UCLA
UCLA Law & Economics Series

Title
The Limits of the Right to Sell and the Rise of Federal Corporate Law

Permalink
https://escholarship.org/uc/item/37s9479z

Journal
70 Okla. L. Rev. 159 (2017

Author
Park, James

Publication Date
2017-07-01

eScholarship.org Powered by the California Digital Library
University of California

UCLA School of Law

Law & Economics Research Paper

THE LIMITS OF THE RIGHT TO SELL AND THE RISE OF FEDERAL CORPORATE LAW

BY

JAMES J. PARK

PROFESSOR OF LAW

70 *OKLA. L. REV.* 159 (2017).

Oklahoma Law Review

Volume 70 | Number 1
Symposium: Confronting New Market Realities: Implications for Stockholder Rights to Vote, Sell, and Sue

2017

The Limits of the Right to Sell and the Rise of Federal Corporate Law

James J. Park

Follow this and additional works at: https://digitalcommons.law.ou.edu/olr

 Part of the Business Organizations Law Commons

Recommended Citation

James J. Park, *The Limits of the Right to Sell and the Rise of Federal Corporate Law*, 70 Okla. L. Rev. 159 (2017).

This Panel 2: Right to Sell is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oklahoma Law Review by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact Law-LibraryDigitalCommons@ou.edu.

THE LIMITS OF THE RIGHT TO SELL AND THE RISE OF FEDERAL CORPORATE LAW

JAMES J. PARK*

Table of Contents

I. Introduction 159
II. The Right to Sell and Corporate Law 162
III. Two Limits of the Right to Sell 167
A. Corporate Failures 168
1. Mismanagement and Precipitous Shareholder Losses 168
2. Federal Intervention 170
B. Materiality and Corporate Governance 176
1. The Difficulty of Valuing Governance 176
2. The Example of Executive Compensation 179
IV. Assessing the Rise of Federal Corporate Law 181
A. A Test for Evaluating Federal Corporate Law 181
B. Efforts to Protect Investors from Corporate Failures 182
C. Efforts to Regulate Corporate Governance 184
V. Conclusion 186

I. Introduction

For skeptics of mandatory corporate law, the right to sell is the most important of the three investor rights.[1] The legal rights to vote and sue are of limited effectiveness in the modern corporation, where the directors control the proxy statement and are generally shielded from suit by the business judgment rule. The self-help strategy of selling is a simple but powerful way for the unhappy shareholder to protect himself when he believes that the governance of a corporation is corrupt.

Indeed, the right to sell is arguably the defining characteristic of a public corporation. Public shareholders can easily exit their investment by selling their shares while private shareholders cannot. Public companies are thus

* Professor of Law, UCLA School of Law. Thanks to Jaclyn Newell for excellent research assistance.

1. *See, e.g.*, Strougo v. Hollander, 111 A.3d 590, 595 n.21 (Del. Ch. 2015) (identifying the "default powers of shareholders as three: the right to vote, the right to sell, and the right to sue" (quoting WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 177 (2d ed. 2007)).

Published by University of Oklahoma College of Law Digital Commons, 2017

subject to a different sort of regulation than private companies.[2] Because public shareholders can easily sell their shares, the market will check poor corporate governance. As unhappy investors exit, the price of the company's stock will drop, making it easier for a new owner to purchase control of the company. Henry Manne, who first recognized the significance of this market for corporate control, thus declared that there were "Two Corporation Systems," with the economic incentives of investors playing an equal role as the law in regulating the public corporation.[3]

Scholars who view corporate law through a law and economics lens thus argue for less government regulation rather than more. In the context of corporate governance debates, the right to sell has long supported the argument that the ongoing judgment of a market of self-interested investors is a better judge of good and bad governance than regulators and judges.[4] Under this view, public companies are mainly public in the sense that they are subject to monitoring by public markets. They are not public in the sense that the government should shape them in a way that furthers the public good. In the United States, public companies have thus been regulated by a relatively limited set of federal securities laws, with the bulk of corporate governance rules left to the states.

Over the last decade and a half, this framework has come under pressure. The argument that public companies should be left relatively free from corporate governance regulation has been challenged by the increasing federalization of corporate law in the United States. Public companies, especially large ones, are increasingly differentiated from private companies through the regulatory requirements of federal law.[5] The federal securities laws have been amended through statutes such as the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")[6] and the Dodd-Frank Wall Street

2. *See* Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 259 (1967) [hereinafter Manne, *Our Two Corporation Systems*].

3. *See generally id.*

4. The right to sell corresponds with the concept of Exit described by Albert Hirschman as one of three ways a member can influence an organization. *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: REPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 4 (1970). Hirschman observes that "exit" corresponds to "market" rather than "non-market forces," which correspond to the option of "voice." *Id.* at 19.

5. For an analysis of this trend, see Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013).

6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 15, 18, 28, & 29 U.S.C.).

https://digitalcommons.law.ou.edu/olr/vol70/iss1/4

Reform and Consumer Protection Act ("Dodd-Frank"),[7] which contain mandates relating to corporate governance. Now, public companies are being shaped by law rather than economics.

The heightened federal interest in corporate governance can be linked to the limits of the right to sell.[8] This Article focuses on describing two of these limits. First, when there are serious corporate governance problems that result in a precipitous decline in the company's fortunes, shareholders do not have time to exercise the right to sell. Investors thus are unable to meaningfully pressure management for change and are unable to protect themselves from substantial losses. The second limit relates to corporate governance practices that may be suboptimal, but do not significantly impact the economic value of the firm. Because shareholders will not sell with respect to "immaterial" governance concerns, the right to sell is unable to pressure managers to change.

The Article then shows how federal regulation of corporate governance can be understood as addressing these two limits. The internal control provisions of Sarbanes-Oxley seek to prevent substantial destruction of shareholder value caused by misappropriation or fraud by managers. Executive compensation reforms—such as those found in Dodd-Frank—were partly necessitated by the view that the market was unable or unwilling to pressure the board to change compensation policy. In particular, the Say-on-Pay reform is an attempt to increase shareholder voice on executive compensation.

These interventions have blurred the distinction between corporate and securities law. More and more, federal securities laws are imposing mandatory requirements on public corporations. These regulations are corporate law in that they are meant to protect shareholders from destruction of value while they own a stock, rather than securities law that protects investors when they purchase securities. As the limits of the right to sell have become more apparent, federal corporate law is addressing those limits.

---

7. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

8. Another prominent explanation has been the general tendency of Congress to pass governance measures in response to a stock market collapse. *See, e.g.*, Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1782-83 (2011) (discussing passage of Dodd-Frank); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005) (discussing passage of Sarbanes-Oxley).

Published by University of Oklahoma College of Law Digital Commons, 2017

The Article concludes by evaluating these federal interventions under a framework developed in a previous article.[9] The danger of federal corporate law is that it can impose mandatory rules that only benefit a subset of shareholders. The question Congress should ask when making federal corporate law is whether such efforts would clearly benefit almost all shareholders. Applying this framework shows that there is a better case for federal intervention to ensure the integrity of large public company valuations than there is for federal executive compensation reform. Shareholders have a strong interest in preventing precipitous destruction of shareholder value, but shareholders may not agree on the need for particular corporate governance provisions.

Part II of the Article briefly traces the intellectual history of the right to sell in the context of corporate law. Part III then describes two major limitations on the right to sell and how aspects of recent federal legislation are best understood as responses to these limitations. Part IV assesses these federal reforms. Part V concludes the Article.

