeri, *Meet the Friendly Corporate Raiders*, BUS. WK., Sept. 20, 2004, at 102 (describing the success of the Relational Investing fund in pressuring underperforming companies to improve).

108. See Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163, 165 (1991) (stating that “the proxy voting system already provides shareholders with an effective voice in corporate governance”); Lipton & Rosenblum, *supra* note 61, at 92-94 (*semble*); see also RAKESH KHURANA, *SEARCHING FOR A SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* xii-xiii (2002) (claiming that institutional investors have excessive power and use that power to saddle CEOs with “unreasonable expectations” then firing them when they “fail to meet such extravagant expectations”).

109. See Roberta Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Directors?*, 60 BUS. LAW. 1, 10-11 (2004); *infra* notes 141-157 and accompanying text (discussing proposed rule 14a-11).

110. See Bebchuk, *supra* note 55, at 45-46 (concluding that in a seven-year period only about 80 companies had proxy fights for control, and only 10 of those had market capitalization over \$200 million); Lucian Arye Bebchuk, *The Myth of Shareholder Franchise* 7-14 (Oct. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=829804>.

111. See Letter from Henry A. McKinnell, Chairman, Bus. Roundtable, to Jonathan Katz, Secretary., Sec. & Exchange Comm. (Dec. 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/brt122203.htm>.

112. See *supra* note 70 and accompanying text.

113. See Licht, *supra* note 72, at 715 (positing that people’s conduct is “altruistic” in accordance with the principle of “fairness”).

114. Berle and Means recognized this danger. See *supra* note 13 and accompanying text; see also Bebchuk, *supra* note 55, at 59 (“[T]here is no reason to think that reduced accountability to shareholders would translate into increased attention to stakeholders . . . . The interests of directors and executives are even less aligned with

production theorists have offered no technique for producing a board that truly would be independent. Past corporate governance movements dedicated to other constituencies or to the “public interest” have foundered on the same rock.<sup>115</sup> The problem is particularly acute because the interests of other constituencies conflict.<sup>116</sup> Even if some method could guarantee director independence, directors might not exercise their discretion for the benefit of non-shareholder constituencies; they might act for their own benefit.<sup>117</sup> Until this problem is resolved, the team production theory and related models are untenable; shareholder primacy and managerial control are the only options realistically available.

Another claim of team production theorists (shared with many defenders of the corporate establishment) is that many, if not most, shareholders value short-term profits over maximization of long-term share value.<sup>118</sup> Recognizing this reality, the law confirms the weak role of shareholders in corporate governance by making it difficult for them to influence elections to the board or to hold directors liable for actions the shareholders dislike.<sup>119</sup> In fact, however, there is no empirical evidence that myopic shareholder short-termism is “of significant magnitude.”<sup>120</sup> Some investors do stress short-term corporate performance; some investors also focus on astrology or pester managers about obscure social causes. There is no evidence that these groups are more than a small minority with little power.

Critics charge that many investors seek a “short-term pop in the company’s share price,”<sup>121</sup> so that they can bail out before markets realize the firm’s long-term weaknesses. This claim rests on several dubious premises. First, it assumes that securities markets focus on short-term performance. If that were so, it should be easy for rational

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the interest of stakeholders than they are aligned with the interests of shareholders.”); Giovanni Cespa & Giacinta Cestone, *Stakeholder Activism, Managerial Entrenchment, and the Congruence of Interests Between Shareholders and Stakeholders* (Universitat Pompeu Fabra Econ. & Bus. Working Paper No. 634, 2002), available at <http://ssrn.com/abstract=394300>; EISENBERG, *supra* note 5, at 19 (“[I]t is only the shareholders’ role that prevents . . . a de jure self-perpetuating oligarchy.”). For evidence of the self-serving use of managers’ power, see *supra* notes 49-51 and accompanying text.

115. See ROBERT CHARLES CLARK, *CORPORATE LAW* 688-90 (1986) (stating that “social responsibility” advocates have been vague about goals and inconsistent about means); Berle, *supra* note 67, at 1367; William W. Bratton, *Welfare, Dialectic, and Mediation in Corporate Law*, 2 *BERKELEY BUS. L.J.* 59, 73-74 (2005) (stating that past and present critics of shareholder primacy “have never managed to produce an alternative model that surmounts coherence objections and resonates in the context of our social settlement”).

116. See Sundaram & Inkpen, *supra* note 77, at 354. They also do not need a voice on the board because their interests are protected by contract while those of shareholders are not. See *id.* at 355-56.

117. See Millon, *supra* note 14, at 1042; see also Oliver Hart, *An Economist’s View of Fiduciary Duties*, 43 *U. TORONTO L.J.* 299, 303 (1993) (stating that a requirement that management consider all constituencies “[i]s essentially vacuous, because it allows management to justify almost any action on the grounds that it benefits some group”); Licht, *supra* note 72, at 707 (*semble*).

118. See Lipton & Rosenblum, *supra* note 61, at 78 (Some investors “may seek to push the corporation into steps designed to create a short-term pop in the company’s share price.”); Eduard Gracia, *Corporate Short-Term Thinking and the Winner-Take-All Market* (unpublished manuscript), available at <http://ssrn.com/abstract=445260>; *Harvard Symposium on Corporate Elections*, *supra* note 2, at 8 (comments of Martin Lipton) (stating that shareholders pressure managers to maximize quarterly earnings and to exaggerate reported earnings); Rosenbaum, *supra* note 108, at 178 (“[M]ost money managers have an interest in short-term gains, even at the expense of broader or longer term values.”).

119. See Stout, *supra* note 87, at 692-94.

120. *Symposium on Corporate Elections*, *supra* note 2 (comments of Lucian Bebchuk).

121. See Lipton & Rosenbaum, *supra* note 61, at 78.

investors to identify stocks that are over- or under-priced; that does not seem to be the case.<sup>122</sup> Second, it assumes that investors who pressure managers to accentuate the short term plan and are able to bail out before the short-term bubble bursts, which in turn assumes that they know something the rest of the market does not know. No evidence has been offered to support either assumption. Finally, this hypothesis assumes that after these “short-termers” bail out of an overpriced stock they can identify and purchase other stocks that are not overpriced, which in turn assumes that the “short-termers” can consistently outperform the market. Again, no evidence is offered to support these assumptions.

When shareholders do focus on quarterly earnings, it is more an effect than a cause of separation of ownership and control. People pay more attention to daily weather reports than to climate because they can adjust their plans to deal with the weather, but they can do little about climate. Similarly, some investors may stress the short term because they have so little influence over corporate strategy. Even if a firm’s long-term strategy succeeds, investors cannot be sure they will ever see the benefits; managers often fritter away profits on empire-building rather than increasing dividends.<sup>123</sup>

It is unnecessary, though, to refute completely allegations of shareholder short-termism. The question is not whether shareholder attitudes and behavior are perfect, but whether investor control is better than any alternative. Of course, managers often *charge* that investors pressure them to stress the short term, and some may believe these claims, but that does not make the charges true. Indeed, if managers overemphasize the short term it may be for their own benefit, not to obey investor demands.<sup>124</sup> Executives of a poorly performing firm may doctor their reports in order to deflect just criticism from directors and shareholders. In so doing they may also temporarily fool the securities markets, thereby enabling themselves to unload stock and options at inflated prices. Such behavior seems to have been common among executives of companies hit by the recent scandals.<sup>125</sup> When the truth emerges, the stock price plummets. The executives may have bailed out of the stock, but public investors are stuck. They gain nothing from short-term hype unless they are tipped and also bail out; there is little evidence that this happens often.

