STRENGTHENING THE PUBLIC COMPANY BOARD OF DIRECTORS: LIMITED SHAREHOLDER ACCESS TO THE CORPORATE BALLOT VS. REQUIRED MAJORITY BOARD INDEPENDENCE

SETH W. ASHBY*

Federal regulators continue to capitalize on the onslaught of massive corporate fraud in the United States, promulgating corporate governance legislation seeking to reform and improve public company boards of directors. This note considers two such reforms, both of which purport to influence the composition of public company boards to improve shareholder confidence in corporate management. The first regulation, already approved by the SEC, requires majority board independence for publicly-held companies listed on the NYSE and Nasdaq. The second is a proposed amendment to SEC proxy rules to allow direct shareholder access to the corporate ballot for the purpose of facilitating shareholder-nominees to the boards of publicly-held companies. The effectiveness of both regulations is examined under the director primacy model of corporate governance. This note concludes that, while public companies should not be required to place a majority of independent directors on their boards, a narrowly defined access rule to provide shareholders with a proactive means to hold management accountable to its fiduciary duties is a tenable option. Accordingly, the proposed shareholder access mechanism should be adopted by the SEC.

I. INTRODUCTION

On March 3, 2004, in dramatic and historic fashion, shareholders of Walt Disney Co. (Disney) delivered a powerful message to management at their annual election: a "startling" forty-three percent withheld their vote for incumbent Michael Eisner as Chairman of the Board.[1] The strong vocal dissent against Eisner was just one of two threats Disney's

* J.D., University of Illinois College of Law (2005); B.A., *summa cum laude*, Western Michigan University (2001). I would like to thank my wife, Miriam, for her love, support, and patience. I would also like to thank Professor Cynthia A. Williams of the University of Illinois College of Law for her helpful assistance and substantive comments.

1. Bruce Orwall et al., *Disney's Eisner Steps Down from Chairman Post after Protest Garners 43% of Voted Shares*, WALL ST. J., Mar. 4, 2004, at A1.

board recently faced. The second was a potential hostile takeover attempt of the entertainment company by cable giant Comcast Corp.[2]

Despite the clarity of the shareholder message, Eisner was reelected to the Disney board.[3] This is so because he ran *unopposed*. Eisner ran unopposed because, as Chairman and Chief Executive Officer (CEO) of Disney, he essentially exercised exclusive control over whose names would appear on the corporate ballot—"[t]he key for a director's reelection."[4] Nonetheless, the Disney board stripped Eisner of his Chairman post, while leaving him in place as CEO, in an attempt to appease the shareholders.[5]

Although Eisner stated that he "do[es] not belittle a large shareholder withhold vote," he intends to remain at Disney as CEO for the remainder of his contract term.[6] Yet, the "historic protest vote" clearly indicates widespread shareholder dissatisfaction with "Eisner's leadership, the company's corporate governance practices, and its lagging financial performance and stock price over most of the last seven years."[7] Thus, for nearly a decade, Disney shareholders have been unhappy—and apparently for good reason. Change, however, has not been forthcoming. Disney's new Chairman, although a prominent independent director and former U.S. senator, is unlikely to satisfy investors since he himself suffered a substantial twenty-four percent withhold vote at the same election.[8]

Change is in the air, however. The perceived prevalence of shareholder dissatisfaction with corporate management, as well as repeated instances of outright corporate fraud in the United States, has caused regulators increasingly to be attentive to corporate governance reform, particularly with respect to the public company board of directors. In fact, one cannot overstate the extent to which recent, massive corporate scandals have shaken investor confidence in the domestic capital markets.[9] Thus, regulators have the continued advantage of a favorable po-

2. *Id.* Comcast subsequently dropped its unsolicited bid. Peter Grant, *Comcast Drops Its Offer to Buy Disney*, WALL ST. J., Apr. 29, 2004, at A3.

3. Laura M. Holson, *Defied in Vote, Disney Leader Loses One Post*, N.Y. TIMES, Mar. 4, 2004, at A1.

4. Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45 (2003) [hereinafter Bebchuk I].

5. Orwall et al., *supra* note 1.

6. *Id.*

7. *Id.*

8. *Id.*; Michael McCarthy, *Disney Outlines Its Plan for Succession*; *Eisners's Replacement to Be Named by June*, USA TODAY, Sept. 22, 2004, at B2.

9. *See, e.g.*, André Douglas Pond Cummings, *The Integration Conundrum: Debilitating Failures of the Securities and Exchange Commission Must Be Addressed as U.S. Corporate Malfeasance Is "Getting Serious, So Serious*," 48 WAYNE L. REV. 1305, 1380–81 (2003) ("It is a fact that in this troubled and volatile economic time, with capital markets deteriorating under the weight of accounting fraud, financial restatement and executive management corruption, the SEC and the U.S. capital markets have lost investor confidence.") (footnotes omitted); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 420–21 (2004) ("Interestingly, as reported in a recent poll, eighty-four percent of U.S. investors believe that dubious accounting practices are

litical climate in which to promulgate reform aimed at improving corporate management and shareholder value.[10]

With this political climate as a backdrop, Congress enacted the Sarbanes-Oxley Act of 2002, regarded by many observers as the most sweeping federal corporate governance legislation since the 1930s.[11] Yet 2003 also witnessed the proposal of equally momentous federal regulation.[12] Two such reforms constitute the subject of this note. Although their similarity might not be readily apparent, both reforms seek to influence significantly the composition of public company boards of directors.

First, the traditional corporate governance goal of required majority board independence has been approved by the Securities and Exchange Commission (SEC) for publicly-held companies listed on the New York Stock Exchange (NYSE) and Nasdaq.[13] Second, the SEC has proposed amending its proxy rules to allow, under certain circumstances, direct shareholder access to the corporate ballot for the purpose of facilitating shareholder-nominees to the boards of publicly-held companies.[14] Interestingly, because of the strong withhold vote against Eisner, Disney could be the first company to have its corporate proxy machinery opened to shareholder nominees under this access mechanism should it be adopted.[15]

This note examines the efficacy of these regulations according to the prevailing corporate theory of contractarianism,[16] as modified by the director primacy model of corporate governance. Such an examination is both prudent and timely because of the significant impact both reforms likely will have on how public companies are governed in the United States. Furthermore, although the policies behind these reforms have

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responsible for U.S. markets' dismal performances this year, much more than the war in Iraq or terrorism concerns.").

10. *See* Steven Pearlstein, *Gamesmanship on Wall Street and the Hill*, WASH. POST, May 9, 2003, at E1 (stating that former SEC Chairman Arthur Levitt "credits public humiliation as much as stepped-up regulation for changing corporate behavior"); *see also* Greg Ip, *Mood Swings in Favor of Regulation*, WALL ST. J., Mar. 29, 2002, at A14 ("The politics of regulation, turned upside down by terrorists and Enron Corp. executives, are starting to produce real change. The combination of the energy company's collapse and the Sept. 11 attacks generated a tidal wave of public support for government moves to bolster security and to crack down on corporate fraud.").

11. *See*, *e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. LAW 1, 3 (2002). *But see* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 917 (2003) (describing the Act as "more sweep than reform").

12. NASD and NYSE Rulemaking: Relating to Corporate Governance, SEC Release No. 34-48745, 68 Fed. Reg. 64, 154, 64,156–66 (Nov. 12, 2003) [hereinafter SEC Release No. 34-48745]; Proposed rule: Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274), *available at* http://www.sec.gov/rules/proposed/34-48626.pdf (last visited Feb. 7, 2004) [hereinafter Proposed Rule: Security Holder Director Nominations].

13. SEC Release No. 34-48745, *supra* note 12, at 64,161.

14. Proposed Rule: Security Holder Director Nominations, *supra* note 12.

15. Dennis K. Berman & Deborah Solomon, *Death by Proxy? Vote on Eisner Causes a Stir*, WALL ST. J., Mar. 4, 2004, at C5.

16. *See* William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993) (characterizing contractarianism as the "dominant legal academic view").

been the focus of past legal and economic scholarship, these reforms have not been examined together under the newly articulated director primacy theory. In fact, whereas other commentators have used contractarian theory to propose embracing an independent board, but rejecting shareholder access to the corporate ballot,[17] this note comes to the precise opposite conclusion under similar theoretical assumptions about the public company.