II. The Right to Sell and Corporate Law

This Part II traces the origins of the right to sell in the corporate law literature. Two prominent law and economics scholars, Henry Manne and Ralph Winter, discussed the right to sell in challenging two influential arguments. The first was that agency costs within the corporation make it likely that managers will exploit shareholders, necessitating protection through corporate law. The second was that federal intervention is necessary to remedy the laxity of state corporate law.

Writing in 1959, Harvard Law Professor Abram Chayes was one of the first legal scholars to note the role of the right to sell in protecting shareholders.[10] Commenting on efforts to promote shareholder democracy to check corporate power, Chayes argued that increasing shareholder voice would be ineffective in regulating the power of significant public corporations.[11] Unlike other stakeholders, shareholders are free to sell their shares, and thus are able to protect themselves from poor corporate decision making. Because of this ability to disassociate from the corporation,

9. James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116, 137-43 (2017).

10. Abram Chayes, *The Modern Corporation and the Rule of Law*, *in* THE CORPORATION IN MODERN SOCIETY 25, 40 (Edward S. Mason ed., 1959).

11. *Id.* at 40 ("It is unreal, however, to rely on the shareholder constituency to keep corporate power responsible by the exercise of the franchise.").

shareholders are no more entitled to a voice than groups such as workers that cannot exit the corporation.[12]

Citing aspects of Chayes's work a few years later, Henry Manne challenged the famous Berle and Means theory.[13] Under their agency costs framework, corporate law is necessary to address the "separation of ownership and control" that leaves managers unchecked in furthering their interests at the expense of shareholders.[14] In discussing the issue of corporate democracy, Manne noted that the right to sell provided an alternative remedy for poor corporate governance. As more and more unhappy shareholders sell their shares, the company's stock price will decline, making it easier for an outside investor to purchase enough shares to gain control of the company.[15]

This, of course, was Manne's famous market for corporate control argument, which he later elaborated on in a 1965 article, *Mergers and the Market for Corporate Control*.[16] In that article, Manne described the role of markets in policing the effectiveness of managers.[17] While state corporate law does not actively judge management performance, the market for control provides "some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders."[18] The market, rather than the law, thus provides shareholders with protection from mismanagement.

---

12. For a more recent argument that the right to sell undermines the shareholder democracy analogy, see Usha Rodriguez, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1398 (2006) (referring to "the power of easy exit through the sale of their shares – that is, the power to leave their polity").

13. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Transaction Publishers 1991) (1932).

14. Henry G. Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 399, 418 (1962) [hereinafter Manne, *The Modern Corporation*].

15. *Id.* at 410-11. Adolf Berle responded to the right to sell argument, noting that corporations do not always need to seek financing, thus the right to sell may not meaningfully check managers. *See generally* Adolf A. Berle, *Modern Functions of the Corporate System*, 62 COLUM. L. REV. 433 (1962). However, Berle did not directly address Manne's market for corporate control argument.

16. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) [hereinafter Manne, *Mergers and the Market*].

17. *Id.* at 113.

18. *Id.*

Published by University of Oklahoma College of Law Digital Commons, 2017

It is perhaps no accident that Manne's work coincided with the development of the efficient markets hypothesis by financial economists.[19] If stock prices reflect available information about the corporation and its value, they should also reflect information about the governance of the corporation. Manne's work thus linked an emerging body of research to debates among corporate law scholars about the nature and scope of public company regulation.

Another important Manne article, *Our Two Corporation Systems: Law and Economics*, further developed the implications of the right to sell for corporate governance.[20] The article began by noting that corporate law scholarship should distinguish between public corporations, which are subject to market forces, and closely held corporations, which are not. An advantage of the public corporation is "the investor's freedom to dissociate himself from a particular corporation if for any reason he becomes dissatisfied with its management."[21] "[T]he market allows discrete decisions to be made by individual investors" to sell their shares rather than requiring a collective decision to dissolve the corporation.[22] According to Manne, the right to sell is a more effective way of regulating management than the legal method of the derivative suit, "which can be used only to police the more blatant forms of wrongdoing."[23] The operation of "market forces" should "constrain managers in a far more significant fashion than does the derivative suit."[24]

Building on Manne's insights nearly a decade later, Ralph Winter defended state regulation of corporate law against persistent arguments for federal incorporation.[25] Prominent commentators such as William Cary, a former SEC Chairman and Columbia Law School professor, had criticized state corporate law, particularly the law of Delaware, as failing to adequately protect shareholders from managers.[26] For Cary, federalism in corporate law leads to a "race for the bottom," where states will cut back on

19. Eugene Fama's article *The Behavior of Stock-Market Prices* was published in 1965, the same year as Manne's *Mergers and the Market for Corporate Control*. *See* Eugene F. Fama, *The Behavior of Stock-Market Prices*, 38 J. BUS. 34 (1965).

20. Manne, *Our Two Corporation Systems*, *supra* note 2.

21. *Id*. at 264.

22. *Id*.

23. *Id*. at 273.

24. *Id*.

25. Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

26. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

shareholder protections to influence managers to choose their jurisdiction when forming a corporation. Winter noted that these criticisms implied that the stock prices of Delaware corporations would be lower than corporations formed in other states because Delaware shareholders would sell their shares if they were not protected from corporate mismanagement relative to other states.[27] It would not be "in the interest of Delaware corporate management or the Delaware treasury for corporations chartered there to be at a disadvantage in raising debt or equity capital relative to corporations chartered in other states."[28] Citing Manne, Winter also noted that a corporation whose shareholders are selling their shares would be vulnerable to a hostile takeover that would replace its management.[29] Because of the shareholder's right to sell, the "chartering decision . . . so far as the capital market is concerned, will favor those states which offer the optimal yield to both shareholders and management."[30]

The next generation of corporate law scholars empirically tested Winter's hypothesis that Delaware had an incentive to create law that would dissuade shareholders from valuing the company less because of poor corporate governance. An event study by Roberta Romano showed that corporations moving to Delaware did not suffer a statistically significant negative stock price reaction.[31] In discussing Delaware's incentive to maximize shareholder wealth, Romano discussed the right to sell, explaining:

> Stockholders are expected to sell their shares if their firm is in a jurisdiction with inferior (non-value-maximizing) laws, in order to invest in the more valuable firms located in states with more favorable legislation. These transactions will cause the stock price of the business incorporated under the inefficient legal regime to decline. . . . As a result, the corporation may be the

27. Winter, *supra* note 25, at 256.

28. *Id.* at 257.

29. *Id.* at 266.

30. *Id.* at 275.

31. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 226-73 (1985). A later study by Robert Daines found evidence that the average Tobin's Q, a measure of the market value of a firm, was higher for companies incorporated in Delaware. *See generally* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001). This Delaware effect, however, has not persisted. *See* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32 (2004).

