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

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

Steven A. Ramirez†

The pernicious influence of politics continues to pollute corporate governance applicable to public corporations in the United States. In particular, the political process has yielded a corporate governance regime that simultaneously imposes excessive regulatory costs and impairs investor confidence. CEOs continue to enjoy too much autonomy over the public corporation. Increasingly, empirical evidence shows that corporate governance standards in the U.S. are sub-optimal. This Article proposes to change the legal structure by which corporate governance standards are articulated. Using the Federal Reserve Board as a model, this Article urges the creation of a depoliticized federal agency with authority over an optional federal regime selected by shareholders. As such, corporate governance would be based upon market verdicts and the best corporate governance science rather than institutions (legislatures, courts, and the SEC), which are poorly equipped to impose standards based upon science instead of political caprice.

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Introduction

There are growing signs from a broad spectrum of sources that corporate governance for publicly held companies in the United States is dysfunctional. In a related work, I have argued that the core problem with corporate governance in the United States is the political influence wielded by management. A chorus of voices now recognizes that the political power of CEOs has naturally led to a system of CEO primacy. Legendary mutual fund founder John Bogle asserts that a “pathological mutation” has transmogrified corporate governance from “traditional owners’ capitalism to the new managers’ capitalism.” Prominent business commentator Robert J. Samuelson claims that CEOs have “contrived... a moral code that justifies grabbing as much as they can.” Harvard Business School Professor D. Quinn Mills posits that “CEOs used their enormous power... to enrich themselves at the expense of investors.” Recent events lend support to these views.

The widening scandal over backdated options grants, revolving around whether “incentive” compensation plans were in fact rigged games designed to enrich officers at the expense of shareholders, indicates that the law has not sufficiently constrained management. Meanwhile, CEO compensation at America’s leading public corporations continues to soar. At least some legal
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scholars have traced the roots of “CEO primacy” in American corporate governance to certain key legal changes in the 1980s and 1990s. The cost of such CEO primacy to the economy and shareholders is huge. Moreover, the costs of a system that permits a dictatorship of the CEO are not limited only to the most egregious companies, as the perception of inadequate checks as a matter of law on CEO power is bound to erode investor confidence generally and lead to a higher cost of capital for American business.

Other scholars raise different concerns, focusing instead on the costs of the Sarbanes-Oxley (“SOX”) reforms. Professors Butler and Ribstein claim that the SOX reforms were a “costly mistake” that have imposed net costs of $1.1 trillion and were enacted in a “regulatory panic.” Professor Roberta Romano asserts that SOX was “ill-conceived” and contrary to the best learning available at the time. SOX has resulted in real benefits, and the Act is certainly not without its fans. Nevertheless, overall it, too, seems to have resulted in a higher cost of capital in America.

8 See, e.g., Steven A. Ramirez, The Chaos of Smith, 45 WASHBURN L.J. 343, 344 n.10 (2006) (attributing CEO primacy to the death of the duty of care, the “reform” of the federal securities laws to protect managers from private litigation, and management’s continued domination of the proxy mechanism); Joel Seligman, Rethinking Private Securities Litigation, 73 U. CIN. L. REV. 95, 113-15 (2004) (stating that lax state fiduciary duties contributed to a “dramatic increase in the ratio of the compensation of the corporate CEO to that of the average corporate blue collar employee” from 42:1 in 1980 to 475:1 in 2000).

9 See M. P. Narayanan et al., The Economic Impact of Executive Stock Options (unpublished manuscript), available at http://www.michiganlawreview.org/symposium/docs/narayanan.pdf (finding that backdated options at eighty-nine sampled companies resulted in an average of $500,000 in extra compensation for executives per firm while costing shareholders at each company $400 million in market capitalization). “Recent research has established that many executives exert not only legal influence over their compensation, but also illegal influence in many cases.” Id. at 75-76. “[O]ur evidence suggests that managerial theft is not a zero-sum game, but involves huge dead-weight losses for the shareholders.” Id. at 76.

10 To the extent the public associates opportunistic 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, Anderson Graduate School of Management Working Paper, Feb. 28, 2005, available at http://repositories.cdlib.org/anderson/fin/1-05 (finding that weak shareholder rights are associated with a higher volatility risk—and therefore a higher cost of capital—in a transnational empirical analysis, impairing macroeconomic performance).

11 I do not intend to claim that all scholarly assessments of SOX are uniformly negative. I do not even claim that federal intervention was an inappropriate response to the corporate fiascoes that surfaced commencing with the failure of Enron Corporation. See Jonathan R. Macey, A Pox on Both of Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficiency of Mandatory Versus Enabling Rules, 81 WASH. U. L.Q. 329, 355 (2003) (“Sarbanes-Oxley was a measured and appropriate response to the abject failures in U.S. corporate governance typified by Enron.”).


14 Stephen Wagner & Lee Dittmar, The Unexpected Benefits of Sarbanes-Oxley, HARV. BUS. REV., Apr. 2006, at 133, 140 (stating that SOX has improved the operations of corporate America).

15 See supra notes 9, 10, 12; infra notes 16, 17, 19, 20, 21.
A rising cost of equity capital in the United States since mid-2002 appears to be driving companies to eschew public capital markets in favor of private debt.\(^{16}\) This trend risks more severe economic contractions and is stunting the development of public capital markets,\(^{17}\) which have universally been associated with superior economic performance.\(^{18}\) Indeed, the United States has lost its position as the leading equity capital market, and now lags both Great Britain and China in terms of initial public offerings (IPOs) of securities.\(^{19}\) The United States's share of IPOs has declined from 50% in 2000 to 5% in 2005.\(^{20}\) This increased cost of capital is likely due to increased compliance costs stemming from the Sarbanes-Oxley Act of 2002, as well as a relative loss of investor confidence in the United States.\(^{21}\)

The common thread between those arguing that corporate governance in the United States has harmed investor confidence and those arguing that the system has imposed regulatory costs that are too high is politics. In other words, compliance costs are unnecessarily high and CEOs are largely unplugged from legal constraints because of politics. Therefore, the solution to the problems of corporate governance should involve depoliticization.\(^{22}\) This Article argues for an end to the means by which corporate governance law is promulgated today, in favor of a structure that can operate to optimize corporate governance, and thereby stem the economic losses associated with a suboptimal corporate governance regime.\(^{23}\)

Specifically, this Article proposes a new depoliticized administrative agency for the promulgation of corporate governance standards, which would rely upon markets as well as emerging economic and financial science to

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\(^{16}\) In the Shadows of Debt, ECONOMIST, Sept. 23, 2006, at 79 ("Since 2003, the after tax cost of raising debt has been much lower than the cost of issuing shares, even in the more expensive high-yield market.").

\(^{17}\) Id. at 80.

\(^{18}\) See, e.g., Committee on Capital Markets Regulation, Interim Report of the Committee on Capital Markets Regulation, at ix (2006), available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf ("[T]here is considerable evidence that countries with better financial markets, like the United States, enjoy more rapid economic growth, which creates more new jobs nationwide. The U.S. legal and regulatory regimes that promote accountability, disclosure, and transparency are an important element in the success of U.S. capital markets.").


\(^{20}\) Committee on Capital Markets Regulation, supra note 18, at x.

\(^{21}\) Id. at x.

\(^{22}\) See Steven A. Ramirez, Depoliticizing Financial Regulation, 41 WM. & MARY L. REV. 503, 504 (2000) (finding that "the Federal Reserve Board's administration of monetary policy exemplifies the possibility of depoliticizing regulation" in that it regulates effectively in the general public interest, and is not beholden to special interest influence).

\(^{23}\) Optimal corporate governance would consist of those laws, regulations, disclosure requirements, and contractual provisions that would serve to maximize benefits from the alignment of interests between investors and managers net of compliance, regulatory, and other transaction costs. Thus, optimal corporate governance would minimize net agency costs. See, e.g., John E. Core et al., Is U.S. CEO Compensation Inefficient Pay Without Performance?, 103 MICH. L. REV. 1142, 1160-61 (2005) (reviewing Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (2004)).
optimize corporate governance applicable to public companies. A
depoliticized regulatory structure is necessary to assure that the agency
responsible for corporate governance is resistant to special interest influence
and can instead operate to place corporate governance upon a scientific
foundation. The standards articulated by the agency would be subjected to a
market test that would allow shareholders to have a direct voice in the system
of corporate governance applicable to their corporation, which would vindicate
shareholder primacy rhetoric. This system should create constant pressure for
improving corporate governance standards—in other words, for a race to the
top among all competing jurisdictions to provide optimal models of corporate
governance for public companies. Courts, state legislatures, and politicized
regulatory agencies would be displaced by an expert administrative agency
subject to market tests and resistant to special interest influence. In short, this
Article proposes an administrative agency with a depoliticized structure (akin
to the Federal Reserve Board or the “Fed”) with control over a federal
incorporation regime that shareholders may select.
At least since William Cary's landmark 1974 article, *Federalism and Corporate Law: Reflections on Delaware,* there has been a running debate, among legal academics, economists, finance professors, and others regarding the proper role for the federal government in the area of corporate governance. On one side of this debate are those arguing that state lawmakers seek to enhance their tax revenues from dispensing corporate charters by providing otherwise sub-optimal corporate governance standards that are indulgent to managers, who currently make incorporation decisions. On the other are those claiming that capital markets would punish corporations hobbled by sub-optimal corporate governance, and therefore neither states nor managers would pursue such standards; instead, market competition assures that there is a race to the top, whereby states compete to offer ever more optimal corporate governance. This Article seeks a synthesis of these positions, and attempts to forge an optimal regulatory structure for specifying corporate governance standards based upon this synthesis. I argue that corporate governance law can be responsive to market action (and shareholder choice) under the guidance of a depoliticized administrative agency charged with promulgating optimized corporate governance for publicly held companies based upon the best emerging finance and economic science.

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30 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. Louis K. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting).

31 See, 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 the 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.").

32 See, e.g., ROBERTA ROMANO, *The Genius of American Corporate Law* 14-16 (1993) (stating that empirical evidence shows that choice among jurisdictions for incorporation benefits rather than harms shareholders); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation,* 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.").

33 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) (giving an overview of empirical evidence regarding diversity in governance 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 "[m]uch of the literature on corporate governance" took a "Darwinian
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As such, this Article urges scholars to rethink the system by which corporate governance is promulgated rather than try to divine the substance of optimal corporate governance, as courts, legislatures, and the SEC currently do today. 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, at both the federal and state levels. 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 optimized regulatory structures that can operate to move our system toward optimized corporate governance on a continuous basis through market action. In other words, the thesis of this Article is that market action can assure that corporate governance moves inexorably toward optimality. This Article seeks to articulate such a mechanism. Lawyers can create a unified regulatory structure that puts corporate governance in the hands of specialists capable of interpreting the science of corporate governance and using market pressure to create a scientifically based standard of corporate governance, as they did for monetary policy through the creation of the Federal Reserve Board.

Part I of this Article shows that, as presently structured, the law permits inappropriate political influence to subvert corporate governance in the United States. Viewing federal and state regulation as a whole shows that agency costs and compliance costs have not been minimized under either federal or state law. Instead, the entire system responds to political power more than economic or financial science. While this analysis includes an assessment of the best and most current learning on the race-to-the-bottom/race-to-the-top debate, I argue that competition between states for chartering of public corporations is only one means by which corporate governance standards are distorted. An

34 See, e.g., Romano, supra note 13, at 1529-40 (demonstrating that Sarbanes-Oxley reforms rest on a weak empirical basis in terms of the science of corporate governance). Corporate scholars recognize that the federal securities laws are an essential element of the system of corporate governance in the United States, particularly with respect to the disclosure obligations of management of publicly held companies. Robert B. Thompson & Hillary Sale, Securities Fraud as Corporate Governance: Reflections upon Federalism, 56 VAND. L. REV. 859, 909-10 (2003) (stating that “we now have a functional division of monitoring between the state and federal governments”).

35 See, 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”).

36 See, e.g., 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).

37 See ROMANO, supra note 32, at 149 (concluding that corporate federalism creates constant incentives for the improvement of corporate governance standards).

38 The Fed was created in the wake of the Panic of 1907, and its modern structure was refined in the wake of the Great Depression. Ramirez, supra note 22, at 523-29.
assessment of the propriety of corporate governance regulation at the federal level (where there is no argument of any race) is also important to whether politics is corrupting corporate governance.

Part II introduces and reviews the emerging science of corporate governance, with a view towards assessing outcomes of the current regulatory structure governing the means by which the duties and obligations of managers are defined. Part II demonstrates the inferiority of the current regulatory regime in achieving optimal corporate governance standards. The conclusions of both Part I and Part II are fully consistent: The United States is in peril of becoming a second world nation in terms of corporate governance. Our current system does not reflect the best learning available.

