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THE SEC AND THE FUTURE OF CORPORATE GOVERNANCE

Mark J. Loewenstein*

I. INTRODUCTION

As the Securities and Exchange Commission (SEC or Commission) looks to the future and contemplates the unknown, it can be comforted, or disturbed, that one of the thorniest issues of the past will remain on its agenda—corporate governance. Whether and how to influence corporate governance is something that the Commission has grappled with many times in the past and without much success. Because it lacks the authority to promulgate rules or regulations directly affecting corporate governance, the Commission has moved cautiously, requiring

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1. As this symposium focuses on the Securities and Exchange Commission, which has little concern with closely held corporations, this Article will correspondingly focus on large, publicly held corporations. In this regard, "corporate governance" refers to the mechanisms, both legal and practical, that regulate the relationship between and among the management of a corporation (its senior executive officers), the board of directors, and the shareholders. See generally MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 1 (1976) (discussing the legal role and rights of shareholders).

That corporate governance remains on the Commission's agenda was confirmed by its new chairman, Arthur Levitt, Jr., who so testified before the Senate Subcommittee shortly after his confirmation, Fed. Sec. L. Rep. (CCH) No. 1567, at 7 (Aug. 4, 1993), and by SEC Commissioner Roberts in remarks to the Association of Publicly Traded Companies, see Fed. Sec. L. Rep. (CCH) No. 1560, at 7 (July 16, 1993).

2. For example, the Commission tried to address the abuse, adopted by some companies, of disenfranchising threatening shareholders through plans that resulted in differentiated voting rights. The Commission's one-share, one-vote rule did not survive in the courts. See infra text accompanying notes 81-88.

3. See infra notes 81-88 and accompanying text.

4. See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 472-73 (1977);
enhanced disclosure that might result in substantive changes in the way corporations are governed.

The Commission's cautious approach has left it behind a growing movement of academicians, prominent lawyers, and others who are increasingly calling for change, sometimes radical change, in corporate governance. There is, of course, a question of whether this cadre of would-be reformers is correct in its assessment that change is necessary, a question that is addressed below. But, assuming that these critics are right that change is necessary, another question arises—what role, if any, should the Commission play?

It is the thesis of this Article that change is necessary in the way corporations are governed and that the Commission should be an active player in bringing about reform. More specifically, the Commission should play a role in solidifying what has come to be regarded as an essential element to effective corporate governance—an independent board of directors. I propose that the Securities Act of 1933 be amended to authorize the Commission to condition the availability of certain simplified methods of issuing securities under the Act on the existence of an independent board. The Commission should also be empowered to

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9. See infra text accompanying notes 104-14.

10. For instance, the use of Form S-3, a simplified form for the registration of securities, and rule 415, allowing for "shelf registration" of securities, are available
adopt rules and regulations defining what constitutes an independent board for these purposes.

This is both a modest and radical proposal. Few in corporate America would dispute either the efficacy or the importance of an independent board of directors to monitor senior management. Evidence of failure in corporate boardrooms is readily apparent. The going-private scandals, foreign corrupt payments, and illegal campaign contributions of the 1970s; abusive tender offer defenses and management-led leveraged buy-outs of the 1980s; and the executive pay fiasco and corporation failures of the 1990s all point to such a failure. Improving the board, making it more professional and a real source of oversight, is a goal many have espoused. But no real reformation is possible unless the board is sufficiently independent of management to adopt changes. A board would be hard-pressed to adopt any proposal that significantly altered its relationship with management unless it had a degree of independence from management. What this proposal does is simply create a climate that would permit other, possibly more meaningful, reforms. In that respect, the proposal is a modest one.

But it is also radical because even indirect Commission involvement in corporate governance is much feared in the business community, in the same way that the established medical community opposed Medicare when it was first proposed.

only to issuers who meet certain tests. The Commission could be empowered to further condition the availability of these provisions to registrants that meet certain defined corporate governance standards.

11. A report of the SEC staff so concluded in 1980: "The board of directors has come to be viewed by many as the center of efforts to enhance corporate accountability. With an increased number of truly independent directors and an effectively functioning committee system, an institutionalized process for holding management accountable will be created." STAFF OF SEC, 36TH CONG., 2D SESS., REPORT ON CORPORATE ACCOUNTABILITY, PRINTED FOR USE OF THE SENATE COMM. ON BANKING, HOUSING & URBAN AFFAIRS 579 (Sept. 4, 1980). The Business Roundtable, a natural opponent of the Commission's staff, has concurred in the value of independent directors. The Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 BUS. LAW. 2083, 2105-08 (1978) [hereinafter The Composition of Boards].

12. See, e.g., EISENBERG, supra note 1; LOWENSTEIN, supra note 5; JACOBS, supra note 7.

13. Business leaders object to SEC meddling in corporate governance because of the perceived need to separate political and economic power. See, e.g., The Composition of Boards, supra note 11, at 2105-08; Roberta S. Karmel, Is It Time for a
was not so much the underlying policy that doctors feared; rather it was a suspicion that Medicare would somehow result in socialized medicine that drove the opposition. Similarly, the business community might oppose this sort of Commission involvement, not because an independent board of directors is necessarily objectionable, but rather because Commission authority to act in this area would be viewed as impermissible governmental interference in the free market.\textsuperscript{14}

But this opposition would be misplaced. Much of the current dissatisfaction with corporate governance stems from the observation that senior management lacks accountability because the board of directors, which should monitor management, has been co-opted by it. The appearance of co-option, if not the reality, would be far less prevalent if the board were truly independent of management. And, while many corporations are moving toward more independent boards, the degree of independence varies. It is still the norm to have significant representation of senior management on the board and for the corporation’s chief executive to be the chairman of the board of directors. The chief executive also is influential in the selection of new board members, who thus are somewhat beholden for their selection to the CEO.\textsuperscript{15}

This proposal, and in particular the idea that the Commission ought to take a more direct role in corporate governance, is prompted by the observation that the accountability of corporate boards to the shareholders has declined in recent years, and the sources for reform have been stifled in their ability to make an impact. I will explore each of these phenomena in turn.

II. THE DECLINE OF CORPORATE ACCOUNTABILITY

The regulation of the internal affairs of American business corporations and, thus, corporate governance, has largely and traditionally been a function of state law.\textsuperscript{16} A widely recognized

15. See Lorsch, \textit{supra} note 5, at 184-87.
conflict-of-laws principle establishes that the law of the corporation's state of incorporation is the governing law for that corporation. As more than fifty percent of the Fortune 500 companies are incorporated in the State of Delaware, its corporate code is a prime source for what state law provides with respect to corporate governance. But even if Delaware were not such a popular domicile for American corporations, its code would be a fair proxy for the law of corporate governance, as state law does not vary significantly on questions of corporate governance. As we shall see, state law has taken a minimalist approach to corporate governance, and neither shareholders nor the federal government has filled the gap.

A. The Role of the States

Virtually all states provide that the business and affairs of corporations shall be managed by, or managed under the direction of, a board of directors, and that directors are elected to office by the shareholders at an annual meeting. Insofar as corporate governance is concerned, that is about all state corporation statutes say. State law does not, for the most part, address whether directors, or any portion of the board of directors,
must be independent of management; whether corporate boards may have advisory committees of shareholders; who can nominate directors; whether corporate boards may have access to the corporate proxy statement; what qualifications (beyond a minimum age) a nominee for the board of directors must possess; or who can serve as chair of the board of directors, to name a few of the issues that concern reformers. In short, state law is silent on the critical questions that determine the quality of the board of directors and the structural relationship between the board and the management of the corporation.

