In the Interests of Avoiding Further Federal “Quackery”


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Introduction

Professor Stephen M. Bainbridge’s Corporate Governance After the Financial Crisis presents a cogent discussion of the congressional and regulatory reaction to two significant economic crises within the past decade and the unprecedented federal expansion into the traditional state bulwark of corporate law that resulted. Much has been written about corporate governance and the federal reaction to these crises in the aftermath of the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act or Sarbanes-Oxley) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act or Dodd-Frank). For those trying to understand the state of corporate governance regulation today and the key debates and tensions that are at work, Bainbridge’s book is a must read, along with Lynn Stout’s The Shareholder Value Myth, and—to balance things out with a broader perspective about how crises drive governance regulation and change—Ira Millstein’s and Paul MacAvoy’s book, The Recurring Crisis in Corporate Governance. Indeed, when the next crisis comes along, but before the federal legislators and regulators pick up their pens, these should all be required reading to help avoid further federal imposition of “quack
I. Sarbanes-Oxley and Dodd-Frank as Federal “Quackery”

Lest there be any doubt about Bainbridge’s views on the breadth of federal quackery, he states at the outset:

Are Dodd-Frank’s governance provisions quackery, as were Sarbanes-Oxley’s? In short, yes. 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. Finally, each of Dodd-Frank’s governance provisions erodes the system of competitive federalism that is the unique genius of American corporate law by displacing state regulation with federal law. Dodd-Frank is thus shaping up to be round two of federal quack corporate governance regulation.

The Sarbanes-Oxley Act was adopted in reaction to the Enron and WorldCom accounting frauds and concerns about the potential for management malfeasance in public companies. The Dodd-Frank Act was enacted just eight years later in reaction to the failure of various financial institutions and regulators to adequately assess risks in the housing market and related market for mortgage securities. In both instances, Congress apparently believed corporate governance failures played a role and that new regulations were needed, but the focus of the legislated corporate governance fixes were dramatically different: The corporate governance provisions in Sarbanes-Oxley were designed in large measure to position boards to hold the CEO and CFO and other members of senior management more accountable. Sarbanes-Oxley focused on enhancing the independence of board audit committees and on enhancing the board’s oversight of internal controls. Underlying the federal legislation (as well as amendments to listing rules at about the same time) was the decided view that strong, independent boards were key to avoiding similar problems in the future. While Sarbanes-Oxley worked a fundamental expansion of federal corporate governance regulation, at least the underlying philosophy was generally in line with notions of director primacy under state law. In contrast, the

7. BAINBRIDGE, supra note 1, at 8.
8. Id. at 15.
9. Id. at 5–8.
10. Id. at 1.
11. Id. at 59–60.
12. Id.
13. Id. at 77–78.
corporate governance provisions of Dodd-Frank veer sharply away from director primacy. Rather than look to strong independent boards as the solution, Dodd-Frank provides shareholders with enhanced powers (through regulations promulgated by the Securities and Exchange Commission (the SEC)) to hold boards accountable—and this is a clear departure from the director primacy that is embodied in state corporate law, with implications for our economy at large.

II. Director Primacy Under State Law and Its Erosion by Federal Law and Regulation

By giving the board clear authority for the business and affairs of the corporation within a framework of fiduciary duties owed to shareholders, state corporate law creates an efficient decision-making structure for entrepreneurial activities that require capital from a variety of sources. Shareholders, as the providers of capital, can share in the benefits of corporate activity while limiting their liability to their investment. The board determines what actions are in the best interests of the corporation through its authority to manage and direct the affairs of the corporation. This includes determining corporate strategies and considering how short-term interests in effecting immediate return to shareholders (for example, through dividends or share repurchases) are best balanced with investments in technology, R&D, and brand development necessary for sustainable, long-term success. It also includes determining which executives are best able to develop and implement successful strategies and appropriate benchmarks and compensation incentives. To perform this role, boards must have flexibility and discretion—and this discretion is what is at stake as director primacy erodes under federal law and regulation.

As noted by Bainbridge, Stout, and others—and quoting from the report of the American Bar Association Task Force on the Delineation of Governance Roles and Responsibilities (the ABA Task Force Report)—“Discussions about the roles of shareholders and boards may be hampered by the use of terms that are charged with meaning from other, non-corporate contexts, and hence are evocative yet not wholly accurate.” Specifically, discussions of corporate governance are often imbued with references to “[s]hareholder democracy,” shareholders as “[c]orporate owners,” and

14. Id. at 14.
15. Id. at 1–2.
17. Id. at 8.
18. Id. at 5.
directors as “agents” of shareholders. This unfortunate but pervasive lexicon has muddied the understanding of shareholder and director relations and roles, and may sway public, media, and legislative viewpoints. Bainbridge asserts that political forces rather than empirical or theoretical justifications underlie Dodd-Frank’s corporate governance reform provisions, which makes the federal incursion and its shift toward shareholder primacy all the more troubling. One would hope at minimum that legislators and regulators would ground their actions in an understanding of the delicate balance that is inherent in the current system and what it is designed to achieve.

