

2007

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Recommended Citation

Brett McDonnell, *Recent Skirmishes in the Battle Over Corporate Voting and Governance*, 2 J. BUS. & TECH. L. 349 (2007), available at https://scholarship.law.umn.edu/faculty_articles/118.

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BRETT H. MCDONNELL*

Recent Skirmishes in the Battle Over Corporate Voting and Governance

ABSTRACT

This Article considers how some recent developments affect our understanding of the relative superiority of our mixed federal system of corporate lawmaking as compared with either a purely state system or a purely national one. The mixed federal system can potentially capture the gains of efficiency, flexibility, and responsiveness from state competition, while using the threat and occasional reality of federal intervention to reduce Delaware's managerialist tendency. The Article argues that, on the whole, this story fits the reaction to the corporate scandals of the nineties. The Sarbanes-Oxley Act moved regulation in a less managerialist direction, and Delaware courts have responded, albeit subtly.

The Article also considers evidence for counter-stories. It may be that federal intervention has gone too far, and led to a worse outcome than the states would have achieved on their own. Some claim that Sarbanes-Oxley is an example of such unnecessary federal intervention. That might be true, but the evidence to date does not clearly support that conclusion. On the other side, the ongoing leading role of Delaware in corporate lawmaking might be inhibiting the system from reacting as well as a purely national system would. The Article considers this possibility in the context of developments in the regulation of shareholder access to corporate proxy material for making board nominations. This skirmish is continuing, but the latest battle, the Second Circuit opinion in *American Federation of State, County & Municipal Employees v. American International Group, Inc.*, suggests the mixed federal system is working pretty well.

I. INTRODUCTION

IN OUR MIXED FEDERAL SYSTEM, CORPORATE LAW IS SET AT BOTH the state and the national level. Several different decisionmakers work at each level. State legislatures and courts work at the state level. Congress, the President, the Securities and Exchange Commission (SEC), and the securities exchanges work at the national level.

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A question of much interest is how well that system works in creating efficient and responsive corporate law.

Events over the past half-decade have severely tested that system. A variety of scandals—such as Enron, WorldCom, Tyco, corrupt initial public offerings (IPOs), options backdating—revealed that we have a more flawed system of corporate governance than was generally believed in the gung-ho nineties. The system has responded with many reforms and reform proposals.

Have those responses made sense? Have they helped improve American corporate governance; have they been ineffective; or might they have actually made things worse? This brief Article ponders those questions, focusing on two main recent reforms: the Sarbanes-Oxley Act¹ (SOX), and the ongoing battle over shareholder access to the corporate proxy material for making nominations to the board of directors.

In addressing the questions, I use a framework that I have developed elsewhere to help understand how our federal system of corporate lawmaking works.² This framework stresses the interaction between state and federal actors in setting federal law. State actors, particularly the Delaware courts, tend to be efficient and responsive in setting corporate law. They also, however, tend to be overly sympathetic to the interests of corporate officers and directors. The federal actors, though less efficient, are less prone to capture. It may be that by having the states set corporate law initially, but subject to a threat of federal intervention, we get the best of both worlds: the states create effective law, but the threat of federal intervention limits the states from going too far in placating corporate managers. Part II lays out this basic framework.

That basic framework suggests that our mixed federal system may do a better job than either a purely state or a purely national system. However, “it ain’t necessarily so.” It is possible that the federal actors may be so incompetent that we would be better off with a purely competitive state system. Alternatively, the central role of the states may prevent federal actors from doing as well as they would have in a purely national system. The remainder of this paper explores those three possibilities.

Part III makes the case that SOX and proxy access reform present a system responding fairly well to the scandals, with the interaction between the federal and state level helping to explain that response. Part IV considers the possibility that the federal government has gotten it badly wrong by implementing SOX because it is a

1. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

2. See generally Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99 (2004) [hereinafter McDonnell, *Two Cheers*]; Brett H. McDonnell, *Delaware, Federalism, and the Expertise-Bias Tradeoff* (Univ. of Cal., Berkeley Law & Econ. Workshop, Paper No. 6, 2004), available at http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1095&context=berkeley_law_econ [hereinafter McDonnell, *Expertise-Bias Tradeoff*].

horribly expensive intervention that is not worth it. I argue that this is possible, but the evidence to date does not support such a conclusion. In Section V, I consider whether the system has done too little to respond to the scandals, in part due to the drag imposed by the states, especially Delaware. In doing so, I focus on the ongoing skirmish over shareholder proxy access. This story remains in progress: the SEC is still debating how to respond to the recent case of *American Federation of State, County & Municipal Employees (AFSCME) v. American International Group (AIG)*.³ If the agency lets the pro-shareholder decision in that case stand, it will show that our mixed federal system is working things out pretty well. The system will appear in a less flattering light if the SEC moves to reverse the result.

II. CONCEPTUAL FRAMEWORK—OUR MIXED FEDERAL SYSTEM

I will place the developments of the last few years within a general framework by describing and analyzing our federal system for making corporate law. The core of corporate law in the United States is set at the state level by state legislatures and courts. Corporations can choose which state's law they prefer to govern them by choosing where they incorporate. A favorite topic of debate among corporate law scholars has long been whether this system leads to a race to the bottom, to the top, or somewhere in between, if indeed there is a race at all.⁴

Recently, a variety of scholars have pointed out that much corporate law is really set at the national level, in the guise of securities law.⁵ Mark Roe has also emphasized that the threat of federal action conditions the actions of the Delaware legislatures and courts.⁶ The details of how such a mixed federal system works, and whether or not it is likely to lead to good outcomes, remain open questions. I have addressed those questions in recent work, and that work provides the framework within which I will address recent developments.⁷

I will compare the tendencies of three systems: a purely state-based system with a dominant jurisdiction, a purely national system where only the federal government

3. 462 F.3d 121 (2d Cir. 2006).

