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COMMENT: CORPORATE GOVERNANCE: DIRECTORS VS. SHAREHOLDERS?

Craig Owen White†

My compliments to Professor Bebchuk.[1] His voice has been an important contribution to this expansive dialogue on how to improve our system of corporate governance.

Today's symposium is about corporate governance. The presentations you heard this morning and those that you will hear throughout the balance of the day are focused on the governance of publicly traded corporations. How we permit or insist that publicly traded corporations govern themselves is a very important issue and it is timely that we have this discussion, particularly as it relates to shareholder access.

Some have called this the "New Age of Corporate Governance". A writer on one of the many "blog" sites dedicated to discussing corporate governance issues proclaimed that the "package" of governance changes required under Sarbanes-Oxley, implemented in the listing requirements of NYSE, NASDAQ and the other exchanges and the trial shareholder access balloon being floated by the SEC, when taken together constitute the most significant changes in how corporations will operate in years to come.

As you weigh the sides of the different arguments you will hear today about public corporation governance, remember that this very public debate is being anxiously watched by a number of people.

A great number of enterprises that have adopted the corporate form of existence and a substantial amount of the corporate wealth in

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[1] Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557 (2005).

America reside *not* in publicly traded corporations, but in private concerns. These corporations look to the laws of the states of their incorporation for rules about governance and to courts of those jurisdictions for guidance as to the rights, duties and responsibilities of the corporation, shareholders, directors and officers alike. Many of these enterprises, some larger than publicly traded corporations, also look to their public company counterparts for best practices.

Will this new round of federalization add confusion by suggesting that there might be new standards of conduct by which corporate directors of privately held companies will be judged? Will a new view of shareholder access have a trickle down effect where majority shareholders will have to give voice or control to their minority shareholders?

Critics view the rush to impose broad and expansive federal requirements on all publicly traded corporations to redress the ills of a relatively small percentage of abusive corporations as a thinly veiled excuse to broaden the authority of the SEC and to move further toward the federalization of all aspects of corporate law. State law makers and attorneys general like those in California or New York, weigh in by making their own preemptive strikes that range from introducing legislation that would protect their ability to govern corporations transacting business in their states to showing how federalized concepts can be extended into areas like non-profit law.

It is good that we are having this discussion in public forums, not just here but around the country. And, I think it is important for the SEC commissioners to hear the concerns, particularly of companies thinking about going public as well as small cap public companies. So, I applaud Professor Bebchuk for the feedback he gave this morning to Commissioner Campos and think that everyone should be encouraged to continue to raise their voices and be heard.[2]

Obviously, the SEC has not yet adopted the proposed shareholder access rules, and probably for good reason—there are still far more questions at this stage than there are good, solid answers. Is the proposed shareholder access rule just a first step or is it a first step in a series? In the end, how far should the SEC intervene into the substantive internal workings of corporations? When does regulation incidental to disclosure of information to the public or to facilitation of that disclosure start to look like just plain regulation?

Will greater shareholder access really increase accountability? Assume for the moment that you agree with Professor Bebchuk that

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[2] Bebchuk, *supra* note 1.

the more directors are accountable to shareholders,[3] the more economically successful that corporation will be. But how much more economically successful? If the increase in shareholder value is only marginal in the largest corporations (or even the majority of corporations), does it justify the increased burdens that might be thrust upon smaller corporations? These are just some of the questions that the SEC should resolve before it enacts the final shareholder access rules.

THE CORPORATION AS A SHAREHOLDER DEMOCRACY

The issue of shareholder access and the effectiveness of the corporate proxy mechanism are not new. As early as 1942, the SEC considered addressing the issue of shareholder access. It considered the issue again in 1977 and 1992. Each time, the SEC made minor changes but otherwise concluded that, overall, the proxy mechanism fairly balanced the ownership interests of the shareholders against the long-standing premise that directors elected by the shareholders, not the shareholders themselves, should manage the corporation.

Of course, we need to periodically revisit and update how the proxy process works and how corporations interact with their shareholders, if for no other reason than that constant review is required just to keep pace with the change in the technology that allows us to communicate with one another in faster, more efficient ways.