Published by University of Oklahoma College of Law Digital Commons, 2017

> target of a takeover attempt, for new owners will be able to increase firm value by changing the corporate domicile.[32]

The right to sell is also relevant to modern corporate governance debates about increasing shareholder power. For some time, shareholder rights were seen as unimportant to large investors, who were apathetic about exercising such rights because they could simply sell their shares.[33] Opponents of increasing shareholder rights have cited the ability of shareholders to exit in resisting significant changes to the balance of power between shareholders and the board. As Stephen Bainbridge wrote in response to a proposal by Lucian Bebchuk to increase shareholder power,[34] when "governance terms are unfavorable, investors will discount the price they are willing to pay for that firm's securities. As a result, the firm's cost of capital rises, leaving it, inter alia, more vulnerable to bankruptcy or hostile takeover."[35] According to Bainbridge, shareholder power is thus unnecessary to protect most shareholders and could result in disruptive activism that undermines the power of the board to exercise centralized authority over the corporation on behalf of all shareholders.[36] Bebchuk's reply to Bainbridge noted that the idea of a vibrant market for corporate control is no longer realistic given the potency of takeover defenses such as the poison pill.[37]

Recently, John Morley and Quinn Curtis invoked the right to sell in another context, the governance of mutual funds.[38] Investors in an open-ended mutual fund are permitted to exchange their shares immediately for

---

32. Romano, *supra* note 31, at 229-30.

33. *See, e.g.*, Louis Lowenstein, *Beating the Wall Street Rule with a Stick and a Carrot*, 7 ANN. REV. BANKING L. 251, 251 (1988) ("The Wall Street Rule, which has been immutable for as long as any of us can remember, dictates that shareholders not take an active role in corporate affairs.").

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

35. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736 (2006) [hereinafter Bainbridge, *Director Primacy*]; *see also* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 122 (2004) (noting market constraints on management).

36. Bainbridge, *Director Primacy*, *supra* note 35, at 1744-51.

37. *See, e.g.*, Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1790 (2006) ("The market for corporate control thus leaves management with considerable slack.").

38. John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84 (2010). Morley also invokes the right to sell in explaining why investors give managers significant control over investment funds. *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228 (2014).

https://digitalcommons.law.ou.edu/olr/vol70/iss1/4

cash. Their withdrawal represents a proportionate share of the value of the assets held by the mutual fund. In contrast, investors who own stock directly will find that their investment reflects the future prospects of the firm, including the value destruction that may be caused by poor governance. Although a shareholder must sell at a price discounted by the possibility of mismanagement, the mutual fund shareholder can sell at a price that does not reflect the future impact of poor fund governance. Morley and Curtis are thus skeptical about the need for mutual fund governance measures such as voting, boards, and excessive fee litigation. They argue that the right of mutual fund investors to sell may mean that such governance may be unnecessary and should be replaced by other forms of regulation.

More than fifty years after Manne's initial work on the subject, the right to sell continues to be influential with respect to the assessment of corporate governance rules. Scholars who view markets as the primary regulator of corporate governance "focus on exit as a kind of first among equals" with respect to the various options (Exit, Voice, and Loyalty) that Albert Hirschman described for influencing an organization.[39] The argument that shareholders can protect themselves from managerial misconduct by exiting offers a powerful reason for limiting corporate governance regulation.

III. Two Limits of the Right to Sell

Over the years, the right to sell has had varying degrees of success as an argument to resist federal regulation of the public corporation. The world has changed since the time of Manne and Winter. Corporations have grown larger and more complex. Technology has created ventures that can be extremely profitable for investors but are difficult to value. The creation of wealth has provided more opportunities for managers to divert gains for themselves. As a result, investors must place more and more trust in the integrity of management and the systems they have put in place to monitor risk.

In part because of the complexity of this new world, the severity of corporate governance scandals has increased, highlighting the limits of the right to sell in protecting shareholders. This Part III argues that two of these limitations explain increasing federal intervention with respect to the public corporation. First, the right to sell can be ineffective when bad corporate governance results in a rapid and substantial decline in corporate value.

39. Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1673 (1985).

Published by University of Oklahoma College of Law Digital Commons, 2017

Shareholders may not have time to pressure management to change or sell to protect themselves in such circumstances. Second, some corporate governance issues may be difficult to directly link to the economic performance of the firm. Even if shareholders prefer a particular governance measure, if it does not have a direct impact on the stock price, shareholders will not have an economic incentive to sell their shares. The recent efforts to federalize corporate law might be understood as addressing these two limitations to the right to sell.[40]

A. Corporate Failures

1. Mismanagement and Precipitous Shareholder Losses

The right to sell's effectiveness depends in part on whether shareholders have time to exercise the right. One obvious drawback of the right to sell is that selling shareholders will necessarily take a loss. As Manne acknowledged, "sales by dissatisfied shareholders are necessary to trigger the mechanism and . . . these shareholders may suffer considerable losses."[41] According to Manne, the right to sell operates after these initial losses in preventing "even greater capital losses,"[42] presumably by either pressuring management to change or by selling to a new control group that will implement new management and policies.

The right to sell should work best in situations where a particular governance policy has a clear but modest impact on the company's performance. Over time, shareholders who are unhappy with the stock price will gradually exit from the company. Such shareholders can take a manageable loss and move on to another investment. This basic pattern does not apply to the modern corporate crisis where public companies of substantial size have quickly collapsed, arguably because of poor corporate governance, leaving shareholders with little time to exercise the right to sell.

To be fair, the proponents of the right to sell do not view it as a panacea in preventing serious losses. Manne noted that in certain circumstances,

---

40. There are, of course, other limitations, such as the ability of managers to entrench themselves so they do not have to respond to the market for corporate control.

41. Manne, *Mergers and the Market*, *supra* note 16, at 113; *see also* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1443 (1989) (noting that shareholders in company with an unfavorable change in governance "can sell, but they can't avoid the loss"); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1550 (1989) ("The seller of shares bears the consequences of agency costs through a lower sale price.").

42. Manne, *Mergers and the Market*, *supra* note 16, at 113.

selling by shareholders may "imply that the corporation will not survive."[43] Manne also acknowledged that "corporation law must still provide some device for recovering damages from dishonest, disloyal or grossly negligent managers," though he criticized the derivative suit as ineffective relative to the right to sell.[44] Nevertheless, Manne may not have anticipated the events that in more recent years have resulted in questions concerning the effectiveness of the right to sell.

Corporate governance scholars have long observed that shareholders are best able to protect themselves from poor management when it is observable prior to their investment in the firm. Lucian Bebchuk, for example, in discussing the issue of whether corporate law should be mandatory or enabling, distinguishes between governance provisions that are set forth in the initial corporate charter and those that are adopted midstream by managers.[45] While shareholders can price the likely effect of poor governance before they enter an investment, they are vulnerable when there is an unexpected governance change after they have invested.

A distinction might also be drawn between situations where midstream conduct causes modest harm and where midstream conduct causes significant harm. In cases of modest harm, shareholders can react by selling their shares, putting pressure on the company to make a change. In cases of significant harm, the damage may be so substantial that the company is unable to recover. Even if shareholders sell their shares, the damage has already been done and may not be reversible.

The distinction between modest and significant declines in value depends on the assumption that the market is not completely efficient in assessing the fundamental value of the company. If the market were that efficient, shareholders would be compensated for the risk of a precipitous decline. The initial price they paid for the stock would have been appropriately discounted to take into account the possibility of a complete loss.