The policy of required majority board independence dictates the proportion of independent directors that serve on boards of directors. This policy instructs companies to have a majority of independent directors serve on their boards. A related but distinct issue involves the precise meaning of "independence." Regulators continue to grapple with a sufficient standard by which to attach the independence label to those outside directors who are most likely to further the policy goals of an independent board.[18] This issue is beyond the scope of this note, however, which operates on a simple assumption: an "independent director" is a director who has no material affiliation or relationship with the company on whose board he sits.[19] Moreover, as the phrase "required majority board independence" implies, this policy is mandatory.[20]

The shareholder access mechanism as proposed by the SEC, however, is a *default* rule. As discussed below,[21] shareholders would first be required to opt-in before the access mechanism becomes available; moreover, the board may be able to opt-out completely, depending on whether its state of incorporation disallows shareholders from nominating directors. In addition, the access mechanism's influence on board composition is different than that of required majority board independence. Instead of mandating a particular proportion of independent directors, a shareholder access mechanism facilitates shareholder selection of the actual individuals who serve on the particular company's board.

This note is organized in the following manner. Part II.A provides background on both required majority board independence and shareholder access to the corporate ballot.[22] Next, Part II.B provides a working theory of the firm, which supplies the theoretical foundation upon which the analysis of Part III operates.[23] To that end, Part III.A first sets forth the case for required majority board independence according to the

17. *See*, *e.g.*, Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 67–70 (2003).

18. *See* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, at 7 (SSRN Elec. Library, Working Paper), *at* http://ssrn.com/abstract_id=317121 (last visited Feb. 21, 2004) [hereinafter Bainbridge I] (criticizing new NYSE and Nasdaq listing requirements, in part, for their "complicated" definition of independence).

19. Thus, in addition to being an "outside director," i.e., a nonemployee, an independent director must also have no significant business or familial contacts with the other directors on the board.

20. *See infra* text accompanying notes 42–48.

21. *See infra* text accompanying notes 75, 86–89.

22. *See infra* text accompanying notes 30–103.

23. *See infra* text accompanying notes 105–74.

traditional monitoring theory and then thoroughly critiques this policy,[24] exposing both its theoretical and practical failings. In a similar fashion, Part III.B first sets forth the case for a default shareholder access mechanism and then critiques this proposal on a point/counterpoint basis.[25]

Finally, Part IV makes concrete policy recommendations.[26] Specifically, the imposition of required majority board independence onto NYSE- and Nasdaq-listed companies should be rejected. It is a costly and inefficient accountability mechanism. By contrast, however, the shareholder access mechanism should be adopted, provided that it is narrowly construed to maintain efficiency in corporate decisionmaking inherent in the separation of ownership from control. If so construed, the shareholder access mechanism will very likely enhance overall corporate value.[27]

II. BACKGROUND

A. *Overview of Recent Corporate Governance Reforms*

The corporate governance regulations at issue in this note focus on the composition of the board of public companies. This part provides an overview of each regulation's history, scope, and operation. One model suggests regulation geared toward requiring majority board independence,[28] while the other suggests regulation geared toward facilitating shareholder-nominated directors to the board.[29]

1. *Required Majority Board Independence—New NYSE and Nasdaq Listing Standards*

Traditional corporate reformers have placed great reliance on the independent director as the arch-defender of the investing public.[30] In fact, studies indicate that the average number of independent directors on a public company's board of directors has grown steadily in the last

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24. *See infra* text accompanying notes 176–276.

25. *See infra* text accompanying notes 280–429.

26. *See infra* text accompanying notes 430–39.

27. *Cf.* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1430 (1989) ("The mechanism by which stocks are valued ensures that the price reflects the terms of governance and operation.").

28. *See infra* text accompanying notes 30–51.

29. *See infra* text accompanying notes 52–103.

30. *See* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 899–900, 900 n.4 (1996); REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY pt. III, at 9 (Mar. 31, 2003), *available at* http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf (last visited Nov. 24, 2003) ("Corporate responsibility and sound corporate governance thus *depend upon* the active and informed participation of independent directors and advisors who act vigorously in the best interests of the corporation and are empowered effectively to exercise their responsibilities.") (emphasis added); *see also* Ribstein, *supra* note 11, at 11.

thirty years.[31] As an example of the growing emphasis on board independence, the American Law Institute's 1982 draft of its Principles of Corporate Governance would have recommended mandating majority board independence for public companies.[32] However, as a result of significant political opposition,[33] the 1994 final draft merely recommended that majority board independence be instituted as a matter of sound corporate policy, not regulatory fiat.[34]

Political opposition to majority board independence began to subside, however, as the mood of the investing public toward corporate behavior soured after the massive corporate scandals involving Enron and other public companies, along with the market decline attributable in part to global terrorism.[35] Even so, it took the unveiling of WorldCom's massive earnings restatement in June 2002 to spur Congress into action.[36] Thereafter, Congress quickly sought to enact new large-scale corporate regulations.[37]

Accordingly, the Sarbanes-Oxley bill, the only pending piece of corporate reform legislation at the time, was hurriedly pushed through the congressional pipeline.[38] Enacted on July 30, 2002, the Sarbanes-Oxley Act imposes new federal regulation on public companies.[39] Not surprisingly, part of the regulation is focused on the independence of the board of directors.[40] Section 301 of the Act, for example, directs securities exchanges to prohibit the listing of the security of any issuer that does not have an audit committee entirely composed of independent directors.[41]

31. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 232 (2002).

32. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03(a) (Tentative Draft No. 1 1982) [hereinafter PRINCIPLES].

33. Lin, *supra* note 30, at 911–12.

34. PRINCIPLES, *supra* note 32, at § 3A.01(a).

35. Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 45 (2003); *see also* Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1582–84 (2002) (noting that the capital markets have been significantly impaired by both corporate scandals and terrorism).

36. Brooke A. Masters & Christopher Stern, *Former WorldCom CEO Indicted*, WASH. POST, March 3, 2004, at A1 (stating that the collapse of WorldCom, which happened "soon after the disintegration of Enron Corp., made WorldCom's name shorthand for the corporate excess of the late 1990s and spurred legal efforts—including the Sarbanes-Oxley Act—to make top executives more accountable for their companies' actions").

37. Hamilton, *supra* note 35, at 45.

38. *Id.* at 46.

39. *Id.* at 46, 49; *see* Ribstein, *supra* note 11, at 3. President George W. Bush praised this legislation as the most sweeping reform of business practice since the New Deal—to which one academic noted, "Odd praise, indeed, coming from a conservative president." Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 SEC. REG. L.J. 26, 28, *available at* http://ssrn.com/abstract=389403 (last visited Feb. 17, 2004).

40. Ribstein, *supra* note 11, at 12 ("Suggestions and requirements of greater board independence and more board monitoring are predictable responses to Enron and other corporate frauds.").

41. *Id.* (citing Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78f (2002)).

In the midst of this political climate, on August 1, 2002, the NYSE picked up where the American Law Institute's tentative recommendations for corporate governance left off by proposing amendments to its rules that require listed companies to have a majority of independent directors on their boards of directors.[42] Dick Grasso, the NYSE chairman and CEO at the time, stated that the "confidence and participation [of investors] are essential to the strength of our market and our economy."[43] To that end, this sweeping regulation purports to "help win back the trust and confidence of investors."[44] The National Association of Securities Dealers (NASD) soon followed suit and proposed similar amendments to the standards governing the companies listed on its over-the-counter market, Nasdaq.[45]

On November 4, 2003, the SEC approved the new listing standards for the NYSE and Nasdaq.[46] The SEC stated in an accompanying press release that these rule changes would "require and facilitate independent director oversight of processes relating to corporate governance, auditing, director nominations, and compensation."[47] Although there was some opposition to mandating majority board independence, the SEC concluded that "many" commentators supported the rule change.[48]

In reality, commentators continue to disagree on the efficacy of independent directors, let alone requiring majority board independence.[49] Although many public companies have a majority of independent directors on their boards through voluntary private ordering,[50] virtually all will now be forced to comply with this mandatory policy to participate in the lucrative capital markets of the United States.[51]

2. *Shareholder Access to the Corporate Ballot—Proposed Rule 14a-11*

Most of the protection currently afforded to shareholders by federal securities laws lies in a mandatory disclosure regime whose goal is trans-

42. *NYSE Approves Measures to Strengthen Corporate Accountability: New Standards Aim to Restore Investor Confidence*, THE EXCHANGE (N.Y. Stock Exch.), Aug. 2002, at 2, http://www.nyse.com/pdfs/xnlv9n08.pdf (last visited Nov. 24, 2003).

43. *Id.* at 1.

44. *Id.*

45. *See* SEC Release No. 34-48745, *supra* note 12, at 64,155.

46. *Id.* at 64,154.

47. Press Release, Securities and Exchange Commission, SEC Approves NYSE, NASDAQ Strengthening of Corporate Governance Standards for Listed Companies (Nov. 4, 2003), http://www.sec.gov/news/press/2003-150.htm (last visited Nov. 24, 2003).

48. SEC Release No. 34-48745, *supra* note 12, at 64,176.

49. *See* Lin, *supra* note 30, at 901 n.12 and accompanying text.

50. Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1299 (2003) (stating that "currently seventy-five percent of publicly-held companies have more than a majority of independent directors") (citation omitted).

