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Article

**Dodd-Frank: Quack Federal Corporate Governance Round II**

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To say that the Naughts was a tumultuous decade for the United States and global economies flirts with gross understatement. The decade opened with the bursting of the tech-stock bubble in March 2000.<sup>1</sup> Coupled with a sharp decline in consumer spending, rising energy prices, and the economic fallout of the September 11, 2001 terrorist attacks, the result was an extended bear market and a lengthy recession. Unemployment rose from 3.9 percent in December 2000 to 4.9 percent in August 2001 and eventually peaked at 6.3 percent in June 2003.<sup>2</sup> As for the stock market, it generated negative returns every year from 2000 to 2002, which was the first three-year consecutive decline since the Great Depression of the 1930s.<sup>3</sup>

The tumult was not exclusively economic, however. The now infamous scandal at Enron turned out not to be an isolated case, as news of corporate shenanigans at companies like WorldCom, Global Crossing, Tyco, Adelphia, and others soon followed.<sup>4</sup> New York Attorney General Eliot Spitzer launched an investigation into conflicts of interest on the part of stock

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1. DAVID M. JONES, UNLOCKING THE SECRETS OF THE FED, at xi (2002).
2. N. GREGORY MANKIW, ESSENTIALS OF ECONOMICS 535 (5th ed. 2008).
3. ROY C. SMITH, PAPER FORTUNES: WALL STREET, WHERE IT'S BEEN AND WHERE IT'S GOING 272 (2010).
4. See Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 640–41 (2010) (noting the SEC's failure to "recognize the fraud and attendant abuses at Enron in 2001, shortly followed by similar problems at Adelphia, WorldCom, Global Crossings, Tyco, and a host of other companies").

market analysts.<sup>5</sup> Spitzer also turned up problems at many large mutual funds.<sup>6</sup>

In response to public outrage prompted by stock market losses and seemingly rampant fraud, Congress passed the Sarbanes-Oxley Act of 2002<sup>7</sup> (SOX).<sup>8</sup> When President George W. Bush signed the Act later that month, he praised it for making “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt.”<sup>9</sup> In contrast, however, Yale law professor Roberta Romano slammed SOX as “quack corporate governance.”<sup>10</sup>

Romano singled out four of SOX’s provisions for detailed criticism:

1. SOX section 301 mandates that all public corporations must have an audit committee comprised exclusively of independent directors, even though the empirical evidence on the efficacy of director independence in general and audit committee composition in specific was, at best, mixed.<sup>11</sup>
2. Section 201 prohibits accounting firms from providing a wide range of nonaudit services to public corporations they audit, even

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5. See Sung Hui Kim, *Lawyer Exceptionalism in the Gatekeeping Wars*, 63 SMU L. REV. 73, 127 n.339 (2010) (“In 2002, New York Attorney General Eliot Spitzer announced that high-profile securities analysts had publicly recommended that investors buy stocks that they had privately disparaged, even referring to touted stocks as ‘dogs’ or ‘junk’ in internal e-mails.”).

6. See Macey, *supra* note 4, at 641 (noting that “Eliot Spitzer issued scathing attacks on the SEC’s dismal performance in regulating mutual fund abuses”).

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

8. See Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1081 (2008) (describing SOX as “crisis-inspired legislation that made clear that if investor outrage was widespread enough, even a Republican-controlled Congress was prepared to enact federal laws affecting corporate governance”).

9. Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1, available at 2002 WLNR 4020235.

10. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005). As should be apparent, the title of my Article is an homage to what Judge Frank Easterbrook called Romano’s “wonderful article.” Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685, 694 (2009). *But see* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1844 (2007) (disputing Romano’s claims: “(1) that Congress can do substantial harm when it legislates in haste and did so when passing SOX, and (2) that four key corporate governance provisions of SOX were unsupported by empirical academic literature”).

11. Romano, *supra* note 10, at 1529–33.

though the weight of the evidence was that provision of such services did not degrade audit quality.<sup>12</sup>

3. Section 402(a) prohibits most loans by corporations to their executives, even though such “loans in many cases appear to serve their purpose of increasing managerial stock ownership, thereby aligning managers’ and shareholders’ interests.”<sup>13</sup>

4. Sections 302 and 906 require the chief executive officer (CEO) and chief financial officer (CFO) to certify their firm’s SEC filings, even though the evidence as to whether such certifications provide useful information to investors is ambiguous.<sup>14</sup>

As it turned out, none of these provisions proved to be SOX’s most contentious mandate. Instead, that dubious honor fell to section 404’s requirement that management and the firm’s outside auditor certify the effectiveness of the company’s internal controls over financial reporting.<sup>15</sup>

When SOX was adopted neither Congress nor the Securities and Exchange Commission (SEC) appreciated just how costly it would prove. The SEC estimated that the average cost of complying with section 404 would be approximately \$91,000.<sup>16</sup> As it turned out, a 2005 survey put the direct cost of complying with section 404 in its first year at \$7.3 million for large accelerated filers and \$1.5 million for accelerated filers.<sup>17</sup> “First-year implementation costs for larger companies were

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12. *Id.* at 1533–37.

13. *Id.* at 1539.

14. *Id.* at 1540–43.

15. SOX section 404(a) ordered the SEC to adopt rules requiring reporting companies to include in their annual reports a statement of management’s responsibility for “establishing and maintaining an adequate internal control structure and procedures for financial reporting” and “an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer, for financial reporting.” Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404(a)(1)–(2), 116 Stat. 745, 789. Section 404(b) required that the company’s independent auditors attest to and report on management’s assessment. *Id.* § 404(b). The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), permanently exempted nonaccelerated filers from compliance with section 404(b). Meredith P. Burbank, *Dodd-Frank Act Permanently Exempts Non-Accelerated Filers from SOX Auditor Attestation Requirement*, WOMBLE CARLYLE SANDBRIDGE & RICE (July 29, 2010), <http://www.wcsr.com/resources/pdfs/cs072910.pdf>. The Act further “directs the SEC to conduct a study within the next nine months to determine how the burden of compliance with section 404(b) could be reduced for companies with market capitalizations between \$75 million and \$250 million.” *Id.*

16. Joseph A. Grundfest & Steven E. Bochner, *Fixing 404*, 105 MICH. L. REV. 1643, 1645 (2007).

17. *Id.*

thus eighty times greater than the SEC had estimated, and sixteen times greater than estimated for smaller companies.”<sup>18</sup>

Second-year compliance costs dropped, although surveys report widely differing estimates of the extent of the drop.<sup>19</sup> According to all the surveys, however, second-year compliance costs remained many times greater than the SEC’s estimate of first-year costs.<sup>20</sup> “Absent fundamental reform, the third, fourth, and fifth rounds are also likely to cost too much, *ad infinitum*.”<sup>21</sup>

SOX was not a one-off event. To the contrary, it was a fairly standard example of the boom-bust-regulate pattern that characterizes U.S. federal regulation of corporate governance. In a pattern that can be traced back at least to England in the late 1600s, major new corporate regulation has tended to follow market turmoil.<sup>22</sup>

When the economy suffered through an even worse patch at the end of the decade, it was thus perfectly predictable that another round of regulation would be forthcoming. The story of the housing bubble’s burst, the subprime mortgage crisis, and the Great Recession is far too complex to recount herein.<sup>23</sup> Suffice it to say that, as was the case with SOX, populist outrage motivated Congress to pass the Dodd-Frank Wall Street

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18. *Id.* at 1645–46. Reporting companies are those issuers registered with the SEC pursuant to the Securities Exchange Act of 1934. Large accelerated filers are those reporting companies with a market float of \$700 million or more. Accelerated filers are those reporting companies having a float of at least \$75 million, but less than \$700 million. Nonaccelerated filers are reporting companies with a float of less than \$75 million. The reference to acceleration reflects that the first two categories of companies have a reduced amount of time following the end of a fiscal quarter or year to file their quarterly and annual reports. See generally Mary E.T. Beach, *Continuous Reporting Requirements Under the Exchange Act of 1934*, in ALI-ABA COURSE OF STUDY (2010) (discussing these terms).

19. See Grundfest & Bochner, *supra* note 16, at 1646 (discussing the surveys).

20. *Id.*

21. *Id.* at 1647. The SEC and the Public Company Accounting Oversight Board (PCAOB) have undertaken a number of efforts aimed at reducing the costs associated with section 404 compliance. See generally Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 55 n.60 (2009) (detailing such efforts).

22. See STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860*, at 9 (1998) (explaining that “new regulation tended to come immediately after price declines”).

23. For an overview, see generally RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* (2009).

Reform and Consumer Protection Act (Dodd-Frank or the Dodd-Frank Act).<sup>24</sup>

Although Dodd-Frank's 2319 pages dwarf SOX in both size and scope, most of the Act deals with issues other than corporate governance. The key provisions pertinent to our inquiry are six in number:

1. Section 951's so-called say-on-pay mandate, requiring periodic shareholder advisory votes on executive compensation.
2. Section 952's mandate that the compensation committees of reporting companies must be fully independent and that those committees be given certain specified oversight responsibilities.
3. Section 953's direction that the SEC require companies to provide additional disclosures with respect to executive compensation.
4. Section 954's expansion of SOX's rules regarding clawbacks of executive compensation.
5. Section 971's affirmation that the SEC has authority to promulgate a so-called shareholder access rule pursuant to which shareholders would be allowed to use the company's proxy statement to nominate candidates to the board of directors.
6. Section 972's requirement that companies disclose whether the same person holds both the CEO and chairman of the board positions and why they either do or do not do so.

The question before us is whether Dodd-Frank's corporate governance provisions, like those of SOX, are mere quackery.

Part I of this Article focuses on the problem of quack corporate governance regulation in the abstract. What are the defining characteristics of a quack law? Why would Congress adopt such laws? What are the consequences of such laws for companies, investors, and the economy as a whole?

Part II examines the six provisions of Dodd-Frank listed above. It will argue that some of them are meaningless symbolism but that others are likely to have serious adverse consequences. Hence, Part II argues, Dodd-Frank is to corporate governance as quackery is to medical practice.

Part III concludes by asking whether there is anything that can be done to prevent future quack corporate governance laws. It argues that the best alternative would be some form of a prophylactic barrier pursuant to which Congress precommits

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24. See Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 333 (2011), available at <http://ssrn.com/abstract=1617890> (opining that "the emergence of so thoroughly shareholder-centric a set of proposals in the wake of the crisis is best understood as one reflection of a much broader populist backlash against managers").

to refraining from emergency post-bubble legislation. Part III concludes, however, that Congress is unlikely to do so. It seems likely that quackery in federal regulation of corporate governance is subject to a ratchet effect. State legislators therefore need to develop defensive strategies designed to limit the opportunities for further federal intervention.

## I. BUBBLE LAWS

### A. REGULATORS AND INTEREST GROUPS

Although the federal government has been an active regulator of corporate governance since at least the New Deal, the core remains a matter of state corporate law. It is state law, for example, that determines the rights of shareholders, “including . . . the voting rights of shareholders.”<sup>25</sup> Likewise, “the first place one must look to determine the powers of corporate directors is in the relevant State’s corporation law. ‘Corporations are creatures of state law’ and it is state law which is the font of corporate directors’ powers.”<sup>26</sup> As the predominant state of incorporation for public corporations, of course, Delaware is the leading regulator of corporate governance.