Nevertheless, our current approaches to shareholder access seem to work, for the most part, for the great number of companies. And, having withstood the test of time, these overall assumptions should not be hastily abandoned. Any change in how we think about corporate governance should be the result of a careful, thoughtful and deliberate process.

One cannot get more deliberate than the course that the proposed 14a-11[4] shareholder access rule has traveled. The proposed rule has drawn at least as many comments from a broadly diverse field of commentators as almost any other rule proposed by the SEC. As evidenced by the exchange this morning between the Commissioner and members of this audience, our views of shareholder access touch and affect many of us in different ways. What we have seen, and what I think is becoming clear to the SEC, is that while we can all agree on general principles, the devil is in the details.

How could anyone argue *against* shareholder "democracy" and increased shareholder access and not sound like an apologist for the

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[3] *Id.*

[4] Security Holder Director Nominations, 69 Fed. Reg. 60784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249 and 274).

corporate abuses made so evident by Enron, WorldCom, and Adelphia, just to mention a few?

But is shareholder "democracy" really the right construct? And, even if it is, how much shareholder access is appropriate? If we get either question wrong, will shareholder democracy and increased shareholder access be turned on their heads and utilized as a weapon against otherwise functioning corporations?

Those who believe in the free market approach say that shareholders should have the power to decide how their enterprise is governed and by whom. One share, one vote—what could be simpler? Institutional Shareholder Services said in its comments to the SEC on the proposed shareholder access rule that "any democracy is only as robust as its electoral process."[5]

But a corporation is not a political entity; it is a complex economic proposition. The shareholders contribute their capital to a professionally managed enterprise operated with the goal of maximizing the return on that capital. Reasonable people can differ as to how to measure the maximization of return on capital and over what period of time the measurement is to occur, but a common proxy to determining shareholder value is the price the market assigns to the corporation's stock at any given time. To suggest that this complicated arrangement of internal and external constituencies, with the constant entrance and exit of citizens (shareholders) is or should be viewed as a true democracy is romantic, at best. I know of no evidence that suggests that the great number of corporations that function more like true democracies would better perform on the economic proposition however measured. Certainly, closely held private corporations as well as publicly held corporations dominated by founding families or other control groups could not be viewed as democracies and seem to excel in the execution of their economic proposition.

There are at least a couple of reasons we should be careful about granting full shareholder access on the order of a true democracy. Such access could serve to destabilize otherwise performing corporations. It is not difficult to imagine a scenario in which a publicly traded corporation could be held hostage by special interest shareholders willing to sacrifice the basic economic proposition on the altar of their cause. Even the threat of doing so might be enough to coerce corporations to adopt positions in order to avoid the cost and

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[5] Letter from James E. Heard, Chief Executive Officer in Institutional Shareholder Services, to Jonathan G. Katz, Secretary of U.S. Securities and Exchange Commission (June 13, 2003), *available at* http://www.sec.gov/rules/other/s71003/iss061303.htm.

distraction of working through the application of proposed Rule 14a-11.

Another concern is rooted in the reality of today's market. Large institutional shareholders rarely have the inclination to evaluate the governance requirements of each of their portfolio companies. This can lead to an over-dependence on independent advisors, many of whom develop policies and across-the-board governance criteria and guidelines. Faced with having to vote on a broader array of issues and director candidates that might result from broader shareholder access, the institutional investors will rely on advisors who may espouse a one-size-fits-all approach to corporate governance.

Each corporation should be judged on its own accord and according to its own circumstances. It is dangerous to conclude that staggered Boards are always bad, that poison pills never have a place on the corporate landscape, and that the role of Chairman and CEO should always be separate.

For instance, in a merger, the most critical period for the preservation of shareholder value is the period immediately following the merger. Failure of the entities to effectively integrate has been the death knell of the economic proposition of many mergers. In a merger of equals, it is not uncommon for the parties to agree on the composition of the board in order to ensure stability and internal harmony in this critical period. But ISS, for instance, has stated its fundamental opposition to what it calls "stacked" boards and has suggested that it will always oppose such arrangements.