III. Corporate Governance as Cause and Solution

Bainbridge asks the key questions: were corporate governance failures at the root of the economic crises that led to Dodd-Frank and were Dodd-Frank’s corporate governance reforms necessary to respond to the crisis?  

19. The Task Force Report summarizes the deficiencies in these references:

- **Shareholder democracy:** Although the corporation’s governing body—the board of directors—is elected by the shareholders, the board’s governance powers are determined by law and therefore neither delegated by, nor derived from, the shareholders. Upon election to the board, each director becomes a fiduciary to the corporation and must act in the best interests of the corporation and the entire body of shareholders, no matter who nominated or what groups the director is affiliated with. Therefore, analogies to democratic forms of government are imprecise.

- **Corporate owners:** The corporate form bifurcates the provision of equity capital and the control of the business and affairs of the corporation. This specialization of functions is famously referred to as the ‘separation of ownership and control,’ and shareholders are often referred to as the ‘owners’ of the corporation. However, the corporation is a legal person in its own right rather than a mere asset. Once the separation of equity rights and control occurs in the formation of the corporate entity, the analogy of shareholders to ‘owners’ of the corporate ‘asset’ is imperfect at best. The asset that shareholders own is the stock that represents their investment interest. (Shareholders may more accurately be called ‘shareowners’ or ‘stockowners.’) Whether individually or collectively, stock represents limited contractual and decision rights in the corporation that fall short of the full bundle of powers and responsibilities typically associated with ownership. Shareholders do not have the right to come to corporate headquarters and remove a proportionate share of the machinery or dictate how widgets will be manufactured. They do have the right to elect directors and determine certain fundamental matters . . . .

- **Principals and agents:** Contrary to the often-used analogy, directors are not ‘agents’ in a principal-agent relationship with shareholders, since shareholders cannot dictate board actions and directors are obligated to make their own judgments based on the best interests of the corporation and bear the full liability for those judgments. Moreover, directors lack the ability to bind shareholders to contracts, and the corporate assets managed by directors are not subject to claims from a shareholder’s creditors. Thus, the basic indicia of the principal-agent relationship are missing in the shareholder-director relationship.

Id. (citations omitted).

20. BAINBRIDGE, supra note 1, at 15.

21. Id.
His answers, not surprisingly, are “no” and “no.”22 “[S]ystemic 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.”23 Moreover, any connection between the key corporate governance reforms of the Dodd-Frank Act and the economic crisis are tenuous in the extreme. He asserts that a powerful interest group of activist institutional investors hijacked the legislative process to achieve long-standing goals unrelated to the causes of the financial crisis.24

Most of the corporate governance reforms in Dodd-Frank relate to executive compensation.25 One of the concerns was that executive compensation may have driven unduly risky behavior at financial services firms and thereby played a role in the economic crisis.26 However, the compensation reforms in Dodd-Frank are primarily aimed at all public companies including those outside of the financial services industry,27 and the compensation reforms that are applicable to public companies generally have little, if any, relation to risk. They are on their face far more related to the increase of shareholder influence as well as populist concerns about the level of executive pay. For example:

- Section 951 mandates that public companies provide shareholders with a periodic “advisory” vote on the compensation paid to the CEO, the CFO, and the three other top paid executive officers (“say on pay”), and also requires an advisory vote on golden parachutes.28
- Section 953 mandates that the SEC impose additional disclosure requirements with respect to executive compensation, including disclosure of the relationship between executive compensation and the company’s financial performance and disclosure of the median of the annual total compensation of all employees except the CEO, the CEO’s annual total compensation, and the ratio of the two amounts.29
- Section 954 mandates that the SEC direct the exchanges to require listed companies to adopt and disclose compensation “clawback” policies that would require executives to return

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22. Id.
23. Id. at 10.
24. Id. at 15.
25. Id. at 122–37 (describing Dodd-Frank’s executive compensation reforms).
27. Id. at 111–12.
29. Id. § 953.
“excess” incentive compensation paid to an executive in light of certain financial restatements.\textsuperscript{30}

- Section 971 expressly authorizes the SEC to adopt rules and procedures relating to the inclusion of shareholder board nominees in a company’s proxy solicitation materials (“proxy access”).\textsuperscript{31}

- Section 972 requires companies to disclose in the proxy statement the reasons for combining or separating the positions of chair and CEO.\textsuperscript{32}