51. *See* Bainbridge I, *supra* note 18, at 3–4 (discussing the benefits that being listed on a national exchange provides corporations, such as reduced cost of capital and prestige, and hence the extent to which national exchanges "wield considerable power over the governance of public corporations").

parency in managerial conduct.[52] Conversely, state corporation law provides shareholders with certain substantive rights, for example, the right to approve certain board decisions by a majority vote.[53] This right is justified by the fact that certain transactions put equity capital at an extraordinary risk that may not be readily controlled by other means.[54] Such transactions include the sale of all, or substantially all of the company's assets,[55] a merger,[56] or an amendment to the corporate charter.[57] The practical limitation of this right is that shareholders react, while the board acts.[58] The power to manage the company is, thus, preserved in the board of directors and the officers and executives acting pursuant to the board's authority.[59]

One potentially active shareholder right is the corporate election, whereby shareholders elect directors to the board.[60] Additionally, the corporate election is a situation which involves the intersection of state corporation law and the federal securities laws. While state law provides shareholders with substantive rights, federal law sets forth the procedural regime, governing disclosure with respect to the proxy machinery and the solicitation of votes.[61] However, the shareholder franchise is, in reality, only ceremonial because the federal securities laws accord executive management exclusive control over whose names appear on the corporate ballot.[62]

Although shareholders may suggest nominees to the public company's nominating committee, the committee is currently under no duty to place a shareholder-nominee on the corporate ballot.[63] Moreover, the

52. *See*, *e.g.*, Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2365 (1998). *But cf.* Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83, 84–90 (2000) (arguing that managerial discretion regarding the timing and content of corporate disclosures in the wake of performance-based compensation schemes has actually led to further divergence of interests between managers and shareholders).

53. *See* LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS 124–25 (4th ed. 2003).

54. *See id.* at 88 ("Owner voting might therefore be reserved for those instances where . . . other [monitoring] mechanisms do not function effectively.").

55. *See*, *e.g.*, DEL. CODE. ANN. tit. 8, § 271(a) (2001).

56. *See*, *e.g.*, *id.* at § 251(a)–(d).

57. *See*, *e.g.*, *id.* at § 242(b).

58. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559 (2003) [hereinafter Bainbridge II].

59. *See* RIBSTEIN & LETSOU, *supra* note 53, at 123–25.

60. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985) ("If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.").

61. *See* Securities and Exchange Act Schedule 14A, 17 C.F.R. § 240.14a-101 (2001).

62. *See* Securities and Exchange Act Rule 14a-8(i)(8), 17 C.F.R. 240.14a-8(i)(8) (2001); *see also* Bebchuk I, *supra* note 4, at 45 (characterizing shareholder power to replace incumbents as a "myth" and remarking, perhaps sarcastically, that "[t]he key for a director's re-election is remaining on the firm's slate").

63. Final Rule: Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, 68 Fed. Reg. 69,204, 69,204 (Nov. 28, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 270 & 274), *available at* http://www.sec.gov/rules/final/33-

costs of creating and circulating a separate proxy statement for the solicitation of votes are quite expensive and thus very few proxy contests are conducted for the purpose of strengthening existing management.[64] The proxy contest is mainly a tool for corporate takeovers rather than corporate reform.[65] Consequently, because it is so difficult to replace incumbent directors who fail to act in furtherance of the company's best interests, executive management's control over the nomination process increases managerial insulation and entrenchment.[66]

One noteworthy federal regulation, however, has been proposed that could strengthen the shareholder franchise as well as increase managerial accountability: shareholder access to company proxy materials for the purpose of nominating directors.[67] Although the SEC has considered the issue of direct shareholder access to the corporate ballot several times,[68] such consideration has failed to ripen into a decision to allow direct access due to the emergence of nominating committees.[69] As nominating committees can theoretically consider shareholder-nominees when creating the ballot, the SEC previously decided not to propose changes to the proxy process which would give shareholders direct access to the nominating procedure.[70] In addition, the SEC has been reluctant to facilitate direct shareholder access to company proxy materials because of the "substantial change" such a mechanism would represent to the traditional corporate election.[71]

The current political climate, on the other hand, has given new life to the idea of providing shareholders with direct access to the corporate ballot.[72] On October 23, 2003, the SEC announced proposed changes to the proxy rules which would "create a mechanism for nominees of long-term security holders, or groups of long-term security holders, with significant holdings to be included in company proxy materials where there are indications that the proxy process has been ineffective or that security holders are dissatisfied with that process."[73] According to the SEC,

8340.pdf (last visited Mar. 15, 2004) [hereinafter Final Rule: Disclosure Regarding Nominating Committee Functions] (summarizing most recent amendment to federal proxy rules that requires, inter alia, enhanced disclosure requirements with respect to the operation of nominating committees, cautioning that the new rules "do not mandate any particular action by a company or its board of directors").

64. Bebchuk I, *supra* note 4, at 45–46.

65. *Id.*

66. *Id.* at 61–63.

67. *See generally* Proposed Rule: Security Holder Director Nominations, *supra* note 12.

68. *Id.* at 60,785.

69. *Id.* The modern nominating committee is an independent committee of the board charged with the duty to select and nominate directors on behalf of the company.

70. *Id.* However, the SEC did recommend revisiting the question in the future if the efforts of nominating committees proved to be insufficient. *Id.* The SEC now admits that "the presence of nominating committees has not eliminated the concerns among some security holders with regard to the barriers to meaningful participation in the proxy process in connection with the nomination and election of directors." *Id.* at 60,786.

71. *Id.* (quoting Exchange Act Release No. 34-31326, 48,288 (Oct. 22, 1992)).

72. *Id.* at 60,784.

73. *Id.* at 60,785.

this mechanism will "help facilitate the full and informed exercise of existing security holder nomination and voting rights through the proxy process . . . ."[74]

This nomination procedure is embodied in Proposed Rule 14a-11,[75] which would apply to all public companies whose states of incorporation do not prohibit shareholders from nominating a candidate for election as a director.[76] Proposed Rule 14a-11, however, would place several conditions and limitations on the availability of this mechanism.[77]

One eligibility requirement would be that the shareholder-nominee be independent of the nominating shareholder, or shareholder group, purportedly to avoid special interest or single-issue directors, who some commentators fear could cause considerable disruption in the board room.[78] Similarly, the shareholder-nominee would be required to meet the same independence standards imposed on all directors by other regulations.[79] For reasons similar to those discussed *infra* Part III.A, these independence requirements are problematic.

In addition, because the SEC does not intend for this nomination procedure to be used in contested elections, Proposed Rule 14a-11 would not be available to every shareholder, or shareholder group, seeking control of the corporation.[80] Accordingly, the number of candidates a qualifying shareholder, or shareholder group, would be able to nominate would depend on the size of the particular board.[81]

74. *Id.* at 60,786.

75. Identifying the SEC's proposed shareholder access mechanism as "Proposed Rule 14a-11" is only partially accurate because, in addition to creating new Rule 14a-11, the mechanism would amend numerous existing rules and regulations. *See* Proposed Rule: Security Holder Director Nominations, *supra* note 12, at 60,784. However, for purposes of simplicity, when this note refers to the SEC's proposed mechanism, the term "Proposed Rule 14a-11" will be used. Similarly, the term "shareholder access mechanism" will be used to refer to such a mechanism generally.

76. *Id.* at 60,787. The purpose of the state law exception, as Professor Bainbridge explains, is to allow companies to effectively "opt-out" of the shareholder access mechanism by adopting a relevant charter provision where state law so permits. Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal*, at 5 (SSRN Elec. Library, Working Paper), *at* http://ssrn.com/abstract=470121 (last visited Jan. 24, 2004) [hereinafter Bainbridge III].

77. Proposed Rule: Security Holder Director Nominations, *supra* note 12, at 60,788.

78. *Id.* at 60,795–96.

79. *Id.* at 60,796.

80. *Id.* at 60,797–98. Further logistical problems related to the application of the nomination procedure include notice to the company of the shareholder's intent to place a nominee on company proxy materials, new filing procedures with the SEC, applicability of federal security law liability provisions to shareholder statements in company proxy materials, a limited exception to the proxy solicitation rule to allow a certain number of shareholders to communicate regarding the nomination procedure without having to file a proxy statement, and the applicability of the nomination procedure to investment companies. *Id.* at 60,793–804.

81. *Id.* at 60,797. If the board has eight or fewer members, management would be required to place one shareholder-nominee on the corporate proxy. *Id.* If the board has between nine and nineteen members, shareholders could nominate two candidates. *Id.* And if the board has twenty or more members, management would be required to place three shareholder-nominees on the corporate proxy. *Id.* Moreover, if a company has a "classified" or "staggered" board, the rules would prevent a shareholder or shareholder group from placing more candidates on the board than they could without such a board. *Id.* at 60,797–98.