4. See, e.g., Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 555 (2002) (describing the no race thesis); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (describing race to the bottom thesis); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977) (describing race to the top thesis).

5. See Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721, 740 (2005); Reza Dibadj, *Delaying Corporate Law*, 34 HOFSTRA L. REV. 469, 516, 521 (2005); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 628 (2004); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 872 (2003).

6. See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600–05 (2003) [hereinafter Roe, *Delaware's Competition*]; Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2518 (2005) [hereinafter Roe, *Delaware's Politics*].

7. McDonnell, *Two Cheers*, *supra* note 2, at 100; McDonnell, *Expertise-Bias Tradeoff*, *supra* note 2, at 4, 32.

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dictates corporate law, and our mixed federal system, where states set the basic law but the federal government can and does step in to set rules in a variety of areas. In doing so, I will first compare the relative strengths and weaknesses of the state and national systems.⁸

For a variety of reasons, the state system leads to a dominant jurisdiction, Delaware, which sets high quality law. The existence of fifty different states creates a chance to discover what works and what does not through experimentation. Delaware's success, including the resulting large revenue and interested groups like the corporate bar, gives it strong incentive to commit to continuing to be responsive to corporate needs.⁹ Delaware courts and judges are fast and knowledgeable. Its common law system allows both flexibility and a fair degree of predictability and guidance. Moreover, Delaware's ongoing dominance provides assurance that Delaware law will continue to adapt to new circumstances with new case law.

A purely national system could re-create some of these advantages, such as an experienced and knowledgeable rulemaking body like the SEC. However, important elements of Delaware's strengths would disappear without the competition that it faces from other states. The ultimate rulemaking body in a national system, Congress, is likely to be far less knowledgeable and interested in corporate law than the Delaware legislature. Granted, the SEC will be more knowledgeable, but its lack of competition will give it less incentive to respond quickly to changes or to evidence of problems in its rules. Moreover, the impulse to over-regulate as a way to expand bureaucratic turf will not be tempered by the threat of losing corporate subjects to competitors, as is the case with in Delaware. Thus, the state system is likely to lead to higher quality law than a national system.¹⁰

However, this quality comes at a price. Delaware is likely to be more biased in the interests of corporate directors and officers, and to ignore the interests of non-shareholder constituencies such as creditors, employees, and customers.¹¹ Corporate managers are likely to be the best-organized constituency group interested in how corporate law is set, and they play the leading role in determining where corporations will incorporate.¹² The strong Delaware corporate bar will largely, although not perfectly, reflect the interests of managers. Consequently, Delaware legislators and judges will be particularly attentive to managerial interests. Al-

8. See McDonnell, *Two Cheers*, *supra* note 2, at 138-40 (discussing, in part, the advantages and disadvantages of state and federal law).

9. See Robert Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 241 (1985).

10. See McDonnell, *Two Cheers*, *supra* note 2, at 138; McDonnell, *Expertise-Bias Tradeoff*, *supra* note 2, at 14.

11. See Roe, *Delaware's Politics*, *supra* note 6, at 2502-03.

12. See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 718 (1998); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 473 (1987).

though some degree of managerialist bias may exist at the national level as well, it is likely to be weaker than what we observe in Delaware.

We thus face a tradeoff in comparing the state and national systems: the state system tends to lead to higher quality law, but it is also more biased in favor of managers and against other non-shareholder constituencies.¹³ Assuming that we care about both quality and achieving a desirable balance between interest groups, which of these two systems is better depends on exactly how much the two systems differ in quality and interest group bias and on how we desire to trade off between quality and bias.

In a wide range of circumstances, a mixed federal system might achieve a better tradeoff. Let's consider how such a system works. As Roe has emphasized, Delaware (and other states) may act first in setting corporate law, but it is subject to the risk of federal preemption if it sets a law that the national decisionmakers do not like.¹⁴ Roe does not really spot the possible gains from this system, though, because he essentially conceives corporate rulemaking as a pure struggle between interest groups. Roe fails to focus on the quality dimension of corporate laws. Once we add the quality dimension to the analysis, the following possibility occurs. If Delaware's preferred outcome, what it would do in a purely state-based system, lies too far in a managerialist direction, then it faces action from Congress or the SEC if it sets the law there. The federal actors will be willing to overturn Delaware's law despite the general high quality of that law. Facing this threat, Delaware will choose to curb its managerial bias enough so that it will not be preempted.¹⁵

The result is Delaware quality with less of Delaware's managerialist bias. It is worth noting that Delaware's managerialist bias will not disappear for several reasons. First, governmental institutions face inertia in rulemaking. As such, federal rulemakers may not intervene, even if the law is somewhat more biased than the federal rulemakers like. Second, insofar as the federal rulemakers want to achieve high quality law, they will allow Delaware law to stand when it is better than they can create, even if it is somewhat more pro-manager than they would like. Still, the Delaware bias will often be reduced from the state-only system.

I show elsewhere that under many circumstances this result is better than either the state or the national system can produce.¹⁶ Indeed, if we assume that social preferences coincide with the preferences of the national actors, this must be true—the national actors can always intervene if they want. So if the national actors do not intervene, the result must be at least as good as they can achieve on their own.

13. McDonnell, *Two Cheers*, *supra* note 2, at 128; McDonnell, *Expertise-Bias Tradeoff*, *supra* note 2, at 4–5, 14.

14. Roe, *Delaware's Competition*, *supra* note 6, at 601.

15. See McDonnell, *Expertise-Bias Tradeoff*, *supra* note 2, at 2–3 (elaborating on the interaction between Delaware's laws and subsequent federal action).