There is reason to believe, though, that it is difficult to adequately compensate investors for taking on the risk of a sudden collapse. Consider a case where there is a 50% chance that a firm is worth $90, and a 50% chance the firm is worth $10. One view might be that the correct stock price should be $50. An investor who pays that amount is arguably compensated for the risk of loss. On the other hand, because of the wide variance in possible outcomes, there is an argument that $50 would not be a meaningful

43. Manne, *The Modern Corporation*, *supra* note 14, at 410.

44. Manne, *Our Two Corporation Systems*, *supra* note 2, at 272.

45. Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

Published by University of Oklahoma College of Law Digital Commons, 2017

price. As finance professor and valuation expert Aswath Damodaran observes:

> In general . . . best-case/worst-case analyses are not very informative. After all, there should be no surprise in knowing that an asset will be worth a lot in the best case and not very much in the worst case. Thus, an equity research analyst who uses this approach to value a stock priced at $50 may arrive at values of $80 for the best case and $10 for the worst case; with a range that large, it will be difficult to make a judgment on whether the stock is a good investment.[46]

When risk is uncertain, there is a danger of substantial mispricing. Consider a scenario where the market believes there is a 0% chance of a complete collapse for a $100 stock, but the true risk is 10%. Under that scenario, the stock should be priced at $90. The shareholder who purchases the stock for $100 would overpay by $10.

Even if a market is efficient, the risk of loss may not stay constant. The initial price the shareholder paid for the stock becomes less relevant when a shareholder holds the stock for a significant length of time. A shareholder may purchase at a time when there was no risk that a stock would go to $1, but several years later, the risk of such a loss suddenly increases to 80%. One might argue that the price the shareholder paid reflected the risk that years later the risk of loss would increase, but it is unlikely that the market will always be able to meaningfully assess the probability of events years in the future.

The right to sell thus assumes that investors are able to adequately assess the risk of a catastrophic governance failure. Because it can be difficult to evaluate such risk, the right to sell will not always protect investors from midstream conduct that results in significant value destruction.

2. Federal Intervention

Though there have always been questionable public companies that collapse in the wake of poor decisions, there are now more examples of companies that were thought to be stable companies of significant value but have quickly failed, arguably because of systematic corporate governance failure. These cases illustrate the limits of the right to sell and were the

46. ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF *ANY* ASSET 895 (3d ed. 2012).

https://digitalcommons.law.ou.edu/olr/vol70/iss1/4

main impetus for the passage of federal corporate law that seeks to protect shareholders of significant public companies from substantial loss.

Three of the most startling examples of failed public companies are Enron, WorldCom, and Lehman Brothers. Enron was an energy company with the seventh-highest market capitalization in the United States and a triple-A credit rating. It issued a substantial earnings restatement in October 2001, issued a multi-year restatement in November 2001, and then filed for bankruptcy less than a month later.[47] WorldCom was a telecommunications company. In June 2002, it reported that it had understated its expenses by $3.852 billion and restated its earnings.[48] It filed for bankruptcy less than a month later. Lehman Brothers was an investment bank with a market capitalization of over $30 billion in January 2008.[49] Less than eight months later, it filed for bankruptcy protection after its market capitalization declined by nearly 95%.

External events likely played a major role in the decline of these companies. Both the Enron and WorldCom crises occurred in the wake of the collapse of the first internet bubble.[50] Investors became less willing to invest in companies with speculative businesses. The market for telecommunications services declined, making it difficult for WorldCom to maintain its earnings. Lehman Brothers collapsed in the wake of the financial crisis of 2008, as investors began questioning the value of mortgage-related assets on the balance sheets of financial institutions.

All three of these failures were also arguably caused by poor corporate governance. Enron failed to manage transactions with special purpose entities that resulted in significant conflicts of interest.[51] WorldCom failed to prevent significant accounting fraud.[52] Lehman Brothers failed to

47. Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 J. ECON. PERSP. 287, 288 (2003).

48. DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. 2 (Mar. 31, 2003).

49. Report of Anton R. Valukas, Examiner at 2, *In re* Lehman Brothers Holdings Inc., 526 B.R. 481 (Bankr. S.D.N.Y. 2014) (Nos. 08–13555 (SCC), 08–01420 (SCC)).

50. *See generally* ROGER LOWENSTEIN, ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING (2004).

51. For a report on some of these transactions, see First Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Oct. 23, 2003).

52. For a concise description of the fraud, see First Amended Complaint, Sec. & Exch. Comm'n v. WorldCom, Inc., 452 F. Supp. 2d 531 (S.D.N.Y. 2006).

Published by University of Oklahoma College of Law Digital Commons, 2017

manage the risk of its balance sheet.[53] Executives at both Enron and WorldCom were convicted of criminal securities fraud.[54] The board members of WorldCom were required to personally contribute to settlements of civil actions arising from the fraud.[55]

The failure of these companies and the resulting shareholder losses illustrate the limits of the right to sell. Investors suffered billions of dollars in permanent losses from investments in what were established public companies. Many investors had no meaningful opportunity to sell, and even if they had, the pressure caused by their sales was too late to effectuate meaningful governance change. These events lead some investors to question their approach to corporate governance problems. As a 2010 policy paper by TIAA-CREFF analyzing the "Crises of the Last Decade" noted, investors can no longer rely on their right to sell for protection but instead "should be vigilant in trying to prevent problems before value is lost and it is too late to sell . . . ."[56]

The governmental response to these monumental governance failures was significant federal intervention. Rather than leave the protection of shareholders to the states, Congress passed two major Acts that have helped shape the governance of large public companies. The first, the Sarbanes-Oxley Act,[57] addressed the problem of unexpected company failures by strengthening internal control requirements and requiring board audit committees to be independent.[58] As described by a congressional report, Sarbanes-Oxley was prompted by "recent corporate failures" and included measures to "improve investor protection in connection with the operation

---

53. *See* Valukas, *supra* note 49.

54. *See* Alexei Barrionuevo, *Enron Chiefs Guilty of Fraud and Conspiracy*, N.Y. TIMES (May 25, 2006), http://www.nytimes.com/2006/05/25/business/25cnd-enron.html; Ken Belson, *Ex-Chief of WorldCom Is Found Guilty in $11 Billion Fraud*, N.Y. TIMES (Mar. 16, 2005), http://www.nytimes.com/2005/03/16/business/exchief-of-worldcom-is-found-guilty-in-11-billion-fraud.html.

55. *See, e.g.*, Gretchen Morgenson, *10 Ex-Directors from WorldCom to Pay Millions*, N.Y. TIMES (Jan. 6, 2005), http://www.nytimes.com/2005/01/06/business/10-exdirectors-from-worldcom-to-pay-millions.html.

56. TIAA-CREFF INST., POLICY BRIEF: RESPONSIBLE INVESTING AND CORPORATE GOVERNANCE: LESSONS LEARNED FOR SHAREHOLDERS FROM THE CRISES OF THE LAST DECADE 1-3 (Mar. 2010), https://www.tiaadirect.com/public/pdf/institute/pdf/pb_responsibleinvesting0310a.pdf.

57. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 15, 18, 28, & 29 U.S.C.).

58. *Id.* § 404. Sarbanes-Oxley contains a number of other corporate governance provisions such a ban on personal loans to corporate executives, *id.* § 402, and provisions relating to the independence of auditors, *id.* §§ 201-209.

of public companies."[59] The second, the Dodd-Frank Act,[60] addressed the problem of systemic risk that resulted in the sudden failure of financial institutions. Congress explained that Dodd-Frank was meant to form "a new framework to prevent a recurrence or mitigate the impact of financial crises that could cripple financial markets and damage the economy."[61]

Sarbanes-Oxley was meant to help ensure the integrity of a company's financial statements. In doing so, Sarbanes-Oxley not only protects investors who are purchasing the company's stock, but also the shareholders who continue to hold the stock. A House Report noted this concern when acknowledging the losses incurred by Enron shareholders who were unable to sell their shares while the company collapsed.[62] By helping reduce material deficiencies in a company's financial statements, internal controls provide shareholders with protection from surprise losses that can quickly destroy value. By requiring independent audit committees for listed public companies, Sarbanes-Oxley sought to create a structure where the board can better supervise the audit process. In effect, Sarbanes-Oxley rejects the view that the right to sell will largely protect shareholders from significant losses.

