The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top

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Introduction

Corporate governance law in the United States is deeply flawed. Legendary mutual fund founder John Bogle asserts that a "pathological mutation" has transmogrified corporate governance from "traditional owners' capitalism" to "new managers' capitalism."[1] Prominent business commentator Robert J. Samuelson claims that CEOs have "contrived" a "moral code that justifies grabbing as much as they can."[2] In the summer of 2006, a widening scandal over backdated options grants had ensnared more than 100 companies in criminal and civil probes (including two that resulted in criminal fraud charges) revolving around whether "incentive" compensation plans were in fact rigged games designed to enrich officers at the expense of shareholders.[3] Meanwhile, CEO compensation at America's leading public corporations continues to soar.[4] At least some legal scholars have traced the roots of "CEO primacy" in American corporate governance to certain key legal changes in the 1980s and 1990s.[5] The cost of

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1 JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 28 (2005).

2 Robert J. Samuelson, *Delinquency of the CEOs,* WASH. POST, July 13, 2006, at A23.

3 The *Wall Street Journal* maintains an options backdating scorecard which lists the names of companies ensnared and the nature of the probes. *Perfect Payday: Options Scorecard,* WALL STREET J. ONLINE, http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html. As of this writing, the FBI has disclosed 52 inquiries and the SEC was pursuing 100. Stephen Taub, *FBI Probing 52 Companies Over Backdating,* CFO.COM, September 26, 2006, http://www.cfo.com/article.cfm/7962096/c_7961008?f=home_todayinfinance; *see also* Liz Moyer, *Who's Next in the Crosshairs?,* FORBES.COM, Aug. 10, 2006, http://www.forbes.com/business/2006/08/09/options-crosshairs-backdating-cx_lm_0810options.html.

4 In 2004 and 2005, CEO compensation at large American corporations continued to reach ever increasing heights. *E.g.,* Gary Strauss & Barbara Hanson, *CEO Pay Soars in 2005 as a Select Group Break the $100 Million Mark,* USA TODAY, April 11, 2006 (stating that compensation for CEOs at America's largest 100 corporations soared 25% in 2005 and 25% in 2004) available at http://www.usatoday.com/money/companies/management/2006-04-09-ceo-compensation-report_x.htm.

5 *E.g.,* Steven A. Ramirez, *The Chaos of* Smith, 45 WASHBURN L.J. 343, 344 n. 10 (2006) (attributing CEO primacy to the death of the duty of care, the "reform" of the federal securities laws to protect managers from private litigation and management's continued domination of the proxy mechanism); Joel Seligman, *Rethinking Private Securities Litigation,* 73 U. CIN. L. REV. 95, 113-115 (2004)

such CEO primacy to the economy and shareholders is huge.[6] This article argues for an end to the means by which corporate governance law is promulgated today, in favor of a structure that can operate to optimize corporate governance, and thereby stem these kinds of economic losses.[7]

Specifically, this article proposes a new depoliticized administrative agency for the promulgation of corporate governance standards that would rely upon markets (and emerging economic and financial science) to optimize corporate governance applicable to public companies.[8] A depoliticized regulatory structure is necessary to assure that the agency responsible for corporate governance is resistant to special interest influence and

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(stating that lax state fiduciary duties contributed to a "dramatic increase in the ratio of compensation of the corporate CEO to the average corporate blue collar worker" from 42 to 1 in 1980 to 475 to 1 in 2000). The former Chairman of the Federal Reserve Board, Alan Greenspan (at the time, arguably the most powerful economist in the nation), has echoed those voices that are concerned about the ascendancy of CEO power. Federal Reserve Board's Semiannual Monetary Policy Report to the Congress: Hearing Before the Comm. on Banking, Housing, & Urban Affairs, 107th Cong. (2002) (testimony of Chairman Alan Greenspan), (stating that lax boards had contributed to a CEO-centric corporate power structure that permitted senior executives to "harvest" gains through manipulation of share prices) available at http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm.

6 *See* M. P. Narayanan et al., *The Economic Impact of Executive Stock Options,* 105 MICH. L. REV.__(2007) (finding that backdated options at 48 sampled companies resulted in $600,000 in extra compensation for executives while costing shareholders at each company $500 million in market capitalization). "Recent research has established that many executives exert not only legal influence over their compensation, but also in many cases illegal influence as well." *Id.* "[O]ur evidence suggests that managerial theft is not a zero sum game, but involves huge dead-weight losses for the shareholders." *Id.*

7 The costs exceed the market capitalization costs isolated in the study, *supra* note 6, assessing costs of back dating. To the extent the public associates such behavior with weak corporate governance, then the cost of capital is likely to rise nationwide, impairing macroeconomic performance. *See* Mark J. Garmaise & Jun Liu, Corruption, Firm Governance, and the Cost of Capital, 2005 (working paper on file with author) (finding that weak shareholder rights are associated with a higher volatility risk (and therefore a higher cost of capital) in a transnational empirical analysis, implicating the possibility of stunted macroeconomic performance) available at http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1273&context=anderson/fin.

8 *See* Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 504 (2000) (finding that "the Federal Reserve Board's administration of monetary policy exemplifies the possibility of depoliticizing regulation" in that it regulates effectively in the general public interest, and is not beholden to special interest influence).

can operate to place corporate governance upon a scientific foundation.[9] The standards articulated by the agency would be subjected to a market test that would allow shareholders to have a direct voice in the system of corporate governance applicable to their corporation, which would vindicate shareholder primacy rhetoric.[10] This system should create constant pressure for improving corporate governance standards—in other words for a race to the top among all competing jurisdictions to provide optimal models of corporate governance for public companies.[11] Courts, state legislatures and politicized regulatory agencies would be displaced by an expert administrative agency subject to market tests and resistant to special interest influence.[12] In short, this article proposes an

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[9] *Id.* at 553 ("The Fed thus demonstrates [that] important financial regulation can be secured against the pernicious influences of special interests. Benefits of expertise, regulatory flexibility and stability of policy can [also] be secured.").

[10] *See id.* at 549 (noting that Fed independence is supported by markets). Shareholder primacy has long been the rhetorical value upon which corporate governance is constructed. *See, e.g.,* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders."). My focus on shareholder empowerment builds upon Professor Lucian Bebchuk's proposals. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833, 913 (2005) (proposing that shareholders satisfying some minimum holding requirement would have the power to place on the ballot initiatives to change the state of incorporation). However, as will be shown, Professor Bebchuk's approach would give shareholders a wealth of choices among regimes polluted by special interest influence, just as both state and federal systems today have fallen prey to such power. Additionally, I am skeptical of Professor Bebchuk's proposal because it has no mechanism for assuring that sophisticated empirical studies from the emerging science of corporate governance would be manifest in the articulation of corporate governance standards.

[11] Publicly held companies are: 1) those companies or corporations traded on a national securities exchange such as the New York Stock Exchange; and 2) those with 500 or more shareholders and $10 million or more in assets. 15 U.S.C. § 78l (g) (2004) (stating statutory definition of public company); 17 C.F.R. § 12g-1 (2006) (SEC exemption for certain companies). Public corporations are the central economic institution in the U.S., as they command a total market capitalization of $16 trillion. *See* Wilshire Assoc., Fundamental Characteristics of the Wilshire 5000 available at http://www.wilshire.com/Indexes/Broad/Wilshire5000/Characteristics.html (last visited May, 27, 2006). As such they are the primary store of investment capital in the U.S.

[12] For example, Arthur Levitt, the Chairman of the SEC during the 1990s has catalogued his efforts to quell CEO power over corporate governance issues, and the power of special interests to frustrate his efforts. ARTHUR LEVITT, TAKE ON THE STREET 106-15 (2002) (recounting how "the business lobby" and "CEOs" successfully used Congress and the SEC to thwart an effort by the Financial Accounting Standards Board to require that options be expensed on corporate income statements).

administrative agency with a depoliticized structure (akin to the Federal Reserve Board or the "Fed") with control over a federal incorporation regime that shareholders may select.

At least since William Cary's landmark 1974 article, *Federalism and Corporate Law: Reflections on Delaware*,[13] there has been a running debate, among legal academicians, economists, finance professors and others, regarding the proper role for the federal government in the area of corporate governance.[14] On one side of this debate are those arguing that state lawmakers seek to enhance their tax revenues from dispensing corporate charters by providing otherwise sub-optimal corporate governance standards that are indulgent to managers, who currently make incorporation decisions.[15] On the other, are those claiming that capital markets would punish corporations hobbled by sub-optimal corporate governance, and therefore neither states nor managers would pursue such standards; instead market competition assures that there is a race to the top, whereby states compete to offer ever more optimal corporate governance.[16] This article seeks a synthesis of these positions, and attempts to forge an optimal regulatory structure for

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[13] William L. Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L. J. 663, 774 (1974) (advocating minimum federal standards for corporate governance for publicly held companies).

[14] As early as 1933, authorities recognized that state competition for charters could lead to regulatory "laxity," as corporations sought charters in more permissive states and states indulged corporations in search of franchise revenues. Liggett v. Lee, 288 U.S. 517 (1933) (Brandeis, J., dissenting).

[15] *E.g.*, Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?,* 90 CAL. L. REV. 1775, 1820-21 (2002) (finding that empirical record does not support the conclusion that state competition for incorporations yields optimal corporate law outcomes); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 861-862 (1969) ("Delaware is in the business of selling its corporation law" and it therefore "tries to give the [CEO] what he wants. In fact, those who will buy the product are not only consulted about their preferences but are also allowed to design the product and run the factory.").

[16] *E.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14-16 (1993) (stating that empirical evidence shows that choice among jurisdictions for incorporation benefits rather than harms shareholders); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporations,* 6 J. LEG. STUD. 251 (1977) ("So far as the capital market is concerned, it is not in the interest of management to seek out a corporate legal system which fails to protect shareholders, and the competition between states for charters is generally a competition as to which legal system provides an optimal return to each.").

specifying corporate governance standards based upon this synthesis. Essentially, this article argues that corporate governance law can be responsive to market action (and shareholder choice) under the guidance of a depoliticized administrative agency charged with promulgating optimized corporate governance for publicly held companies based upon the best emerging finance and economic science.[17]

As such, this article urges to scholars to rethink the *system* by which corporate governance is promulgated rather than trying to divine the *substance* of optimal corporate governance, as courts, legislatures and the SEC currently do today.[18] Getting regulatory incentives right is just as important as getting private incentives right, and in the field of corporate governance there is compelling evidence that incentives are distorted.[19] To the extent there are manifest deficiencies in our integrated system of corporate governance (arising from state incorporation laws and federal regulation of public companies), there

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17 *Compare* Harold Demsetz , *The Firm in Economic Theory: A Quiet Revolution,* 87 AM. ECON. REV. 426 (1997) (stating that under "neoclassical theory" the firm is a "black box" in that its functioning is assumed to be optimal) *with* Andrew Fields & Phyllis Y. Keys, *The Emergence of Corporate Governance from Wall St. to Main St.: Outside Directors, Board Diversity, Earnings Management, and Managerial Incentives to Bear Risk,* 38 FIN. REV. 1, 12-13 (2003) (overview of empirical evidence regarding governance structures associated with superior financial performance). Given the recent vintage of corporate governance science, and the fact that few legislators, regulators and judges have interdisciplinary facility it is somewhat understandable that much of its learning has not influenced corporate governance law. *See* Stacey Kole & Kenneth Lehn, *Deregulation, the Evolution of Corporate Governance Structure, and Survival,* 87 AM. ECON. REV. 421, 421 (1997) (stating that as of 1997 "much of the literature on corporate governance" took a "Darwinian view" in that surviving firms are "presumed to have optimal governance structures" leading to an "absence of evidence" regarding optimal governance structures).

18 *See, e.g.,* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* 114 YALE L. J. 1521 (2005) (demonstrating that Sarbanes-Oxley reforms rest on a weak empirical basis in terms of the science of corporate governance). Corporate scholars recognize that the federal securities laws are an essential element of the system of corporate governance in the US, particularly with respect to the disclosure obligations of management of publicly held companies. Robert B. Thompson & Hillary Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism,* 56 VAND. L. REV. 859, 909-910 (2003) ("we now have a functional division of monitoring between state and federal governments").

19 *E.g.,* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty through Legal Liability,* 42 HOUS. L. REV. 393, 456 (2005) (concluding that current regime of essentially no liability for directors is "defective" and that "Enron suggests that the costs of eliminating liability completely and thereby allowing corporate malfeasance to go unchecked are simply unacceptable.").

is a need for optimized regulatory structures that can operate to move our system toward optimized corporate governance on a continuous basis through market action.[20] In other words, the thesis of this article is that market action can assure that corporate governance moves inexorably toward optimality and this article seeks to articulate such a mechanism.[21] Lawyers can create a unified regulatory structure that expertises corporate governance in the hands of specialists capable of interpreting the science of corporate governance and using market pressure to create a scientifically based standard of corporate governance, as they did for monetary policy through the creation of the Federal Reserve Board.[22]

Part I of this article will review the current learning on corporate federalism, special interest influence and corporate governance, in an integrated and unified manner. The entire system of regulation of the duties and obligations of corporate managers will be assessed to determine if special interest influence has in fact subverted the system of corporate governance applicable to publicly held companies. Naturally, this analysis includes an assessment of the best and most current learning on the race to the bottom/race to the top debate. However, this is a beginning, and not an end. An assessment of the propriety of corporate governance regulation at the federal level (where there is no argument of any race) is also important to whether special interest influence is corrupting corporate governance. The focus will be on the substance of corporate

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[20] Andrew Parker, *It Is Time for a Transfer of Power*, FIN. TIMES (LONDON), Aug. 4, 2005, at 10 (stating that ferocious opposition from corporate CEOs had stifled proxy reform, leading to management power over the director selection process and higher compensation).

[21] *See* ROMANO, *supra* note 16, at 149 (concluding that corporate federalism creates constant incentives for the improvement of corporate governance standards).

[22] The Fed was created in the wake of the Panic of 1907 and its modern structure was refined in the wake of the Great Depression. Ramirez, *Depoliticizing, supra* note 8, at 523-529.

governance and the operation of prevailing regulatory structures, not any truncated view limited to just state law dynamics or just federal law dynamics.

Part II introduces and reviews the emerging science of corporate governance, with a view towards assessing outcomes of the current regulatory structure governing the means by which the duties and obligations of managers are defined. Part II proceeds on the premise that this science is not static and that it requires a multi-disciplinary facility to comprehend. Nevertheless, Part II will demonstrate that inferiority of the current regulatory regime in achieving optimal corporate governance standards. The conclusion of both Part I and Part II will be fully consistent: The United States is in peril of becoming a second world nation in terms of corporate governance. The empirical evidence will show that continuation of our current regime will hobble our most successful enterprises with a higher cost of capital and will burden our economy with stunted macroeconomic performance.

Part III will propose a solution to this problem. Specifically, Part III will attempt to articulate an optimized regulatory and market structure for achieving optimized corporate governance. Central to this proposal will be the creation of an expert and specialized regulatory agency with a depoliticized structure on par with the Fed. Part III will further argue that shareholders of publicly held companies should hold an annual option to select a federal charter that supplants the operation of any state corporate governance standards in favor of the optimized structure promulgated by the depoliticized federal agency. This will assure that agency costs are minimized and the cost of capital reduced. It will create a market driven model for continuous corporate governance evolution in the direction of scientifically based standards.

The article concludes that corporate governance should be committed to the discretion of more institutionally capable agency that is more adept as well as more insulated from special interest influence than current mechanisms with power over corporate governance standards. No more should these standards be left to rent-seeking state legislatures, non-expert judges and a federal regulatory system overrun by special interest influence.

I. RACE TO THE TOP OR RACE TO THE BOTTOM?

Historically the issue of U.S. corporate governance has been left to the states, and Delaware has appropriated the role of providing corporate governance standards for about half of American publicly held companies.[23] However, in specific contexts, the federal government has intervened in corporate governance when investor confidence has eroded to such a level that macroeconomic instability results or is threatened.[24] A recent example of this kind of intervention is the Sarbanes-Oxley Act of 2002[25] which according to many respected voices imposed compliance costs upon American business far in

[23] Mark J. Roe, *Delaware's Politics,* 118 HARV. L. REV. 2491, 2493 (2005) (arguing that although "Delaware writes most state corporate law" the federal government is poised to intervene in a way that limits the autonomy of Delaware lawmakers and interest groups). Corporations are permitted to incorporate in any state, and when they incorporate within a state the internal affairs doctrine will operate to direct courts to the substantive law of that state for virtually all corporate governance issues, other than those governed by federal law. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 201 (9th ed. 2005). Fifty percent of all publicly traded corporations have selected Delaware as their state of incorporation and Delaware is now dependent on the franchise fees generated from dispensing charters as it constitutes 20% of the state's tax revenue. *Id.* at 202. Management essentially exercises autonomy over the state of incorporation. *Id.*

[24] Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence,* 42 WASHBURN L. J. 31, 40-41 (2002) ("The reason for federal financial regulation is macroeconomic not microeconomic, failure. . . .The Fed was created in the wake of the panic of 1907 and the SEC was created in the wake of the Great Depression; both of these events were notable for their macroeconomic consequences, not some flaw in the efficient market hypothesis.").

