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The Special Interest Race to CEO Primacy and the End of Corporate Governance Law.

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THE SPECIAL INTEREST RACE TO CEO PRIMACY AND THE END OF CORPORATE GOVERNANCE LAW

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ABSTRACT

Recently, many respected business leaders have voiced concern that corporate governance in American public companies has moved toward CEO primacy or a "dictatorship of the CEO," and away from traditional notions of shareholder primacy. This article shows that this concern is well-founded. The current system of corporate governance tends toward management indulgences. This is clearly reflected in key legal elements of corporate governance, which embrace increasing laxity. New empirical evidence also suggests that the trend of corporate governance is away from more demanding standards that seem to reduce agency costs and enhance financial and economic performance. The model that best explains corporate governance dynamics are economic models of special interest influence rather than any largely mythical race to ever more optimal corporate governance standards. This article concludes that the sub-optimality of corporate governance is crisis prone and subject to challenge from competing nations. Therefore as currently constructed the system is unsustainable.

I. 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 Chief Executive Officers (CEOs) have "contrived" a "moral code that justifies grabbing as much as they can."[2] In late 2006 and early 2007, a widening scandal over backdated options grants had ensnared more than 200 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

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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.

designed to enrich officers at the expense of shareholders.[3] Meanwhile, CEO compensation at America's leading public corporations continues to soar.[4] This article shows that "CEO primacy" is rooted in certain key legal changes in the 1980s and 1990s that are in turn rooted in special interest influence.[5] The cost of such CEO primacy to the economy and shareholders is huge.[6] This article argues that this CEO primacy as embedded in law is neither economically nor politically sustainable, and will create

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[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 ST. J. ONLINE, *available at* http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html. As of this writing, the FBI has disclosed 52 inquiries and the Securities and Exchange Commission (SEC) was pursuing 100. Stephen Taub, *FBI Probing 52 Companies Over Backdating*, CFO.COM, Sept. 26, 2006, *available at* 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, *available at* http://www.forbes.com/ business/2006/08/09/options-crosshairs-backdating-cx_lm_0810options.html (pointing out that the government is cracking down on companies expected of backdating stock options to CEOs, with the possibility that directors will be held responsible for any accounting irregularities).

[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, Apr. 11, 2006, *available at* http://www.usatoday.com/money/companies/management/2006-04-09-ceo-compensation-report_x.htm (stating that compensation for CEOs at America's largest 100 corporations soared 25% in both 2004 and 2005).

[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, 114 (2004) (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 Backdating Executive Stock Options*, 105 MICH. L. REV. (forthcoming June 2007), *available at* http://ssrn.com/abstract=931889 (finding that backdated options at forty-eight sampled companies resulted in approximately $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.*

constant pressure for reform until the current system of corporate federalism is scuttled.[7]

Our system of corporate governance is dysfunctional because the governing legal structure underlying that system is dysfunctional.[8] Essentially, our system is based upon a historically path dependent corporate federalism that yields three pernicious outcomes, each of which are inherent in the structure of the system. First, a very small group of citizens (those residing in the state of Delaware) has autonomy over corporate law that affects the entire economy coast to coast; however, Delaware has little interest in getting corporate governance right.[9] Second, federal intervention into this system is in response to broad-based political pressure arising from financial crises; at such time, it is more expedient for federal lawmakers to do something rather than the sound thing.[10] Third, in a non-crisis political equilibrium, management interests are sufficiently dense that they may concentrate their resources on corporate governance issues while the public is oblivious; thus, in the ordinary course,

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[7]In assessing the costs of backdating, the study found that the costs exceed the market capitalization costs isolated in the study. *Id.* 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*, (AFA 2005 Philadelphia Meetings Paper, 2005), *available at* http://ssrn.com/abstract=644017 (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).

[8]This article focuses upon corporate governance of the public corporation. 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.A. § 78*l*(g) (2004) (stating statutory definition of public company); 17 C.F.R. § 12g-1 (2006) (SEC exemption for companies with less than 500 shareholders and $10 million or less in assets). Public corporations are the central economic institution in the U.S., as they command a total market capitalization of almost $16 trillion. *See* Wilshire Assoc., Fundamental Characteristics of the Wilshire 5000, *available at* http://www.wilshire.com/Indexes/Broad/Wilshire5000/Characteristics.html (last visited Oct. 31, 2006). As such they are the primary store of investment capital in the U.S.

[9]*See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 629, 638 (2004) (documenting that Delaware is far more concerned with quelling threats of federal intervention than getting corporate governance right); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1105 (1997) (discussing Delaware's politically vulnerable position as a small state with national governing power).

[10]*See* HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE 3 (2006) (stating that the "best evidence" shows that the Sarbanes-Oxley Act (SOX or Act), which was enacted pursuant to a "regulatory panic," has imposed net losses of $1.1 trillion).

management has the greatest political sway over corporate governance.[11] Each of these elements is exacerbated by deep information deficiencies regarding corporate governance outcomes.[12] The result of this system is to maximize the ability of management to reduce constraints, achieve ever increasing levels of compensation, and impose agency costs upon shareholders and the economy as a whole; indeed, the system is devolving towards CEO primacy and the end of shareholder primacy.[13] This article posits that the resolution of these dynamics will require a deep restructuring of the regulatory environment governing the American public corporation.[14]

At least since William Cary's landmark 1974 article, *Federalism and Corporate Law: Reflections upon Delaware*,[15] there has been a running debate regarding the proper role for the federal government in the area of corporate governance.[16] 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 suboptimal corporate governance standards that are indulgent to managers, who currently make incorporation

[11]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).

[12]There is scanty evidence, at best, that corporate governance is impounded into individual stock prices. Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 572 (2000).

[13]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.").

[14]Financial regulation can be founded upon effective regulatory structures that are not beholden to special interest influence. *See* Ramirez, *supra* note 12, at 504 (finding that "the Federal Reserve Board's administration of monetary policy exemplifies the possibility of depoliticiz[ing] regulation" in that it regulates effectively in the general public interest, and is not beholden to special interest influence). In contrast to the system of regulation applicable to corporate governance, the Federal Reserve's administration inspires far more accolades than reform proposals. *See id.* at 553 ("The Fed thus demonstrates [that] important economic regulation can be secured against the pernicious influences of special interests. Benefits of expertise, regulatory flexibility and stability of policy can [also] be secured.").

[15]William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701 (1974) (advocating minimum federal standards for corporate governance for publicly held companies).

[16]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 Co. v. Lee, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting).

decisions.[17] On the other side are those claiming that capital markets would punish corporations hobbled by suboptimal 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.[18] This article proffers a diagnosis that is more dependent upon the negative influence of special interests rather than state versus federal law. Essentially, this article argues that corporate governance law is polluted by familiar notions of regulatory capture and public choice. In fact, this article will show empirically that corporate governance standards are suboptimal under both federal and state law.[19]

As such, this article urges to scholars to rethink the *system* by which corporate governance is promulgated at both the federal and state level.[20]

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[17] *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, 861-62 (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.").