Bainbridge concludes that say on pay in particular is an example of quack corporate governance, supported by a powerful group of policy entrepreneurs pursuing an agenda unrelated to the financial crisis. . . . Like other quack corporate governance statutes, say on pay federalizes matters previously left to state corporate law. It does so without strong empirical support. It is inconsistent with the board-centric model that has been the foundation of the U.S. corporate governance system’s success.\textsuperscript{33}

IV. Federal Versus State Regulation of Corporate Governance

What can we learn from the impact of these changes regarding the relative merits of the federal government and the states as sources of corporate governance regulation? State corporate law has for more than a century determined the rules by which corporations are both formed and governed.\textsuperscript{34} The primary federal intervention in the area has been through SEC disclosure regulations for public companies.\textsuperscript{35} Sarbanes-Oxley and Dodd-Frank expand disclosure but also provide specific mandates with respect to behavior through federal securities regulation by the SEC and listing rules.\textsuperscript{36}

Bainbridge acknowledges the long-running debate over whether state competition in the area of corporate law creates a “race to the top” or a “race to the bottom.”\textsuperscript{37} He concludes that “[w]herever one comes out on that debate, the case studies of federal corporate governance regulation confirm that the new form of vertical competition between the states and Washington

\textsuperscript{30} Id. § 954.

\textsuperscript{31} Id. § 971.

\textsuperscript{32} Id. § 972.

\textsuperscript{33} BAINBRIDGE, supra note 1, at 136–37.

\textsuperscript{34} See id. at 21 (explaining that even though “the federal government and the stock exchanges play important” roles in corporate law, essentially “corporations are creatures of state law” (footnotes omitted)).

\textsuperscript{35} Id. at 28.

\textsuperscript{36} Id. at 29.

\textsuperscript{37} Id. at 261.
is no improvement.” He cites evidence that he finds to be “quite conclusive” that due in part to the regulatory burden imposed by Sarbanes-Oxley, “U.S. capital markets became less competitive vis-à-vis other markets” with respect to share of the global IPO market. (Note that the Jumpstart Our Business Startups Act was signed into law in April 2012, with the aim of facilitating private capital formation, among other things.)

Bainbridge expresses concern about the expansion of federal power with respect to corporate governance and favors less federal intrusion generally. He believes there are three reasons why federal intervention in corporate governance tends to be ill conceived:

- “[L]aws tend to be enacted in a climate of political pressure that does not facilitate careful analysis of costs and benefits.” This point is illustrated by the July 2011 decision of the United States Court of Appeals for the District of Columbia Circuit to vacate the SEC’s rule mandating proxy access, on the basis that the SEC “failed adequately to consider the rule’s effect upon efficiency, competition, and capital formation.”
- “[L]aws tend to be driven by populist anti-corporate emotions.”
- “[Content of the laws] is often derived from prepackaged proposals advocated by policy entrepreneurs skeptical of corporations and markets.” In particular, he expresses concern about lobbying by special interest institutional and activist investors and “policy entrepreneurs pursuing an agenda unrelated to the financial crisis”—this is perhaps a veiled reference to proxy advisors such as Institutional Shareholder Services (ISS). He does not, however, discuss the significant lobbying efforts of the Business Roundtable and the U.S. Chamber of Commerce.

38. Id.
39. Id. at 261–62.
41. See id. (memorializing Congress’s intent to “increase American job creation and economic growth by improving access to public capital markets for emerging growth companies”).
42. BAINBRIDGE, supra note 1, at 268–69.
44. BAINBRIDGE, supra note 1, at 269.
45. Id.
46. Id. at 137, 156, 270.
47. Id. at 256; see also About ISS, ISS, http://www.issgovernance.com/about (describing ISS’s proxy-voting operations and mechanics information services).
He also cites concern about the “ratchet effect”—that the rules put in place for crises do not shrink back to precrisis levels once the crises end and therefore the size and scope of government and its regulation tend to only move in one ever-increasing direction.49

Imposition of governance “one size fits all” practices through federal fiat compounds the problem because it lessens the experimentation that comes with private ordering. It reduces “opportunities for experimentation with alternat[e] solutions to the many difficult regulatory problems that arise in corporate law.”50 Bainbridge quotes Justice Brandeis: “It 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 country.”51 The ABA Task Force Report also noted concerns about potential unintended consequences from reform efforts in its recommendation:

[S]pecial care [should be] taken to ensure that short-term shareholders are not unduly enabled to take actions that could undermine the long-term interests of the corporation and other shareholders. Consideration should also be given to whether a proposed reform is likely to change decision rights to a degree that the accountability mechanisms associated with such decisions would also need adjustment.52

The ABA Task Force Report emphasized the need for policy makers and regulators to “understand the rationale for the current ordering of roles and responsibilities in the corporation and assess the impact of proposed reforms on such ordering. Reform discussions should include an assessment of how the distinct interests of long-term and short-term shareholders will likely be affected . . . .”53

