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TOWARD COMMON SENSE AND COMMON GROUND?
REFLECTIONS ON THE SHARED INTERESTS OF MANAGERS AND LABOR
IN A MORE RATIONAL SYSTEM OF CORPORATE GOVERNANCE

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THE INCONVENIENT TRUTH ABOUT CORPORATE GOVERNANCE:
SOME THOUGHTS ON VICE-CHANCELLOR STRINE'S ESSAY

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The Inconvenient Truth About Corporate Governance: Some Thoughts On Vice-Chancellor Strine's Essay

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Vice Chancellor Strine's contribution to the corporate governance debate is a welcome reminder that the fundamental and final goal of corporation law is social prosperity, broadly conceived. Wealth creation, job creation, and a long-term investment perspective need to be brought back to the forefront. These have been the traditional aims of corporation law.¹ They have been implemented through a legal framework that locates initiative and decision making power in management and the board of directors. The director-centric governance structure has created the most successful economy the world has ever seen, unequalled in its ability to reward employees as well as investors by raising overall standards of living through the mobilization of large pools of capital over a long-range time horizon.

We believe Vice Chancellor Strine is right to suggest that there can be much common ground between management and labor when it comes to corporate governance issues. The basic reason for this harmony of interest is that both management and labor have a common adversary—the governance lobby made up of Institutional Shareholder Services (ISS)-type advisers, short-term hedge fund “activists,” and Bebchuk-style academics. These pressure groups are seeking to destroy the director-centric model of corporate governance, in which boards moderate and balance the interests of management, employees, creditors, and shareholders. They seek to replace this model with a ruthless and simplistic rule that the shareholders own everything and therefore have the power to decide everything in their own interests.²

In the shareholder-centric model, the interests of non-shareholder groups are accorded no legitimacy at all. Indeed, the governance lobby and its allies argue that corporate boards have a positive duty to damage the economic interests of employees, managers, creditors, and localities, if doing so maximizes (short-term) shareholder value. Thus, we see these groups devise campaigns to cause companies to pay large special dividends; to divert capital expenditure to equity buy-backs; to engage in transactions that

1 REINIER KRAAKMAN, *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 17-19 (2004) (“the overall objective of corporate law . . . is presumably to serve the interests of society as a whole”)

2 See, e.g., Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005)

reduce high-rated corporate debt to junk status; and to divest businesses, close facilities, and cut employment.

The key elements of the existing corporate governance order have been (1) centralized professional management; (2) supervision of management by knowledgeable, largely independent groups of directors who help set long-term policy and deal with extraordinary events; (3) a federal regulatory system largely limited to disclosure and punishment for outright fraud; (4) a body of state law that recognizes the critical importance of the business judgment rule and therefore limits judicial intervention to egregious cases; and (5) a role for shareholders that is generally restricted to votes on rare events like mergers and proxy contests.

In attacking this model, the corporate governance lobby has pursued a double-barreled strategy: first, it has created a long list of “best practices” that constitute micromanagement of board-level issues, which it attempts to impose by holding directors hostage to “withhold” campaigns;³ and second, it has supported a growing number of bylaw amendments that even more directly supplant directorial discretion and judgment by purporting to require the board to do or not do certain things within the board’s legal prerogatives (such as to adopt poison pills).

Despite the demonstrated success of the existing framework, it has been under sustained attack for more than two decades. As Vice Chancellor Strine’s essay suggests, the reasons for the current demands for change can be traced to the confluence of two trends, long in the building: first, the decades-long obsession of academic corporation law with solving a single problem (the “agency problem,” whereby managements’ personal interests are assumed to diverge in some persistently material and harmful way from the interests of stockholders); and second, the growth of a large group of corporate governance professionals—individuals who earn their living devising, implementing, and monitoring “best practices” that supposedly address the “agency problem” the academics have endowed with transcendent importance.