16. *Id.* at 2.

Furthermore, the mixed federal system is better in so far as the threat of national intervention has made Delaware less biased without sacrificing its quality.

The mixed federal system, however, is not better than both alternatives under all circumstances. Sometimes the state system may be better. This may happen if the federal lawmakers are too anti-manager in their approach, if the federal lawmakers intervene too much as a way of increasing their own political power (had you ever heard of Representative Michael Oxley before the summer of 2002?), or if the federal lawmakers mistakenly intervene too often. Even then, however, the mixed system is better than a purely national system because it still retains some of the state system's advantages.¹⁷

Other times the national system may do better than the mixed federal system. This may occur if the federal lawmakers are overly biased in favor of managers, although less biased than Delaware. In that case, the federal lawmakers may tolerate Delaware rules that are socially worse than what the federal lawmakers could do on their own because federal lawmakers are willing to trade off more bias for quality than is socially optimal. Still, even if this is the case, the mixed system is better than a purely state system—at least it curbs Delaware somewhat, though not enough.¹⁸

Thus, the framework suggests three possible situations: the mixed federal system improves upon both the state and the national system; the mixed federal system is not as good as the state system, but better than the national system; or the mixed federal system is not as good as the national system but better than the state system. The rest of this Article will attempt to use recent developments to help determine which of these three possibilities appears to be the most plausible description of reality.

Part III presents the case that the mixed federal system has responded to the recent corporate scandals better than either a state or national system would have. Sarbanes-Oxley and other national responses moved the law in a less managerialist direction than the states would have achieved on their own, and also helped push the more expert decisionmakers to step in and make less biased law. Part IV considers the case for believing that a pure state system would have done better. The core claim here is that Sarbanes-Oxley has been an expensive failure. I survey the evidence so far and suggest that although this is a possibility, the evidence does not by any means compel such a conclusion, and indeed, it seems implausible. More likely, it has been an expensive mixed bag. Part V considers the case for believing that a pure national system would have done better. Though less trendy, I find this claim more plausible than the opposite. An overly pro-manager bias may well pervade governmental decisionmakers at all levels, and the national lawmakers may therefore be acceding to a biased state system that is worse than what they would do on their own. In particular, recent battles over the rules governing shareholder

17. *Id.* at 2–3.

18. *Id.* at 3.

voting and proxy access suggest that managers have re-taken political ground that they appeared to have given up in the first few years after the scandals broke. As of this writing, however, the battle continues and it is not easy to see how it will end.

III. THE CASE FOR OUR FEDERAL SYSTEM: MUDDLING AHEAD

It is quite hard to determine the quality of a corporate law system and how far it has gone in favoring the interest of managers. Still, at a broad level, a variety of pieces of evidence suggest that as of 2000, the American system of corporate regulation had gone too far in the direction of favoring managers. The major scandals that would soon erupt at companies like Enron, WorldCom, Tyco, and so on were the tip of the iceberg. Lower scale fraud-like behavior in the form of things such as earnings management, or laddering in IPOs, appears to have been widespread. Executive compensation exploded, apparently beyond what any reasonable form of performance-based rewards would allow.¹⁹ Hostile takeovers, with their potential to discipline bad managers, virtually disappeared, while ill-considered acquisitions that subsequently appear to have been bad news for the shareholders of the acquirers flourished.

Developments in Delaware helped explain some of this managerial recklessness. The *Unocal* standard²⁰ for reviewing antitakeover measures had become mostly toothless. The *Revlon* standard²¹ for reviewing sales of control had some more bite, but its range of application had been narrowed significantly. Case law setting the pleading standard for derivative causes of action had made it hard for plaintiffs to survive a motion to dismiss.²² For a moment in the mid-1980's, the Delaware courts appeared to take the duty of care seriously,²³ but the legislature quickly moved to allow corporations to circumvent director liability for care violations, and most companies took advantage of that escape clause.²⁴ Even the tougher loyalty standard of review loosened over the years.²⁵

Into this atmosphere came the collapse of the dot.com stocks and a spate of serious corporate scandals. There was a cry for a regulatory response to the problems, and the leading response came at the national level. In 2002, Congress passed the Sarbanes-Oxley Act.²⁶ SOX changed corporate law in a variety of ways. Among its most important elements, it strengthened requirements for internal control procedures, mandating that CEOs and CFOs must certify a variety of points

19. See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

20. *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 955–57 (Del. 1985).

21. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 (Del. 1986).

22. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

23. See *Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985).

24. DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).

25. See Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 444, 491 (1993).

26. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

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concerning their controls and that outside auditors must opine on the controls as well; it created a new, more independent body to regulate the accounting industry; it limited the ability of auditors to provide other services to audit clients; and it added new requirements for independent audit committees.²⁷

Does SOX fit the relatively optimistic version of federal intervention sketched in the previous section? On the dimension of favoring competing constituency groups, it certainly does seem like a clear move against the interests of directors and officers, as the theory predicts. This fits the general historical pattern of federal intervention in corporate governance rules.²⁸ However, many have claimed that SOX intervened in clumsy, heavy-handed, and poorly targeted ways.²⁹ At least up to a certain point, those claims also fit our theory about purely national corporate lawmaking—Congressional rulemaking should in general lead to lower quality law than Delaware rulemaking. If Congress messed up too badly, however, it could be that we would have been better off with no intervention at all. In the next part, I will consider the case for believing that this is what happened, including a quick look at the existing empirical evidence on the net benefits of SOX. I will argue that current evidence does not strongly point to SOX having costs that clearly outweigh its benefits, although the evidence does not strongly point in the opposite direction either.