Part III proposes a solution to this problem that seeks to displace politics in favor of specific mechanisms for making use of the best corporate governance science. Specifically, Part III attempts to articulate an optimized regulatory and market structure for achieving optimized corporate governance. Central to this proposal is the creation of an expert and specialized regulatory agency with a depoliticized structure on par with the Fed. Part III further argues that shareholders of publicly held companies should hold an option to annually select a federal charter that supplants the operation of any state corporate governance standards in favor of the optimized structure promulgated by the depoliticized federal agency. This will assure that agency and compliance costs are minimized and that the cost of capital is reduced. It will create a market driven model for continuous corporate governance evolution in the direction of scientifically based standards. Because they are ultimately based upon an incomplete diagnosis, proposals for reform that do not advocate similar depoliticization will not meet with success. Simply put, if politics is what ails corporate governance, then depoliticization is the only remedy.

The Article concludes that corporate governance should be committed to the discretion of a more institutionally capable agency that is more insulated from special interest influence. No more should these standards be left to rent-seeking legislators, non-expert judges, and a federal regulatory system overrun by special interest influence.

I. The Problems of Corporate Governance

Historically, corporate governance in the United States has been left to the states, and Delaware has appropriated the role of providing corporate governance standards for about half of all American publicly held companies. 39
Despite this, the federal government has intervened in corporate governance when investor confidence has eroded to such a level that macroeconomic instability results or is threatened. This part of this Article seeks to demonstrate that both federal and state regulation is held hostage to special interest influence, leading simultaneously to higher compliance costs and lower investor confidence.

A. SOX: A Case Study of Regulatory Dysfunction

A recent example of federal intervention into corporate governance is the Sarbanes-Oxley Act of 2002 (SOX). SOX enhanced white collar crime sanctions, extended the statute of limitations for securities fraud actions, and banned loans to senior executives. Still, for the vast majority of CEOs, SOX had limited impact on the power of the CEO over the corporation. The Act did not significantly alter the balance of power within the corporation between CEOs and shareholders, beyond the audit function. CEO primacy survived SOX. Nevertheless, SOX was the most invasive federal intervention into traditionally state-regulated corporate governance since the New Deal.

now dependent on the franchise fees generated from dispensing charters; such fees constitute 20% of the state’s tax revenue. Id. at 202. Management essentially exercises autonomy over the state of incorporation. Id.

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 are notable for their macroeconomic consequences, not evidence of some flaw in the efficient market hypothesis. Steven A. Ramirez, Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence, 42 WASHBURN L.J. 31, 40-41 (2002) (citation omitted).


§ 905.

§ 804.

§ 402(a).

For example, the only new obligation imposed upon CEOs is the certification of financial statements and internal controls. §§ 404, 906.

The Sarbanes-Oxley Act excluded management from control over the audit function, by requiring an independent audit committee. Sarbanes-Oxley Act of 2002, §§ 204, 301 (requiring an independent audit committee for public companies). It created an entirely new regulator for auditors of public companies. §§ 101-09 (creating the “Public Accounting Oversight Board” to regulate audit firms of public companies). It also imposed new federal rules of professional responsibility for attorneys “appearing or practicing before the Commission” on behalf of public companies. § 307 (directing SEC to promulgate rules governing the conduct of attorneys “appearing or practicing before the Commission”). These are the provisions that invaded traditional state law based corporate governance most substantively; other than securing the integrity of audits, however, none of these provisions significantly subverts the autonomy of the CEO.

The Act did create new pressures for independent directors. 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 create an optional qualified Legal Compliance Committee, which provides for a central role for independent directors. See 17 C.F.R. § 205.2(k) (2006). But the Act defines independence in a relatively modest way. An independent director may not receive any compensation from the issuer other than board fees and may not be affiliated with the issuer. Sarbanes-Oxley Act of 2002 § 301(B). A final
As such, SOX continues a pattern of special interest influence at the federal level, even if punctuated by public cries for reform. The corporate corruption crisis that commenced with the failure of Enron in late 2001, and climaxed with the hurried passage of SOX in mid-2002, shows how excessive political influence can distort corporate governance. Events following the enactment of SOX reinforced this view as special interest influence operated in the wake of the Act to blunt much of its sting. In fact, the ink was not dry on SOX when President Bush used a signing statement to protect incumbent managers. Thus, leading investor advocates now believe, notwithstanding SOX, that the American public corporation is a "dictatorship" of the CEO.

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 Joel Seligman, A Modest Revolution in Corporate Governance, 80 NOTRE DAME L. REV. 1159, 1170-75 (2005).

One such example of this special interest domination at the federal level is the Private Securities Litigation Reform Act of 1995 ("PSLRA"). See, 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) ("The recent 'reforms' of private securities litigation are a betrayal of several fundamental goals of the federal securities laws and expose our financial system to risks that are not fully appreciated.").

An example of corporate influence operating to stymie reform occurred shortly after the passage of Sarbanes-Oxley, when the SEC attempted to reform the rules governing proxy voting for shareholders in a public corporation. See, e.g., Amy Borrus, SEC Reforms: Big Biz Says Enough Already, BUS. WK., Feb. 2, 2004, at 43 (detailing the efforts of corporate managers to stifle proxy reform); Amy Borrus & Mike McNamee, A Legacy That May Not Last, BUS. WK., June 13, 2005, at 38 (discussing business lobbying efforts to frustrate proxy reform). Consequently, the entire Sarbanes-Oxley reform effort (including associated reforms in corporate governance at the New York Stock Exchange and the NASDAQ Marketplace) has left CEOs in virtual unfettered control of the machinery of so-called corporate democracy. See Thomas W. Joo, A Trip Through the Maze of "Corporate Democracy": Shareholder Voice and Management Composition, 77 ST. JOHN'S L. REV. 735, 767 (2003) ("For all the current talk of corporate governance reform, corporate democracy remains a myth."). See also Parker, supra note 36 (noting proposed proxy reforms faced fierce opposition from the business community).

Professor Lynn Turner, former SEC chief accountant, asserts that the Bush Administration kept former SEC Chairman Harvey Pitt on in order to continue to further the goals of special interests and to minimize the impact of the Sarbanes-Oxley Act. Tim Reason, Two Weeks in January, CFO MAG., Mar. 1, 2003, at 75, available at http://www.cfo.com/article.cfm/3008446/3046587?ff=insidecfo (quoting Lynn Turner as saying that "[i]t'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").

Compare Statement by President George W. Bush upon Signing H.R. 3763, 2002 U.S.C.C.A.N. 543, 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 § 806(a), Pub. L. No. 107-204, 116 Stat. 802 (codified at 18 U.S.C. § 1514A(a)(1)(B) (2006)) (providing whistleblowers protection against retaliation for providing information to "(B) any Member of Congress or any committee of Congress").

See Bogle, supra note 3, at 29-30.
Congress passed the Act with one eye on the elections of 2002.\textsuperscript{54} After the failure of Enron in late 2001 and WorldCom in mid-2002 (followed by a parade of other instances of corporate corruption),\textsuperscript{55} financial markets were in the throes of a meltdown.\textsuperscript{56} Politicians in both parties feared facing reelection without acting to stem any brewing financial panic.\textsuperscript{57} Republicans in particular seemed anxious to avoid being tarred as beholden to a tainted business sector.\textsuperscript{58} The political impetus behind SOX became irresistible and the Act passed the Senate by a vote of 99-0.\textsuperscript{59} An initially reluctant President Bush signed the Act on July 30, 2002.\textsuperscript{60}

Indeed, commentators have used terms such as “panic”\textsuperscript{61} or “mad dash”\textsuperscript{62} to describe the haste that marked the passage of SOX in July of 2002.\textsuperscript{63} These circumstances were hardly conducive to thoughtful legislative deliberation.\textsuperscript{64} As Professor Romano has asserted, “SOX stands as an exemplar of low-quality legislative decisionmaking in the context of a crisis . . . .”\textsuperscript{65} In fact, many of the key elements of SOX were hardly debated at all in Congress, seemed to have little public salience (and thus analysis), and were swiftly passed pursuant to an expedited legislative process.\textsuperscript{66} Moreover, many of the Act’s innovations had been implemented by Enron, meaning that Congress knew the Act would have limited efficacy.\textsuperscript{67} Congress is not institutionally adept at applying the best

\textsuperscript{54} See BUTLER \& RIBSTEIN, supra note 12, at 14.
\textsuperscript{55} See MILLS, supra note 2, at 13-24 (highlighting scandals at thirteen companies).
\textsuperscript{56} See Ramirez, supra note 40, at 31 (showing that the Dow Jones Industrial Average fell 700 points in one 48 hour period and 1000 points over one week during mid-July of 2002).
\textsuperscript{57} Indeed, the market gained 500 points on the day the Conference Committee approved SOX. See Ramirez, supra note 40, at 35 n.28.
\textsuperscript{58} See BUTLER \& RIBSTEIN, supra note 12, at 14.
\textsuperscript{59} Id. at 16.
\textsuperscript{60} See Ramirez, supra note 40, at 31-35.
\textsuperscript{61} BUTLER \& RIBSTEIN, supra note 12, at 18.
\textsuperscript{63} Romano, supra note 13, at 1602 (“In the frantic political environment in which SOX was enacted, legislators adopted proposals of policy entrepreneurs with neither careful consideration nor assimilation of the literature at odds with the policy prescriptions.”).
\textsuperscript{64} As Professor Romano writes:
\textsuperscript{65} [*]In the wake of additional revelations of accounting irregularities at WorldCom, its subsequent bankruptcy filing, and the continued tanking of the stock market [*]members of Congress feared that there might be additional revelations of corporate misconduct that would further depress the market and make corporate scandals a potent reelection issue.
\textsuperscript{66} Id. at 1567.
\textsuperscript{67} Id. at 1544.
\textsuperscript{66} Id. at 1566 (“Limited consideration and quick floor passage of the bill curtailed partisan debate and shifted discussion of the issues out of the public spotlight. Electoral concerns were thereby addressed at the cost of a comprehensive consideration of the implications of the legislation.”). See also BUTLER \& RIBSTEIN, supra note 12, at 17-20.
\textsuperscript{67} See 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 13 of 15 Enron directors were independent); Jeffrey A. Sonnenfeld, What Makes Great Boards Great, HAV. BUS. REV., Sept. 2002, at 106-08 (contending, for example, that many of the most notable corporate failures had independent boards); see also Steven A. Ramirez, Games CEOs
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financial and economic learning regarding corporate governance to the legislative process due to the range of issues it must address in the ordinary course of its business, the consequent limited opportunities for full debate, and its intensely politicized environment. The rush to enact SOX in the shadow of an election did not enhance its institutional functioning and resulted in an Act that imposed significant compliance costs with too few positive benefits in terms of enhanced investor confidence.

Thus, SOX is best viewed as the subordination of sound policy to interest group politics. Public choice theory generally holds that those with economic power will have decisive influence over the shape of regulation. Corporate governance increasingly benefits narrow interest groups at the expense of public investors: “Politics, not economics, determines which corporate governance devices are favored and which are not.” For example, because SOX makes access to public capital more expensive, it favors established businesses over smaller insurgent businesses. Another powerful winner was the auditing industry which anticipated a surge of revenues as a result of SOX. Combined with a favorable reform moment, these interests were able to guide the reform effort in ways that protected their interests rather than vindicating the general public interest. Most importantly, the Act failed to reduce CEO power, as evidenced by the continued upward trajectory of executive compensation. Yet, the inferior outcome yielded by the SOX reform effort is a predictable consequence of the inferior mechanisms that determine corporate governance elements in the absence of federal intervention.

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Play and Interest Convergence Theory: Why Diversity Lags in America’s Boardrooms and What To Do About It, 61 WASH. & LEE L. REV. 1583, 1584 n.3 (2004) (demonstrating that SOX failed to impose real board independence). Enron also had a financial expert on its audit committee, as required by SOX. See Dan Feldstein, The Fall of Enron, HOUS. CHRON., Feb. 4, 2002, at A1 (discussing the fact that the chair of the Enron audit committee was a former Dean of the Stanford Business School).