The moving forces behind the attack are two groups who have no direct stake in the success or failure of American business or American capital markets: for-profit corporate governance advisers and tenured academics. These two groups have the least real-world experience of anyone involved with corporate governance, and are the least accountable players on the corporate governance chess board. Paradoxically, they have made a prominent place for themselves by calling attention to the supposed lack of accountability of directors and CEOs—persons who *are* subject to market discipline, government

3 ISS’s 2007 *US Corporate Governance Policy Updates* reflects an agenda that includes specific “policy position” updates on such matters as auditor ratification, indemnification clauses in auditor agreements, climate change, whether the company uses a plurality or majority standard for elections, whether a director is deemed “not independent” based on three tests, proposals to eliminate or provide for cumulative voting, whether a nominating committee exists, the effect of the existence of a director resignation policy on plurality voting in certain elections, withhold recommendations based on measures of shareholder return, the methodology for calculating “shareholder value transfer,” i.e., employee compensation, identifying 11 “poor compensation practices” and certain “best practices” for employee compensation, options backdating, performance-based equity compensation, options repricing, and lobbying practices. These are just the “updates” for 2007 INST S’HOLDER SERVICES, ISS US CORPORATE GOVERNANCE POLICY 2007 UPDATES (2006), available at <http://www.issproxy.com/pdf/2007%20US%20Policy%20Update.pdf>.

regulation, judicial oversight, and press scrutiny.

These groups are driven by their own rational self-interest. If you are in the business of selling advisory services to passive investment vehicles, it makes sense that you would create a perceived demand for your product by emphasizing the supposed ills that your advice can cure. If you are a tenured academic (or, worse, an academic *seeking* tenure) seeking professional recognition, leading the charge for “reform” is more likely to pay off than analyzing the strengths of the current system. But while the motivation of these groups is easily understood, there is no good reason to take their positions at face value. No real-world crisis has shown that this system needs radical revision. Six years after Enron and WorldCom, the capital markets are well into a cycle of unprecedented vigor, and no one seriously argues that shareholder activism, governance grandstanding, or Sarbanes-Oxley deserves the credit.

Yet the common consensus among academics and corporate governance professionals is that the state of American corporate governance is grave if not desperate. In their hyper-critical view, American capital markets are at risk from a laundry-list of supposedly poor governance practices, ranging from executive pay practices to poison pills to audit firm relationships. The remedies the corporate governance lobby proposes for these deviations from corporate governance orthodoxy are sweeping—wholesale restructuring of the relationship between shareholders and boards. This is a classic case of proposing radical surgery for a patient without a serious illness, and it happens because the “doctor” needs work.

The constant talk of “best practices” and emphasis on incremental changes, always accompanied with appeals to mom-and-apple-pie concepts like “openness” and “dialogue,” has been a key component of the governance lobby’s success. They conceal the corporate activists’ real agenda. If the principle that shareholder plebiscites can tie the hands of directors on seemingly innocuous issues is established, then it will be only a matter of time before directors find themselves powerless—or, more accurately, with the power of mere agents—while retaining the liability of principals. And the corporate governance debate is not, at bottom, about apparently harmless “dialogue” and “openness.” It is all about power—is all power in the hands of shareholders because they are the “residual owners” of the corporation? Or is power to be confided in boards of directors, subject to legal and real-world constraints? The corporate governance lobby frames the debate as one in which the corporation is a kind of political democracy in which the ability of the shareholder-voters to decisively implement their desires is the sole benchmark of success. But what is really being made is a claim to exclusive ownership. The appeal to “democracy” is a diversion. The debate is really about the claim of the shareholder-centric camp that shareholders and only shareholders are entitled to the fruits of corporate success. The shareholder-centrics are thus consistent when they ignore demands to supply concrete evidence that corporate governance “best practices” correlate with economic success, since to them, shareholder “ownership” confers absolute control prerogatives on shareholders that do not depend on any proofs of utility. What I own, I can treat as I wish.

The best way to understand the error of the shareholder-centric position is to go behind the rhetoric and explore its underpinnings. The shareholder-centric assault on the director-centric model rests on three main propositions: (1) directors have no independent

right to do anything but implement the general will of shareholders, since shareholders are “owners” and directors are mere “agents”; (2) there is no social or shareholder wealth maximizing purpose to be served by recognizing any directorial power greater than an agent’s; and (3) directors are prone to abuse any independent power they are accorded by lining their own pockets or those of corporate managers. Each of these propositions is simply false:

Owners vs. agents: The whole point of the corporate form is to make clear that shareholders are *not* owners—that their share ownership gives them no right to claim or exercise control over their pro rata share of the corporation’s assets or profits. Shareholders have no right to compel or prohibit the declaration of dividends, to commit corporate assets to investment, or to sell or spin-off prior corporate investments. At most, shareholders are entitled to cash payments in the unique event that the directors decide to liquidate or sell the corporation for cash, i.e., if corporate existence is to be terminated. The fundamental “insight” of the shareholder-centric position simply misdescribes legal and economic reality. Finally, the statutory scheme recognizes that power and responsibility are two sides of the same coin—directors have power, and thus potential liability; shareholders lack power but are insulated from liability to creditors, employees, and other shareholders. This is a fundamental bargain society has authorized, through its legislation, for investors—if you want direct decision making power as a director (or a partner, or a trustee) you cannot avoid liability; you can avoid liability only by ceding power to others.⁴ In short, there is a reason that judges, lawyers, and legislators describe directors as “fiduciaries” and describe their duties as fiduciary in nature; they are *not* agents, and they do not owe a legal duty of obedience to principals.

Wealth maximization: Stimulated by the challenge of the shareholder-centric forces, economists have recently developed a persuasive explanation of why—even assuming that maximizing the wealth of common shareholders is the major or even sole goal of corporation law—a system that gives independent status and decision making power to directors is superior to a model in which all power resides with shareholders. Briefly, this economic approach recognizes that large corporations make long-term investments in specialized capital goods, human capital, and intellectual property that have value only if the project is brought to fruition. Constituencies other than shareholders—lenders, employees, management, communities, or governments—need some assurance that ultimate decision making lies not solely in the hands of an ever-changing group that may at any given time have an economically rational incentive to expropriate these investments of non-shareholder stakeholders by, for example, paying large special dividends or cutting off capital investment or laying off key personnel. In other words, other contributors to corporate success must be persuaded that their investment in the corporation cannot be destroyed without compensation by the shareholder “owners.” The traditional, director-centric corporation provides such a method. A switch to a

4 A simple example suffices: if shareholders are empowered to, say, pass a bylaw that has the effect of causing a fraudulent transfer, are the director “agents” who had to obey their principals subject to liability, while the shareholder-beneficiaries who reaped the economic benefit remain protected by the limited-liability principle? When the time comes that major investors are willing to trade limited liability for direct principal-agent style control, we will know the debate is serious. At the moment, all the Bebchuk/ISS camp is asking for is additional power, with no responsibility

shareholder-centric model puts the achievement of the modern corporation—the ability to harness equity, debt, and human resources to invest in large projects with long-term profit horizons—in serious danger. Without powerful directors possessing independent powers recognized by the law, an optimal form of business organization would become unavailable.⁵

This recognition of the need to protect non-shareholder contributors to the corporation from expropriation by “owners” is built into the statutes that authorize the limited-liability corporation. These statutes confer independent power on directors and emphatically give directors a status different from “agents” of shareholder “principals.” The typical statute, such as section 141(a) of Delaware’s General Corporation Law, gives directors the “power to control the business and affairs of the corporation,” and allows shareholders only the most limited pro-active rights. And no corporation statute in *any* U.S. jurisdiction requires that a corporation be organized for the purpose of maximizing stockholder value.

Untrustworthy directors. An entirely different sort of argument is also used to support the attack on directorial prerogatives—the allegation that directors are, as a group, faithless fiduciaries. To this, there are two equally good and sufficient answers—first, that as an empirical matter, very few independent directors are ever found, after judicial inquiry, to be derelict in either their duty of care or of loyalty; and, second, if there is a social consensus that this is a problem, the legal rules for review of the exercise of directorial prerogative could be adjusted without limiting the scope of the prerogative itself. In no other arena would we give credence to an argument that because of a few bad (or negligent) apples, we should chop down all the apple trees.

It is worth noting, also, how out of touch the agenda advanced by the corporate governance lobby is with the genuine problems facing American business and, thus, labor and the polity as a whole. As the Vice Chancellor’s essay points out, imbalances caused by globalization, where American companies suffer externality costs that are not imposed on competitors in developing nations, are a much more serious issue than the litany of corporate governance items on which management and directors are more and more forced to spend their time. The academics and corporate governance professionals have not contributed anything to what should be a vigorous debate about how American corporations can remain competitive in the world’s rapidly changing economic landscape, especially when the American regulatory regime is getting increasingly burdensome and Byzantine while the rest of the world is streamlining regulation.