Moreover, the right to nominate a director under the new procedure would be limited to those shareholders who have owned at least five percent of the company's voting shares for at least two years.[82] Shareholders may aggregate their shares to reach the five percent threshold but then must file beneficial ownership reports on Schedule 13G to utilize the shareholder access mechanism.[83] Proposed Rule 14a-11 also requires qualifying shareholders to intend to hold their shares at least until the date of the next election of directors.[84] The purpose of these substantial ownership and durational requirements is to ensure that the shareholder access mechanism is available only to those shareholders who can demonstrate a sufficient interest in the long-term success of the company.[85] If more than one shareholder or shareholder group qualifies under these eligibility requirements, the board would only be required to place the nominee or nominees of the shareholder or shareholder group with the largest beneficial ownership on the ballot.[86]

Perhaps the most severe limitation on the applicability of the proposed nomination procedure is that shareholders seeking to take advantage of Proposed Rule 14a-11 would first need to establish the existence of a "triggering event."[87] Specifically, direct access to the corporate ballot would be available only if: (1) more than thirty-five percent of shareholders cast "withhold votes"[88] for at least one of the company's board nominees at an annual meeting; or (2) more than fifty percent of shareholders voted to approve a "direct access" shareholder proposal.[89] Once triggered, the SEC intends the nomination procedure to remain available to shareholders for the following two annual meetings.[90]

Interestingly, because the SEC has narrowly construed the purpose of Proposed Rule 14a-11, the nomination procedure would not be available on account of mere poor corporate performance or outright fraud.[91]

82. *Id.* at 60,794.
83. *Id.*
84. *Id.*
85. *See id.*
86. *Id.* at 60,798.
87. *Id.* at 60,789.
88. *Id.* Plurality voting, rather than simple majority, controls in the context of voting director nominees under which process shareholders may either vote for or withhold authority to vote for each nominee. *Id.* at 60,789 n.72. The effect of requiring only a plurality of votes to secure a directorship, however, is that shareholders casting "withhold" votes ordinarily have no outcome-determinative influence.
89. *Id.* at 60,789–90. The "direct access" shareholder proposal would request that the company become subject to the nomination procedure of Proposed Rule 14a-11 by a shareholder, or group of shareholders, holding at least one percent of the company's voting shares for one year or longer as of the date the proposal was submitted. *Id.* Moreover, companies would not be permitted to exclude shareholder proposals intended to serve as a "triggering event" from its proxy materials under Rule 14a-8i, which would be amended to reflect this proscription. *Id.* at 60,789 n.74.
90. *Id.* at 60,789; *see also id.* at 60,789 n.71.
91. *Id.* at 60,790 (among such potential indicators: "lagging a peer index for a specified number of consecutive years, being delisted by a market, being sanctioned by the [SEC], being indicted on criminal charges, having to restate earnings, or having to restate earnings more than once in a specified period").

Instead, only demonstrable ineffectiveness of, or shareholder dissatisfaction with, the proxy process would trigger application of the nomination procedure.[92] The SEC believes that limiting the mechanism's application in such a way serves as a compromise between the competing interests of shareholders and managers.[93] Moreover, on the basis of recent statistical evidence, the SEC has concluded that the actual exercise of the nomination procedure will be relatively rare, allegedly dispelling the fear that expanded shareholder access to the ballot will adversely affect public companies.[94]

The SEC, however, is considering whether a third "triggering event" should be added to the two events already proposed—the so-called nonimplementation trigger.[95] This would occur if a board of directors failed to implement a precatory shareholder proposal submitted pursuant to Rule 14a-8, other than a "direct access" shareholder proposal, after the proposal received a majority of votes cast.[96] As a modification to Rule 14a-8, the proposal would have to be submitted by a shareholder, or group of shareholders, holding at least one percent of the company's voting shares for one year or longer as of the date the proposal is submitted to qualify as a triggering event.[97] The precise content of the shareholder proposal under this trigger, however, would not be limited to a request for "direct access."[98]

When a board fails to implement a proposal that received majority support, there is arguably evidence of a breakdown in the proxy process.[99] But the SEC is concerned with the potentially broad reach of the nonimplementation trigger.[100] Because shareholders and management may genuinely disagree over the appropriateness of various proposals, the nonimplementation trigger might not be associated closely enough with the ineffectiveness of, or dissatisfaction with, the proxy process to justify its use.[101] In addition, the "potential for dispute regarding whether proposals [have in fact been] implemented" would create a serious logistical problem for companies and a likely source of litigation.[102] Even

92. *Id.*

93. *Id.*

94. *See id.* at 60,790–91 (indicating that, in a "sample of 2,227 director elections," only "approximately 1.1% of companies had total withhold votes in excess of 35% of the votes cast" during the last two election years; submission of shareholder proposals by investors holding more than 1% of voting shares is "currently relatively rare"; and only 28–31% of shareholder proposals received a majority of votes cast in a sample taken between 2000 and 2003).

95. *Id.* at 60,791–92.

96. *Id.* at 60,791.

97. *Id.*

98. *See id.* at 60,791–92.

99. *Id.* at 60,792.

100. *See id.*

101. *Id.*

102. *Id.*

more troublesome is the negative effect such new shareholder power could have on the board's statutory authority to manage the company.[103]

Despite the difficulties surrounding the precise operation and extent of the new procedure, a potential regulation giving shareholders direct, yet limited, access to the corporate ballot for the purpose of nominating directors is finally on the table for consideration. Given the momentous implications a shareholder access mechanism is likely to have on corporate governance, nothing short of careful and deliberate consideration must be undertaken prior to its implementation. As of this writing, however, it is doubtful that a shareholder access mechanism will be adopted—at least in its proposed form. Nonetheless, this note will give Proposed Rule 14a-11 its due consideration.[104]

B. A Theory of the Firm: Director Primacy

To provide the proper context for an evaluation of the corporate governance reforms discussed above, this section sets forth a theory of the firm. This discussion is necessary because corporate theory bears directly on corporate policy.[105] Articulating a theory of the firm that accurately describes the public company is thus an important condition to meaningful participation in the various policy debates that exist in the corporate arena.

Although theorists have long debated how to best describe the public company, a new theory of the firm has emerged that appears more complete than its predecessors: Professor Stephen M. Bainbridge's model of director primacy.[106] This part outlines the major points of this model, which provide the critical assumptions under which the policy analysis of Part III operates.[107] Part II.B.1 describes the director primacy theory's explanation of the means of corporate governance,[108] while Part II.B.2 describes its explanation of the ends.[109] Finally, Part II.B.3 summarizes the director primacy model and proposes an efficiency test to be utilized in Part III.[110]

103. *See* Bainbridge III, *supra* note 76, at 4–5.

104. Jonathan Peterson, *Shareholder Proposal Is Stalled at SEC*, L.A. TIMES, Oct. 9, 2004, at C1; Deborah Solomon, *SEC Nears Compromise on Shareholder Plan*, WALL ST. J., Aug. 11, 2004, at C1. For a brief, yet compelling, critique of the so-called compromise plan being considered by the SEC, see Stephen M. Bainbridge, *The SEC: From Bad to Worse?*, TECH CENTRAL STATION, *at* http://www.techcentralstation.com/081204C.html (last visited Jan. 16, 2005).

105. *See* Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 24 (1996) [hereinafter Dallas I].

106. *See generally* Bainbridge II, *supra* note 58 (articulating and defending his director primacy model).

107. *See infra* text accompanying notes 276, 429.

108. *See infra* text accompanying notes 110–31.

109. *See infra* text accompanying notes 132–69.

110. *See infra* text accompanying notes 170–74.

1. The Means of Corporate Governance

Generally speaking, the public company is the sum result of a "massive collectivization of property devoted to production."[111] It is comprised of numerous source inputs, including shareholders, managers, creditors, employees, and other stakeholders, each in pursuit of his own interest.[112] Nevertheless, these inputs choose to unite on the assumption that binding together in a firm is cheaper than transacting individually in the market.[113]

According to contractarian theory, the firm is a "nexus of contracts among the various factors of production."[114] The firm is, therefore, nothing more than a complex web of explicit and implicit contracts—it has no aggregate or reified identity.[115] The law accords the public company entity-like status for the limited practical purpose of enabling the various factors of production to contract directly with the firm.[116] To the limited extent a company can be described as having an identity, its identity is personified in the board of directors, which is the nexus of the contracts.[117]

The means-side of corporate governance seeks to establish a decisionmaking norm for the firm.[118] Because of the public company's numerous inputs, it must choose an efficient system so that the costs of transacting under the corporate form are minimized. Traditional theories have espoused either managerial or shareholder primacy.[119] The former states that the officers control the firm, the directors are mere figureheads, and the shareholders are essentially irrelevant.[120] The latter states that directors and officers are contractual agents of the shareholders, who ultimately retain control of the firm.[121]

The director primacy model rejects both managerial and shareholder primacy and posits that the central decisionmaking authority is

111. ADOLF A. BERLE & GARNIER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (rev. ed. 1968).

112. Lipton & Rosenblum, *supra* note 17, at 79.

113. Bainbridge II, *supra* note 58, at 555 (construing R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386 (1937)).