Short-termism could occur because “managers cannot transmit proprietary, complex,

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122. See GILSON & BLACK, *supra* note 43, at 135 (stating that a corollary of the semi-strong form of the efficient capital markets hypothesis is that “[y]ou can’t consistently beat the market by picking particular stocks that you think are undervalued”).

123. See *supra* note 43 and accompanying text; see also Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 650 (1984) (arguing that waste of free cash flow helps explain the apparent under-pricing of shares of some public companies).

124. See Bratton, *supra* note 50, at 1328 (“Enron’s managers’ obsession with short-term numbers” stemmed in part from “Enron’s performance-based bonus scheme.”); Black, *supra* note 78, at 865 (“Managerial myopia is a serious concern.”); cf. Gracia, *supra* note 118 (ascribing short-termism to globalization and the intensifying competition of the “winner take all” market, not to shareholder pressures).

125. Managers manipulate the timing of 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 (2000); Keith Chauvin & Catherine Shenoy, *Stock Price Decreases Prior to Executive Stock Option Grants*, 7 J. CORP. FIN. 53 (2001); Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005); D. Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997); see generally ROBERT H. TILLMAN & MICHAEL L. INDERGAARD, *PUMP AND DUMP: THE RANCID RULES OF THE NEW ECONOMY* (2005).

and technological information well to distant, atomized shareholders.”<sup>126</sup> If so, however, “[t]he large shareholder would . . . protect managers from outsiders who would second-guess truly profitable long-run investments.”<sup>127</sup> Outside directors currently lack the credibility to reassure investors of the wisdom of management’s strategy.

In sum, then, managers may seek artificially to boost share price temporarily or invest corporate funds in unprofitable empire-building for their own benefit. Outside directors typically own little stock, so they have little incentive to resist these managerial tendencies; they generally defer to management, especially in forming the firm’s business plan. The shareholders’ interest is to maximize (long-term) share price, which coincides with society’s interest in corporations.<sup>128</sup>

Some ascribe a more general irrationality to investors.<sup>129</sup> True, investors are human beings, and humans are not perfectly rational. For that very reason, though, these attacks on shareholder primacy are attacks on a straw man. The question is not whether shareholder primacy is perfect, but whether there is a better alternative. As the current problems of corporate governance show, managerial primacy does not meet that test.<sup>130</sup>

Nor is there any theoretical basis or empirical evidence that shareholder influence inflicts the harm to other corporate constituencies that team production theory predicts. Investors appreciate that abusing other constituencies would rebound to the investors’ detriment. Indeed, “[o]nly residual cash flow claimants have the incentive to maximize the total value of the firm.”<sup>131</sup> On average, employees are not harmed by leveraged buyouts or unsolicited takeovers, in which domination of the board typically passes from management to a controlling shareholder.<sup>132</sup> In recognition of these facts, some team production theorists concede that their model differs from the shareholder primacy model only in its rhetoric.<sup>133</sup> Simply weakening shareholders’ voice in choosing the board does

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126. ROE, *supra* note 94, at 13.

127. *Id.* at 241. *See also id.* at 12-13, 244-45, 247.

128. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001) (“[T]here is convergence on a consensus that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests.”). In 1997 the Business Roundtable adopted this position after years of opposition to it. Holmstrom & Kaplan, *supra* note 3. Support for this conclusion is also growing outside the United States. *See* Paddy Ireland, *Shareholder Primacy and the Distribution of Wealth*, 68 MOD. L. REV. 49, 49-50 (2005).

129. *See, e.g.*, ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (2000); ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000); Nicholas Barberis & Richard H. Thaler, *A Survey of Behavioral Finance*, in 1B HANDBOOK OF THE ECONOMICS OF FINANCE 1053, 1055 (George Constantinides et al. eds., 2003).

130. *See supra* Part III.B.

131. Sundaram & Inkpen, *supra* note 77, at 353. Other constituencies might favor “unrelated diversification” and be excessively risk averse. *Id.* at 354. *But see* Kaufman et al., *supra* note 19, at 15 (denying that shareholders “provide risk capital,” that their investments are “unprotected,” and that they “bear residual risk”).

132. *See* Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 U. TORONTO L.J. 297, 317-25 (1993) (concluding that takeovers don’t harm stakeholders much, if at all); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 133-43 (1992) (same).

133. *See* Blair, *supra* note 80; *see also* Freeman et al., *supra* note 73, at 366 (stating that there is no need to treat shareholder value and stakeholder value as “oppositional”).

nothing to assure that directors will pay any heed to stakeholders. Since most outsiders own little stock, they have little to lose if stakeholders are mistreated and leave the firm or render suboptimal performance.

#### IV. RECENT AND PROPOSED REFORMS

The enactment of the Sarbanes-Oxley Act and adoption of new stock exchange rules have not satisfied many critics of corporate governance. The SEC has proposed a rule to enhance shareholder influence in board elections, and many commentators have urged further reforms. None of these proposals is likely to be effective.

##### A. The Sarbanes-Oxley Act

The Sarbanes-Oxley Act takes some useful steps. It will improve financial reporting and diminish the liquidity of executives' stock.<sup>134</sup> But SOX is no panacea. Its goals are quite modest, being limited primarily to deterring and catching illegal acts.<sup>135</sup> It does not change rules for board composition or selection.<sup>136</sup> Further, whatever benefits SOX generates come at substantial cost. There are out-of-pocket costs for the higher auditing fees necessitated by SOX's new accounting requirements.<sup>137</sup> SOX seems to be behind the recent sharp rise in the cost of D&O insurance.<sup>138</sup> For large companies these costs may not be material, but they are large enough to persuade many smaller public companies to go private.<sup>139</sup> It may also be causing many foreign companies to cease listing on American stock exchanges. In sum, SOX is not the solution to the corporate governance problem.<sup>140</sup>

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134. See Holmstrom & Kaplan, *supra* note 3, at 20.

135. Even there it is not likely to be very effective. See Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley* § 307, 2004 MICH. ST. L. REV. 299.

136. See Brown, *supra* note 60, at 317-21, 338-49, 358-74. SOX also does not authorize shareholder suits; it can be enforced only by the SEC, which is already so busy that it cannot pursue many substantial claims. See MACAVOY & MILLSTEIN, *supra* note 12, at 105.

137. See Section 404 Costs Exceed Estimates, *FEI Finds*, Corp. Governance Rep. (BNA) 38 (Apr. 4, 2005) (reporting a study finding that for large public companies, costs of one year's compliance with section 404 of SOX averaged \$4.36 million, almost 40% more than these companies had estimated in July 2004); William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private'* 7 (Emory Law & Econ. Research Paper No. 05-4, 2005), available at <http://ssrn.com/abstract=672761> (documenting rising accounting costs imposed by SOX).

138. See *id.* at 6. But see Peter C. Hsu, *Going Private—A Response to an Increased Regulatory Burden?* (UCLA Sch. of Law, Law-Econ. Research Paper No. 04-16, 2004) (offering a study showing that avoiding regulatory costs on public companies is not the primary motive for most going private transactions).

139. See Claudia H. Deutsch, *The Higher Price of Staying Public*, N.Y. TIMES, Jan. 23, 2005, at 5 (documenting the growing number of smaller public companies going private because of SOX); Carney, *supra* note 137 (discussing costs imposed by SOX and its effect of causing many companies to go private); Vidhi Chhaochharia & Yaniv Grinstein, *Corporate Governance and Firm Value—The Impact of the 2002 Governance Rules* (Dec. 2005) (unpublished manuscript from the American Finance Association's 2006 Boston meetings), available at <http://ssrn.com/abstract=556990> (stating that share prices rose for big firms forced by SOX to make changes, but that prices of smaller public companies fell); James S. Linck et al., *Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards* (Aug. 31, 2005) (unpublished manuscript from the American Finance Association's 2006 Boston meetings), available at <http://ssrn.com/abstract=687496>.