68 Romano, supra note 13, at 1544.
69 See Butler & Ribstein, supra note 12, at 3. See also Romano, supra note 13, at 1594 (stating that the Sarbanes-Oxley Act’s corporate governance reforms were costly and “poorly conceived”); Enron’s Legacy, WALL ST. J., May 20, 2006, at A8 (“Congress, as usual, ran off in panic and whooped through Sarbox, the intrusive accounting law that has cost the U.S. economy far more than predicted by its backers. Sarbox has added hundreds of billions of dollars in compliance costs, and for no clear public gain.”). Almost immediately upon its passage commentators expressed doubt that the Act would adequately secure investor confidence. See, e.g., Ramirez, supra note 40, at 64 (stating that SOX may turn out to be a “political fraud”).
70 BUTLER & RIBSTEIN, supra note 12, at 13 (“It is ironic that some of the biggest winners from SOX have been those whose gatekeeping failures triggered the law in the first place. . . . Public choice economics suggests . . . that the intent of SOX should be inferred from its consequences.”).
71 Id. at 13-14 (quoting Prof. Jonathan R. Macey).
72 Id. at 12-13.
73 Id. at 13.
74 See id. at 9-16.
75 See supra note 7.
76 See Mark J. Roe, Delaware’s Competition, 117 HARV. L. REV. 588 (2004) (arguing that federal law operates to constrain the autonomy of state corporate governance authorities).
expected to lead to hurried federal intervention that is driven too much by politics rather than the best financial and economic science.\textsuperscript{77}

B. \textit{The Problems of Corporate Federalism}

The race-to-the-top/race-to-the-bottom debate has evolved in the backdrop of the federal regulatory dynamic illustrated by SOX.\textsuperscript{78} Few have tied the two together as part of a singular special interest dynamic.\textsuperscript{79} Yet, there is no logical basis for segregating the activity at the state level of corporate governance from activity at the federal level.\textsuperscript{80} Directors and officers are more interested in the substance of law and regulations governing their conduct than the source of such standards.\textsuperscript{81} It is true that there is a greater wealth of empirical analysis regarding the race-to-the-top/race-to-the-bottom debate from the perspective of state law.\textsuperscript{82} But, if managers use special influence in one arena to dilute their duties, it is only logical that they would seek to do so in the other.\textsuperscript{83} Thus, an integrated view of the evidence is a more efficacious method of assessing the optimality of the current corporate governance regime.\textsuperscript{84} This integrated view of all the evidence leads to the conclusion that whatever competitive force may exist to move corporate governance in any direction, both the state and federal systems are subject to dangerous special interest raids that compromise the

\textsuperscript{77} Obviously, SOX is the best example of this dynamic. See supra notes 11-12 and accompanying text. Financial crises invariably lead to federal intervention. Ramirez, supra note 40, at 34. See also Stuart Banner, \textit{What Causes New Securities Regulation? 300 Years of Evidence}, 75 WASH. U. L.Q. 849, 850 (1997) (finding that scandals and market disruptions generally lead to new financial legislation).

\textsuperscript{78} Some scholars contend that the states compete for corporate charters by indulging managers with lax governance standards, with the hope of generating enhanced tax revenues. See supra notes 30-31. Other commentators suggest that competition among states leads to pressure from states to provide optimal governance standards so that corporations incorporated in a given state will attract capital at a lower cost. See supra note 32.

\textsuperscript{79} 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 22, at 584.

\textsuperscript{80} 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 49, at 1087 n.156 (demonstrating that lobbying and campaign contributions fueled the political effort to eviscerate private securities litigation); see also MILLS, supra note 2, at 45, 87.

\textsuperscript{81} 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 Ramirez, supra note 49, at 1059 n.13.

\textsuperscript{82} Compare Robert Daines, \textit{Does Delaware Law Improve Firm Value?}, 62 J. FIN. ECON. 525 (2001) (finding evidence that Delaware corporations had higher firm value), with Guhan Subramanian, \textit{The Disappearing Delaware Effect}, 20 J.L. ECON. & ORG. 32 (2004) (finding that “Delaware’s trajectory over the past twelve years is more consistent with the predictions of the race to the bottom view.”).

\textsuperscript{83} See supra notes 28, 49, 50, 51.

\textsuperscript{84} See Romano, supra note 13, at 1532-43.
regulatory infrastructure which defines and channels corporate activity and has moved our system of corporate governance toward a CEO primacy model.\(^8\) 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.\(^8\) Federal intervention has thus far been episodic and sporadic rather than comprehensively preemptive.\(^8\) The federal regulatory framework has itself, however, recently been marked by special interest "raids" particularly when the public gaze is diverted from issues of financial regulation—which is to say, almost always.\(^8\) The Securities and Exchange Commission, the primary federal regulatory authority in the area of capital market regulation for corporations issuing securities, has a spotty record at best of resisting special interest influence.\(^8\) 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.\(^9\) Merely calling for federalization of corporate governance misses this point.\(^9\) 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.\(^9\) Federal law leaves too much space for the exercise of political influence.

8 See, e.g., BOGLE, supra note 3, 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).

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

87 See Ramirez, supra note 40, at 40-41.

88 See Ramirez, supra note 22, at 579 ("Inappropriate political and special interest influence pervade financial regulation. The American economy has suffered as a result.").

89 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 28, at 10 ("Once I began pursuing my agenda... I saw a dynamic I hadn't fully 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 underfunded investors across a range of issues, from expensing stock options to auditor independence. Id. at 10-12, 136-37.

90 Id.

91 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).

92 See MILLS, supra note 2, at 45, 87 (blaming the onset of CEO primacy on, among other things, the Private Securities Litigation Act of 1995 (PSLRA)); 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. 22 AUDITING: J. PRAC. & THEORY 93, 93 ("[W]e find that after the PSLRA income-increasing discretionary accruals rise for auditees of Big 6 firms 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.
Optimizing Regulatory Structures

On some levels, the corporate corruption crisis of late 2001 and 2002 settled the debate regarding whether the system of corporate federalism in the United States leads to excessive laxity in corporate governance standards or results in competitive pressure for states to formulate ever more ideal standards. The parade of corporate corruption seems inconsistent with the idea that corporate federalism in the United States has resulted in an optimal corporate governance regime. In addition, to the extent that the current regime is suboptimal and results in periodic financial crises, SOX proves yet again the likelihood of creeping federalization. Federal intervention is therefore an increasing reality in corporate governance for publicly traded companies; indeed, future meltdowns in investor confidence are likely to lead to ever more intrusive federal regulation, ultimately culminating in some system of federal incorporation.

Nevertheless, it is worthwhile to review the empirical record to date with respect to corporate federalism, to assess the possibility that markets can still be used to continuously move corporate governance in a more ideal direction. 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 law of the state of incorporation. The evidence that Delaware corporations are valued more highly by capital markets is inconclusive at best. Instead, investors seem far

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93 By corporate federalism, I mean the combined state and federal law which governs the obligations of the managers of public corporations and the division of authority between state and federal law. See Cary, supra note 29; Romano, supra note 32.

94 See Jones, supra note 86, at 663 (stating that the political response to the spate of corporate corruption in 2001-2002 "reveals flaws in modern federalist arguments denouncing national-level regulation" and that "[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 there is no race. 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. See Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 VA. L. REV. 757, 852 (1995) (noting that “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 39, at 202.

95 Ramirez, supra note 40, 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.”).

96 See supra note 77.

97 See Seligman, supra note 47, at 1185 (calling for a “broad reexamination” of federal corporate governance law).

98 See Romano, supra note 13, at 1523-26 (discussing compelling political pressure for federal intervention in the wake of the stock market plunge of 2002 and the crisis of corporate corruption).

99 See supra note 32.

100 Ramirez, supra note 22, 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 upon their rights or profits,” based upon a review of empirical studies).

101 See supra note 82.
more concerned about actual corporate governance practices at firms (which can be implemented pursuant to any state corporation code) than which state provides that substantive law for corporate governance. There is no empirical basis for the claim that state corporate governance law is reflected by stock market price in a way that will create market pressure for more optimal corporate governance.

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. In 2003, Professors Lucian Bebchuk and Alma Cohen demonstrated that when firm decisions are disaggregated across jurisdictions (rather than viewed only from the perspective of Delaware versus all other jurisdictions), a major factor driving incorporation decisions is the strength of a given state’s anti-takeover legislation. Because anti-takeover legislation entrenches management and shields them from competitive pressures of the market for corporate control, it is impossible to square this finding with a race to the top. Thus, any empirical foundation for any supposed race to the top has essentially crumbled. This suggests that politics, not markets, is driving corporate governance standards at the state level.

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

103 EISENBERG, supra note 22, at 204 (stating that it “difficult if not impossible” to demonstrate the optimality of Delaware’s corporate law based upon stock market valuations.); LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS 563 (3d ed. 1996) (reviewing empirical studies and finding a lack of evidence that markets impound state corporate law).


105 Lucian Arye Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J. L. & ECON. 383, 387 (2003) (noting that “anti-takeover protections are correlated with success in the incorporation market; adding anti-takeover statutes significantly increases the ability of states to retain their local firms and to attract out-of-state incorporations”).

106 The “overwhelming majority” of event studies show that anti-takeover protections have either no effect on shareholder value or harm shareholder value. In addition, there is empirical evidence that such statutes operate to increase agency costs. Id. at 404-05 (citing, inter alia, GRANT A. GARTMAN, STATE ANTITAKEOVER LAW (2000)).

107 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.”).

108 See supra note 82. Even before the Subramanian study showing that there was no durable “Delaware effect” resulting in superior market valuations for Delaware firms, Professor Bebchuk contested the Daines study to the contrary. Bebchuk, supra note 31, 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

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C. The Emergence of CEO Primacy

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. The so-called duty of care illustrates the race to the bottom quite well. In 1985 the Delaware Supreme Court held a board liable for breach of the duty of care in *Smith v. Van Gorkom*. Shortly after the decision to hold the directors liable for gross negligence was issued, the Delaware legislature enacted a statute that allowed directors to obliterates the duty of care through a provision in the corporation’s charter. By 1988, forty states had enacted director insulating statutes. The managers of the vast majority of public companies were subsequently able to use their control over the proxy machinery to eliminate their own duty of care. 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.” 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. It is difficult to

Delaware incorporation and firm value and asserted that proponents of state competition had confused correlation and causation because of possible material differences between firms choosing Delaware charters and those choosing non-Delaware charters. *Id.* Further, Bebchuk argued that the benefits of Delaware incorporation could stem not from Delaware corporate law but from network effects or the benefits associated with Delaware courts. *Id.* These points have been largely vindicated by subsequent empirical analyses including those undertaken by Subramanian (showing very weak robustness) and Feng Chen (showing that firms incorporating in Delaware are materially different from firms incorporating elsewhere and that therefore comparing Delaware firms with non-Delaware firms is like comparing apples and oranges). See *supra* notes 82 and 104. Finally, Professors Bebchuk and Cohen were unable to find any Delaware effect at all in 1999. Bebchuk & Cohen, supra note 105, at 403.

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 managers must be found grossly negligent to breach their duty of care. See Gimbel v. Signal Cos., 316 A.2d 599, 611 (Del. Ch. 1974) (finding that the business judgment rule did not protect directors that had recklessly accepted a “wholly inadequate” price for the sale of the company). In practice, such a standard means that the duty of care seldom triggers manager liability. I have argued in the past that this approach may be optimal, at least when combined with appropriate private rights under the federal securities laws. Ramirez, supra note 8, at 361 n.156.

*See* 488 A.2d 858 (1985).

*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 from 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 109, at 927.


*See, e.g.* Joo, supra note 50, at 752-60 (demonstrating barriers to the effective use of shareholder franchise rights against the wishes of management).

Delaware alone accounts for fifty percent of all public corporations. See *supra* note 39.

Steinberg, supra note 109, at 929.

*Nev. Rev. Stat. § 78.138(7) (2003).* This insulation may be eliminated by the articles of incorporation. *Id.* Between 1980 and 2005, *Smith v. Van Gorkom* stands as the only example of outside
argue that the story of the duty of care in American corporate law is consistent with anything other than a race to the bottom.\footnote{117}

Nor is the death of the duty of care the sole outlet for the efforts of management to limit their duties and obligations.\footnote{118} 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.\footnote{119} Others focus upon the lax standards governing compensation decisions as a problem.\footnote{120} Each of the foregoing reflects accelerating laxity in directors being found liable and paying damages. Bernard Black et al., \textit{Outside Director Liability}, 58 \textit{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, \textit{Why I Do Not Teach Van Gorkom}, 34 \textit{GA. L. REV.} 477, 490 (2000) (stating that because a very high percentage of public corporations take advantage of insulating statutes, the directors’ duty of care is “essentially obsolete”). Prior to 1980, duty of care liability for directors was hardly common, a point lamented by respected corporate law voices, but Professor Bishop found numerous reported cases of liability attaching even though he did not search for unreported settlements. Joseph W. Bishop, Jr., \textit{Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Directors and Officers}, 77 \textit{YALE L.J.} 1078, 1099-101, 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.”).

\footnote{117} One argument frequently trotted out in favor of laxity is that rigor will repel qualified directors from serving. One problem with this position is that there is little empirical support for it. See Steven F. Cahan & Brett. R. Wilkinson, \textit{Board Composition and Regulatory Change: Evidence From the Enactment of the New Companies Law in New Zealand}, 28 \textit{FIN. MGMT.} 32 (1999) (finding that the more rigorous demands of the 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 overbroad—the same argument supports the abolition of all duties and obligations, a position no commentator really supports.