V. The Move Towards a More Shareholder-Centric Model and Implications for the Real World

As discussed above, the Dodd-Frank Act provides shareholders with greater influence than accorded to them under state law. This is at odds with Bainbridge’s preference for fewer legal rules and greater reliance on fiduciary principles applicable under state law (i.e., the duties of care and loyalty and the business judgment rule). Bainbridge describes the change caused by federal intrusion in the role of the board to a primarily monitoring function and expresses skepticism about its value.54 He makes a cogent case

49. BAINBRIDGE, supra note 1, at 269.
50. Id.
51. Id. (quoting Newstate Ice Co. v. Liebman, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting)) (internal quotation marks omitted).
53. Id. at 25.
54. BAINBRIDGE, supra note 1, at 51–65.
that the new regulation has not been effective and notes that good governance, which requires judgment, is not guaranteed—indeed, board decision making may become more bureaucratic and less judgment-focused as hamstrung directors find it difficult to apply fiduciary judgment and discretion.55

This shift in power to shareholders continues the trend towards greater shareholder influence generally over the past several years, driven largely by “the growth of institutional investors and the concentration of share ownership in their portfolios,”56 as well as “the removal of regulatory and technological barriers to communication and coordination between shareholders.”57 In addition, the coordinating impact of proxy advisors raises real-world concerns about the impact of the shift towards a shareholder-centric model. For example, ISS recently adopted changes to its U.S. proxy voting policies, effective 2014, that will result in a negative vote recommendation against individual directors, committee members, or the entire board, if the board “failed to act” on a shareholder proposal that received the support of a majority of votes cast in the previous year.58 “Responding to the shareholder proposal will generally mean either full implementation of the proposal or, if the matter requires a vote by shareholders, a management proposal on the next annual ballot to implement the proposal,” according to ISS.59 “Responses that involve less than full implementation will be considered on a case-by-case basis, taking into account” various factors listed in ISS’s policy.60 This policy change will add significant pressure on boards to act in line with shareholder viewpoints on matters that state law clearly has reserved for directors, subject to their fiduciary responsibilities.

Conclusion

We all share enormous interests in the success of the U.S. corporation—and the governance of that institution has proved remarkably successful and

55. Id. at 63.
56. ABA, TASK FORCE REPORT, supra note 16, at 16.
57. Id. at 15.
59. Id. at 5 n.2.
60. Id. These factors include “[t]he subject matter of the proposal,” “[t]he level of support and opposition provided to the resolution at past meetings,” “[d]isclosed outreach efforts by the board to shareholders in the wake of the vote,” “[a]ctions taken by the board in response to its engagement with shareholders,” and “[t]he continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals).” Id.; see also ISS, 2013 U.S. PROXY VOTING POLICIES AND PROCEDURES, FREQUENTLY ASKED QUESTIONS (EXCLUDING COMPENSATION-RELATED QUESTIONS) 11–14 (2012), available at http://www.issgovernance.com/files/2013ISSFAQPoliciesandProcedures.pdf.
resilient as regulated primarily by state corporate law. While Bainbridge states the case in the extreme, federal legislators would be well-advised to adopt the mantra of “do no harm.” Legislators and regulators would also do well to study how state law apportions governance roles among shareholders, boards of directors and managers, and how that apportionment relates centrally to the success of the corporate form. As advocated in the ABA Task Force Report, clear understanding of the traditional roles played by shareholders and boards under corporate law—and the reasons for those roles—is necessary to understand the potential impact of any reform measure under consideration. More specifically, “Returning to solid economic growth over the long term will depend in part on the ability of policy makers to respond to concerns over corporate governance as a factor in the present crisis while avoiding reforms that are insensitive to positive aspects of the present legal ordering of decision rights and responsibilities within the corporation.” Perhaps there should be imposed on Congress a requirement for cost-benefit analysis of the type the SEC must undergo as part of the rule-making process. “Reform proposals should be assessed in light of their likely impact on the capital raising and capital deployment ability of the corporate form in aid of sustainable growth and wealth creation. . . . The goal of any reform effort should be to ensure that the corporation is positioned to continue its successful role in our economy, ultimately for the benefit of society at large.”

62. Id.
63. Id. at 3.
Early in this century, when quackery came to be recognized as a major problem in the health field, many observers predicted its certain death. Common sense, increasing education, the truths of science, and laws aimed at securing honest labeling would drive quackery from the marketplace. Especially as modern medicine developed and conquered one disease after another, anything so outmoded and unneeded as quackery would shortly wither away. But this has not happened. The phrases "further research is needed" (FRIN), "more research is needed" and other variants are commonly used in research papers. The cliché is so common that it has attracted research, regulation and cultural commentary. Some research journals have banned the phrase "more research is needed" on the grounds that it is redundant; it is almost always true and fits almost any article, and so can be taken as understood.