140. See MACAVOY & MILLSTEIN, *supra* note 12, at 1; Brett H. McDonnell, *Sarbanes-Oxley, Fiduciary Duties, and the Conduct of Officers and Directors* 1 n.3 (Minn. Legal Studies Research Paper No. 04-13, 2004),

### B. Proposed SEC Rule 14a-11

The SEC has proposed a new rule, 14a-11, which would allow certain shareholders to nominate one or two directors under certain circumstances.<sup>141</sup> The first problem with rule 14a-11 as a fix for corporate governance is that it may never be adopted in its proposed form, if at all.<sup>142</sup> The corporate establishment is solidly against it. It urges the SEC to delay action until the effects of Sarbanes-Oxley and other recent reforms can be gauged.<sup>143</sup> It also charges that 14a-11 will result in the election of directors with special interests “that may conflict with the best interests of the public corporation and its shareholder body and other constituencies.”<sup>144</sup> The institutional investors who back these directors may engage in self-dealing.<sup>145</sup> The rule will impose substantial monetary costs, including expensive proxy fights.<sup>146</sup> It will spawn tension and undermine cooperation between directors and managers.<sup>147</sup> This tension and the unpleasantness of proxy fights will dissuade the best board candidates from serving.<sup>148</sup> Increased pressure on CEOs and boards will make them excessively risk-averse.<sup>149</sup> Although the Commission has made no final determination on the proposal, recent related acts do not bode well for 14a-11.<sup>150</sup>

These fears are overblown.<sup>151</sup> The rule will allow substantial shareholders to nominate directors, but they must still be elected by the whole body of shareholders. The

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available at <http://ssrn.com/abstract=570321>; Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance* (N.Y.U. Law & Econ. Research Paper No. 04-032, 2004), available at <http://ssrn.com/abstract=596101>.

141. Security Holder Direct or Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003).

142. Patrick McGurn, executive vice president of Institutional Shareholder Services, says the proposal “not just looks dead, but it is dead.” *ISS’s Proxy Season Preview Features New Voting Policy*, 20 Corp. Counsel Weekly (BNA) 94 (Mar. 23, 2005). See also SEC Access Proposal Seen as Dead; Some Shift Focus to Requiring Majority Vote, 37 Sec. Reg. & L. Rep. 230 (BNA) (Feb. 7, 2005).

143. See Lipton & Rosenblum, *supra* note 61, at 69 (urging the SEC “to allow the reforms that have been adopted to have their effect”); *ABA Task Force Report*, *supra* note 61, at 119; Letter to the SEC from David M. Silk, Chairman, Task Force on Potential Changes to the Proxy Rules, Ass’n of the Bar of the City of New York (June 13, 2002), available at <http://www.sec.gov/rules/other/s71003/ftpccprabny061303.htm> (arguing for delay in any new rules on board elections “until the scope and effect of initiatives already implanted are fully understood”).

144. Lipton & Rosenblum, *supra* note 61, at 78.

145. See Stephen M Bainbridge, *A Comment on the SEC Shareholder Access Proposal* (UCLA Sch. of Law, Law & Econ. Research Paper No. 03-22, 2003), available at <http://ssrn.com/abstract=470121>.

146. See *ABA Task Force Report*, *supra* note 61, at 111 (charging that proxy fights would be “disruptive, expensive and contrary to the best interests of publicly-owned companies and investors”); Bainbridge, *supra* note 25, at 21 (estimating the total costs of the rule at \$100 million per year); Lipton & Rosenblum, *supra* note 61, at 83-85.

147. See Bainbridge, *supra* note 145, at 23; Lipton & Rosenblum, *supra* note 61, at 67 (predicting “Balkanized, dysfunctional boards”); *id.* at 82-85.

148. See *ABA Task Force Report*, *supra* note 61, at 120; Lipton & Rosenblum, *supra* note 61, at 86 (discussing why director recruiting has been more difficult in recent years).

149. See Lipton & Rosenblum, *supra* note 61, at 86-87 (claiming that this is already happening because of recent reforms).

150. See Stephen Labaton, *S.E.C. Rebuffs Investors on Board Votes*, N.Y. TIMES, Feb. 8, 2005, at C2 (reporting that a decision by the SEC that three companies can refuse requests by shareholders to nominate a few candidates for board seats “was seen as an unambiguous sign that [proposed rule 14a-11] is dead”).

151. See Arthur Levitt, *Let the Little Guy in the Boardroom*, N.Y. TIMES, May 24, 2004, at A23 (arguing that “[t]he sky won’t fall” if investors are given the power to nominate directors).



latter have no reason to elect directors who engage in self-dealing or act against their interests. In any case, the rule would allow a shareholder to nominate only one or two directors, who will be unable to pursue such activities even if they were elected. In one form of the proposal the right to nominate directors would arise only after certain trigger events that supposedly signal special corporate governance problems in the firm.<sup>152</sup>

If investors did manage to get some nominees elected, they would have no reason to fight rather than cooperate with management, except to the extent that management's performance is inferior. Directors who are independent and effective should be welcomed by large investors rather than deterred from serving. The very existence of the rule could change the attitudes of executives and directors, making them more attentive to shareholder concerns so as to avoid a proxy challenge that would be embarrassing to incumbents, even if it failed.

Nonetheless, the rule would impose some costs on corporations. Even if special interest investors could not use the rule to elect directors, they could use it as a vehicle to publicize their views at company expense. More important, the rule would probably produce little benefit.<sup>153</sup> Again, the right to nominate candidates for the board may kick in only after certain uncommon trigger events. Shareholders making nominations would have to bear the expenses of proxy solicitations for their nominees if they lose and perhaps even if they win.<sup>154</sup> They would also incur the wrath of managers, not only those they challenge, but of the corporate establishment generally.<sup>155</sup> As a result, investors would probably not bother to nominate board candidates except in rare cases of broad dissatisfaction with incumbent management. The same defects in the proposal undoubtedly account for its lukewarm support from institutional investors.

If rule 14a-11 is adopted and fails to generate much improvement, its failure "could justify consideration of more expansive reforms of corporate elections."<sup>156</sup> It is more likely, though, that the rule's failure would deflate demands for further reform. The corporate establishment is now using SOX and other recent reforms to oppose further reforms like 14a-11. It will undoubtedly use the same tactic if 14a-11 is instituted and has little effect. The failure of 14a-11 would also dampen the enthusiasm of investors and bolster the opposition of managers to further changes in the same direction.

The current impetus for corporate governance reform stems largely from the devastation wreaked by recent corporate catastrophes. As memories of those disasters fade, the inertia that generally prevents corporate governance reform will settle in again.

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152. Security Holder Direct Nominations, Exchange Act Rel. No. 48,626, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003).

153. See Bebchuk, *supra* note 55, at 50 n.17. Significantly, the ABA Task Force agrees: "The history of proxy contests shows how difficult it is to elect directors in opposition to management's nominees . . . . New mechanisms will not likely result in significant numbers of shareholder-nominated directors being elected." *ABA Task Force Report*, *supra* note 61, at 119-20.

154. See BAINBRIDGE, *supra* note 43, at 484 ("Insurgents have no right to reimbursement out of corporate funds. Rather, an insurgent will be reimbursed only if an appropriate resolution is approved by a majority of both the board of directors and the shareholders."). These expenses are substantial. See Bebchuk, *supra* note 110, at 14-17.