The division of responsibility between the states and the federal government is contentious because there are a number of interest groups with skin in the corporate governance game. These include corporate managers, shareholders, unions, consumers, NGOs, and anticorporate populists.<sup>27</sup> In Delaware, however, most of these groups are relatively powerless. Instead, the dominant interest group in Delaware is the bar:

The bar is small, discrete, and highly organized. Its members tend to have a large personal stake in the subject matter of the regulation. They also tend to be more wealthy than other groups and to have good political connections. Indeed, many members of the Delaware legislature are themselves members of the bar. Such legislators tend to be represented disproportionately on legislative committees that draft the provisions of the Delaware Corporation Code.<sup>28</sup>

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25. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987).

26. *Burks v. Lasker*, 441 U.S. 471, 478 (1979) (citations omitted).

27. Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2500, 2517 (2005).

28. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 506 (1987).

In addition, Delaware tends to be highly sensitive to the interests of managers and investors.<sup>29</sup> Other interest groups are generally powerless in Delaware.<sup>30</sup>

In contrast, at the federal level, these other interest groups have considerable influence, diluting the power of the interests that dominate Delaware.<sup>31</sup> In particular, Washington is subject to national public opinion and populist sentiments from which Dover is largely insulated.<sup>32</sup>

In ordinary times, Washington typically has more important issues on its plate than corporate governance.<sup>33</sup> In a bubble period, moreover, federal regulatory action is even less likely because interest groups like shareholders and consumers may be lulled into inaction by the seemingly ever-rising value of their portfolios.<sup>34</sup> At the same time, however, the stage is being set for a post-bubble burst of regulation. In the euphoria associated with a bubble, regulators and private gatekeepers tend to let their guard down, potential fraudsters see an explosion of opportunities, and investors become both more greedy and trusting.<sup>35</sup> The net effect is a boom in fraud during bubbles, especially toward the end, when everybody is trying to keep the music going. When the bubble inevitably bursts, investigators reviewing the rubble begin to turn up evidence of speculative excess and even outright, rampant fraud.<sup>36</sup> Investors burnt by losses from the breaking of the bubble and outraged by evidence of misconduct by corporate insiders and financial bigwigs create populist pressure for new regulation.<sup>37</sup>

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29. Roe, *supra* note 27, at 2500.

30. *Id.* at 2501; *see also* Macey & Miller, *supra* note 28, at 490 (“Because the physical assets of most large Delaware corporations are located in other states, Delaware lawmakers ordinarily are not subject to pressures from unions, environmental groups, local communities, or other special interests associated with the corporation’s physical plant or assets.”).

31. Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 17 (2009).

32. *Id.*

33. *Id.* at 8.

34. Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 79 (2003).

35. *See generally* Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393 (2006) (discussing the relationship between bubbles and fraud).

36. *See generally* CHARLES P. KINDLEBERGER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 73–90* (4th ed. 2000) (discussing the fallout of bubbles).

37. *See* Ribstein, *supra* note 34, at 79 (explaining that after a crash, reformers can draw on populism and envy of the rich).

It is in the post-bubble environment, “when scandals and economic reversals occur” and “when corporate transactions grab the attention of the American public and the U.S. Congress,” that Congress often acts.<sup>38</sup> Because the venue for post-bubble regulatory action shifts from Dover to Washington, interest groups frozen out of the Delaware process participate meaningfully in the legislative or rulemaking processes. Because such periods typically involve an upswing in populist anger and accompanying intense public pressure for action, they offer “windows of opportunity to well-positioned policy entrepreneurs to market their preferred, ready-made solutions when there is little time for reflective deliberation.”<sup>39</sup> Larry Ribstein and Roberta Romano have independently demonstrated that this pattern is a reoccurring phenomenon in American law, going back even before the New Deal.<sup>40</sup> Indeed, according to Stuart Banner, the same pattern of boom, bust, and regulation can be seen far back into the nineteenth century.<sup>41</sup>

Banner contends that the reason for the association is that deep-seated popular suspicion of speculation comes in bad financial times to dominate otherwise popular support for markets, resulting in the expansion of regulation. That is to say, financial exigencies embolden critics of markets to push their regulatory agenda. They are able to play on the strand of popular opinion that is hostile to speculation and markets because the general public is more amenable to regulation after experiencing financial losses.<sup>42</sup>

SOX was merely the latest iteration of this process,<sup>43</sup> at least until Dodd-Frank came along.

#### B. QUACK CORPORATE GOVERNANCE AND THE ECONOMY

Bubble laws tend to be adopted in a hurry, as was the case with SOX.<sup>44</sup> As we have seen, the pressure of time tends to give advantages to interest groups and other policy entrepreneurs who have prepackaged purported solutions that can be readily adapted into legislative form. Hence, for example, many of SOX’s provisions were “recycled ideas” that had been “advocated for quite some time by corporate governance entrepre-

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38. Roe, *supra* note 31, at 8.

39. Romano, *supra* note 10, at 1591.

40. Ribstein, *supra* note 34, at 83–94; Romano, *supra* note 10, at 1591–94.

41. BANNER, *supra* note 22, at 257 (describing early “self-regulation” by New York bankers).

42. Romano, *supra* note 10, at 1593.

43. Ribstein, *supra* note 34, at 83; Romano, *supra* note 10, at 1528.

44. Romano, *supra* note 10, at 1523 (“SOX was enacted in a flurry of congressional activity . . .”).

neurs.”<sup>45</sup> Unfortunately, because the policy entrepreneurs tend to be critics of markets and corporations, bubble laws often “impose regulation that penalizes or outlaws potentially useful devices and practices and more generally discourages risk-taking by punishing negative results and reducing the rewards for success.”<sup>46</sup>

Quack corporate governance thus has real economic consequences. In the mid-Naughts, three high-profile reports raised concerns that the United States’ dominant position in the global capital markets was eroding: the Bloomberg-Schumer Report,<sup>47</sup> the Paulson Committee Interim Report,<sup>48</sup> and the Chamber Report.<sup>49</sup> Although the reports differed in many details, each found that U.S. capital markets were becoming less competitive in the global market. Evidence for this decline is found in such factors as “(1) a decrease in new foreign listings; (2) a decline in IPOs; (3) an increase in going-private transactions; and (4) an increase in firms going ‘dark,’ that is, deregistering but not eliminating all public shareholders.”<sup>50</sup> Each identified various reasons for this decline. Importantly, however, all three identified SOX as one of the causal factors. The Bloomberg-Schumer Report, for example, found that SOX section 404 “posed unintended negative consequences for US competitiveness,” while providing general support for other aspects of SOX.<sup>51</sup> Although the Paulson Committee also thought SOX had made some key improvements, it too concluded that “the

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45. *Id.*

46. Ribstein, *supra* note 34, at 83.

47. See MCKINSEY & CO., SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL SERVICES LEADERSHIP (2007) [hereinafter BLOOMBERG-SCHUMER REPORT], available at [http://www.nyc.gov/html/om/pdf/ny\\_report\\_final.pdf](http://www.nyc.gov/html/om/pdf/ny_report_final.pdf).

48. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (2006) [hereinafter PAULSON COMMITTEE INTERIM REPORT]. The Committee on Capital Markets Regulation—or, as it is better known, the Paulson Committee—subsequently issued a follow-up report identifying thirteen competitive measures that the Committee tracks on a quarterly basis. See COMM. ON CAPITAL MKTS. REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET (2007) [hereinafter PAULSON COMMITTEE REPORT], available at [http://www.capmktreg.org/pdfs/The\\_Competitive\\_Position\\_of\\_the\\_US\\_Public\\_Equity\\_Market.pdf](http://www.capmktreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf).

49. U.S. CHAMBER OF COMMERCE, CAPITAL MARKETS, CORPORATE GOVERNANCE, AND THE FUTURE OF THE U.S. ECONOMY (2006) [hereinafter CHAMBER REPORT], available at <http://www.uschamber.com/sites/default/files/reports/060213capitalmarkets.pdf>.

50. Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 251–52 (2009).

51. BLOOMBERG-SCHUMER REPORT, *supra* note 47, at 97.

implementation of SOX [section] 404 . . . has produced a regime that is overly expensive.”<sup>52</sup> Finally, the Chamber likewise argued that section 404 “has proven tremendously costly by requiring companies to commit extraordinary resources (in time, management and staff resources, and money) to collect, review, and analyze data. These excessive and unnecessary costs damage competitiveness and, ultimately, the interests of investors.”<sup>53</sup>

A number of academic studies have likewise concluded that SOX created significant new costs that have had a deleterious effect on the economy and the capital markets. Several studies report that the increased costs associated with SOX are one reason for an increase in the number of public corporations deciding to go private.<sup>54</sup> The most comprehensive studies have found that the costs associated with SOX negatively impacted foreign firms and encouraged them to delist from U.S. capital markets.<sup>55</sup> In sum, as Romano concludes her review of the evidence:

SOX . . . adversely affected U.S. exchanges through the loss of small-firm listings. The contraction in investing opportunities has, no doubt, adversely affected U.S. investors as well, as they would have to bear currency risk and the other transaction costs of investing abroad rather than domestically in order to invest in such firms. In sum, a fair reading of the empirical literature investigating U.S. capital-market competitiveness post-SOX indicates, at a minimum, that the statute has negatively impacted the stock exchanges’ competitiveness due to losses of small-firm listings. Those are also the firms that have been shown to encounter the greatest proportionate operating cost increase due to SOX, in the literature documenting the changing cost of being a public company post-enactment.<sup>56</sup>

As we have seen, of course, SOX was not the first example of a deleterious bubble law. As we shall see in the next Part, it also was not the last.

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52. PAULSON COMMITTEE INTERIM REPORT, *supra* note 48, at xiii.

53. CHAMBER REPORT, *supra* note 49, at 14.

54. *E.g.*, Stanley B. Block, *The Latest Movement to Going Private: An Empirical Study*, J. APPLIED FIN., Spring/Summer 2004, at 36, 36; Ellen Engel et al., *The Sarbanes-Oxley Act and Firms’ Going-Private Decisions*, 44 J. ACCT. & ECON. 116, 117, 142 (2007); Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 182–83, 204–06 (2008).

55. Romano, *supra* note 50, at 253–54.

56. *Id.* at 255.

C. WASHINGTON OR DOVER?

SOX and Dodd-Frank bring to the fore the question of whether we should prefer Washington to Dover as the principal regulator of corporate governance. If so, we should criticize those acts for not having gone far enough in displacing state law. If not, of course, we should criticize them for representing the latest moves in a creeping federalization of corporate governance law.

1. Does Delaware Compete Horizontally?

The basic case for federalizing corporate law rests on the so-called race-to-the-bottom hypothesis. As the theory goes, states compete in granting corporate charters.<sup>57</sup> After all, the more charters the state grants, the more franchise and other taxes it collects.<sup>58</sup> Because it is corporate managers who decide on the state of incorporation, states compete by adopting statutes favoring the interests of corporate managers vis-à-vis other corporate stakeholders.<sup>59</sup> As the clear winner in this state competition, Delaware is usually presented as the poster child for bad corporate governance law.<sup>60</sup>

A competing story accepts that states compete for corporate charters, but argues that this competition leads to a “race to the top.”<sup>61</sup> As the theory goes, investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management.<sup>62</sup> Lenders will

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57. For the seminal work in the field, which coined the phrase “race for the bottom,” see William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *YALE L.J.* 663, 666 (1974).

58. See *id.* at 684 (opining that “there is no public policy left in Delaware corporate law except the objective of raising revenue”).