Instead of specific statutory provisions designed to assure proper monitoring of corporate management by the board of directors, state law relies, for the most part, on two principles: First, that directors are fiduciaries and, as such, they can be held accountable to the shareholders if they fail properly to discharge their fiduciary duties; and second, shareholders have the power to replace directors and enact provisions in the bylaws or the articles of incorporation that detail the sort of governance they desire. In theory, this is a legitimate approach to the

22. In theory, as shareholders have the right to elect directors, they must have the right to nominate them as well. While state corporation statutes make the former explicit, DEL. CODE ANN. tit. 8, § 211(b) (1991), the latter is left to implication. See Melvin A. Eisenberg, Access to the Corporate Proxy Machinery, 83 HARV. L. REV. 1489, 1505 (1970) ("As a corollary to their exclusive right to elect the board, the shareholders have the right to nominate candidates for directorships."). But, as a practical matter, the right to nominate directors is of little value unless the shareholders have access to the corporation's proxy statement. By contrast, no statute gives directors or the incumbent board of directors the authority to nominate directors. Yet because the board controls the corporate proxy statement, it, again as a practical matter, has the exclusive right to nominate directors.

23. See Eisenberg, supra note 22, at 1492 ("[S]tate corporate statutes do not even recognize the existence of proxy solicitation, let alone regulate it."). In publicly held companies, shareholders elect directors by proxy, figuratively and literally. Because of the large number of shareholders and the fact that they are widely dispersed, the "annual meeting" merely serves as a place where the results of the corporation's proxy solicitation are announced.

24. This laissez-faire philosophy is frequently the target of criticism. See, e.g., Lucian A. Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Toward Proxy Contests, 78 CAL. L. REV. 1071 (1990) (arguing for state law changes that would level the playing field for proxy contests between management and insurgents).

25. But if the shareholders attempt to amend the bylaws to alter the governance structure, the board may adopt an adversarial position. For instance, when the shareholders of Pennzoil Corporation sought to amend the bylaws to create a
question of corporate governance. In practice, however, this approach has proven to be less than ideal. The directors' fiduciary duties of loyalty and care have been seriously eroded by a number of recent developments at the state level. The costs to shareholders of nominating and electing directors of their own choosing (that is to say, not nominated by the board itself) are prohibitive, or nearly so. And the possibility of shareholder action on issues of corporate governance, while more likely now than at any time in the past, is still not a promising avenue for reform in corporate governance.

B. Fiduciary Duties Under Attack

1. Duty of Loyalty.—The duty of loyalty has been a casualty of the tender offer phenomenon of the 1980s. As more and more corporations became the targets of hostile tender offers during the 1980s, those on the sidelines searched for ways to avoid the same fate. Among the many tactics and solutions that emerged, three are noted here—poison pills, antitakeover legislation, and nonshareholder constituency statutes. These three are chosen because of their effectiveness as antitakeover measures, their effect on corporate governance, and their effect on the duty of loyalty.26

a. Poison Pills

Poison pills first appeared on the corporate scene in the early 1980s as a way to deter hostile takeovers. Simply put, a poison pill is a right distributed to corporate shareholders entitling them to buy the corporation's stock at a large discount to market (generally fifty percent) if a third party acquires a certain percent (generally fifteen percent to twenty percent) of the corporation's voting securities.27 This obviously creates a strong

shareholder advisory committee, the Pennzoil board, as have other boards in other such attempts, opposed the shareholders vigorously. For an account of the matter, see Charles F. Richards, Jr. & Anne C. Foster, Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee, 48 BUS. LAW. 1509 (1993).


27. The "flip-in" feature of a poison pill is described in the text. For a detailed description of poison pills, see JOY M. BRYAN, CORPORATE ANTI-TAKEOVER DEFENSES:
disincentive to acquire the stock of such a corporation without the consent of its board, which generally retains the right to redeem "the pill" from its shareholders for a nominal price (provided that the pill has not already been "triggered" by an impermissible acquisition). The poison pill has gained widespread acceptance in America's boardrooms and approval in our courts.

From a practical perspective, the presence of a poison pill in a corporation's capital structure means that someone seeking to take over that corporation must deal with the board of directors. No bidder has proceeded, or indeed can proceed, with a tender offer in the face of a poison pill, because, if the pill is triggered, the resulting dilution is too great a cost for any bidder to bear. The enhanced power of the board of directors, in turn, means that the market for corporate control is less perfect, that a poor performing board of directors faces less discipline from the market place. Although the poison pill does not preclude a

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28. According to Lipton and Steinberger, by the end of 1990, over 1500 companies had adopted poison pills, including 52% of the Business Week 1000 companies, 56% of the Fortune 500 companies, and 68% of the Fortune 200 companies. Lipton & Steinberger, supra note 27, § 6.03[a], at 6-59.


30. Fleischer et al., supra note 26, at 222-23.

31. The notion that there is a market for corporate control and that this market serves as a potential constraint on inefficient management is often traced back to Henry Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110 (1965). Proceeding from this thesis, some scholars have argued that target management should remain passive when faced with a tender offer: passivity reduces the "cost" of tender offers, increasing their likelihood and effectiveness, to the benefit of shareholders as a class. Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161 (1981). While the work of Easterbrook and Fischel has not been uniformly embraced, see, e.g., John C. Coffee, Jr., Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 COLUM. L. REV. 1145 (1984); Martin Lipton, Takeover Bids in the Target's Boardroom: A Response to Easterbrook & Fischel, 55 N.Y.U. L. REV. 1231 (1980), it is fairly well accepted that
change of control, it clearly deters hostile tender offers and has the effect of reducing the board's accountability.

b. State Antitakeover Legislation

Like poison pills, antitakeover legislation, adopted in many states, also has had the effect of insulating corporate boards from the market for corporate control. While state antitakeover legislation predated the tender offer boom of the 1980s, the legality of much of this legislation was in doubt until the United States Supreme Court upheld the constitutionality of Indiana's "control share" statute in 1987. Following the Court's decision, a number of states, including Delaware, adopted new laws to protect local businesses from unwanted takeovers.

Delaware's statute is not a particularly protective statute, but nonetheless significantly enhances the power of the board of directors in relation to the hostile bidder. Under the Delaware provision, persons who own more than fifteen percent of the outstanding stock of a Delaware corporation must wait three years after reaching the fifteen percent threshold before engaging in a "business combination" (which is broadly defined) with the corporation. While there are exceptions to the waiting period, the overall effect of the statute is similar to a poison pill: bidders are encouraged to negotiate with the target's board and
deterred from launching a bid in the first instance. And like the poison pill, state takeover statutes put a barrier between corporate boards and the market for corporate control.

c. Nonshareholder Constituency Statutes

While poison pills and antitakeover legislation have indirectly loosened the bonds between shareholders and directors, the "nonshareholder constituency" statutes have accomplished the same end directly. These statutes permit, and in some instances direct the board, when faced with a potential change of control of the corporation, to take into account the effects of its decision on the interests of the corporation's employees, suppliers, customers, and communities served.36

These statutes thus directly dilute the board's accountability to the shareholders. Decisions which cannot be justified as being in the interests of the corporation's shareholders, may be justified as being in the interests of some other constituency, say some community in which the corporation maintains a plant. When directors are accountable to constituencies with conflicting interests.