155. See Bebchuk, *supra* note 55, at 50 (stating that shareholders will fear "litigation or company retaliation").

156. Bebchuk, *supra* note 55, at 51.

We now have a window of opportunity for change (unless it has already closed).<sup>157</sup> If we choose ineffective reforms, we will blow this opportunity, and may not get another until the next economic debacle.

### C. Enhanced Fiduciary Duties and Legal Liability

Thirty-seven years ago Professor Bishop said, “[t]he search for cases in which directors of industrial corporations have been held liable... for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack. There is little evidence of liability even for Merovingian supineness.”<sup>158</sup>

There are occasional proclamations that the law is changing and that henceforth directors will incur liability if they are less than highly diligent and prudent. This happened after the Delaware Supreme Court’s decision in *Smith v. Van Gorkom*<sup>159</sup> holding directors of TransUnion liable for approving a takeover bid. The proclamation proved wrong—the Delaware legislature enacted a law permitting corporations essentially to eliminate the duty of care<sup>160</sup> and, more important, the Delaware Supreme Court showed itself no more eager to impose liability for lack of care after *Van Gorkom* than it had been before. Personal liability of directors remains almost unheard of.<sup>161</sup>

Now there are new claims of the emergence of a stringent duty of care based on the agreement of ten former directors of Enron to pay \$13 million from their own pockets as part of a settlement of a class action against the board. This, too, seems to be a false alarm. The amount is small and, given the egregious facts of the Enron collapse, the case seems unlikely to have much precedential value.<sup>162</sup>

Occasionally a commentator calls for courts to impose tougher fiduciary duties,<sup>163</sup> and perhaps this would be a good idea. Delaware now holds directors liable for bad decisions only if an act is so unreasonable that it can be ascribed only to bad faith.<sup>164</sup> When interested transactions are approved by a majority of the disinterested directors, plaintiffs challenging the transaction have the difficult burden of proving that it was unfair to the corporation.<sup>165</sup> Corporations might benefit if directors were required to be more diligent, reasonable, and skeptical.

Under current conditions, however, tougher fiduciary standards would bring few benefits. Greater fear of liability might make boards more cautious than investors would like. Most directors own little of the company’s stock and therefore gain little if risky projects succeed. Fear of being sued over risky ventures could dissuade boards from such

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157. See Bratton, *supra* note 50, at 25 (“The post Enron political climate has faded and management influence again registers.”).

158. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099-1101 (1968).

159. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

160. DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).

161. See Bernard S. Black, et al., *Liability Risk for Outside Directors*, 11 EUR. FIN. MGMT. 153 (2005) (giving data).

162. See Lucian Bebchuk, *What’s \$13 Million Among Friends?*, N.Y. TIMES, Jan. 17, 2005, at A17.

163. See Lisa Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393 (2005).

164. See *Brehm v. Eisner*, 746 A.2d 244, 255-56 (Del. 2000) (holding that directors breach the duty of care only if an act is so unreasonable as to be essentially inexplicable by anything other than bad faith).

165. See CLARK, *supra* note 115, at 147-48.

projects even if they could reasonably expect to be exonerated. Directors are insured against liability except for bad faith, so the main effect of higher fiduciary duties might be higher insurance premiums.<sup>166</sup> If personal liability, even for gross negligence, nonetheless became a real possibility, many potential directors might refuse to serve—especially those with substantial personal wealth.

In any case, the states are unlikely to adopt stricter fiduciary duties. *Van Gorkom* triggered a storm of controversy and new legislation that essentially allowed Delaware companies to exempt themselves from its rule.<sup>167</sup> The Delaware courts now seem to have tacitly abandoned *Van Gorkom* and have incurred no criticism for doing so. They have no incentive to ramp up fiduciary duties.

#### D. Other Proposals

Many other proposals to improve corporate governance are being advanced, and some are meritorious. Lucian Bebchuk and Marcel Kahan urge more liberal reimbursement of proxy expenses for insurgents who attain defined levels of support.<sup>168</sup> This may be a good idea, but it still leaves incumbents in control of the corporate proxy machinery; they can be dislodged only by a difficult and debilitating proxy fight. Paul MacAvoy and Ira Millstein, *inter alia*, would not allow the CEO also to be board chairman.<sup>169</sup> This is also a good idea but, like other measures to enhance board disinterestedness, does nothing to insure that the board will be vigorous and wise.<sup>170</sup> Most public companies already have separate CEO and board chairman; their performance has not been shown to be superior.

Removing barriers to unsolicited takeover bids would be beneficial. It would allow shareholders to receive the substantial takeover premiums that now are often blocked. It would also prod managers to improve the firm's performance so as keep its share price high enough to ward off raiders. However, unsolicited takeovers are not a panacea, either. To attract most raiders, a target's stock price must be far below potential value.<sup>171</sup> Contrary to some economic theory, there is little evidence that takeover targets are underperformers.<sup>172</sup>

Increased exposure to hostile bids may also create problems. It “may make it more difficult for corporate managers to foster long-term cooperation and commitment to the corporate enterprise by ‘team members’ other than shareholders.”<sup>173</sup> It may increase the

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166. See BAINBRIDGE, *supra* note 43, at 299 (“After *Smith v. Van Gorkom*, director and liability insurance became very hard to get.”).

167. See *supra* note 160 and accompanying text.

168. Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1135 (1990). See also Bebchuk, *supra* note 55, at 65-66 (proposing procedures that would make it easier for shareholders to remove the entire board).

169. MACAVOY & MILLSTEIN, *supra* note 12, at 4-5, 100.

170. See *supra* notes 53-63 and accompanying text (discussing inadequacy of measures to increase board independence).

171. See Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 934-36 (2002) (giving data on takeover premiums).

172. See Anum Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, 38 J. FIN. & QUANTITATIVE ANALYSIS 721 (2003).

173. Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 36 (2004).

cost of corporate debt.<sup>174</sup> Many raiders overbid,<sup>175</sup> and some stocks may be undervalued by the market,<sup>176</sup> so even ably performing managers could be ousted by hostile bidders. Thus, removing antitakeover devices might induce managers not to improve corporate performance but to ward off raiders in ways even more damaging to shareholders. They might, for example, make unprofitable acquisitions, thereby dissipating free cash and the firm's borrowing capacity, both of which attract raiders.<sup>177</sup> In sum, the net benefits of eliminating antitakeover devices would be small. Further, like other reform proposals, this one is unlikely to be adopted.

Jeffrey Gordon proposes expanded disclosure about executive compensation.<sup>178</sup> This too would have some benefits and might even be cost-effective, but its effect would be minor. First, this disclosure would motivate boards and CEOs to shift to prerequisites that do not require disclosure. Executives of public companies have (or used to have) lower compensation but more lavish prerequisites than comparable officers of private companies.<sup>179</sup> The reason presumably is the desire in public companies to hide part of the executives' benefits by putting it in the form of prerequisites that need not be disclosed. Executives presumably value direct more than indirect compensation; that is, they prefer the firm to give them an extra dollar of salary rather than spend it on a firm hunting lodge. Accordingly, expanded disclosure may merely cause a shift to less efficient forms of compensation.

Calls for more disclosure also assume that it will lead to effective action, but this is dubious. Even if shareholders' approval were required for a compensation package, the usual collective action problems deter them from investigating each firm's package and waging a proxy fight if a package is unreasonable. For example, Enron's compensation package encouraged the officers' "obsession with short-term numbers."<sup>180</sup> How likely is it that even with enhanced disclosure, some Enron shareholders would have detected this problem and waged a successful fight to rectify it? Gordon posits that directors' concern for their reputations will prod them to insist on efficient compensation,<sup>181</sup> but hopes based on outside directors have always been dashed before,<sup>182</sup> and there is no reason to think that this case would be any different.