[18] *E.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14-17 (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. LEGAL STUD. 251, 276 (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 investors, and the competition between states for charters is generally a competition as to which legal system provides an optimal return to both interests.").

[19] Today, it is possible to test the optimality of corporate governance standards through the lens of an emerging science of corporate governance. *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* 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 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).

[20] *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529 (2005) (demonstrating that the SOX 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 U.S., particularly with respect to the disclosure obligations of management of publicly held companies. Robert B. Thompson & Hillary A. Sale, *Securities*

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.[21] 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 is a need for optimal regulatory structures that can operate to move our system toward an optimal system of corporate governance.[22]

Part II of this article will review the current learning on corporate federalism 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 is subverting 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 as to whether special interest influence is corrupting corporate governance. The focus will be on the substance of corporate governance and the operation of prevailing regulatory structures, and not on any truncated view limited to just state law dynamics or just federal law dynamics.

Part III 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 III will demonstrate the inferiority of the current regulatory regime in achieving optimal corporate governance standards. The conclusion of both Parts II and III 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

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Fraud as Corporate Governance: Reflections upon Federalism, 56 VAND. L. REV. 859, 909-10 (2003) ("[W]e now have a functional division of monitoring between state and federal governments.").

[21]*E.g.*, Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty through Legal Liability*, 42 HOUS. L. REV. 393, 451, 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").

[22]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).

enterprises with a higher cost of capital and will burden our economy with stunted macroeconomic performance.

Part IV will place the evidence developed earlier in the article into a theoretical framework of special interest influence that will demonstrate its predominance over corporate governance. At least as early as the drafting of the United States Constitution, influential voices have cautioned that "factions" could operate in the context of a democratic republic to undermine the "general welfare" and pursue their own legal agenda. Today, there is broad support for the idea that small concentrated groups may organize themselves. There is also little dispute that CEOs are a well-organized group with access to significant resources. Theory would therefore predict precisely the outcome plaguing our system of corporate governance: a suboptimal economic outcome tilted strongly in favor of CEOs.

This article concludes that corporate governance law as presently constructed is not likely to survive. The current system yields inferior substantive outcomes and there is no stable regulatory authority capable of remedying this. The current system permits too much management autonomy and fails to reduce agency costs to an acceptable level. Consequently, shareholder primacy rhetoric is likely to give way to CEO primacy reality and throw capital markets into serial crises. Ultimately, superior models of regulating corporate governance will emerge (in the U.S. or elsewhere) that will yield economically superior outcomes for corporate governance standards.

II. 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

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[23]Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2494-95 (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.*

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 (SOX or Act)[25] which according to many respected voices imposed compliance costs upon American business far in 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 U.S. has both the look and feel of regulatory dysfunction—specifically, it appears that management itself dominates the regulatory apparatus that governs its 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 SOX in mid-2002, did nothing to shake this view of special interest domination accompanied by transient exceptions.[28] Indeed, events following the enactment of the SOX

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[24]Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31 (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 evidence of some flaw in the efficient market hypothesis.

Id. at 40-41.

[25]Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in 15 U.S.C. § 7211).

[26]*E.g.*, Romano, *supra* note 20, at 1594 (stating that the SOX 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. SOX has added billions of dollars in compliance costs, and for no clear public gain.").

[27]One such example of this special interest domination at the federal level is the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). *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) ("[R]ecent '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 the SOX, 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 SOX 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. *See* 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.").

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 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 the 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 bottom/race to the top debate from the perspective of state law.[34] But if managers use special interest influence 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 markets and economic 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

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[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 SOX. Tim Reason, *Two Weeks in January*, CFO MAG., Mar. 1, 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, *supra* note 12, 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, *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, 527 (2001) (finding evidence that Delaware corporations had higher firm value), *with* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 57 (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]*See supra* note 33.

[36]*See* Romano, *supra* note 20, at 1529-43.

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 itself, however, has 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 SEC, 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 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

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[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.*, Jones, *supra* note 9, at 629 ("I do not advocate wholesale federal preemption or the development of an optional federal regulatory scheme. Instead, I urge a sustained vigilance from Congress and a willingness to take limited preemptive measures when state corporate law rules fall short in . . . protection for investors.").

[39]*See* Ramirez, *supra* note 24, at 40-41.

[40]"Inappropriate political and special interest influence pervade financial regulation. The American economy has suffered greatly as a result." Ramirez, *supra* note 12, at 579.

[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 11, 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, 136-37.

[42]*Id.* at 10-12, 136-37. Professors Bebchuk and Hamdani have recently demonstrated that federal intervention follows an historic pattern of imposing more rigourous constraints upon managers. Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793 (2006). While it is certainly true that federal intervention has traditionally operated to mitigate shortcomings in state corporate governance, more recently federal intervention has been marred by far more qualitatively important special interest indulgences that will be shown to be closely associated with massive corporate scandals. Thus, Bechuck and Hamdani fail to account for the role of special interest influence over federal regulation in the 1990s, leading to the crisis of 2001-2002. *See, e.g.*, *supra* note 41.

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 U.S. leads to excessive laxity in corporate governance standards, or results in competitive pressure for states to formulate even more ideal standards.[45] For example, to the extent the race to the bottom 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 SOX—the most invasive federal regulation of corporate

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[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.* Federal 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. Federal Reserve Board's Semiannual Monetary Policy Report, *supra* note 5, at 44 ("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]."). I argued in 1999 that the PSLRA "is a betrayal of the policy foundations of the federal securities laws and a threat to the long term stability of our securities markets." Ramirez, *supra* note 27, at 1093.

[45]*See* Jones, *supra* note 9, at 663 (stating that the spate of corporate corruption in 2001 and 2002 "reveals flaws in modern federalist arguments denouncing national-level regulation" and that the "[u]nreflective 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 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, 852 (1995) (concluding "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% of its revenue from franchise fees paid by corporations chartered there. EISENBERG, *supra* note 23, at 202.

governance in history.[46] The SOX excluded management from control over the audit function by requiring an independent audit committee.[47] Therefore, 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 also enhanced the need for independent directors.[50] These are just the provisions of the Act that deal most directly with corporate governance 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 and 2002 seems to have steam-rolled the idea that corporate federalism in the U.S. 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 in order to assess the possibility that

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[46]*See* Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159 (2004) (calling the SOX a "modest revolution"); *Annual Review of Federal Securities Regulation*, 58 BUS. LAW. 747, 748 (2003) [hereinafter *Annual Review*] (stating that the U.S. 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-1(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-1(m).

[48]*Id.* §§ 101-109, 15 U.S.C. § 7211-7219 (creating the "Public Company Accounting Oversight Board" to regulate audit firms of public companies).