36. More than one-half of the states have adopted such statutes. For a compilation and comparison of these statutes, see Steven M.H. Wallman, The Proper Interpretation of Corporate Constituency Statutes and the Formulation of Director Duties, 21 STETSON L. REV. 163, 194-96 (1991).

By way of example, the Pennsylvania statute provides, in relevant part:

In discharging the duties of their respective positions, the board of directors . . . may, in considering the best interests of the corporation, consider to the extent they deem appropriate:

(1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.


Delaware has not enacted "other constituency" legislation, but Delaware case law gives directors some latitude to consider the effects of their decision on nonshareholder constituencies. See Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). See generally FLEISCHER ET AL., supra note 26, at 180-83 (discussing takeover defense statutes).
interests, they become accountable to no one.\textsuperscript{37}

In sum, these developments, which protect corporations from hostile tender offers, have had the effect of reducing the accountability of corporate boards to their shareholders. Moreover, these developments have seriously undercut the fiduciary duty of loyalty. Antitakeover laws and nonshareholder constituency statutes make it much harder for shareholders to prove that directors acted to protect their positions as directors or out of loyalty to management. Indeed, the whole notion that directors owe a high degree of loyalty to shareholders has been eroded by these developments.

2. Duty of Care.—The duty of care also was eroded during this period, but for an entirely different reason. In 1985, the Delaware Supreme Court decided the case of \textit{Smith v. Van Gorkom},\textsuperscript{38} and thereby focused the attention of the corporate bar on the duty of care. \textit{Van Gorkom} involved a friendly, maybe too friendly, takeover. It was so friendly, in fact, that the directors of the acquired company, Trans Union, felt they needed little time to review the $700 million offer for the company. Some Trans Union shareholders, however, had a different view of the matter, believing the company was worth more than the board had agreed to sell it for and, in any event, the board spent so little time reviewing the deal that they could not have known whether the price was fair. The shareholders found a sympathetic ear in the Supreme Court of Delaware.

In a lengthy opinion, the Delaware Court determined that the directors breached their duty of care to the corporation: they treated the deal in too cavalier a fashion.\textsuperscript{39} There were a number of things that the board could have done, but did not do.\textsuperscript{40}

\textsuperscript{37} "A manager responsible to two conflicting interests is in fact answerable to neither." Easterbrook & Fischel, supra note 31, at 1192. This proposition, sensible as it seems, is not without its critics. Morey W. McDaniel, \textit{Stockholders and Stakeholders}, 21 \textit{Stetson L. Rev.} 121, 158 (1991) ("That is a fine aphorism, but it is neither law nor fact."). For a thoughtful economic analysis of such statutes, see Jonathan R. Macey, \textit{An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties}, 21 \textit{Stetson L. Rev.} 23 (1991).

\textsuperscript{38} 488 A.2d 858 (Del. 1985).

\textsuperscript{39} \textit{Van Gorkom}, 488 A.2d at 881.

\textsuperscript{40} Among other failings, the directors did not receive or review a written summary of the terms of the merger; they did not receive or review documentation
The court reached this conclusion despite the fact that the Trans Union board was a blue ribbon panel of sorts—prominent business people, academics, public figures. And, to add insult to injury, the court held the directors would be personally liable to the shareholders for the damage caused. This holding was remarkable as the conventional wisdom had been that absent extraordinary circumstances, directors would not be personally liable for breach of the duty of care.

While the merits of the court’s legal and factual analysis has been debated, the corporate bar quickly moved beyond the case to a more friendly arena, the Delaware legislature. In 1986, Delaware passed a statute that, in effect, provided a means by which directors could avoid monetary liability for breaching their duty of care, and a number of other states quickly followed suit. The unintended consequence of *Smith v. Van Gorkom*, then, was to erode the duty of care.

Combined with the defensive maneuvers to hostile takeovers to support the adequacy of the price offered; they made no attempt “to value the entire enterprise”; they did not request the company’s chief financial officer to make a valuation study of adequacy of the price offered; they failed to ask probing questions about the deal and the manner in which the price was determined; they raised no questions as to the tax implications of a cash-out merger; etc. *Id.* at 874.

41. *Id.* at 894 (McNeilly, J., dissenting).
42. *Id.* at 864.
43. This wisdom is based on a 1968 article by Professor Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 *Yale L.J.* 1078 (1968). This Article has been frequently cited for this observation: “The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.” *Id.* at 1099.
44. Two justices dissented from the result in *Van Gorkom*. Following the decision, a number of critical articles were published. See, e.g., Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 *Bus. L. Rev.* 1 (1985).
45. Delaware law permits a corporation to include, in its certificate of incorporation,
[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of [the] fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director . . . [for breach of the duty of loyalty and certain other exceptions].
46. A listing of the statutes is collected in *Fleischer et al.*, *supra* note 26, at 122-23 nn.185-86.
approved by the courts and the legislatures, fiduciary duties of directors were different in the late 1980s than they were at the beginning of that decade. Consequently, one of the two rationales that might justify the "hands off" approach of state legislatures in the area of corporate governance was much less persuasive. The second rationale, shareholder activism, never a factor before the 1980s, has proven to hold some promise for reform, but probably not enough.

C. The Unrealizable Promise of Shareholder Activism

Under typical state corporation statutes, shareholders have the right to amend the bylaws of the corporation, and the bylaws can say a great deal about the way in which the corporation is governed. This state law right fits nicely with rule 14a-8 of the Securities Exchange Act of 1934, which assures shareholders some access to the corporate proxy statement. Thus, a shareholder could propose, for instance, that the bylaws be amended to provide that only persons who are independent of management of the corporation are eligible to serve as directors of the corporation. But the likelihood is remote that such a bylaw amendment, or any shareholder-proposed bylaw amendment for that matter, would be adopted because of the obstacles that shareholders face in a rule 14a-8 proposal.

As a preliminary matter, the corporation's board of directors is unlikely to look kindly on any proposal that affects its own composition, particularly if one or more of the current board would be rendered ineligible to serve if the proposal were adopted. This potential hostility can manifest itself initially in a re-

47. The 1984 Revised Model Business Corporation Act, in contrast to earlier versions of the Model Business Corporation Act, also has diluted traditional notions of fiduciary duty. See Branson, supra note 21, at 270-72; Marc I. Steinberg, The Evisceration of the Duty of Care, 42 SW. L.J. 919 (1988) (commenting on the state statutory law developments that have reduced the duty of care).