\footnote{118} The Delaware legislature was responding to “the perceived crisis in the D&O liability insurance industry” when it passed Section 102(b)(7), according to the synopsis of the bill. See Michael Bradley & Cindy A. Schipani, \textit{The Relevance of the Duty of Care in Corporate Governance}, 75 \textit{IOWA L. REV.} 1, 43 (1989). This is odd given that the market value of such insurance companies rose significantly after the \textit{Smith v. Van Gorkom} decision. \textit{Id.} at 73-74. It appears insurance companies were able to use the decision to enhance their premium revenues with little real additional risk. \textit{Id.} (“Surprisingly, we found that the common stock of firms that write D&O liability insurance rose significantly in the wake of \textit{Trans Union}. This increase in equity values suggests that insurers were able to increase their premiums beyond the actuarially fair level.”). \textit{Id.} at 74.

\footnote{119} Seligman, \textit{supra} note 91, at 949-71 (“The most distinctive aspect of the last decade in corporate law was the celerity with which traditional constraints on corporate managers weakened.”). \textit{Id.} at 949.

\footnote{120} Linda J. Barris, \textit{The Overcompensation Problem: A Collective Approach to Controlling Executive Pay}, 68 \textit{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, \textit{Reflections on Executive Compensation and Modest Proposal for (Further) Reform}, 50 \textit{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). \textit{Id.} at 214. According to some commentators, Delaware courts have traditionally been deferential to management. Jones, \textit{supra} note 86, at 646-55. Indeed, Professor Jones suggest that Delaware law provided “officers and directors a virtually impregnable shield from monetary liability for corporate misdeeds.” \textit{Id.} at 646.
the duties of managers during the 1980s and 1990s.\textsuperscript{121} This laxity is certainly consistent with the race to the bottom thesis.\textsuperscript{122}

However, a similar dynamic was transpiring simultaneously at the federal level, where the focus had traditionally been on disclosure duties to shareholders. In late 1995, Congress passed the Private Securities Litigation Reform Act\textsuperscript{123} (PSLRA).\textsuperscript{124} The PSLRA imposed a new, more stringent pleading standard on plaintiffs seeking relief under the federal securities laws; imposed a new sanctions provision applying a loser-pays rule to 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.\textsuperscript{125} In 1998, Congress followed up with the Securities Litigation Uniform Standards Act (SLUSA),\textsuperscript{126} which eliminated state class actions in securities disputes involving public companies. The dual effect of the PSLRA and the SLUSA is to dilute the penalties and enforcement available to deter securities fraud.\textsuperscript{127} Thus, laxity is not limited to state law, nor the result solely of any state competition for corporate franchise revenues.

Of course, diluting the enforcement mechanisms and remedies available could be beneficial if they are too harsh.\textsuperscript{128} Unnecessary or excessive regulation could amount to a tax on innovation or a tax on companies seeking access to the public capital markets.\textsuperscript{129} However, there is no 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.\textsuperscript{130} Second, the late 1980s and early 1990s were hardly emblematic of a high degree of corporate integrity and honesty in our capital markets and have been

\begin{itemize}
\item \textsuperscript{121} See, e.g., supra notes 118-120.
\item \textsuperscript{122} See supra notes 29-31.
\item \textsuperscript{124} See Ramirez, supra note 49, at 1080.
\item \textsuperscript{125} Id. at 1072-80.
\item \textsuperscript{126} Pub. L. No. 105-353 (1998).
\item \textsuperscript{127} Ramirez, supra note 49, at 1083-84.
\item \textsuperscript{128} Ramirez, supra note 40, at 43-44 (describing risks facing an active entrepreneur including the possibility of ruinous litigation pursued by passive investor). The issue of whether there is too much liability risk facing entrepreneurs will also be assessed in light of empirical analyses discussed in Part II of this paper. In short, that Part will demonstrate that there appears to be too little investor protection and not too much. This is, in turn, supported by theories of special interest influence discussed in Part III of this paper which suggest that because CEOs are a small group with concentrated wealth at their disposal, operating in an environment that has low salience to the public, one could predict the decisively pro-management outcomes yielded by our current system of corporate federalism.
\item \textsuperscript{129} Ralph K. Winter, Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America, 42 DUKE L.J. 945, 976 (1993).
\item \textsuperscript{130} Ramirez, supra note 49, at 1082 n.128.
\end{itemize}
termed a "sordid time for financial markets in the United States." Finally, lax conduct quickly followed the diminution of private enforcement, and empirical evidence demonstrates that auditors in particular responded to the PSLRA/SLUSA in predictable fashion: They allowed the spoliation of audit quality so that CEOs could increase current income and thus their own compensation. As such, it appears that the PSLRA/SLUSA led directly to the spate of accounting driven securities frauds that plagued our capital markets in the 1990s. For the first time ever, federal law operated to restrict investor rights under state law, turning the federal securities laws on their head.

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. 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. As Professor Tom Joo has demonstrated, even if a shareholder mounts a proxy challenge, there are rules that systematically load the dice in favor of management. If a mere shareholder wishes to place a person on the board, the shareholder must absorb printing costs, postage costs, and legal costs of mounting a full-blown proxy solicitation, and these costs can amount to millions of dollars. Thus, there is typically only one candidate for

131    Id. at 1089.
132    Lee & Mande, supra note 92, at 294.
133    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. Comm'n on Pub. Trust & Private Enterprise, Findings and Recommendations 5-6 (2003), available at http://www.conference-board.org/pdf_free/ SR-03-04.pdf (finding that excessive compensation, resulting in part from lax monitoring by boards, led to an "unprecedented" loss of investor confidence). Id. at 5.
134    Ramirez, supra note 49, at 1059 n.13. Historically, the federal securities laws had operated only to expand investor rights because federal remedies were cumulative with any state law rights of recovery. See Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) (stating that Congress enacted the federal securities laws in order "to rectify perceived deficiencies in the available common-law protections"). After SLUSA, federal law now operates to destroy state law private rights of action. See, e.g., Merrill Lynch, Pierce, Fenner, and 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).
137    Joo, supra note 50, at 735. Professor Joo identifies two 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.
138    Id. In addition, the management may spend corporate funds to resist shareholder proposals. Designed by Committee, ECONOMIST, June 15, 2002, at 71 (recounting a proxy contest at
board positions in public corporations, and that candidate is selected by management. This means that the CEO may stack the board with cultural and social clones in order to maximize compensation. Shareholder democracy is a myth in the United States, and management interests have worked to keep it a myth.

Predictably, all of these pro-management outcomes led to a crisis in investor confidence, culminating in a parade of corporate corruption scandals in 2001-2002. Recent events illustrate just how weak American corporate governance standards have become and just how ineffective SOX has been in restoring investor confidence. 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. While backdating may not be illegal if both appropriately disclosed and granted in accordance with tax law, by the end of the summer

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139 Id. ("The CEO puts up the candidates, no one runs against them and management counts the votes.") (quoting shareholder activist Nell Minow of The Corporate Library). One commentator has stated that "electoral challenges" to incumbent management "are rare" and that the incidence of successful challenges is "negligible." Lucian A. Bebchuk, The Myth of the Shareholder Franchise 103, 155 (Harvard John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 567, 2007), 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. 

140 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, 1599 (2004) (concluding that CEOs play the game of "homosocial reproduction" when selecting directors and thereby increase their compensation). 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 36, 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).

141 Id. The reductions in investor rights and protections are not limited to legislative and regulatory promiscuity toward management, as the Supreme Court too has turned hostile to private claims under the federal securities laws. See, e.g., Lampf v. Gilbertson, 501 U.S. 350 (1991) (restricting the statute of limitations for federal securities fraud to 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); 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).

142 See supra notes 2, 35, 92, 119, 132. Professor Steinberg raised the possibility that the securities law had turned too far in favor of management in early 2002: "[T]he 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).

143 See MILLS, supra note 2, at 180 (calling SOX "a very incomplete reform" and "insufficient" to restore investor confidence).

144 Stephanie Saul, Study Finds Backdating of Options Widespread, N.Y. TIMES, July 17, 2006, at C1 (reporting on an academic study finding that "[m]ore than 2,000 companies appear to have used backdated stock options to sweeten their top executives' pay packages").
two criminal cases had been filed against executives at Brocade Communications and Comverse Technology.\footnote{Phantom of the Options, INT’L HERALD TRIB., Aug. 24, 2006, http://www.iht.com/articles/2006/08/24/opinion/edoption.php.} Moreover, over 100 companies disclosed that their options practices were under investigation.\footnote{Id.} 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 "stealing money from the company and shareholders."\footnote{Carolyn Said, Possible Options Scams at Several Local Companies, S.F. CHRON., May 6, 2006 (quoting compensation expert Fred Whittlesey). "It is stealing, in effect. It is ripping off shareholders in an unconscionable way." Charles Forelle & James Bandler, Matter of Timing: Five More Companies Show Questionable Options Pattern, WALL ST. J., May 22, 2006, at A1 (quoting former SEC Chair Arthur Levitt).} It appears that this occurred systematically over a period of ten years throughout corporate America.\footnote{See Randall A. Herron & Erik Lie, Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?, 83 J. FIN. ECON. 271, 294 (2007) ("[W]e find evidence suggesting that backdating is the major source of the abnormal stock return patterns around executive option grants."). "We . . . estimate that 29.2% of firms at some point engaged in manipulation of grants to top executives between 1996 and 2005." Randall A. Herron & Erik Lie, What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated? 24 (Nov. 1, 2006) (unpublished manuscript, available at http://www.biz.uiowa.edu/faculty/elie/Grants-11-01-2006.pdf).} Such practices seem more about the crass enrichment of executives than creating any incentive for performance; indeed, one company backdated options grants to enrich a dead executive.\footnote{Dead Executive Gets Stock Options, BBC NEWS, Sept. 22, 2006, available at http://news.bbc.co.uk/go/pr/fr/-/1/hi/business/5371494.stm.} 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.\footnote{On the contrary, former SEC Chair Arthur Levitt has termed options backdating to be "the ultimate in greed." See Forelle & Bandler, supra note 147. If compensation is the litmus test of CEO power, then the legal inducements of the 1980s and 1990s have served to greatly empower the CEO of the public company. Lucian Bebchuk & Yaniv Grinstein, The Growth of Executive Pay, 21 OXFORD REV. ECON. POL’Y 283, 297 (2005) (finding that the proportion of S&P 500 “aggregate earnings” going to top executive compensation approximately doubled as a percentage of profits from 1993 to 2003).}

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.\footnote{See supra note 3.} 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.\footnote{See supra notes 109-142 and accompanying text.} At both the state and federal level, corporate governance in the 1980s and 1990s became a parade of managerial indulgences.\footnote{See supra notes 109-142 and accompanying text.} It seems that at every turn, legislators, judges, and regulators eliminated or diluted constraints on the
power of management. 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. 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. The fact that this occurred at both the state and federal level suggests that the problem transcends corporate federalism and any debate about the race to the top versus the race to the bottom. The problem is inappropriate political influence.

II. The Emerging Science of Corporate Governance

At the same time, there is an emerging science of corporate governance that exists independently of any debate regarding special interest influence or any race either way at the state level. This body of evidence empirically tests the outcomes of specific elements of corporate governance. Empirical

154 See supra notes 109-142 and accompanying text.
155 See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 308 (1976) ("It is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint."). The problem of agency costs within the corporation has bedeviled shareholders and scholars from the very inception of corporate power; in fact, agency costs are inherent to the issuance of corporate equity. Id. at 312-13. Controlling agency costs is key to the economic basis of the corporation. Jensen & Meckling, supra, at 357.
156 As recently as 1983, authorities stated that the business judgment rule protected management only when they act with a "reasonable basis." HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 242 (1983). Even after the enhanced SOX criminal provisions took effect, there remain gaps in the degree to which criminal law can serve as an effective means of reducing agency costs and assuring that corporations adhere to legal mandates. Mary Kreiner Ramirez, Just in Crime: Guiding Economic Reform After the Sarbanes-Oxley Act of 2002, 34 LOY. U. CHI. 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). Criminal prosecutions also require public resources; private civil actions can be pursued free of politics.
157 For a complete analysis of the underlying political dynamics of corporate governance, see Ramirez, supra note 1. CEOs are a concentrated group that commands concentrated economic resources. See MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 1-2, 11-12, 165-66 (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; smaller groups therefore will exercise disproportionate political influence). This will be discussed in greater detail in Part III, infra.
158 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 Indicators: In Search of the Holy Grail, 12 CORP. Gov. 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 C. Coffee, Jr., The Roles of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control, 111 YALE L.J. 1, 64-65 (2001) (stating that the 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 "crises").
159 See, 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
studies test the impact of corporate governance on macroeconomic performance across nations, or the impact of specific innovations on corporate financial performance. 160 This emerging interdisciplinary science of corporate governance means that there is an emerging vision of optimized corporate governance. 161 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. 162 Instead of theorizing or speculating about sound corporate governance, corporate governance is now studied in terms of actual outcomes across disciplines. 163 These empirical analyses therefore demonstrate the inferiority of the current regime of corporate federalism by showing how that regime yields deeply suboptimal outcomes.