While Sarbanes-Oxley addressed the governance problem of accounting fraud, Dodd-Frank responded to a somewhat different problem: the failure of financial institutions to manage risk. For example, under the Volcker Rule, certain financial institutions are limited in their proprietary trading and investments in private equity and hedge funds.[63] This regulation is based on the premise that some types of trading risk are too difficult for shareholders to effectively monitor. The Dodd-Frank Act thus attempts to protect shareholders by reducing such risk.

Both Sarbanes-Oxley and Dodd-Frank are controversial for the costs they impose on public companies. Whether or not these Acts are efficient ways to protect shareholders is a topic that is best left for another day. Indeed, an argument could be made that the failure of the right to sell should not lead to the conclusion that private ordering should be abandoned. Another right, the right of shareholders to diversify, would be

59. S. REP. NO. 107-205, at 23 (2002).

60. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

61. S. REP. NO. 111-176, at 2 (2010).

62. H.R. REP. NO. 107-414, at 18 (2002).

63. Dodd-Frank Act § 619.

Published by University of Oklahoma College of Law Digital Commons, 2017

sufficient to protect investors from substantial losses.[64] For this Article, the important point is that both Acts can be linked to the perception that investors need protection beyond the right to sell.

It is telling that in the wake of the Enron and WorldCom scandals, Delaware, the leading state corporate law maker, made efforts to protect investors from systemic corporate governance failure. In the 2006 case *Stone v. Ritter*,[65] the Delaware Supreme Court held that a board has a duty to monitor the corporation for wrongdoing.[66] This duty to monitor was narrowly defined. The board can only be liable if it "consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[67] This narrow duty, however, still permitted the Delaware Chancery Court to find that two AIG board directors failed to adequately monitor the company for financial wrongdoing.[68] Such efforts might have been motivated by the concern that the inability of Delaware to prevent massive corporate governance failures could result in increasing federal intervention with respect to corporate governance.[69]

Other states also reacted to protect investors from sudden value destruction. The California Supreme Court created a right of action for holders of stock to sue for securities fraud in *Small v. Fritz Companies*.[70] Because federal law only permits purchasers and sellers of stock to bring suit,[71] such state causes of action provide additional protection to shareholders who are unable to sell to avoid significant losses. The California Supreme Court was prompted to create such a cause of action

64. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 641 (1985).

65. 911 A.2d 362 (Del. 2006).

66. *Id.* at 370. This duty was introduced in an earlier decision by Chancellor Allen. *See In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996). The duty to monitor was rooted in the board's duty of good faith, which for a time was seen as a standalone duty. *See, e.g.*, Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004). However, *Stone v. Ritter* clarified that good faith was derivative of the duty of loyalty and not an independent duty. *See Stone*, 911 A.2d at 370.

67. *Stone*, 911 A.2d at 370.

68. *In re* Am. Int'l Grp., Inc., 965 A.2d 763, 799 (Del. Ch. 2009). In other cases, however, the Delaware Chancery did not find a breach of the duty. *See, e.g.*, *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

69. One might question whether these efforts were lasting changes or merely efforts to deflect criticism in the wake of Enron. *See, e.g.*, Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005).

70. 65 P.3d 1255 (Cal. 2003).

71. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-32 (1975).

because of the wave of fraud that resulted in the collapse of Enron and WorldCom. It explained:

> The last few years have seen repeated reports of false financial statements and accounting fraud, demonstrating that many charges of corporate fraud were neither speculative nor attempts to extort settlement money, but were based on actual misconduct. "To open the newspaper today is to receive a daily dose of scandal, from Adelphia to Enron and beyond. Sadly, each of us knows that these newly publicized instances of accounting-related securities fraud are no longer out of the ordinary, save perhaps in scale alone." The victims of the reported frauds, moreover, are often persons who were induced to hold corporate stock by rosy but false financial reports, while others who knew the true state of affairs exercised stock options and sold at inflated prices.[72]

For a time, there was a surge of class actions filed in state court asserting fraud brought pursuant to this holder theory. Though the U.S. Supreme Court later found that such holder cases were preempted by federal law if brought as a class action,[73] the creation of the right reflects the concern of protecting shareholders from misconduct.

Despite the efforts of Delaware and other states to create duties protecting shareholders from sudden value destruction, it is likely that federal law will be more influential in regulating public corporations. Federal internal controls and corporate governance requirements apply to most of the largest public corporations. Any financial institution will need to comply with the extensive mandates of Dodd-Frank. In contrast, Delaware sets a minimal floor that only requires the existence of a monitoring system.

Thus, there is a connection between one of the limits of the right to sell, that it does not protect against substantial failures of corporate governance, and the rise of federal corporate law. The most prominent federal

---

72. *Small*, 65 P.3d at 1263-64 (quoting STEVEN G. SCHULMAN ET AL., COMM. ON CONTINUING LEGAL EDUC., AM. BAR ASS'N, THE SARBANES-OXLEY ACT: THE IMPACT ON CIVIL LITIGATION UNDER THE FEDERAL SECURITIES LAWS FROM THE PLAINTIFFS' PERSPECTIVE 1 (2002)).

73. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 84-85 (2006). For an argument that such holder claims should not be preempted, see Amanda M. Rose, *Life After SLUSA: What Is the Fate of Holding Claims?*, 69 DEF. COUNS. J. 455 (2002).

Published by University of Oklahoma College of Law Digital Commons, 2017

interventions directly address the problem that shareholders cannot always react quickly enough to stop corporate wrongdoing.

B. Materiality and Corporate Governance

The right to sell is also limited in that it is only triggered with respect to corporate governance provisions and practices that are obviously material to the firm's economic performance.[74] There may be governance that the shareholders are unhappy with, but if it has a minor impact on the firm's value, shareholders may not be willing to sell what could be a profitable investment.

1. The Difficulty of Valuing Governance

The value of good corporate governance is difficult to measure. An electronics company with strong checks on management may nevertheless perform poorly because consumer tastes change and demand for the company's product declines. In contrast, an energy company with little protection for shareholders may perform well because the market price of oil is strong. Even if there is an argument that the energy company could perform better with strong governance, it will be difficult for shareholders to prove that such measures would have such a result, and little pressure for management to adopt such measures if they choose not to.

Corporate governance matters most in particular circumstances that not all companies will face. For example, if managers want to make a decision that is likely to result in the destruction of value, an effective board could challenge the managers so that they do not make the wrong choice. But how often will a company find itself in that particular situation? It might be rare for such decisions to arise, making the value of a good board difficult to assess.