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

excess of any benefits in terms of transparency and reduced agency costs.[26] Irrespective of such episodic, even chaotic, interventions, the system of corporate governance (often termed "corporate federalism") in the United States has both the look and feel of regulatory dysfunction—specifically it appears that management itself dominates the regulatory apparatus that governs their duties and obligations at both the state and federal level except when a crisis emerges.[27] The corporate corruption crisis that commenced with the failure of Enron in late 2001, and climaxed with the hurried passage of the Sarbanes-Oxley Act in mid-2002 ("SOX"), did nothing to shake this view of special interest domination accompanied by transient exceptions.[28] Indeed, events following the enactment of SOX served only to reinforce this view, as special interest influence operated in the wake of the Act to blunt much of its sting.[29] Thus, leading investor

[26] *E.g.,* Romano, *supra* note 18, at 1594 (stating that the Sarbanes-Oxley Act corporate governance reforms were costly and "poorly conceived."). *See also Enron's Legacy,* WALL ST. J., May 20-21, 2006, at A8 ("Congress, as usual, ran off in panic and whooped through Sarbanes-Oxley, the intrusive accounting law that has cost the U.S. economy far more than predicted by its backers. Sarbox has added billions of dollars in compliance costs, and for no clear benefit.").

[27] One such example of this special interest domination at the federal level is the Private Securities Litigation Reform Act of 1995 ("PSLRA"). *E.g.,* Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as well as the Frivolous,* 40 WM. & MARY L. REV. 1055, 1084 (1999) ("recent 'reforms' of private securities litigation are a betrayal of several fundamental goals of the federal securities law and expose our financial system to risks that are not fully appreciated").

[28] An example of corporate influence operating to stymie reform occurred shortly after the passage of Sarbanes-Oxley, when the SEC attempted to reform the rules governing proxy voting for shareholders in a public corporation. *E.g.,* Amy Borrus, *SEC Reforms: Big Biz Says Enough Already,* BUS. WK., Feb. 2, 2004, at 43 (detailing the efforts of corporate mangers to stifle proxy reform); Amy Borrus & Mike McNamee, *A Legacy that May not Last,* BUS. WEEK, June 13, 2005, at 38 (discussing business lobbying efforts to frustrate proxy reform). Consequently, the entire Sarbanes-Oxley reform effort (including associated reforms in corporate governance at the New York Stock Exchange and the NASDAQ Marketplace) has left CEOs in virtual unfettered control of the machinery of so-called corporate democracy. Thomas W. Joo, *A Trip Through the Maze of "Corporate Democracy": Shareholder Voice and Management Composition,* 77 ST. JOHN'S L. REV. 735 (2003) ("For all the current talk of corporate governance reform, corporate democracy remains a myth."). *See supra* note 20.

[29] Professor Lynn Turner, former SEC chief accountant, asserts that the Bush Administration kept Former SEC Chairman Harvey Pitt on in order to continue to further the goals of special interests and to minimize the impact of the Sarbanes-Oxley Act. Tim Reason, *Two Weeks in January*, CFO MAG., Mar. 1,

advocates now believe that the American public corporation is a "dictatorship" of the CEO.[30]

The race to the top/race to the bottom debate has evolved in the backdrop of this federal regulatory dynamic. Few have tied the two together as part of a singular special interest dynamic.[31] Yet, there is no logical basis for segregating the activity at the state level of corporate governance, from activity at the federal level.[32] Directors and officers are more interested in the substance of law and regulations governing their conduct rather than the source of such standards.[33] It is true that there is a greater wealth of empirical analysis regarding the race to the top/race to the bottom debate from the perspective of state law.[34] But, if managers use special influence interest in one arena to dilute their duties, it is only logical that they would seek to do so in the other.[35] Thus, an integrated view of the evidence, and its manifestations in law, as well as capital market, economic

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2003, at 75 ("It's becoming more and more clear to investors that the Administration kept Pitt in place to get done what the special interests wanted, which was to minimize Sarbanes-Oxley as much as possible.").

30 BOGLE, *supra* note 1, at 29-30.

31 In 2000, I stated that viewing financial regulation from a "transcendent" perspective, involving an analysis of both state and federal law, showed that as then structured our system of corporate governance regulation "face[d] grave difficulties acting in the public interest." Ramirez, *Depoliticizing, supra* note 8, at 584.

32 There is powerful evidence that the dilution of investor remedies under the federal securities laws (pursuant to the PSLRA) was the product of special interest influence. *See* Ramirez, *Arbitration and Reform, supra* note 27, at 1087 n. 156 (demonstrating that lobbying and campaign contributions fueled the political effort to eviscerate private securities litigation).

33 Indeed, managers and their associated interest groups have used federal law to preempt state law not to their liking, and have used their influence to change federal law not to their liking. *See id.* at 1059 n. 13.

34 *Compare* Robert Daines, *Does Delaware Law Improve Firm Value,* 62 J. FIN. ECON. 525 (2001) (finding evidence that Delaware corporations had higher firm value), *with* Guhan Subramanian, *The Disappearing Delaware Effect,* 20 J. L. ECON. & ORG. 32 (2004) (finding that "Delaware's trajectory over the past 12 years is more consistent with the predictions of the race to the bottom view.").

35 *Supra* note 33.

and financial performance seems to be a more efficacious method of assessing the optimality of the current corporate governance regime.[36] This integrated view of all the evidence inescapably leads to the conclusion that whatever competitive force may exist to move corporate governance in any direction, both the state and federal systems are subject to dangerous special interest raids that compromise the regulatory infrastructure which defines and channels corporate activity and has moved our system of corporate governance towards a CEO primacy model.[37]

Some commentators have suggested that federal standards should be expanded or that federal incorporation should displace the operation of state corporate governance standards for publicly held companies, to varying degrees.[38] Federal intervention has thus far been episodic and sporadic rather than comprehensively preemptive.[39] The federal regulatory framework has itself, however, recently been marked by special interest "raids" particularly when the public gaze is diverted from issues of financial regulation—which is to say almost always.[40] The Securities and Exchange Commission, the primary federal regulatory authority in the area of capital market regulation for corporations issuing securities, has a spotty record, at best of resisting special interest

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36 *See* Romano, *supra* note 18, at 1532-1543.

37 *E.g.,* BOGLE, *supra* note 1, at 28 (stating that a "pathological mutation" has gripped corporate governance as "owners' capitalism" has become "managers' capitalism" and executive compensation soared resulting in the transfer of trillions in wealth from shareholders to CEOs and other insiders).

38 *E.g.* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform,* 29 J. CORP. L. 625, 629 (2004) ("I do not advocate wholesale federal preemption or the development of an optional federal scheme. Instead I urge a sustained vigilance from Congress and a willingness to take limited preemptive measures when state law rules fall short in … protection of investors.")

39 *See* Ramirez, *Law and Macroeconomics, supra* note 24*,* at 40-41.

40 "Inappropriate political and special interest influence pervade financial regulation. The American economy has suffered as a result." Ramirez, *Depoliticizing, supra* note 8, at 579.

influence.[41] Thus, vesting comprehensive power over corporate governance for publicly held companies in the SEC (as currently structured at least) is not likely to be successful.[42] Merely calling for federalization of corporate governance misses this point.[43] Indeed, there is good reason to believe that a federal special interest raid was a key precipitating cause of the corporate scandals that erupted in 2001 and 2002.[44]

On some levels, the corporate corruption crisis of late 2001 and 2002 settled the debate regarding whether the system of corporate federalism in the US leads to excessive laxity in corporate governance standards or results in competitive pressure for states to formulate ever more ideal standards.[45] For example, to the extent the race to the bottom

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41 Former SEC Chair Arthur Levitt has documented how special interest influence subverted the ability of the SEC to protect the investing public and pursue reform in the 1990s. LEVITT, *supra* note 12, at 10 ("Once I began pursuing my agenda . . . I saw a dynamic I hadn't witnessed before: the ability of Wall Street and corporate America to combine their considerable forces to stymie reform efforts."). Levitt asserts that these two "interest groups" thwarted the interests of disorganized and under-funded investors across a range of issues, from expensing stock options to auditor independence. *Id.* at 10-12 and 136-137.

42 *Id.*

43 *See* Joel Seligman, *The Case for Minimum Federal Corporate Law Standards,* 49 MD. L. REV. 947, 949 (1990) (discussing laxity as a result of state law changes in shareholder litigation, restrictions in shareholder suffrage, and decline of tender offers, but failing to explain how federal law would lead to a superior outcome).

44 *See* Ho Young Lee & Vivek Mande, *The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and Non Big 6 Auditors.* AUDITING: J. PRACT. & THEORY, Mar. 1, 2003, at 93 ("We find that after the PSLRA income-increasing discretionary accruals rise for auditees of Big 6 but not for auditees of non Big 6 firms."). The authors use Big 6 firms to illustrate the impact of the PSLRA because their deep pockets make them more susceptible to litigation, and thus more sensitive to the changes wrought by the PSLRA. *Id.* Fed Chair Alan Greenspan asserts that the manipulation of the corporate accounting system to enhance income in order to increase executive compensation keyed the corporate corruption crisis. *Supra* note 5 ("Too many corporate executives sought ways to 'harvest'. . . stock market gains. As a result, the highly desirable spread of shareholding and options among business managers perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising")*; see also* BOGLE, *supra* note 1, at 28 ("The change from traditional owners' capitalism to the new managers' capitalism is at the heart of what went wrong in corporate America during the early 2000s.").

45 *See* Jones, *supra* note 38, at 663 (stating that the spate of corporate corruption in 2001-2002 "reveals flaws in the modern federalist arguments denouncing national-level regulation" and that "the unreflective allegiance to the internal affairs doctrine and the economic theories invoked in its defense" should not stop future federal intervention into the corporate governance arena). Others contend that fear of federal intervention has ended the race, as Delaware has acted to preserve its monopoly over chartering

supports more extensive federal intervention into the internal affairs of the publicly held corporation, the spectacular corporate failures of 2001 and 2002 led directly to the Sarbanes-Oxley Act—the most invasive federal regulation of corporate governance in history.[46] The Sarbanes-Oxley Act excluded management from control over the audit function, by requiring an independent audit committee.[47] It created an entirely new regulator for auditors of public companies.[48] It also imposed new federal rules of professional responsibility for attorneys "appearing or practicing before the Commission" on behalf of public companies.[49] The Act enhanced the need for independent directors.[50] These are just the provisions of the Act that deal most directly with corporate governance

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corporations free from federal interference. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law,* 55 STAN. L. REV. 679 (2002). Delaware's monopoly position may stem from network externalities, meaning that Delaware is chosen not based upon merit as reflected in the demand for corporate charters, but Delaware's familiarity among other corporate constituents. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts,* 81 VA. L. REV. 757, 841-42 (1995) ("the possibility that network externalities are significant in the corporate charter market implies that the products produced in that market may be suboptimal"). Delaware obtains 20 percent of its revenue from franchise fees paid by corporations chartered there. EISENBERG, *supra* note 20, at 202.

[46] *See* Joel Seligman, *A Modest Revolution in Corporate Governance,* 80 N.D. L. REV. 1159, 1159 (calling the Sarbanes-Oxley Act and associated reforms at the New York Stock Exchange and the NASDAQ marketplace a "modest revolution"); *Annual Review of Federal Securities Regulation,* 58 BUS. LAW. 747, 748 (2003) (stating that the US Congress enacted the "sweeping" legislation "designed to alter the fundamental way in which public companies are governed and operated").

[47] Sarbanes-Oxley Act of 2002, §§204, 301, 15 U.S.C.§§78j-l(k), (m) (2004) (requiring an independent audit committee for public companies). An independent director may not receive any compensation from the issuer other than board fees and may not be affiliated with the issuer. *Id.* § 301, 15 U.S.C. §78j-l(m).

[48] *Id.* §§101-109, 15 U.S.C. §7221-7219 (2004) (creating the "Public Accounting Oversight Board" to regulate audit firms of public companies).

[49] *Id.* §307, 15 U.S.C.A. §7245 (2004) (directing SEC to promulgate rules governing the conduct of attorneys "appearing or practicing" before the Commission).

[50] *Supra* note 47. In addition to requiring each member of the audit committee to be independent of management, the SEC's rules under section 307 of the Act creates an optional qualified Legal Compliance Committee, which provides for a central role for independent directors. *See* 17 C.F.R §205.2(k) (2006). A final source of increased pressure for independent board members are rule changes at the New York Stock Exchange and the NASDAQ that apply to companies listed on those markets, with the approval of the SEC. *See generally* Seligman, *Modest Revolution, supra* note 46, at 1170-1175.

and the duties of agents involved in the flow of financial information within the public corporation.[51] Federal intervention is therefore an increasing reality in corporate governance for publicly traded companies;[52] indeed, future meltdowns in investor confidence are likely to lead to ever more intrusive federal regulation, ultimately culminating in some system of federal incorporation.[53]

On another fundamental level, the corporate corruption crisis of 2001-2002 seems to have steam-rolled the idea that corporate federalism in the US has resulted in an optimal corporate governance regime.[54] Nevertheless, it is worthwhile to review the empirical record to date with respect to corporate federalism, to assess the possibility that markets can still be used to continuously move corporate governance in a more ideal direction.[55] The major problem with any argument that markets will move states toward more optimal corporate governance law is that no study has been able to find any evidence that investors make decisions based upon state of incorporation.[56] Thus, the evidence that Delaware corporations are valued more highly by capital markets is inconclusive at best.[57] Instead investors seem far more concerned about actual corporate

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51 *See generally Annual Review, supra* note 46.

52 *See* Seligman, *Revolution, supra* note 46, at 1183 (calling for a "broad reexamination" of federal corporate governance law to "augment" and evaluate current mandates).

53 *See* Romano, *supra* note 18, at 1523 (discussing compelling political pressure for federal intervention in wake of stock market plunge of 2002 and a crisis of corporate corruption).

54 Ramirez, *Law and Macroeconomics, supra* note 24, at 61 ("So long as executive of bankrupt firms haul in millions while leaving their shareholders penniless, reality suggests that we have allowed blinding adoration of market efficiency to lead us into the corporate governance gutter.").

55 *Supra* note 45; Ramirez, *Depoliticizing, supra* note 8, at 572 (concluding that "investors neither care about nor have the ability to judge the impact the state of incorporation has on either their rights or profits," based upon a review of empirical studies).

56 *Id.*

57 *Supra* note 34.

governance practices at firms (which can be implemented pursuant to any state corporation code) than which state provides that substantive law framework for corporate governance.[58] There is simply no strong empirical basis that state corporate governance law is impounded into stock market price in a way that will create market pressure for more optimal corporate governance standards.[59]

The most recent empirical analyses of the operation of corporate federalism do not show that there is any race to the top spurred by corporate federalism. One recent study found that firms that choose Delaware charters are fundamentally different, and that any Delaware effect—a putative increase in firm market value for Delaware firms—disappears after controlling for factors such as accounting biases and analyst forecasts.[60] In 2003, Professor Lucian Bebchuk and Alma Cohen demonstrated that when firm decisions are disaggregated across jurisdictions (rather than viewed only from the perspective of Delaware versus all other jurisdictions) a major factor driving incorporation decisions is the strength of a given state's anti-takeover legislation.[61] Because anti-takeover legislation entrenches management and shields them from

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58 For example, Institutional Shareholder Services, a provider of corporate governance rating data for large shareholders, rates quality corporate governance based upon 63 factors—none of which is based upon which state provides substantive law for the internal affairs of the corporation. ISS.com, Corporate Governance Quotient Domestic Rating Criteria, available at http://www.issproxy.com/professional/analytics/uscgqcriteria.jsp (last visited Sept. 14, 2006).

59 EISENBERG, *supra* note 23, at 204 (stating that it "difficult if not impossible" to demonstrate the optimality of Delaware's corporate law based upon stock market valuations.").

60 Feng Chen et al., Are Delaware Firms Oranges? Fundamental Attributes and the Delaware Effect, 2006 (working paper on file with author) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=912942.