For the benefits of federal intervention to work, though, we should see other sorts of responses beyond that of Congress. In particular, we should see Delaware responding with new, less pro-manager rules. Several major cases in 2003 seemed to move in that direction.³⁰ Most importantly, the Delaware Court of Chancery's decision *In re The Walt Disney Co. Derivative Litig.*,³¹ case suggested a new, strengthened duty of good faith that might have some bite in executive compensation and other areas where the duty of loyalty does not apply and the duty of care provides too little in the way of limits.³² In the *In re Oracle Corp. Derivative Litig.*,³³

27. *See id.*

28. *See* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1828–29, 1831 (2006).

29. *See, e.g.*, Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 MICH. ST. L. REV. 299, 324–26 (characterizing SOX section 307 as weak and likely ineffective); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 61 (2002) (concluding costs of increased regulation could be significant and cause harm by misdirecting the market); Larry E. Ribstein, *Sarbanes-Oxley after Three Years* 7 (Ill. L. & Econ. Working Paper Series, Working Paper No. LE05-016, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=840484 [hereinafter Ribstein, *Three Years*] (noting significant costs and elusive benefits); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1585–90 (2005) [hereinafter Romano, *Quack Corporate Governance*] (characterizing SOX governance mandates as “symbolic” and as “window-dressing” based on the actual burdens and additional costs associated with compliance in small firms).

30. Brett H. McDonnell, *SOX Appeals*, 2004 MICH. ST. L. REV. 505, 525–28.

31. 825 A.2d 275 (Del. Ch. 2003).

32. *Id.* at 278–79.

33. 824 A.2d 917 (Del. Ch. 2003).

the court seems to have toughened the standard for reviewing the independence of directors, at least in the context of reviewing the decisions of special litigation committees.³⁴ In *Omnicare, Inc. v. NCS Healthcare, Inc.*,³⁵ the court was unusually tough in reviewing deal protection measures in an acquisition.³⁶ None of these cases announced significantly new doctrines, but they all applied existing rules in tough, interesting ways which, if extended, could lead to a significant expansion of judicial oversight. Notably, the cases retained the careful, fact-specific, knowledgeable approach for which Delaware judges are known.

More recently, the Delaware legislature also got into the act, albeit in a modest way. It amended the General Corporation Law to make it easier for shareholders to enact bylaws specifying that directors must be elected by a majority vote.³⁷ Under the amendment, boards would not be able to amend such a shareholder-passed bylaw, a legal question that remains open for all other forms of shareholder bylaws. In Part V, I shall look at other developments in the area of shareholder voting, of which this is just one part.

Also notable is action by other more expert regulators in the shadow of SOX. The New York Stock Exchange and NASDAQ passed a range of rules that required listed companies to have three sets of committees of independent directors, including the audit, nominating, and compensation committees.³⁸ The SEC was also active in the years after SOX. This activity was, in part, passing a wide range of regulations implementing the Act. Interestingly, there was a proposal that if passed would allow shareholders, under certain circumstances, to use the company proxy to nominate candidates for the board.³⁹ This could significantly expand shareholder power, and may well be a better way of addressing problems in corporate governance than most or all of SOX.

Alas, these developments have led to pushback, some of which will be the topic of Part V. More recent Delaware cases seem to have pulled back from the 2003 trio. The SEC has pulled back as well. The shareholder proxy access proposal has died. However, the federal courts have stepped in. Shareholder activists at AIG attempted to use Rule 14a-8⁴⁰ to put on the ballot a bylaw giving shareholders the right to use the company proxy to nominate director candidates, thus achieving in their company much the same result that the proxy access proposal required. The SEC, in a no-action letter, allowed the company to exclude this proposal because it relates to

34. *Id.* at 929, 938–39.

35. 818 A.2d 914 (Del. 2003).

36. *See id.* at 940 (Veasey, C.J., dissenting) (noting the majority's new toughened standard of review).

37. DEL. CODE ANN. tit. 8, § 141(b) (2006).

38. *See* NYSE, Inc., Listed Company Manual § 303(A) (2004).

39. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders & Boards of Directors, Exchange Act Release No. 34-48,301, Investment Company Act Release No. 26,145, 80 SEC Docket 2407 (proposed Aug. 8, 2003); Press Release, Sec. & Exch. Comm'n, SEC Proposes Rules to Increase Proxy Access by Shareholders (Oct. 8, 2003), available at <http://sec.gov/news/press/2003-133.htm>.

40. 17 C.F.R. § 240.14a-8 (2006).

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an election. This has been the SEC's usual position on such bylaws for at least fifteen years, although earlier it did not interpret its rule in this way. Also, briefly in 2004 the SEC's staff flirted with allowing such shareholder proposals. Concern for managerial interests seems to have held back the Commission on this one. However, the more politically-insulated federal courts, in this case the Second Circuit, disagreed with the SEC, and ruled that shareholders had the right to have their proposal included in the company proxy material.⁴¹

Both the pullback of the more politically-attuned Delaware courts and the SEC as well as the greater receptiveness to shareholder activism of the federal courts, fit our framework. The move back to a more pro-manager position of the specialist regulators follows a political backlash against SOX that appears to make further pro-shareholder reform less likely, and which may lead to significant pruning of SOX. For now, Delaware would seem to have less to fear from further Congressional intervention than was the case in 2003. Less sensitive to political pressure in this area, the federal judiciary is the only actor left willing to push on in advancing shareholder interests. Still, the possibility definitely exists that Congress and the SEC were ultimately too reluctant to enact pro-shareholder reforms and too willing to defer to Delaware's scheme limiting the influence of shareholders. We shall explore this possibility further in Part V.