59. See *id.* at 672–90 (analyzing various Delaware statutes and cases purportedly favoring management vis-à-vis shareholders).

60. See *id.* at 705 (asserting that Delaware is “in the lead” of the race to the bottom).

61. The seminal article here is Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251, 254–58 (1977). Judge Winter later moderated the strength of his claim in Ralph K. Winter, *The “Race for the Top” Revisited: A Comment on Eisenberg*, 89 *COLUM. L. REV.* 1526, 1528–29 (1989).

62. Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 *YALE L. & POLY REV.* 381, 393 (2005) (explaining that the race-to-the-bottom theory asserts that “rational investors should discount the amounts they are willing to pay for the company’s stock to reflect their view of the likelihood of managers working for shareholders and the adequacy of protection against future changes of heart. Since the value of stock is de-

not lend to such firms without compensation for the risks posed by management's lack of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall.<sup>63</sup> Among other things, such firms thereby become more vulnerable to a hostile takeover and subsequent management purges.<sup>64</sup> Corporate managers therefore have strong incentives to incorporate the business in a state offering rules preferred by investors. Competition for corporate charters thus should deter states from adopting excessively pro-management statutes.<sup>65</sup>

Some recent evidence, however, suggests that the basic premise of both stories (i.e., that states compete actively for corporate charters) is wrong.<sup>66</sup> Lucian Bebchuk and Alma Cohen, for example, argue that:

[T]he conventional view regards incorporation choice as a "pure" choice of a legal regime, based on only a comparison of states' corporate law systems and a judgment on which of those systems would be best for the firm. . . . On this view, all states are viewed as "selling" their corporate law system to all publicly traded firms, and not especially to the firms located in them.<sup>67</sup>

They then assert that their study disproves that conventional view, arguing that their findings "cast substantial doubt on the proposition that there is a vigorous competition among states over corporate charters."<sup>68</sup>

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pendent on its future returns, rational IPO investors should price protections that will inure to the benefit of later secondary market investors as well.").

63. See *id.* (explaining that race-to-the-bottom theorists believe that "[m]anagers who convince the financial market that they will work for shareholders, not themselves or other corporate participants, will be able to obtain investment capital at far lower cost than competitors who do not").

64. *Id.* at 393–94.

65. See Todd J. Zywicki, *Is Forum Shopping Corrupting America's Bankruptcy Courts?*, 94 GEO. L.J. 1141, 1157–58 (2006) ("As a result, [race-to-the-top theorists] argue, managers' private incentives will be aligned with the incentives of shareholders to maximize firm value rather than their private interests, creating a natural incentive to incorporate in the state that offers the most-efficient law that tends to maximize firm value, rather than states that permit managerial agency costs.").

66. E.g., Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 574–76 (2002); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 681 (2002).

67. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 396 (2003).

68. Lucian Bebchuk & Alma Cohen, *Not-So-Fierce Rivalry*, DAILY DEAL, Jan. 31, 2003, available at <http://www.law.harvard.edu/faculty/bebchuk/pdfs/2003.bebchuk-cohen.not-so-fierce-rivalry.pdf>; see also Bebchuk & Hamdani, *supra* note 66, at 555 ("The alleged vigorous race among states vying for incorporations . . . simply does not exist.").

Bebchuk and Cohen's chosen foil, however, is a caricature of the race hypothesis. No one ever claimed that, say, a Los Angeles-based lawyer sits down and thumbs through all fifty states' corporation statutes before deciding where to incorporate a client. Instead, a fairer picture of the conventional view is that each state views itself as competing with Delaware, not with the other forty-eight. The claim that states compete not to attract incorporations but rather to retain local businesses finds support in the evidence that ninety-seven percent of all U.S. public corporations are incorporated either in their home state or Delaware.<sup>69</sup>

A theory of home state versus Delaware competition also finds support from a behavioral economic analysis of the role lawyers play in choosing the state of incorporations. Lawyers are subject to the same bounded rationality constraints everyone else is, as well as the familiar incentives of agency cost economics.<sup>70</sup> Under such conditions, lawyers naturally will adopt a decisionmaking heuristic,<sup>71</sup> with home state versus Delaware being far and away the most logical heuristic for them to choose.

In other words, even if state competition is more of a brisk walk than a race, Delaware still competes.<sup>72</sup> Because of its small population and economy, Delaware is uniquely able to rely on franchise fees to fund a considerable portion of its government. In fact, Delaware generates \$750–800 million per year in franchise taxes, which amounts to a quarter of the state's budget.<sup>73</sup> This income flow is of great benefit to Delaware, but it also puts Delaware at risk. If Delaware were to make disadvantageous changes in its law, some firms incorporated there would leave and other firms would not migrate into Delaware. If Delaware law became sufficiently unattractive to

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69. David M. Wilson, *Climate Change: The Real Threat to Delaware Corporate Law, Why Delaware Must Keep a Watchful Eye on the Content of Political Change in the Air*, 5 ENTREPRENEURIAL BUS. L.J. 481, 489 (2010).

70. For sources discussing bounded rationality effects on parties and lawyers, see generally Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113 (1996), which discusses constraints and incentives faced by counsel.

71. See generally Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974) (describing the use of heuristics in decisionmaking).

72. See Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125, 129 (2009) (arguing it is "indisputable" that Delaware competes, "albeit possibly weak[ly]").

73. Wilson, *supra* note 69, at 489.

decisionmakers, another state might well decide to begin competing directly and vigorously with Delaware.<sup>74</sup> Pennsylvania and Nevada, for example, have long been lurking in the wings as potential competitors.<sup>75</sup> The potential for such deleterious effects on its budget thus forces Delaware to constantly update and improve its law.

As the principal interest group affecting Delaware law,<sup>76</sup> the local bar likewise has a strong interest in maintaining Delaware's dominance. Unlike New York, Washington, or Los Angeles, to cite but a few examples, Delaware lacks the population, economic size, and financial centers necessary to sustain a large and prosperous corporate bar. The bar thus has an active interest in maintaining the efficiency and attractiveness of Delaware corporate law.

Although the empirical evidence is hardly uncontested, there is substantial evidence that state competition tends to lead to efficient results. Roberta Romano's event study of corporations changing their domicile by reincorporating in Delaware, for example, found that such firms experienced statistically significant positive cumulative abnormal returns.<sup>77</sup> In other words, reincorporating in Delaware increased shareholder wealth. This finding strongly supports the race-to-the-top hypothesis. If shareholders thought that Delaware was winning a race to the bottom, shareholders should dump the stock of firms that reincorporate in Delaware, driving down the stock price of such firms. As Romano found, however, and all of the other major event studies confirm, there is a positive stock-price effect upon reincorporation in Delaware.<sup>78</sup>

The event study findings are buttressed by a Robert Daines study in which he compared the Tobin's Q of Delaware and non-Delaware corporations.<sup>79</sup> Tobin's Q is the ratio of a firm's market value to its replacement cost of its assets and is a wide-

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74. Roe, *supra* note 72, at 129.

75. See Kahan & Kamar, *supra* note 66, at 693, 716–22 (noting the efforts of Nevada and Pennsylvania, as well as Maryland, to compete with Delaware).

76. See Macey & Miller, *supra* note 28, at 506.

77. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 265–73 (1985).

78. See ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* 64–73 (2002) (discussing the relevant studies and criticisms thereof).

79. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

ly accepted measure of firm value.<sup>80</sup> Daines found that Delaware corporations in the period 1981–1996 had a higher Tobin's Q than those of non-Delaware corporations, suggesting that Delaware law increases shareholder wealth.<sup>81</sup>

Additional support for the event study findings is provided by takeover regulation. Compared to most states, which have adopted multiple antitakeover statutes of ever-increasing ferocity, Delaware's single takeover statute is relatively friendly to hostile bidders.<sup>82</sup> Given the clear evidence that hostile takeovers increase shareholder wealth,<sup>83</sup> this finding is especially striking. The supposed poster child of bad corporate governance, Delaware, turns out to be quite takeover friendly and, by implication, shareholder friendly.

The takeover regulation evidence is especially important, because state antitakeover laws are the principal arrow in the quiver of modern race to the bottom theorists. Lucian Bebchuk and Allen Ferrell point out that state takeover regulation demonstrably reduces shareholder wealth but that most states have nevertheless adopted antitakeover statutes.<sup>84</sup> Even many advocates of the race-to-the-top hypothesis concede that state regulation of corporate takeovers appears to be an exception to the rule that efficient solutions tend to win out.<sup>85</sup> But so what? Nobody claims that state competition is perfect. The question is only whether some competition is better than none. Delaware's relatively hospitable environment for takeovers suggests an affirmative answer to that question.

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80. BRIAN KETTELL, VALUATION OF INTERNET AND TECHNOLOGY STOCKS: IMPLICATIONS FOR INVESTMENT ANALYSIS 70 (2002).

81. Daines, *supra* note 79, at 533. Although subsequent research suggests that this effect may not hold for all periods, *see generally* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32 (2004) (presenting evidence that the Delaware effect disappears when examined over a longer time frame), Daines' study remains an important confirmation of the event study data.

82. *See* Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation Takeover Legislation*, 25 J. FIN. ECON. 291, 298, 315 (1989) (explaining that Delaware has a weak statute whose adoption did not adversely affect stock prices of Delaware corporations).

83. *See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 612–14 (2002) (reviewing studies on hostile takeovers).

84. *See* Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1174 (1999).

85. *See, e.g.*, Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 860 (1993).

## 2. Delaware's Vertical Competition

No one seriously doubts that Congress has the power under the Commerce Clause to preempt the field of corporate governance law.<sup>86</sup> Although it has never done so, it was in the business of piecemeal federalization long before SOX and Dodd-Frank.<sup>87</sup> The New Deal securities laws, for example, effectively displaced state law as to such matters as proxy voting and insider trading.<sup>88</sup> In this sense, both SOX and Dodd-Frank simply represent additional milestones in a process of gradual federalization.

We have seen, however, that, unlike state law, federal intrusions typically have resulted in quack corporate governance. We have already seen three reasons why this is so persistently the case. First, federal bubble laws tend to be enacted in a climate of political pressure that does not facilitate careful analysis of costs and benefits.<sup>89</sup> Second, federal bubble laws tend to be driven by populist anticorporate emotions.<sup>90</sup> Finally, the content of federal bubble laws is often derived from prepack-

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86. See, e.g., William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 624 (2006) (opining that "Congress could draw on the same Commerce Clause on which it draws in supplementing the state system to occupy the entire field of corporate law").

87. As Mark Roe explains:

Washington makes corporate law. From 1933 to 2002, that is, from the passage of the securities laws to the passage of Sarbanes-Oxley, Washington has made rules governing the voting of stock and the solicitation of proxies to elect directors. It has made the main rules governing insider trading, stock buybacks, how institutional investors can interact in corporate governance, the structure of key board committees, board composition (how independent some board members must be), how far states could go in making merger law, how attentive institutional investors must be in voting their proxies, what business issues and transactional information public firms must disclose (which often affect the structure and duties of insiders and managers to shareholders in a myriad of transactions), the rules on dual class common stock recapitalizations, the duties and liabilities of gatekeepers like accountants and lawyers, and more.

Roe, *supra* note 31, at 10.

88. See John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 577 (2001) ("Federal regulation of proxies, tender offers, and insider trading are all arguably much more integral to the substantive relationships among investors, firms, directors, and managers that are at the heart of corporate law, than they are to the disclosure-oriented emphasis of the existing federal securities statutes.").