114. *Id.* at 552; *see also* Easterbrook & Fischel, *supra* note 27; Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318–28 (1993).

115. Bainbridge II, *supra* note 58, at 548; *accord* Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 36 (1999); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (1991).

116. Bainbridge II, *supra* note 58, at 553 ("Corporate constituents thus contract not with each other, but with the corporation . . . . The existence of a real nexus with the power to contract is necessitated by the absence of mechanisms for corporate constituents to communicate, let alone contract, with one another. The various constituencies thus must be, and are, linked to a real nexus [i.e., the board] and not one another.").

117. *Id.* at 560.

118. *Id.* at 552.

119. *Id.* at 547.

120. *Id.* at 548.

121. *Id.* at 547–48.

the board of directors.[122] An authority-based decisionmaking norm is efficient for the public company because organizing large-scale economic activity under an authoritative regime reduces transaction costs.[123] The public company is a vehicle by which capital is hired by the board and put to efficient use pursuant to the board's directive.[124] Moreover, the board's powers to manage flow "from the *complete* set of contracts constituting the firm."[125] The board is thus the nexus which negotiates and modifies the implicit and explicit contracts that make up the firm.[126]

The director primacy model accurately accounts for modern corporation law wherein the managing authority of the public company is generally vested in a board of directors.[127] In contrast, both managerial and shareholder primacy theories are incorrect in their explanation of statutory law.[128] Directors are not mere figureheads, while shareholders are not owners within the private property sense of ownership and thus have no right to control the firm. Shareholders do not own the company for the simple reason that it is not a thing to be owned.[129] Rather, shareholders own the residual claim to the company's earnings and assets.[130] Therefore, director primacy theory is both economically efficient and statutorily accurate with respect to the means-side of corporate governance.[131]

2. *The Ends of Corporate Governance*

The ends-side of corporate governance seeks to answer the question: In whose ultimate interests should the firm be managed?[132] Traditionally, corporate theorists have advocated the interests of either the shareholders or other stakeholders.[133] The director primacy model em-

122. *Id.* at 550.
123. *Id.* at 556–57.
124. *Id.* at 560. As a practical matter, the board generally exercises only broad oversight and delegates day-to-day management to the officers of the company. *See id.* at 559 n.62. Still, the officers' power to manage is wholly derived from the board. And despite the historical figurehead-like function of directors, it appears that directors are finally beginning to exercise their power over officers. *See id.* at 562–63 (expanding recognition and empowerment of the board's managerial role "culminated in a series of high-profile board revolts against incumbent managers at such iconic American corporations as General Motors, Westinghouse, and American Express").
125. *Id.* at 560 (emphasis added).
126. *See id.*
127. *See*, *e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2001) (providing that the corporation's business and affairs "shall be managed by or under the direction of a board of directors").
128. *See* Bainbridge II, *supra* note 58, at 563, 573.
129. *Id.* at 564–65, 577; *cf.* Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918) (noting that "the directors in the performance of their duty possess [the company's property], and act in every way as if they owned it").
130. Bainbridge II, *supra* note 58, at 565 (citations omitted).
131. *See id.* at 572.
132. *Id.* at 549–50.
133. *Id.* at 549.

braces the former and states that the board manages the public company to maximize shareholder wealth.[134]

The efficacy of the shareholder wealth maximization norm can be demonstrated utilizing the hypothetical bargain methodology.[135] This methodology is premised on the idea that "by providing the rule to which the parties would agree if they could bargain (the so-called 'majoritarian default'), society facilitates private ordering."[136] Pursuant to this exercise, therefore, corporation law functions as a substitute to private ordering through default rules, and each default rule is tested economically by articulating a hypothetical bargain between the particular parties thereto.[137]

Under director primacy theory, the board negotiates the contracts of the firm's inputs and is thus the principal party to this hypothetical bargain.[138] The other relevant party for demonstrating the efficacy of the shareholder wealth maximization norm is, of course, the group of shareholders.[139] Therefore, whether the board and the shareholders would agree to be bound by the shareholder wealth maximization norm can be (hypothetically) tested.[140]

According to Professor Bainbridge, both parties would strike a bargain for the maximization of shareholder wealth: boards would choose it to reduce the cost of capital, while shareholders would choose it to reduce the risk of shirking.[141] The cost of capital measures the market's evaluation of the risk of default which a particular company poses as it continues its ongoing operations. Reducing the cost of capital is important to the board because "a higher cost of capital increases the probability of firm failure or takeover."[142] At the same time, however, shareholders are particularly vulnerable to managerial shirking due to the particular incompleteness of the shareholders' contract with the firm.[143]

The board exercises immense discretion with respect to how equity capital is used. As Berle and Means famously described the situation, there is an inevitable separation of ownership from control.[144] Shareholders invest "risk capital"[145] for the ephemeral purpose of earning the

134. *Id.* at 550.
135. *Id.* at 578–79.
136. *Id.* at 579 n.159.
137. *See id.* at 578–79.
138. *Id.* at 592.
139. *Id.* at 579.
140. *See id.*
141. *Id.* These explanations are really two sides of the same coin, since a lower risk of shirking translates into a lower cost of capital. *See infra* notes 145–47 and accompanying text.
142. *See* Bainbridge II, *supra* note 58, at 580.
143. *See id.* at 565–66, 586.
144. BERLE & MEANS, *supra* note 111, at 129.
145. Although admittedly ambiguous, "risk capital" is, at the very least, "capital provided by investors" subject to "substantial risk" of loss. *See* JAMES D. COX ET AL., SECURITIES REGULATION 126 (3d ed. 2001) (analyzing the meaning of the term within the context of defining a "security" for purposes of the Securities Act of 1933).

highest rate of return commensurate with the level of risk assumed. Given the wide gaps in the shareholders' contract, the risks of managerial shirking would be high absent adequate protection.[146] In exchange for this heightened risk, shareholders should demand a higher rate of return on their investment, which, in turn, raises the cost of capital for the board and depresses the price of the company's stock.[147] A depressed stock price makes a public company vulnerable to takeover. To reduce the cost of capital, and increase the price of the company's stock, the board would agree to put the interests of the shareholders above those of other stakeholders.[148]

How much this guarantee actually reduces the cost of capital, however, should depend upon its value to the shareholders. Assurance of accountability thus becomes vital to the bargain between the board and the shareholders. Under agency theory, the costs attributable to shirking are known as "agency costs."[149] Applying that concept to corporation law, minimizing agency costs, i.e., assuring board accountability to the shareholder wealth maximization norm, is referred to as the "corporate-agency problem."[150]

Minimizing the effects of the corporate-agency problem requires firms to "align manager incentives with shareholder preferences."[151] Corporate governance accomplishes this goal through various monitoring devices.[152] The principal monitoring device relevant to the board/shareholder bargain is the board's duty to put the interests of the company above its own interests.[153] This fiduciary obligation holds the board directly accountable to the shareholders.[154] Other important moni-

146. *See* Bainbridge II, *supra* note 58, at 566.

147. *See id.* at 580.

148. *See id.*

149. *See*, *e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976), *at* http://papers.ssrn.com/s013/paper.taf?ABSTRACT_ID=94043. Essentially, "[a]gency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents." Bainbridge I, *supra* note 18, at 15. And "shirking is defined to include as any action by a member of a production team that diverges from the interests of the team as a whole"—irrespective of the shirking team member's motives or culpability. *Id.* at 12 n.67.

150. Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L.J. 723, 726 (2003).

151. *Id.* It should be noted, however, that the costs of vesting discretion in the board cannot be completely eliminated without removing discretion. *See* Bainbridge II, *supra* note 58, at 568. Given the favorable virtues of discretion, the costs attributable to the risk of shirking cannot be reduced to zero. *Id.*

152. *See* Lin, *supra* note 30, at 957–61 (listing such monitoring systems: "(1) the market for corporate control, (2) executive compensation programs with incentive systems . . . (3) the product market, (4) the external managerial labor market, (5) competition among the firm's top managers, (6) monitoring by creditors . . . (7) monitoring by large blockholders unaffiliated with management, and (8) legal rights granted to shareholders, such as the right to bring actions against officers and directors for breach of duties of care and loyalty." (footnotes omitted)).