IV. THE CASE FOR DELAWARE: IS SOX A COSTLY FLOP?

A number of corporate law scholars and others have argued that SOX is a costly flop. Among corporate scholars, leading advocates of this position are Roberta Romano, Larry Ribstein, and Stephen Bainbridge.⁴² They argue that SOX is an unwise federalization of corporate law whose costs have greatly outweighed its benefits. This misbegotten attempt at regulation occurred as Congress panicked in the wake of the Enron and WorldCom scandals with a closely-fought midterm election looming. There is much political pressure to roll back the most controversial elements of SOX, especially section 404, which requires an outside auditor to certify companies' internal controls. A certain degree of Congressional incompetence is not inconsistent with our story of the superiority of the federal system; indeed, it is very much a part of that account. However, has Congress gone too far in its intervention, either because (a) it is overly beholden to non-managerial constituency groups; (b) it is too prone to regulation due to the benefits that come to legislators from action; or (c) out of sheer ignorance? Let us consider the evidence for such a claim.

41. *Am. Fed'n of State, County, & Mun. Employees v. Am. Int'l Group, Inc. (AFSCME)*, 462 F.3d 121, 128 (2d Cir. 2006).

42. See Bainbridge & Johnson, *supra* note 29; Ribstein, *Three Years, supra* note 29; Romano, *Quack Corporate Governance, supra* note 29.

Probably the best evidence for the net effects of SOX is its effect on stock prices. If one believes in the efficient market hypothesis, then share prices should reflect the best guess available as to the likely effects on the value of corporations. Of course, it is hard to do such empirical work—because all companies within given categories had to follow the rules, it is hard to separate out the effects of SOX from other things going on at the same time. If stock prices rose after SOX, was it because of the Act or other events? If prices fell, the same question applies. It is also hard to figure out when information about SOX was reflected in stock prices. Moreover, event studies can at best tell us what shareholders predicted the effects of the Act would be—they could have been wrong.

Still, event studies of the effect of SOX on share prices are the first place to look for an economics-minded scholar interested in analyzing the effects of SOX. Somewhat oddly, Romano does not really systematically do so in her lengthy anti-SOX diatribe. Ribstein does, though, in his look at SOX after three years. He surveys seven such studies. He summarizes these as saying “[t]he results of these studies have been mixed, but the studies tend to indicate that the market has reacted negatively to the adoption and implementation of SOX.”⁴³ This is slightly odd, as four of the seven studies he discusses tend to show a positive effect, one no effect, and one indeterminate effects. Of the seven studies, only one study shows a significant negative effect. Ribstein accomplishes this odd summary by focusing on whatever negative evidence each study contains, disparaging the methodology of studies finding a positive effect, and lauding the one study that finds a large negative effect. Thus, the best type of evidence available on the effects of SOX does not systematically support the case against the Act. If anything, the evidence mildly supports the Act.

Another strategy is to consider other sorts of empirical evidence as to the likely effect of various sections of SOX. The section that has received the most negative popular attention is the internal control provisions of section 404. Here there seem to be rather high costs, driven in good part by outside auditors who have interpreted the provisions as requiring quite extensive new control procedures—at much profit to the auditors. The most cited evidence on the direct costs of these controls is a survey by Financial Executives International (FEI), which shows costs of more than \$3 million for large companies.⁴⁴ This, however, is a survey of the CFOs, by the CFOs, and for the CFOs; its figures should be treated with extreme caution. Romano considers two studies on these rules, which reach conflicting results. From these results Romano manages to conclude that the certification regime

43. Ribstein, *Three Years*, *supra* note 29, at 14.

44. Grace L. Hinchman, Senior Vice President, Fin. Exec. Int'l, Testimony before the U.S. House of Representatives Government Reform Subcommittee on Regulatory Affairs of the Committee on Government Reform at a Hearing on the Securities and Exchange Commission's Implementation of Sarbanes-Oxley Act, with Particular Attention on the Requirements of Section 404 (Apr. 5, 2006), *available at* http://www.fei.org/download/Hinchman_Testimony_4_5_06_.pdf.

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should be made optional.⁴⁵ Why indeterminate results support a conclusion that the regime should be significantly weakened is not quite clear.

Romano considers evidence as to three other provisions: the independent audit committee requirement of section 301, the auditor conflict rules of section 201, and the prohibition on executive loans of section 402.⁴⁶ It is hard to find supporters of the loan ban, and I will not dispute that scholarly consensus. As to the other two provisions though, Donald Langevoort, a leading scholar of the relationship between auditing and corporate governance, has recently considered the evidence and Romano's arguments and shown that, although Romano's position is defensible, there is also plenty of evidence suggesting that the SOX auditing provisions were either harmless or positively beneficial.⁴⁷

Bainbridge has focused on the provision affecting the regulation of lawyers, section 307. He makes a fairly persuasive case in arguing that this provision has little effect because lawyers often have strong incentives not to rat on the officers that employ them.⁴⁸ Maybe so, but Bainbridge produces no real empirical evidence for his claims, nor does he make much of a case for concluding that the provision has proven all that costly, either.