89. See *supra* notes 44–45 and accompanying text.

90. See *supra* note 37 and accompanying text.

aged proposals advocated by policy entrepreneurs skeptical of corporations and markets.<sup>91</sup>

A further concern is that ousting the states from their traditional role as the primary regulators of corporate governance would eliminate a valuable opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law. As Justice Brandeis pointed out many years ago, “[i]t is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”<sup>92</sup> So long as state legislation is limited to regulation of firms incorporated within the state, as it generally is, there is no risk of conflicting rules applying to the same corporation. Experimentation thus does not result in confusion, but instead may lead to more efficient corporate law rules.

In contrast, the uniformity imposed by federal law precludes experimentation with differing modes of regulation. Accordingly, as the sphere of federal domination grows, the room for new and better regulatory ideas to be developed shrinks. Instead of the laboratories of federalism, we risk being stuck with rules that may well be wrong from the outset and, because Washington moves only in response to crises, may quickly become obsolete.

The point is not merely to restate the race-to-the-top argument. Competitive federalism promotes liberty as well as shareholder wealth. When firms may freely select among multiple competing regulators, oppressive regulation becomes impractical. If one regulator overreaches, firms will exit its jurisdiction and move to one that is more *laissez-faire*. In contrast, when there is but a single regulator, such that exit by the regulated is no longer an option, an essential check on excessive regulation is lost. Hence, a transfer of power from Dover to Washington is a likely indicator of a bubble law with potential for quackery.

#### D. SUMMARY

In sum, this review suggests that quack corporate governance regulation will have some or all of the following features:

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91. See *supra* note 46 and accompanying text.

92. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

1. It is a bubble law, enacted in response to a major negative economic event.
2. It is enacted in a crisis environment.
3. It was a response to a populist backlash against corporations and/or markets.
4. It is adopted at the federal rather than state level.
5. It transfers power from the states to the federal government.
6. Interest groups that are strong at the federal level but weak at the Delaware level support it.
7. Typically, it is not a novel proposal, but rather a long-standing agenda item of some powerful interest group.
8. The empirical evidence cited in support of the proposal is, at best, mixed and often shows the proposal to be unwise.

All of Dodd-Frank meets the first four criteria. It was enacted in the wake of a massive populist backlash motivated by one of the worst economic crises in modern history.<sup>93</sup> As we will see in the next Part, each corporate governance provision satisfies all or substantially all of the remaining criteria.

## II. QUACKERY ROUND II

Compared to some of the proposals floated in Congress following the 2007–2008 financial crisis, Dodd-Frank’s corporate governance provisions were relatively modest. Senators Maria Cantwell’s and Charles Schumer’s Shareholder Bill of Rights, for example, would have mandated the use of majority voting in the election of directors.<sup>94</sup> It also would have banned the use of staggered boards of directors and required creation of board-level risk management committees.<sup>95</sup> None of these provisions made it into the final Dodd-Frank Act. Other provisions of the Cantwell-Schumer bill made it into Dodd-Frank only in a much weakened form. Instead of instructing the SEC to adopt a proxy

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93. *See supra* note 24 and accompanying text (noting populist aspects of the process).

94. Press Release, Senator Charles E. Schumer, Schumer, Cantwell Announce ‘Shareholder Bill of Rights’ to Impose Greater Accountability on Corporate America (May 19, 2009), *available at* [http://schumer.senate.gov/new\\_website/record.cfm?id=313468](http://schumer.senate.gov/new_website/record.cfm?id=313468). Specifically, they proposed that incumbent members of the board of directors would have “to receive at least 50% of the vote in uncontested elections in order [to] remain on the board.” *Id.*

95. *Id.* Dodd-Frank section 165 does mandate risk management committees, but only for nonbank financial services companies supervised by the Federal Reserve and bank holding companies. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1423–32 (2010).

access rule, Dodd-Frank merely affirms that the SEC has authority to do so.<sup>96</sup> Instead of requiring that companies separate the positions of CEO and chairman of the board (chairman), with the latter being an independent director, Dodd-Frank merely requires the companies disclose their policy with respect to filling those positions.<sup>97</sup> Even so, however, the question remains whether the provisions that survived are likely to improve corporate governance.

#### A. THERAPEUTIC DISCLOSURES

Therapeutic disclosures are not intended to inform investors. Instead, they are intended to affect substantive corporate behavior.<sup>98</sup> Two such provisions are contained in Dodd-Frank.

##### 1. Pay Disclosures

Section 953 requires that each reporting company's annual proxy statement contain a clear exposition of the relationship between executive compensation and the issuer's financial performance.<sup>99</sup> It further requires disclosure of "the median of the annual total compensation of all employees of the issuer," except the CEO, the CEO's annual total compensation, and the ratio of the two amounts.<sup>100</sup> This requirement is expected to be hugely burdensome:

[It] means that for every employee, the company would have to calculate his or her salary, bonus, stock awards, option awards, nonequity incentive plan compensation, change in pension value and nonqualified deferred compensation earnings, and all other compensation (e.g., perquisites). This information would undoubtedly be extremely time-consuming to collect and analyze, making it virtually impossible for a company with thousands of employees to comply with this section of the Act.<sup>101</sup>

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96. Compare Dodd-Frank Wall Street Reform and Consumer Protection Act § 971 (affirming authority), with Press Release, Senator Charles E. Schumer, *supra* note 94 (mandating adoption).

97. Compare Dodd-Frank Wall Street Reform and Consumer Protection Act § 972 (requiring disclosure), with Press Release, Senator Charles E. Schumer, *supra* note 94 (mandating separation).

98. Cf. Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 464 (2003) ("The strategy of shaming is premised on actively using disclosure to influence corporate conduct . . .").

99. Dodd-Frank Wall Street Reform and Consumer Protection Act § 953.

100. *Id.* § 953(b)(1)(A).

101. Warren J. Casey & Richard Leu, *United States: New Executive Compensation Disclosures Under Dodd-Frank*, MONDAQ.COM (Aug. 3, 2010), <http://www.mondaq.com/unitedstates/article.asp?articleid=106962>; see also Jean Ea-

The Senate Committee cited the Council of Institutional Investors (CII) as having supported this provision.<sup>102</sup> CII's position as a de facto trade association for large, activist investors makes it an important policy entrepreneur.<sup>103</sup> In addition to thus being part of a key interest group's agenda, however, the provision also should be seen as part of the populist backlash against corporations and markets. "The law taps into public anger at the increasing disparity between the faltering incomes of middle America and the largely recession-proof multimillion-dollar remuneration of the typical corporate chief."<sup>104</sup>

## 2. Board Structure Disclosure

Section 972 directs the SEC to adopt a new rule requiring reporting companies to disclose whether the same person, or different persons, holds the positions of CEO and chairman.<sup>105</sup> In either case, the company must disclose its reasons for doing so. "The legislation does not endorse or prohibit either method."<sup>106</sup> Even so, however, it seems likely that some policy entrepreneurs hope that the provision will shame companies into separating the two positions:

Mr. Joseph Dear, Chief Investment Officer of the California Public Employees' Retirement System, on behalf of the Council of Institutional Investors, wrote in testimony for the Senate Banking Committee that "Boards of directors should be encouraged to separate the role of chair and CEO, or explain why they have adopted another method to assure independent leadership of the board."<sup>107</sup>

If this is the effect section 972 ends up having, it will be without compelling support in the empirical literature. A study by

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glesham & Francesco Guerrero, *Pay Law Sparks 'Nightmare' on Wall St*, FIN. TIMES, Aug. 31, 2010, at 1 ("The rules' complexity means multinationals face a 'logistical nightmare' in calculating the ratio, which has to be based on the median annual total compensation for all employees, warned Richard Susko, partner at law firm Cleary Gottlieb. 'It's just not do-able for a large company with tens of thousands of employees worldwide.'").

102. S. REP. NO. 111-176, at 135 (2010).

103. Cf. Jeanmarie LoVoi & Klaus Eppler, *Corporate Governance*, in PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2002, at 220 (PLI Corporate Law & Practice, Course Handbook Series No. B0-018D, 2002) ("The Council of Institutional Investors ('CII') founded in 1985, is a trade association of over 120 pension fund members that own more than \$1 trillion of investments in the United States and over 100 honorary international participants and educational sustainers.").

104. Eaglesham & Guerrero, *supra* note 101, at 1.

105. Dodd-Frank Wall Street Reform and Consumer Protection Act § 972.

106. S. REP. NO. 111-176, at 147.

107. *Id.*

Olubunmi Faleye, for example, finds support for the hypothesis that firms actively weigh the costs and benefits of alternative leadership structures in their unique circumstances and concludes that requiring a one-size-fits-all model separating the CEO and chairman positions may be counterproductive.<sup>108</sup> Another study by James Brickley, Jeffrey Coles, and Gregg Jarrell found evidence “that the costs of separation are larger than the benefits for most large firms.”<sup>109</sup> As John Coates summarizes the field, the evidence is mixed, at best:

At least 34 separate studies of the differences in the performance of companies with split vs. unified chair/CEO positions have been conducted over the last 20 years, including two “meta-studies.” . . . The only clear lesson from these studies is that there has been no long-term trend or convergence on a split chair/CEO structure, and that variation in board leadership structure has persisted for decades, even in the UK, where a split chair/CEO structure is the norm.<sup>110</sup>

Although Coates concludes that splitting the CEO and chairman positions by legislation “may well be a good idea for larger companies,” he further concludes that mandating such a split “is not clearly a good idea for all public companies.”<sup>111</sup>

In my view, proponents of a mandatory nonexecutive chairman of the board have overstated the benefits of splitting the positions, while understating or even ignoring the costs of doing so. Michael Jensen identified the potential benefits in his 1993 Presidential Address to the American Finance Association, arguing that: “The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO. . . . Therefore, for the board to be effective, it is important to separate the CEO and chairman positions.”<sup>112</sup> In fact, however, overseeing the “hiring, firing, evaluating, and compensating the CEO” is the job of the board of directors as a whole, not just the chairman of the board.

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108. See Olubunmi Faleye, *Does One Hat Fit All? The Case of Corporate Leadership Structure*, 11 *J. MGMT. & GOVERNANCE* 239, 239 (2007).

109. James A. Brickley et al., *Leadership Structure: Separating the CEO and Chairman of the Board*, 3 *J. CORP. FIN.* 189, 189 (1997).

110. *Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 47–48 (2009) (statement of John C. Coates IV, Professor of Law & Economics, Harvard Law School).

111. *Id.* at 49.

112. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 *J. FIN.* 831, 866 (1993).

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To be sure, in many corporations, the chairman of the board is given unique powers to call special meetings, set the board agenda, and the like.<sup>113</sup> In such companies, a dual CEO-chairman does wield powers that may impede board oversight of his or her performance. Yet, in such companies, the problem is not that one person holds both posts; the problem is that the independent members of the board of directors have delegated too much power to the chairman. The solution is to adopt by-laws that allow the independent board members to call special meetings, require them to meet periodically outside the presence of managers, and the like.

Turning from the benefit side to the cost side of the equation, even if splitting the posts makes it easier for the board to monitor the CEO, the board now has the new problem of monitoring a powerful nonexecutive chairman. The board now must expend effort to ensure that such a chairman does not use the position to extract rents from the company and, moreover, that the chairman expends the effort necessary to carry out the post's duties effectively. The board also must ensure that a dysfunctional rivalry does not arise between the chairman and the CEO, both of whom presumably will be ambitious and highly capable individuals. In other words, if the problem is "who watches the watchers?" splitting the two posts simply creates a second watcher who also must be watched.