61 Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate,* 46 J. L. & ECON. 383 (2003) ("anti-takeover protections are correlated with success in the incorporation market; adding anti-takeover statutes significantly increases the ability of states to retain their local firms and to attract out-of-state incorporations").

competitive pressures of the market for corporate control,[62] it is impossible to square this finding with a race to the top.[63] Thus, any empirical foundation for any supposed race to the top has essentially crumbled.[64]

Any uncertainty remaining from the empirical record must be viewed in light of lawmaking that is consistent only with the race to the bottom thesis: increasingly relieving management of legal duties and responsibilities. The so-called duty of care illustrates the race to the bottom quite well.[65] In 1985 the Delaware Supreme Court held a board liable for breach of the duty of care in *Smith v. Van Gorkom*.[66] The facts of *Van*

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[62] The "overwhelming majority" of event studies show that anti-takeover protections have either no effect on shareholder value or harm shareholder value. In addition, there is empirical evidence such statutes operate to increase agency costs. *Id.* at 404-405 (citing, *inter alia,* GRANT A. GARTMAN, STATE ANTI-TAKEOVER LAW (2000)).

[63] "In contrast to the beliefs of supporters of state competition, the evidence does not indicate that the incorporation market has penalized even those . . . states that passed statutes universally regarded as detrimental to shareholders." *Id.* at 421.

[64] *See supra* note 34. Even before the Subramanian study showing that there was no durable "Delaware effect" resulting in superior market valuations for Delaware firms, *supra* note 34, Professor Bebchuk contested the Daines study to the contrary, *supra* note 34. Bebchuk, *supra* note 15, at 1820 ("This Article has shown that the body of empirical evidence on which supporters of state competition rely does not warrant their claims of empirical support.") Bebchuk questioned both the robustness of the association between Delaware incorporation and firm value and asserted that proponents of state competition had confused correlation and causation because of possible material differences between firms choosing Delaware charters and those choosing non-Delaware charters. *Id.* Further, Bebchuk argued that the benefits of Delaware incorporation could stem not from Delaware corporate law but from network effects or the benefits associated with Delaware courts. *Id.* These points have been largely vindicated by subsequent empirical analyses including those undertaken by Subramanian (showing very weak robustness) and Feng Chen (showing that firms incorporating in Delaware are materially different from firms incorporating elsewhere and that therefore comparing Delaware firms with non-Delaware firms is like comparing apples and oranges). *See supra* note 60. Finally, Professor Bebchuk was unable to find any Delaware effect at all in 1999. Bebchuk & Cohen, *supra* note 61, at 403.

[65] *See* Marc I. Steinberg, *The Evisceration of the Duty of Care,* 42 SW. L.J. 919, 927, 928 (1988). The business judgment rule has long operated to protect business managers from improvident business decisions. In Delaware, this meant that business mangers must be found grossly negligent to breach their duty of care. *See* Gimbel v. Signal Cos., Inc., 316 A.2d 599 (Del. Ch. 1974) (finding that the business judgment rule did not protect directors that had recklessly accepted a "grossly inadequate" price for the sale of the company). In practice, such a standard means that the duty of care seldom triggers manager liability. I have argued in the past that this approach may be optimal, at least when combined with appropriate private rights under the federal securities laws. Ramirez, *Chaos, supra* note 5, at 361 n. 156.

[66] 488 A.2d 858 (1985).

Gorkom could hardly be more compelling because the outside directors assumed a joint defense with the CEO[67]—and the CEO signed the agreement to sell the public company without reading it and without showing it to an attorney.[68] Nevertheless, shortly after the decision to hold the directors liable for gross negligence was issued, the Delaware legislature enacted a statute that allowed directors to obliterate the duty of care through a provision in the corporation's charter.[69] By 1988, 40 states had enacted director insulating statutes.[70] The managers of the vast majority of public companies were subsequently able to use their control over the proxy machinery[71] to eliminate their own duty of care.[72] Professor Marc Steinberg thus stated: "The evisceration of the duty of care is a drastic step in the corporate governance framework. Any further erosion makes a mockery of fiduciary duty."[73] The state of Nevada has now taken the next mocking step: Nevada insulates all directors and officers from all liability unless it is proven they

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67 The Delaware Supreme Court specifically inquired of defense counsel (who represented all of the director defendants) whether there was a basis for treating the outside directors differently from officer directors, such as CEO Jerome Van Gorkom. Counsel for the defense said there was no such basis. *Id.* at 898 (opinion on motion for reargument).

68 *Id.* at 867 and 869.

69 DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Section 102(b)(7) authorizes a provision in the charter of a Delaware corporation that shields directors for monetary liability for breaches of the duty of care. Although such a provision requires shareholder approval, meaningful shareholder consent in this context is an illusion given management's control of the proxy machinery process, the strong inclination of institutional investors to vote with management, and the typical individual stockholder's ignorance of corporate charter provisions. Steinberg, *supra* note 6, at 927

70 James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indeminfication,* 43 BUS. LAW. 1207, 1209-21 (1988).

71 *E.g.* Joo, *supra* note 28, at 752-760 (demonstrating barriers to the effective use of shareholder franchise rights against the wishes of management).

72 Delaware alone accounts for fifty percent of all public corporations. *Supra* note 23.

73 Steinberg, *supra* note 65, at 928.

acted intentionally, fraudulently or in knowing violation of law.[74] It is difficult to argue that the story of the duty of care in American corporate law is consistent with anything other than a race to the bottom.[75]

Nor, is the death of the duty of care the sole outlet for the effort's of management to limit their duties and obligations.[76] Dean Seligman highlights the restriction of shareholder suffrage rights, the decline of tender offers as a source of discipline and the decline in the ability of shareholders to pursue litigation.[77] Others focus upon the lax

[74] NEV. REV. STAT. § 78.138(7) (2003). This insulation may be eliminated by the articles of incorporation. *Id.* Between 1980 and 2005, *Smith* stands as the only example of outside directors being found liable and paying damages. Bernard Black et al., *Outside Director Liability,* 58 STANFORD L. REV. 1065 (2006) (studying actual out-of-pocket liability rather than nominal liability). Thus, Nevada's insulation seems more symbolic than substantive. In Nevada, as elsewhere, the duty of care for directors is dead letter law. Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477, 490 (2000) (stating that because a very high percentage of public corporations take advantage of insulating statutes the directors' duty of care is "essentially obsolete"). Prior to 1980, duty of care liability for directors was hardly common, a point lamented by respected corporate law voices, but Professor Bishop found numerous reported cases of liability attaching even though he did not search for unreported settlements. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Directors and Officers,* 77 YALE L. J. 1078, 1099-1101, 1103 (1968) ("In sum, I think that the practice of protecting corporate executives against litigation and liability has now been carried about as far as it ought to be carried and perhaps a little farther.")

[75] One argument frequently trotted out in favor of laxity is that rigor will repel qualified directors from serving. One problem with this position is there is little empirical support for it. *See* S.F. Cahan & B.R. Wilkinson, *Board Composition and Regulatory Change: Evidence From the Enactment of the New Companies Law in New Zealand,* 28 FIN. MGMT. 32 (1999) (finding that more rigorous demands of New Companies Act in New Zealand did not lead to a reduction in outside director representation). An additional problem with this approach is that it is radically overboard-the same argument supports the abolition of all duties and obligations, a position no commentator really supports.

[76] The Delaware legislature was responding to concerns of the directors and officers insurance industry when it passed Section 102(b)(7), according to the synopsis of the bill. *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care in Corporate Governance,* 75 IOWA L. REV. 1, 43 n. 317 (1989). This is odd given that the market value of such insurance companies rose significantly after the *Smith v. Van Gorkom* decision. *Id.* at 73-74. It appears insurance companies were able to use the decision to enhance their premium revenues with little real additional risk. *Id.*

[77] Seligman, *Minimum Federal Standards, supra* note 43, at 949, 949-971 ("The most distinctive aspect of the last decade in corporate law was the celerity with which traditional constraints on corporate managers weakened.").

standards governing compensation decisions as a problem.[78] Each of the foregoing reflects accelerating laxity in the duties of managers during the 1980s and 1990s, under state law.[79] This laxity is certainly consistent with the race to the bottom thesis. However, a similar dynamic was transpiring simultaneously at the federal level, where the focus has traditionally been on disclosure duties to shareholders.

In late 1995, Congress passed the Private Securities Litigation Reform Act[80] ("PSLRA").[81] The PSLRA imposed a new more stringent pleading standard on plaintiffs seeking relief under the federal securities laws; imposed a new sanctions provision, approaching a loser pays rule, on such plaintiffs; created a safe harbor for forward looking frauds; restricted the ability of plaintiffs to seek class action relief under the federal securities laws; imposed a stricter statutory causation standard for private securities litigants; and restricted the availability of joint and several liability for such claimants.[82] In 1998, Congress followed-up with the Securities Litigation uniform Standards Act ("SLUSA"), which eliminated state class actions in securities disputes

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78 Linda J. Barris, *The Overcompensation Problem: A Collective approach to Controlling Executive Pay,* 68 IND. L. J. 59, 100 (1992) ("With the massive compensation now being awarded, courts have the perfect opportunity to find specific plans are unreasonable and unfair to shareholders, instead of shielding excess compensation practices with the business judgment rule."); Mark J. Loewenstein, *Reflections on Executive Compensation and Modest Proposal for (Further) Reform,* 50 SMU L. REV. 201, 214, 220 (1996) (stating that while some law suggests courts will enforce outer limits regarding compensation "in publicly-held corporations, in fact the courts just do not reach the merits of a claim of excessive compensation" because of difficult procedural hurdles). According to some commentators, Delaware courts have traditionally been deferential to management. Jones, *supra* 38, at 646-655. Indeed, Professor Jones suggest that Delaware law provided "officers and directors a virtually impregnable shield from liability for corporate misdeeds." *Id.* at 646.

79 *E.g., supra* note 74.

80 Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

81 Ramirez, *Arbitration and Reform, supra* note 27, at 1080.

82 Ramirez, *Arbitration and Reform, supra* note 27, 1072-1080.

involving public companies.[83] The dual effect of the PSLRA and the SLUSA is to dilute the penalties and enforcement available to deter securities fraud.[84] Thus, laxity is not limited to state law, nor the result solely of any state competition for corporate franchise revenues.

Of course, diluting the enforcement mechanisms and remedies available could be beneficial if they are too harsh.[85] Unnecessary or excessive regulation could amount to a tax on innovation or a tax on companies seeking access to the public capital markets.[86] However, there is zero evidence that the private enforcement of the federal securities laws was not needed either at the time of the passage of the PSLRA and the SLUSA, or today. First, there was near unanimity that investor confidence required supporting regulation and that private litigation was essential to enforcing the federal securities laws.[87] Second, the late 1980s and early 1990s were hardly emblematic of a high degree of corporate integrity and honesty in our capital markets, and have been termed a "sordid time for financial markets in the United States."[88] Finally, lax conduct quickly followed

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83 Pub. L. No. 105-353 (1998).

84 Ramirez, *Arbitration and Reform, supra* note 27, at 1083-1084.

85 Steven A. Ramirez, *Law and Macroeconomics, supra* note 24, at 43-44 (stating risks facing an active entrepreneur and including the possibility of ruinous litigation pursued by passive investor). The issue of whether there is too much liability risk facing entrepreneurs will also be assessed in light of empirical analyses discussed in Part II of this paper. In short, that Part will demonstrate that there appears to be too little investor protection and not too much. This is in turn supported by theories of special interest influence discussed in Part III of this paper which suggest that because CEOs are a small group with concentrated wealth at their disposal, operating in an environment that has low salience to the public, one could predict the decisively pro-management outcomes yielded by our current system of corporate federalism.

86 Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America,* 42 DUKE L.J. 945, 976 (1993).

87 Ramirez, *Arbitration and Reform, supra* note 27, at 1082 n. 128.

88 Ramirez, *Arbitration and Reform, supra* note 27, at 1089.

the diminution of private enforcement, and empirical evidence demonstrates that auditors in particular responded to the PSLRA/SLUSA in predictable fashion: they allowed the spoliation of audit quality so that CEOs could increase current income and thus their own compensation.[89] As such, it appears that the PSLRA/SLUSA led directly to the spate of accounting driven securities frauds that plagued our capital markets in the 1990s.[90] For the first time ever, federal law operated to restrict investor rights under state law, turning the federal securities laws on their head.[91]

The end of private securities litigation as a constraint on management is not the only element of federal law favoring the prerogatives of the CEO. CEOs of public companies have the unique privilege of picking their own nominal supervisors—the board of directors.[92] Under the federal proxy rules (applicable to all publicly traded corporations) only management (i.e., the CEO) has the power to use corporate funds to

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89 Lee & Mande, *supra* note 44.

90 *See* Douglas Guerrero, *The Root of Corporate Evil*, INTERNAL AUDITOR, Dec. 2004, at 37 ("It appears that . . . highly placed executives used their power . . . to achieve financial targets fraudulently, boost the stock price, and further enrich themselves via compensation schemes that rewarded those achievements."); s*ee also* THE CONFERENCE BD., COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 6 (2003) (finding that excessive compensation, resulting in part from lax monitoring by boards, led to an "unprecedented" loss of investor confidence).

91 Ramirez, *Arbitration and Reform, supra* note 27, at 1059-60 n. 13. Historically, the federal securities had operated only to expand investor rights because federal remedies were cumulative with any state law rights of recovery. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) (stating that Congress enacted the federal securities laws in order "to rectify perceived deficiencies in common-law protections."). After SLUSA, federal law now operates to destroy state law private rights of action. *See, e.g.,* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503 (2006) (holding that SLUSA preempted class action relief for plaintiffs alleging fraudulent inducement to hold securities, and thereby destroyed such claims).

92 "The CEO typically holds ultimate control over management and decisive control over the selection of directors." Steven A. Ramirez, *Rethinking the Corporation (and Race) in America: Can Law (and Professionalization) Fix Minor Problems of Internalization, Externalization and Governance?*, 79 ST. JOHN'S L. REV. 977, 982 n. 24 (2005).

solicit proxy votes for their slate of director candidates.[93] As Professor Tom Joo has demonstrated, even if a shareholder mounts a proxy challenge, there are rules that systematically load the dice in favor of management.[94] If a mere shareholder wishes to place a person on the board, the shareholder must absorb printing costs, postage costs and legal costs of mounting s full blown proxy solicitation, and these costs can amount to millions of dollars.[95] Thus, there is typically only one candidate for board positions in public corporations, and that candidate is selected by management.[96] This means that the CEO may stack the board with cultural and social clones in order to maximize compensation.[97] Shareholder democracy is a myth in the US, and management interests have worked to keep it a myth.[98]

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[93] *See* 17 C.F.R. 240.14a (8) (i) (8) (2006).

[94] Thomas W. Joo, *supra* note 28, at 735. Professor Joo identifies the following impediments to shareholder voting power: federal proxy rules that prohibit inclusion of shareholder proposals relating to board membership within management's proxy, meaning dissident shareholders must bear the steep costs of their own proxy challenge; and authorization of brokers to vote shares within client accounts—invariably voting with management—unless they receive contrary instructions. *Id.* at 758-60.

[95] *Id.* In addition, the management may spend corporate funds to resist shareholder proposals. *Designed by Committee: Corporate Governance,* ECONOMIST, June 15, 2002, at 71 (recounting a proxy contest at Hewlett-Packard in which the company spent $150 million to fend off a proxy challenge brought by the son of a company founder, Walter Hewlett).

[96] *Id.* ("The CEO puts up the candidates, no one runs against them and management counts the votes.") (quoting shareholder activist Nell Minow of the Corporate Library). One commentator has stated that the incidence of electoral challenges to incumbent management is "extremely rare" and that the incidence of successful challenges is "practically negligible." Lucian Arye Bebchuk, The Myth of the Shareholder Franchise (Nat'l Bureau of Econ. Research, Oct. 2005), available at http://ssrn.com/abstract=829804. Walter Hewlett, for example, lost his challenge, despite having the prodigious advantages of a board seat and being heir to a founder. Steve Lohr, *Suit Against Hewlett Deal is Dismissed,* NY TIMES, May 1, 2002, at C1.

[97] Steven A. Ramirez, *Games CEOs Play and Interest Convergence Theory: Why Diversity Lags in America's Boardrooms and What to Do About It,* 61 WASH. & LEE L. REV. 1583, 1589-91 (2004) (concluding that "CEOs play the game of homosocial reproduction when selecting directors" and thereby increase their compensation).

[98] *Supra* note 28. Recently, management interests have trumped the SEC's efforts to break the stranglehold that management has over the proxy machinery and therefore voting power within the public corporation. Andrew Parker, *It Is Time for a Transfer of Power*, FIN. TIMES (London), Aug. 4, 2005, at 10

The reductions in investor rights and protections are not limited to legislative and regulatory promiscuity towards management, as the Supreme Court too has turned hostile to private claims under the federal securities laws.[99] Beginning in the early 1990s, the Supreme Court began seriously pruning the private rights of action available under the federal securities laws.[100] In 1991, the Court narrowed the statute of limitations applicable to federal securities fraud cases.[101] Three years later the Court eliminated liability for aiding and abetting securities fraud.[102] Then in 1995, the Court limited investor remedies under the Securities Act of 1933.[103] One commentator has noted that: "In forty federal securities law decisions, the Court decided 32 cases in favor of defendants, and in almost every one of them significantly narrowed the reach of the federal securities laws."[104] Most recently, the Court broadly read the preemptive reach of the SLUSA to protect management of public corporations from class actions based upon

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(stating that ferocious opposition from corporate CEOs had stifled proxy reform, leading to management power over the director selection process and higher compensation).