Another complaint about SOX is that it is an incoherent hodgepodge of many different provisions. Clearly, not everything makes sense or hangs together well. The main thrust of SOX, however, is to focus on a variety of important gatekeepers: independent directors, auditors, lawyers, investment bankers, securities analysts, and even employees. SOX tries a variety of ways to give those actors incentives to closely monitor what is going on within their clients and to disclose problems that they find. SOX also tries to give more tools to these gatekeepers to keep informed. This is a coherent strategy, and one that is very much in keeping with the way American corporate governance has been evolving over the last few decades.⁴⁹

We also should not consider SOX in isolation. SOX's opponents argue that even without it, state regulators and markets would have adequately replied to the scandals and with less cost. Perhaps, but my theory in Parts II and III suggests the contrary. Indeed, the regulatory responses from Delaware, the exchanges, and the SEC may well have been spurred and strengthened by the looming threat of Congressional intervention.

A recurring theme of the SOX opponents has been that its political history shows a populist panic. Politicians reacted too quickly and without seriously considering

45. Romano, *Quack Corporate Governance*, *supra* note 29, at 1542–43.

46. *Id.* at 1529–40.

47. See Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley* 11–20, 28 (Univ. of Mich. Law Sch. Publ'n Ctr., Paper No. 105-8, 2006), available at <http://www.michiganlawreview.org/symposium/docs/langevoort.pdf>.

48. See Bainbridge & Johnson, *supra* note 29, at 319.

49. See John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 *BUS. LAW.* 1403, 1405–07 (2002).

the accumulated evidence against SOX's reforms.⁵⁰ However, one can paint a quite different picture of SOX's creation. Clearly, it was a quick reaction to the Enron and WorldCom scandals. This does seem to reflect a form of availability bias—the recent news focused popular attention in an unusual way, and many people and politicians were not well-informed about the issues of corporate governance.

However, there is a bright side to this. Normally, the politics of corporate governance are subject to capture by motivated interest groups, with corporate managers and the lawyers who serve them as the most important players. This leads to a managerialist bias at both the state and national levels, though it is strongest in Delaware. The popular attention brought on by the scandals represents a relatively rare chance to circumvent this political bias. Even if not as well-informed as one would like, such populist moments might well represent the public interest more accurately than the normal politics of corporate law.

Moreover, it is not at all clear that most of the provisions of SOX were really as poorly informed as the critics maintain. As Romano herself stresses, most of the provisions represented reforms that had been put forth by various policy entrepreneurs for many years.⁵¹ Many provisions codified either best practices or rules that the exchanges had already adopted, or tweaked existing rules in relatively modest ways. Thus, Congress largely drew upon ideas that had been around for a while, had received a lot of debate, and had been tried out in many companies. That is precisely what a relatively uninformed regulator such as Congress should do. Romano portrays the policy entrepreneurs who suggested many of the Act's provisions (people like Arthur Leavitt, Richard Breeden, Roderick Hills, and Lynn Turner) in an unflattering light. Yet, these are experienced former top regulators at the SEC, now free from the press of interest groups and the temptations of bureaucratic power—I find it rather hard to imagine a much better group of people for Congress to look to for ideas.

Thus, the arguments and evidence marshaled against SOX are not overwhelming, to say the least. That is not to say that the evidence in SOX's favor is overwhelming either. The evidence is deeply mixed. Yet, I get the sense that a perception is growing that SOX's costs outweigh its benefits. Why is this? I think we need to look to who is leading the anti-SOX charge. There are two main groups. One is corporate officers and directors, the main targets of the regulation. Their motivation is clear, and they have more relevant information concerning SOX's functioning than anyone else. Thus, they are able to manipulate public perception rather effectively. The FEI survey is a leading example.⁵² The other main group consists of corporate law scholars. This is not a homogenous group by any means. However, the dominance of a particular brand of pro-market economic reasoning

50. See Romano, *Quack Corporate Governance*, *supra* note 29, at 1559–64.

51. *Id.* at 1550, 1568.

52. See *supra* text accompanying note 41.

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within corporate law scholarship is having a big effect on the reception of SOX. To those familiar with the prior work of Romano, Ribstein, and Bainbridge, it should come as no surprise that they paint a negative picture. They are strongly pre-disposed to believe that most efforts at mandatory corporate regulation are bad. Thus, it is no surprise that they focus on the negative news and do little to update their prior beliefs when confronted with mixed evidence.⁵³

For those not strongly inclined to believe that an Act like SOX is doomed to fail, I do not think the existing evidence clearly shows that its costs outweigh its benefits. The costs of a few provisions, especially section 404, have been greater than expected,⁵⁴ and some provisions, such as the loan ban, are intuitively not good ideas. These flaws, however, do not necessarily doom the whole Act. Moreover, it is worth emphasizing again that much of SOX does represent an attempt to more closely regulate officers and directors—the direction of national regulation suggested as predictable and appropriate by our basic theory. To someone inclined to have an open mind to the evidence here, the question as to the net benefits of SOX remains quite open.

V. THE CASE FOR NATIONALIZATION: ARE WE TOO EASY ON MANAGERS?

In general, the mixed federal system seems more likely to go wrong in the opposite direction from that considered in the previous section. Rather than intervening too much, Congress and other national regulators would, if anything, seem prone to intervene too little. After all, it seems likely that although managers and corporate lawyers will have a less decisive influence in Congress than in Delaware, the basic Olsonian logic of collective action suggests that at all levels, including the national level, managers and corporate lawyers will be better organized than those opposing them. Thus, even national regulation is prone to tilt in a managerialist direction. Where that is so, our basic theory suggests that Congress may let Delaware law stand in cases where Congressional intervention, even if of lower quality, would be best for the public interest.⁵⁵

Developments over the last several years provide a fair amount of evidence for this view. It seems that after the high water mark of SOX, public interest in corporate governance has waned, and the threat of further Congressional action has receded. As this has happened, the normal pattern of managerial dominance of the politics of corporate governance has re-asserted itself at both the state and federal level. One area where this pattern appears is Delaware case law. As discussed in Part

53. Robert B. Ahdieh rightly emphasizes that much of the debate over federal versus state regulation is really a debate over mandatory regulation. Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 *BUFF. L. REV.* 721, 740 (2005).