In addition, a nonexecutive chairman inevitably will be less well informed than a CEO. Such a chairman therefore will be less able to lead the board in performing its advisory and networking roles. Likewise, such a chairman will be less effective in leading the board in monitoring top managers below the CEO, because the chairman will not know those managers as intimately as the CEO.

### 3. Summary

In sum, corporate governance is not an arena in which one size fits all. Different firms have different governance needs. Boards of directors should be free to select the governance structures optimal for their unique firm without being shamed

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113. See James Verdonik & Kirby Happer, *Role of the Chairman of the Board*, CORP. DIRECTORS F., <http://www.directorsforum.com/resources/pdf/role-of-the-chairman-verdonik-happer.pdf> (last visited Apr. 8, 2011) (explaining that "one of the duties of the Chairman is to call meetings of the Board of Directors and the shareholders" and that "Chairmen often set the agenda for Board meetings").

by therapeutic disclosure. Yet, this is precisely what Dodd-Frank does.

Even setting aside the unique foibles of Dodd-Frank's provisions, which surely qualify them as quack corporate governance, therapeutic disclosure almost always qualifies as such for more general reasons. Seeking to effect substantive goals through disclosure requirements is inconsistent with the original congressional intent behind the federal securities laws. When the New Deal-era Congresses adopted the Securities Act and the Securities Exchange Act, there were three possible statutory approaches under consideration: (1) the fraud model, which would simply prohibit fraud in the sale of securities; (2) the disclosure model, which would allow issuers to sell very risky or even unsound securities, provided they gave buyers enough information to make an informed investment decision; and (3) the blue sky model, pursuant to which the SEC would engage in merit review of a security and its issuer.<sup>114</sup> The federal securities laws adopted a mixture of the first two approaches, but explicitly rejected federal merit review.<sup>115</sup> As such, the substantive behavior of corporate issuers was never intended to be part of the federal scheme; instead, the substance of corporate governance was left to the states.<sup>116</sup> Therapeutic disclosure violates that scheme by de facto preempting state law, which is just as problematic as preemption by substantive regulation.

The criteria for quack corporate governance are thus satisfied. The various forms of therapeutic disclosure were supported by institutional investors, who are more powerful at the federal than state level and for whom some of these proposals are long-standing goals, some of the provisions de facto federalize aspects of corporate governance, and the provisions are likely to prove unwise from a cost-benefit perspective.

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114. See BAINBRIDGE, *supra* note 83, at 17 (describing these models).

115. See *Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130–31 (7th Cir. 1993) (“Federal securities law does not include ‘merit regulation.’”); Symposium, *New Approaches to Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505, 505 (1973) (“The Securities Act of 1933 was really a ‘rotten egg statute.’ You could sell all the rotten eggs you wanted if you told people fully how rotten they were.” (quoting panelist A.A. Sommer, Jr.)).

116. See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 503 (7th Cir. 1989) (“Federal securities laws frequently regulate process while state corporate law regulates substance.”).

## B. PROXY ACCESS

Dodd-Frank section 971 affirms that the SEC has authority to adopt proposed proxy access rules.<sup>117</sup> It does not require that the SEC do so.<sup>118</sup> If the SEC does so, however, Congress intends that the SEC should have “wide latitude in setting the terms of such proxy access.”<sup>119</sup> In particular, section 971 expressly authorizes the SEC to exempt “an issuer or class of issuers” from any proxy access rule and specifically requires the SEC to “take into account, among other considerations, whether [proxy access] disproportionately burdens small issuers.”<sup>120</sup>

Proxy access is a long-standing goal of shareholder activists, especially among the institutional investor community. Not surprisingly, it was supported by policy entrepreneurs from the CII and “[a] coalition of state public officials in charge of public investments, AFSCME, CalPERS, and the Investor’s Working Group.”<sup>121</sup>

Section 971 probably was unnecessary. An SEC rulemaking proceeding on proxy access was well advanced long before Dodd-Frank was adopted, so a shove from Congress was superfluous. Although the SEC lacks authority to regulate the substance of shareholder voting rights, proxy access almost certainly fell within the disclosure and process sphere over which the SEC has unquestioned authority.<sup>122</sup> By adopting section 971, however, Congress did preempt an expected challenge to any forthcoming SEC regulation.<sup>123</sup>

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117. S. REP. NO. 111-176, at 146 (2010) (discussing the proxy access provision, then numbered section 972).

118. *Id.*

119. *Id.*

120. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971(c), 124 Stat. 1376, 1915 (2010).

121. S. REP. NO. 111-176, at 147. Former SEC Commissioner Paul Atkins observed that “[u]nions and special-interest groups successfully lobbied Congress to include a provision in the recent Dodd-Frank Act to empower the SEC to make rules regarding proxy access.” Paul Atkins, *The SEC’s Sop to Unions*, WALL ST. J., Aug. 27, 2010, at A15. The special interests he identified are “politically powerful trade-union activists, self-nominated shareholder-rights advocates, [and] trial lawyers.” *Id.*

122. See Stephen M. Bainbridge, *The Scope of the SEC’s Authority over Shareholder Voting Rights*, ENGAGE, June 2007, at 25 (analyzing relevant case law and legislative history).

123. Broc Romanek, *It’s Coming: SEC to Consider Proxy Access on Wednesday*, CORPORATECOUNSEL.NET (Aug. 19, 2010, 7:44 AM), <http://www.thecorporatecounsel.net/Blog/2010/08/shareholder-engagement-uk-style-recently-1.html> (noting that “the US Chamber of Commerce may be gearing up to sue if the SEC approves access”).

In any case, on August 25, 2010, the SEC released a proposed proxy access rule.<sup>124</sup> Newly adopted Rule 14a-11 will require companies to include in their proxy materials, alongside the nominees of the incumbent board, the nominees of shareholders who own at least three percent of the company's shares and have done so continuously for at least the prior three years.<sup>125</sup> A shareholder may only put forward a short slate consisting of at least one nominee or up to twenty-five percent of the company's board of directors, whichever is greater.<sup>126</sup> Application of the rule to small companies will be deferred for three years, while the SEC studies its impact.<sup>127</sup>

Because proxy access's effect will be to increase the number of short slates, albeit to an uncertain extent, its impact on corporate governance likely will be analogous to that of cumulative voting. Both result in divided boards representing differing constituencies. In turn, while some firms might benefit from the presence of skeptical outsider viewpoints, divided boards are likely to be dominated by adversarial relations between the majority block and the minority of shareholder nominees.<sup>128</sup>

The likely effects of proxy access therefore will not be better governance. It is more likely to be an increase in interpersonal conflict (as opposed to the more useful cognitive conflict). There probably will be a reduction in the trust-based relationships that causes horizontal monitoring within the board to provide effective constraints on agency costs.<sup>129</sup> There may also be an increase in the use by the majority of pre-meeting caucuses and a reduction in information flows to the board as a whole.<sup>130</sup>

As SEC Commissioner Troy Paredes pointed out in dissenting from adoption of new Rule 14a-11, moreover, proxy access

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124. See Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

125. See *id.* at 56,688.

126. See *id.* at 56,675.

127. See *id.* at 56,686–88.

128. See BAINBRIDGE, *supra* note 83, at 445–46 (“Opponents of cumulative voting argue it produces an adversarial board . . .”).

129. Cf. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 35–38 (2002) (discussing how trust and cooperation norms affect horizontal monitoring within the board).

130. Cf. BAINBRIDGE, *supra* note 83, at 445–46 (“Opponents of cumulative voting argue it . . . results in critical decisions being made in private meetings held by the majority faction before the formal board meeting.”).

marks a considerable displacement of state corporate law by federal securities regulation: “Rule 14a-11’s immutability conflicts with state law. Rule 14a-11 is not limited to facilitating the ability of shareholders to exercise their state law rights, but instead confers upon shareholders a new substantive federal right that in many respects runs counter to what state corporate law otherwise provides.”<sup>131</sup> Commissioner Paredes further pointed out that:

The mixed empirical results do not support the Commission’s decision to impose a one-size-fits-all minimum right of access. Some studies have shown that certain means of enhancing corporate accountability, such as de-staggering boards, may increase firm value, but these studies do not test the impact of proxy access specifically. Accordingly, what the Commission properly can infer from these data is limited and, in any event, other studies show competing results. Recent economic work examining proxy access specifically is of particular interest in that the findings suggest that the costs of proxy access may outweigh the potential benefits, although the results are not uniform. The net effect of proxy access—be it for better or for worse—would seem to vary based on a company’s particular characteristics and circumstances.

To my mind, the adopting release’s treatment of the economic studies is not evenhanded. The release goes to some length in questioning studies that call the benefits of proxy access into doubt—critiquing the authors’ methodologies, noting that the studies’ results are open to interpretation, and cautioning against drawing “sharp inferences” from the data. By way of contrast, the release too readily embraces and extrapolates from the studies it characterizes as supporting the rulemaking, as if these studies were on point and above critique when in fact they are not.<sup>132</sup>

SEC Commissioner Kathleen Casey pointed out in dissent that the new rule favors a specific interest group:

The paradigm of a power struggle between directors and shareholders is one that activist, largely institutional, investors assiduously promote, and this rule illustrates a troubling trend in our recent and ongoing rulemaking in favor of empowering these shareholders through, among other things, increasingly federalized corporate governance requirements. Yet, these shareholders do not necessarily represent the interests of all shareholders, and the Commission betrays its mission when it treats these investors as a proxy for all shareholders.<sup>133</sup>

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131. Troy A. Paredes, Comm’r, U.S. Sec. & Exch. Comm’n, Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations (“Proxy Access”) (Aug. 25, 2010), *available at* <http://www.sec.gov/news/speech/2010/spch082510tap.htm>.

132. *Id.*

133. Kathleen L. Casey, Comm’r, U.S. Sec. & Exch. Comm’n, Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Di-

In sum, proxy access is bad public policy, unsupported by the empirical evidence, and the pet project of a powerful interest group. As we have seen, these are the characteristics of quack corporate governance.

### C. EXECUTIVE COMPENSATION

#### 1. Independent Compensation Committees

Section 952 contains a number of provisions relating to compensation committees, including a directive that the SEC direct the self-regulatory organizations (SROs) to adopt listing standards requiring that each member of an issuer's compensation committee be independent.<sup>134</sup> This provision was supported by CII, which argued that the bill should “ensure that compensation committees are free of conflicts and receive unbiased advice.”<sup>135</sup> Once again we see another one-size-fits-all model being forced on all public companies. Once again the mandate lacks support in the empirical evidence. Most empirical studies have rejected the hypothesis that compensation committee independence is positively correlated with firm performance or with improved CEO compensation practices.<sup>136</sup>

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rector Nominations (Aug. 25, 2010), *available at* <http://www.sec.gov/news/speech/2010/spch082510klc.htm>.

134. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952(a), 124 Stat. 1376, 1900-03 (2010). “In the context of securities regulation, the two main self-regulatory organizations are National Association of Securities Dealers and the national stock exchanges. These SROs are given the authority and responsibility to enforce standards and requirements related to their securities trading and brokerage practices . . . .” Christopher M. Wood, *Federalism in Securities Regulation: A Brief Introduction and Reflection*, 40 U.S.F. L. REV. 795, 796 n.7 (2006).