Especially in light of the fundamental error at the heart of the shareholder-centric position, the question remains why the shareholder-governance lobby has been as successful as it has been. Prominent corporations have conceded the notion that it is a good-governance practice to meet periodically with self-appointed shareholder representatives, and the custodians of large sections of the investment universe have outsourced their voting decisions to ISS and its clones.⁶ The corporate governance

5 Two highly illuminating examples of recent scholarship recognize the value of the director-centric model. Margaret M Blair & Lynn A Stout, *Specific Investment Explaining Anomalies in Corporate Law*, 31 J CORP. L 719 (2006), and Stephen M Banbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV L REV 1735 (2006)

6 It appears that this outsourcing should raise issues of fiduciary liability for the index funds, mutual

lobby's greatest real-world success has been diversion of attention from two key flaws—lack of support for its key claim that “good governance” improves performance, and the internal conflicts of interest of the governance industry itself.

I. THE FOR-PROFIT CORPORATE GOVERNANCE INDUSTRY

The for-profit corporate governance advisory industry is flawed in two major respects. First, the “good governance” standards it seeks to impose are not based on any objective evidence or method that correlates with corporate performance. As one commentator has concluded,

[G]overnance firms may be overstepping their expertise in proxy voting decisions, and in governance rating, in part because of their reliance on “good governance metrics” for which there is little evidentiary support. Erroneous governance metrics (and indeed, a reliance on one-size-fits-all governance checklists) not only affect important shareholder voting decisions and decisions on whether to invest in or divest from a particular company, but may also have a more general, harmful effect on corporate governance regulation.⁷

The corporate governance advisory industry is itself big business—ISS was sold for approximately \$550 million in 2006—and is accordingly under pressure to generate profits. Like any other industry, the corporate governance advisers are under pressure to create new “products” and re-tool existing ones, thus creating an ever-changing menu of new “best practices” and controversies that become the subject of actual or threatened proxy campaigns. The products must be cutting-edge for the benefit of the advisory firms, even if there is no discernible benefit to corporate performance or to investors. This “methodology churn”⁸ is intended to keep the demand for the industry's products strong. “[I]t does not make good business sense to wait for evidence to support governance claims when money can be made advocating them right now.”⁹

So far as there being any demonstrable positive correlation between firm performance and adherence to “good governance” metrics, it is increasingly clear that the emperor has no clothes—there simply is no such correlation. One professor has summed up his colleagues' work as follows:

A 2005 study by Professors Larcker, Richardson, and Tuna analyzed the effect on firm performance of a number of corporate governance indicators falling into “seven general categories.” . . .

In the study, [the authors] tried to combine the factors in different ways in order to test the significance of various governance structures. The authors of the study start with the proposition that governance matters; indeed [one author] states that: “[w]e set the study up to err on the side of, ‘The relationship [between governance measures and good performance] is there.’” However,

funds, and other asset aggregators. The self-evident conflicts of governance-advisory services should put these intermediaries on notice.

7 Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 891 (2007)

8 See *supra* note 3 (highlighting ISS's 2007 “policy positions”)

9 Rose, *supra* note 7, at 915

[he] notes: “[W]e can’t even find it when we do that. We biased the analyses in favor of finding something . . . [but] [t]he structural indicators just don’t seem to have that much ability to explain whether companies have to do accounting restatements, whether they’re selling at a higher multiple”¹⁰

The authors conclude that the typical structural indicators of corporate governance used in academic research and institutional rating services have a very limited ability to explain managerial decisions and firm valuation.

Discussing the study, [one of the authors] observes that “[l]ots of people are coming up with governance scorecards. . . . They’re coming up with best practices and selling this stuff. As far as we can tell, there’s no evidence that those scorecards map into better corporate performance or better behavior by managers.”¹¹

Second, the industry model in which the firms both “grade” and “monitor” the governance of individual corporations, and also market profitable services to those same corporations, is an almost perfect example of a classic conflict of interest. ISS both sells services to corporations, and acts as the adviser to the corporations’ shareholders in deciding how votes will be cast for elections of directors and other matters. This obvious conflict has motivated at least a few public pension funds (notably certain Ohio, Colorado, and Missouri funds) to terminate their relationship with ISS.