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. 164 However, empirical studies suggest this theoretical supposition is flawed. 165 One recent study found companies that provided frequent earnings guidance spent less on research and development than those companies that provided less guidance, and therefore that such companies suffered stunted financial performance over the long term. 166 It

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).

160 Compare Ross Levine & Sara Zervos, Stock Markets, Banks, and Economic Growth, 88 AM. ECON. REV. 537 (1998) (relating economic growth to financial development), and 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 Demirgic-Kunt & Vojislav Maksimovic, Law, Finance and Firm Growth, 53 J. FIN. 2107, 2134 (1998) (finding that firms in countries with active stock markets were able to obtain greater funds to finance growth) and 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).

161 Analyses of optimal corporate governance standards appear in economics journals, finance journals, law journals, and accounting journals. See supra notes 10, 34, 122, 132, 133.

162 Professor Romano relies upon an empirical analysis of corporate governance standards to impugn the Sarbanes-Oxley Act, but no scholar has thus far used this body of evidence to impugn our current system of corporate federalism and to articulate a new regulatory framework that can incorporate this learning into law in a systematic way. See Romano, supra note 13, at 1533-43.


164 The Sound of Silence, ECONOMIST, Apr. 29, 2006, at 79 (noting that defenders of corporate earnings guidance argue that disclosure of "more information is always better").


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

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appears that the flawed system of American corporate governance gives CEOs the opportunity to forgo long term financial performance in favor of short term profitability (and presumably higher CEO pay).

Corporate governance should operate to limit CEO autonomy and to protect investors; this will lead to superior outcomes, because if investors are confident that their reasonable expectations will be secured by law they will invest at a lower cost to entrepreneurs.\(^\text{167}\) Thus, investor protection is associated with higher economic growth.\(^\text{168}\) One study found that companies with superior corporate governance measures (based upon an assessment of twenty-four different corporate governance elements that affect shareholder rights) enjoyed superior stock market valuations.\(^\text{169}\) Weak investor protection leads to a shift in the corporate balance of power in favor of management which will increase self-dealing and lead to higher compensation for executives.\(^\text{170}\) If executive compensation is the “canary in the coal mine” signaling pervasively

\(^{167}\) 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.

Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002). Financial market development is key to economic growth. See supra note 160.


\(^{169}\) 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: (i) factors associated with delaying hostile threats to corporate control; (ii) factors associated with voting rights; (iii) factors designed to protect officers and directors from liability or termination; (iv) other anti-takeover protections; and (v) state laws bearing upon takeovers. Id. at 110-14. One of the factors included in this study is the existence of 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 118, at 43. Other studies link various indices of shareholder rights to financial performance. See Lucian Bebchuk et al., *What Matters in Corporate Governance?*, Harvard John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 491, 2005, at 4, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=593423 (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); Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Company Performance 3 (December 7, 2005) (unpublished manuscript, available at http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf) (finding that a governance index based upon fifty-one elements influences operating performance, valuation, and cash payouts to shareholders).

\(^{170}\) Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Governance and Control*, in 1 A HANDBOOK OF THE ECONOMICS OF FINANCE 1 (George M. Constantinides, Milton Harris & René M. Stulz eds., 2003) (stating that corporate governance must stem self-dealing by managers and that soaring executive compensation in the United States is difficult to justify).
weak corporate governance, then there is cause for serious concern in the United States, where CEO compensation relative to earnings has doubled over the past ten years.\footnote{Bebchuk & Grinstein, supra note 150, at 297 (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).} 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 traditionally required under the federal securities laws in the United States.\footnote{Michael Greenstone et al., Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments, 121 Q.J. ECON. 399, 447 (2006) (noting that “these results should cause policymakers to question the basis of recent calls to repeal U.S. federal mandatory disclosure requirements”).} 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.\footnote{Id. at 399-400.} 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.\footnote{Id. at 405.} Beyond that, management is likely to be more focused on shareholder maximization if they are required to disclose financial information periodically.\footnote{Id. at 406-07 (citing Andrei Shleifer & 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)).} Empirical evidence now supports these theoretical conclusions. Specifically, Professors Greenstone, Oyer, and Vissing-Jørgensen found that when the applicability of the federal mandatory disclosure regime was extended to firms traded in over-the-counter markets in 1964, those firms enjoyed excess returns and gains in operating performance when they commenced compliance as well as in the period following the relevant legislative proposals.\footnote{Id. at 446-47.} “Overall, the results suggest that the benefits

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\item \footnote{Compare George J. Stigler, Public Regulation of the Securities Markets, 37 J. BUS. 117, 124 (1964) ("[S]tudies suggest that the SEC registration requirements had no important effect on the quality of new securities sold to the public.")}, with Irwin Friend & Edward S. Herman, The SEC Through a Glass Darkly, 37 J. BUS. 382, 389 (1964) ("We doubt that any person reasonably well acquainted with the evolution of stock-market practices between the pre- and post-SEC periods could lament or underrate the success of the new legislation in eradicating many of [the] weaknesses in our capital markets."). These studies suffered from an inability to isolate the impact of the federal securities laws from exogenous events that impacted stock prices generally. Greenstone et al. 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. Greenstone et al., supra note 172, at 401.}
\end{itemize}\]
of the 1964 Amendments substantially outweigh the costs of complying with this law as measured by stock returns."

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. In fact, empirical evidence now demonstrates that "standards of liability facilitating investor recovery of losses are associated with larger stock markets." This conclusion is supported by a comparison of forty-nine nations in terms of financial development and strength of investor remedies, compiled with the input of attorneys from around the world. 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. 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: "[T]he 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." As shown in Part II, however, these rights, and therefore the entire mandatory disclosure regime, have been legally diluted over the past few decades.

An additional issue that has been studied in depth is the effect of board diversity upon corporate financial performance. Human resource theorists have supported expectations for increased performance and increased value for companies providing programs that integrate diversity initiatives since at least

177 Greenstone et al., supra note 172, at 403.
178 Ramirez, supra note 49, at 1082-83. Finance professors state the justification for broader investor remedies as based upon efficiency considerations (which suggest the issuer is the lowest cost provider of information) and the need to create adequate incentives for the disclosure of information. Rafael La Porta et al., What Works in Securities Laws?, 61 J. FIN. 1, 5 (2006).
179 La Porta et al., supra note 178, at 28. More specifically:
The results on liability standards are also consistently strong. The estimated coefficients predict that a two-standard deviation increase in this variable (roughly the distance from Denmark to the U.S.) is associated with an increase of 0.23 percentage points in the external-market-to-GDP ratio, a 28% rise in listed firms per capita, a 1.88 increase in the IPO-to-GDP ratio, a 6.6 percentage point drop in the block premium, a 0.75 point improvement in the access-to-equity index, a decrease of 6.6 percentage point drop in ownership concentration (but with a t-stat of only 1.58), and a 45.8 points increase in the volume-to-GDP ratio.

180 Id. at 5.
181 Id. at 7.
183 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.").
In general, diversity at the board level is associated with superior corporate governance and better financial performance. 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. Left to their own discretion, it appears that CEOs specifically engage in homosocial reproduction to stock boards with those friendly to the CEO’s interests in general in order to enhance their compensation. 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. Despite powerful evidence suggesting that board diversity leads to superior outcomes in terms of corporate performance and corporate governance, CEOs today reign supreme under law in selecting board members.

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184 Fields & Keys, supra note 33, 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).


186 See Daniel P. Forbes & Frances J. Milliken, Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups, 24 ACAD. MGMT. REV. 489, 494-99 (1999) (stating that heterogeneous boards benefit from cognitive conflict that results in a more thorough consideration of problems and solutions); see also Marlene A. O’Connor, The Enron Board: The Perils of Groupthink, 71 U. CIN. L. REV. 1233, 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”).

187 Rosabeth Kanter originally coined the term “homosocial reproduction” to explain why white male managers seemed inclined toward 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.

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

189 Eliezer M. Fich & Lawrence J. White, CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards, 38 WAKE FOREST L. REV. 935, 947-51 (2003) (“[T]he number of mutual director interlocks is found to be significant and positively associated with total compensation.”).
A further area of inquiry involves anti-takeover protections, which typically operate at the state level to insulate current management from the pressures of competitive corporate control markets. 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. Another study found that anti-takeover legislation also weakened management incentives to negotiate lower labor costs generally, as CEOs apparently utilized their enhanced power to favor co-employees over more distant and less visible shareholders. 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. 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. In all, it appears that anti-takeover

190 Bebchuk & Cohen, supra note 105, at 404 (stating that most states have anti-takeover statutes and Delaware courts have permitted management to engage in anti-takeover tactics such as poison pills which operate to dilute those attempting to seize control).

191 Marianne Bertrand & Sendhil Mullainathan, Corporate Governance and Executive Pay: Evidence from Takeover Legislation 22 (Nov. 29, 1999) (unpublished manuscript, available at http://post.economics.harvard.edu/faculty/mullainathan/papers/execcomp.pdf) (“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 . . . ”). One may have expected compensation to go down in the wake of anti-takeover 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. Instead, the finding of the study tends to confirm a skimming model of CEO compensation. Id. at 22. Importantly, the authors found that the presence of a large shareholder mitigated pay raises and was associated with greater incentive compensation innovations in the wake of anti-takeover legislation, as larger shareholders apparently acted more optimally as agents and searched for substitute forms of discipline. Id.


193 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. POL. ECON. 1043, 1072 (2003).

194 See, e.g., 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); 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); Westphal & Zajac, supra note 188, at 77, 79 (finding that “in firms in which CEOs are relatively powerful, new directors are likely to be demographically similar to the firm's incumbent CEO” and compensation increases).
protections serve to enhance management power and compromise performance.\textsuperscript{195}

Board composition has also commanded significant attention from corporate governance scholars.\textsuperscript{196} For example, a staggered board may be a powerful anti-takeover device that operates to frustrate the ability of outsiders to seize control of a corporation.\textsuperscript{197} There is robust evidence that a board that is independent of the CEO enhances corporate valuation.\textsuperscript{198} Moreover, boards selected without input from the CEO are more independent and achieve a higher market valuation.\textsuperscript{199} Yet, evidence of the efficacy of so-called outside directors (those who are not otherwise employees of the corporation) is mixed at best.\textsuperscript{200} 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.\textsuperscript{201} Similarly, there is evidence that an independent nominating committee for the selection of directors is associated with superior performance.\textsuperscript{202} It appears that board composition that reduces CEO autonomy

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\item \textsuperscript{195} Lucian A. Bebchuk, \textit{Letting Shareholders Set the Rules}, 119 HARV. L. REV. 1784, 1790 (2006) (showing that the market for corporate control is distorted by staggered boards as well as golden parachute and other payments to incumbent management, and therefore “leaves management considerable slack”).
\item \textsuperscript{196} Fields & Keys, supra note 33, at 4-12.
\item \textsuperscript{198} Anil Shivdasani & David Yermack, \textit{CEO Involvement in the Selection of New Board Members: An Empirical Analysis}, 54 J. FIN. 1829, 1832 (1999) (finding a higher stock market valuation when the CEO is not 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. \textit{id.} at 1831.
\item \textsuperscript{199} 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, \textit{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).
\item \textsuperscript{201} Brown & Caylor, supra note 169, at 7-8 (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., \textit{Corporate Governance, Chief Executive Compensation, and Firm Performance}, 51 J. FIN. ECON. 371 (1999) (finding lower CEO compensation when CEO and board chair are split) and David Yermack, \textit{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)).
\item \textsuperscript{202} Brown & Caylor, supra note 169, at 18, 45 tbl.5 (finding that an independent nominating committee is a top three factor in terms of return on equity and net profits). As elsewhere, endogeneity problems plague research in this area and it is difficult to discern if board composition drives performance or performance drives board composition. Fields & Keys, supra note 33, at 5 (summarizing
\end{itemize}
is associated with superior outcomes based upon the best corporate governance science available; nonetheless, corporate governance law fails to do anything to facilitate real board independence.