[99] *See, e.g.,* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975) ("[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."). Rule 10b-5 is the broadest federal remedy for securities fraud. *See* 17 C.F.R. § 240.10b-5 (2006) (outlawing fraud in connection with the purchase or sale of securities).

[100] Ramirez, *Arbitration and Reform, supra* note 27, at 1069-1070.

[101] Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (holding that statute of limitations for federal securities fraud is one year from the date of the discovery of the fraud and in no event more than three years from the date of the fraud).

[102] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) (holding that aiding and abetting securities fraud is not actionable in federal private claim).

[103] Gustafson v. Alloyd Co., Inc., 513 U.S. 561 (1995) (holding that express rescission rights of investors purchasing securities is actually only available to those purchasing in a public offering).

[104] Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3, 6 (1996).

state law claims[105] and has used the causation requirements of securities claims to limit investor rights.[106] Simply put, the Court's approach to private securities litigation evinces deep hostility to investor rights.

Predictably, all of these pro-management outcomes led to a crisis in corporate confidence—culminating in a parade of corporate corruption scandals in 2001-2002.[107] The public's gaze focused on corporate governance deficiencies.[108] With elections looming Congress rushed through the SOX "reforms" that passed the Senate by a vote of 97-0.[109] Almost immediately scholars voiced concerns about the efficacy of the SOX.[110] And, literally on the day the SOX was signed, reactionary forces began to cut back on its reforms.[111] This pattern continued,[112] and ultimately short-circuited the SEC's proxy

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105 Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503 (2006) (holding that class action for shareholders of public company cannot pursue claims under state law).

106 Dura Pharm., Inc. v. Bruno, 125 S. Ct. 1627 (2005) (holding that plaintiffs seeking to recover under the federal securities laws must show "economic loss"). Professor Michael Kaufman has noted that this requirement of "economic loss" is not in the legislation nor in the legislative history, and "raises the specter of result-oriented reasoning." Michael J. Kaufman, *At a Loss: Congress, the Supreme Court and Causation Under the Federal Securities Laws,* 2 NYU J. L. & BUS. 1, 48-49 (2005).

107 *Supra* note 27. Professor Steinberg raised the possibility that the securities law had turned too far in favor of management in early 2002: "the risk and irony of the tripartite action taken by Congress, the courts, and the SEC [is that] [i]n seeking to enhance capital formation and alleviating the burdens placed on business by the threat of vexatious litigation, the scales may be tipped disproportionately against investor protection" which may make raising capital more difficult for business. Marc I. Steinberg, *Curtailing Investor Protection Under the Securities Laws: Good for the Economy?*, 55 SMU L. REV. 347 (2002)

108 Ramirez, *Law and Macroeconomics, supra* note 24, at 31-33.

109 Shailagh Murray & John D. McKinnon, *Senate Passes Tough Fraud Bill in Unanimous Vote,* WALL ST. J., July 11, 2002, at A1 ("[L]awmakers voted 97-0 to establish sweeping new powers to target corporate fraud.").

110 *E.g.,* Ramirez, *Law and Macroeconomics, supra* note 24, at 64 (stating that SOX may turn out to be a "political fraud.").

111 *Compare* Statement by President George W. Bush upon Signing H.R. 3763, 2002 U.S.C.C.A.N. 543, *available* at 2002 WL 31046071 ("[T]he legislative purpose of section 1514A . . . is to protect against company retaliation for lawful cooperation with investigations . . . not to define the scope of investigative authority." Thus, the President decided to "construe section 1514A(a)(1)(B) as referring to investigations authorized by the rules of the Senate or the House of Representatives and conducted for a proper legislative purpose."), *with* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 806(a), 116 Stat. 802,

reform initiative.[113] Many of the SOX reforms seemed to codify practices that were employed by Enron and others; thus, it was known such reforms would not prevent future Enrons.[114] Meanwhile, reforms that enjoyed empirical support languished.[115] Thus, the SOX reforms have been largely ineffective in stopping corporate abuses.[116] Perhaps the most compelling indictment of the SOX reforms is to follow the money; CEO power seems to have been largely unaffected as compensation for senior executives continues to soar.[117]

Recent events illustrate just how weak American corporate governance standards have become. In the summer of 2006, it became clear that thousands public corporations

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(codified at 18 U.S.C. § 1514A(a)(1)(B)) (providing whistleblowers protection against retaliation for providing information "when the information is provided to or the investigation is conducted by . . . (B) any Member of Congress or any committee of Congress").

112 *Supra* note 29.

113 *Supra* notes 20 and 28. It is notable that during the time surrounding the enactment of the SOX, there was no significant effort for reform at the state level. Thompson & Sale, *supra* note 18, at 876. In Delaware, the primary response was to forestall further federal encroachment; not any concern with possible weaknesses in Delaware corporate governance. Jones, *supra* note 38, at 643-646. This suggests that at least in times of economic or financial crisis the political source for more exacting demands upon manangement is the federal government, responding to broad nationwide constituiencies in favor of financial stability and investor confidence. In political equilibrium, Congress remains sidelined, and state laxity for managers is the norm. *See* Jones, *supra* note 38, at 644-647 and 654-656.

114 Janis Sarra, *Rose Colored Glasses, Opaque Financial Reporting, and Investor Blues: Enron as Con and the Vulnerability of Canadian Corporate Law,* 76 ST. JOHN'S L. REV. 715, 723, 728 (2002) (stating that 13 of 15 Enron directors were independent); Jeffrey A. Sonnenfeld, *What Makes Great Boards Great,* HARV. BUS. REV., Sept. 2002, at 106-108 (contending, for example, that many of thee most notable corporate failures had independent boards). Enron also had a financial expert on its audit committee, as required by SOX. Dan Feldstein, *The Fall of Enron*, HOUS. CHRON., Feb. 4, 2002, at 1 (discussing the fact that the chair of the Enron audit committee was a former Dean of the Stanford Business School).

115 Ramirez, *Games CEOs Play, supra* note 97, at 1587-1588.

116 *Infra* notes 118 to 123, and accompanying text.

117 *Supra* note 4. If compensation is the litmus test of CEO power, then the legal indulgences of the 1980s and 1990s have served to greatly empower the CEO of the public company. Lucian Bebchuk & Yaniv Grinstein, *The Growth of U.S. Executive Pay,* 21 OXFORD REV. ECON. POL'Y 283 (2005) (finding that the proportion of S&P 500 profits going to top executive compensation approximately doubled as a percentage of profits from 1993 to 2003).

were backdating options grants to past dates when their stock was trading lower to maximize payoffs to their senior executives.[118] While backdating may not be illegal if both appropriately disclosed and in accordance with tax law, by the end of the summer two criminal cases had been filed against executives at Brocade Communications and Comverse Technology.[119] Moreover, over 100 companies disclosed that their options practices were under investigation by the end of the summer.[120] Rigging options grants to maximize payoff to executives by picking some low price point in the past as a fantasy and fraudulent grant date is "like stealing money from the company and shareholders."[121] It appears that this occurred systematically over a period of ten years throughout corporate America.[122] Such practices seem more about the crass enrichment of executives than creating any incentive for performance; indeed, one company

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118 Stephanie Saul, *Study Finds Backdating of Options Widespread,* NY TIMES, July 17, 2006, at C1 (reporting on an academic study finding "more than 2,000 companies appear to have used backdated stock options to sweeten their top executives' pay packages").

119 *Phantom of the Options,* INT'L HERALD TRIBUNE, Aug. 24, 2006, http://www.iht.com/articles/2006/08/24/opinion/edoption.php.

120 *Id.*

121 Carolyn Said, *Possible Options Scams at Several Local Companies,* SF CHRON., May 6, 2006 (quoting compensation expert Fred Whittlesey). "It is stealing, in effect. It is ripping off shareholders in an unconscionable way." Charles Forelle & James Bandler, *Matter of Timing: Five More Companies Show Questionable Options Pattern,* WALL ST. J., May 22, 2006, at A1 (quoting former SEC Chair Arthur Levitt).

122 Randall A. Herron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?,* 82 J. FIN. ECON.__ (2006) ("we find evidence suggesting that backdating is the major source of the abnormal stock return patterns around executive stock option grants."). "We . . . estimate that 29.2% of firms at some point engaged in manipulation of grants to top executives between 1996 and 2005." Randall A Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executive have been Backdated or Manipulated?*, at 23 (July 14, 2006) (working paper on file with author) *available at* http://www.biz.uiowa.edu/faculty/elie/Grants%207-14-2006.pdf (site last visited Sept. 15, 2006).

backdated options grants to enrich a dead executive.[123] The mere fact that this kind of scam was occurring at publicly traded companies at all suggests that corporate governance is not operating to reduce CEO autonomy (and thus agency costs) to acceptable levels.[124]

Overall, considering the legal trajectory of corporate governance law for publicly held companies it is not surprising that investment experts like John Bogle see a pathological mutation in our system of capitalism that exalts the interests of the CEO over all others.[125] CEO primacy is a direct outcome of the system of corporate governance law that devolved in the 1980s and 1990s into a dictatorship of management, by management, and for manangement.[126] At both the state and federal level corporate governance in the 1980s and 1990s became a parade of managerial indulgences.[127] At every turn, legislators, judges and regulators eliminated or diluted constraints on the power of management.[128] One must believe that the best means of controlling agency costs is to grant the agent unfettered discretion in order to believe that corporate federalism yields optimal outcomes.[129] Traditionally some level of judicial deference to

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[123] *Cablevision: Dead Exec. Got Backdated Options,* CNN MONEY.COM, Sept. 22, 2006, available at http://money.cnn.com/2006/09/22/news/companies/bc.media.cablevision.options.reut/.

[124] On the contrary, former SEC Chair Arthur Levitt has termed options backdating to be "the ultimate in greed." Forelle & Bandler, *supra* note 121.

[125] *Supra* note 1.

[126] *Supra* notes 65-106, and accompanying text.

[127] *Supra* notes 65-106, and accompanying text.

[128] *Supra* notes 65-106, and accompanying text.

[129] *See* Michael Jensen & William Menkling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("It is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint."). The problem of agency costs within the corporation has bedeviled shareholders and scholars from the very incipiency of corporate power; in fact, agency costs are inherent to the issuance of corporate

management was manifest in the business judgment rule; recently, that concept has succumbed to a new more promiscuous paradigm of CEO power unencumbered by virtually any civil liability.[130] The fact that this occurred at both the state and federal level suggests that the problem transcends corporate federalism and any debate about the race to the top versus the race to the bottom.

II. THE EMERGING SCIENCE OF CORPORATE GOVERNANCE

At the same time, there is an emerging science of corporate governance that exists independently of any debate regarding special interest influence or any race either way at the state level.[131] Instead this body of evidence empirically tests the outcomes of competing systems of corporate governance or specific elements of corporate governance.[132] The studies test the impact of corporate governance on macroeconomic

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equity. *Id.* at 312-313; *see also* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY xviii (2003). Controlling agency costs is key is key to the economic basis of the corporation. Jensen & Menkling, *supra,* at 357.

[130] As recently as 1983, authorities stated that the business judgment rule protected management only when they act with a "reasonable basis." HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 242 (1983). Even after the enhanced SOX criminal provisions took effect, there remain gaps in the degree to which criminal law can serve as an effective means of reducing agency costs and assuring that corporations adhere to legal mandates. Mary Kreiner Ramirez, *Just in Crime: Economic Reform After the Sarbanes-Oxley Act of 2002,* 34 LOYOLA (CHICAGO) L. REV.359, 427 (2003) (finding that criminal liability has been diluted, in a way not addressed by SOX, through downward sentencing departures granted by judges). Criminal prosecutions also require public resources; private civil actions can be pursued free of politics.

[131] It is clear that corporate governance can influence the functioning of the corporation in terms of financial performance and macroeconomic output. Nick Bradley, *Corporate Governance Scoring and the Link Between Corporate Governance and Performance,* CORP. GOV., Jan. 2004, at 8 (2004) (stating that "the good news" is that there are links between corporate governance and performance, but it is difficult to isolate the precise mechanisms driving such links). It is also clear that these links have only recently been integrated at all into corporate governance law, and then only in a most general sense. *See, e.g.,* John Coffee, *The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control*, 111 YALE L. J. 1, 64-65 (2001) (stating that empirical record "does fairly suggest that securities markets cannot grow or expand to their full potential under a purely voluntary legal regime" and that mandatory law is needed to prevent market "crashes.").

[132] *E.g.,* Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1166-1169 (2002) (finding evidence of higher valuation of firms in countries with better protection of minority shareholders and higher cash flow ownership by controlling shareholders, especially in countries with weak

performance across nations, or the impact of specific innovations on corporate financial performance.[133] This emerging interdisciplinary science of corporate governance means that there is an emerging vision of optimized corporate governance.[134] This emerging science serves a dual purpose: not only does it provide aspirational guidance, it also serves as a test of the current system's ability to deliver appropriate corporate governance standards.[135] Instead of theorizing or speculating about sound corporate governance, corporate governance is now studied in terms of actual outcomes, across disciplines.[136] These empirical analyses have covered a wide range of corporate governance issues.

For example, given the centrality of information to the functioning of markets, one may be tempted to conclude that any disclosure of corporate information is beneficial

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investor protections); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (providing empirical evidence that common law systems have superior shareholder protections than civil law systems, and that greater shareholder protections gives rise to more dispersed share ownership structures and larger capital markets); Rafael La Porta et al., *Legal Determinants of External Finance,* 52 J. FIN. 1131 (1997) (arguing that countries with weak investor protections tend to have stunted capital markets.)

133 *Compare* Ross Levine & Sara Zervos*, Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537 (1998) (relating economic growth to financial development); Maurice Obstfeld, *Risk-Taking, Global Diversification and Growth*, 84 AM. ECON. REV. 1310 (1994) (finding that the ability of investors to diversify through markets encourages growth), *with* Asli Demirgüç-Kunt & Vojislav Maksimovic, *Law, Finance and Firm Growth,* 53 J. FIN. 210 (1998) (finding that firms in countries with active stock markets were able to obtain greater funds to finance growth); Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998) (finding that industries dependent on external finance are more developed in countries with better protection of external investors).

134 Analyses of optimal corporate governance standards appear in economics journals, finance journals, law journals, and accounting journals. *See supra* notes 17, 89, 34, 122, 132, and 133.

135 Professor Romano relies upon an empirical analysis of corporate governance standards to impugn the Sarbanes-Oxley Act, but no scholar has thus far used this body of evidence to impugn our current system of corporate federalism and to articulate a new regulatory framework that can impound this learning into law in a systematic way. *See* Romano, *supra* note 18, at 1533 to 1543.

136 *E.g.*, M. Andrew Fields & Phyllis Y. Keys, *The Emergence of Corporate Governance from Wall St. to Main St. Outside Directors, Board Diversity, Earnings Management, and Managerial Incentives to Bear Risk,* 38 FIN. REV. 1, 12-13 (2003) (overview of empirical evidence regarding governance structures associated with financial performance).

to the functioning of financial markets and the corporation as an institution.[137] However, empirical studies suggest this theoretical supposition is flawed.[138] Instead, corporations providing frequent earnings guidance seem inclined to forgo expenditures that yield long term profits in order to inflate earnings over the short term.[139] Thus, in one recent study companies that provided frequent earnings guidance were found to have spent less on research and development than those companies that provided less guidance, and therefore to have suffered stunted financial performance over the long term.[140] It appears that the flawed system of American corporate governance gives CEOs the opportunity to forgo long term financial performance in favor of short term profitability (and presumably higher CEO pay).

Corporate governance should operate to limit CEO autonomy and to protect investors; this will lead to superior outcomes, because if investors are confident that their reasonable expectations will be secured by law they will invest at a lower cost to entrepreneurs.[141] Thus, investor protection is associated with higher economic growth.[142]

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137 *The Sounds of Silence,* THE ECONOMIST, Apr. 29, 2006, at 79-80 (noting that defenders of corporate earnings guidance argue that disclosure of "more information is always better").

138 Mei Cheng, K.R. Subramanyam & Yuan Zhang, Earnings Guidance and Managerial Myopia, Nov. 2005, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=851545 (working paper on file with author). This study involved a sample of 984 companies across 10 industries. *Id.* at 11.