The most promising current proposal is that election of directors require a majority (rather than a plurality) shareholder vote.<sup>183</sup> This rule would enable shareholders to

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174. See Mark S. Klock et al., *Does Corporate Governance Matter to Bondholders?*, 40 J. FIN. & QUANTITATIVE ANALYSIS 693 (2005) (stating that antitakeover provisions lower the cost of debt financing).

175. In many, if not most, takeovers the acquirer's stock price falls. See *supra* note 43.

176. In an efficient market, no stock should be undervalued. And, if a stock somehow *were* undervalued, a raider's bid for it should alert the market, which would then correct the valuation. However, it is hard for managers to transmit complex proprietary information to the market. See *supra* note 126. The problem is exacerbated by the managers' lack of credibility in the securities markets, especially in light of the frequency of false and misleading disclosures in recent years. Thus, markets may not always be efficient.

177. In one notable example, Paramount made a bid for Time conditioned on Time's abandonment of its proposed acquisition of Warner. Time and Warner persisted, and Paramount dropped its bid. See *generally* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990).

178. Gordon, *supra* note 27.

179. See MCEACHERN, *supra* note 36, at 65-66, 80, 87.

180. Bratton, *supra* note 50, at 1328.

181. Gordon, *supra* note 27, at 123-24.

182. See *supra* Part III.C.

183. See Louis Lavelle, *A Simple Way to Make Boards Behave*, BUS. WK., Jan. 31, 2005, at 38 (reporting

remove unsatisfactory directors without having to present a rival candidate. The threat of embarrassment would pressure boards to pay more heed to investors. Nonetheless, the proposal stops far short of a remedy for separation of ownership and control. First, the proposal is being advanced in nonbinding shareholder resolutions. It is always difficult to get shareholder approval of resolutions opposed by management.<sup>184</sup> Even if resolutions are adopted, the boards most in need of reform are the ones most likely to ignore the resolution; already, “many boards routinely ignore shareholder resolutions even when they win.”<sup>185</sup> Further, even with majority voting the disapproval of a candidate would leave the candidate on the board until a successor is chosen or create a vacancy, which in most states would be filled by the other directors.<sup>186</sup>

Even if majority election was imposed by law, its effects would still depend largely on the incumbents’ fear of embarrassment. Again, the worst boards are most likely to be impervious to shareholder rejection of some directors. Unless the entire board is rejected, the remnant could still govern as it pleases. A majority vote requirement would probably weed out only the worst directors; their replacements may be no better than mediocre.<sup>187</sup>

The requirement could also cause problems. Some major shareholders would still have to campaign against a board candidate. In so doing, they would incur financial costs, management retribution, and possibly legal difficulties.<sup>188</sup> Companies with low shareholder turnout could have board candidates rejected despite small opposition. For instance, if only 51% of the shares were voted, a mere 2% negative vote would doom a candidate.<sup>189</sup> In such cases, a minority of shareholders with a separate agenda (such as a union, a competitor, or a political faction) could torpedo a director it opposes with only a few votes. The prospect of an unpleasant campaign could deter good candidates from running.

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that this proposal has been submitted as a shareholder resolution at as many as 100 companies); Patrick McGeehan, *It’s Voting Time Again, But No Isn’t an Option*, N.Y. TIMES, Apr. 10, 2005, § 3, at 4. The American Bar Association Business Law Section’s Committee on Corporate Laws is considering changing the Model Business Corporation Act to require a majority vote to elect directors. *ABA Panel Weighing Possible Changes To Model Act on Voting for Directors*, 8 Corp. Governance Rep. (BNA) 39 (Apr. 4, 2005).

184. At Bristol-Myers Squibb Co. a majority vote resolution in 2004 was supported by only 7.4% of the votes cast. Lavelle, *supra* note 183.

185. *Id.*

186. *See, e.g.*, DEL. CODE ANN., tit. 8, § 141(b) (2005) (“Each director shall hold office until such director’s successor is elected and qualified or until such director’s earlier resignation or removal.”); *id.* § 142(e) (“Any vacancy occurring in any office of the corporation . . . shall be filled as the bylaws provide. In the absence of such provision, the vacancy shall be filled by the board of directors or other governing body.”). A majority vote requirement could also create unintended results in corporations with low voter turnout. If only 51% of the shares were voted and 49% were voted in favor of a board candidate, that candidate would not be elected even though the decision of holders of a mere 2% of the shares to vote against the candidate or to withhold their votes from her would hardly signal strong shareholder disapproval.

187. *See* Lavelle, *supra* note 183 (“In reality, only directors deemed to have been particularly bad stewards would likely be ousted.”).

188. For example, shareholders who cooperated in such an effort could trigger poison pills or Williams Act obligations. *See generally* Black, *supra* note 101, at 550-51, 556-59.

189. If, on the other hand, only a majority of the votes cast were required, shareholders would be forced to openly vote against a candidate, rather than just abstaining from voting. That necessity would increase their exposure to pressures from management. *See supra* note 98 and accompanying text.

## V. REUNITING OWNERSHIP AND CONTROL

A. *Nomination of Directors by Major Shareholders*

Most serious legal problems do not admit of an easy solution. Fortunately, the problem of corporate governance does: The official slate of nominees for the board of directors on the corporation's proxy statement should be chosen by a committee (the "Shareholders' Committee") comprising the corporation's ten to twenty largest shareholders. This committee would only nominate candidates for the board; other shareholders (perhaps in cooperation with management) could run competing slates. However, given the uniformity of shareholders' interests in maximizing share value,<sup>190</sup> such contests should be extremely rare.

Creation of the Shareholders' Committee will overcome the collective action problem that now denies shareholders, the owners of the corporation, true participation in control. Individual shareholders will not have to bear the costs of proxy solicitations. The Committee's nominees will appear on the company's proxy statement and the solicitation costs will be borne by the company. Even if the costs of serving on the Committee are borne by the members themselves, these costs should be small. If these costs nonetheless prove problematic, rules could provide for their reimbursement.

This approach will result in nomination of better qualified directors. CEOs want passive boards. Despite increasingly stringent definitions of independence, many directors still have "soft" conflicts of interest that make them beholden to the CEO.<sup>191</sup> In order to maximize the value of their stock in the company, the largest shareholders would have a strong motive to find and nominate the most independent and able people and give them the right incentives. Currently, cooperative directors are rewarded with re-nomination, friendship, and often with side payments,<sup>192</sup> all of which can be withheld from obstreperous directors. Directors who go along with the CEO acquire reputations as desirable directors and can hope for further directorships, while directors who rock the boat are rarely named to other boards. If directors were nominated by the largest shareholders, they would be rewarded for maximizing share value, and would act accordingly.

The Shareholders Committee is not merely a solution to the corporate governance problem. It, or something quite similar, is probably the only solution. Since the fundamental problem of corporate governance is the separation of ownership and control, any solution must make governance responsive to the shareholders. That is, corporations must be managed so as to maximize shareholder wealth. This can be done only by vesting control in the shareholders. Since the total body of shareholders is too numerous to act together, there must be an effective way of selecting a representative group (i.e., a board of directors) responsive to the shareholders. Since collective action problems and rational

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190. See *infra* note 201 and accompanying text.

191. See *supra* notes 56-57 and accompanying text.

192. Even when an outside director has no affiliation with the CEO, he always has some interest that the CEO can serve. For example, the CEO can reward a cooperative director with a corporate contribution to the director's favorite charity. See *supra* note 56 and accompanying text. In effect, if the director has no prior connection with the company, one can be created.

apathy also prevent most shareholders from making informed votes on a regular basis, the nomination process must serve as the effective choice point. Shareholder voting must serve only to rubber stamp the nomination process, except in rare circumstances. Likewise, most shareholders cannot take part in the nomination process, which therefore must be delegated to a group that is both competent and dedicated to maximizing share value. That group must be the corporation's large institutional shareholders.