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

[50]*See* Sarbanes-Oxley Act of 2002, *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, *supra* note 46, at 1170-75.

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

[52]*See* Seligman, *supra* note 46, at 1185 (calling for a "broad reexamination" of federal corporate governance law to "augment" and evaluate current mandates).

[53]*See* Romano, *supra* note 20, 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, *supra* note 24, at 61-62 ("So long as executives 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.").

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 the 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 governance practices at firms (which can be implemented pursuant to any state corporation code) than which state provides the 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] Markets seem unable to grapple with the impact and content of corporate law, meaning that markets operate blindly with respect to law and regulation in this area.

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

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[55]*See generally supra* note 45; Ramirez, *supra* note 12, at 572 (concluding that "investors neither care about nor have the ability to judge the state of incorporation and the impact that this has on either their rights or profits," based upon a review of empirical studies).

[56]Ramirez, *supra* note 12, at 572.

[57]*Supra* note 34 (comparing Daines and Subramanian).

[58]For example, Institutional Shareholder Services, a provider of corporate governance rating data for large shareholders, rates quality corporate governance based upon sixty-three factors—only six of which are 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 Feb. 21, 2006).

[59]EISENBERG, *supra* note 23, at 204 (stating that it is "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* (July 15, 2006), *available at* http://papers.ssrn.com/sol3/ papers.cfm?abstract _id=912942.

strength of a given state's antitakeover legislation.[61] Because antitakeover legislation entrenches management and shields them from 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 a

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[61]Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 387 (2003) ("[A]ntitakeover protections are correlated with success in the incorporation market; adding antitakeover statutes significantly increases the ability of states to retain their local firms and to attract out-of-state incorporations.").

[62]The "overwhelming majority" of event studies show that antitakeover protections have either no effect on shareholder value or harm shareholder value. In addition, there is empirical evidence that such statutes operate to increase agency costs. *Id.* at 404-05 (citing, *inter alia,* GRANT A. GARTMAN, STATE ANTI-TAKEOVER LAW (2000)).

[63]*See id.* at 421 ("[I]n 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.").

[64]*See generally* Daines, *supra* note 34. Even before the Subramanian study showing that there was no durable "Delaware effect" resulting in superior market valuations for Delaware firms, *id.*, Professor Bebchuk contested the Daines study to the contrary. Bebchuk et al., *supra* note 17, 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* Chen et al., *supra* note 60, at 22. 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, 927-28 (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., 316 A.2d 599, 610 (Del. Ch. 1974) (finding that the business judgment rule did not protect directors that had recklessly accepted a "grossly inadequa[te]" 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, *supra* note 5, at 361 n.156.

breach of the duty of care in *Smith v. Van Gorkom*.[66] The facts of *Van 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 acted intentionally, fraudulently, or in knowing violation of law.[74] It is difficult to argue that the story of the duty

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

[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 899 (opinion on motion for reargument).

[68]*Id.* at 867, 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, "[m]eaningful 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 65, 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 752-60 (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. *See* EISENBERG, *supra* note 23.

[73]Steinberg, *supra* note 65, at 929.

[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 STAN. 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,

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 efforts 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 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

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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 Standard 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, *supra* note 43, at 949, 949-71 ("The most distinctive aspect of the last decade in corporate law was the celerity with which traditional constraints on corporate managers weakened.").

[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* note 9, at 646-55. Indeed, Professor Jones suggested that Delaware law provided "officers and directors a virtually impregnable shield from monetary liability for corporate misdeeds." *Id.* at 646.

[79]*See generally supra* notes 74 & 76 (demonstrating the laxity of state statutes regarding the duty of care).

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 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 is it 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

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

[81]Ramirez, *supra* note 27, at 1080.

[82]*Id.* at 1072-80.

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

[84]Ramirez, *supra* note 27, at 1083-84.

[85]Ramirez, *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 III of this article. 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 IV of this article 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, *supra* note 27, at 1082 n.128.

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 the diminution of private enforcement, and empirical evidence demonstrates that auditors, in particular, responded to the PSLRA and the 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 and the SLUSA led directly to the spate of accounting-driven securities frauds that plagued our capital markets in the 1990s and thereafter.[90] For the first time ever, federal law restricted 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 solicit proxy votes for its 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

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[88] *Id.* at 1089.

[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."); *see 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, *supra* note 27, at 1059-60 n.13. Historically, the federal securities 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).

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

of management.[94] If a mere shareholder wishes to place a person on the board, the shareholder must absorb the printing costs, postage costs, and legal costs of mounting a 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 U.S., and management interests have worked to keep it a myth.[98]

The reductions in investor rights and protections are not limited to legislative and regulatory promiscuity towards management, as the United States Supreme Court has also turned hostile to private claims under the federal securities laws.[99] Beginning in the early 1990s, the Court began to

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[94]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*, THE 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]*Designed by Committee*, *supra* note 95, at 71 ("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* 1, 10 (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*, N.Y. 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, 1613 (2004) (concluding that "CEOs play the game of homosocial reproduction when selecting directors" and thereby increase their compensation).

[98]*See generally supra* note 28 (stating that corporate democracy is a myth). 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. Parker, *supra* note 22, 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).

[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).

seriously prune 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 thirty-two cases in favor of defendants, and in almost every one, 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 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 and 2002.[107] The public's gaze focused on corporate governance deficiencies.[108] With elections looming, Congress rushed

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[100]Ramirez, *supra* note 27, at 1069-70.

[101]Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (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]Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 183 (1994) (holding that aiding and abetting securities fraud is not actionable in federal private claim).

[103]Gustafson v. Alloyd Co., 513 U.S. 561, 567 (1995) (holding that express rescission rights of investors purchasing securities is 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).

[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, 544 U.S. 336 (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 N.Y.U. J.L. & BUS. 1, 48-49 (2005).

[107]*See 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, 354 (2002).

[108]Ramirez, *supra* note 24, at 31-33.

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 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

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[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, *supra* note 24, at 64 (stating that the 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, § 806(a), 116 Stat. 802 (codified at 18 U.S.C. § 1514A(a)(1)(B) (2006)) (providing whistleblowers protection against retaliation for providing information "when the information or assistance is provided to or the investigation is conducted by . . . (B) any Member of Congress or any committee of Congress").

[112]*See supra* note 29.

[113]*See generally supra* notes 20 & 28 (stating that many SOX reforms are ineffective). 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 20, 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 9, at 643-46. 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 id.* at 644-47, 654-56.

[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, 728 (2002) (stating that thirteen of fifteen Enron directors were independent); Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 106-08 (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, *supra* note 97, at 1587-90.

[116]*Infra* notes 118-23 and accompanying text.

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 of public corporations 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 it is 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, by 2007, over 200 companies (including Apple, Inc.) disclosed that their options practices were under investigation.[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

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[117]*See 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, 287 (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).