48. Delaware Corporation Code § 109(a) provides that stockholders have the right to amend the bylaws to the exclusion of the board of directors, unless the certificate of incorporation confers that power on the directors as well. DEL. CODE ANN. tit. 8, § 109(a) (1991). Section 10.20 of the RMBCA empowers both the board and the shareholders to amend the bylaws, unless the articles reserve that power exclusively to the shareholders.

quest to the Commission for permission to exclude the propos-
al.\(^5\) The possibility that the board will find a basis to exclude
the proposal is real: rule 14a-8 includes thirteen categories of
proposals that may be excluded from a proxy statement.\(^6\)

One of these categories, that the corporation may omit a
proposal if it relates to "an election to office,"\(^5\) has proven to be
an obstacle to corporate governance reform. Mobil Oil cited this
provision as the basis for excluding a shareholder proposal that
would have disqualified citizens of countries belonging to OPEC
from serving on Mobil's board of directors.\(^5\) Mobil persuaded
the staff of the Commission and the federal courts that this
proposal, if adopted, would have precluded the reelection of
Suliman S. Olayan, a member of its board and a citizen of Saudi
Arabia. Therefore, the proposal was one related to an election
and thus excludable from the proxy statement.\(^4\) Under similar
reasoning, a corporation could exclude shareholder proposals
that would adversely affect sitting members of its board.\(^5\)

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50. The practice of the SEC is to permit a registrant that desires to exclude a
shareholder proposal to request the staff of the Commission to issue a no-action
letter—that is, a letter assuring the registrant that if the proposal is omitted the
staff will not recommend to the Commission that action be taken against the regis-
trant as a result of the omission. If the letter is refused, the registrant might still
omit the proposal, risking enforcement action by the Commission, or private action
by the disappointed shareholder. The courts have recognized a private right of action
on the part of shareholders to enforce rule 14a-8. See Rauchman v. Mobil Corp., 739
F.2d 205, 207-08 (8th Cir. 1984).

The Board's resistance to shareholder proposals can result in lengthy and
costly battles for inclusion in the proxy statement. See, e.g., Richards & Foster,
supra note 25 (detailing the efforts of some Pennzoil shareholders who sought to
create a shareholder advisory committee).

51. Among the exclusions that have often tripped up shareholder proposals are:

- the proposal is not a proper subject of action by security holders
  under the laws of the registrant's domicile;
- the proposal would violate applicable law or a Commission proxy rule
  or regulation;
- the proposal relates to the conduct of the ordinary business operations
  of the registrant; and
- the proposal relates to an election to office.


54. Rauchman, 739 F.2d at 206.

5, 1983) (proposal calling for the election of a salaried, nonmanagement employee
excludable under rule 14a-8(c)(8)).
Even if a proposal is not caught by one of the thirteen exclusions, significant obstacles lie in its path. While making a proposal is relatively inexpensive, a vigorous and expensive campaign for its adoption seems to be indispensable. As a result of the free-rider problem, a proposing shareholder has little incentive to campaign for the proposal's adoption. Further, as in any proxy contest, whether over the election of directors or the adoption of a shareholder proposal, incumbent management has a distinct advantage over outsiders. Many shareholders routinely give proxies to the corporation's designated proxy voters. Of those aware of shareholder proposals, a certain number will support management's position because of some preexisting relationship with management. Finally, and most importantly, management has access to the corporate treasury to fund its opposition to such a proposal; it can solicit, on a basis that is essentially cost-free to itself, votes against the proposal, while the proposing shareholders must fund, at their own expense, the uphill battle it will take to achieve its adoption. It is no wonder, then, that shareholder proposals lacking the support of the corporation's board of directors are rarely adopted pursuant to rule 14a-8.

Nevertheless, recent amendments to the Commission's proxy rules, and increased activism by some of the nation's largest

56. To make a proposal, a shareholder need only (a) be a record or beneficial holder of at least one percent or $1000 in market value of the registrant's securities, and (b) submit the proposal and a supporting statement of no more than 500 words to the registrant in a timely manner. 17 C.F.R. § 240.14a-8 (1988).

57. There is empirical evidence that the relationship of some institutional investors with management causes those investors to side with management. See James A. Brickley et al., Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267, 276-83 (1988). This would be reduced or eliminated if firms had confidential voting.

58. Part of the expense the proponents of a rule 14a-8 shareholder proposal must bear is the cost of compliance with the Commission proxy rules on filing and delivery of proxy solicitations if the shareholder is seeking proxies. See JAMES D. COX ET AL., SECURITIES REG. 890 (1991).

59. See Patrick Ryan, Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy, 23 GA. L. REV. 97, 120 (1988). By contrast, corporate management rarely loses when it makes a proposal to the shareholders. For instance, data collected by the Investor Responsibility Research Center showed that for the period September 1, 1985 to August 31, 1986, 390 companies submitted 578 different antitakeover proposals to their shareholders, of which only 13 were defeated.

60. Regulation of Communication Among Shareholders, Securities Exchange Act
institutional shareholders, might be a cause for mild optimism. However, this optimism ought to be tempered by the evidence. At the end of the 1980s, for instance, institutional shareholders became disenchanted with poison pills and other corporate antitakeover devices. These shareholders sponsored resolutions at a number of companies to overturn these protections and, for the most part, were unsuccessful. For instance, the most recent comprehensive study available, compiled by the Investor Responsibility Research Center, Inc. (IRRC), discloses that in 1990, shareholders voted on an aggregate of 294 shareholder proposals, sixteen of which passed. Of these sixteen, nine were proposed in connection with proxy contests. By contrast, management submitted 1047 proposals to shareholders, and all but twenty-two passed. 61

The lack of success of shareholder-initiated proposals is even more striking when the nature of the proposals is considered. In 1990, of forty-seven shareholder proposals to repeal classified boards, none passed; of fifty shareholder proposals to adopt cumulative voting, none passed; and of fifty-one proposals to adopt confidential voting, only four passed. All but one of those four proposals were submitted in connection with an organized proxy contest over the election of directors. 62 The only sorts of shareholder proposals that met with any degree of success were proposals to redeem poison pills, where nine of forty-one proposals passed. Of those nine, however, three were related to proxy contests. 63 Shareholder proposals in prior years fared even worse.

Data from 1992 meetings, and preliminary data from 1993 annual meetings, both compiled by the IRRC, do not suggest that the new proxy rules are resulting in dramatic changes. In 1992, only seven of 187 shareholder proposals received a majority of the votes cast, and only two passed. In 1993, preliminary

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61. WILLIAM F. SANDER, SHAREHOLDER VOTING ALMANAC 3-5 (1991) (a publication of the Investor Responsibility Research Center, Inc. (IRRC)).
62. Id. at 77-87.
63. Id.
results indicate that eleven of 163 shareholder-initiated corporate governance proposals received a majority of the votes cast, and six passed.64

It may be the case that shareholder activism is at its very beginnings, and that we can expect great reforms in the future. But there are strong reasons to doubt this. First, shareholder proposals to undo antitakeover provisions largely failed despite the fact they were backed by the large, institutional shareholders and were clearly in the interest of shareholders as a class. That does not bode well for corporate governance reforms that are more abstract and less clearly linked to potential monetary returns to shareholders.

Second, the structural advantages that management has to defeat a shareholder proposal are still a factor that cannot be overlooked. So long as management has the corporate treasury at its disposal, shareholders will always face an uphill battle. Under Delaware law, moreover, if the certificate of incorporation so provides, shareholder proposals must garner a majority of the outstanding shares to gain adoption, not just a plurality of the shares voting in the election.65

Finally, the 1992 amendments to the proxy rules, which are intended to facilitate shareholder action, are limited in scope. Basically, these rules simply permit shareholders to communicate among themselves without having to file a proxy statement with the SEC. But such communication was taking place routinely even before the adoption of the new rules.66 More radical reform, such as allowing unregulated solicitation of proxies by shareholders, subject only to the antifraud rules, was not se-

64. INVESTOR RESPONSIBILITY RESEARCH CENTER, INC., CORPORATE GOVERNANCE BULL. 7-8 (May/June, 1993).
65. DEL. CODE ANN. tit. 8, § 216 provides:
In the absence of [a specification in the certificate of incorporation or bylaws on the number of votes that shall be necessary for the transaction of business] . . . : 

.......