The emerging science of corporate governance also casts doubt on the efficacy of the Sarbanes-Oxley reform initiatives. Professor Roberta Romano has tested those reforms against the best empirical data regarding such reforms. 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. She also finds “compelling” empirical support that prohibiting auditors from providing non-audit services (as required by Section of 201 of SOX) does not affect audit quality. Apparently there is little evidence supporting the efficacy of the requirement that CEOs and CFOs certify the accuracy of financial statements, as mandated by Section 302 of SOX. 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.” Moreover, the one SOX initiative that is supported by empirical evidence, the appointment of a financial expert to the audit committee, is not a mandate but a disclosure requirement. Thus, Professor Romano concludes that the corporate governance initiatives were “seriously misconceived.”

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

Romano, supra note 13, at 1526-27.

Id. at 1532 (citing 16 studies assessing efficacy of independent audit committees).

Id. at 1535-36 (citing 25 studies addressing the impact of permitting auditors to provide non-audit services).

Id. at 1542 (citing two studies with inconsistent findings).

Id. at 1543.

Id. at 1532.

Id. at 1602. There is empirical evidence to the contrary. Brown and Caylor find that many of the SOX reform initiatives are associated with superior financial performance. Brown & Caylor, supra note 169, at 31 (“We find that independent board of directors, nominating committees and compensation committees are associated with good firm performance.”); see also Reena Aggarwal & Robin Williamson, Did the New Regulations Target the Relevant Corporate Governance Attributes?, Feb. 12, 2006, at 1, 28 (unpublished manuscript) available at http://www.issproxy.com/pdf/Reenaaggarwal-GovernanceandFirmPerformance0206.pdf) (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”). It is notable that the authors declined to opine on 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. She argues (again) in favor of the current system of corporate federalism with a limited role for Congress. 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 SOX. It is difficult, for example, 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. 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. Nor has Delaware or any other state since exhibited any sensitivity to empirical outcomes. Certainly, it is the case that some of the

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210 My agreement with Professor Romano’s diagnosis is limited by the recognition that corporate federalism had degenerated to such an extent that something had to be done by the summer of 2002. I agree that Congress could have crafted better legislation, and that it would have been well-advised to heed the science of corporate governance. Unfortunately, corporate federalism had yielded such power to CEOs during the 1980s and 1990s that the market reacted favorably to SOX, even though it may have been a sub-optimal solution to the problem of management run amok. See supra notes 201-202. 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.

211 See supra note 32.

212 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 chose 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 Brehm v. Eisner (In re Walt Disney Corp. Derivative Litig.), 906 A.2d. 27 (Del. 2006).

213 On the contrary, Gompers et al. specified duty of care insulation as one indicium of weak corporate governance that they found associated with inferior performance. See Gompers et al., supra note 169, at 144-45, 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 118, 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. COMM’N ON PUB. TRUST & PRIVATE ENTERPRISE, supra note 133, at 5-6 (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 2001-2002). Id. at 5.

214 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 & Meckling, supra note 155, at 357.

215 Most recently, the Delaware courts gave meaning to section 102(b)(7) by holding that to be liable under that provision a plaintiff must show an absence of good faith, meaning: A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. Brehm v. Eisner, 906 A.2d. at 67 (quoting Post-trial Op. at *36, (footnotes omitted)). Again the court was oblivious to any empirical learning regarding optimal corporate governance. See id. Professor Jones argues that Delaware courts imposed “strict judicial scrutiny” over management, in an possible effort
state law outcomes discussed above predate the empirical data suggesting they are economically and financially suboptimal outcomes. Nevertheless, there is no apparent movement by any authority to revise these outcomes. 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. Legislators and judges are not required to have advanced degrees in these areas, nor should they be. They have jurisdiction over a wide variety of legal issues and have neither the time nor the expertise for such specialized knowledge. It is hard to imagine a productive debate in the halls of Congress or the courthouses of America regarding the appropriate weight to give to the emerging science of corporate governance in making corporate governance law. Even an institution with the resources of the Supreme Court of the United States seems unlikely to rest its opinions on the state of empirical data. Institutionally, neither legislators nor judges are well-suited to interpreting and integrating the best learning on corporate governance into law.

The lack of institutional capability and expertise certainly transcends the corporate federalism debates about whether there is a race to the top or the to preserve Delaware's position as the primary source of charters for public companies. Jones, supra note 86, at 645. She wrote before the Delaware Supreme Court ruled in the Disney case. Apparently, the Delaware judiciary reverted to its previous 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.

*See, e.g.*, supra notes 68-69.

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 33, at 19.

*See, e.g.*, U.S. CONST. art. I, III (stating qualifications for federal legislature and federal courts and not requiring an advanced degree in finance, accounting, or economics).

*See Marver H. Bernstein, Regulating Business by Independent Commission 137-43 (1955) (articulating bases for agency regulation and including (i) the need to professionalize and provide expertise for regulation; (ii) regulatory continuity; (iii) allow for rapid adaptation to changing conditions; and (iv) reduce special interest influence); Stephen Breyer, Breaking the Vicious Circle 10-29, 39-61 (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).

With respect to the PSLRA, for example, scholars had shown that there was no litigation explosion, there was no evidence of impaired capital formation, and there was no showing of extortionate settlements. Yet, these were the policy bases for the precipitous deregulation of the securities markets that occurred with the substantial destruction of private enforcement. Ramirez, supra note 49, at 1086-87.

*For example, in the two most recent Supreme Court cases to diminish investor rights, Dabit and Dura, 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. Merrill Lynch, Pierce, Fenner, and Smith, Inc. v. Dabit, 126 S.Ct. 1503, 1510 (2006) (ignoring empirical record regarding economic importance of investor protection in favor of empirically unsound rhetoric from the 1970s about the supposed “vexatiousness” of litigation under 10(b)(5)); Dura Pharm., Inc., v. Broudo, 544 U.S. 336, 338 (2004) (finding that plaintiff’s claim legally insufficient without appearing to consider empirical data on importance of investor protections).
bottom. Neither federal nor state authorities have exhibited any sensitivity to the emerging science of corporate governance.\textsuperscript{222} Indeed, the lack of empirical support for SOX is only the beginning of legal dysfunction.\textsuperscript{223} Many corporate governance initiatives have not made it into law despite enjoying empirical support.\textsuperscript{224} There is an intolerable chasm between the teachings of corporate governance science and corporate governance law.\textsuperscript{222} In fact, one empirical study assessing the impact of shareholder rights and investor protection on the cost of capital found that the magnitude of departure from an optimal capital structure is quite large even in advanced countries because of sub-optimal corporate governance.\textsuperscript{226} The study is founded on two premises which the authors empirically confirmed: First, weaker investor protection leads to more inside ownership, and second, more inside ownership leads to a higher cost of capital.\textsuperscript{227} 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.\textsuperscript{228} 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.\textsuperscript{229} There is no restriction

\textsuperscript{222} See supra notes 213-216 and accompanying text.
\textsuperscript{223} See id.
\textsuperscript{224} For example, consider the issue of board diversity. See Ramirez, supra note 140.
\textsuperscript{226} 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 sub-optimal corporate capital structures in terms of inside ownership, is “potentially quite large”); see also Gompers et al., supra note 169, at 145 (finding that potential gains from improvements in corporate governance “would be enormous”).
\textsuperscript{227} Himmelberg et al., supra note 225, at 38.
\textsuperscript{228} 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.
\textsuperscript{229} In an assessment of fifty-one corporate governance elements, firm valuation was positively correlated with sound corporate governance, even after 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 209, at 28. It is not my intent to construct a new index of investor protection, but rather simply to highlight glaring deficiencies in the trajectory of corporate governance law versus the best corporate science offered by economists and financial experts. Thus, the factors I focus upon are driven by a subjective sense of specific elements that are most at odds with empirical learning rather than on elements that seem most powerfully associated with firm value, firm financial performance, and macroeconomic performance.
on management's earnings guidance. There is no standard for encouraging more diverse boards to disrupt homosocial reproduction. Anti-takeover protections serve to entrench management across the nation. Congress and the Supreme Court have gutted private securities claims, even though investor protection is crucial to sound corporate governance. Courts and legislatures have aggressively reduced private remedies over the last twenty years. All of this is precisely in accordance with the predictions of public choice and other theories of legislation and lawmaking. Moreover, there are quite often footprints of management interests surrounding diluted shareholder protections and compromised investor rights. The science of corporate governance shows that there is no market pressure for optimized corporate governance—there is only market pressure for indulgent pro-management corporate governance law. The next Part seeks to articulate a means by which market action can be harnessed to achieve more optimal corporate governance standards.

III. Toward a Federal Reserve of Corporate Governance

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

230 See supra notes 164-166 and accompanying text.
231 See supra notes 183-189 and accompanying text.
232 See supra notes 190-195 and accompanying text.
233 See supra notes 167-171, 178-182 and accompanying text.
234 See supra notes 109-142 and accompanying text.
235 See infra Part III.
236 See supra notes 28, 36, 49, 50, 71, 80, 118. Professor Cary noted that in 1963 Delaware declared it the policy of the state to enact pro-management corporation laws. Cary, supra note 29, at 669. 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).
237 Supra Parts I, II.
238 See supra notes 49, 80.
239 See supra notes 36, 50.
political power at the federal level but not at the state level.\textsuperscript{241} Outcomes at both the federal and state level are simply not consistent with any explanation other than special interest influence.

The exercise of special interest influence in this context would not surprise the economists, political scientists, and legal scholars who have studied the impact of economic and political power upon legal and regulatory outcomes.\textsuperscript{242} Mancur Olson's focus on the problem of collective action would predict a highly pro-CEO outcome in corporate governance standards, given the small number of CEOs, the wealth they command, their stakes in the outcomes of corporate governance, and the barriers to organization that shareholders face.\textsuperscript{243} Economists predict that growing inequality would naturally lead to legal system outcomes that favor the rich and powerful.\textsuperscript{244} Public choice enthusiasts would argue that law and regulation will always be shaped by the economic and political power of those subject to regulation.\textsuperscript{245}

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\textsuperscript{241} There is evidence of special interest indulgences and inappropriate political influence subverting corporate governance at all levels and institutional branches with lawmaking authority in the area of corporate governance, resulting in compromised investor confidence and unjustified compliance costs. \textit{See supra} notes 12-15, 21, 36, 50, 51, 52, 44-77, 89, 109, 118, 133, 215, 225, 236.

\textsuperscript{242} Even the Supreme Court is the mere extension of politics by other means; for example, Professor Derrick Bell long ago argued that the Court's remarkable eradication of American apartheid, \textit{Brown v. Board of Education}, 347 U.S. 483 (1954), responded to powerful economic and political pressure to develop the south and to sway people of color around the world against Communism. \textit{See} Derrick A. Bell, \textit{Brown v. Board of Education and the Interest-Convergence Dilemma}, 93 HARV. L. REV. 518, 523 (1980) (showing that \textit{Brown} was the "subordination of law to interest-group politics"). Bell's thesis has since been buttressed by the research of Professor Dudziak. \textit{See} Mary L. Dudziak, \textit{Desegregation as a Cold War Imperative}, 41 STAN. L. REV. 61, 66, 82-84 (1988) (summarizing materials from the Department of State and the Department of Justice supporting Bell's thesis). The additional political insulation that the judiciary enjoys under the Constitution can not only be pierced by major issues of the day, but can be affirmatively threatened by the political branches, as President Franklin Roosevelt did in the 1930s. \textit{See} William E. Leuchtenburg, \textit{The Origins of Franklin D. Roosevelt's "Court-Packing" Plan}, 1966 SUP. CT. REV. 347.

\textsuperscript{243} \textit{See} McCaffery & Cohen, supra note 240, at 1161 ("In the now standard view of politics . . . small groups with high stakes arise independently, motivated by common interests and are able to solve the 'free rider' problem of collective action on account of their small size.") (citing \textit{MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GOODS} (1965)). McCaffery and Cohen suggest that the triumph of special interest influence is a two way street: Well-organized groups and legislators bargain to exchange legislative largess for campaign contributions and other benefits for legislators. \textit{Id.} at 1233-35 (finding that Congress exploits special interests by stringing issues along and having repeated votes without resolving anything on issues such the repeal of the estate tax).

\textsuperscript{244} Edward Glaeser et al., \textit{The Injustice of Inequality}, 50 J. MONETARY ECON. 199 (2003). One recent study found that in the United States over the last twenty-five years the income share of the top 10\% increased substantially, garnering between 40-45\% of earnings. Thomas Piketty & Emmanuel Saez, \textit{The Evolution of Top Incomes: A Historical and International Perspective}, 96 AM. ECON. REV. PAPERS & PROC. 200, 201 (2006), \textit{available at} http://elsa.berkeley.edu/~saez/piketty-saezAEAPP06.pdf. The increase is attributed to "the very large increases in top wages (especially top executive compensation)."] \textit{Id.} at 204.