139 *Id.* at 2 ("We find that . . . dedicated guiders spend significantly less on R&D than occasional guiders, which suggests that earnings guidance is indeed associated with myopic behavior with respect to R&D spending.").

140 *Id.* at 29 ("[W]e document that dedicated guiders invest less in R&D and have significantly lower [return on assets] growth than occasional guiders.").

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> When their rights are better protected by the law, outside investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognize that, with better legal protection, more of the firm's profits will come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm. By limiting the expropriation, the law raises the price that securities fetch in the

One study found that companies with superior corporate governance measures (based upon an assessment of 24 different corporate governance elements that operated to restrict shareholder rights) enjoyed superior stock market valuations.[143] This is consistent with other studies linking various indices of shareholder rights to financial performance.[144] Weak investor protection leads to a shift in the corporate balance of power in favor of management which will increase self-dealing and lead to higher compensation for executives.[145] If executive compensation is the "canary in the coal

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> marketplace. In turn, this enables more entrepreneurs to finance their investments externally, leading to the expansion of financial markets.

La Porta, et al., *Investor Protection, supra* note 132, at 1147. Financial market development is key to economic growth. *Supra* note 131.

142 Rui Castro, Gian Luca Clementi & Glenn MacDonald, *Investor Protection, Optimal Incentives, and Economic Growth,* 119 Q.J. ECON. 1131, 1131-35, 1166-67 (2004) ("[W]e employ standard techniques from the empirical growth literature to investigate the nature of the relation between investor protection and growth. Consistent with earlier studies we find a positive association.").

143 Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 108-109 (2003). The index used in this study consisted of 24 factors of corporate governance that the authors broke down into five groups: i) factors associated with delaying hostile threats to corporate control; ii) factors associated with voting rights; iii) factors designed to protect officers and directors from liability or termination; iv) other anti-takeover protections; and v) state laws bearing upon takeovers. *Id.* at 110-114. One of the factors included in this study are charter amendments to limit director liability for breach of the duty of care. *Id.* at 148-149. Prior studies also found that this particular factor is destructive of shareholder value. Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance,* 75 IOWA L. REV. 1, 43 (1989).

144 For example, the index used in the Gompers study, *supra* note 142, has since been refined into an apparently more powerful entrenchment index. *See* Lucian Bebchuk et al., What Matters in Corporate Governance?, March 2005, at 4 (working paper on file with author) (finding that staggered boards, supermajority voting requirements, poison pills, golden parachute provisions, and limits on shareholder voting power, all of which entrench management, accounted for most of the drag on financial performance attributable to weak corporate governance) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=593423. Other authors have tested the efficacy of other more expansive corporate governance indices. Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Company Performance, December 7, 2005, at 3 (working paper on file with author) (finding that a governance index based upon 51 elements influences operating performance, valuation and cash payouts to shareholders) available at http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf.

145 Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Governance and Control,* in 1A HANDBOOK OF THE ECONOMICS OF FINANCE 1 (George M. Constantinides, Milton Harris & René M. Stulz eds., 2003) (stating that corporate governance must stem self-dealing by managers and that soaring

mine" signaling pervasively weak corporate governance, then there is cause for serious concern in the US, where CEO compensation relative to earnings has doubled over the past 10 years.[146] In the long run, securing the reasonable expectations of investors through legal protection serves the economy, in general, and entrepreneurs in particular, while also operating to limit agency costs.

Investor protection entails mandatory disclosure of material information to the investing public—such as that required under the federal securities laws in the US.[147] To the extent investors have access to reliable investment information they should theoretically be more willing to invest, meaning entrepreneurs and businesses will enjoy a lower cost of capital.[148] While one may expect private contracts to be the most effective way to assure an efficient means of securing appropriate information flows, in fact, such contracting appears prohibitively costly.[149] Moreover, management is likely to be more focused on shareholder maximization if they are required to disclose financial information periodically.[150] Empirical evidence now supports these theoretical

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executive compensation in the United States is difficult to justify).

[146] Lucian Bebchuk & Yaniv Grinstein, *The Growth of U.S. Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005) (finding that the proportion of S&P 500 profits going to top executive compensation approximately doubled as a percentage of profits from 1993 to 2003). More than excess compensation may result from weak corporate governance. For example, the Gompers study found that weak corporate governance was also associated with inferior investment outcomes, as unconstrained CEOs engaged in acquisitions and investments that did not maximize shareholder value. Gompers et al., *supra* note 129, at 132-137.

[147] Michael Greenstone, Paul Oyer & Annette Vissing-Jorgensen, *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments,* 121 Q. J. ECON. 399, 447 (2006) ("these results should cause policymakers to question the basis of recent calls to repeal U.S. federal mandatory disclosure requirements.").

[148] *Id.* at 399-400.

[149] *Id.* at 405.

[150] *Id.* at 406-407 (citing Andrei Schleifer & Daniel Wolfenzon, *Investor Protection and Equity Markets,* 66 J. FIN. ECON. 3, 5 (2002) (articulating a theoretical financial model that accounts for the

conclusions. Specifically, Professors Greenstone, Oyer and Vissing-Jorgensen (GOV-J) found that when the applicability of the federal mandatory disclosure regime was extended to firms traded in over-the-counter markets, those firms enjoyed excess returns and gains in operating performance when they commenced compliance as well as in the period following the relevant legislative proposals.[151]

Previous studies had reached divergent conclusions regarding the efficacy of the federal mandatory disclosure regime.[152] Yet, these studies suffered from an inability to isolate the impact of the federal securities laws from exogenous events that impacted stock prices generally.[153] GOV-J are able to avoid these problems by using the extension of the federal securities laws pursuant to the 1964 Securities Act Amendments to compare the performance of affected firms against firms listed on the major stock

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following empirical facts associated with better shareholder protection: that it yields larger firms that are more valuable and plentiful; that it lowers the diversion of profits and raises dividends; and, that it yields a lower concentration of ownership and more developed financial markets)).

[151] *Id.* at 446-447.

[152] *Compare* George J. Stigler, *Public Regulation of the Securities Markets,* 37 J. BUS. 117, 124 (1964) ("[S]tudies suggest that the SEC registration requirements had no important effect on the quality of new securities sold to the public."), *with* Irwin Friend & Edward S. Herman, *The SEC Through a Glass Darkly,* 37 J. BUS. 382, 389 (1964) ("We doubt that any person reasonably well acquainted with the evolution of stock-market practices between the pre-and post-SEC periods could lament or underrate the success of the new legislation in eradicating many of [the] weaknesses in our capital markets."). The mainstream approach to these conflicting authorities was to ignore one, and to embrace the laissez-faire outcome of the other. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW § 15.8 (5th ed. 1998) (stating that economists "widely accepted" that mandatory disclosure for new issues does not help investors).

[153]

> We compare the stock returns and changes in operating performance of affected OTC firms with NYSE/AMEX firms. We also contrast these outcomes among OTC firms that are differentially affected by the 1964 Amendments. This research design provides an opportunity to avoid confounding the effect of the law with unobserved shocks to all firms' stock returns and operating performance. This feature of the analysis is an improvement on much of the previous empirical research on mandatory disclosure laws (e.g., Stigler, Friend and Herman , Robbins and Werner , and Jarrell).

Greenstone et al., *supra* note 147, at 401 (internal references omitted).

exchanges already covered by federal mandatory disclosure requirements.[154] While the GOV-J study is thus unique, it is consistent with other empirical analyses that have attempted to isolate their focus upon the impact of the mandatory disclosure regime.[155] "Overall, the results suggest that the benefits of the 1964 Amendments substantially outweigh the costs of complying with this law as measured by stock returns."[156] In addition, the GOV-J study concludes that the 1964 Amendments had a positive impact on operating performance "consistent with the hypothesis that mandatory disclosure laws can cause managers to focus more narrowly on the maximization of shareholder value."[157]

Given that investor protection is essential to securing the appropriate economic and financial operation of the public corporation, it would be natural to consider private enforcement and private rights of action as necessary components of an investor protection regime.[158] In fact, empirical evidence now demonstrates that "standards of

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[154] *Id.*

[155] *E.g.,* Carol J Simon., *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues,* 74 AM. ECON. REV. 295, 313 (1989) (finding that mandatory disclosure served to lower risk of new issues and in at least some cases raised returns).

[156] Greenstone et al., *supra* note 147, at 403.

[157] *Id.* at 447.

[158] Ramirez, *Arbitration and Reform, supra* note 27, at 1082-1083. Finance professors state the justification for broader investor remedies as follows:

> Efficiency considerations suggest that the lowest cost provider of information about a security should collect and present this information, and be held accountable if he omits or misleads. In the Grossman-Hart model, for example, the lowest cost providers are not the investors, but the issuers, the distributors, and the accountants. An efficient system would provide them with incentives to collect and present information to investors, and hold them liable if they do not. In securities laws, this strategy generally takes the form of disclosure requirements and liability standards that make it cheaper for investors to recover damages when information is wrong or omitted -- the two features we try to capture empirically.

liability facilitating investor recovery of losses are associated with larger stock markets."[159] This conclusion is supported by a transnational comparison of 49 nations in terms of financial development and strength of investor remedies, compiled with the input attorneys from around the world.[160] The authors compared liability standards by focusing on the degree of culpability of the defendant—ranging from fraud to strict liability as a means of assessing strength of investor rights.[161] Importantly, this study regarding the appropriate role of private securities enforcement tracks the outcome of a parallel study of private remedies for self-dealing under corporate law: "the results [of this study] suggest that giving aggrieved shareholders the standing to sue, access to information to identify self-dealing, and a low burden of proof would deter self-dealing and promote stock market development."[162] Thus, it appears that facilitating private rights of action in favor of investors is a key element of sound corporate governance.[163]

Rafael La Porta et al., *What Works in Securities Laws?,* 61 J. FIN. 1, 5 (2006).

159 More specifically:

> The results on liability standards are also consistently strong. The estimated coefficients predict that a two-standard deviation increase in this variable (roughly the distance from Denmark to the U.S.) is associated with an increase of 0.23 percentage points in the external-market-to-GDP ratio, a 28% rise in listed firms per capita, a 1.88 increase in the IPO-to-GDP ratio, a 6.6 percentage point drop in the block premium, a 0.75 point improvement in the access-to-equity index, a decrease of 6.6 percentage point drop in ownership concentration (but with a t-stat of only 1.58), and a 45.8 points increase in the volume-to-GDP ratio.

Id. at 19.

160 *Id.* at 5.

161 *Id.* at 7.

162 Simeon Djankov et al., The Law and Economics of Self-Dealing (April 2006) (working paper on file with author) available at http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/working_papers/SelfDeal_April13.pdf.

163 The Djankov study, *supra,* was undertaken by a team that included many of the authors of the study assessing private securities enforcement, *supra* note 158, as well as many of the other studies associating investor protections with superior financial and economic outcomes, *supra* note 132. As such

An additional issue that has been studied in depth is the effect of board diversity upon corporate financial performance.[164] "Human resource theorists have supported expectations for increased performance and increased value for companies providing programs that integrate diversity initiatives since at least the 1990s."[165] In general, diversity at the board level is associated with superior corporate governance and better financial performance.[166] Diversity has been shown to enhance cognitive functioning of groups and to disrupt groupthink, a dynamic characterized by mindless adherence to group norms and assumptions.[167] Left to their own discretion, it appears that CEOs

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they addressed the multicollinearity challenges posed by using different indices to determine stock market development. They concluded that "both disclosure and the power to enforce contracts through private litigation" appeared "important." *Id.* at 34.

[164] David A. Carter et al., *Corporate Governance, Board Diversity and Firm Value,* 38 FIN. REV. 33, 36 (2003) ("[D]iversity produces more effective problem solving. While heterogeneity may initially produce more conflict…the variety of perspectives that emerges causes decision makers to evaluate more alternatives and more carefully explore the consequences of these alternatives.").

[165] Fields & Keys, *supra* note 136, at 12. *See also* Steven A. Ramirez, *Diversity and the Boardroom,* 6 STANFORD J. L. BUS. & FIN. 85 (2000) (summarizing theoretical and empirical case that law should encourage businesses to embrace diversity).

[166] Carter, *supra* note 164, at 51 ("After controlling for size, industry and other corporate governance measures we find statistically significant positive relationships between the presence of women and minorities on the board and firm value."); *see also* DAVID A. BROWN ET AL., WOMEN ON BOARD: NOT JUST THE RIGHT THING . . . BUT THE BRIGHT THING i-ii (The Conference Bd. of Canada, May 2002) (finding that gender diversity enhanced corporate governance); Renee B. Adams & Daniel Ferreira, *Gender Diversity in the Boardroom,* European Corporate Governance Institute, Working Paper 58/2004 ("Overall, our results suggest quite strongly that in boards with relatively more women, more directors participate in decision-making, which may enhance their effectiveness.") available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=594506.

[167] *See* Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups,* 24 ACAD. MGMT. REV. 489, 494-99 (1999) (stating that heterogeneous boards benefit from cognitive conflict that results in a more thorough consideration of problems and solutions); *see also* Marlene A. O'Connor, *The Enron Board: The Perils of Groupthink,* 71 U. CIN. L. REV. 1233, 1241 (2003) (stating that "social homogeneity on corporate boards harms critical deliberation" and that "the best way to avoid groupthink is to prevent enclaves of like-minded people from making group decisions;" therefore, "reform proposals should discourage groupthink by promoting more diversity on boards in terms of gender, race, class, ethnicity, age, national origin, sexual orientation, and socio-economic background, as well as expertise and temperament.").

specifically engage in homosocial reproduction[168] to stock boards with those friendly to the CEO's interests in general in order to enhance their compensation.[169] This natural tendency is also demonstrated through CEO exploitation of board interlocks (where networks of CEOs serve on each other's boards) in a way that enhances their compensation.[170] There is therefore powerful evidence suggesting that board diversity leads to superior outcomes in terms of corporate performance and corporate governance, by disrupting the CEO's ability to exploit social dynamics such as groupthink and homosocial reproduction.

A further area of inquiry involves anti-takeover protections—which typically operate at the state level to insulate current management from the pressures of competitive corporate control markets.[171] Such protections make it difficult to oust incumbent managers from control which serves to enhance their power and increase

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168 Rosabeth Kanter originally coined the term "homosocial reproduction" to explain why white male managers seemed inclined towards homogeneity. ROSABETH MOSS KANTER, MEN AND WOMEN OF THE CORPORATION 48, 63 (1977). Thus, homosocial reproduction may be a significant factor in disparate treatment of women and minorities throughout the corporate hierarchy.

169 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) (finding that "when CEOs are relatively powerful, new directors are likely to be demographically similar to the firm's incumbent CEO"). Westphal and Zajac's study is based upon data from 413 Fortune/Forbes 500 companies from 1986 to 1991. Id. at 61. They define demographic diversity in terms of age, educational background, tenure with the organization, and insider/outsider status. *Id.* at 63-65. Nevertheless, the authors proceed from the assumption that "in-group bias" is "quite powerful" even when based upon irrelevant factors. *Id.* at 62. Westphal and Zajac conclude that cultural homogeneity on the board leads to higher compensation for the CEO. *Id.* at 79.

170 Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935, 947-51 (2003) ("[T]he number of mutual director interlocks is found to be significant and positively associated with total compensation.").

171 Bebchuk & Cohen, *supra* note 61, at 404 (stating that most U.S. states have anti-takeover statutes and Delaware courts have permitted management to engage in anti-takeover tactics such as poison pills which operate to dilute those attempting to seize control).

agency costs, in the form of higher executive compensation.[172] Another study found that anti-takeover legislation also weakened management incentives to negotiate lower labor costs generally, as CEOs apparently utilized their enhanced power to favor co-employees over more distant and less visible shareholders.[173] Indeed, it appears that in general such laws are associated with more lethargic management as the enhanced entrenchment leads to diminished investment in plants and lower productivity and profitability.[174] These facts are consistent with a slew of studies that demonstrate enhanced CEO power is closely associated with higher CEO pay, although not enhanced performance.[175] In all, it

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172 Marianne Bertrand & Sendhil Mullainathan, Corporate Governance and Executive Pay: Evidence from Takeover Legislation, Nov. 29, 1999, at 22 (working paper on file with author) ("We supply some evidence that state anti-takeover laws on average raised the total compensation for CEOs. This finding is consistent with the view that CEOs expropriate what they can from relatively weak shareholders and pay themselves more when takeover discipline goes down.") available at http://post.economics.harvard.edu/faculty/mullainathan/papers/execcomp.pdf. One may have expected compensation to go down in the wake of anti-takeover legislation, as CEOs would no loner demand compensation for the risk of takeover. *Id.* at 2. This would have vindicated the idea CEO pay is the result of an optimal contract between principal and agent. *Id.* Instead, the finding of the study tends to confirm a skimming model of CEO compensation. *Id.* at 22. Importantly, the authors also found that the presence of a large shareholder mitigated pay raises and was associated with greater incentive compensation innovations in the wake of anti-takeover legislation, as larger shareholders apparently acted more optimally as agents and searched for substitute forms of discipline. *Id.*

173 Marianne Bertrand & Sendhil Mullainathan, *Is there Discretion in Wage Setting? A Test Using Takeover Legislation,* 30 RAND J. ECON. 535 (1999)

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> We found that antitakeover laws generated rises in blue-collar workers' wages and even larger rises in white-collar workers' wages. This suggests that managers prefer to pay workers (especially white-collar ones) higher wages, which is consistent with stakeholder theories of the firm. However, we found that these higher wages did not, on net, translate into greater operating efficiency, suggesting that stakeholder protection did not "pay for itself." We also found evidence of a decline in the level of both plant creation and destruction, with little effect on overall firm size.

Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences,* 111 J. POLI. ECON. 1043, 1072 (2003).

175 *E.g.,* Richard M. Cyert et al., *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence,* 48 MANAGEMENT SCI. 453 (2002) (finding that the presence of large shareholders, boards with higher equity ownership, and higher firm default risk are associated with lower compensation); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are,* 116 Q.J. ECON. 901, 920- 26 (2001) (finding more pay-for-luck at firms without a large outside shareholder); Westphal & Zajac, *supra* note 145, at 77 and 79 (finding that "when CEOs are

appears that anti-takeover protections serve to enhance management power and compromise performance.[176]

Board composition has also commanded significant attention from corporate governance scholars.[177] For example, a staggered board may be a powerful anti-takeover device that operates to frustrate the ability of outsiders to seize control of a corporation.[178] There is robust evidence that a board that is independent of the CEO enhances corporate valuation.[179] Moreover, boards selected without the input from the CEO have more independent boards and achieve a higher market valuation.[180] Yet, evidence of the efficacy of so-called outside directors (those who are not otherwise employees of the corporation) is mixed, at best.[181] On the other hand, there is powerful

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relatively powerful, new directors are likely to be demographically similar to the firm's incumbent CEO" and compensation increases).

176 Lucian A. Bebchuk, *Letting Shareholders Set the Rules,* 119 HARV. L. REV. 1784, 1790 (2006) (showing that the market for corporate control is distorted by staggered boards as well as golden parachute and other payments to incumbent management, and therefore "leaves management considerable slack."). *See also supra* note 62.

177 Fields & Keys, *supra* note 136, at 4-12 (summarizing literature).

178 Lucian A. Bebchuk & Alma Cohen, The Costs of Entrenched Boards, June 2004, at 28 (working paper on file with author) ("We find that, even after controlling for firm value in 1990, having a staggered board in 1990 is associated with a significantly lower value during the period 1995-2002. This finding is consistent with staggered boards brining about a lower firm value and not merely being selected by low-value firms.") available at http://www.law.harvard.edu/faculty/bebchuk/pdfs/03.Bebchuk-Cohen.Entrenched-Boards.pdf.

179 Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis,* 54 J. FIN. 1829, 1852 (1999) (finding a higher stock market valuation when the CEO is involved in the director selection process than when the CEO is involved). Significantly, Shivdasani and Yermack distinguish between outside directors who have close links to the CEO versus more independent outsiders. *Id.* at 1831.

180 Varma found that in the closed-end mutual fund context when directors are selected without management involvement funds trade at higher valuations relative to net asset value. Raj Varma, *An Empirical Examination of Sponsor Influence Over the Board of Directors,* 38 FIN. REV. 55, 75 (2003) (finding that closed-end mutual fund sponsors capture boards and that the market values boards selected without sponsor involvement).

181 *Compare* S. Bhagat & B. Black, *The Non-Correlation Between Board Independence and Long Term Financial Performance,* 27 J. CORP. LAW 81 (2002) (finding no linkage between proportion of outside

evidence that the separation of CEO and chair of the board into two positions reduces agency costs and enhances firm value.[182] Similarly, there is evidence that an independent nominating committee for the selection of directors is associated with superior performance.[183] As elsewhere, endogeniety problems plague research in this area and it is difficult to discern if board composition drives performance or performance drives board composition.[184] Nevertheless, it does appear that board composition that reduces CEO autonomy is associated with superior outcomes, based upon the best corporate governance science available.

The emerging science of corporate governance also casts doubt on the efficacy of the Sarbanes-Oxley reform initiatives ("SOX"). Professor Roberta Romano has assiduously tested those reforms against the best empirical data regarding such reforms.[185] Professor Romano found that the "compelling thrust" of the empirical

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directors and various measures of performance), *with* R. Anderson et al., *Board Characteristics, Accounting Report Integrity, and the Cost of Debt,* 37 J. ACCT. & ECON. 315 (2004) (finding that firms with more outside directors enjoy a lower cost of debt).

182 Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance, December 7, 2004, at 7-8 (working paper on file with author) (summarizing literature and finding, consistent with that literature, that "firms are more valuable when the CEO and board chair positions are separate.") (citing J. Core et al., *Corporate Governance, Chief Executive Compensation, and Firm Performance,* 51 J. FIN. ECON. 406 (1999) (finding lower CEO compensation when CEO and board chair are split) and David Yermack, *Higher Market Valuation for firms with A Small Board of Directors*, 40 J. FIN. ECON. 185 (1996) (finding higher firm valuations when CEO and board chair are split).

183 *Id.* at 18 and 21-22 (empirical analysis finding that an independent nominating committee is one of three corporate governance factors "most closely linked" to performance and that it was a top three factor in terms of return on equity and net profits).

184 Fields & Keys, *supra* note 136, at 5 (summarizing literature); *see also* Gompers et al., *supra* note 143, at 144-145 (noting inability to eliminate possible operation of some "unobservable firm characteristic.").

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> The gist of the literature, that the proposed mandates would not be effective, was available to legislators while they were formulating SOX. Yet, it went unnoticed or was ignored. With the scholarly literature at odds with the proposed governance mandates being treated as though it did not exist, the quality of the of decision making that went into the SOX legislative process was, to put it mildly, less than optimal

literature did not support Section 301 requirement that public companies have an audit committee composed entirely of outside directors, as defined by Congress.[186] She also finds "compelling" empirical support that prohibiting auditors from providing non-audit services (as required by Section of 201 of SOX) does not affect audit quality.[187] Apparently there is little evidence supporting the efficacy of the requirement that CEOs and CFOs to certify the accuracy of financial statements, as mandated by Section 302 of SOX.[188] In short, Professor Romano concludes that a "brief review of the empirical literature suggests that a case does not exist for the principal corporate governance mandates in SOX."[189] Moreover, the one SOX initiative that is supported by empirical evidence, the appointment of a financial expert to the audit committee, is not a mandate but a disclosure requirement.[190] Thus, Professor Romano concludes that the corporate governance initiatives were "seriously misconceived."[191]

Romano, *supra* note 18, at 1526-1527.

[186] *Id.* at 1533 (citing 16 studies assessing efficacy of independent audit committees).

[187] *Id.* at 1537 (citing 25 studies addressing the impact of permitting auditors to provide non-audit services).

[188] *Id.* at 1543 (citing two studies with inconsistent findings).

[189] *Id.* at 1543.

[190] *Id.* at 1532.

[191] *Id.* at 1602. There is empirical evidence to the contrary. Brown & Caylor find that many of the SOX reform initiatives are associated with superior financial performance. Brown & Caylor, *supra* note 181, at 31 ("We find that independent board of directors, nominating committees and compensation committees are associated with good firm performance."); *see also* Reena Aggarwal & Robin Williamson, Did the New Regulations Target the Relevant Corporate Governance Attributes? (Feb. 12, 2006) (working paper on file with author) (finding that SOX reforms enhanced firm values in a "statistically and economically significant" way but simultaneity issues may mean that "more valuable firms opt for better governance") available at http://www.issproxy.com/pdf/Reemaaggarwal-GovernanceandFirmPerformance0206.pdf. It is notable that the authors declined to opine regarding the necessity of the SOX reforms because it appeared that the market rewarded sound voluntary corporate governance during the pre-Sox period of 2002-2003 before the reforms were mandatory. *Id.* at 28.

Professor Romano is correct in her diagnosis but not her prescription.[192] She argues (again) in favor of the current system of corporate federalism with a limited role for Congress.[193] The problem with this approach is there is little evidence that states are at all attentive to the very body of empirical data that Professor Romano relies upon to impugn the SOX.[194] It is difficult for example to find any empirical data supporting the destruction of the duty care, yet the Delaware legislature has led the nation in doing exactly that.[195] Similarly, when the Delaware courts permitted management to obtain shareholder approval for incentive compensation programs without disclosing management's valuation of such programs, there was no mention of any empirical data.[196] Nor has Delaware or any other state since exhibited any sensitivity to empirical

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192 My agreement with Professor Romano's diagnosis is limited by the recognition that corporate federalism had degenerated to such an extent that something had to be done by the summer of 2002. I agree that Congress could have crafted better legislation, and that it would have been well-advised to heed the science of corporate governance. Unfortunately, corporate federalism had yielded such power to CEOs during the 1980s and 1990s, that the market reacted favorably to SOX, even though it may have been a sub-optimal solution to the problem of management run amok. *See supra* note 190. Thus, my agreement with Professor Romano's diagnosis is strictly focused on the need for greater harmony between corporate governance standards and the best learning available.

193 *See supra* note 16.

194 For example, in the recent *Disney* litigation, the Delaware courts had a clear opportunity to vindicate extant empirical evidence shoeing the importance of investor protections and the need to curb CEO power, but choose instead to be oblivious to this evidence and to allow management to conduct itself without any risk of civil liability for any degree of negligence. *See* In re Walt Disney Corp. Derivative Litig., __ A2d.__ (Del. 2006).

195 On the contrary, Gompers, Ishii and Metrick specified duty of care insulation as one indicia of weak corporate governance that they found associated with inferior performance. *See* Gompers et al., *supra* note 143, at 148-149. Moreover, Bradley and Schipani found that Delaware firms generally lost value when the Delaware legislature provided for enhanced insulation with respect to the duty of care, and that firms that took advantage of such insulation declined further in value. *See* Bradley & Schipani, *supra* note 76, at 73-74. It would be inconsistent with any logic that the destruction of causes of action held by shareholders would be costless. Thus, it seems the destruction of the duty of care can only be deemed economically suboptimal. *See* THE CONFERENCE BD., COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 6 (2003) (finding that excessive compensation, resulting in part from lax monitoring by boards, led to an "unprecedented" loss of investor confidence during the corporate corruption crisis of 2001-2002).

196 *See* Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997) (holding that "allegations of failure to disclose estimated present value calculations [of stock option grants] fails to state a claim upon which relief

outcomes.[197] Certainly, it is the case that some of the state law outcomes discussed above predate the empirical data suggesting they are economically and financially suboptimal outcomes; nevertheless, there is no apparent movement by any of authority to revise these outcomes—evinced most clearly by the ill-founded outcomes of recent vintage.[198] Thus, state legislatures and courts are guilty of the same obliviousness to empirical evidence as Congress.

In addition, there is likely a dearth of institutional capabilities within any of these law making organs to integrate financial, economic and accounting studies into their deliberative process.[199] Legislators and judges are not required to have advanced degrees in these areas, nor should they be.[200] They have jurisdiction over a wide variety of legal

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can be granted" when management seeks shareholder approval of compensation and citing no empirical evidence that this is an economically appropriate outcome). It is difficult to see how shareholders can control agency costs if they are deprived of the information that management has regarding the value of options grants. *See* Jensen & Menkling, *supra* note 129, at 357.

197 Most recently, the Delaware courts gave meaning to section 102 (b)(7) by holding that to be liable under that provision a plaintiff must show an absence of good faith, meaning:

> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

In re Walt Disney Corp. Derivative Litig., __ A2d.__ (Del. 2006). Again the court was oblivious to any empirical learning regarding optimal corporate governance. *See id.* Professor Jones argues that Delaware courts imposed "stricter judicial scrutiny" over management, in an effort to preserve Delaware's position as the primary source of charters for public companies. Jones, *supra* note 38, at 645. She wrote before the Delware Supreme Court ruled in the *Disney* case. Apparently, the Delaware judiciary reverted to its pro-management deference. *Id.* at 646. Professor Jones musters convincing evidence that this shift was intended to protect Delaware's corporate law franchise. *Id.* at 643-660.

198 *Supra* note 197.

199 The sheer volume of research in the science of corporate governance is tremendous. In fact, "it is impossible to cover even a small percentage of the literature." Fields & Keys, *supra* note 136, at 19.

200 *E.g.,* UNITED STATES CONST, ART I AND ART. III (stating qualifications for federal legislature and federal courts and not requiring an advanced degree in finance, accounting or economics).

issues and have neither the time nor the expertise for such specialized knowledge.[201] It is hard to imagine a productive debate in the halls of Congress or the courthouses of America regarding the appropriate weight to give to the emerging science of corporate governance in making corporate governance law.[202] Even an institution with the resources of the Supreme Court of the United States seems unlikely to rest its opinions on the state of empirical data.[203] Institutionally, neither legislators nor judges are well-suited to interpreting and integrating the best learning on corporate governance into law.

The lack of institutional capability and expertise certainly transcends the corporate federalism debates about whether there is a race to the top or the bottom. Neither federal nor state authorities have exhibited any sensitivity to the emerging science of corporate governance.[204] Indeed, considering the lack of empirical support for the SOX is only the beginning of legal dysfunction.[205] Many corporate governance

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201 *See* STEPHEN BREYER, BREAKING THE VICIOUS CIRCLE 12, 55-81 (1993) (arguing that regulation is dominated by "random agendas" and institutional conflicts that create inconsistencies and uncoordinated regulation and proposing the creation of a class of super-regulators with specific expertise and experience); MARVER H. BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION 137-143 (1955) (articulating basis for agency regulation and including: i) the need to professionalize and provide expertise for regulation; ii) regulatory continuity; iii) allow for rapid adaptation to changing conditions; and iv) reduce special interest influence).

202 With respect to the PSLRA, for example, scholars had shown that there was no litigation explosion, there was no evidence of impaired capital formation, and there was no showing of extortionate settlements. Yet, these were the policy bases for the precipitous deregulation of the securities markets that occurred with the substantial destruction of private enforcement. Ramirez, *Arbitration and Reform, supra* note 27, at 1086-1087.

203 For example, in the two most recent Court cases to diminish investor rights, *Dabit* and *Dura* the Court ignores all empirical data regarding the importance of investor protections to corporate performance and economic growth, and instead continued its relentless march to CEO primacy. Dabit, 126 S. Ct. at 1510 (ignoring empirical record regarding economic importance of investor protection in favor of empirically unsound rhetoric from the 1970s about the supposed "vexatiousness" of deterring securities fraudfeasors); Dura, 125 S. Ct. at 1634 (finding plaintiffs claim legally insufficient without regard to empirical data on importance of investor protections).

204 *Supra* notes 198 and 203.

205 *Supra* notes 198, 202 and 203..

initiatives have not made it into law despite enjoying empirical support.[206] There is an intolerable chasm between the teachings of corporate governance science and corporate governance law.[207] In fact, one empirical study assessing the impact of shareholder rights and investor protection on the cost of capital found that the magnitude of departure from an optimal capital structure is quite large even in advanced countries because of sub-optimal corporate governance.[208] The study is founded on two premises which the authors empirically confirmed: first, weaker investor protection leads to more inside ownership; and second, more inside ownership leads to a higher cost of capital.[209] The finding of too much inside ownership (and therefore an unnecessarily high cost of capital) stems from the fact that weak investor protection leaves entrepreneurs holding too much firm specific risk that they cannot diversify.[210] Thus, the gap between optimal corporate governance and corporate governance law has been empirically demonstrated.

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206 Ramirez, *Games CEOs Play, supra* note 97, at 1603-1611.

207 *See* Charles P. Himmelberg, et al., Investment, Protection, Ownership and the Cost of Capital, May 2002, at 38-39 (working paper on file with author) ("there is still substantial room for improvement in the design of the legal and regulatory environment for financial contracting and corporate governance" even in developed countries like the US because the continued presence of inside ownership suggests that business managers hold too much costly undiversified risk) available at http://www.nbb.be/doc/oc/repec/reswpp/WP25.pdf.

208 *Id.* (stating that the magnitude of the gap between ideal corporate governance and actual corporate governance law, as evinced by the persistence of sub-optimal corporate capital structures in terms of inside ownership, is "potentially quite large."); *see also* Gompers et al., *supra* note 143, at 145 (finding that potential gains from improvements in corporate governance "would be enormous.").

209 *Id.* at 38.