153. Bainbridge II, *supra* note 58, at 574–76.

154. *Id.*

toring devices include the market for corporate control[155] and the professional reputation market.[156]

Significantly, the director primacy model does not contemplate a broad monitoring role for shareholders themselves.[157] Professor Bainbridge argues that "shareholders lack either direct or indirect mechanisms of control"[158] based upon the various statutory disincentives of owning significant holdings of stock and impediments to effective communication with other shareholders.[159] In addition, institutional investors tend to be quite passive with respect to corporate governance.[160] A lack of control translates into minimal ability to effectively monitor.[161] In contrast to possessing control, shareholders do possess certain power.[162] However, shareholder power is all but limited to the right to elect the directors to the board.[163] Once directors are elected thereto, "[t]he power of directors is present in their ability to manage the business enterprise *without direct interference of shareholders*."[164]

Director primacy "sever[s] the link between [the] means and ends" of corporate governance by positing that, while ultimate managerial control of the public company vests in the board alone, the board manages the firm principally for the maximization of shareholder wealth.[165] Corporation law demands the same by requiring fiduciary duties to the shareholders to the exclusion of other stakeholders.[166] Professor Bainbridge asserts that stakeholders are given more meaningful protection through complete contracts[167] and targeted legislation and thus would not

155. *See* Adams, *supra* note 150, at 726. The combination of professional analysts and the capital markets provide shareholders with a strong monitoring device. *Id*. According to the semi-strong efficient capital market hypothesis, analysts impound all publicly available information quickly so that stock prices accurately reflect the value of the underlying security. *See* COX ET AL., *supra* note 145, at 30. At the same time, a company's stock price can be described as a public score card against which public approval of management can be measured. *See* Adams, *supra* note 150, at 726–27. Because an undervalued company may become the target of a takeover, management has an ongoing incentive to maximize shareholder wealth. *Id.* Thus, the market for corporate control provides a strong check against managerial shirking, provided the market is an efficient one. *Id.* at 727.

156. Bainbridge II, *supra* note 58, at 580. *But see infra* note 190 (questioning the professional reputation market as an efficacious monitoring device).

157. *See* Bainbridge II, *supra* note 58, at 568.

158. *Id.* at 572.

159. *Id.* at 569–72.

160. *Id.* at 571–72.

161. *Cf. id.* at 567–69 (discussing and rejecting the argument proffered by some theorists that shareholders ultimately control the company to constrain agency costs through monitoring the board).

162. Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1366–67 (2002) [hereinafter Dallas II].

163. *Id.*

164. *Id.* at 1367 (emphasis added).

165. Bainbridge II, *supra* note 58, at 572, 574.

166. *Id.* at 574–75; *see* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the board are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself.").

167. Bainbridge II, *supra* note 58, at 588–89. For example, with respect to bondholders, the company must either pay them a sum certain in the manner set forth in the parties' indenture agreement or

necessarily benefit from open-ended fiduciary duties.[168] Therefore, the director primacy model provides both a justification for, and a positive account of, the widely accepted end of corporate governance, the maximization of shareholder wealth.[169]

3. Applying Theory to Policy: An Efficiency Test

The director primacy model shows that "the chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise."[170] The public company operates effectively as a business entity precisely because it vests the right to make binding decisions in an authoritarian manner.[171] Ensuring the responsible exercise of this authority, however, is also a fundamental attribute of a successful firm.[172] Thus, the key to corporate governance lies in maintaining the proper balance of authority and accountability.[173]

Furthermore, because the directors' power to control and manage the public company becomes virtually absolute once they have been elected to the board, mechanisms of accountability cannot be accurately founded on a claim of shareholder power.[174] But this does not mean that shareholders are wholly irrelevant to corporate governance. Rather, the participation of shareholders in the pursuit of accountability must be grounded in their bargained-for shareholder wealth-maximization norm.

Director primacy teaches that the overarching goal of corporate governance is to balance properly authority and accountability. Therefore, in addition to an operational cost-benefit analysis, this note will test the corporate governance regulations described above on the basis of achieving that crucial balance.

III. ANALYSIS

Now that the two regulatory efforts at issue in this note have been described, and a theoretical framework for examining them has been set forth, this part examines them both.[175] The principal objective of both reforms is essentially the same—facilitating the composition of a well-functioning board—but their means are quite different. Nevertheless,

risk default and accompanying creditors' action. *Id.* at 588. There is little to no room for shirking when the particular contractual arrangement is highly specified in this manner.

168. *Id.* at 590–92.
169. *Id.* at 592.
170. *Id.* at 572.
171. *Id.*
172. *Id.* at 573.
173. *Id.*
174. *Id.* at 572.
175. *See infra* text accompanying notes 176–429.

because each regulation addresses the role of the board in a public company, this part also explores various theoretical models to test better both required majority board independence and the shareholder access mechanism.

A. Rejecting a Mandatory Board Composition Rule

1. The Board of Directors: Conflicts Monitor

a. The Case for Required Majority Board Independence

Recall that the primary goal of corporate governance is to minimize the effects of the corporate-agency problem without unduly abrogating the effective exercise of board discretion. Because minimizing the effects of the corporate-agency problem contemplates the alignment of management incentives with shareholder preferences, effectively monitoring real and potential conflicts of interest between these two groups is an important means of accomplishing this end.

Traditionally, the principal function of the board of directors has been to monitor and control conflicts of interest that arise between the day-to-day managers, i.e., the executives, and the shareholders.[176] According to Professor Melvin A. Eisenberg, the board of directors is "uniquely suited" to function as a conflicts monitor.[177] Professor Eisenberg argues that conflicts monitoring is the primary function of the board, which is an essential tenet of the monitoring theory of the board.[178]

Underlying this argument is the idea that the board of directors represents the only genuine, proactive internal mechanism of corporate governance to which managerial self-interest can be held accountable.[179] The ability of shareholders to serve some proactive function is limited by their disunity and tendency simply to sell their shares rather than mount an expensive effort to hold overreaching managers accountable.[180] In fact, the board of directors is understood to be the only institution that can properly "insist on being kept informed, impose compliance procedures, and take appropriate corrective action."[181]

The inevitable corollary to this theory is that, to be an effective monitor, the board of directors should not be subject to the influence of

176. Dallas I, *supra* note 105, at 3.
177. MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION 162 (1976).
178. Dallas I, *supra* note 105, at 13 (construing EISENBERG, *supra* note 177, at 169–70); *see also* EISENBERG, *supra* note 177, at 172 ("[T]he board's principal function is to monitor management's performance.").
179. *See* Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455, 457 (1984); D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1086 (1996).
180. *See* Borowski, *supra* note 179, at 458.
181. *Id.*

the executives.[182] In fact, Professor Eisenberg argues that the board must be "completely independent" of executive management in order to be an effective monitor.[183] This conclusion can be deduced from the premises that (1) executive management cannot be trusted to effectively monitor itself, and (2) a board closely allied with executive management is the practical equivalent of executive management monitoring itself.[184] According to this logic, the greater the proportion of independent directors on the board, the greater the likelihood the board will act as an effective monitor.[185] Professor Eisenberg submits that the board must be either composed entirely of independent directors or composed of a "clear majority" of them by regulatory fiat.[186]

However, effective conflicts monitoring depends on the board receiving "adequate and objective information on the executives' performance."[187] Professor Eisenberg argues that legal rules should fashion an "independent mechanism" for securing such information.[188] Otherwise, the historical trend of board members relying on executive management for information will continue, rendering the independent director ineffective as a practical matter.[189] In addition, to be effective, independent directors must have an actual incentive to protect the shareholders' best interests. According to the "effective monitor" theory, independent directors are motivated to further the shareholders' best interests in order to protect their own "reputation capital" as directors and decisionmaking experts.[190]

Assuming that the board receives objective information and has a sufficient incentive to protect shareholder interests, the efficacy of required majority board independence can purportedly be demonstrated.

182. Dallas I, *supra* note 105, at 4.

183. EISENBERG, *supra* note 177, at 166; *see also* Christian J. Meier-Schatz, *Corporate Governance and Legal Rules: A Transnational Look at Concepts and Problems of Internal Management Control*, 13 J. CORP. L. 431, 467–68 (1988).

184. *See* EISENBERG, *supra* note 177, at 166; Lin, *supra* note 30, at 900–01.

185. *See* Lin, *supra* note 30, at 901.

186. *See* EISENBERG, *supra* note 177, at 172.

187. *Id.* at 170.

188. *See id.* at 172.

189. *See id.*; *see also* Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427, 1442 (1995) (emphasizing that, in addition to directors' need for adequate sources of information independent of executive management, properly educating and orientating outside directors to the "company's core businesses, competitive posture, and strategic plans and objectives" is "critical").