Curiously, there is disagreement as to whether section 952 mandates that SRO listing standards require all listed companies to have an independent compensation committee. *See* Stephen M. Bainbridge, *A Question re Compensation Committees Under Dodd Frank 952*, PROFESSORBAINBRIDGE.COM (Sept. 14, 2010, 12:47 PM), <http://www.professorbainbridge.com/professorbainbridge.com/2010/09/a-question-re-compensation-committees-under-dodd-frank-952.html> (citing authorities on both sides of the debate). The issue has salience because current NASDAQ listing standards permit executive compensation decisions to be made either by a committee comprised solely of independent directors or by a majority of the independent directors. *See id.* (discussing relevant standards). Nothing in section 952 or the Senate Committee report addresses explicitly the status of those standards, thereby creating some uncertainty. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; S. REP. NO. 111-176 (2010).

135. S. REP. NO. 111-176, at 135.

136. *See* Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1582-83 (2005) (reviewing studies).

## 2. Clawbacks

Dodd-Frank section 954 adds a new section 10D to the Securities Exchange Act, pursuant to which the SEC is instructed to direct the SROs to require their listed companies to disclose company policies for clawing back incentive-based compensation paid to current or former executive officers in the event of a restatement of the company's financials due to material non-compliance with any federal securities law financial reporting requirement.<sup>137</sup> Issuers failing to adopt such a policy must be delisted.<sup>138</sup> The requisite policy must provide for clawing back any "excess" compensation any such executive officer received during the three-year period prior to the date on which the issuer was obliged to issue the restatement.<sup>139</sup> Excess compensation is defined as the difference between what the executive was paid and what the executive would have received if the financials had been correct.<sup>140</sup>

Section 954 is seriously flawed in a number of respects. On the one hand, as a deterrent to financial reporting fraud and error, it is overinclusive. It encompasses all executive officers, without regard to their responsibility or lack thereof for the financial statement in question. Some innocent executives therefore will have to forfeit significant amounts of pay. On the other hand, it is underinclusive. Executive officers include an issuer's "president, any vice president . . . in charge of a principal business unit, division or function . . . , any other officer who performs a policy making function or any other person who performs similar policy making functions."<sup>141</sup> As the Senate Committee acknowledged, the policy therefore applies only to a "very limited number of employees."<sup>142</sup> The trouble with this limitation is that "decisions of individuals such as proprietary traders, who may well not be among" an issuer's executive officers, nevertheless "can adversely affect, indeed implode, a firm."<sup>143</sup>

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137. Dodd-Frank Wall Street Reform and Consumer Protection Act § 954.

138. S. REP. NO. 111-176, at 135.

139. Dodd-Frank Wall Street Reform and Consumer Protection Act § 954.

140. *Id.*

141. 17 C.F.R. § 240.3b-7 (2010).

142. S. REP. NO. 111-176, at 136.

143. Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 366 (2009).

Another concern is the high probability of unintended consequences. In response to SOX's much narrower clawback provision, "companies increased non-forfeitable, fixed-salary compensation and decreased incentive compensation, thereby providing insurance to managers for increased risk."<sup>144</sup> Because current federal policy seeks to promote pay-for-performance, mandatory clawbacks undermine that goal.<sup>145</sup> There is a significant risk, moreover, that other unintended consequences will develop in light of the "many ambiguities in the legislative language which will have to be clarified in implementing SEC regulations, e.g., [.] is it retroactive, how to calculate recoverable amount, the dates during which the recovery must be sought."<sup>146</sup>

### 3. Say-on-Pay

Dodd-Frank section 951 creates a new section 14A of the Securities Exchange Act, pursuant to which reporting companies must conduct a shareholder advisory vote on specified executive compensation not less frequently than every three years.<sup>147</sup> At least once every six years, shareholders must vote on how frequently to hold such an advisory vote (i.e., annually, biannually, or triannually).<sup>148</sup> The compensation arrangements subject to the shareholder vote are those set out in Item 402 of Regulation S-K.<sup>149</sup> In addition, a shareholder advisory is required of golden parachutes.<sup>150</sup> The vote must be tabulated and disclosed, but is not binding on the board of directors.<sup>151</sup> The vote shall not be deemed either to effect or affect the fiduciary

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144. *Id.*

145. *See id.* ("As critics of executive compensation, including President Obama, object to large pay packages that are independent of performance, firms' adaptation to the clawback provisions had precisely the opposite effect of what they would wish to see of a pay package.")

146. Ben W. Heineman, Jr., *Making Sense Out of "Clawbacks,"* HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 13, 2010, 4:10 PM), <http://blogs.law.harvard.edu/corpgov/2010/08/13/making-sense-out-of-clawbacks/>.

147. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-900 (2010).

148. *Id.*

149. *See id.* (requiring a vote "to approve the compensation of executives, as disclosed pursuant to section 229.402 of title 17, Code of Federal Regulations, or any successor thereto").

150. *See id.*

151. S. REP. NO. 111-176, at 133 (2010).

duties of directors.<sup>152</sup> The SEC is given exemption power and is specifically directed to evaluate the impact on small issuers.<sup>153</sup>

Say-on-pay was highly contentious. Supporters included the CII, “the Consumer Federation of America, AFSCME, and the Investor’s Working Group.”<sup>154</sup> It is a long-standing goal of the AFL-CIO.<sup>155</sup> Business groups, such as the Business Roundtable<sup>156</sup> and the U.S. Chamber of Commerce, have long opposed it.<sup>157</sup>

*a. Is There an Executive Compensation Crisis?*

The core argument for say-on-pay is that executive compensation has been decoupled from the financial performance of their firms. As the Senate committee put it, “[t]he economic crisis revealed instances in which corporate executives received very high compensation despite the very poor performance by their firms.”<sup>158</sup>

House Report 110-88, which accompanied an earlier say-on-pay bill, explained that in FY 2005 the median CEO among 1400 large companies “received \$13.51 million in total compensation, up 16 percent over FY 2004.”<sup>159</sup> The Report also noted that “in 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500 to 1.”<sup>160</sup> Yet, it is difficult to describe those amounts as constituting a crisis in and of themselves when many occupations today carry even larger rewards. The highest-paid investment banker on Wall Street in 2006 was Lloyd Blankfein of Goldman Sachs, for example, who “earned \$54.3 million in salary, cash, restricted stock and stock options,”<sup>161</sup> or about four times the median CEO salary from the year before. But the pay of some private hedge fund managers dwarfed even

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152. Dodd-Frank Wall Street Reform and Consumer Protection Act § 951.

153. *Id.*

154. S. REP. NO. 111-176, at 134.

155. Doug Halonen, *Retirement Policy Is Unlikely to Be Part of GOP Convention*, PENSIONS & INVESTMENTS, Sept. 1, 2008, at 3.

156. *Id.*

157. Del Jones, *CEOs Openly Pull Against Say-on-Pay*, USA TODAY, July 16, 2009, at 1B, available at 2009 WLNR 13548976.

158. S. REP. NO. 111-176, at 133.

159. H.R. REP. NO. 110-88, at 3 (2007).

160. *Id.*

161. Jenny Anderson & Julie Creswell, *Make Less than \$240 Million? You're Off Top Hedge Fund List*, N.Y. TIMES, Apr. 24, 2007, at A1, available at 2007 WLNR 7686080.

that sum. Hedge fund manager James Simons earned \$1.7 billion in 2006, for example, and two other hedge fund managers also cracked the billion dollar level that year.<sup>162</sup>

Instead, the crisis argument rests on two premises. First, that top executive compensation is not set through arms-length negotiations. Instead, top managers have effectively captured the boards of directors who nominally set their pay.<sup>163</sup> Second, “managers have used their influence [over corporate boards of directors] to obtain higher compensation through arrangements that have substantially decoupled pay from performance.”<sup>164</sup> In other words, the executive compensation scandal is not the rapid growth of management pay in recent years, but rather the failure of compensation schemes to award high pay only for top performance.

The literature on this topic is immense. Suffice it to say that the foregoing claims are highly contested. There is evidence, for example, “that in many settings where ‘managerial power’ exists, observed [compensation] contracts anticipate and try to minimize the costs of this power, and therefore may in fact be written optimally.”<sup>165</sup> A careful review of the empirical literature concludes that “most of the results” cited by those who “postulate managerial dominance turn out to be consistent with a less sinister explanation.”<sup>166</sup> In addition, “CEO compensation has risen sharply (and paradoxically) at a time when boards are increasing their independence, CEO tenure is declining, and accounting rules are becoming more transparent. Under the managerial power approach, which requires tame boards, entrenched CEOs, and opaque reporting, this should not happen.”<sup>167</sup> A third study found that “[t]he sixfold increase in CEO pay between 1980 and 2003 can be attributed to the sixfold increase in market capitalization of large U.S. compa-

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162. *Id.*

163. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 5 (2004) (arguing that “directors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation”).

164. *Id.* at 6.

165. John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1160 (2005).

166. Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 165 (2003).

167. *Id.* at 133 (footnotes omitted).

nies during that time period.”<sup>168</sup> In other words, CEOs got richer because their shareholders got richer. Indeed,

[t]he fact that shareholders of U.S. companies earned higher returns *even after* payments to management does not support the claim that the U.S. executive pay system is designed inefficiently; if anything, shareholders appear better off with the U.S. system of executive pay than with the systems that prevail in other countries.<sup>169</sup>

In sum, there has not been closure on the executive compensation debate. The core premise behind say-on-pay remains, at best, unproven. As such, the case for regulation simply had not been made.

b. *Will It Work?*

The effectiveness of say-on-pay is highly contested. The Senate committee report argued that:

The UK has implemented “say on pay” policy. Professor John Coates in testimony for the Senate Banking Committee stated that the UK’s experience has been positive; “different researchers have conducted several investigations of this kind . . . . These findings suggest that say-on-pay legislation would have a positive impact on corporate governance in the U.S. While the two legal contexts are not identical, there is no evidence in the existing literature to suggest that the differences would turn what would be a good idea in the UK into a bad one in the U.S.”<sup>170</sup>

In contrast, Professor Jeffrey Gordon argues that the U.K. experience with say-on-pay makes a mandatory vote a “dubious choice.”<sup>171</sup> First, because individualized review of compensation schemes at the 10,000-odd U.S. reporting companies will be prohibitively expensive, activist institutional investors will probably insist on a narrow range of compensation programs that will force companies into something close to a one-size-fits-all model.<sup>172</sup> Second, because many institutional investors rely on proxy advisory firms, a very small number of gatekeepers will wield undue influence over compensation.<sup>173</sup> This likely

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168. Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49, 50 (2008).

169. Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong* 4 (European Corporate Governance Inst., Finance Working Paper No. 23/2003, 2003), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=441100](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441100).

170. S. REP. NO. 111-176, at 134 (2010).

171. Jeffrey N. Gordon, “*Say on Pay*”: *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in*, 46 HARV. J. ON LEGIS. 323, 325 (2009).