54. These costs may decline over time.

55. See McDonnell, *Expertise-Bias Tradeoff*, *supra* note 2, at 17–18.

III, in 2003 a variety of Delaware cases moved towards closer scrutiny of director actions.⁵⁶

Since then, the Delaware courts seem to have fallen back to their more usual deference. In both a recent article⁵⁷ and the *In Re Toys "R" Us, Inc. Shareholder Litigation*⁵⁸ case, Vice-Chancellor Strine advocates an approach to deal-protection measures that gives boards more room to agree to such measures than *Omnicare* suggests. In the Martha Stewart litigation, the court seemed to cut back on the closer scrutiny of director independence that *Oracle* opened up.⁵⁹ Perhaps most significantly, both the Court of Chancery and Supreme Court decisions in the *Disney* case after trial showed less sympathy to the plaintiffs than the 2003 Chancery decision.⁶⁰

Still, we should not go too far in concluding that Delaware has returned to its old ways. *Omnicare* was always an odd case with odd facts. Indeed, serious scrutiny of deal protection measures and protection of shareholder voting rights still seems alive in Delaware. The independence scrutiny in *Beam* and *Oracle* is highly fact-specific; the basic legal standard remains the same. *Disney* created the potential for wider use of a new good faith standard in executive compensation cases and other areas, even though it did not give much guidance as to what that standard might entail.⁶¹

Of most interest at the federal level is the ongoing dispute over shareholder access to the corporate proxy to nominate board candidates. Perhaps the most interesting and potentially important post-SOX development at any level of government was the SEC's proposed new rule giving shareholders the right to use the corporate proxy to nominate directors candidates under carefully limited circumstances.⁶² This proposal could cut more deeply to the heart of the balance of power between directors and shareholders than anything else in the SOX flurry of reform. However, the post-SOX resurgence of normal interest group politics seems to have killed this proposal.

56. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 940 (Del. 2003) (Veasey, C.J., dissenting); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938–39 (Del. Ch. 2003); *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 278 (Del. Ch. 2003).

57. Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It Is Equitable to Take That Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft*, 60 *BUS. LAW.* 877, 879–80 (2005).

58. 877 A.2d 975, 1015–16 (Del. Ch. 2005).

59. *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004).

60. See *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 34, 49 (Del. 2006); *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 757 n.470 (Del. Ch. 2005).

61. Claire Hill & Brett McDonnell, *Disney, Good Faith, and Structural Bias*, *J. CORP. L.* (forthcoming), available at <http://ssrn.com/abstract=929488>.

62. See Press Release, Sec. & Exch. Comm'n, SEC Proposes Rules to Increase Proxy Access by S'holders (Oct. 8, 2003), available at <http://sec.gov/news/press/2003-133.htm>; Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders & Boards of Directors, Exchange Act Release No. 34-48,301, Investment Company Release No. 26,145, 80 SEC Docket 2407 (proposed Aug. 8, 2003).

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I do not believe that the SEC's proposal was the best way to go on the shareholder access issue. It would be better to allow shareholders to propose bylaws granting shareholders proxy access to nominate directors under the conditions laid out in the bylaws. This would allow greater flexibility and experimentation than the one-size-fits-all SEC proposed rule.⁶³ A bylaw-based approach, however, requires favorable action at both the state and federal level. At the state level, state courts must recognize as valid shareholder bylaws that grant proxy access under specified conditions. At the federal level, the SEC must not allow companies to exclude shareholder proposals that propose such bylaws.

The validity of shareholder bylaws that may impinge upon board authority is an open and vexed question under Delaware law. The type of bylaw that has received the most scholarly attention is bylaws limiting the power of boards to adopt or use poison pills. Proxy access bylaws are a newer innovation, and so far have received less analysis. In a recent article I analyzed both types of bylaws under Delaware law.⁶⁴ I found that proxy access bylaws are likely to be held as valid under Delaware law, but poison pill bylaws are more questionable.⁶⁵ We shall see what happens if and when the issue ever actually reaches a Delaware court. Pro-shareholder-power scholar Lucian Bebchuk recently tried to force the issue by bringing a case in Delaware, but the Court of Chancery held that the case was not ripe for decision.⁶⁶

Part of the reason that this important issue has not yet made its way to the state courts is that shareholders have not been able to get the issue on the ballot without enduring the expense of soliciting proxies on their own. That is because of the way the SEC has interpreted one of its rules implementing Rule 14a-8. Rule 14a-8 allows shareholders who have met relatively minimal procedural requirements to use the corporate proxy material to distribute proposals for other shareholders to vote on.⁶⁷ However, the rule contains a variety of exclusions which companies can use to refuse to include a shareholder proposal in their proxies. One of these exclusions is 14a-8(i)(8), which allows companies to exclude a proposal if it "relates to an election for membership on the company's board of directors or analogous governing body."⁶⁸

This exclusion has a broad and a narrow interpretation. Under the broad interpretation, all proposals which regulate or affect board elections may be excluded. Under the narrow interpretation, only proposals which relate to one particular election, e.g., using the Rule to propose a slate of directors, may be excluded. Under

63. Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 260–61 (2005) [hereinafter McDonnell, *Poison Pills*].

64. The analysis would be similar but not identical under the law of most other states.

65. McDonnell, *Poison Pills*, *supra* note 63, at 251–52.

66. *Bebchuk v. CA, Inc.*, 902 A.2d 737, 745 (Del. Ch. 2006).