(2) In all matters other than the election of directors, the affirmative vote of the majority of the shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders.

riously considered. Furthermore, other statutory provisions and SEC rules—such as provisions and rules that discourage the accumulation of blocks of stock in excess of ten percent, rules that limit joint action outside of the proxy rules, and rules that limit shareholder access to proxy statements for the purpose of nominating directors—have the cumulative effect of discouraging reform initiated by shareholders.67

C. The Lost Promise of the ALI

Responding to a growing concern in the law of corporate governance,68 the American Law Institute authorized a thorough reexamination of the subject in 1978. This massive undertaking, which concluded at the Institute's 1992 annual meeting, resulted in a large and impressive document entitled Principles of Corporate Governance: Analysis and Recommendations (ALI Principles). But this project neither satisfied the aspirations of those seeking reform of corporate governance,69 nor realized the fears of those dreading it.70


68. See Donald E. Schwartz, Federalism and Corporate Governance, 45 Ohio St. L.J. 545 (1984) (history of the corporate governance movement and the factors that prompted the ALI project).

69. The late Professor Donald E. Schwartz, a leading corporate law scholar of the 1970s and 1980s and a proponent of federal intervention in corporate governance, see, e.g., Donald E. Schwartz, A Case for Federal Chartering of Corporations, 31 Bus. Law. 1125 (1976), was typical of those who regarded the ALI project with optimism: "Although it is far from complete, I believe that the American Law Institute's [corporate governance] project affords the best prospect for achievable reform." Schwartz, supra note 68, at 587.

70. The Business Roundtable, which consists of approximately 200 chief executives of large U.S. corporations, was highly critical of the early efforts of the project:

Fundamentally, the proposed Restatement represents an attempt to impose an additional and unnecessary layer of regulation on United States corporations. Ignoring the realities of competition and the marketplace, the Reporters appear intent on setting forth rules on exactly how corporate boards should be structured . . . and what functions corporate boards should perform. See Joel Seligman, A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project, 55 Geo. Wash. L. Rev. 325, 325-27 (1987) (quoting Statement of The Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Rec-
To quote one prominent scholar, the ALI Principles "largely restate[] and clarify[] existing cases and statutes, making only occasional, incremental proposals to change the law." This observation was published in 1987 and was based on earlier drafts of the ALI Principles. But subsequent drafts, if anything, have tended to be even less ambitious. As the project reached its conclusion, for instance, the derivative litigation section underwent an important amendment, the effect of which was to make it more difficult for plaintiffs to maintain such actions. The most significant achievement of the ALI Principles, in the end, may be its scholarship—a comprehensive source of fiduciary duties that can be consulted by courts and practitioners.

**D. Federal Involvement**

The near void in corporate governance standards that state law has created has not been filled by the federal government. Although Congress surely has the power to implement corporate

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73. *See* Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1370-84 (1993). The last-minute amendment to § 7.04(a) of the final draft, which was dubbed the "Smith Amendment" at the 1992 annual meeting, was a compromise proposed by the corporate defense bar and accepted by the Reporters to avoid defeat of the section and, possibly, the whole project. To those present at the meeting, the Reporters obviously acquiesced with some misgivings. *See* Richard B. Smith, *An Underview of the Principles of Corporate Governance*, 48 BUS. LAW. 1297, 1308-11 (1993) (describing the compromise).
74. At least this is how Professor John C. Coffee, Jr., one of the Reporters on the project, modestly characterized the results. John C. Coffee, Jr., *The ALI Corporate Governance Project*, N.Y.L.J., June 9, 1992, at 1.
governance reforms for business corporations engaged in inter-state commerce,⁷⁵ and it has often been urged to do so,⁷⁶ it has thus far resisted the temptation. For the most part, Congress has restricted its involvement in corporate governance to a few governance issues in regulated industries.⁷⁷ For instance, under the Investment Company Act of 1940, no more than sixty percent of the directors of an investment company can be “interested persons,” as defined in the Act, subject to certain exceptions.⁷⁸ Similarly, under the National Bank Act, individuals who are affiliated with securities firms are prohibited from being directors of member banks, subject to the authority of the Board of Governors of the Federal Reserve System to provide limited exceptions.⁷⁹ In each of these instances, and a few others,⁸⁰ Congress reacted to identified problems in particularly sensitive industries.

Outside of the instances noted above, congressional involvement in corporate governance has been limited. Indeed, even the federal legislation most likely to reach governance issues of publicly held corporations, the Securities Exchange Act of 1934 (the Exchange Act), has no such purpose.⁸¹ Any doubt on this

⁷⁵. See Schwartz, supra note 68, at 571.
⁷⁷. See Schwartz, supra note 68, at 558-71.
⁸⁰. In response to disclosures that many publicly held corporations had made illegal corporate campaign contributions and improper payments to foreign governments to obtain business, Congress enacted the Foreign Corrupt Practices Act in 1977. 15 U.S.C. §§ 78m(b)(2)-(3), 78dd-1, 78dd-2, 78ff (1982). This law, like others that might be noted, indirectly affected corporate governance. Among other things, the Act required covered corporations to maintain accurate accounting records and implement internal financial controls. The latter requirement helped encourage corporations to create independent audit committees on their boards of directors. The Commission played an instrumental role in bringing to light the abuses that led to the legislation. SECURITIES AND EXCHANGE COMMISSION, REPORT ON QUESTIONABLE ILLEGAL PAYMENTS AND PRACTICES, SUBMITTED TO THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMM., 94th Cong., 2d Sess. (May 12, 1976).
⁸¹. The CONFERENCE REPORT TO THE SECURITIES EXCHANGE ACT OF 1934, H.R.
was settled in the D.C. Circuit Court's 1990 decision in *Business Roundtable v. Securities Exchange Commission*, which involved the SEC's controversial attempt to legislate a one-share, one-vote rule.

The Commission action that gave rise to the litigation was the adoption in 1988 of rule 19(c)-4, barring self-regulatory organizations (national securities exchanges and national securities associations) from listing stock of a corporation that takes any corporate action "with the effect of nullifying, restricting or disparately reducing the per share voting rights of [existing common stockholders]." The Business Roundtable challenged the rule on the theory that the Commission acted beyond its authority, and the circuit court agreed. In its well-reasoned opinion, the court made clear that the Commission had no free-wheeling power under the Exchange Act to implement its notions of corporate governance. The Commission's argument that it had such authority under section 14, which allows it to adopt rules regulating the solicitation of proxies, was flatly rejected by the court: "[I]t is not seriously disputed that Congress's central concern [in enacting section 14] was with disclosure."

What is particularly significant about the Business Roundtable decision is that section 14 was the Commission's

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See also S. Rep. No. 792, 73d Cong., 2d Sess. 10 (1934) (denying that the Exchange Act contained any intention to interfere with the management of corporations).

82. 905 F.2d 406 (D.C. Cir. 1990).

83. In an attempt to discourage a hostile takeover, some companies adopted differential voting plans that, in effect, reduced the voting power of shares acquired by corporate raiders. See Cox et al., supra note 58, at 918-19.