Another reason investors may not see governance as material is that as a company grows larger, it is difficult for any one particular governance issue to affect more than a small percentage of the company's market value. Shareholders might disagree with individual polices, but it may be unclear whether each individual policy will have more than a nominal impact on the company's value. As Lucian Bebchuk and Ehud Kamar show, companies may bundle questionable governance measures with actions shareholders agree with, making it difficult for shareholders to oppose the entire

74. For purposes of assessing legal liability, a "fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important" with respect to a decision. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

bundle.[75] A shareholder is unlikely to sell for the sole reason that he disagrees with one particular governance practice.[76]

Furthermore, the right to sell may not be particularly effective with respect to issues where shareholders' preferences substantially vary. Some shareholders may care about ethical issues, such as whether the company sells diamonds from questionable sources,[77] while other shareholders who are focused on the economic performance of the firm will not. Even if a shareholder sells, it is unlikely that such sales will affect the market price for the shares. The right to sell thus would not be effective in pushing through change that does not fit the interests of the traditional profit-maximizing shareholder.

Thus, the literature has yet to conclusively establish a link between particular corporate governance provisions and shareholder wealth. A study by Sanjai Bhagat and Bernard Black failed to find evidence that companies with more independent directors on their boards perform better than companies with fewer independent directors.[78] This finding cuts against the intuition that such boards are more likely to discipline poor managers. On the other hand, there is evidence that a staggered board, which makes it more difficult for a company to change control, is negatively associated with a firm's market value.[79] On balance, it is fair to say that "the empirical literature investigating the effect of individual corporate governance

---

75. Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549 (2010) (studying proposals for staggered boards bundled with a merger).

76. For example, institutional investors may have an investment strategy that makes it difficult for them to exit. *See, e.g.*, Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.-Feb. 1994, at 140 (noting that exit is not feasible for investors using a passive investment strategy); Robert Profusek, *The Increasing Power of Institutional Investors*, WALL ST. J.: THE EXPERTS (June 24, 2015, 7:00 AM), https://blogs.wsj.com/experts/2015/06/24/the-increasing-power-of-institutional-investors/ (noting that because of the increasing size of investments, "major institutional investors have become the equity markets and cannot just vote with their feet when a company in which they are invested underperforms or misallocates capital—that is to say, the 'Wall Street Rule' is dead").

77. Congress through the passage of Dodd-Frank required the SEC to pass rules relating to the disclosure of the use of conflict minerals. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1502, Pub. L. No. 111-203, 124 Stat. 1376, 2213-18 (2010).

78. *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002).

79. *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005); *but see* K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67 (2016).

Published by University of Oklahoma College of Law Digital Commons, 2017

mechanisms on corporate performance has not been able to identify systematically positive effects and is, at best, inconclusive."[80]

Studies have, however, found that groups of corporate governance provisions appear to be correlated with firm performance. Paul Gompers, Joy Ishii, and Andrew Metrick constructed an index based on twenty-four governance rules, and found that firms with the strongest shareholder rights earned abnormal returns of 8.5% per year relative to the firms with the weakest shareholder rights.[81] Lucian Bebchuk, Alma Cohen, and Allen Ferrell constructed a narrower index with six governance provisions relevant to the entrenchment of a board, and found that firms with higher entrenchment had lower valuations.[82]

Though they are suggestive, these studies do not establish a strong case that particular governance provisions are material to investors.[83] If good governance is associated with groups of factors, it is unlikely that investors will put pressure on management by selling their shares if one or two desirable governance provisions are not present. Moreover, these studies are by their nature retrospective—looking at the past performance of firms over many years. They do not establish that present-day investors will react to the presence or absence of these factors, though perhaps these results may encourage investors to examine governance indices going forward in deciding whether to sell.[84] Although there have been efforts to construct indices that can guide investment decisions, it is unclear whether investors are actually using these indices to decide whether to exit an investment.

There is an intuition that good governance is better for corporations, but it is far from certain whether it affects investor decisions. Absent clear breakdowns in corporate culture, investors are unlikely to put pressure on managers by actively selling their shares. Thus, while the right to sell might

---

80. Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1814 (2008).

81. *See* Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

82. *See* Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009).

83. There have been some studies that have questioned the link between these governance indices and firm performance. *See* Bhagat et al., *supra* note 80, at 1827-32. Moreover, evidence of a correlation does not establish causation. *See* Yair Listokin, *Interpreting Empirical Estimates of the Effect of Corporate Governance*, 10 AM. L. & ECON. REV. 90 (2008).

84. Indeed, there is now a significant industry that produces governance indices for investors. *See* Bhagat et al., *supra* note 80, at 1807.

provide a check against what is clearly bad governance, it is unlikely that the right to sell is always effective in encouraging firms to reform.

2. The Example of Executive Compensation

When the right to sell does not induce companies to adopt particular governance provisions, reformers have pushed for federal intervention to mandate corporate governance standards. This dynamic is illustrated by federal efforts to regulate executive compensation in public companies.

One of the most controversial issues of corporate governance relates to the compensation paid to high-level corporate managers.[85] One allegation is that executives manipulate boards so that they are paid richly, even when their performance does not warrant high compensation.[86] Because executives often influence who sits on the board of directors, and many board members themselves are executives at other companies, there seems to be a corrupt system where insiders benefit themselves at the expense of shareholders. Though the rise in executive compensation is arguably linked to the growth in the size of public companies,[87] there is an argument that there are abuses in the way executive compensation is awarded.

The right to sell does not put meaningful pressure on companies to change executive compensation policies. While payments can be substantial to an individual, they are usually an immaterial fraction of the company's value.[88] Absent a clear link to company performance, even shareholders

85. The issue has attracted the attention of the popular press. *See, e.g.*, David Owen, *The Pay Problem: What's to Be Done About C.E.O. Compensation*, NEW YORKER (Oct. 12, 2009), http://www.newyorker.com/magazine/2009/10/12/the-pay-problem. For a brief history of the issue, see Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 857-64 (2011).

86. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004); Charles M. Elson, *Executive Overcompensation – A Board-Based Solution*, 34 B.C. L. REV. 937, 947-48 (1993).

87. *See, e.g.*, Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49 (2008) (presenting evidence of correlation between increase in CEO pay and growth in market capitalizations of public companies).

88. *See, e.g.*, Lawrence A. Hamermesh, *Twenty Years After* Smith v. Van Gorkom*: An Essay on the Limits of Civil Liability of Corporate Directors and the Role of Shareholder Inspection Rights*, 45 WASHBURN L.J. 283, 290 (2006) (noting that "the area of executive compensation is one in which the materiality threshold is rarely reached"); Bevis Longstreth, *A Real World Critique of* Pay Without Performance, 30 J. CORP. L. 767, 771 (2005) (noting that the issue of executive compensation "lacks materiality and, therefore, deserves far less attention than it gets"); *see also* BEBCHUK & FRIED, *supra* note 86, at 55-57 (discussing why markets do not check excessive executive compensation).

Published by University of Oklahoma College of Law Digital Commons, 2017

who object to the size of such compensation may still not sell their shares. Thus, there will be little pressure on boards from selling shareholders to reform their practices. The persistence of high executive compensation is an indication that the market is unable to resolve the issue.

As the problem of executive compensation remained unsolved, reformers turned to federal legislation.[89] While executive compensation has long been subject to disclosure under the federal securities laws, recent disclosure rules are more aggressive in attempting to pressure companies to reduce executive pay. For example, Dodd-Frank requires disclosure of the ratio between the CEO's compensation and the typical worker of the company,[90] as well as the relationship between executive compensation and the company's performance.[91] Moreover, following the example of independent audit committees set forth by Sarbanes-Oxley, Dodd-Frank requires all members of the compensation committees of a listed public company to be independent.[92] By separating the committee that approves compensation from management, the hope is that the board will negotiate more aggressively with management. Rather than allow shareholders to protect themselves, federal standards attempt to create boards that act to protect shareholders from executive compensation abuses.