Professor Bebchuk largely dismisses these concerns in his advocacy for true corporate democracy. In his writings, Professor Bebchuk compares shareholders in U.S. publicly traded corporations with citizens of a mythical land he refers to as Corporatia. Corporate shareholders, he says, should be on the same par as citizens in a democracy. In his preferred world, shareholders and citizens alike can only be truly protected if there exists a safety valve in the electoral process wherein those who govern are threatened with removal for failure to represent the best interests of those whom they govern.

I will come back to this analogy in a moment, but I first want to address the frame of mind that the analogy seems to suggest.

Professor Bebchuk's analogy presumes a fundamental misalignment of the interests of the director and those of the shareholders. In other words, the typical director is not to be trusted; and, left to his or her own devices, the director would, absent the threat of removal from office, act either contrary to the best interests of shareholders or in a manner that would *not* maximize shareholder value.

We all have war stories about individual directors or entire boards that have acted in questionable ways and with suspect motives. But these have always been the exception, not the norm. Even if the problem of misbehaving or inattentive directors were as widespread as Professor Bebchuk would suggest, the new rules imposed under Sarbanes-Oxley, the listing of standards of the various exchanges requiring independent directors on the audit and nominating committees, and the possibility of directors incurring serious personal liability have already had a significant impact on how boards work and how directors go about their business. And I might add that lawyers and accountants today are far more active in counseling their corporate clients and boards than they may have been in the past.

The great number of directors today take their duties seriously. They act in a professional manner and try to do the right thing; boards in even the most modestly sized companies are working hard. There are far fewer examples of cow-towed boards that are not willing to say "no" to unreasonable demands of management, whether regarding business strategies, compensation issues or otherwise. Today's seminar is subtitled "Directors vs. Shareholders." It implies some sort of contest or trade off. I do not believe that most directors see it that way. Directors are eager to hear and to take into account the concerns of shareholders while trying to maximize the overall value of the corporation. If anything, perhaps the struggle, if there is one, is between management and a variety of constituencies, including shareholders—but that is for another conference.

Professor Bebchuk would have directors consider only the interests of shareholders; for if they do not, the directors will be removed. And that is where my views part with those of Professor Bebchuk. At this point I cannot tell whether his call for accountability is a call for voice or control. Why does Professor Bebchuk say that proposed Rule 14a-11 goes in the right direction but does not go far enough? Because under the proposed rule, a disgruntled, motivated shareholder only gets to nominate directors. Not only does the shareholder have to convince a plurality of shareholders to go along but, more importantly, with a staggered board, the new directors would only be voices on the board.

Professor Bebchuk wants to go much further. He wants the shareholders to elect the full board annually and to be able to take control of the corporation to change its course. The directors, whether independent or not, are expected to maximize shareholder value. Presumably, Professor Bebchuk looks only at share price to determine if shareholder value is being maximized.

Short-term shareholder value, however, is not always the last word. In many states, including Ohio,[6] directors *are* permitted (and should be encouraged) to consider the impact of corporate decisions on other stakeholders in the corporation. Where is the impact on employees who have committed their work lives to the success of the corporation or a community that has committed low cost funds and other investments in Professor's Bebchuk's calculation of shareholder value? Can we be sure that directors subjected to removal by shareholders will even explore these broader perspectives? What is the long-term commitment of shareholders to the corporation? Proposed Rule 14a-11 does a credible job of establishing qualifying bars for shareholders to access the rule.[7] But in Corporatia, a motivated shareholder could have his cake and eat it too. For under the rules that Professor Bebchuk advocates, any shareholder who was so motivated could launch his campaign and, if successful, could replace a majority of the directors and get reimbursed by the corporation for having waged the fight. But having done so, where is the commitment from the shareholder to stick around? Having changed the directors, if the company starts to lose money, there is nothing to keep the shareholder from cashing out and saying, "Oh, never mind."

In the absence of sufficient data to support the conclusion that directors in most corporations are not responsive to shareholders or are acting to suppress shareholder value, the case for expanding shareholder access beyond what is called for in proposed Rule 14a-11 is shaky at best.[8]

To come back to Professor Bebchuk's analogy comparing a corporation to a democratic entity he calls Corporatia. Can traditional principles of democracy really be effectively applied in the realm of corporate governance? The average person could tell you of which country he or she is a citizen. And, except for the distinct minority of persons who hold dual citizenship, the rule of thumb is one country of citizenship per person. As a result, whether a person comes to citizenship by birth or voluntary election, there is a serious and deep commitment to the relationship. And, while it may be possible to renounce one's citizenship, to do so is an involved and serious step.