\textsuperscript{245} \textit{See} Ronald A. Cass, \textit{The Meaning of Liberty: Notes on Problems Within the Fraternity}, 1 NOTRE DAME J.L. ETHICS & PUB. POL'y 777, 790 (1984-85) ("Take almost any government program at random, and a 'special interest' counter-majoritarian explanation can be found that is more plausible than the public interest justification for it."). While a compelling argument can be made that regulation may be subverted by special interests, important areas of regulation can be protected from special interest influence, as exemplified by the Fed's administration of monetary policy. Ramirez, supra note
Given this rich theoretical framework in favor of the centrality of special interest influence, it is somewhat astonishing that corporate governance scholars have not focused more on how special interest influence has set corporate governance on such an indulgent pro-CEO course. The sheer weight of debate on corporate federalism seems to dominate the rethinking of how corporate governance is made in the United States. Nevertheless, the highly pro-CEO outcomes yielded by corporate governance (most notably regarding compensation), the relatively small number of CEOs, the wealth they command, the high stakes they have in corporate governance, the transitory nature of public scrutiny, and the highly political context in which corporate governance law is made (legislatures and politicized agencies), seem to fit theories of special interest power better than any race to the top thesis. CEOs are simply better organized and have superior economic and political resources than the investing public.

Special interest influence does not invariably subvert regulation, even in an area that is typically characterized as less than fascinating to the public. I have previously demonstrated that the legal structure, the economic and political context, and the nature of the regulatory franchise each influence the ability of a regulatory agency to deliver upon its premise of specialized and expert regulation in the general public interest. This reality of depoliticized financial regulation is exemplified in the structure of the Federal Reserve Board. The Fed has been a remarkable regulatory success story in that it seems far more responsive to economic science and market realities than to any

22, at 553. I have previously argued that when the public is focused upon an issue, it is possible that special interests can be thwarted, particularly when the public is unified. Id. at 506 (stating that when the public is focused on an issue or area of regulation, special interests cannot dominate regulation) (citing Dorothy A. Brown, The Invisibility Factor: The Limits of Public Choice Theory and Public Institutions, 74 WASH. U. L.Q. 179, 181 (1996)).

246 Professors Cary, Miller, and Macey are exceptions. See supra notes 71 and 236. Professor Roe considers public choice theory and interest group politics in exploring the federal versus state regulatory dynamics, but not insofar as the decidedly pro-management outcomes are concerned on both levels. Roe, supra note 39, at 2541-43. Notably, he does not focus upon "statute after statute or exact judicial holdings" but instead on "broad boundaries of corporate lawmaking," Id. at 2542.

247 See supra notes 29-32, 79-108.

248 Even the sporadic interference of Congress into state corporate governance law would be forecast by theories of legal reform, particularly given the ability of corporate governance to influence macroeconomic growth and stability. See Dani Rodrik, Understanding Economic Policy Reform, 34 J. ECON. LIT. 9, 31-38 (1996) (articulating a theory of economic reform which views economic crises as a central factor); see also supra notes 41-77.

249 Ramirez, supra note 22, at 553 ("The historical and empirical record suggests that the Fed has not exercised its power over monetary policy for the benefit of special interests.").

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

Id. at 518.

251 Id. at 522-32.
kind of political or special interest pressure. Monetary policy mirrors corporate governance in that it is highly specialized, it is a topic that rarely engages public scrutiny, and it has tremendous economic importance. This Part of this Article seeks to light the way for the creation of a regulatory entity that can achieve similar success in the area of corporate governance.

The first element of such an agency is its legal structure. The Fed Board of Governors enjoys extended terms and can only be removed for cause. Their terms are staggered so no single president may exert too much influence over monetary policy. Each Board member is subject to post-employment job restrictions. Fed Governors enjoy competitive salaries. The Fed is self-funded and obtains its operating revenue through statutorily authorized assessments on member banks. Thus, the Fed is not beholden to the congressional appropriations process. This structure was created so that the Fed could exercise its prodigious power over monetary policy in accordance "with the general public interest" and not "the majority of special interests." An agency charged with the creation of a federal incorporation regime should

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

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

Id. at 554.

256 Id.
258 12 U.S.C. §§ 243-44 (2006). In 2000, I proposed the creation of a depoliticized SEC. Ramirez, supra note 22, at 574. I have now essentially abandoned that idea in favor of the more aggressive proposal of a depoliticized federal chartering authority, for three reasons. First, although I was pessimistic in 2000 regarding the ability of corporate federalism to appropriately operate to optimize corporate governance, I underestimated how seriously flawed corporate governance had become until the parade of corporate corruption scandals in 2001-2002. Id. at 561, 584 (stating that financial regulation as then structured faced "grave difficulties" acting in the public interest, but that crises in investor confidence may only occur "once a century"). Second, I underestimated the degree of special interest influence over the SEC until its senior officers blew the whistle on the operation of such influence. See supra notes 5, 29, and 41. Third, in 2000 the science of corporate governance was more primitive than its current infancy; there is little reason to think that the SEC has the multidisciplinary expertise necessary to translate corporate governance science into corporate governance standards. See supra note 10. Thus, I propose a new agency without the history and fundamentally different focus than the SEC, which has long been fixated upon disclosure.

259 Ramirez, supra note 22, at 522-24. The Fed is, however, periodically reviewed by government auditing agencies, and presumably if abuses were uncovered, Congress could reign in the current funding latitude that the Fed enjoys. Id. at 525 n.110. No agency of the United States should have unbridled discretion over its funds and expenditures.

260 H.R. REP. NO. 74-742, at 1, 6 (1935).
be structured along these lines, and should be free from the politics implicit in
the congressional appropriations process by having the power to assess public
companies for its operating costs.

The legal structure of a depoliticized agency, however, must be supported
by a political and economic context that favors non-interference from the more
political branches. The Fed, for example, is fully cognizant of the limitations on
its powers posed by the fact that the political branches could abolish it. This
is a real source of restraint. On the other hand, if the political branches were
ever to precipitously impinge upon the Fed’s independence, financial markets
would react negatively. Corporate governance standards like monetary
policy are debated moment to moment as investors and markets react to the
actual financial performance of companies. Thus, like monetary policy,
corporate governance would be subject to market tests and limitations. Depoliticized monetary policy has stood the test of time: Financial markets
essentially demand it, and politicians acquiesce to it. There must be the
development of a similar political and economic coalition in favor of corporate
governance based upon economic science instead of power. The context of a
depoliticized agency is most assuredly supported by elements of market
discipline. Thus, I also propose a market check on the power of any agency
created to formulate corporate governance for public corporations.

262 JOHN T. WOOLLEY, MONETARY POLITICS: THE FEDERAL RESERVE AND THE POLITICS OF
MONETARY POLICY 125-30 (1984) (studying monetary policy and concluding that the Fed “lies low”
during election years for fear of being accused of playing political favorites).
263 Id. at 118 (reporting on Reagan Administration effort to threaten the Fed and the adverse
financial reaction this generated); see also Vartanig G. Vartan, Independent Fed Is Supported, N.Y.
TIMES, June 28, 1982, at D7 (noting the resistance of the financial community to the threat to Fed
independence).
264 See, e.g., Ramirez, supra note 40, at 31-36; see also supra note 100.
265 The Fed only has direct control over short-term interest rates, and is at the mercy of the
market’s inflationary expectations insofar as long-term rates are concerned. E. Gerald Corrigan, Are
266 Ramirez, supra note 22, at 528-30.
267 There are many powerful capitalists that would favor an institutional framework that
resulted in superior corporate governance. Indeed, John D. Rockefeller and representatives of J.P.
Morgan were early proponents of federalizing corporate governance in order to stem a race to the
bottom. GABRIEL KOLKO, THE TRIUMPH OF CONSERVATISM: A REINTERPRETATION OF AMERICAN
HISTORY, 1900-1916, at 63-64 (1963). Moreover, institutional investors are increasingly recognizing
that corporate governance in America has failed. Institutional investors now hold 55% of all equity in
the United States. Thus far social, cultural, and regulatory realities have impeded this potential force for
shareholder rights from fully manifesting itself. See EISENBERG, supra note 39, at 154-62.
268 Centralization of regulatory authority is another key element of contextual support for a
depoliticized agency. Centralization of regulatory authority means that an agency has autonomy over a
zone of issues without attending to the potentially conflicting charter of other regulatory authorities. If
an agency has centralized authority then it will not have overlapping authority with another regulator
that may have conflicting goals. Similarly, concurrent agency authority may also lead to inconsistent
approaches and rules relating to the same or related issues. See Larry D. Wall & Robert A. Eisenbeis,
Financial Regulatory Structure and the Resolution of Conflicting Goals, 16 J. FIN. SERVICES RESEARCH
223, 241 (1999) (“In most cases, Congress may be best served by . . . assigning the problems to a single
agency, setting clear priorities for the agency and holding the agency accountable for its actions.”). I am
essentially arguing for the creation of a new agency that would have comprehensive authority over all

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Investors should have the specific right to elect corporate governance regimes—specifically, by electing to incorporate under the authority of federal law. Vesting the right to select corporate governance regimes in shareholders puts real substance into shareholder primacy rhetoric. As such it would vindicate the corporation’s essential purpose: to facilitate the application of capital from passive investors to productive investment in profitable enterprises. Shareholders should have some defined means of selecting the optional federal regime or exiting the federal regime. The power of the depoliticized agency would also be limited by the market’s assessment of optimal corporate governance; to the extent inappropriate standards are promulgated, charters (and accompanying franchise revenues) will migrate away from the federally-sponsored regime. Vesting shareholders with the aspects of corporate governance for companies choosing to submit to the new agency. The states and the SEC would lose all direct authority over such companies insofar as corporate governance is concerned.

269 Bebchuk, supra note 26, at 836 (“Increasing shareholder power to intervene in the affairs of the corporation] would improve corporate governance and enhance shareholder value by addressing important agency problems that have long afflicted publicly traded companies.”). My proposal differs from that of Professor Bebchuk in that I call for a very limited notion of shareholder empowerment: specifically, the power to elect a federal regime of corporate governance. Along those lines, it is noteworthy that because I call only for a single additional shareholder power my proposal does not implicate arguments that management’s business judgment would be inappropriately impaired. First, the selection of the chartering authority has nothing to do with managing the business of the corporation. Second, the depoliticized agency I advocate would be limited to those innovations founded upon corporate governance science and these innovations would be subject to market testing. See Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 HARV. L. REV. 1735, 1744-46 (2006) (arguing that management must have the power to make non-reviewable business decisions).

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

Bebchuk, supra note 26, at 838.

271 Ramirez, supra note 135, at 986 (explaining that shareholder primacy, limited liability, and the ability to lock-in capital free from claims of shareholders (or their creditors) operate to maximize the flow of capital from passive investors to productive enterprises).

272 Professor Bebchuk includes a detailed proposal regarding submissions, management counter-proposals, holding period requirements, expense reimbursement, limitations on resubmission, and the like. Bebchuk, supra note 26, at 870-75. A full assessment of such procedures is beyond the scope of this Article, which seeks merely to spotlight and resolve the problems of special interest influence over corporate governance and the need for a depoliticized agency to align corporate governance standards with corporate governance science. In general, Professor Bebchuk’s framework appears thoughtful and appropriate and would seemingly function as well in the context of my proposal as in his. It is notable that Professor Bebchuk points out that other nations (including the United Kingdom) already have such mechanisms in place for empowering shareholders. Id. at 847-51.

273 It may well be that, in general, it is highly appropriate that a depoliticized agency structure have a market foundation for its creation and continued existence. In other words, Congress would only part with such power on a durable basis if markets force it to do so, or if Congress is confident that a check on the agency’s power is manifest through market action. Either way, relying on market assessments of corporate governance standards is central to my proposal for the institutional framework advocated herein. See Joan MacLeod Heminway, Rock, Paper, Scissors: Choosing the Right Vehicle for
option of setting the authority for corporate governance would likely impose real constraints on managers even if shareholders rarely exercised such rights. Like a well-oiled shotgun has deterrence value even if never fired, such an option would deter expropriation and reduce agency costs. Moreover, other jurisdictions, particularly Delaware, would likely respond to optional federal threats with greater attentiveness to a more even-handed corporate governance.

An agency similar to the Fed could bring to bear the kind of expertise to corporate governance that the Fed applies to monetary policy. Monetary policy is not debated in Congress, much less in state legislatures or state and federal courts. Monetary policy is instead the subject of intense debates in financial markets around the world and among economists at the Fed. Law review articles do not debate whether the Fed should raise or lower the discount rate. Indeed, there is no monetary policy law, and, for the same reasons, there should be no corporate governance law.

Corporate governance

Federal Corporate Governance Initiatives, 10 FORDHAM J. CORP. & FIN. L. 225, 384 (2005) (advocating that corporate law scholars think about the institutional context in which rules are made as much as the content of rules themselves).