[118]Stephanie Saul, *Study Finds Backdating of Options Widespread*, N.Y. TIMES, July 17, 2006, at C1 (reporting on an academic study finding "[m]ore 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, *available at* http://www.iht.com/articles/2006/08/24/opinion/edoption.php.

[120]Jessica Guynn, *Ex-Apple Execs in SEC Crosshairs; Deal Likely With Former CFO; Counsel Faces Suit*, SAN FRAN. CHRONICLE, Apr. 23, 2007, at C-1, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2007/04/23/BUGCUPDU8N17.dtl&hw=ex+apple&sn=001&sc=1000.

[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—Chip Industry's KLA-Tencor Among Firms with Grants Before Stock-Price Jumps—A 20 Milliion-to-One Shot*, WALL ST. J., May 22, 2006, at A1 (quoting former SEC Chair Arthur Levitt).

[122]Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 82 J. FIN. ECON. (forthcoming 2006) (on file with *The Delaware Journal of Corporate Law*) ("[W]e find evidence suggesting that backdating is the major source of the abnormal stock return patterns around executive stock option grants."). "[W]e . . . 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?* 23 (Working Paper, July 14, 2006), *available at* http://www.biz.uiowa.edu/faculty/elie/Grants-11-01-2006.pdf (last visited Sept. 15, 2006).

performance; indeed, one company 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 management.[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 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

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[123]Allen Wastler, *Fat Cat Sleaze Escapes Our Outrage*, CNNMONEY.COM, Sept. 22, 2006, *available at* http://money.cnn.com/2006/09/22/commentary/wastler/index.htm ("Even a dead man was getting a piece of the pie.").

[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]*See supra* note 1, at 28.

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

[127]*Id.*

[128]*Id.*

[129]*See* Michael Jensen & William Menkling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("[I]t 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 equity. *Id.* at 312-13; *see also* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY xviii (2003). Controlling agency costs 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, *Blowing the Whistle on Whistleblower Protection: A Tale of Reform Versus Power*, 75 U. CIN. L. REV. (forthcoming 2007), *available at* http://works.bepress.com/

occurred at both the state and federal level suggests that the problem transcends corporate federalism and any debate about the race to the bottom versus the race to the top.

III. 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 performance across nations, or the impact of specific innovations on corporate financial performance.[133] This emerging interdisciplinary science of corporate

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mary_ramirez/1 (showing that whistleblower protection after SOX is still largely illusory); Mary Kreiner Ramirez, *Just in Crime: Economic Reform After the Sarbanes-Oxley Act of 2002*, 34 LOYOLA (CHICAGO) L.J. 359, 427 (2003) (finding that criminal liability has been diluted, in a way not addressed by SOX, through downward sentencing departures granted by judges).

[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, 64-66 (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, 1166-69 (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 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).

governance means that there is an emerging vision of optimal 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 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).

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[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, & 132-33.

[135]Professor Romano relies upon an empirical analysis of corporate governance standards to impugn the SOX, 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 20, at 1529-43.

[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 and diversity associated with financial performance).

[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 et al., *Earnings Guidance and Managerial Myopia*, Nov. 2005, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=851545. This study involved a sample of 989 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.").

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] One study found that companies with superior corporate governance measures (based upon an assessment of twenty-four 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

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[141]LaPorta et al. describe this phenomenon in *Investor Protection and Corporate Valuation*:

> 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 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. *See also generally supra* note 131 (stating that corporate governance influences the functioning of the corporation in terms of financial performance and macroecoomic output).

[142]Rui Castro et al., *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, 108-09 (2003). The index used in this study consisted of twenty-four factors of corporate governance that the authors broke down into five groups: (1) factors associated with delaying hostile threats to corporate control; (2) factors associated with voting rights; (3) factors designed to protect officers and directors from liability or termination; (4) other antitakeover protections; and (5) state laws bearing upon takeovers. *Id.* at 110-14. One of the factors included in this study is charter amendments to limit director liability for breach of the duty of care. *Id.* at 148-49. Prior studies also found that this particular factor is destructive of shareholder value. Bradley & Schipani, *supra* note 76, at 43.

[144]For example, the index used in the Gompers study, *supra* note 143, has since been refined into an apparently more powerful entrenchment index. *See* Lucian Bebchuk et al., *What Matters in Corporate Governance?* 4 (Mar. 2005) (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* 3 (Dec. 7, 2005) (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.

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 mine" signaling pervasively weak corporate governance, then there is cause for serious concern in the U.S., where CEO compensation relative to earnings has doubled over the past ten 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 U.S.[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 conclusions. Specifically, Professors Greenstone, Oyer, and Vissing-Jorgensen 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

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[145]Marco Becht et al., *Corporate Governance and Control, in* 1A HANDBOOK OF THE ECONOMICS OF FINANCE 1 (George M. Constantinides et al. eds., 2003) (stating that corporate governance must stem self-dealing by managers and that soaring executive compensation in the United States is difficult to justify).

[146]*See* Bebchuk & Grinstein, *supra* note 117, at 287 (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 143, at 132-37.

[147]Michael Greenstone et al., *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments*, 121 Q.J. ECON. 399, 447 (2006) ("[T]hese results should cause policy-makers 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 406-07 (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 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)).

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] Professors Greenstone, Oyer, and Vissing-Jorgensen 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 exchanges already covered by federal mandatory disclosure requirements.[154] While their study is thus unique, it is consistent with other empirical analyses that have attempted to isolate the impact of the mandatory disclosure regime.[155] "Overall, the results suggest that the benefits of the 1964 Amendments substantially outweighed the cost of complying with this law as measured by stock returns."[156] In addition, their 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]

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[151]Greenstone et al., *supra* note 147, at 446-47.

[152]*Compare* George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) ("[S]tudies suggest that the S.E.C. 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 law and economics 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]As noted in the study by Greenstone et al.:

> 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 [1964], Friend and Herman [1964], Robbins and Werner [1964], and Jarrell [1981]).

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

[154]*Id.*

[155]*E.g.*, Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 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.

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 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 input from 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]

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[158]Ramirez, *supra* note 27, at 1082-83. 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 and Hart model (1980), for example, the lowest cost providers are not the investors, but the issuers, distributors, and accountants. An efficient system would provide them with incentives to collect and present information to investors, and would 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.

Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 5-10 (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 United States) 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 points 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.

La Porta et al., *supra* note 158, at 19.

[160]*Id.* at 5.

[161]*Id.* at 7.

[162]Simeon Djankov et al., *The Law and Economics of Self-Dealing* 38 (Apr. 2006), *available at* http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/working_papers/SelfDeal_April13.pdf.