Because shareholder exit has not been an effective way of regulating executive compensation, Congress has attempted to reinvigorate shareholder voice on the issue.[93] The Say-on-Pay Reforms thus require public companies to periodically have a shareholder vote on the company's executive compensation practices.[94] The results of such votes are nonbinding, but a negative vote could serve as an impetus for changing a

89. State efforts to regulate executive compensation through corporate law have been minimal. Though the Disney derivative litigation, *In re Walt Disney Derivative Litigation*, 907 A.2d 693 (2005), brought attention to the issue, the case set a high bar for finding a board liable for approving an excessive compensation package.

90. Dodd-Frank Wall Street Reform and Consumer Protection Act § 953(b), Pub. L. No. 111-203, 124 Stat. 1376, 1903-04 (2010); *see also* Pay Ratio Disclosure, 80 Fed. Reg. 50,104 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249).

91. Dodd-Frank Act § 953(a).

92. Dodd-Frank Act § 952(a).

93. Moreover, shareholders have their own incentive to exercise voice when they are unable to exercise the right to sell. Sophia Grene, *SRI: Ethics Beyond the Wall Street Walk*, FIN. TIMES (Jan. 10, 2015), https://www.ft.com/content/a032abf0-86b0-11e4-9c2d-00144feabdc0?mhq5j=e3 ("Company boards are starting to accept that they have to engage with shareholders, particularly asset managers. With the rise of passive managers, who do not have the option of selling shares with which they are unhappy, engagement is likely to grow.").

94. Dodd-Frank Act § 951.

company's compensation policy. According to the legislative history, the hope is that such "votes on pay would serve as a direct referendum on the decisions of the compensation committee and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members."[95] Put another way, requiring such votes arguably allows shareholders to express displeasure with executive compensation payments without more drastic measures such as selling their shares. A fact that may not be material to the investor's decision to sell may be material with respect to the investor's decision to vote. It is telling that Congress has tried to remedy the failure of the right to exit to solve the problem by mandating a right to voice.

IV. Assessing the Rise of Federal Corporate Law

Part III argued as a descriptive matter that aspects of the Sarbanes-Oxley and Dodd-Frank reforms can be understood as addressing limits of the right to sell. This Part IV takes up the normative question of whether this federal response is warranted. It concludes that there is a stronger case for federal intervention with respect to protecting shareholders from precipitous declines in value than for intervening to correct governance issues that are not economically material to shareholders.

A. A Test for Evaluating Federal Corporate Law

The increasing federal intervention with respect to the governance of public corporations has blurred the distinction between corporate and securities law. These reforms have been implemented through amendments to the federal securities laws, increasing the regulation of what was once the domain of the states.[96] Though many of these provisions have elements of securities law in that they relate to disclosure, there is a sense that they do more than create securities law.

In a prior article,[97] I argued that corporate and securities law can be distinguished based on the type of protection they provide to investors. Securities law protects investors while they are trading; corporate law protects investors while they are owners of shares. As a trader, an investor is vulnerable to buying or selling at a distorted price. As an owner, an

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

96. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478-79 (1977) (observing that the states "traditionally" have regulated a "wide variety of corporate conduct" and that "extension of the federal securities laws" may "interfere with state corporate law").

97. Park, *supra* note 9.

Published by University of Oklahoma College of Law Digital Commons, 2017

investor is vulnerable to corporate misconduct that destroys the value of his shares.

Judged by this standard, significant aspects of both Sarbanes-Oxley and Dodd-Frank are effectively federal corporate law. These efforts were prompted by failures of significant public companies, where the regulatory regime, both state and federal, seemed ineffective in preventing massive harm to shareholders. Internal controls are partly motivated by the desire to protect shareholders from precipitous destruction of value. Executive compensation reform is motivated by the argument that shareholders need protection from executives who manipulate the compensation process to capture value for themselves. Though they are formally part of the securities laws, these interventions are better thought of as a type of corporate law.

In my prior project, I argued that because corporate and securities law protect different types of interests, there is an argument that they should differ in their regulatory approaches.[98] Because all trading investors have a strong interest in valuation, securities law is both uniform and mandatory. In contrast, it is more difficult to identify uniform interests for shareholder-owners. Some shareholders have a short-term horizon and prefer to defer less to managers, while other shareholders have a long-term horizon and are more willing to defer to managers. There is thus a stronger case that corporate law should be diverse and enabling.

Though there is good reason to distinguish between federal securities law and state corporate law, there will be situations where it may be appropriate to create federal law to protect ownership interests. Regulators should be most wary of the possibility that a federal intervention will unduly favor one set of shareholders over others. Thus, when making federal corporate law, there are two considerations to keep in mind.[99] The first is whether there is a compelling case that the policy would benefit shareholders. The second is whether the policy might favor some groups of shareholders over others.

B. Efforts to Protect Investors from Corporate Failures

Viewed in light of this framework, there is a case that efforts to protect investors from sudden corporate failure are warranted. For one thing, there is an argument that such reforms, which include Sarbanes-Oxley's internal controls, are a hybrid of securities and corporate law. Internal controls and

98. *Id.* at 119.

99. *See id.* at 180 (describing test to assess federal corporate law).

independent audit committees benefit not only shareholder-owners, but also purchasing investors who rely on the integrity of company financial statements in trusting market valuations. They are thus consistent with the traditional role of federal securities law in protecting the integrity of markets. To the extent that internal controls are primarily directed at large public companies, there is a national interest in the soundness of such companies.

There is a case that some level of internal control regulation offers benefits for shareholders. While internal controls are costly, such costs are modest for large public companies. To the extent that they improve the reliability of financial statements, internal controls will provide assurance to shareholders that there is a lower risk of wrongdoing by management that will reduce the value of their shares. Internal controls offer additional protection to shareholders who are unable to identify significant problems before it is too late to sell without incurring a substantial loss. It is difficult, if not impossible, to identify precisely what level of internal controls is appropriate, but there is an argument that efforts to improve the accuracy of financial reporting can help remedy the inability of shareholders to protect themselves through the right to sell.

A significant objection to internal control regulation is that shareholders will likely disagree about the appropriate extent of internal controls. Some investors may be satisfied with a minimal level of protection, while others may want more. Mandating a uniform rule with respect to internal controls may favor those investors who are risk-averse over investors who are more willing to take on risk.

One solution to this objection could be to limit internal control requirements to larger companies that tend to be attractive investments for investors who are relatively risk-averse. Indeed, the regulatory consensus has been that the most stringent rules should be reserved for larger, established public companies that are able to afford the cost.[100] Smaller companies are exempt until they grow to a size where there is a greater expectation that financial controls will be effective.[101] To the extent that investors want to take on substantial risk, they can do so by investing in smaller companies.

---

100. Moreover, some of the costs of internal controls for larger public companies are offset by benefits that are exclusive to larger companies, such as easier access to the capital markets. *See* James J. Park, *Two Trends in the Regulation of the Public Corporation*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 429 (2012).

101. *See, e.g.*, Jumpstart Our Business Startups Act § 103, Pub. L. No. 112-106, 15 U.S.C. § 7262 (2012).