## B. Possible Objections

### 1. The Unity of Shareholder Interests

A common objection to shareholder primacy is that investors have various preferences; there is no united investor goal that boards could pursue even if they wanted to do so.<sup>193</sup> The critique has two facets. First, some object that the supposed investor goal of maximizing share value is amorphous because it fails to distinguish between short-term and long-term maximization and between the effects of accurate, as opposed to false and misleading, disclosure. Shareholders can profit from false disclosures only if they thereby pump up the stock price and then dump their own stock at the inflated price before the market wises up.

In weighing the charge that institutional investors are obsessed with the short term (and all other objections), one must beware the Nirvana fallacy—that is, the fallacy that if an approach might create a problem, however remote the possibility and however trivial the problem, that approach must be rejected. Rather, as Winston Churchill recognized with respect to democracy, the question must be how a given system compares with the options.<sup>194</sup> Assume, for instance, that some mutual funds might stress a portfolio company's short-term performance so as to boost its stock price briefly and thereby improve the fund's short-term performance. However, it is unlikely that a majority of nominating committee members would favor such a policy.<sup>195</sup> Further, such members could not easily induce directors and managers to act on that preference. If needed, however, rules could deter such behavior. For example, private contacts between directors and nominating committee members and transactions between the corporation and committee members might be barred.

Further, giving large shareholders a major role in corporate governance would

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193. See Stephen M. Bainbridge, *Pension Funds Play Politics*, TECH CENT. STATION, Apr. 21, 2004, <http://www.techcentralstation.com/042104g.html> (stating that “the interests of large and small shareholders often differ”); K.A.D. Camara, *Classifying Institutional Investors*, 30 J. CORP. L. 219 (2005) (noting that interests of different types of institutional shareholders may differ, and that some often do not seek maximization of share value); Lipton & Rosenblum, *supra* note 61, at 78 (some shareholders, like labor unions and shareholders promoting social causes, pursue special interests); Rosenbaum, *supra* note 108, at 177-78 (public pension funds have their own agendas). Concerning charges of short-termism, see *supra* notes 118-123 and accompanying text.

194. “No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of Government except all those other forms that have been tried from time to time.” Winston Churchill (Nov. 11, 1947) (quoted in THE OXFORD DICTIONARY OF QUOTATIONS 202 (4th ed. 1992)).

195. A fund might favor this tactic if it were trying to avoid an extremely bad quarter, which could prompt many investors to abandon the fund. It is unlikely, though, that many funds would have the same problem at the same time.

improve their attitudes by shifting their incentives. True, institutions attending informational sessions with corporate executives typically focus their questions on the next quarter's earnings. The reason for this, though, is not that this is the only topic of interest to them, but that this is the only topic that executives consider appropriate and deserving of a straight answer. Serious questions about a company's long-term strategy would be treated as hostile and brushed off with a reiteration of statements from the company's annual report.

With a significant voice in control, large shareholders would be able to focus on long-term strategy and have strong reasons to do so. Like all shareholders, they will want to optimize the performance of companies in which they invest. Further, many institutional investors compete for funds. Currently these institutions make some effort to compete on the basis of ability to pick winners, but savvy investors know that their claims are largely empty: the relative performance of mutual funds tends to rise and fall in a random walk.<sup>196</sup>

If these institutions participated in control of portfolio companies, they would compete by trying to improve the performance of those companies. Not only their own investors but other shareholders of the portfolio company would ask what criteria they use in nominating and evaluating corporate directors. It is hard to imagine the institutions would claim any pole star other than maximization of share value. Could they make such statements but then secretly instruct directors to stress the short term? Such a ploy would be hard to carry out and would run a risk of suits for fraud. Moreover, directors concerned about their reputations and prospects for directorships with that and other companies would have a strong motive to ignore such instructions. In short, under a system of shareholder committees several vectors would push corporate governance away from emphasis on the short term and toward emphasis on maximizing share value. Nonetheless, if fear of short-termism were a fatal objection to this plan, membership on the shareholder committee could be limited to investors who have held their stock in the company for a specified minimum period. In any case, under the current manager-dominated corporate governance system, deviation from the goal of maximizing share value is far greater than it would be under a system with shareholder domination. Managers are often more interested in empire-building than in maximizing share value and, because their investments are not diversified, they have greater opportunities and motives than would institutional investors to engage in pump-and-dump schemes.<sup>197</sup> Managers with high-powered incentive compensation may also take excessive risks.<sup>198</sup>

Critics of shareholder primacy also charge that maximizing share price is not the primary goal of all investors. Some, like employees and suppliers, may prefer growth and caution.<sup>199</sup> Others, like public pension funds, may have political goals, like maximizing

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196. See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 24 (2003) (stating that future steps or directions cannot be predicted based on past actions).

197. See *supra* notes 124-125 and accompanying text.

198. See David J. Denis et al., *Is There a Dark Side to Incentive Compensation?* 2 (Mar. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=695583> (noting that "the convexity of options gives managers the incentive to take excessive risk").

199. Since employees cannot diversify their investments of human and financial capital, they are risk-averse, while non-employee shareholders are risk-neutral. See *supra* note 75 and accompanying text.



the company's employment in the fund's home state.<sup>200</sup> However, such shareholders are a small minority; the vast majority favor maximizing share value.<sup>201</sup> Moreover, society benefits from the efficiency that results from pursuing this goal.<sup>202</sup>

## 2. Opportunism

Another possible objection to nomination of directors by major shareholders is that those shareholders might use their power to benefit themselves through insider trading or interested transactions with the company. Some contend that some institutional investors already gain privileged access to inside information and trade on it.<sup>203</sup>

These concerns cannot be categorically dismissed, but they are minor, far smaller than related problems under current practices, and can be further reduced by some simple steps. Interested transactions between a corporation and its directors are already a problem.<sup>204</sup> By contrast, public investors do not now fear large shareholders but welcome them. A company's stock price generally rises when a large investor buys a big block of its stock.<sup>205</sup> Public investors clearly do not expect the large shareholder to exploit them but protect their (mutual) interests.

Members of a shareholder committee would have incentives to curb insider trading and interested transactions by managers and directors. They would have few

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200. See MICHAEL T. JACOBS, SHORT-TERM AMERICA 53 (1991) (stating that public pension fund trustees are mostly political appointees with their own "political agendas"); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1335 (1991); Rosenbaum, *supra* note 108, at 177; Camara, *supra* note 193, at 27 (stating that the interests of different types of institutional investors sometimes differ and that some do not seek maximization of share value).

201. See BAINBRIDGE, *supra* note 43, at 469-70 n.15 ("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."); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 883-84 (2005) (arguing that shareholders generally favor maximizing long-term share value); Rock, *supra* note 95, at 466 (stating that "the potential for conflict between large and small shareholders will likely be minimal"); Damon A. Silvers & Michael I. Garland, *The Origins and Goals of the Fight for Proxy Access*, in SHAREHOLDER ACCESS TO THE CORPORATE BALLOT (Lucian Bebchuk ed., 2004) (showing that among eight firms writing letters to oppose Rule 14a-11, the largest union or state pension fund held less than .75% of the company's shares). As evidence, note that the "only [shareholder] resolutions that systematically obtain majority support are ones calling for changes that are viewed as value enhancing by a wide range of financial institutions." Bebchuk, *supra* note 110, at 32.