Thus, it appears that facilitating private rights of action in favor of investors is a key element of sound corporate governance.[163]

An additional issue that has been studied in depth is the effect of board diversity upon corporate financial performance.[164] "[H]uman resource theorists have supported expectations for improved performance and increased value for companies providing programs that integrate diversity initiatives since at least the early 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 specifically engage in homosocial

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[163]The Djankov study, *id.*, 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 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." Djankov, *supra* note 162, 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 cause decision makers to evaluate more alternatives and more carefully explore the consequences of these alternatives.").

[165]Fields & Keys, *supra* note 19, at 12. *See also* Steven A. Ramirez, *Diversity and the Boardroom*, 6 STAN. J.L. BUS. & FIN. 85 (2000) (summarizing theoretical and empirical case that law should encourage businesses to embrace diversity).

[166]Carter et al., *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 or 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* 19 (European Corporate Governance Institute, Working Paper No. 57, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=594506 ("Overall, our results suggest quite strongly that in boards with relatively more women, more directors participate in decision-making, which may enhance their effectiveness.").

[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, 494-97 (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, 1306 (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").

reproduction[168] to stock boards with individuals friendly to the CEO's interests 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 antitakeover 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 agency costs in the form of higher executive compensation.[172] Another study found that antitakeover

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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 63-66. 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, 947-48 (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 antitakeover statutes and Delaware courts have permitted management to engage in antitakeover tactics such as poison pills which operate to dilute those attempting to seize control).

[172]Marianne Bertrand & Sendhil Mullainathan, *Corporate Governance and Executive Pay: Evidence from Takeover Legislation* 22 (Nov. 29, 1999) ("We have provided 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 powerless 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 antitakeover legislation, as CEOs would no longer demand compensation for the risk of takeover. *Id.* at 2. This would have vindicated the idea that CEO pay is the result of an optimal contract between principal and agent. *Id.* at 22. Instead, the finding of the study tends to confirm a skimming model of CEO compensation. *Id.* 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 antitakeover legislation, as larger shareholders apparently acted more optimally as agents and searched for

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 appears that antitakeover 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 antitakeover device that operates to frustrate the ability of outsiders to seize control of a corporation.[178] There is robust evidence that

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substitute forms of discipline. *Id.* at 23.

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

[174]More specifically:

> 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 MGMT. 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 169, at 77, 79 (finding that when "CEOs are 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 with considerable slack."). *See also supra* note 62.

[177]Fields & Keys, *supra* note 19, at 4-12 (summarizing literature).

[178]Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, June 2004, at 28 (Working Paper) ("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.

a board that is independent of the CEO enhances corporate valuation.[179] Moreover, boards selected without input from the CEO are more independent, and the corporation achieves 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 evidence that the separation of CEO and chairman 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.

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[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* Sanjai Bhagat & Bernard S. Black, *The Non-Correlation Between Board Independence and Long Term Financial Performance*, 27 J. CORP. L. 231, 233 (2002) (finding no linkage between proportion of outside directors and various measures of performance), *with* Ronald C. Anderson et al., *Board Characteristics, Accounting Report Integrity, and the Cost of Debt*, 37 J. ACCT. & ECON. 315, 320 (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* 7-8 (Working Paper, Dec. 7, 2004) (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 John E. Core et al., *Corporate Governance, Chief Executive Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 372 (1999) (finding lower CEO compensation when CEO and board chair are split); 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, 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 19, at 5 (summarizing literature); *see also* Gompers et al., *supra* note 143, at 144-45 (noting inability to eliminate possible operation of some "unobservable firm characteristic").

The emerging science of corporate governance also casts doubt on the efficacy of the SOX reform initiatives. 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 literature did not support the 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 nonaudit services (as required by section of 201 of the SOX) does not affect audit quality.[187] Apparently there is little evidence supporting the efficacy of the requirement that CEOs and Chief Financial Officers 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 initiative in the SOX 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]

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[185]Specifically, Romano noted:

> 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 decisionmaking that went into the SOX legislative process was, to put it mildly, less than optimal.

Romano, *supra* note 20, at 1526-27.

[186]*Id.* at 1532 (citing sixteen studies assessing efficacy of independent audit committees).

[187]*Id.* at 1535-37 (citing twenty-five studies addressing the impact of permitting auditors to provide non-audit services).

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

[189]Romano, *supra* note 20, 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 182, 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?* (Working Paper, Feb. 12, 2006) (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 in 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 that 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] For example, it is difficult to find any empirical data supporting the destruction of the duty of 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 outcomes.[197]

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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 suboptimal solution to the problem of management run amok. *See supra* text accompanying 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 20.

[194]For example, in the recent *Disney* litigation, the Delaware courts had a clear opportunity to vindicate extant empirical evidence showing 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., 906 A.2d 27 (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 148-49. 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., *supra* note 90, at 6 (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 and 2002).

[196]*See* Lewis v. Vogelstein, 699 A.2d 327, 333 (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 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

Certainly, it is the case that some of the state law outcomes discussed above predate the empirical data suggesting that they are economically and financially suboptimal outcomes. Nevertheless, there is no apparent movement by any 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 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 legislatures 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 United States Supreme

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> 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., 906 A.2d at 67. 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 9, at 645. She wrote before the Delaware 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 643-60.

[198] *Supra* note 197.

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

[200] *E.g.*, U.S. CONST. arts. I, III (stating that the qualifications for federal legislature and federal courts is for the person to be twenty-five years old and a citizen of the United States for seven years, and not requiring an advanced degree in finance, accounting or economics).

[201] *See* MARVER H. BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION 137-43 (1955) (articulating basis for agency regulation and including: (1) the need to professionalize and provide expertise for regulation; (2) regulatory continuity; (3) allow for rapid adaptation to changing conditions; and (4) reduce special interest influence); 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).

[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

Court 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 academic information 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 initiatives have not become 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 suboptimal corporate governance.[208] The study was 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

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deregulation of the securities markets that occurred with the substantial destruction of private enforcement. Ramirez, *supra* note 27, at 1086-87.

[203]For example, in the two most recent Court cases to diminish investor rights, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503 (2006), and *Dura Pharm., Inc. v. Bruno*, 544 U.S. 336 (2005), the Court ignored 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 the empirical record regarding the economic importance of investor protection in favor of empirically unsound rhetoric from the 1970s about the supposed "vexatiousness" of deterring securities fraudfeasors); *Dura Pharm., Inc.*, 544 U.S. at 346-47 (finding plaintiffs' claim legally insufficient without regard to empirical data on importance of investor protections).

[204]*Supra* notes 197, 203.

[205]*Supra* notes 197, 202, & 203.

[206]Ramirez, *supra* note 97, at 1603-11 (discussing the effects of politics, power, and economics on reform initiatives).

[207]*See* Charles P. Himmelberg et al., *Investment, Protection, Ownership and the Cost of Capital* 39 (Nat'l Bank of Belgium, Working Paper No. 25, May 2002) ("[t]here 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 U.S. 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.* at 38 (stating that the magnitude of the gap between ideal corporate governance and actual corporate governance law, as evinced by the persistence of suboptimal 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").