II. PROFESSOR BEBCHUCK AND THE ACADEMICS

The professorial wing of the corporate governance lobby has given intellectual cover to the for-profit advisers and the activist hedge funds, by appearing to lack their economic motives. Throughout the last two decades, these academics have produced a seemingly endless series of articles that purport to quantify and provide empirical support for the governance agenda devised by the for-profit advisers.

But this attempt to overlay a veneer of scholarly rigor on the corporate governance agenda has been unraveling—due, ironically, to the efforts of other professors who have reviewed the contentions of Professor Bebchuck and his colleagues. For example, the theory that staggered boards are a proven suboptimal governance practice has been a centerpiece of recent corporate legal scholarship.¹² However, the most recent—and first large-scale—study of the empirical relationship between staggered boards, takeover response, and shareholder returns concludes that all the academic sound and fury about staggered boards is based on absolutely no meaningful evidence, even looked at solely from a shareholder wealth-maximization standpoint. This recent study (written by business school professors rather than law school professors) reaches several conclusions that undercut the work of Professor Bebchuk and his acolytes:

[W]e find that targets with a classified board are ultimately acquired at an

¹⁰ *Id.* at 912-13

¹¹ *Id.* at 913

¹² See, e.g., Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN L. REV. 887 (2002)

equivalent rate as targets with a single class of directors. This result is not consistent with the premise that board classification is systematically used by entrenched managers to defeat takeover bids. . . .

. . . [Moreover,] the CEOs of targets with classified boards are employed by the acquiring firm, either as a manager or director, at a statistically equivalent rate as the CEOs of targets with a single class of directors. This finding does not comport with the notion that board classification facilitates self-dealing by incumbent managers during takeover bids.¹³

In addition to these findings, the authors find that shareholders of firms with staggered boards receive the same “cumulative abnormal returns” from takeover bids as do shareholders of firms without staggered boards. And they find evidence that staggered boards actually improve returns for target shareholders:

[T]arget shareholders of firms with classified boards receive a larger proportional share of the total value gains to mergers relative to the gains to target shareholders of firms with a single class of directors. . . . [C]lassification may improve the relative bargaining power of target managers on behalf of their constituent shareholders.¹⁴

We do not cite and discuss these latest academic findings because we believe the shape of corporation law and the structure of American corporate governance ought to be dictated by studies conducted by social scientists. To the contrary, we refer to these conflicting studies to show that there is no consensus, even among the social scientists, as to what is good and bad about various features of corporate governance. It is inherently foolish to design a corporate law structure based on the “findings” of academics, since their studies are contradictory and their positions change over time—as one would expect, since academics need an ever-changing mix of new “product” to aggrandize their professional status. This is to be expected. But it is not reason to refashion American corporate governance. As Vice Chancellor Strine reminds us, there is simply too much at stake in the real world, where real workers perform real work and managers attempt to deal with real problems.

Between the ideologically based assault on traditional corporate governance, on the one hand, and the economically driven wave of take-private transactions on the other hand, it is indeed time to ask whether the “eclipse of the public corporation”—to use a phrase first coined by Professor Michael Jensen in 1989—is finally at hand. Those who irresponsibly seek massive reorganization of American corporations should be careful what they wish for, and understand the dangers involved:

Directors of large public corporations bear the weight of tremendous responsibility. The situations they face and the decisions they must make are complex and nuanced and require the willingness to take risk, all the while knowing that failure may have devastating consequences for shareholders,

13 Thomas W Bates, David A Becher & Michael L Lemmon, *Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control* 2-3 (HKUST Business School Research Paper No. 07-05, 2007), available at <http://ssrn.com/abstract=923408>.

14 *Id.* at 3

employees, retirees, communities and even the economy as a whole. We cannot afford continuing attacks on the board of directors.¹⁵

The intensity of the assault on boards has only intensified since those words were written. The risks posed by these attacks have also grown. We simply cannot abandon director-centric corporate governance in favor of an unsupported and untested shareholder-centric system. As Vice Chancellor Strine so cogently and brilliantly points out, we must recognize the threat to our overall economic well-being, and reverse the trend.

¹⁵ Martin Lipton, Keynote Address at the 25th Annual Institute on Federal Securities Shareholder Activism and the "Eclipse of the Public Corporation" (Feb 7, 2007)