172. *Id.*

173. *Id.* at 326.

outcome seriously undercuts the case for say-on-pay. As we have seen, proponents of say-on-pay claim it will help make management more accountable, but they ignore the probability that say-on-pay really will shift power from boards of directors not to shareholders but to advisory firms like RiskMetrics.<sup>174</sup> There is good reason to think that boards are more accountable than those firms. “The most important proxy advisor, RiskMetrics, already faces conflict issues in its dual role of both advising and rating firms on corporate governance that will be greatly magnified when it begins to rate firms on their compensation plans.”<sup>175</sup> Ironically, the only constraint on RiskMetrics’ conflict is the market (i.e., the possibility that they will lose credibility and therefore customers), “the very force most shareholder power proponents claim [does not] work when it comes to holding management accountable.”<sup>176</sup>

As for the U.K. experience, Gordon’s review of the empirical evidence finds that shareholders almost invariably approve the compensation packages put to a vote.<sup>177</sup> He further finds that while there is some evidence that pay-for-performance sensitivity has increased in the United Kingdom, executive compensation has continued to rise “significantly” there.<sup>178</sup> Indeed, the growth rate for long-term incentive plans has been “higher” than in the United States.<sup>179</sup>

Gordon concludes “that ‘say on pay’ has some downsides even in the United Kingdom, downsides that would be exacerbated by a simple transplant into the United States.”<sup>180</sup> He recommended that any federal rule be limited to an opt-in regime or, if some form of mandatory regime was politically necessary,

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174. See Stephen M. Bainbridge, *Will the Unaccountable Power of RiskMetrics Put Teeth in the Dodd Bill’s Say on Pay Provision?*, PROFESSOR-BAINBRIDGE.COM (Apr. 22, 2010, 4:32 PM), <http://www.professorbainbridge.com/professorbainbridge.com/2010/04/will-the-unaccountable-power-of-risk-metrics-put-teeth-in-the-dodd-bills-say-on-pay-provision.html>.

175. Gordon, *supra* note 171, at 326 (footnote omitted).

176. Bainbridge, *supra* note 174.

177. See Gordon, *supra* note 171, at 341 (explaining that “shareholders invariably approve the Directors Remuneration Report, with perhaps eight turndowns across thousands of votes over a six-year experience”). The same is true of the limited U.S. experience with voluntary say-on-pay. See *id.* at 339 (“The number of proposals grew only moderately [in 2008], to seventy, and the level of shareholder support has remained at the same level, approximately forty-two percent.”).

178. *Id.* at 341.

179. *Id.* at 344.

180. *Id.* at 367.

that it be limited to the very largest firms.<sup>181</sup> As we have seen, Congress went in a different direction, despite the considerable uncertainty as to whether say-on-pay will be effective.

*c. The Departure from Board Centrism*

There is no more basic question in corporate governance than “who decides.” Is a particular decision or oversight task to be assigned to the board of directors, management, or shareholders? Corporate law generally adopts what I have called “director primacy.”<sup>182</sup> It assigns decisionmaking to the board of directors or the managers to whom the board has properly delegated authority.<sup>183</sup> Under state law, executive compensation is no exception.<sup>184</sup>

To be sure, the say-on-pay provision contained in Dodd-Frank is only an advisory vote.<sup>185</sup> Yet, the logic of an advisory vote on pay seems to be the same as that underlying precatory shareholder proposals made pursuant to Rule 14a-8. Even though they are not binding, they are nevertheless expected to affect director decisions.<sup>186</sup>

Say-on-pay is just one small piece of the shareholder activists’ agenda,<sup>187</sup> moreover. As we have seen, Dodd-Frank presages the accomplishment of another of those agenda items by authorizing the SEC to go forward with proxy access.<sup>188</sup>

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181. See *id.* (setting out recommendations). Gordon’s proposal finds support in a recent behavioral economics laboratory experiment finding that say-on-pay has a more positive impact on investors when it is voluntarily effected by companies than when it is mandated. See Kendall O. Bowlin et al., *Say-on-Pay and the Differential Effects of Voluntary Versus Mandatory Regimes on Investor Perceptions and Behavior* 3–4 (Aug. 16, 2010) (unpublished meeting paper), available at <http://ssrn.com/abstract=1659862>.

182. BAINBRIDGE, *supra* note 83, at 198.

183. See DEL. CODE ANN. tit. 8, § 141(a) (2001) (stating that the corporation’s “business and affairs . . . shall be managed by or under the direction of a board of directors”).

184. See, e.g., *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 55–60 (Del. 2006) (analyzing whether the board and the compensation committee complied with their fiduciary duties in setting executive compensation).

185. See *supra* text accompanying note 151.

186. See Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1065–67 (1999) (finding some support for the claim that nonbinding shareholder proposals affect compensation outcomes).

187. See *supra* text accompanying notes 154–55 (noting activist investor support for say-on-pay).

188. See *supra* text accompanying note 121 (noting activist investor support for proxy access).

Another of the activists' agenda items was recently achieved when states began changing their corporation statutes to allow the use of majority voting in election of directors.<sup>189</sup>

[In sum, there have been] a number of important developments—including increased institutional investing, changes in federal proxy law, the creation of shareholder advisory services, the rise of activist hedge funds, and financial innovations that can magnify activists' voting power—[that] have worked together to significantly shift the balance of power in public firms away from executives and boards and toward activist shareholders. The trend seems likely only to continue as would-be reformers push to increase shareholder power further.<sup>190</sup>

Because even an advisory say-on-pay vote is part of this package of what Cardozo called, albeit in a different context, “the ‘disintegrating erosion’ of particular exceptions”<sup>191</sup> by which director primacy is slowly being undermined, it is worth reminding ourselves why board-centric corporate governance has value.

The case for board centrism is grounded in Kenneth Arrow's work on organizational decisionmaking, which identified two basic decisionmaking mechanisms: “consensus” and “authority.”<sup>192</sup> Organizations use some form of consensus-based decisionmaking when each voting stakeholder in the organization has comparable access to information and similar interests.<sup>193</sup> In the absence of information asymmetries and conflicting interests, collective decisionmaking can take place at relatively low cost.<sup>194</sup> In contrast, organizations resort to authority-based decisionmaking structures where stakeholders have conflicting interests and asymmetrical access to information.<sup>195</sup> In such organizations, information is funneled to a cen-

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189. See J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 *BUS. LAW.* 1007, 1009–12 (2007) (discussing a 2006 amendment to Delaware's corporate statute authorizing bylaw amendments relating to majority voting for the board of directors).

190. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 *STAN. L. REV.* 1255, 1261 (2008).

191. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (quoting *Wendt v. Fischer*, 154 N.E. 303, 304 (N.Y. 1926)).

192. KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 68–70 (1974).

193. See BAINBRIDGE, *supra* note 83, at 192 (discussing preconditions for the use of consensus).

194. See *id.* (discussing decisionmaking in partnerships).

195. See *id.* at 201 (discussing preconditions for use of authority-based decisionmaking).

tral agency empowered to make decisions binding on the whole organization.<sup>196</sup>

Small business firms typically use some form of consensus decisionmaking.<sup>197</sup> As firms grow in size, however, consensus-based decisionmaking systems become less practical and, by the time we reach the publicly held corporation, their use becomes essentially impractical.<sup>198</sup> Hence, it is hardly surprising that “a publicly held corporation’s decisionmaking structure is principally an authority-based one.”<sup>199</sup> Shareholders have neither the information nor the incentives necessary to make sound decisions on either operational or policy questions.<sup>200</sup> Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly.<sup>201</sup> Rather, shareholders should prefer to irrevocably delegate decisionmaking authority to some smaller group.<sup>202</sup>

Granted, the resulting “separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge.”<sup>203</sup> Corporate governance therefore necessarily must include measures by which to hold directors and managers accountable, of which shareholder voting is one.<sup>204</sup> In a complete theory of the firm, neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organ-

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196. *See id.* (noting the use of a “central office”).

197. *See id.* at 192 (discussing partnerships).

198. *See generally* Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1055–75 (1998) (explaining the necessity of authority-based governance in public corporations).

199. BAINBRIDGE, *supra* note 83, at 192.

200. *See* Bainbridge, *supra* note 198, at 1057–60 (identifying the conflicting interests and access to information of corporate constituents).

201. *Id.* at 1056.

202. As Arrow explains, under conditions of disparate access to information and conflicting interests, it is “cheaper and more efficient to transmit all the pieces of information to a central place” and to have the central office “make the collective decision and transmit it rather than retransmit all the information on which the decision is based.” ARROW, *supra* note 192, at 68–69. In the dominant M-form corporation, the board of directors and the senior management team function as that central office. *See* Bainbridge, *supra* note 198, at 1009 (discussing M-form corporations).

203. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1932).

204. *See, e.g.*, *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (“The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”).

izations.<sup>205</sup> At the same time, however, the power to hold to account is ultimately the power to decide.<sup>206</sup> Managers therefore cannot be made more accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question. Unfortunately, it is also a question no one in Congress appears to have pondered in connection with say-on-pay; instead, only accountability concerns seem to have mattered.<sup>207</sup>

#### 4. Summary

Dodd-Frank's executive compensation provisions are yet another example of quack corporate governance. They were strongly supported by institutional investors. In particular, say-on-pay is a long-standing institutional investor agenda item. They federalize matters previously left to state corporate law. They do so without strong empirical support. They are inconsistent with the board-centric model that has been the foundation of the U.S. corporate governance system's success.

#### D. THE SUSPECT POLICY ENTREPRENEURS

As already noted, the question of why the financial crisis of 2007–2008 occurred is beyond the scope of this work.<sup>208</sup> It seems clear, however, that systemic flaws in the corporate governance of Main Street corporations were not a causal factor in the housing bubble, the bursting of that bubble, or the subsequent credit crunch. To the contrary, “[a] striking aspect of the stock market meltdown of 2008 is that it occurred despite the strengthening of U.S. corporate governance over the past few decades and a reorientation toward the promotion of shareholder value.”<sup>209</sup> The problem necessitating remedial action was the need to address the moral hazard inherent in the idea that some firms were too big to fail.<sup>210</sup>

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205. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463–64 (1992).

206. See ARROW, *supra* note 192, at 77–78.

207. See S. REP. NO. 111-176, at 133–34 (2010) (discussing the need for legislation).

208. See *supra* text accompanying note 23.

209. Brian R. Cheffins, *Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 2 (2009).

210. See *id.* at 5 (“[A] case could be made that strict corporate governance requirements should be imposed on financial firms apparently ‘too big to fail.’ Subject to this potentially important caveat, . . . lawmakers should

What about Wall Street firms' corporate governance, however? Assuming for the sake of argument that flaws in the corporate governance of banks and financial institutions were a causal factor in the crisis,<sup>211</sup> that still would not explain the form Dodd-Frank took. Banks have a number of characteristics that make their corporate governance problems radically different than those of nonfinancial firms.<sup>212</sup> Yet, the provisions of Dodd-Frank addressed herein regulate the corporate governance of all public corporations, whether they are in the financial industry or not.

Instead, Dodd-Frank's corporate governance provisions were included in the legislation because key policy entrepreneurs were able to hijack the legislative process to advance a long-standing political agenda. Specifically, as we have seen, all the major governance provisions were strongly supported by activists in the institutional investor community, especially union and state and local pension funds, for whom such items as proxy access and say-on-pay were high priority agenda items.<sup>213</sup>

It seems reasonable to assume that these same activist investors will be the shareholders most likely to make use of their new powers.<sup>214</sup> The interests of these activists, however, are likely to differ significantly from those of retail investors or even other institutions. Indeed, union and state and local pension funds are precisely the shareholders most likely to use their position to self-deal (i.e., to take a non-pro rata share of the firm's assets and earnings) or to otherwise reap private benefits not shared with other investors. With respect to union

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refrain from introducing wholesale changes to the corporate governance scheme currently in place.”).