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.

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] Antitakeover protections serve to entrench management across the nation.[214] Congress and the United States 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] These results are 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

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[209]Himmelberg et al., *supra* note 207, at 38.

[210]The following analysis further clarifies this concept:

> 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.

[211]In an assessment of fifty-one 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 U.S. corporate governance. Aggarwal & Williamson, *supra* note 191, at 27. 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]*See supra* notes 137-40 and accompanying text.

[213]*See supra* notes 164-70 and accompanying text.

[214]*See supra* notes 171-76 and accompanying text.

[215]*See supra* notes 80-91 and 141-63 and accompanying text.

[216]*See supra* notes 99-106 and accompanying text.

[217]*Infra* Part IV.

compromised investor rights.[218] The science of corporate governance shows that there is no market pressure for optimal corporate governance; there is only market pressure for indulgent pro-management corporate governance law. The next section seeks to articulate a means for understanding the suboptimality of corporate governance for public companies in the U.S.—the role of special interest influence.

IV. CEO PRIMACY AS A SPECIAL INTEREST OUTCOME

The idea that a "faction" of citizens can subvert government for their own ends at the expense of the "aggregate interests" of society dates at least to the founding of the nation.[219] The solution to this problem animates the antidemocratic structures embedded in the United States Constitution, particularly as initially ratified.[220] The Founders specifically contemplated some form of depoliticized lawmaking to protect against factions.[221] The result, which endures today, is a vision of democratic accountability rather than democratic decision making.[222] Thus, there is little new in considering the pernicious potential of special interest influence, nor the proper political structures for controlling such influence.

Indeed, decades ago, economist Mancur Olson laid a more refined foundation for understanding how narrow and well-organized groups may operate to subvert the commonweal through law and regulation in *The Logic of Collective Action*.[223] Olson recognized that collective action

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[218] *Supra* notes 12, 29, 41, & 76. Professor Cary noted that in 1963 Delware declared it the policy of the state to enact pro-management corporation laws. Cary, *supra* note 15, at 663. Other commentators have noted the control that the corporate bar exercises over corporate law in Delaware. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 506-09 (1987).

[219] THE FEDERALIST NO. 10, at 78 (James Madison) (Isaac Kramnick ed., 1961).

[220] *See* Julian N. Eule, *Judicial Review of Direct Democracy*, 99 YALE L.J. 1503, 1522 (1990) ("If the Constitution's Framers were keen on majority rule, they certainly had a bizarre manner of demonstrating their affection.").

[221] For example, the President serves a four-year term, subject only to impeachment, and Senators serve six-year terms. Article III judges enjoy lifetime tenure subject only to "good behavior." U.S. CONST. art. III. American citizens thus elect leaders that are democratically accountable for their decisions to various extents. Therefore, so long as political leaders remain accountable for their decisions in supervising agencies, delegation to such agencies cannot be termed antidemocratic, in any traditional sense. Ramirez, *supra* note 12, at 537.

[222] Rebecca L. Brown, *Accountability, Liberty, and the Constitution*, 98 COLUM. L. REV. 531, 565 (1998) ("Indications from the time surrounding the drafting and ratification of the Constitution suggest that . . . the view of accountability that the founding community held . . . is a view of accountability as a notion of blame.").

[223] MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 2, 11, 165 (rev. ed. 1971) (stating that very large groups will not pursue organizations to influence public goods like law because rational actors will instead assume that they can free ride on the efforts of others). Olson's

problems encumbered large groups from pursuing their collective interests and that as a consequence, taxpayers, consumers, those interested in peace, and those in favor of sound economic policies are frequently foiled by "special interests" with superior organizational capabilities and resources.[224] Large groups must contend with the fact that rational individuals will not devote time and resources to efforts that they cannot possibly influence.[225] Instead they will seek to free ride on the efforts of others.[226] Olson further recognized that the apparent disproportionate representation of business interests among any accounting of lobby groups was a direct result of their concentrated economic power.[227] Under Olson's analysis,

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seminal work has transcended economics and taken root in both political science as well as law. THEODORE J. LOWI, THE END OF LIBERALISM: THE SECOND REPUBLIC OF THE UNITED STATES 278-79 (2d ed. 1979) (impugning the regulatory state because centralized power facilitates "personal plunder rather than public choice" and is more appropriately characterized as "socialism for the organized, capitalism for the unorganized"); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 343 (1974) (stating the economic theory of regulation rejects the use of the term "capture" as "inappropriately militaristic," but recognizes that private interests may subvert regulation).

[224]Olsen made this point succinctly when he wrote:

> The taxpayers are a vast group with an obvious common interest, but in an important sense they have yet to obtain representation. The consumers are at least as numerous as any other group in the society, but they have no organization to countervail the power of organized monopolistic producers. There are multitudes with an interest in peace, but they have no lobby to match those of the "special interests" that may on occasion have an interest in war. There are vast numbers who have a common interest in preventing inflation and depression, but they have no organization to express that interest.

OLSON, *supra* note 223, at 165.

[225]*Id.* at 2, 48, & 53. "Group size is crucial for two reasons: (1) given the same total benefit to the group, size is inversely related to the magnitude of any individual's stake; and (2) size increases transaction costs." *See* Daniel A. Farber & Philip P. Frickey, *Public Choice Revisited*, 96 MICH. L. REV. 1715, 1718 (1998) (reviewing MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY (1997)).

[226]For example, Macey states:

> By definition, the benefits from public spirited legislation fall on the public generally. As such, it is extremely unlikely that any individual will find it advantageous to devote privately the necessary resources to obtain such legislation. Those members of the public who spend nothing will have a free ride at the expense of those who invest in public-regarding legislation. Since any gain goes to the group as a whole, those who contribute nothing benefit just as much as those who have contributed a great deal. Thus it pays for each individual to do nothing and to hope that others will make an effort upon which he can "free ride."

Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 231 n.44 (1986).

[227]OLSON, *supra* note 223, at 141-48.

concentrated economic power will prevail in the contest over law and regulation.[228]

The idea that regulation and law are subject to special interest influence exercised by well-organized groups with economic resources has recently been extended to financial markets generally.[229] Financial markets are a key engine of growth and innovation.[230] The corporation is the central economic institution underlying modern finance as limited liability permits financial diversification, driving down the cost of capital and expanding the pool of financial capital.[231] Nevertheless, "[t]he economically powerful are concerned about the institutions underpinning free markets because they treat people equally, making power redundant."[232] Moreover, "[t]hey are a source of competition, forcing the powerful to prove their competence again and again."[233] Thus, the powerful will seek to entrench their control and position, rather than expose themselves to a truly competitive environment.[234] They will do this, if necessary, through well-organized groups that sacrifice competitive markets for legal indulgences.[235] This is why today there is broad support across the political spectrum[236] for the proposition that left unchecked, capitalism "easily degenerates into a system of incumbents, by incumbents and for incumbents."[237]

There are few incumbents more powerful than the incumbent CEOs of public corporations. CEOs have been able to double their share of corporate profits just in the past few years.[238] Soaring executive compensation has substantially contributed to rising economic inequality

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[228] *Id.*

[229] RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS 164-71 (2004) ("Small well-focused groups can sway government policies toward their interests at the expense of the public. Since financial markets rely on the government for good policies, these polices may never be enacted when well-organized incumbents oppose them.") (citing OLSON, *supra* note 223; George Stigler, *Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971)).