67. 17 C.F.R. § 240.14a-8 (2006).

68. *Id.* § 240.14a-8(i)(8).

the broad interpretation, proxy access bylaw proposals are excludable; under the narrow interpretation they are not.

The SEC has vacillated over time in how it interpreted this exclusion. Initially it interpreted the exclusion narrowly. For the last fifteen years or so it has usually interpreted it broadly.⁶⁹ Recently, in the shadow of the proxy access rule proposal, the staff suggested returning to the narrow interpretation in a no action letter for a proposal by Disney shareholders. The Commission, however, reverted to the broad interpretation—another sign of the post-SOX resurgence of manager political influence.⁷⁰

When AIG excluded a proxy access proposal by the AFSCME union pension plan, the union went to court to try to push for the narrow interpretation. The union lost at the district court level, but won in the Second Circuit. The circuit court noted the ambiguity of the exclusion's text, making the nice albeit rather fine point that the "an" in front of "election" in the exclusion suggests reference to one particular election. The court then noted the muddled history of SEC interpretation of the exclusion. It decided to side with the SEC's earlier interpretation, which occurred closer in time to the initial adoption of the exclusion.⁷¹

I am quite sympathetic to the court's opinion, although it is not clear that the opinion gives appropriate deference to the SEC's current stance, thereby allowing the agency flexibility to adapt to changing circumstances. I suspect that the court was in part influenced by a covert policy preference for the narrow interpretation. My analysis of the politics underlying this area suggests a policy-based reason in favor of the decision beyond simply arguing that this is the better substantive outcome. Managers and their allies are likely to be able to organize better to influence the SEC. This suggests that, when in doubt, the court should interpret the rule against the interests of managers. If that interpretation is not in fact good policy, there is a good chance that managers will be able to organize effectively to overturn the decision. Indeed, that may well happen in this case, as we shall see. If instead the court were to follow a pro-manager interpretation, it is much less likely that shareholder activists will be able to successfully lobby the SEC to overturn the decision even if the public interest favors their preferred rule.⁷²

This argument for how the federal courts should approach the SEC's rules dovetails with our general analysis of the interaction between federal and state regulators and between informed and uninformed regulators. The federal courts do not

69. See *Am. Fed'n of State, County, & Mun. Employees v. Am. Int'l Group, Inc. (AFSCME)*, 462 F.3d 121, 128 (2d Cir. 2006).

70. See McDonnell, *Poison Pills*, *supra* note 63, at 212.

71. *AFSCME*, 462 F.3d at 128.

72. This suggestion resembles the recommendation by Bebchuk and Hamdani to set statutory defaults in favor of shareholders, but my suggestion operates at the level of judicial interpretation of rules and is based upon shareholder weakness relative to managers in the political lobbying process rather than at the level of setting rules within individual corporations. See Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 Nw. U. L. Rev. 489, 495 (2002).

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know much about securities and corporate law—they do not face related cases very often. They are thus uninformed, but for the very same reason, the federal courts are also less likely to be biased in favor of managers or any other corporate constituency group. By interpreting rules such as this one in a pro-shareholder way, the courts help counteract managerialist bias although still allowing the more informed SEC to change the rule if it believes strongly enough that the court's decision is wrong.

The SEC is considering a proposed rule change in response to *American Federation of State County & Municipal Employees v. American International Group, Inc.* As of this writing they have not yet published their proposal, and twice they have cancelled scheduled public meetings to discuss it. It remains an open question whether or not shareholder activists will be able to muster strong enough opposition to keep the *AIG* status quo in place. If they do succeed, it will be a nice example of our complex system of regulating corporations at work, with its mix of federal and state, informed and uninformed regulators interacting in myriad ways.⁷³ If corporate managers succeed in getting their way and overturning the court's decision, the system will look less good, although even then it would be far from clear that any other system would do any better. The greater lobbying power of managers and corporate lawyers will be a systematic problem for any form of legal regulation of corporations.

VI. CONCLUSION

No system of corporate governance or corporate lawmaking is perfect. We want a system that both controls abuses by corporate managers while also providing flexibility and avoiding heavy-handed regulation whose costs outweigh its benefits. We want our lawmakers to respond to market realities without being in thrall to them, and we want all of the various constituencies with a significant stake in corporate life to have a seat at the table. The hoped-for virtue of our mixed federal system of corporate lawmaking is that it does all of these things pretty well, at least better than a purely state-based or purely national system would do. Do the events of the past half-decade support that hopeful assessment?

The evidence is not yet fully in, and what evidence we have is, as usual, ambiguous and difficult to interpret. Moreover, the system's response to the excesses of the nineties is ongoing. Hence, we cannot affirmatively tell how well we are doing. On balance, though, the system has done a decent job. Much of SOX was a measured response that appropriately focused on tweaking the system of gatekeeper responsibility that already characterized American corporate governance. Not everything was right, but the system appears to be working to reduce the costs associated with the most suspect part of SOX, section 404.

73. For more on Rule 14a-8 and federal-state cooperation, see Ahdieh, *supra* note 53.

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Probably more important than SOX are efforts to get shareholders more actively involved in corporate governance. Allowing shareholders access to the corporate proxy to nominate directors is perhaps the most important single available reform. Getting that right will involve work at both the state and federal level. We will see what the system ultimately comes up with, but as of now the movement is in the right direction, albeit hesitant and uncertain. The skirmishing in the ongoing debate among officers, directors, and activist shareholders, a debate carried out at various levels of government and within board rooms across America, is ongoing.