274 Just as Delaware acts to prevent federal preemption threats, management would act to reduce threats posed by alternatives to their own choice for incorporation. Jones, supra note 86, at 663.

275 For example, there is evidence that management rarely listens to shareholders even when they make their preferences clear and even when the shareholder preference seemingly would add value to the firm. Bebchuk, supra note 26, at 868-71. Naturally, management can presently ignore shareholder preferences if shareholders have no recourse, except of course to sell and invest in another firm that will ignore their preferences; if management risks a major disruption to their prerogatives they would be more responsive.

276 As Professor Bebchuk highlights, if shareholders have autonomy in the selection of corporate governance regimes, then states would have new incentives to cater to shareholder preferences. Id. at 868-69. Delaware appears to endeavor to maintain its position as the state of incorporation of choice for public companies. See Jones, supra note 86, at 662-63 (concluding that Delaware law shifted to prevent federal preemption).

277 See generally Ramirez, supra note 22.

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

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

Heminway, supra note 273, at 304. Many maintain that Delaware has superior expertise, yet it acts without regard to the empirical science on the issues it addresses. See supra notes 203-221; see also supra notes 63-69.

279 See supra notes 263, 265.

280 In this respect, I take the fundamental point of Professor Heminway one step further. She argues, correctly, that scholars should think not just about optimal legal outcomes, but the legal institutions necessary to secure such outcomes. I posit that the institutional structure for corporate governance of public companies should be optimized and never debated again—essentially the reality today for monetary policy law. See Heminway, supra note 273, at 384.

281 See supra note 253 (stating general conditions for when depoliticization is appropriate).
standards affect the operation of the key economic institution in the world.\textsuperscript{282} Corporations are the pivotal store of risk capital in the United States, and the key holder of society’s wealth.\textsuperscript{283} The manner in which corporations are governed will affect a wide range of national issues—from economic inequality to globalization.\textsuperscript{284} Like monetary policy, corporate governance is too important to be left to politics and special interest influence.\textsuperscript{285} If left to an expert administrative agency with interdisciplinary expertise, the science of corporate governance could be incorporated into corporate governance standards.\textsuperscript{286} Until such an agency is created, the best learning regarding appropriate corporate governance standards is likely to continue to fall on deaf ears, or at least ears with insufficient expertise or too beholden to interest group politics.\textsuperscript{287}

At first glance, creating such an agency for articulation of corporate governance standards for public companies may seem radical and undemocratic.\textsuperscript{288} Yet, corporate governance rarely becomes a contested election issue.\textsuperscript{289} Indeed, politicians seem to work to keep such issues from reaching any significant degree of political salience.\textsuperscript{290} Moreover, the very design of corporate governance assures that states like Delaware may have influence over how capital is deployed nationwide, even though only the citizens of Delaware have any voice in the substantive content of corporate governance.\textsuperscript{291} The citizens of Delaware have incentives to generate franchise tax revenue, but little incentive to assure that corporate governance is optimized

\begin{itemize}
\item \textsuperscript{282} See supra note 24.
\item \textsuperscript{283} Id.
\item \textsuperscript{284} Ramirez, supra note 135, at 1009 (arguing that an optimized legal infrastructure surrounding the corporation could serve many broad societal goals, specifically including racial issues).
\item \textsuperscript{285} As Professor Heminway notes, Congress does have specialized committees and the ability to hold hearings, which no doubt justifies some degree of deference to its fact-finding. Heminway, supra note 273, at 271-76. Nevertheless, “highly specialized matters” such as corporate governance are outside the “actual and potential expertise” of legislatures because of the time and expertise needed to address such subjects in depth. Id.
\item \textsuperscript{286} As presently constituted it is not clear that the SEC has interdisciplinary facility with regard to corporate governance science. See supra notes 28, 36.
\item \textsuperscript{287} The SEC, as a specialized administrative agency, no doubt has substantial expertise in securities regulation. Heminway, supra note 273, at 284-91. Nevertheless, the SEC has been shown by its own senior managers to be too beholden to interest group politics, particularly the lobbying efforts of corporate managers and their minions. See supra notes 28, 51.
\item \textsuperscript{288} The Fed has, over the course of its history, come under attack for the degree of power it wields free of political accountability. WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 12 (1987) (“The Federal Reserve System was the crucial anomaly at the very core of representative democracy, an uncomfortable contradiction with the civic mythology of self-government. Yet the American system accepted the inconsistency. The community of elected politicians acquiesced to its power.”).
\item \textsuperscript{289} In fact, during the corporate corruption crisis of 2002, Congress acted quickly and in unison specifically to avoid corporate corruption from being a campaign issue. Romano, supra note 13, at 1566.
\item \textsuperscript{290} Id.
\item \textsuperscript{291} Cary, supra note 29, at 701 (arguing that Delaware, as a “pigmy” state, ought not to have such power over corporate governance).
\end{itemize}
in accordance with the best economic and financial science.\textsuperscript{292} Under these circumstances, it is hardly surprising that corporate governance standards are sub-optimal.\textsuperscript{293} The political system is custom-made for those with great stakes in corporate governance—the CEOs of America’s public corporations—to dominate the content of corporate governance.\textsuperscript{294} A depoliticized agency would operate to shift power away from such interests and in the direction of economic and financial science, which can be an excellent means of vindicating the public interest in corporate governance.\textsuperscript{295} Understanding the astounding costs of the current system and the real shift in power away from CEOs and in favor of the public interest under my proposal is the key to understanding the pro-democratic nature of the reform suggested herein.\textsuperscript{296} Indeed, Professors Butler and Ribstein identify $1.1 trillion in unjustified net compliance costs from SOX alone.\textsuperscript{297}

Other recent proposals for reform of corporate governance fail to appreciate the fundamental problems driving both excessive compliance costs and impaired investor confidence under the current regime, and the costs imposed by this pernicious reality. For example, Professors Bebchuk and Hamdani have recently proposed a standing federal commission to periodically review corporate governance and make recommendations for improvements.\textsuperscript{298} This proposal, which would address precipitous federal regulation, does nothing to address inappropriate political influence.\textsuperscript{299} So long as the standards are subject to approval through political action (either through a politicized SEC or a legislature) then history suggests that durable reform in terms of shifting power away from incumbent managers will be difficult, if not impossible.\textsuperscript{300}

Professors Butler and Ribstein advocate that federal efforts at reform be made temporary, voluntary, and subject to sunset provisions.\textsuperscript{301} This approach does not allow for federal regulation of proven efficacy, such as the federal mandatory disclosure regime.\textsuperscript{302} There is now compelling empirical evidence

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\item \textsuperscript{292} Twenty percent of Delaware’s tax revenues are attributable to corporate franchise fees, while most states garner less than 1% of their revenues from this source. \textit{Eisenberg, supra} note 39, at 202.
\item \textsuperscript{293} \textit{See supra} notes 192, 193.
\item \textsuperscript{294} \textit{See supra} Part I.
\item \textsuperscript{295} \textit{Ramirez, supra} note 22, at 504, 553.
\item \textsuperscript{296} \textit{Supra} Part II.
\item \textsuperscript{297} \textit{Butler \& Ribstein, supra} note 12, at 3.
\item \textsuperscript{299} \textit{See id.} at 1799 (leaving Congress in command of corporate governance standards).
\item \textsuperscript{300} Arthur Levitt furnishes compelling testimony regarding the frustrated reform agenda he pursued in the 1990s at the SEC and how political influence was at the crux of his failures. \textit{See supra} notes 28, 89. The PSLRA and the money contributed by those who benefited from the demise of private securities litigation demonstrates the problem of any proposal relying upon the extant political process for corporate governance reform. \textit{See supra} notes 89, 92.
\item \textsuperscript{301} \textit{Butler \& Ribstein, supra} note 12, at 102.
\item \textsuperscript{302} \textit{See supra} notes 172-177
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of the efficacy of the federal securities laws.\textsuperscript{303} Professors Butler and Ribstein also focus only on the shortcomings of federal regulation, while ignoring the flawed system that creates the financial crises that lead to federal intervention.\textsuperscript{304} As previously shown, precipitous federal regulation is an inherent element of inferior state corporate governance mechanisms.

Professor Romano continues to advocate for a market-based solution to corporate governance; indeed, she would argue for extending "competitive federalism" to securities regulation.\textsuperscript{305} While markets certainly are powerful tools for allocating resources, they do not seem to imbue corporate governance standards with any degree of precision sufficient to positively influence law and regulation.\textsuperscript{306} This is the essential lesson from the race to the bottom debate.\textsuperscript{307} Markets clearly value corporate governance, at least today.\textsuperscript{308} I posit that markets would respond to an expert agency insulated from politics to signal a superior corporate governance regime.\textsuperscript{309} Thus, my proposal would signal an option for shareholders concerned about corporate governance at their corporation.

Others seem satisfied with the status quo.\textsuperscript{310} I have posited in the past that absent compelling evidence of significant problems and effective solutions, the status quo should prevail.\textsuperscript{311} The empirical record today shows real shortcomings in the current system, ranging from excessive regulatory costs to too much concentration in the ownership of equity securities.\textsuperscript{312} The cost of equity capital is too high.\textsuperscript{313} Moreover, the Fed demonstrates the possibility of complex financial regulation being insulated by law from inappropriate political influence.\textsuperscript{314} These factors justify a departure from the status quo. Simply stated, inappropriate political influence is hurting investor confidence while at the same time imposing high regulatory costs, and this problem should be addressed.

All of this suggests that a depoliticized agency for corporate governance is both possible and likely to be effective. It is possible because there is a compelling economic case for a more rational legal structure for the
promulgation of corporate governance. Corporate governance law has yielded corruption crisis after corruption crisis. Globalization means that other nations will strive to optimize their legal infrastructure. If the United States continues to allow politics and regulatory obsolescence to dictate a fundamentally pro-CEO approach to corporate governance, then other nations are likely to discover more optimal means of articulating corporate governance standards in order to seize a competitive advantage. These would be effective because, in the end, experts protected from special interests and steeled by market tests would invariably outperform rent-seeking state lawmaking organs and federal legislatures and regulators beholden to management interests. The question is not whether corporate governance

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315 See supra Parts I, II.

316 Between the summer of 2002, with its parade of corporate scandals, and the summer of 2006, with revelations of a widening options scandal that former SEC Chair Arthur Levitt called the "ultimate in greed," was the Refco public offering fraud of the fall of 2005. See Ramirez, supra note 8, at 359. Refco was the largest independent futures broker in the United States. 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 Sarbanes-Oxley Act, but only after the company consummated its public offering. The SEC had regulatory authority over the Refco public offering and its securities brokerage units. Grant Thornton audited the firm's books in accordance with the new Sarbanes-Oxley regime governing audits of public firms. Numerous underwriters and other professionals (including the attorneys) would have been subject to the "due diligence" requirements of the 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.

317 See supra notes 225-226 (showing that nations around the globe have the incentives and opportunities to optimize corporate governance).

318 China has already demonstrated an ability to achieve remarkable growth by finding alternatives to the American system. See JOSEPH STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 126 (2002) (stating that China's economy is "directly opposite" to the market fundamentalism prescribed by the United States through the International Monetary Fund).

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

Heminway, supra note 273, at 315.

320 See id. at 319-27 (assessing influence of interest group politics on the SEC and finding that SEC is subject to the same influences as Congress, but may also be a captured agency) (citing Frank Partnoy, A Revisionist View of Enron and the Sudden Death of "May", 48 VILL. L. REV. 1245, 1280 (2003) (noting that "[p]ublic choice scholars looking for recent examples of agency capture will feast on the SEC's" rulemaking under Section 401 of SOX regarding disclosure of off-balance sheet transactions, which the SEC diluted under pressure from business executives, financial interests, corporate law firms, and the accounting industry) and Stephen Labaton, S.E.C. at Odds on Plan to Let Big Investors Pick Directors, N.Y. TIMES, July 1, 2004, at C1 ("The paralysis at the agency [regarding proxy reform] is a major victory for corporate executives who have fought to kill the rule and a setback for labor organizations and institutional investors who have pushed for years to get the commission to adopt it.").
regulatory structures will be optimized, but rather by which nation in response to what financial crisis.

IV. Conclusion

Corporate governance in the United States suffers from a flawed legal structure that yields deeply suboptimal results. The SEC is subject to the distortions implicit in a politicized regulatory agency. Legislators show little capability or desire to achieve 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 United States 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. Thus, the current regime yields unnecessarily high compliance costs and impaired investor confidence simultaneously.

There is little evidence that any market for corporate governance is operating to move standards toward optimal outcomes. Investors seem not to bring material corporate governance law into their investment decisions. Our history of corporate federalism is pocked with instances of special interests holding decisive power, 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.

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

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