[230] RAJAN & ZINGALES, *supra* note 229, at 1 ("[F]inancial markets keep alive the process of 'creative destruction'—whereby old ideas and organizations are constantly challenged by new, better ones.").

[231] *Id.* at 45-47 (stating that limited liability corporations are "one of the more ingenious economic institutions created by mankind").

[232] *Id.* at 9.

[233] *Id.*

[234] RAJAN & ZINGALES, *supra* note 229, at 9.

[235] *Supra* note 223.

[236] RAJAN & ZINGALES, *supra* note 229, at xi-xii.

[237] *Id.* at 312.

[238] *Supra* note 117.

in the United States.[239] CEOs enjoy almost unfettered discretion over the composition of the central governing organ of American corporations—the board of directors.[240] Short of intentional wrongdoing, neither CEOs nor their nominal supervisors—directors—face any real risk of legal liability, specifically as a result of relatively recent legislative victories.[241] CEOs of public companies are the primary stewards of vast stores of wealth, as the combined market capitalization of the approximately 5000 public companies in the U.S. exceeds $16 trillion.[242]

As Olson would have predicted, with tremendous economic resources and relatively small numbers, CEOs face few constraints in organizing politically. One organization, the Business Roundtable, consists largely of CEOs of major public corporations.[243] It litigates and lobbies with the specific intent of minimizing constraints on the power of CEOs.[244] Another organization, the U.S. Chamber of Commerce, represents big business generally, and also operates to free CEOs of legal constraints.[245] Each of these organizations has a long and successful history of achieving pro-CEO outcomes in law and regulation. Other trade associations, such as the American Institute of Certified Public Accountants, also pursue vigorous lobbying efforts that invariably coincide with the interests of their corporate masters, which are operated under the authority of the CEO.[246] In addition, each individual corporation frequently has its own legions of lobbyists that are controlled by CEOs.[247] CEOs also have the ear of elected politicians through their control of campaign contributions, including control over the corporation's own political action committee.[248]

Against this array of CEO power, shareholders hold little sway, also in accordance with the predictions of Olson's theory. Shareholders, unlike

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[239]The income garnered by the top decile in the United States increased over last twenty-five years to 40-45% of overall U.S. income. Thomas Piketty & 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 (last visited Sept. 14, 2006). This increase is attributable to "the very large increases in top wages (especially top executive compensation)." *Id.* at 204.

[240]*Supra* notes 94-98.

[241]*Supra* note 74.

[242]*Supra* note 8.

[243]Former SEC chair Arthur Levitt describes the Business Roundtable as "an association of chairmen and CEOs of large corporations." LEVITT, *supra* note 11, at 96.

[244]*See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406, 407, 415 (D.C. Cir. 1990) (invalidating SEC rule that required listed companies to adhere to one vote per share voting).

[245]*See* LEVITT, *supra* note 11, at 237.

[246]*See id.* at 114-15.

[247]*Id.* at 238.

[248]*Id.*

CEOs, have no authority to disburse corporate funds to influence law and regulation.[249] The large number of shareholders means that any lobby group formed to pursue their interests generally would face serious collective action problems.[250] Consequently, there is no organization that lobbies in favor of public shareholders.[251] "They are the most overlooked and underrepresented interest group in America."[252] Thus, any political contest between shareholders and managers is a mismatch to say the least.

It would be pleasant to believe that somehow financial markets could remedy this mismatch. Unfortunately, there is little evidence to support such faith in markets.[253] The first problem with such faith is that all markets suffer from imperfect information, and financial markets are no exception.[254] On the contrary, financial markets could not exist if there was perfect information.[255] One manifest imperfection is that capital markets fail to impound information regarding corporate governance issues.[256] For example, there is little credible evidence that incorporation in Delaware adds financial value.[257] As previously shown, corporate governance is manifestly suboptimal in the United States, and seems to permit excessive agency costs.[258] The empirical analysis of Part III of this article shows there is no market force in favor of optimal—or even acceptable—corporate governance standards.[259] While corporate governance can be material in certain transient contexts,[260] the markets often seem impervious to its financial consequences.[261] In short, there is little reason to think that the current political structure governing corporate governance generally is

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[249]For example, Walter Hewlett expended $150 million in a contest with Hewlett-Packard, and lost. *Supra* notes 95-96.

[250]As Arthur Levitt states, in the lobbying hierarchy "[s]hareholders, and especially individual investors come last. There is no one, in fact, who represents individual investors full-time." LEVITT, *supra* note 11, at 237.

[251]*Id.* Institutional shareholders face problems similar to accountants in pursuing the interests of shareholders generally; specifically, many institutional shareholders depend upon corporations, and management in particular, for patronage.

[252]*Id.*

[253]*See supra* notes 34, 55-58 and accompanying text.

[254]RAJAN & ZINGALES, *supra* note 229, at 28-29, 56.

[255]*See* Sanford J. Grossman & Joseph Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

[256]*See supra* notes 34, 55-64.

[257]*See supra* note 34.

[258]*See supra* Part III.

[259]*Id.*

[260]In the wake of the scandals of 2001 to 2002, investors focused more on corporate governance considerations, but apparently not the state of incorporation. *See supra* notes 58, 191.

[261]*See supra* notes 55-64.

likely to ever be efficacious at impounding the best empirical learning regarding corporate governance.[262] In the backwater of the markets' neglect, special interests will hold sway over both state corporate governance law and federal corporate governance law.

Special interest influence can often be difficult to trace.[263] On the other hand it is often quite manifest, in the use of money and influence, and the outcomes that seem otherwise inexplicable, but operate to benefit those with power and influence. For example, Congress has used federal power to eviscerate securities litigation based upon "anecdotal evidence and unproven theories."[264] The PSLRA was driven more by "money and influence peddling" than by any evidence of securities litigation abuses.[265] Similarly, Delaware has long been influenced by corporate management and the corporate bar more than the influence of sound policy.[266] Thus, the evisceration of the duty of care is associated not only with interests of management, but with interests of the insurance industry as well, even though the insurance industry was the only actor that left its fingerprints on the Delaware legislation.[267] Sometimes the exercise of special interest influence is notorious, as the efforts of management to maintain their domination of the proxy machinery were.[268] Other times, eyewitnesses attest to the exercise of special interest influence, as former SEC senior managers have done.[269] In sum, while the outlines of special interest power may be clear, inferences must sometimes be used to explain otherwise highly indulgent outcomes that in context seem best explained by special interest influence.[270]

This means that any proposed improvements to corporate governance in America that do not reckon with the reality of special interest influence are unlikely to lead to durable reform. For example, those arguing that the status quo is acceptable, or that it should be extended to some sort of competitive federalism for securities regulation, fail to acknowledge how

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[262]*See supra* Part III.