Being a shareholder in a corporation, in all but rare instances, is a wholly voluntary act. And, while the citizen of a country is raised to expect at least the very basics from his nation, this is not the case with shareholders. In the last few days, I took a poll of my friends and

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6 OHIO REV. CODE ANN. § 1701.59(E) (West 2004).

7 Security Holder Director Nominations, 68 Fed. Reg. at 60784.

8 *Id.*

family who are invested in the capital markets. Only a few could tell me the names of more than a few corporations in which they are shareholders, and of those, none could name directors or executive officers of those corporations. Most held interests in mutual or pension funds, never having held a share certificate in their name and rarely saw, let alone read, a proxy statement.

Today's shareholders, institutional or mom-and-pops, shop for their investments as a diner would compose a lunch tray in a cafeteria. There are a number of diverse opportunities from which the investor may choose. State law affords an annual meeting where management must at least appear before shareholders and where directors are periodically elected and the cost of entering a corporation is as low as the cost of exiting.

Shareholders who are disgruntled over corporate performance (i.e., share price) or policies are more likely to sell their shares and move on than to incur the cost of picking their way through the rule's procedures only to risk an uncertain outcome. Professor Bebchuk thinks that it is an injustice for a shareholder to have to accept less than what he believes might be the maximum economic potential of those shares had the board been changed.[9] Since there are so many factors that impact the value of shares, it is hard for me draw a direct positive correlation between the composition of the board of directors and the market's valuation of a corporation at any given time. I must conclude that Professor Bebchuk's concerns, while real and worthy, are not enough to offset the countervailing considerations, especially in light of added costs that would be incurred by the corporation as well as by the SEC in having to police a full access rule.

THE FEDERALIZATION OF CORPORATE LAW.

In the wake of corporate scandals, it was appropriate for Congress and the SEC to take action to shore up confidence in our capital markets. But SEC authority in this area is designed to ensure the fair, open, and equal disclosure of information. Proposed Rule 14a-11 clearly goes beyond merely compelling disclosure of information and moves into substantive areas involving the internal workings of corporations.[10]

Congress preempted state corporate law in the 1933 and 1934 securities acts and a host of other laws governing specialized securities concerns. But, in each instance, the focus of the preemption was on how those concerns operated within the public securities markets.

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[9] Bebchuk, *supra* note 1.

[10] Security Holder Director Nominations, 68 Fed. Reg. at 60784.

Unless and until Congress decides to test its preemptive powers on substantive issues of corporate law, the SEC must remain respectful of the fact that corporations are creatures of state law. Nothing could be more fundamental to substantive corporate law than the relationship between the corporation and its owners.

The proposed Rule 14a-11, as currently structured, represents a compromise by reserving to the states the ability to prohibit or otherwise restrict shareholder participation in the director nomination process.[11] Professor Bebchuk, on the other hand, advocates a fundamental restructuring of the shareholder franchise and, in doing so, would seriously encroach upon state law.[12]

Whether it is the limited scope of the proposed Rule 14a-11 or Professor Bebchuk's more expansive theories, this much is clear: The federal government is poised to take the next major step in federalizing corporate law, and there are signs that some states are not going to take this issue laying down. Already we have seen preemptive strikes from an activist Attorney General in New York[13] and a proactive state legislature in California.[14]

For instance, earlier this year, the Corporation Election Fairness Act of 2004 was introduced in the California statehouse.[15] The California bill would have applied to any publicly traded corporation doing business in the State of California. In those corporations, shareholders holding just two percent of a company's securities could nominate forty percent of the directors in each election and would have access to the company's website and proxy materials to advocate for its candidates. Reading between the lines, the California Secretary of State, not the SEC or even the law of the incorporating state, would govern the operation of the Corporation. Although the bill died a predictable death, it could herald a new wave of activism as states maneuver around the SEC.

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[11] *Id.*

[12] Bebchuk, *supra* note 1.