Published by University of Oklahoma College of Law Digital Commons, 2017

Another way of addressing the concerns associated with a mandatory rule is to allow companies some flexibility in how they may comply with it. For example, the regulations governing the reliability of internal controls appear to be principles-based rather than rules-based. The ambiguity of these provisions allows companies to balance different shareholder interests. Initially, there was significant concern about the meaning of the internal control requirements, perhaps making public companies overcautious in their compliance, but over time, companies have become more comfortable with the regime. There have not been aggressive enforcement actions directed at ex ante compliance with the internal control provisions of Sarbanes-Oxley that would prompt public companies to apply the mandate in a uniform way. Different companies have room to comply in different ways, allowing for some regulatory diversity.

C. Efforts to Regulate Corporate Governance

In contrast, the case for federal intervention to address the second limit on the right to sell is weaker. The fact that certain governance policies are immaterial to investors indicates that investors themselves do not believe that reform would benefit them. The fact that investors are not selling could indicate substantial disagreement about which governance rules are optimal.

On the other hand, it may be that shareholders need some protection from policies that are difficult to trace to value destruction. It is telling that some of the more extensive executive compensation measures were passed in the wake of the financial crisis of 2008-2009. One justification for Dodd-Frank's regulation of executive compensation was the belief that problems in the design of such compensation contributed to excessive risk-taking that destroyed shareholder value.[102] There is a strong argument, though, that the problematic compensation policies of the financial firms that failed during the crisis were specific to the investment banking industry.

There will likely be substantial shareholder disagreement with respect to corporate governance reform. Although virtually all shareholders would agree that value destruction is a bad thing, it is unlikely that all or even most shareholders will believe that addressing immaterial corporate governance issues is a priority. The danger of some proposals to increase mandatory governance regulation is that they will advance the interests of some shareholders over others. Congress and the SEC should exercise

102. *See, e.g.*, S. REP. NO. 111-176, at 35 (2010) (asserting that "executive compensation practices that promoted excessive risk-taking" contributed to the financial crisis).

caution in promulgating federal governance standards because of the difficulty of linking such standards to the one unifying concern of shareholders, the value of their shares.

As governance interventions increase, the danger is that they will snowball, affecting areas that are more and more tangential to the common interests of shareholders. The precedent of executive compensation regulation, while only somewhat controversial, could lead to other regulatory reforms that are more questionable. For example, after the Supreme Court's 2010 decision in *Citizens United v. Federal Elections Commission*,[103] there have been efforts to require public companies to disclose political spending pursuant to the securities laws. There are indications that some investors are interested in knowing more about the political spending of corporations,[104] but it is far from clear that there is a consensus by shareholders on the issue. It is likely that political spending is fairly minimal in amount, and would be immaterial to shareholders.[105] The issue has resulted in an unfortunate politicization of the issue, where Senators rather than shareholders appear to be pushing for reforms that have unclear economic benefits for shareholders.[106]

Rather than mandatory federal intervention, a preferable approach might be to provide avenues for shareholders to express their preferences with respect to particular governance policies. Put another way, thoughtful ways of allowing shareholders to exercise voice can be an appropriate response when the right to sell is ineffective. The Say-on-Pay law might be an example of such intervention. There are some indications that the law, which requires nonbinding votes, has increased dialogue with shareholders without leading to routine second-guessing of executive pay packages.[107] Another example relates to the question of whether shareholders should have access to the company's proxy statement so they can nominate their own director candidates to the board. In the wake of the D.C. Circuit's

---

103. 558 U.S. 310 (2010).

104. *See, e.g.*, Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L.J. 923, 937-41 (2013).

105. *See* Michael D. Guttentag, *On Requiring Public Companies to Disclose Political Spending*, 2014 COLUM. BUS. L. REV. 593 (2014).

106. *See* Elizabeth Dexheimer, *SEC's White Attacked by Democrats over Political Spending Stance*, BLOOMBERG NEWS (June 14, 2016), http://www.fa-mag.com/news/sec-s-white-attacked-by-democrats-over-political-spending-stance-27470.html.

107. *See, e.g.*, Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1249-62 (2012) (reporting high approval rates with respect to executive compensation along with greater shareholder dialogue).

Published by University of Oklahoma College of Law Digital Commons, 2017

decision to strike down federal rules relating to proxy access,[108] the SEC enacted a rule that allows shareholders to propose that the company implement rules allowing for such access.[109] To the extent that the right to sell is deficient in pressuring for change, opening up avenues for shareholders to express their preferences through the right to vote might be warranted.

V. Conclusion

More than fifty years later, Henry Manne's work on the role of markets in regulating corporate governance continues to be influential. Manne offers a sensible response to the problem of the separation of ownership and control identified by Berle and Means. Rather than relying solely on law, investors rely on the discipline of the market to protect themselves from poor management. This argument has been utilized in a number of contexts to argue for less rather than more corporate governance regulation.

The power of the right to sell has been a reason to maintain a system of regulatory federalism with respect to large public corporations. Limited mandatory rules through federal securities law protect trading investors, while the protection of the diverse interests of shareholder-owners is delegated to the enabling rules of the states, primarily Delaware. To some extent, investors should be expected to take care of themselves when they are unhappy with a company's governance.

This system has come under pressure in recent years, primarily because of the limits of the right to sell. The right to sell works best when shareholders are able to identify a clear problem and have time to express their displeasure with management by exiting the firm through selling. The sudden collapse of a number of prominent public companies and the persistence of governance problems (such as executive compensation) highlight the limits of the market's ability to regulate the public corporation. Much of the federal corporate law enacted over the last fifteen years was motivated by the desire to remedy market failures. The process described by Manne and other law and economics scholars simply has not

108. Section 971 of Dodd-Frank authorized the SEC to pass a rule allowing for proxy access. Pursuant to that provision, the SEC passed Rule 14a-11, which required proxy access. This rule was challenged, and the D.C. Circuit held that the SEC "acted arbitrarily and capriciously" by failing to "adequately assess the economic effects" of the rule. Business Roundtable v. Sec. & Exch. Comm'n, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

109. *See* Facilitating Shareholder Director Nominations, Securities Act Release No. 9259, Exchange Act Release No. 62,764, Investment Company Act Release No. 29384, 76 Fed. Reg. 58100 (Sept. 20, 2011).

https://digitalcommons.law.ou.edu/olr/vol70/iss1/4

been sufficient to protect shareholders from the effects of corporate mismanagement.

When attempting to protect the ownership interest of investors, the concern is that regulation unduly favors one set of shareholders over others. Thus, regulators should be cautious in making federal corporate law. To the extent that certain governance problems raise national concerns, and benefit the vast majority of shareholders, some federal intervention is justified. The protection of investors through internal controls arguably meets these criteria.

At the same time, not every governance issue should be the subject of federal concern. The lack of shareholder interest in pressuring managers over certain practices cannot be completely ignored when assessing corporate governance policy. At the very least, when the market views an issue as immaterial, there is likely shareholder disagreement as to whether intervention would be beneficial. When shareholders do not exercise the right to sell, it may mean that they view governance through a different lens than reformers who seek to change the prevailing practice.

Ultimately, the case for mandatory corporate rules rests on the assumption that investors cannot protect themselves. History has shown that there are situations in which markets do not prevent corporate misconduct. The federal securities laws can be a source of protection when markets fail, but only when it is clear that intervention would be beneficial.

Published by University of Oklahoma College of Law Digital Commons, 2017