[263]*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").

[264]Ramirez, *supra* note 27, at 1086.

[265]*Id.* at 1087.

[266]*See supra* note 218.

[267]*See supra* note 76.

[268]*See supra* notes 28, 98.

[269]*See supra* notes 11, 29.

[270]*See supra* note 111.

collective action distorts markets for law and regulation.[271] Those arguing in favor of an expanded role for the federal government fail to acknowledge that federal law can fall prey to special interest influence as much as state law.[272] By ignoring special interest influence, both approaches, although seemingly at polar opposites, essentially leave the basic collective action and public choice dynamics in place.[273] Both, therefore, to the same extent, are bound to leave corporate governance subject to a continued cycle of chaotic evolution untethered to policy and vulnerable to special interest raids.[274] This is not optimal.

On this latter point, there is broad agreement: both sides to the race to the bottom debate claim that, as currently structured, corporate governance yields suboptimal results.[275] This is also in accord with the empirical evidence to date. This suboptimality is not likely to improve. Many voices in fact concur that creeping federalization in response to repeated corporate governance crises is likely.[276] The federal response has been a mixed bag at best.[277] There is little reason to think state law evolution will be superior. Indeed, at both levels one constant seems true: CEOs seemingly always accrue more power subject to fewer constraints.[278] In fact, the pattern is likely to reinforce itself: economists predict that growing inequality would naturally lead to legal system outcomes that

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[271]*See supra* note 38.

[272]*E.g.*, Bebchuk & Hamdani, *supra* note 42, at 1798. Bebchuck and Hamdani do not address the role of the PSLRA in precipitating the corporate corruption crisis of 2001 and 2002, as well as other documented instances of federal law falling prey to special interest influence. *See supra* notes 11, 28, 29, 41, 44, & 111. I argue that as presently constituted, federal law is central to the creation of CEO primacy, notwithstanding the historic pattern of federal intervention articulated by Bebchuk and Hamdani.

[273]For example, Bebchuk and Hamdani advocate the creation of a federal commission to study corporate governance and make recommendations to Congress. Bebchuk & Hamdani, *supra* note 42, at 1798. I am skeptical of any recommendation to throw corporate governance issues to Congress without adequate safeguards regarding special interest influence.

[274]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).

[275]*Compare* Romano, supra note 20, at 1602 (stating that SOX is "seriously misconceived"), *with* Fairfax, supra note 21, at 456 (finding director liability regime "defective").

[276]*See* Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REG. 26, 28 (Spring 2003) (stating that corporate scandals are a "bullish signal" for further federal intervention).

[277]*See generally supra notes* 81-117 (discussing the ineffective impact of the SOX reforms).

[278]*See supra* notes 118-24.

favor the rich and powerful.[279] Until the system is depoliticized to some extent, suboptimal results will continue and perhaps even deepen.

In a related work, I have proposed an optimal depoliticized regulatory structure for public companies that would be charged with articulating corporate governance standards based upon the best empirical data available.[280] Shareholders directly would be empowered to select the federal corporate governance regime.[281] This would create immediate competitive pressure to adhere to the best learning regarding corporate governance for all jurisdictions.[282] The market would react to the pronouncements of an agency with recognized expertise and a depoliticized regulatory structure on par with the Federal Reserve Board.[283] This approach would directly seek to impound the best empirical data available into the nation's corporate governance regime.

Earlier, I proposed that senior officers and directors of public companies be subject to a federal professional regulation regime, subject to the supervision of a regulatory agency.[284] There is reason to believe that such a regime could well operate to depoliticize governance standards, as it has to an extent so operated in the securities industry, or with respect to accountants and attorneys.[285] In each instance, professional self-regulation has produced a stable regulatory outcome, without any major crisis.[286] Professional self-regulation of senior officers and directors (under the supervision of an administrative agency) may thus hold the promise of depoliticizing corporate governance.

The same cannot be said of the current corporate governance regime. Academic voices are increasingly recognizing that the current system is not stable in the sense that it yields standards that are not tethered to sound policy, and that the crux of the problem is politics.[287] So long as political considerations dominate the motives of both federal and state policymakers,

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279 Edward Glaeser et al., *The Injustice of Inequality*, 50 J. MON. ECON. 199, 199-200 (2003).

280 Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. REG. (forthcoming 2007), *available at* http://law.bepress.com/expresso/eps/1809.

281 *Id.* at 3.

282 *Id.*

283 *Id.* at 3-5.

284 Ramirez, *supra* note 92, at 1005-08.

285 *Id.*

286 *Id.* at 1008.

287 *Id.* at 1006-08.

corporate governance will not be based upon the best empirical learning.[288] Ultimately, there will be constant economic pressure for reform.[289] To this extent, the current regime is inherently non-sustainable.[290] Foreign regimes will adopt superior regimes yielding superior economic outcomes and/or the U.S. will be plagued by serial financial crises until durable reform takes hold.[291]

IV. 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.

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[288]*See generally supra* notes 99-106, 192-210 (discussing the different legislative policy regarding corporate governance).

[289]As previously demonstrated, the economic costs of a suboptimal corporate governance regime are significant. *See generally supra* notes 207-11 (discussing how improvements in corporate governance would be economically different).

[290]China has already demonstrated an ability to achieve remarkable growth by finding alternatives to the American system. JOSEPH STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 180-86 (2002) (finding that China's economy is "directly opposite to the market fundamentalism prescribed by the U.S.").

[291]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* Forelle & Bandler, *supra* note 121, at A1; Ramirez, *supra* note 5, at 359. Refco was the largest independent futures broker in the U.S. Its CEO concealed $430 million in debts that he owed Refco through entities he controlled, leading to his indictment for securities fraud. The Refco public offering would have triggered the full applicability of the SOX, 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 SOX regime governing audits of public firms. Numerous underwriters and professionals (including 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.*

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 packed with instances of special interest influence holding decisive power, and not any concept of optimality. More importantly, it is now clear that capital markets are 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 effective 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.

Thus, solutions to the patent suboptimality of corporate governance in the U.S. must account for the need to create legal structures that can resist the power of special interest influence. The emerging science of corporate governance lights the way for formulating more powerful corporate governance standards. It is up to lawyers to articulate legal and political structures that can make that vision a reality. Either crises or international competition is likely to create pressure for more optimal corporate governance mechanisms. The long-standing system of corporate federalism in the U.S. seems rigged for self-destruction.