211. See, e.g., Peter O. Mülbart, *Corporate Governance of Banks After the Financial Crisis: Theory, Evidence, Reforms* 8–9 (European Corporate Governance Inst., Law Working Paper No. 130/2009, 2010), available at <http://ssrn.com/abstract=1448118> (discussing claims by legislators, regulators, and opinionmakers that bank corporate governance failures contributed to the crisis).

212. See generally *id.* at 10–14 (identifying major differences).

213. See Tomoeh Murakami Tse, *Activist Investors Rally to Reclaim Power*, WASH. POST, Mar. 20, 2010, at A11 (describing lobbying efforts by activist investors on issues like say-on-pay and proxy access).

214. As I have noted elsewhere, “activism is principally the province of a very limited group of institutions. Almost exclusively, the activists are union and state employee pension funds. They are the ones using shareholder proposals to pressure management. They are the ones most likely to seek board representation.” Stephen M. Bainbridge, *Pension Funds Play Politics*, TCS DAILY (Apr. 21, 2004), [http://www.ideasinactiontv.com/tcs\\_daily/2004/04/pension-funds-play-politics.html](http://www.ideasinactiontv.com/tcs_daily/2004/04/pension-funds-play-politics.html).

and public pension fund sponsorship of shareholder proposals under existing law, for example, Roberta Romano observes:

It is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. The disparity in identity of sponsors—the predominance of public and union funds, which, in contrast to private sector funds, are not in competition for investor dollars—is strongly suggestive of their presence. Examples of potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, as well as advancements in personal employment . . . . Because such career concerns—enhancement of political reputations or subsequent employment opportunities—do not provide a commensurate benefit to private fund managers, we do not find them engaging in investor activism.<sup>215</sup>

This is not just academic speculation. The pension fund of the union representing Safeway workers, for example, used its position as a Safeway shareholder in an attempt to oust directors who had stood up to the union in collective bargaining negotiations.<sup>216</sup> Union pension funds reportedly have also tried shareholder proposals to obtain employee benefits they could not get through bargaining.<sup>217</sup>

SEC Commissioner Casey echoed these concerns in her dissent from the SEC's adoption of proxy access:

I believe many [investor] activists will concede that their interests in proxy access do not lie solely in the ability to successfully place a nominee on a company's board of directors; instead, the proxy access right is also an important means of obtaining leverage to seek outcomes outside of the boardroom that may otherwise not be achievable—outcomes that are often unrelated to shareholder value maximization.<sup>218</sup>

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215. Roberta Romano, *Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance*, 18 *YALE J. ON REG.* 174, 231–32 (2001) (footnote omitted). None of this is to deny, of course, that union, state, and local pension funds also often have interests that converge generally with those of investors. See Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 *MICH. L. REV.* 1018, 1078–80 (1998).

216. See Bainbridge, *supra* note 214.

217. *Id.*

218. Casey, *supra* note 133. Former SEC Commissioner Paul Atkins likewise argues that:

It's no coincidence that only unions and cause-driven, minority shareholders want this coveted access. They would use it to advance their own labor, social and environmental agendas instead of the corporation's goal of maximizing long-term shareholder wealth. The rule will give them pressure points with which to hold companies hostage until their pet issues are addressed.

Atkins, *supra* note 121.

What we have in Dodd-Frank thus is a bubble law designed to promote rent seeking by a powerful interest group, which is a defining characteristic of quack corporate governance.

#### E. THE ILLOGICAL BASIC PREMISE

The proposition that Dodd-Frank's corporate governance provisions were a sop to special interests is further confirmed by the odd disconnect between the internal logic of those provisions and the back story of the financial crisis. Consider, for example, the question of executive compensation. Regulators identified executive compensation schemes that focused bank managers on short-term returns to shareholders as a contributing factor almost from the outset of the financial crisis.<sup>219</sup> As was the case with almost all public U.S. corporations, banks and other financial institutions shifted in the 1990s to a much greater reliance on equity-based pay-for-performance compensation schemes.<sup>220</sup> The rationale for such schemes is that they align the risk preferences of managers and shareholders. Because managers typically hold less well-diversified portfolios than shareholders, having significant investments of both human and financial capital in their employers, they tend to be much more averse to firm-specific risk than diversified investors would prefer.<sup>221</sup> Pay-for-performance compensation schemes that link managerial compensation to shareholder returns are designed to counteract that inherent bias against risk and thus align managerial risk preferences with those of shareholders.<sup>222</sup>

As already noted, shareholder activists long have complained that these schemes provide pay without performance.<sup>223</sup> This was one of the corporate governance flaws Dodd-Frank was intended to address, most notably via say-on-pay.<sup>224</sup>

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219. See Mülbart, *supra* note 211, at 8.

220. See Gordon, *supra* note 171, at 363–67 (discussing compensation practices of banks precrisis).

221. See GERHARD SCHROECK, RISK MANAGEMENT AND VALUE CREATION IN FINANCIAL INSTITUTIONS 83–86 (2002) (discussing managerial risk aversion).

222. Frederick Tung, *The Great Bailout of 2008–09*, 25 EMORY BANKR. DEV. J. 333, 340 (2009) (arguing that “[w]hen you pay managers of banks with equity, you increase their risk-taking incentives by giving them a direct equity stake in the upside payoff from taking big risks”).

223. See *supra* text accompanying note 164 (discussing how pay and performance purportedly decoupled).

224. See *supra* text accompanying note 158 (quoting the Senate Committee report's discussion of the need for pay-for-performance in the context of say-on-pay).

The trouble, of course, is that shareholders and society do not have the same goals when it comes to executive pay. Society wants managers to be more risk averse. Shareholders want them to be less risk averse, for the reasons just discussed.<sup>225</sup> If say-on-pay and other shareholder empowerment provisions of Dodd-Frank succeed, manager and shareholder interests will be further aligned, which will encourage the former to undertake higher risks in the search for higher returns to shareholders.<sup>226</sup> Accordingly, as Christopher Bruner aptly observed, “the shareholder-empowerment position appears self-contradictory, essentially amounting to the claim that we must give shareholders more power because managers left to themselves have excessively focused on the shareholders’ interests.”<sup>227</sup>

In sum, the shareholder empowerment measures adopted before the crisis did nothing to prevent it and may well have contributed to it.<sup>228</sup> The new provisions included in Dodd-Frank thus are unlikely to prevent another such crisis and may even increase the odds of some similar crisis induced by excessive risk taking. Once again, it thus seems fair to regard Dodd-Frank as a classic example of a bubble law.

### III. CAN ANYTHING BE DONE?

In her critique of SOX, Roberta Romano concluded that:

The straightforward policy implication of this chasm between Congress’s action and the learning bearing on it is that the mandates should be rescinded. The easiest mechanism for operationalizing such a policy change would be to make the SOX mandates optional, i.e., statutory default rules that firms could choose whether to adopt. An alternative and more far-reaching approach, which has the advantage

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225. See *supra* text accompanying notes 221–22.

226. See Carl R. Chen et al., *Does Stock Option-Based Executive Compensation Induce Risk-Taking? An Analysis of the Banking Industry*, 30 J. BANKING & FIN. 915, 943 (2006) (arguing that the structure of executive compensation in the banking industry precrisis induced risk taking by managers); Kose John & Yiming Qian, *Incentive Features in CEO Compensation in the Banking Industry*, FRBNY ECON. POLY REV., Apr. 2003, at 109, 109 (arguing that if executive compensation induces the interests of managers to be “closely aligned with equity interests in banks, which are highly leveraged institutions, [management] will have strong incentives to undertake high-risk investments”).

227. Bruner, *supra* note 24, at 322.

228. Bruner observes that “features such as independent board chairs and ‘say on pay’ votes have been available to U.K. shareholders for years, yet evidently did little to prevent the crisis or mitigate its effects on the U.K. financial system.” *Id.* at 332–33. Indeed, “stock prices fell faster in Britain during 2008 than they did in the United States, underpinned by a banking crisis every bit as serious as America’s.” Cheffins, *supra* note 209, at 4 (footnote omitted).

of a greater likelihood of producing the default rules preferred by a majority of investors and issuers, would be to remove corporate governance provisions completely from federal law and remit those matters to the states. Finally, a more general implication concerns emergency legislation. It would be prudent for Congress, when legislating in crisis situations, to include statutory safeguards that would facilitate the correction of mismatched proposals by requiring, as in a sunset provision, revisiting the issue when more considered deliberation would be possible.<sup>229</sup>

In adopting Dodd-Frank, Congress ignored that advice.

The federal role in corporate governance thus appears to be a case of what Robert Higgs identified as the ratchet effect.<sup>230</sup> Higgs focused on wars and other major crises. In the case of the former, for example, there is typically a dramatic growth in the size of government, accompanied by higher taxes, greater regulation, and loss of civil liberties.<sup>231</sup> Once the war ends, government may shrink somewhat in size and power, but rarely back to prewar levels.<sup>232</sup> Just as a ratchet wrench works only in one direction, the size and scope of government tends to move in only one direction—upwards—because the interest groups that favored the changes now have an incentive to preserve the status quo, as do the bureaucrats who gained new powers and prestige. Hence, each crisis has the effect of ratcheting up the long-term size and scope of government.

We now observe the same pattern in corporate governance. As we have seen, the federal government rarely intrudes in this sphere except when there is a crisis.<sup>233</sup> At that point, policy entrepreneurs favoring federalization of corporate governance spring into action, hijacking the legislative response to the crisis to advance their agenda.<sup>234</sup> Although there may be some subsequent retreat, such as Dodd-Frank's section 404 relief for small reporting companies,<sup>235</sup> the overall trend has been for each major financial crisis of the last century to result in an expansion of the federal role.

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229. Romano, *supra* note 10, at 1594–95.

230. See ROBERT HIGGS, CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE GROWTH OF AMERICAN GOVERNMENT 73–74, 150–56 (1987) (describing the “ratchet” effect by which Congress increases not only the scale but also the scope of the federal government on a permanent basis).

231. See John Joseph Wallis, *The National Era*, in GOVERNMENT AND THE AMERICAN ECONOMY: A NEW HISTORY 148, 152 (2007).

232. See HIGGS, *supra* note 230, at 58–59.

233. See *supra* text accompanying note 38.

234. See *supra* notes 39–43.

235. See *supra* note 15 (describing the relief provision).

The take-home lesson thus is that the states—especially Delaware and the drafters of the Model Business Corporation Act—must do a better job of playing defense. The game must be played in Dover, not Washington. The interest groups that dominate Delaware politics must anticipate possible instances of federal intervention and proactively preempt them through new legislation or case law whenever possible. In addition, they must develop sufficient strength in Washington to successfully lobby against federal intervention. To be sure, the political dynamics described in Part I may render such a defensive strategy unavailing in times of crisis. If Delaware sits out future crises as it did in 2008, however, there will be no resistance to the steady federalization of corporate governance.

#### CONCLUSION

Like their predecessors in SOX, the six key corporate governance provisions of Dodd-Frank satisfy the key criteria of quack corporate governance. A powerful interest group coalition centered on activist institutional investors hijacked the legislative process so as to achieve long-standing policy goals essentially unrelated to the causes or consequences of the financial crisis that began back in 2007. Without exception, the proposals lack strong empirical or theoretical justification. To the contrary, there are theoretical and empirical reasons to believe that each will be at best bootless and most will be affirmatively bad public policy. Furthermore, each erodes the system of competitive federalism that is the unique genius of American corporate law by displacing state regulation with federal law. Unfortunately, this has become a recurring pattern whenever the federal government is moved to action by a new economic crisis. The federalization of corporate governance thus continues to creep ahead.