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> If the exogenous level of investor protection were perfect, insiders would optimally choose to sell 100% of the equity (to diversify fully idiosyncratic risk) and steal nothing, but with imperfect investor protection, this contract cannot be (costlessly) enforced. By retaining a higher fraction of equity, insiders can credibly commit to lower rates of stealing, but are forced to bear higher levels of diversifiable risk.

Id. at 2.

Beyond that, however, deficiencies are manifest across corporate governance issues. The current system of corporate governance law looks nothing like emerging corporate governance science.[211] There is no restriction on management's earnings guidance.[212] There is no standard for encouraging more diverse boards to disrupt homosocial reproduction.[213] Anti-takeover protections serve to entrench management across the nation.[214] Congress and the Supreme Court have gutted private securities claims, even though investor protection is crucial to sound corporate governance.[215] Courts and legislatures aggressively reduced private remedies over the last 20 years.[216] All of this is precisely in accordance with the predictions of public choice and other theories of legislation and lawmaking.[217] Moreover, there are quite often footprints of management interests surrounding diluted shareholder protections and compromised investor rights.[218] The science of corporate governance shows that there is no market

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211 In assessment of 51 corporate governance elements, firm valuation positively correlated to sound corporate governance, even after the SOX, although not as strongly as prior to SOX. This is further empirical evidence that at least with respect to that particular index there is still room for improvement in US corporate governance. Aggarwal & Williamson, s*upra* note 191, at 28. It is not my intent to construct a new index of investor protection, but rather simply to highlight glaring deficiencies in the trajectory of corporate governance law versus the best corporate science offered by economists and financial experts. Thus, the factors I focus upon are driven by a subjective sense of specific elements that are most at odds with empirical learning rather than on elements that seem most powerfully associated with firm value, firm financial performance and macroeconomic performance.

212 *Supra* notes 137 to 140, and accompanying text.

213 *Supra* notes 164 to 170, and accompanying text.

214 *Supra* notes 171 to 176, and accompanying text.

215 *Supra* notes 80 to 91 and 141to 163, and accompanying text.

216 *Supra* notes 99 to 106, and accompanying text.

217 *Infra* Part III.

218 *Supra* notes 12, 29, 41 and 76. Professor Cary noted that in 1963 Delware declared it the policy of the state to enact pro-management corporation laws. Cary, *supra* note 13, at 663. Other commentators have noted the control that the corporate bar exercises over corporate law in Delaware. Jonathan R. Macey

pressure for optimized corporate governance there is only market pressure for indulgent pro-management corporate governance law. The next section seeks to articulate a means by which market action can be harnessed to achieve more optimal corporate governance standards.

III. TOWARD A FEDERAL RESERVE OF CORPORATE GOVERNANCE

American corporate governance is so indulgent of managers and so sub-optimal because of the dual problems of corporate federalism and special interest influence.[219] Managers freed themselves from the burden of private securities litigation through the use of special interest influence.[220] The same special interest influence subverted proxy reform.[221] With respect to the pattern of indulgences at the state level, it is more difficult to isolate special interest influence, but the fact that every change seems to operate to entrench the power of management and enhance the sway of the CEO over the corporation suggests that corporate federalism is ideally suited to the exercise of special interest influence, not any largely mythological race to the top.[222] As previously argued, it would make little sense for managers to use their economic and political power at the federal level, but not at the state level.[223] Outcomes at both the federal and state level are

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& Geoffrey P. Miller, *Toward and Interest Group Theory of Delaware Corporate Law,* 65 TEX. L. REV. 469, 506-509 (1987).

219 *Supra* Part II.

220 *Supra* notes 27 and 33.

221 *Supra* notes 20 and 28.

222 *See* Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action,* 84 N.C. L. REV. 1159, 1233 (2006) (stating that special interest negotiation taking place between lawmakers and organized groups with wealth can be "well-hidden").

223 There is evidence of special interest indulgences subverting corporate governance at all levels and institutional branches with lawmaking authority in the area of corporate governance. *Supra* notes 12, 29, 28, 27, 32, 33, 40, 41, 76, 91, 98 and 218.

simply too promiscuous to be consistent with any explanation other than special interest influence.

The exercise of special interest influence in this context would not surprise the economists, the political scientists, and the legal scholars who have studied the impact of economic and political power upon legal and regulatory outcomes.[224] Mancur Olsen's focus on the problem of collective action would predict a highly pro-CEO outcome in corporate governance standards, given the small number of CEOs, the wealth they command, their stakes in the outcomes of corporate governance, and the barriers to organization that shareholders face.[225] Economists predict that growing inequality would naturally lead to legal system outcomes that favor the rich and powerful.[226] Public choice

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[224] Even the Supreme Court is the mere extension of politics by other means; for example, Professor Derrick Bell long ago argued that Court's remarkable reversal of American apartheid, *Brown v. Board of Education,* 347 U.S. 483 (1954), responded to powerful economic and political pressure to develop the south and to sway people of color around the world against communism. *See* Derrick Bell, Brown v. Board of Education *and the Interest-Convergence Dilemma*, 93 HARV. L. REV. 518, 523 (1980) (showing that *Brown* was the "subordination of law to interest group politics"). Bell's thesis has since been buttressed by the research of Professor Dudziak. *See* Mary L. Dudziak, *Desegregation as a Cold War Imperative*, 41 STAN. L. REV. 61, 66, 82-84 (1988) (summarizing materials from the Department of State and the Department of Justice supporting Bell's thesis). The additional political insulation that the judiciary enjoys under the Constitution can not only be pierced by major issues of the day, but can be affirmatively threatened by the political branches, as President Franklin Roosevelt did in the 1930s. *See* William E. Leuchtenburg, *The Origins of Franklin D. Roosevelt's "Court-Packing" Plan,* 1966 SUP. CT. REV. 347-400.

[225] *See* McCaffery & Cohen, *supra* note 222, at 1161 (2006) ("In the now standard view of politics . . . small groups with high stakes arise independently, motivated by common interests and are able to solve the "free rider" problem of collective action on account of their small size.") (citing MANCUR OLSON , THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GOODS (1965)). McCaffery and Cohen suggest that the triumph of special interest influence is a two way street: well-organized groups and legislators bargain to exchange legislative largess for campaign contributions and other benefits for legislators. *Id.* at 1233-1235 (finding that Congress exploits special interests by stringing issues along and having repeated votes without resolving anything on issues such the repeal of the estate tax).

[226] Edward Glaeser, Jose Scheinkman & Andrei Shleifer, *The Injustice of Inequality*, 50 J. MON. ECON. 199 (2003). One recent study found that in the US over the last 25 years the income share of the top 10% increased substantially over last 25 years, garnering between 40-45% of earnings. Thomas Piketty and Emmanuel Saez, *The Evolution of Top Incomes: A Historical and International Perspective*, 96 AEA Papers & Proceedings 200, 201 (2006), *available at* http://elsa.berkeley.edu/~saez/piketty-saezAEAPP06.pdf (site last visited Sept. 14, 2006). The increase is attributed to "the very large increases in top wages (especially top executive compensation)." *Id.* at 204.

enthusiasts would argue that law and regulation will always be shaped by the economic and political power of those subject to regulation.[227] Given this rich theoretical framework in favor of the centrality of special interest influence, it is somewhat astonishing that corporate governance scholars have not focused more on how special interest influence has set corporate governance on such an indulgent pro-CEO course.[228] The sheer weight of debate on corporate federalism seems to occupy the full spectrum of rethinking how corporate governance is made in the U.S.[229] Nevertheless, the highly pro-CEO outcomes yielded by corporate governance (most notably regarding compensation), the relatively small number of CEOs, the wealth they command, the high stakes they have in corporate governance, the transitory nature of public scrutiny, and the highly political context in which corporate governance law is made (legislatures and politicized agencies), seems to fit theories of special interest power better than any race to the top

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[227] *See* Ronald A. Cass, *The Meaning of Liberty: Notes on Problems Within the Fraternity,* 1 NOTRE DAME J.L. ETHICS & PUB. POL'Y 777, 790 (1985) ("Take almost any government program at random, and a 'special interest' counter-majoritarian explanation can be found that is more plausible than the public interest justification for it."). While a compelling argument can be made that regulation may be subverted by special interests, important areas of regulation can be protected from special interest influence, as exemplified by the Fed's administration of monetary policy. Steven A. Ramirez, *Depoliticizing, supra* note 8, at 553. I have previously argued that when the public is focused upon an issue, it is possible that special interest can be thwarted, particularly when the public is unified. Ramirez, *Depoliticizing, supra* note 8, at 506 (stating that when the public is focused on an issue or area of regulation, special interests cannot dominate regulation, and citing Dorothy A. Brown, *The Invisibility Factor: The Limits of Public Choice Theory and Public Institutions,* 74 WASH. U. L.Q. 179, 181 (1996)).

[228] *Supra* notes 65 to 106. Professor Roe considers public choice theory and interest group politics in exploring the federal versus state regulatory dynamics, but not insofar as the decidedly pro-management outcomes are concerned on both levels. Roe, *supra* note 23, at 2541-2543. Notably, he does not focus upon "statute after statute or exact judicial holdings" but instead on "broad boundaries of corporate lawmaking." *Id.* at 2542.

[229] *Supra* notes 13, 14, 15, 16, 23, and 38.

thesis.[230] CEOs are simply better organized, and have superior economic and political resources than the investing public.

Special interest influence does not invariably subvert regulation, even in an area that is typically characterized as less than fascinating to the public.[231] I have previously demonstrated that the legal structure, the economic and political context, and the nature of the regulatory franchise, each influence the ability of a regulatory agency to deliver upon its premise of specialized and expert regulation in the general public interest.[232] This reality of depoliticized financial regulation is exemplified in the structure of the Federal Reserve Board.[233] The Fed has been a remarkable regulatory success story in that it seems far more responsive to economic science and market realities than to any kind of political or special interest pressure.[234] Monetary policy mirrors corporate governance in that it is highly specialized, it is a topic that rarely engages public scrutiny,

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230 Even the sporadic interference of Congress into state corporate governance law would be forecast by theories of legal reform, particularly given the ability of corporate governance to influence macroeconomic growth and stability. *See* Dani Rodrik, *Understanding Economic Policy Reform*, 34 J. ECON. LIT. 9, 31-38 (1996) (articulating a theory of economic reform which views economic crises as a central factor); *see also supra* notes 22 and 24).

231 Ramirez, *Depoliticizing, supra* note 8, at 553 ("The historical and empirical record suggests that the Fed has not exercised its power over monetary policy for the benefit of special interests.").

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> [T]he degree of political independence of an agency can be determined by considering: (1) the breadth of its delegation; (2) the extent to which its governing body can be removed by the President; (3) the terms of the members of its governing body, especially its Chair; (4) the method of funding the agency; and (5) the degree to which the agency enjoys bipartisan, long-term political commitment to its independence.

Id. at 518.

233 *Id.* at 522-532.

234 *Id.* at 552 (demonstrating that Fed has imbued monetary policy with a high degree of expertise and that its staff is "splendid proof of an American meritocracy.") (quoting WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 71 (1987)).

and it has tremendous economic importance.[235] This part of this article seeks to light the way for the creation of a regulatory entity that can achieve similar success in the area of corporate governance.

The first element of such an agency is its legal structure. The Fed Board of Governors enjoys extended terms and can only be removed for cause.[236] Their terms are staggered so no single President may exert too much influence over monetary policy.[237] Each Board member is subject to post employment job restrictions.[238] Fed Governors enjoy competitive salaries.[239] The Fed is self-funded and obtains its operating revenue through statutorily authorized assessments on member banks.[240] Thus, the Fed is not

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> [D]epoliticization is an appropriate means of improving regulation, and not an attack on our republican tradition, when: (1) the voting public has insufficient time, interest and resources to make informed electoral decisions; (2) powerful interests exist that may benefit disproportionally from regulatory policy; (3) the costs of misregulation are diffused and deferred; (4) the regulatory environment evolves quicker than Congress can legislate; (5) competing power blocks may persistently "freeze" Congress; and (6) the regulated area is so complex that a high degree of expertise is necessary for effective regulation.

Id. at 554.

236 Ramirez, *Depoliticizing, supra* note 8, at 522-524 (citing 12 U.S.C. §§ 241, 242).

237 *Id.* § 242.

238 *Id.*

239 5 U.S.C. §§ 5313, 5314.

240 12 U.S.C. §§ 243, 244. In 2000, I proposed the creation of a depoliticized SEC. Ramirez, *Depoliticizing, supra* note 8, at 574. I have now essentially abandoned that idea in favor of the more aggressive proposal of a depoliticized federal chartering authority for three reasons. First, although I was pessimistic in 2000 regarding the ability of corporate federalism to appropriately operate to optimize corporate governance, I underestimated how seriously flawed corporate governance had become until the parade of corporate corruption scandals in 2001-2002. *Id.* at 561 and 584 (stating that financial regulation as then structured faced "grave difficulties" acting in the public interest, but that crises in investor confidence may only occur "once a century"). Second, I underestimated the degree of special interest influence over the SEC, until its senior officers blew the whistle on the operation of such influence. *Supra* notes 12, 29 and 41. Third, in 2000, the science of corporate governance was more primitive than its current infancy; there is little reason to think that the SEC has the multidisciplinary expertise necessary to impound corporate governance science into corporate governance standards. *Supra* note 17. Thus, I

beholden to the Congressional appropriations process.[241] This structure was created so that the Fed could exercise its prodigious power over monetary policy in accordance "with the general public interest" and not "the majority of special interests."[242] An agency charged with the creation of a federal incorporation regime should be structured along these lines, and should be free from the politics implicit in the congressional appropriations process by having the power assess public companies for its operating costs.

The legal structure of a depoliticized agency, however, must be supported by a political and economic context that favors non-interference from the more political branches. The Fed for example is fully cognizant of the limitations on its powers posed by the fact that the political branches could abolish it.[243] This is a real source of restraint.[244] On the other hand, if the political branches were to ever precipitously impinge upon the Fed's independence financial markets would react negatively.[245] Corporate governance standards like monetary policy are debated moment to moment as

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propose a new agency without the history and fundamentally different focus than the SEC, which has long been fixated upon disclosure.

241 Ramirez, *Depoliticizing, supra* note 8, at 522-524. The Fed is, however, periodically reviewed by government auditing agencies, and presumably if abuses were uncovered Congress could reign in the current funding latitude that the Fed enjoys. *Id.* at 525 n. 110. No agency of the US should have unbridled discretion over its funds and expenditures.

242 H.R. REP. NO. 74-742, at 1, 6 (1935).

243 THIBAUT DE SAINT PHALLE, THE FEDERAL RESERVE 77 (1985).

244 JOHN T. WOOLLEY, MONETARY POLITICS: THE FEDERAL RESERVE AND THE POLITICS OF MONETARY POLICY 125-130 (1984) (studying monetary policy and concluding that the Fed "lies low" during election years for fear of being accused of playing political favorites).

245 *Id.* at 118 (reporting on Reagan Administration effort to threaten the Fed and the adverse financial reaction this generated); *see also* Vartanig G. Vartan*, Independent Fed Is Supported*, N.Y. TIMES, June 28, 1982, at D7 (noting the resistance of the financial community to the threat to Fed independence).

investors and markets react to the actual financial performance of companies.[246] Thus, like monetary policy, corporate governance would be subject to market tests and limitations.[247] Depoliticized monetary policy has stood the test of time and financial markets essentially demand it, and politicians acquiesce to it.[248] There must be the development of a similar political and economic coalition in favor of corporate governance based upon economic science instead of power.[249] The context of a depoliticized agency is most assuredly supported by elements of market discipline.[250] Thus, I also propose a market check on the power of any agency created to formulate corporate governance for public corporations.

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246 *E.g.,* Ramirez, *Law and Macroeconomics, supra* note 24, at 31-36; *see also supra* note 6.

247 The Fed only has direct control over short term interest rates, and is at the mercy of the market's inflationary expectations insofar as long term rates are concerned. E. Gerald Corrigan*, Are Banks Special?,* in FEDERAL RESERVE BANK OF MINNEAPOLIS 11 (1982).

248 Ramirez, *Depoliticizing, supra* note 8, at 528-530.

249 There are many powerful capitalists that would favor an institutional framework that resulted in superior corporate governance. Indeed, John D. Rockefeller and representatives of J.P. Morgan were early proponents of federalizing corporate governance in order to stem a race to the bottom. GABRIEL KOLKO, THE TRIUMPH OF CONSERVATISM: A REINTERPRETATION OF AMERICAN HISTORY, 1900-1916, at 63-64 (1963). Moreover, institutional investors are increasingly recognizing that corporate governance in America has failed. BOGLE, *supra* note 1. Institutional investors now hold 55% of all equities in the US. Thus, far social, cultural and regulatory realities have impeded this potential force for shareholder rights from fully manifesting itself. EISENBERG, *supra* note 23, at 154-162.