190. Lin, *supra* note 30, at 917–18 (explaining that because directors invest significant time and energy into developing their reputation as professional decision makers, they have an incentive to monitor effectively in order to increase their own value in the external labor market, translating into additional lucrative directorships). For a summary of several empirical studies that indicate a market for independent directors does in fact exist, see *id.* at 941–45. However, because executives will not materially benefit from placing those independent directors who are notoriously critical of executive management on their boards, and because shareholders typically assign their proxies in favor of management's slate of directors, the precise nature of the "reputation capital" qualified independent directors enjoy may not in fact be very favorable to shareholders. *See id.* at 954–55 ("If management is the one who chooses which outside directors serve on the board, it is not clear why directors would benefit from having a reputation as effective monitors.").

First, the judiciary positively relies on the ability of independent directors acting as a majority to monitor effectively and prevent managerial overreaching.[191] As judicial review is considered an inherent component of efficient corporate governance, the courts' reliance on independent directors corroborates the usefulness of requiring majority board independence.[192]

Second, although the available empirical evidence is mixed,[193] some studies have found a positive relationship between board independence and overall corporate performance,[194] as well as between board independence and various conflict-of-interest transactions or situations.[195] The judiciary's reliance on a majority of independent directors, in addition to a correlation between board composition and firm performance, appear to bolster the theoretical case for the policy of required majority board independence.

b. A Critique

Despite the seemingly strong theoretical case for the policy of required majority board independence, the painful reality of boards acting in their monitoring capacity severely undermines it.[196] Aside from the problem of accepting the monitoring theory of the board,[197] the critique

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191. *Id.* at 904. For example, the standard for determining demand futility in the context of shareholder derivative suits under Delaware law turns in part on whether the shareholder can raise a reasonable doubt as to the independence of the directors. *Id.* at 907 (citing, inter alia, Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988)). In addition, when faced with the threat of a hostile takeover, a board can "materially enhance[ ]" its proof that it satisfied the *Unocal* test by showing that its chosen defensive measure was approved by "a board comprised of a majority of outside independent directors . . . ." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

192. *See* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621–22 n.9 (1989).

193. Lin, *supra* note 30, at 921.

194. *Id.* at 921–25.

195. *Id.* at 926–40 (discussing results of studies which focused on "(1) CEO dismissal, (2) executive compensation, (3) corporate acquisitions, (4) adoption of poison pills, (5) payment of greenmail, (6) adoption of golden parachutes, (7) management buy-outs, and (8) shareholder derivative suits," and concluding that "outside directors do seem to make a [positive] difference in certain situations"). However, Professor Lin believes that, because the causes of these results are complex, the results should not be interpreted to suggest that the use of independent directors inevitably leads to effective conflicts monitoring. *See id.* at 939–40. Instead, Professor Lin believes that the evidence should be interpreted to mean that "particular *kinds* of outside directors are more likely to be effective than others" in certain situations. *Id.* (emphasis added). Examples include: professional outside directors versus nonprofessional outside directors, equity-holding outside directors versus non-equity-holding outside directors, and longer-tenured outside directors versus shorter-tenured outside directors. *Id.* at 939–50.

196. *See* Borowski, *supra* note 179, at 458 (explaining that history has shown that the board of directors is a poor tool of corporate accountability as conflicts monitor); EISENBERG, *supra* note 177, at 170–71; *see also* Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1385 (2002) (noting that the Enron board itself had a majority of independent directors, despite the board's utter failure to detect and prevent the fraud that infamously ruined that public company).

197. *See infra* text accompanying notes 219–42. In addition, the monitoring theory is flawed for its failure to distinguish between directors and officers or executives. *Cf.* Bainbridge II, *supra* note 58,

of board independence traditionally has focused on the various constraints on the independent director's ability to accomplish his main task: monitoring executive management effectively and independently.[198] These constraints can be placed into three categories: (1) nomination and selection biases, (2) information disparity, and (3) "board culture" hostility.[199]

Nomination and selection biases prevent independent directors from actively challenging executive management for fear of losing their tenure on the board, greatly compromising their capacity to monitor effectively.[200] This effect is exacerbated by the fact that independent directors are often chosen for their willingness to accept the company's existing methods of operation.[201] Moreover, despite an increasing reliance on nominating committees comprised of independent directors, executive management still exercises considerable influence over the nomination process,[202] and current federal securities law allows management to restrict access to the ballot.[203] Management thus ultimately retains control over whose names appear on the corporate ballot for purposes of the corporate election.

Furthermore, there is no independent mechanism that allows directors to receive the type of objective information needed for effective monitoring.[204] To a significant degree, the board is dependent on executive management for inside information.[205] In addition to having intimate knowledge of a company's business plans and financial data, executives also control the means by which board members receive such information. For example, executives who serve on the board have the power to schedule board meetings, as well as the power to control the specific content of the information divulged at those meetings.[206] The result is that independent directors may simply "see major issues confronting the cor-

at 561 (pointing out a similar flaw in the managerial primacy theory of the firm). Instead, the monitoring theory merely distinguishes between independent directors and "managers." But independent directors are actually a sub-set of managers. In fact, according to both director primacy theory and corporation law, it is the board of directors as a whole which alone has the original authority to manage the company. The "managers" of which monitoring theory speaks are actually the company's executives whose power over the day-to-day operations of the firm are not original, but delegated by the board. For theoretical accuracy as well as for clarification, therefore, this note explicitly distinguishes between directors on the one hand and executives on the other hand.

198. *See*, *e.g.*, Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 632–39 (1982); Ribstein, *supra* note 11, at 26–27.

199. Lin, *supra* note 30, at 912–17.

200. *Id.* at 913–14.

201. *Id.* (citation omitted).

202. Dallas I, *supra* note 105, at 5.

203. *See* Shareholder Proposals, 17 C.F.R. § 240.14a-8(i)(8) (1998) (noting that a company may exclude a proposal "if the proposal relates to an election for membership on the company's board of directors or analogous governing body").

204. Lin, *supra* note 30, at 914.

205. Dallas I, *supra* note 105, at 4.

206. *Id.* at 4–5; Lin, *supra* note 30, at 914.

poration through [executive] management's eyes."[207] Moreover, companies whose boards are composed of a large proportion of independent directors may incur significant information costs to compensate for the independent directors' lack of communication channels.[208]

Finally, independent directors suffer from the effects of a "board culture" that is hostile to open criticism of the CEO absent imminent crisis.[209] All directors, like executives, are self-interested;[210] as such, it is naïve to assume independent directors are motivated by altruism to act in shareholders' best interests. Without a mechanism to combat the hostility of board culture, the self-interest of independent directors may go unchecked.[211] Similarly, because a clear majority of independent directors serving on corporate boards are actually CEOs of other companies, "[t]hese directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards."[212] Furthermore, because the threat of ouster is minimal due to the substantial costs of running a proxy contest, incumbents have little incentive to overcome their self-interest.[213]

Numerous empirical studies reinforce the conclusions of this critique.[214] Although empirical evidence does not support the proposition that the board is invariably dependent on executive management irre-

207. Lin, *supra* note 30, at 914.

208. *See* Ribstein, *supra* note 11, at 41.

209. Lin, *supra* note 30, at 915–16; *see also infra* text accompanying notes 257–68 (discussing the group decisionmaking peril "groupthink" associated with a socially homogeneous board).

210. *See* Borowski, *supra* note 179, at 456–57.

211. *See id.*

212. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991); *see also* Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1803–04 (1976) (stating that besides pressure to follow the leader in the boardroom, other factors make independent directors particularly apt to view management's demands congenially, including the sharing of professional backgrounds).

213. *See* Bebchuk I, *supra* note 4, at 45.

214. *See*, *e.g.*, Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 575 (1984) (optimal proportion of independent directors well below a majority); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 888–91 (2002) (firms with majority board independence appear to abuse defensive tactics in context of hostile takeover bid to the detriment of shareholders to the same degree as firms without); Bhagat & Black, *supra* note 31, at 233 (addition of more independent directors does not increase a corporation's profitability); Rajeswararao S. Chaganti et al., *Corporate Board Size, Composition and Corporate Failures in Retailing Industry*, 22 J. MGMT. STUD. 400, 400 (1985) (no significant difference between percentage of independent directors serving on boards of failed and unfailed retailing firms); Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101, 111 (1991) (no relation between board composition and corporate performance); Paul W. MacAvoy et al., *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis, in* STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED PRINCIPLES OF CORPORATE GOVERNANCE AND RESTRUCTURE: RESTATEMENT AND RECOMMENDATIONS, at C-1, C-26 to C-27 (1983) (same); *see also* James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1239 (1993) ("Overall, studies have found no correlation between board composition and firm performance.").

spective of its composition,[215] this evidence also does not support the proposition that independent directors will be effective monitors of managerial overreaching.[216] In an exhaustive, large-sample, long-horizon study on board independence published in 2002, for example, Professors Sanjai Bhagat and Bernard Black showed that low-profitability companies do not improve their profitability by adding more independent directors to their boards.[217] In fact, their study indicated that companies with boards that are more "independent" may actually perform worse than other companies that are not.[218]