85. The Business Roundtable is an organization consisting of the CEOs of the nation's 200 largest corporations.

86. *Business Roundtable*, 905 F.2d at 410 (citing J.I. Case Co. v. Borak, 377 U.S. 425, 441 (1964)) ("The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation.").
best hope for the authority to effect corporate governance. Indeed, in its opinion, the court questioned one of the SEC's section 14 rules (rule 14a-4(b)(2)) that arguably crosses the line from regulation of the process of proxy solicitation, which is within its section 14 authority, to the substance of corporate governance.\(^87\) Rule 14a-4(b)(2) itself is quite innocent; it simply requires that the form of proxy provide a means for the person whose proxy is solicited to withhold the authority to vote for any nominee.\(^88\)

In light of its limited authority under the Exchange Act, the Commission has sought to influence corporate governance indirectly, through disclosure and accounting rules. For instance, it has adopted rule 13e-3, requiring increased disclosure in going private transactions, and recently amended its proxy disclosure rules on executive compensation.

To the extent that the Commission sought to influence the substantive problems that gave rise to these rules, e.g., abusive going private transactions or excessive executive compensation, the rules have not been effective. To the extent the Commission sought to increase disclosure in each of these areas, it probably has succeeded, but lack of disclosure was not the problem that prompted the rule in the first instance.

1. Rule 13e-3.—The Commission adopted rule 13e-3 in 1979 in response to widespread publicity concerning “round-trip” financings: several of the companies that went public during the “go-go” years of the late-1960s\(^90\) were reacquiring their outstanding common stock at a fraction of the initial public offering price in “going private” transactions.\(^90\) When this matter came

\(^87\) Id. at 411 (“Rule 14a-4(b)(2) may lie in a murky area between substance and procedure.”).

\(^88\) 17 C.F.R. § 240.14a-4(b)(2) (1993). The court noted the implicit substantive effect of the rule: “It thus bars a kind of electoral tying arrangement, and may be supportable as a control over management's power to set the voting agenda, or, slightly more broadly, voting procedures.” Business Roundtable, 905 F.2d at 411 (citing DENNIS C. MUELLER, PUBLIC CHOICE 38-58 (1979)).

\(^90\) For an interesting and informative account of this period, see J. BROOKS, THE GO-GO YEARS (1973).

\(^90\) A “going private” transaction can take many forms. The simplest technique is an issuer tender offer that succeeds in acquiring enough shares from enough shareholders to cause the issuer to be delisted from a national securities exchange and, under SEC rules, to cease to be subject to SEC reporting requirements. Following this issuer tender offer, or independent of it, management of the issuer going
before the Commission, one option under consideration was to require that the price paid to the shareholders be "fair." This option met with considerable opposition, and ultimately the Commission opted for a rule that simply required issuers engaging in going private transactions to disclose whether the transaction was "fair" to the shareholders.

If the rule was intended to restrain these transactions (and the genesis of the rule was a dissatisfaction with the occurrence of these transactions, not the lack of disclosure about them), it was not a success. In the decade that followed the adoption of the rule, these transactions continued, increasing in number and size. However, "round-trips" were not so much the problem; management-led leveraged buyouts (LBOs) were. The prototypical going private transaction of the 1980s involved companies that, in some instances, had been public for decades. And fueled by the availability of "junk bonds," the LBOs of the 1980s were larger and more numerous than the round-trippers of the

private might engineer a "squeeze-out" merger, in which the shares of the public shareholders are converted to cash, debt instruments, or other nonequity securities in connection with a statutory merger with a corporation controlled by management. For a fuller description of these techniques, see Gregory L. Schwartz, Comment, Regulation of Leveraged Buyouts to Protect the Public Shareholders and Enhance the Corporate Image, 35 CATH. U. L. REV. 489 (1986) and authorities cited therein.


92. Schedule 13E-3, item 8(a) requires the following disclosure: "State whether the issuer or affiliate filing this schedule reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders." 17 C.F.R. § 240.13e-100 (1993). This rule, perhaps predictably, has given rise to a new line of business for investment bankers—"made to order fairness opinions"—that serve the interest of managers purchasing the company and not public shareholders. Dale A. Oesterle & Jon R. Norberg, Management Buyouts: Creating or Appropriating Shareholder Wealth?, 41 VAND. L. REV. 207, 214 (1988).


94. The profits to management in some of these transactions (and the corresponding loss to shareholders) are breathtaking. For example, one of the most notorious deals involved Metromedia. In mid-1984, it was taken private by its chairman and controlling stockholder for $1.1 billion and within two years assets of Metromedia fetched $5.5 billion in a series of separate transactions. For a brief review of such deals, see James R. Repetti, Management Buyouts, Efficient Markets, Fair Value, and Soft Information, 67 N.C. L. REV. 121, 121-22 (1988).
The reason that going private transactions came under the scrutiny of the Commission was the perceived unfairness to shareholders. The transactions were structured in such a way that shareholders had little choice in the matter; they could either accept the price offered to them or seek a state appraisal remedy. They could not choose to remain shareholders in a publicly held corporation. That choice had been made for them by the board of directors, who seemed to have elevated the interests of incumbent management over the interests of the public shareholders.

To the surprise of many, the Delaware Supreme Court reacted to this perceived unfairness. In its 1977 decision of Singer v. Magnovox, the court held that a corporation engaging in a going private transaction had to establish some independent business purpose for the transaction. Otherwise, the transaction could be enjoined. Since most of the going private transactions lacked any such purpose, the Delaware decision foreshadowed what could have been the end of the phenomenon. The Commission’s action, two years later, increased, if only marginally, the disincentives for undertaking these deals. But only four years after the adoption of rule 13e-3, the Delaware court reversed itself, abandoning the business purpose test in Weinberger v. UOP, Inc. The Delaware court did not indicate that federal involvement in this area, in the form of an SEC rule, mooted the necessity of its recently adopted business purpose test. But surely the intervening rule made it easier for the court to abandon the test.

95. The number of public firm buyouts increased fairly consistently throughout the 1980s, from 13 in 1980 to 125 in 1988. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporation Law 113 (1991). Concern over this new round of going private transactions was as great as the concern in the 1970s, and again SEC commissioners were among the critics. See Bevis Longstreth, Management Buyouts: Are Public Shareholders Getting a Fair Deal? 17 (Oct. 6, 1983) (remarks to the International Bar Association published by the SEC) (“We see with increasing frequency the spectacle of a conflicted management surrounding itself with procedural shields to defend a deal widely believed to be substantively unfair to shareholders. Such behavior is threatening to tarnish the image of our corporate community—to give corporate fiduciaries a bad name.”) (quoted in Schwartz, supra note 90, at 490 n.3).

96. 380 A.2d 969 (Del. 1977).

97. 457 A.2d 701 (Del. 1983).
And the result was that a state-adopted substantive test was replaced by a federally promulgated disclosure rule. Shareholders were the losers. More importantly, many looked with skepticism on the way that corporate directors were discharging their fiduciary duties. In some instances, the board was favoring management offers to take the company private over the higher offers of third parties.98

2. Executive Compensation.—The Commission’s involvement in executive compensation is similar to its involvement in going private transactions. Throughout the 1980s, executive compensation (particularly CEO compensation) increased at an alarming rate.99 This increase could not be explained by the usual factors: increased demand or decreased supply of qualified executives; inflation; improved corporate performance; or competition from abroad for U.S. executives. Indeed, studies seemed to indicate that there is no relationship between CEO compensation and corporate performance.100 United States CEOs were outearning, although not out-performing, their Japanese and German counterparts by a large margin.101 The explanation, like the explanation for the presence of going private transactions, seemed to rest with the board of directors. Something was amiss; directors seemed to be favoring management at the expense of shareholders.