250 Centralization of regulatory authority is another key element of contextual support for a depoliticized agency. Centralization of regulatory authority means that an agency has autonomy over a zone of issues without attending to the potentially conflicting charter of other regulatory authorities. If an agency has centralized authority then it will not have overlapping authority with another regulator that may have conflicting goals. Similarly, concurrent agency authority may also lead to inconsistent approaches and rules relating to the same or related issues. *See* Larry D. Wall & Robert A. Eisenbeis, *Financial Regulatory Structure and the Resolution of Conflicting Goals,* 17 J. FIN. SERV. 223, 241 (2000) ("In most cases, Congress may be best served by . . . assigning the problems to a single agency, setting clear priorities for the agency and holding the agency accountable for its actions."). I am essentially arguing for the creation of a new agency that would have comprehensive authority over all aspects of corporate governance for companies choosing to submit to the new agency. The states and the SEC would lose all direct authority over such companies insofar as corporate governance is concerned.

Investors should have the specific right to elect corporate governance regimes—specifically, by electing to incorporate under the authority of federal law.[251] Vesting the right to select corporate governance regimes in shareholders puts real substance into shareholder primacy rhetoric.[252] As such it would vindicate the corporation's essential purpose: to facilitate the application of capital from passive investors to productive investment in profitable enterprises.[253] Shareholders should have some defined means of selecting the optional federal regime, or exiting the federal regime.[254] The power of the

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251 Bebchuk, *Increasing Shareholder Power, supra* note 10, at 836 ("Increasing shareholder power to intervene [in the affairs of the corporation] would improve corporate governance and enhance shareholder value by addressing important agency problems that have long afflicted publicly traded companies."). My proposal differs from that of Professor Bebchuk in that I call for a very limited notion of shareholder empowerment: specifically, the power to elect a federal regime of corporate governance. Along those lines, it is noteworthy that because I call only for a single additional shareholder power my proposal does not implicate arguments that management's business judgment would be inappropriately impaired. First, the selection of the chartering authority has nothing to do with managing the business of the corporation. Second, the depoliticized agency I advocate would be limited to those innovations founded upon corporate governance science and these innovations would be subject to market testing. *See* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment,* 119 HARV. L. REV. 1735, 1744-1746 (2006) (arguing that management must have the power to make non-reviewable business decisions).

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> [W]ithout shareholder intervention power, management's monopoly over the initiation of rules-of-the-game decisions might well result in inefficient corporate governance arrangements. Considering that public companies often live long lives in dynamic environments, management's control over rules-of-the-game decisions can produce severe distortions over time. Shareholder power to make rules-of-the-game decisions would address this problem. It would ensure that corporate governance arrangements do not considerably depart from the ones that shareholders view as value-maximizing.

Bebchuk, *Increasing Shareholder Power, supra* note 10, at 838.

253 Ramirez, *Rethinking, supra* note 92, at 986 (explaining that shareholder primacy, limited liability and the ability to lock-in capital free from claims from shareholders (or their creditors) operate to maximize the flow of capital from passive investors to productive enterprise).

254 Professor Bebchuk includes a detailed proposal regarding submission process, management counter-proposals, holding period requirements, expense reimbursement, limitations on resubmission, and the like. Bebchuk, *Increasing Shareholder Power, supra* note 10, at 870-876. A full assessment of such procedures is beyond the scope of this article which seeks merely to spotlight and resolve the problems of special interest influence over corporate governance and the need for a depoliticized agency to align corporate governance standards with corporate governance science. In general, Professor Bebchuk's framework appears thoughtful and appropriate, and would seemingly function as well in the context of my proposal as his. It is notable that Professor Bebchuk points out that other nations (including the UK) already have such mechanisms in place for empowering shareholders. *Id.* at 847-851.

depoliticized agency would also be limited by the market's assessment of optimal corporate governance; to the extent inappropriate standards are promulgated, charters (and accompanying franchise revenues) will migrate away from the federally-sponsored regime.[255] Vesting shareholders with the option of setting the authority for corporate governance would likely impose real constraints on managers even if shareholders rarely exercised such rights.[256] Like a well-oiled shotgun such an option would deter expropriation and reduce agency costs even if never fired.[257] Moreover, other jurisdictions, particularly Delaware would likely respond to optional federal threats with greater attentiveness to a more even-handed corporate governance.[258]

At first glance, creating such an agency for articulation of corporate governance standards for public companies may seem radical and undemocratic.[259] Yet, corporate

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[255] It may well be that in general it is highly appropriate that a depoliticized agency structure have a market foundation for its creation and continued existence. In other words, Congress would only part with such power on a durable basis if markets force it to do so, or Congress is confident that a check on the agency's power is manifest through market action. Either way relying on market assessments of corporate governance standards is central to my proposal for the institutional framework advocated herein. *See* Joan Macleod Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives,* 10 FORDHAM J. CORP. & FIN. L. 225, 384 (2005) (advocating that corporate law scholars think about the institutional context in which rules are made as much as the content of rules themselves).

[256] Just as Delaware acts to prevent federal preemption threats, management would act to reduce threats posed by alternatives to their own choice for incorporation. Jones, *supra* note 38, at 663.

[257] For example, there is evidence that management rarely listens to shareholders even when shareholder voters makes their preferences clear and even when the shareholder preference seemingly would add value to the firm. Bebchuk, *Increasing Shareholder Power, supra* note 10, at 868-871. Naturally, management can presently ignore shareholder preferences if shareholders have no recourse (except of course to sell and invest in another firm that will ignore their preferences); if management risks a major disruption to their prerogatives they would be more responsive.

[258] As Professor Bebchuk highlights, if shareholders have autonomy in the selection of corporate governance regimes, then states would have new incentives to cater to shareholder preferences. *Id.* at 868-869. Delaware appears to endeavor to maintain its position as the state of incorporation of choice for public companies. *See* Jones, *supra* note 38, at 663.

[259] The Fed has over the course of its history come under attack for the degree of power it wields free of political accountability. WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 12 (1987) ("The Federal Reserve System was the crucial anomaly at the very core of

governance rarely becomes a contested election issue.[260] Indeed, politicians seem to work to keep such issues from reaching any significant degree of political salience.[261] Moreover, the very design of corporate governance assures that states like Delaware may have influence over how capital is deployed nationwide, even though only the citizens of Delaware have any voice in the substantive content of corporate governance.[262] The citizens of Delaware have incentives to generate franchise tax revenue, but little incentive to assure that corporate governance is optimized in accordance with the best economic and financial science.[263] Under these circumstances, it is hardly surprising that corporate governance standards are sub-optimal.[264] The political system is custom made for those with great stakes in corporate governance—the CEOs of America's public corporations—to dominate the content of corporate governance.[265] A depoliticized agency would operate to shift power away from such interests and in the direction of economic and financial science—which can be an excellent means of vindicating the public interest in corporate governance.[266] Understanding the astounding costs of the current system and

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representative democracy, an uncomfortable contradiction with the civic mythology of self-government. Yet the American system accepted the inconsistency. The community of elected politicians acquiesced to its power.").

[260] In fact, during the corporate corruption crisis of 2002, Congress acted quickly and in unison specifically to avoid corporate corruption from being a campaign issue. Romano, *supra* note 18, at 1566.

[261] *Id.*

[262] Cary, *supra* note 13, at 701 (arguing that Delaware, as a "pigmy" state, ought not to have such power over corporate governance.

[263] Twenty percent of Delaware's tax revenues are attributable to corporate franchise fees, and most states garner less than 1% of their revenues from this source. EISENBERG, *supra* note 23, at 202.

[264] *See supra* notes 207 and 208.

[265] *See supra* notes 225, 232 and 235.

[266] Ramirez, *supra* note 8, at 504, 553.

the real shift in power away from CEOs and in favor of the public interest is the key to understanding the pro-democratic nature of the reform suggested herein.[267]

Finally, an agency similar to the Fed could bring to bear the kind of expertise to corporate governance that the Fed applies to monetary policy.[268] Monetary policy is not debated in Congress, much less in state legislatures or state and federal courts.[269] Monetary policy is instead the subject of intense debates in financial markets around the world and among economists at the Fed.[270] Law review articles do not debate whether the Fed should raise or lower the discount rate.[271] Indeed, there is no monetary policy law; and, for the same reasons there should be no corporate governance law.[272] Corporate governance standards affect the operation of the key economic institution in

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[267] *Supra* notes 6, 7, 207 and 208.

[268] *Supra* note 9.

[269] Professor Heminway has assessed the institutional expertise of the federal courts with respect to corporate governance law:

> Certain federal judges have been or are well versed in corporate and securities law, including corporate governance issues. But many have no such expertise. In fact, the securities regulation and corporate governance expertise of the federal courts specifically has been questioned on a number of occasions, and there is evidence that the Supreme Court is not confident in its own competence to handle corporate governance matters. The lack of expertise of the Supreme Court in securities regulation and corporate governance may reflect, at least in part, the small number of business law cases it has decided relative to the number of cases it has decided in other subject matter areas.

Heminway, *supra* note 255, at 304. Many maintain that Delaware has superior expertise, yet it acts without regard to the empirical science on the issues it addresses. *Supra* note 197.

[270] *Supra* note 247

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[271] In this respect, I take the fundamental point of Professor Heminway one step further. She argues, correctly, that scholars should think not just about optimal legal outcomes, but the legal institutions necessary to secure such outcomes. I posit that the institutional structure for corporate governance of public companies should be optimized and never debated again—essentially the reality today for monetary policy law. *See* Heminway, *supra* note 255, at 384.

[272] *Supra* notes 232 and 235.

the world.[273] Corporations are the pivotal store of risk capital in the U.S., and the key holder of society's wealth.[274] The manner in which corporations are governed will hold sway over a wide range of national issues—from economic inequality to globalization.[275] Like monetary policy, corporate governance is too important to be left to politics and special interest influence.[276] If left to an expert administrative agency, with interdisciplinary expertise, then the science of corporate governance could be impounded into corporate governance standards.[277] Until such an agency is created the best learning regarding appropriate corporate governance standards is likely to continue to fall on deaf ears—or at least ears with insufficient expertise or too beholden to interest group politics.[278]

All of this suggests that a depoliticized agency for corporate governance is both possible and likely to be effective. It is possible because there is compelling economic case in support for a more rational legal structure for the promulgation of corporate

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273 *Supra* note 11.

274 *Supra* note 11.

275 Ramirez, *Rethinking, supra* note 92, at 1009 (arguing that an optimized legal infrastructure surrounding the corporation could serve many broad societal goals, specifically including race).

276 As Professor Heminway notes, Congress does have specialized committees and the ability to hold hearings, which no doubt justifies some degree of deference to its fact-finding. Heminway, *supra* note 255, at 271-276. Nevertheless, "highly specialized matters" such as corporate governance are outside the "actual and potential expertise" of legislatures because of the time and expertise needed to address such subjects in depth. *Id.*

277 As presently constituted it is not clear that the SEC has interdisciplinary facility with regard to corporate governance science. *See supra* notes 17 and 132.

278 The SEC, as a specialized administrative agency no doubt has substantial expertise in securities regulation. Heminway, *supra* note 255, at 284-291. Nevertheless, the SEC has been shown by its own senior managers to be too beholden to interest group politics, particularly the lobbying efforts of corporate managers and their minions. *Supra* notes 12, 20, 28 and 29.

governance.[279] Corporate governance law has yielded corruption crisis upon corruption crisis.[280] Globalization means that other nations are striving to optimize their legal infrastructure.[281] If the US continues to allow politics and regulatory obsolescence to dictate a fundamentally pro-CEO approach to corporate governance then other nations are likely to discover a more optimal means of articulating corporate governance standards in order to seize a competitive advantage.[282] It would be effective because in the end experts protected from special interests and steeled by market tests would invariably outperform rent-seeking state law making organs and federal legislatures[283]

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279 *Supra* Parts I and II.

280 Between the summer of 2002, with its parade of corporate scandals, and the summer of 2006, with revelations of a widening options scandal that former SEC Chair Arthur Levitt called the "ultimate in greed," was the Refco public offering fraud of the fall of 2005. *See* Ramirez, *Chaos,supra* note 5, at 359. Refco was the largest independent futures broker in the US. Its CEO concealed $430 million in debts that he owed Refco through entities he controled, leading to his indictment for securities fraud. The Refco public offering would have triggered the full applicability of the Sarbanes-Oxley Act, but only after the company consummated its public offering. The SEC had regulatory authority over the Refco public offering and its securities brokerage units. Grant Thornton audited the firm's books in accordance with the new Sarbanes-Oxley regime governing audits of public firms. Numerous underwriters and professionals (includeing the attorneys) would each have been subject to the "due diligence" requirements of federal securities laws. Still, despite all of this oversight millions in debts owed by the firm's CEO were not discovered until after the public offering. One expert concluded that "[t]here is no way you can rely on an auditor or an investment bank for a seal of approval or a guarantee of no chicanery . . . . The lesson to be learned from Refco is that you must do sleuth work yourself." *Id.*

281 *Supra* note 224.

282 China has already demonstrated an ability to achieve remarkable growth by finding alternatives to the American system. JOSEPH STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 74 (2002) (finding that China's economy is "directly opposite to the market fundamentalism prescribed by the US).

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> Among the interest groups that may influence congressional deliberations are associations comprised of businesses with joint or overlapping rulemaking interests, industry or trade groups, professional associations, and other business interest organizations (e.g., the Chamber of Commerce and the Business Roundtable). In fact, many observers assert that business interests have disproportionate influence in American politics because of their strong representation in U.S. interest groups. Interest groups representing accounting and business interests are widely credited with defeating a proposal (made in the early 1990s) to expense stock options.

Heminway, *supra* note 255, at 315.

and regulators beholden to management interests.[284] The question is not whether corporate governance regulatory structures will be optimized, but rather by which nation in response to what financial crisis.

CONCLUSION

Corporate governance in the United States suffers from a flawed legal structure that yields suboptimal results. The SEC is subject to the distortions implicit in a politicized regulatory agency. State legislatures show little concern over achieving optimal corporate governance standards. Courts seem to guess at the best corporate governance outcomes rather than rely upon the best financial and economic science available. In short, the reason why corporate governance in the U.S. diverges from the optimal corporate governance emerging from economic and financial science is because there is no mechanism at present to assure that optimal corporate governance standards prevail.

There is little evidence that any market for corporate governance is operating to move standards toward optimal outcomes. Investors seem not to impound material corporate governance law into their investment decisions. Our history of corporate federalism is pocked with instances of special interest influence holding decisive power, not any concept of optimality. More importantly it is now clear that capital markets are

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[284] *See id.* at 319-327 (assessing influence of interest group politics on the SEC and finding that SEC is subject to the same influences as Congress, but may also be a captured agency) (citing Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May"*, 48 VILL. L. REV. 1245,1280 (2003) ("[p]ublic choice scholars looking for recent examples of agency capture will feast on the SEC's" rulemaking under section 401 of SOX regarding disclosure of off-balance sheet transactions, which the SEC diluted under pressure from business executives, financial interests, corporate law firms and the accounting industry) and Stephen Labaton, *S.E.C. at Odds on Plan to Let Big Investors Pick Directors*, N.Y. TIMES, July 1, 2004, at C1 ("The paralysis at the agency[regarding proxy reform] is a major victory for corporate executives who have fought to kill the rule and a setback for labor organizations and institutional investors who have pushed for years to get the commission to adopt it.")).

yielding unsatisfactory outcomes in terms of corporate governance. Indeed, permitting unbridled CEO power to reign in corporate America, as it does today, is inconsistent with any principled economic view of how corporate governance should function.

Instead, it appears the only market functioning to define corporate governance is the market predicted by public choice enthusiasts with respect to regulation and legislative action generally. CEOs have superior resources and organizational capabilities. They have incentives to undertake collective action designed to assure that their interests prevail over the general public interest. Lawmakers are beholden to the views of the powerful and the organized, and there is neither an investors lobby nor any general economic growth lobby. Outcomes are decisively in favor of CEO power, with little legal constraint. At both the federal and state level, corporate governance outcomes seem best explained by special interest influence.

This paper attempts to articulate a new kind of corporate governance regulation. The goal is to create an authority with the power to articulate corporate governance standards in accordance with best corporate governance science available. Such an agency can be structured to resist special interest influence, just as the Fed is so structured. This agency would use markets to optimize corporate governance in accordance with real shareholder primacy, because shareholders would have the power to choose corporate governance regimes for their corporation. Shareholders would be empowered to vote to switch to an optional federal incorporation regime. This would preserve the advantages of the corporation while yielding superior outcomes in terms of corporate governance standards. No longer would courts of law, legislatures and politicized agencies have sway over this important area. Instead science and markets would be vested with decisive influence. Lawyers would be limited to refining the system that produces corporate governance standards, instead of corporate governance law. Corporate governance law would become as relevant as monetary policy law.