202. See MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962).

203. See Bin Ke & Kathy Petroni, *How Informed Are Actively Trading Institutional Investors? Evidence from Their Trading Behavior Before a Break in a String of Consecutive Earnings Increases* (Jan. 14, 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=448720> (alleging that some institutional investors already profit from trading on inside information).

204. See *supra* note 145 and accompanying text; see also Stewart, *supra* note 57 and accompanying text.

205. See Michael Barclay & Clifford Holderness, *The Law and Large Block Trades*, 35 J.L. & ECON. 265 (1992) (presenting a study showing that minority shareholders generally gain substantially when a large block of a company's stock is sold at a premium); Clifford Holderness & Dennis Sheehan, *The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis*, 20 J. FIN. ECON. 317 (1988); Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 465-71 (1986) (stating that the presence of large non-management shareholders benefits small shareholders). In a dramatic recent example, shares of General Motors surged 18% when Kirk Kerkorian made an offer to acquire 9% of the stock. Danny Hakim, *Kerkorian Seeking 9% Stake in G.M.*, N.Y. TIMES, May 5, 2005, at C1. Large institutional shareholdings are also associated with more favorable share price reactions to the selection of a new CEO. See Mark R. Huson et al., *Managerial Succession and Firm Performance*, 74 J. FIN. ECON. 237 (2004).

opportunities to extract private benefits, and would not welcome such conduct by other committee members, so committees will have incentives to monitor themselves.<sup>206</sup> Directors will not want to risk liability or disrepute by approving company transactions with committee members or by feeding insider information to them. The law already prohibits trading on inside information and polices interested transactions under a “strict scrutiny” standard,<sup>207</sup> and would continue to do so. Again, rules restricting contacts between committee members and directors might reduce any potential problems here.

### 3. *Exploitation of Non-Shareholder Constituencies*

The team-production model holds that shareholder control would be undesirable because it would disadvantage non-shareholder constituencies. This charge is contradicted by both theory and evidence.<sup>208</sup>

### 4. *Locking In Capital*

Some adherents of the team-production model posit that shareholder rights are weak as part of the design of corporate law to lock in capital.<sup>209</sup> The claim is feeble.<sup>210</sup> Ease of dissolution can pose a problem in business organizations, but the problem it poses is exploitation by a wealthier owner in a closely held firm by forcing an auction of the firm’s assets when the other owners lack funds to bid the true value of the assets, so that the wealthier owner gets to grab the assets at a bargain price.<sup>211</sup> Clearly this is not a concern with public companies.

It is hard to see what other problem there could be that makes it advisable to lock in the shareholders as a body. Shareholders certainly have no incentive to break up the company through dissolution unless the firm would be more valuable that way than as a going concern. If the shareholders as a body want to cash in their investment, the logical step is to sell the firm as a going concern. That is what actually happens in an acquisition. In that case, stakeholders and society as a whole suffer no loss of the (wealth-increasing) productive capacity of the firm.

Some aspects of the corporate form are necessary to protect creditors, but this has nothing to do with the separation of ownership and control. Creditors suffer if dividend payments leave a corporation with insufficient assets to pay its debts. Corporate law handles this concern by forbidding such dividends,<sup>212</sup> not by trusting in a board free of shareholder control. Indeed, when it serves the interests of managers, boards can slight

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206. See Black, *supra* note 78, at 887 (“If a half-dozen institutions must act jointly to exercise effective voice, the institutions can watch each other at the same time that they’re watching corporate managers.”).

207. See ROBERT W. HAMILTON & RICHARD A. BOOTH, *CORPORATIONS* 581 (5th ed. 2006).

208. See *supra* notes 76-81 and accompanying text.

209. See Lynn A. Stout, *On the Nature of Corporations*, 2005 U. ILL. L. REV. 253; Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 391 (2003); Blair, *supra* note 173, at 3.

210. It also contradicts some other claims of the team productions theorists. See *supra* note 75 and accompanying text.

211. See, e.g., *Page v. Page*, 359 P.2d 41, 45 (Cal. 1961) (holding that a partner’s dissolution by express will violates his fiduciary duties if he is trying to force an auction of the firm’s assets in order to “appropriate to his own use the new prosperity of the partnership without adequate compensation to his copartner”).

212. See, e.g., DEL. CODE. ANN. tit. 8, § 170(a) (2005).

the interests of creditors.<sup>213</sup>

There is one constituency that does profit from locking in the shareholders—the managers. The difficulty shareholders face in selling the firm’s entire equity allows managers to favor their own interests over the shareholders’ with little fear of being ousted by a takeover. There is abundant evidence that managers in fact seize this opportunity. In sum, the inability of shareholders is not part of the solution but part of the problem.

### C. Implementation

#### 1. The Prospects for Institutional Shareholder Activism

The joke is often told of the economist walking with a student who says, “Professor, that looks like a \$20 bill on the street. Shall I pick it up?” The economist replies, “Of course not. If it really were a \$20 bill, someone else would already have picked it up.” If the Shareholders’ Committee is such a great idea, why hasn’t someone already picked it up? The answer lies in the collective action problems and legal obstacles that investors face. In pluralistic and representative democracies a minority often prevails over a majority even if the policy favored by the minority is in sum less beneficial to society than some other policy. If the minority individuals’ interests in the issue are greater than the majority individuals’ interests, the latter have less incentive than the minority to contest the issue.

Although the costs of managerial domination to investors exceed the benefits to corporate executives, even the largest institutional investors lack the incentive to fight for change; the costs to an institution to fight for change would be immense, but the institution would realize only its pro rata share of the benefits. In contrast, corporate executives have an intense interest in preserving the status quo and access to corporate treasuries to ward off threats to their hegemony.

However, the costs of collective action by investors are falling and should continue to fall. Organizations like Institutional Shareholder Services (ISS), the leading proxy advisory service, are becoming more effective at coordinating investor activity.<sup>214</sup> As institutional portfolios grow, the largely fixed costs of activism decline on a percentage basis.

In recent years institutions have increased their participation in corporate governance, and their experience makes it likely that this trend will continue. It was once rare for institutions to undertake proxy fights over antitakeover devices. They now do so regularly, and often win.<sup>215</sup> Recent corporate scandals, the flaws of Sarbanes-Oxley as a cure for corporate governance problems, and the apparent defeat of rule 14a-11 should all

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213. See generally GILSON & BLACK, *supra* note 43, at 627 (citing Arthur Warga & Ivo Welch, *Bondholder Losses in Leveraged Buyouts*, 6 REV. FIN. STUD. 959 (1993)) (showing substantial market losses in bonds of companies in leveraged buyouts); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988) (stating that a firm’s bond rating is routinely downgraded after a highly leveraged takeover).

214. See Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 564 (2005) (stating that many institutional shareholders follow ISS or some other advisory service).

215. See *supra* note 97 and accompanying text.

awaken institutions to the pressing need for new reforms. More institutions are now backing resolutions to require a majority shareholder vote for election of directors.<sup>216</sup> As these resolutions involve election of directors, they intrude further into corporate governance than resolutions against antitakeover devices.

A child must learn to crawl before it can walk, and to walk before it can run. In the corporate governance race, institutional investors learned to crawl and are now mastering walking. Learning to run may be next.

### 2. *The Prospects for Legislation*

In the wake of the evident defeat of rule 14a-11 by the corporate establishment, legislation to institute shareholder nominating committees does not seem politically feasible; investors are still too scattered and disorganized to achieve any substantial reform. The forces that have prevented a “race to the top” in state corporate laws<sup>217</sup> make it unlikely that any state legislature will embrace shareholder nominating committees in an effort to swipe corporate franchise business from Delaware.