Following a public outcry over the size of executive compensation, the Commission reacted in 1992 by adopting a rule that


99. Average CEO compensation increased by more than 200% during the 1980s, while the pay of the average worker increased only about 50%. James E. Heard, Shareholders Focus Concerns on Executive Compensation at 1992 Annual Meetings, P.H. L. & BUS. 1 (June 1992).


required increased disclosure of executive compensation in the annual proxy statement. It seemed that following the adoption of the rule, executive compensation actually (though surely coincidentally) increased. And one can only wonder whether Commission involvement in this area, or whether Commission involvement in the going private area, actually stifled or deterred further state action. In any event, both of these examples, like the abuses that encouraged the Commission to adopt rule 19(c)-4, stem from a shortcoming on the board of directors, a shortcoming the Commission has been able to address only indirectly, and only ineffectively.

E. A Response to the Skeptics

While criticism of corporate governance is by no means a recent phenomenon, it took on new urgency in the 1970s with the disclosures of illegal corporate campaign contributions and improper foreign payments. These disclosures, in turn, came on the heels of an influential study by Harvard Business School Professor Myles Mace, who suspected it was a myth that corporate boards manage the business and affairs of their corporations. Mace's anthropological-type work concluded that the board was not a meaningful check on the corporate CEO; that boards were passive, rather than active, overseers of the corporation; and that, except in crisis situations, boards did not even select the CEO.

These and other developments resulted in calls for re-

102. Securities Act Release No. 33-6962, 17 C.F.R. § 228 (1992). The new rules amend the disclosure requirements set forth in Regulation S-K. E.g., regulation S-K, item 402(a)(2). Corrections to these rules were announced in Securities Act Release No. 33-6966, 17 C.F.R. § 228 (1992). Congress also passed, as part of the 1993 Deficit Reduction Bill, a severe limit on the deducibility of executive compensation in excess of $1 million annually, unless such compensation is tied to corporate performance goals established by an independent compensation committee and approved by the shareholders.


104. Some of the history is recounted in Schwartz, supra note 68, at 547-51.


106. Professor Mace's work was confirmed in a recent study. See LOBSCH, supra note 5.

107. The Penn Central bankruptcy in 1970 and later disclosures of the ineptitude
form from influential circles. But these calls were ignored as public attention shifted from shortcomings within the boardroom to attacks from outside. The takeover phenomenon gained steam throughout the 1970s and 1980s, reaching its peak in 1988. In that year there were 198 tender offers in excess of $1 million each, with a total value of almost $154 billion. Of these, fifty-nine, or thirty percent were contested. As takeovers increased, it became popular to believe that "the market"—that is, the market for corporate control—had solved the problem of inefficiency in corporate management. If a corporation were poorly managed, surely someone would come along and exploit the bargain. By the end of the 1980s, a number of factors converged to strangle this newly developed market. Credit was more difficult to obtain as the "junk bond" market contracted, and state antitakeover laws, together with poison pills and other defensive maneuvers, made hostile takeovers less attractive and more expensive. By 1991, the number of tender offers with a value in excess of $1 million had declined to twenty-three, with a combined value of $14.2 billion. Of these, only four were contested and of those four only one was completed. In the aftermath, as noted above, corporate boards were more insulated than before.

Against this backdrop, some academics would still urge a hands-off approach. The leading proponents of this position, Judge Frank Easterbrook and Professor Daniel Fischel, in their recent book, *The Economic Structure of Corporate Law,* argue that regulators should not interfere with the terms of corporate governance. In their view, entrepreneurs have the right incentives to choose those terms of corporate governance that will help the firm maximize its ability to raise capital because "better terms" of corporate governance will help attract capital. "[T]he firms that pick the wrong terms will fail in competition with other firms competing for capital." A bit later, the authors lay down this challenge: "Unless the person challenging

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109. See supra note 76.
111. Id. at 17.
the portion of the corporate contract can make a convincing argument that the consequences of the term could not have been appreciated by investors and priced efficiently, there is no reason for intervening to correct a mistake.\textsuperscript{111} This theory and this challenge deserve some response. If Messrs. Easterbrook and Fischel are right, then, indeed, the SEC and the states should refrain from any regulation in this area.

But there is reason to doubt the wisdom of their theory and the relevance of their challenge. The people who fix the terms of corporate governance, at least in the large, mature corporations that are the concern of this Article, have other incentives than to maximize the firm's ability to raise capital—namely, to retain and enhance their positions within the firm, even if the policies they choose adversely affect the firm's ability to raise capital. If Easterbrook and Fischel are correct, one would not expect to see a board of directors implement a poison pill that it knows, \textit{ex ante}, is disfavored by investors and adversely affects its stock price.\textsuperscript{112} On the other hand, one would expect to see a board of directors propose capital enhancing devices, such as some limitations on management-initiated leveraged buyouts. Such limitations could be structured in such a way that would make an

\textsuperscript{111} Id. at 31. One may challenge the legitimacy of the question. In proposing a different way to conceptualize the private corporation, not as the nexus of contracts as Easterbrook and Fischel (and many others) suggest, but as an "organic institution" that is more political in nature, Professor Lynne Dallas would reject the appropriateness of the challenge quoted in the text:

Because the power model [Dallas's conceptualization of the firm] rejects the efficiency model's presumption that existing control arrangements are efficient, the important questions to ask in connection with any corporate or market phenomena become who benefits and who loses or, in terms of efficiency, "efficient for whom?" and "at what costs to others?" Governments are justified in asking these questions and reaching conclusions. The burden is not on governments to justify their conclusions, as the efficiency theorists argue, but on those opposing them, because what exists in the private sector is not necessarily more efficient from a societal perspective.


\textsuperscript{112} The authors summarize the data:

Firms that adopt antitakeover devices (more neutrally, devices that give incumbent managers the authority to accept or reject bids) experience immediate reductions in the price of their stock . . . .

Poison pill securities, the principal device that may be used without investors' assent, produce a loss averaging 0.34 percent.

EASTERBROOK \& FISCHEL, \textit{supra} note 109, at 196.
equity investment in the company more attractive by giving public investors the assurance that they will not be cashed out (and chased out) if there is a general stock market decline. But just the opposite is taking place. Poison pills are routinely adopted without shareholder approval and limitations on management-led leveraged buyouts are rare, if they exist at all. In short, there is not active competition in the terms of corporate governance because the suppliers have more to lose from that competition than they have to gain.

Consider Corporation A, a large New York Stock Exchange corporation which has been losing its market share in widgets to foreign and domestic competition. Analysts believe the firm has been too slow to adapt to changes in consumer taste and to modern manufacturing methods. This, in turn, may be attributable to a disengaged board of directors that has relied too heavily on senior management to direct the company. Indeed, like the boards of many companies, the board of Corporation A is complacent and deferential.