[13] *See, e.g.*, Press Release, Office of New York State Attorney General Eliot Spitzer, State *Investigation Reveals Mutual Fund Fraud* (September 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html; Press Release, Office of New York State Attorney General Eliot Spitzer, SEC, *NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices* (December 20, 2002), *available at* http://www.oag.state.ny.us/press/2002/dec/dec20b_02.html.

[14] *See* http://www.governor.ca.gov/state/govsite/gov_htmldisplay.jsp?BV_SessionID=@@@@044768 6570.1113926180@@@@&BV_EngineID=cccjaddeghddgjdcfngcfkmdffidfnf.0&sCatTitle=Press+Release&sFilePath=/govsite/press_release/2004_09/20040922_GAAS43604_LegUpdate.html&sTitle=Legislative+Update+09%2f22%2f2004&iOID=58775 (last visited May 10, 2005).

[15] A.B. 2752, 2003-2004 Reg. Sess. (Cal. 2004) (The bill was later renamed the Corporate Elections Disclosure Act of 2004).

THE LAW OF UNINTENDED CONSEQUENCES.

Moving too fast in the area of shareholder access, especially in the absence of definitive evidence that more shareholder access directly correlates with an increase in shareholder value, could be an invitation to unintended consequences. There have been a lot of changes thrown at corporations and those who manage them. Corporations are still sorting out the new compliance and reporting requirements, especially the 8-K reporting requirements. Smaller corporations are still chafing under increased costs brought about by these changes, and I am sure the same pressures are being felt within the SEC as the staff is called on to provide instruction, explanation and guidance. One possible result is that we have erected hurdles to participating in our public capital markets.

Meanwhile, directors of publicly traded companies may be left wondering what all these changes in shareholder access mean to the business judgment rule. For example, should a shareholder submit a candidate's name to the board of directors, those directors may no longer feel safe in using their own best judgment in evaluating the potential nominee's qualifications. Where the directors may have turned down a potential nominee as unqualified, the directors may now feel that they must accept the shareholder nominee as they may be judged based on the standards set forth in the proposed 14a-11, which requires a public company to put shareholder nominees on the ballot after certain triggering events.[16]

Other possible unintended consequences of broad shareholder access include an unnecessary distraction of directors. Rather than focusing on the corporation's business at hand, Professor Bebchuk's full access approach[17] would invite (or even encourage) the director to worry about the spin on each vote or action, hire a lawyer or a public relations firm to be sure that he or she is appropriately "positioned" for reelection.

TECHNOLOGY ADVANCES MAY RENDER SHAREHOLDER ACCESS RULES MOOT.

The pace of advancement in communication technology is another reason why it makes sense to move cautiously in broadening the current shareholder access to corporations. Our leading goal is to increase the accountability of directors. It is sometimes easy to confuse access for the purpose of control versus access for the purpose of

[16] Security Holder Director Nominations, 68 Fed. Reg. at 60784.

[17] Bebchuk, *supra* note 1.

voice or the right to be heard. Professor Bebchuk seems to take the view that if a director hears shareholders but does not follow their direction, that director is not accountable. He then logically concludes that the offending director should be removed.

But if you see the world as I do, in which access is primarily about voice, then technological advances in how we communicate may solve most of our problems. When a corporation strays too far off course, shareholders who desire a change have many more vehicles today for pressing their case with other shareholders and broader constituencies capable of bringing pressure on directors as well as management.

The monopoly of communicating with shareholders through the formal proxy mechanism once held by corporations has been left in tatters by the Internet, web pages, e-mail, group mail, and now "blogs." Witness the recent public campaign at Disney.

Even when shareholders do not know the identity of other shareholders, they can communicate to key opinion makers and indirectly impact the advice of the advisers who in turn talk to and influence the individual as well as institutional shareholders.

In conclusion, reasonable federal reforms of corporate governance are needed and are, at this time, appropriate. But federal encroachment and preemption on traditional areas of state law, however indirect, must be minimized and reform efforts should be narrowly tailored to address the abuses of problem companies. We should discourage any shotgun approach that is based on the belief that there is a widespread misalignment between the board of directors and shareholders. Moreover, mindful of the law of unintended consequences and the realities of slippery slopes, reform should be focused, deliberate and reflective, rather than general and reactive.