There is, however, some reason for hope. The growing assertiveness and coordination of institutional investors may alter the political balance of forces. In particular, the SEC might become amenable to a quasi-substantive disclosure requirement. When the Commission desires a substantive change but lacks authority to impose it, it has at times adopted a disclosure rule that has the practical effect of requiring public companies to make the change the SEC wants.

Thus when it wanted to stop unfair going private transactions but could not do so directly, the SEC adopted a rule requiring a company going private to state whether it believes that the terms of the deal are fair to public shareholders.<sup>218</sup> As a practical as well as a legal matter, the company must say that it does so believe. Shareholders who consider the term unfair can then sue under the federal securities laws by claiming that the company’s statement is false. More recently Congress used the same ploy in Sarbanes-Oxley by requiring each company to have a financial expert on its audit committee or explain why it does not.<sup>219</sup> In practice, of course, the company cannot say that its audit committee has no financial expert.

The SEC could instead require each company to state whether it has a shareholder-controlled or a self-perpetuating nomination process for its board of directors. At least at first, some companies might defiantly cling to the latter, but experience with the shareholder-controlled process should soon overcome such resistance.

### 3. *The Possibility of Private Reform*

Investors could demand that corporations institute shareholder nominating committees on their own. Nothing in corporate law prohibits such a move. Such efforts

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216. See *supra* note 183 and accompanying text.

217. See *supra* notes 25-26 and accompanying text.

218. 17 C.F.R. § 229.1014 (1999) (requiring a company to “[s]tate whether the subject company . . . reasonably believes that the [going private] transaction is fair or unfair to unaffiliated security holders”).

219. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745; 17 C.F.R. § 229.401(h)(1)(iii) (2005) (requiring that the registrant “must explain why it does not have an audit committee financial expert” if that is the case).

now seem unlikely, but this situation may change. Again, institutional investors have gradually become more assertive in corporate governance. Some investors already appreciate the importance of shareholder rights to share value,<sup>220</sup> and that appreciation is likely to grow.

Managers would furiously resist such efforts because they would end management domination, something no other reform has done or threatens to do. CEOs could exact reprisals against rebellious institutional investors. Further, most managers have links with other business executives through interlocking memberships on boards, charitable foundations and industry organizations.<sup>221</sup> Managers facing demands for real shareholder democracy could expect fellow members of the business aristocracy to join in punishing insurgents, a daunting prospect for investors.

The most likely candidates for shareholder uprisings are poorly performing companies, especially those where managers have committed serious wrongs. Already some institutional investors are now willing to step forward and seek corporate governance changes in such firms.<sup>222</sup> Experiments may begin with something less than complete cession of board nominations to a shareholder committee. Such a committee might be authorized to nominate a minority or half of the board, or a couple of the largest shareholders could be added to existing nominating committees comprised solely of directors.<sup>223</sup> Experience with such half-measures could lead to experiments with full shareholder control.

#### 4. *Impetus for Reform: The Globalization of Financial Markets*

Two possible triggers of corporate governance reform would be a recession or another series of corporate scandals accompanied by a plunging stock market. Neither of these is to be desired. There is another possibility, however: globalization of financial markets. Until recently, America faced limited competition for investment capital. Legal and practical obstacles restricted capital flows across national boundaries. More important, only a few industrialized countries were a viable alternative location for investment, and even these countries had legal systems and traditions less solicitous of investors than America's. America could be complacent about treatment of investors without fear of hemorrhaging capital.

Those days are over. Other countries are reforming their corporate governance systems to be more responsive to shareholders.<sup>224</sup> Nations like China and India that not long ago held no attraction for investors now compete vigorously for capital. The stakes in this competition are steep. For years the United States has been able to run huge trade deficits because foreigners have been willing to invest their trade surplus here. If America

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220. Thus some analysts weigh shareholder rights when valuing stocks. *See supra* note 96.

221. *See* Larcker et al., *supra* note 56 (documenting the correlation between such links and executive compensation).

222. *See supra* note 107.

223. Some states permit exercise of the usual powers of the board by other persons if so provided in the certificate of incorporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2001).

224. *See* Hansmann & Kraakman, *supra* note 128, at 440; *The Bell Tolls for Germany Inc.*, BUS. WK., Aug. 15, 2005, at 40, 40-41 ("Germany's banks . . . are under severe pressure from foreign shareholders to boost returns to the lofty levels of U.S. and British rivals . . . As a result, German managers now receive almost daily reminders of the power of international capital.").

ceases to be the premiere locus of investment and becomes just one of many competitors for capital, we could suffer serious capital outflows.

That discharge would have grave repercussions for many constituencies. The American standard of living is determined by its productivity and treatment of investment capital is a crucial element of productivity. Previously, it has not been thought of that way; from now on, it must be. Even a country with efficient workers cannot prosper if, for example, the fruits of their labor are looted by a corrupt government because investors will not fund businesses unless they expect attractive profits. Likewise, if our corporate governance system condones waste and inefficiency, investment here will flag, American workers will have to accept lower compensation, and the entire economy will falter.

If this threat is recognized, the political vectors impinging on corporate governance will change. American financial institutions have particular reasons for concern. Investors send funds to institutions in countries where they want to invest. If America becomes less appealing to investors, our financial institutions will suffer. They should take the lead in demanding better corporate governance. Their efforts should include publicizing the importance of the issue to other constituencies, which should lend their support once they grasp the threat.

#### *D. Peripheral Benefits*

Many subsidiary issues about the composition and role of the ideal board have been debated for decades: How large should it be? How many insiders (if any) should it have? Are professional directors desirable? How often should the board meet? How far should it intrude into strategic planning? Should it have its own staff? How should directors be compensated?

Empirical answers to these questions have been impossible because of board domination by CEOs. For example, studies have found no correlation between a corporation's performance and the percentage of outsiders on its board,<sup>225</sup> but this fact may merely reflect that CEOs now dominate the selection and conduct of both outside directors and subordinate inside directors. If directors were truly chosen by shareholders, their incentives would be different. This does not necessarily mean that boards would eschew insiders. It may be that subordinate officers, freed from the fetters of groupthink<sup>226</sup> and at least from overt domination by the CEO, would prove a fertile source of knowledge and ideas for outside directors.

Real shareholder control would foster a natural laboratory in which various approaches would be tested to see what works best. Competition could be spirited. Members of each firm's Shareholder Committee will seek to optimize the firm's performance in order to optimize the members' performance.

## VI. CONCLUSION

Despite repeated waves of reform for 75 years, corporate governance still suffers the same basic problem identified by Berle and Means in the 1930s—the separation of ownership and control. The corporate scandals and stock market retreat of 2000-2001

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225. See *supra* notes 55-56 and accompanying text.

226. See *supra* notes 20-22 and accompanying text.

triggered a new spate of changes, but these too seem destined to fail. Moreover, as outrage over business fraud fades and the stock market stabilizes, political pressure for further reform has subsided, so that even the modest change in the SEC's proposed rule 14a-11 has been aborted. The time does not seem propitious for a serious effort to end managerial hegemony.

Nonetheless, latent forces could soon revive the impetus for change. The recovery of stock indices is weak; they remain far below their highs of 2000. Institutional investors are gradually learning to be more assertive. If America's trade deficit continues to deepen and the value of the dollar continues to fall, more attention will focus on corporate governance as a crucial factor in attracting investment capital. At that point there will be renewed concern to end the separation of ownership and control.

This Article has offered a means of solving that problem. Transferring the nomination of directors from a self-perpetuating board to a Shareholders Committee comprised of a company's largest shareholders will align governance structures with the goal of investors to maximize efficiency and with it, share value. The only losers from this revolution would be CEOs who wish not to optimize corporate performance but to rule over a personal fiefdom. The winners will not only be investors but the entire economy, which is to say, all Americans.