Solutions might be found to remedy this familiar scenario. In the 1970s and 1980s, the market for corporate control was thought to provide a solution, as hostile tender offers at times displaced inefficient management. But, as we have seen, this market is now radically different and does not provide the discipline that it was hoped it would provide.¹¹³ In recent years, we have seen two other purported solutions emerge. One has been that boards of directors have done what they were supposed to do: replace inefficient management.¹¹⁴ The other has been that the large, institutional managers have become activated, pressing for changes in management or policy when that seemed to be in the best interest of the long-term growth of the corporation. But both of these solutions suffer from being crisis responses. Before the board has acted, or the institutional man-


¹¹⁴. This has been the case in a few high-profile, low achieving corporations, including IBM, General Motors, American Express, and Westinghouse Electric in late 1992 and early 1993. Unfortunately for the shareholders of these and other underperforming companies, a replacement of the CEO may be too little too late.
agers have become involved, a great deal of damage has already taken place. The well-documented declines of General Motors and IBM, just to name a pair of prominent examples, demonstrate both how a failure of corporate governance can persist for a long time and how a solution can emerge only after the damage has taken place.

Against this background, it seems that tinkering with corporate governance cannot be harmful and holds the potential of improvement. Moreover, the recommendation of this Article, explored more fully in the next section, is both limited and non-compulsory.

III. THE CARROT APPROACH: USING RULEMAKING AUTHORITY UNDER THE 1933 ACT

Seasoned issuers seeking to raise capital in public offerings have had the advantages, as a result of Commission action, of using a simplified form of registration and more flexibility than first-time issuers in issuing securities after registration. The information required by registration Form S-3, which is available only to publicly held companies meeting certain tests,\textsuperscript{115} is easier to gather and less expensive to present than that necessary for Form S-1. Similarly, Commission rule 415 allows large, publicly held companies to file a registration statement (on Form S-3) and then, in lieu of immediately offering those securities for sale in accordance with normal procedures, these companies are permitted to place the registered securities "on the shelf" to be issued when conditions seem most favorable.\textsuperscript{116}

The use of Form S-3 and rule 415 have greatly assisted public companies in raising new equity and debt.\textsuperscript{117} Rule 415

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115. Among other things, the registrant must have a class of securities registered under the Securities Exchange Act of 1934 and cannot have defaulted since the end of the last fiscal year on (a) any dividend or sinking fund installment on preferred stock, or (b) on any installment on indebtedness for borrowed money, or (c) on any rental on any material long term leases.


117. In adopting rule 415 following a trial period, the Commission concluded that the temporary rule "has operated efficiently and has provided registrants with important benefits in their financings, most notably cost savings." Id. See also Barbara A. Banoff, Regulatory Subsidies, Efficient Markets and Shelf Registration: An Analysis of Rule 415, 70 VA. L. REV. 135, 149-55 (1984) (citing studies that demon-
has enabled issuers to avoid having to prepare new registration statements each time they wish to access the public markets, with the result that issuers can move quickly to take advantage of, say, a decline in interest rates by issuing debt securities. The Commission has not sought to limit the availability of rule 415 to issuers with independent boards. But it is the thesis of this Article that the Commission should be given clear rulemaking authority, that, among other things, would allow it to limit the use of forms and rules, like Form S-3 and rule 415, to issuers with independent boards of directors.

Simplified access to the securities markets is based on the premise that less regulation is needed to protect investors. Yet when a corporation maintains a board of directors that is independent of management and thus better able, for instance, to monitor management and determine executive compensation, then arguably the securities laws should recognize this form of self-regulation. Everything else being equal, the securities of such issuers pose less of a risk to investors than securities of issuers without an independent board. Indeed, in reaction to a lack of investor confidence, and in an apparent attempt to enhance its image in the financial markets, the board of IBM recently announced that it was creating a new committee of outside directors to focus on corporate governance. The committee will nominate new directors, handle shareholder proposals, and oversee the board's power structure. The direction being taken by the IBM board is remarkable because it is unique; few other boards focus on issues of corporate governance. Thus, what may be needed here is a carrot to encourage other corporations to take the step taken by the IBM board.

The risks of this proposal are small. Conceivably, independent boards would be less effective than boards that lack independence. But if that is true as a general proposition, then one might question our whole structure of corporate governance; maybe boards should be done away with entirely, leaving to management the task of overseeing itself. To state the propo-

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119. *Id.*
tion is to demonstrate its obvious weakness, for without a board of directors, shareholders would have to appoint corporate officers, monitor their performance, and fix their compensation, tasks that shareholders are ill-equipped to perform. In short, the realistic alternatives to an institution to oversee management of a publicly held corporation are nonexistent. Further, the benefits of such oversight can only be enhanced if the overseers are independent of the overseen.

The question of what constitutes an independent board of directors could be determined in appropriate rulemaking proceedings. I recommend that such a rule focus, at a minimum, on the permissible relationships, both financial and social, between the directors and management; whether a board can be independent of management if the chair of the board of directors is an officer of the corporation; the extent to which officers and employees of the corporation can serve at all on the board; the access to information and the staff support that nonemployee directors ought to receive; and the composition of the nominating committee.

The ALI, in its Principles of Corporate Governance, has dealt with these questions, but its conclusions might be questioned. For instance, the ALI concluded that the board of directors of a large publicly held corporation should consist of a majority of directors who are free of any significant relationship with the corporation’s senior executives. One might wonder how independent this board can be if its chair and several of its members speak with one voice. In their comments, the reporters rationalize including senior executives on the board because the presence of senior executives “ensures knowledgeable and detailed board discussion about the business, and encourages management to take important issues to the board.” But board membership is not necessary to achieve either of these goals. Certainly management can (and, indeed, should) be encouraged to bring issues of importance to the board, and invited to attend board meetings and participate in the discussions. But member-

120. The Principles of Corporate Governance define the terms “large publicly held corporation,” “significant relationship,” and “senior executive” in sections 1.24, 1.34, and 1.33, respectively. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1992).
121. Id. § 3A.01 cmt. C.
ship on the board may, in some instances, make it awkward for the rest of the board to have a frank and open discussion on issues brought by management. Meetings should be structured so that decisions are made after management participation to assure that, to the extent possible, directors feel free to exercise their best judgment.

The Reporters recognized this distinction between membership and participation in section 3A.04, which recommends that large publicly held corporations have nominating committees composed exclusively of directors who are not officers or employees of the corporation.122 In their comments to this section, the reporters explain that while officers and employees are disqualified from membership on the nominating committee, they are “in no way disqualified from playing an active role in the nominating process.”123 Indeed, the reporters expect that officers, and especially the CEO, will play a “highly active” role in nominating and recruiting board members.124 But, presumably, these same officers are disabled from voting on whom to nominate because of the importance of independent judgment. The same analysis would seem to apply to board membership itself.

In sum, this proposal provides an incentive for corporations to move to truly independent boards and systematically identify what constitutes independence. Moreover, working through the Commission, in the context of a rulemaking proceeding, would allow for a thorough examination of the issue and the flexibility that may be needed to implement such a rule. Direct Commission involvement in corporate governance has been resisted and criticized, but the time may have arrived when such involvement is appropriate, especially in the limited manner described above.

122. Id. § 3A.04. Section 3A.04 does provide an exception for corporations that are controlled by a single person, a family group, or a control group. Id.
123. Id. § 3A.04 cmt. C.
124. Id.