2. The Board of Directors: Fulfilling Relational Roles

a. Power Coalition Theory

In contrast to monitoring theory,[219] power coalition theory provides broader insight into the various relational roles a board actually plays in the corporate world.[220] This theory explains that various constituencies, such as shareholders, creditors, and employees, form coalitions to influence corporate behavior.[221] A successful coalition represents the company on any matter over which it gains controlling influence.[222] As "[t]he relationship between the corporation and various coalitions reflects resource dependencies," the board mediates the firm's relationships with these stakeholders.[223] Through board memberships, a company concretely exercises its ability to become more sensitive to its environment and gain access to important resources.[224]

215. Lin, *supra* note 30, at 962.
216. *Id.*
217. Bhagat & Black, *supra* note 31, at 233.
218. *Id.* Compare the curious result of another study, which found that while on average the addition of outside directors to the board positively correlated with an increase in firm performance, so too did the addition of inside directors. John A. Wagner, III et al., *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUD. 655, 663 (1998).
219. A theory similar in its emphasis on conflicts monitoring is agency cost theory. Commentators who oppose legal intervention, but nonetheless subscribe to a monitoring theory of the board of directors, advocate this theory. Dallas I, *supra* note 105, at 8; *see also* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293–94 (1980). Agency cost theory posits that "boards of directors may control managerial opportunism in situations where the interests of managers (agents) conflict with the interests of shareholders (principals)." Dallas I, *supra* note 105, at 8 (citations omitted). According to this theory, a company will utilize monitoring devices other than the independent director when doing so would be less costly. *Id.* Accordingly, because not all firms will require their boards to perform conflicts monitoring, agency cost theorists reject a standardized rule that would require majority board independence. *Id.* at 8–9. However, this theory fails to account for the *purpose* of a board of directors which does not perform a conflicts monitoring role. *Id.* at 9. The reason for this shortcoming is that the theory "is narrowly concerned with the board as an agency cost reduction mechanism." *Id.*
220. Dallas I, *supra* note 105, at 10.
221. *Id.*
222. *Id.*
223. *Id.*
224. *Id.*

Thus, in addition to being the nexus with which corporate inputs contract,[225] the board also serves as an important vehicle for helping a company relate to its external environment to secure resources and reduce uncertainty.[226] The various resources gained through board memberships include: "coordination with [the] external environment; informational access and exchange; support through identification with the corporation; status within some community; legitimacy in the eyes of relevant audiences; advice based on the background and skills of directors; monitoring; and direction."[227] Evaluating these resources indicates that the board functions in numerous relational roles, not merely in a conflicts-monitoring one.[228] Because board members, as fiduciaries, are required by law to act in the best interests of the company, the high value of these relational resources is made secure.[229]

The various roles of the board can be summarily placed into two functional categories.[230] First, in its advisory role, the board provides advice to executives on long-term operational policy.[231] Through this advisory role, the board also provides access to a broad network of external contacts.[232] Second, the board monitors the executives and retains the authority to replace them if necessary.[233] The monitoring function, however, does not dominate the advisory function.[234] This is so because "[o]ther relational roles of the board are at least as important as conflicts monitoring and can often be effectively performed *only* through board memberships."[235]

While board independence is potentially relevant to both the advisory and monitoring functions, "firms do not have uniform needs for managerial accountability mechanisms."[236] Because the purpose of accountability mechanisms is to minimize the risk of shirking, the desirability of a particular mechanism will depend on its costs in relation to the amount of risk to which each firm is exposed.[237] In turn, each firm will inevitably be exposed to different risks of shirking based on its own unique circumstances.[238] Given the various monitoring and control de-

225. *See* Bainbridge II, *supra* note 58, at 592.
226. Dallas I, *supra* note 105, at 11.
227. *Id.* at 12 (footnote omitted).
228. *Id.*
229. *Id.* at 14. *But cf. infra* notes 304–06 and accompanying text. For a discussion of fiduciary duties, see RIBSTEIN & LETSOU, *supra* note 53, at ch. 9.
230. Bainbridge I, *supra* note 18, at 12.
231. *Id.*
232. *Id.*
233. *Id.*
234. *See* Dallas I, *supra* note 105, at 13.
235. *Id.* (emphasis added).
236. Bainbridge I, *supra* note 18, at 23.
237. *See id.*
238. *Id.*

vices available to firms,[239] the one-size-fits-all mentality, from which required majority board independence clearly suffers, may be misplaced.[240]

Regulating board composition is not necessarily improper. According to power coalition theory, regulation may be acceptable to equalize important relationships in which the risks and costs of overreaching by one coalition are great.[241] In particular, legal intervention may be appropriate to strengthen the bargaining relationship between the board and the shareholders.[242] Thus, to the extent regulation aimed at board composition maximizes the benefit of the shareholders' bargain with the board, such regulation could be supported by the relational aspect of power coalition theory.

Because relational theory does not hold conflicts monitoring out to be the board's primary function, however, it does not support the policy of required majority board independence. In addition, relational theory escapes the tendency to emphasize accountability at the expense of authority. In this respect, relational theory is consistent with director primacy theory and is a logical extension thereof. The relational theory of the board should be embraced as a substitute to the traditional monitoring theory. The implications of doing so will be examined immediately below.

b. Required Majority Board Independence: A Failed Policy

As noted above,[243] some evidence suggests that independent directors can be effective monitors in certain situations. It would, therefore, be wrong to conclude that independent directors are irrelevant to effective corporate governance.[244] The totality of the evidence on board composition, however, indicates that the utility of independent directors is of mere *diminishing returns*.[245] Thus, even if the independent director is effective when properly employed, abusing this mechanism by requiring majority board independence for all public companies "may serve to distort the [accountability] process and detract from the role that independent directors can perform effectively."[246]

239. *Id.* at 24; *see also* Lin *supra* note 30, at 957–61.
240. Bainbridge I, *supra* note 18, at 23.
241. Dallas I, *supra* note 105, at 24.
242. *See id.*
243. *See supra* text accompanying notes 193–95.
244. Bhagat & Black, *supra* note 31, at 234; Ribstein, *supra* note 11, at 27.
245. Baysinger & Butler, *supra* note 214, at 573 ("[T]he addition of independent directors to a corporate board is subject to both diminishing marginal increases and absolute declines in relative performance."); *see also id.* at 574–75 (concluding that empirical evidence indicates that the optimal percentage of independent directors "is well below the majority requirement championed by the reformers").
246. Borowski, *supra* note 179, at 456. Moreover, the "optimal mix of inside and outside directors" is likely contingent on the particular industry in which the company participates as well as the particular company itself. Lin, *supra* note 30, at 967; *cf.* Baysinger & Butler, *supra* note 214, at 577 ("The proportion of independent directors to other directors is optimal when there is an adequate

One explanation for the limited utility of independent directors is that inside directors actually add value to boards.[247] This added value reflects the fact that "boards fulfill a number of functions for their corporations" besides that of conflicts monitoring,[248] which in turn corroborates the relational theory of the board.[249] Director primacy theory helps concretize the value insiders add. It explains that while the public company, as a whole, is governed according to an authority-based decisionmaking norm, the board of directors is organized according to a consensus-based decisionmaking norm.[250] Accordingly, board members should have equal access to information and possess the same interests to be effective as a team.[251] Insofar as insiders have comparable interests and secure access to relevant information, insiders are valuable to facilitating efficient consensus-based decisionmaking.[252]

Another explanation for the limited utility of independent directors corresponds to the current regulatory regime by which independent directors are selected for board service. While the underlying purpose of "independence" is to fashion a board capable of critically evaluating executive management,[253] the process by which these independent directors are *selected* is crucial to whether the resulting board is independent in fact.[254] When the selection of independent directors is exclusively controlled by executive management, and board independence is limited to a mechanical application of a regulatory standard of "independence" to outside directors, the boards created thereunder will be independent in name, *but not necessarily in fact*.[255] Unfortunately, this summarizes the current state of affairs. Accordingly, at some point the addition of independent directors does not correlate to increased firm performance because cosmetically independent directors may not be effective monitors.

number of independent directors to provide a signal to shareholders that the monitoring function is going to be performed, but not so many that outsiders hold board seats that could be filled better by inside managers and instrumental directors.").

247. Bhagat & Black, *supra* note 31, at 263.

248. Baysinger & Butler, *supra* note 214, at 568.

249. *See* Dallas I, *supra* note 105, at 16–18 (discussing results of empirical studies which support the relational theory of the board).

250. Bainbridge I, *supra* note 18, at 14.

251. *Id.* (citing Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 467 (1992)).

252. *See id.*

253. *See* EISENBERG, *supra* note 177, at 171 ("[E]ffective performance of the monitoring function is conditioned on monitors who are (i) independent of those who are monitored, and (ii) capable of obtaining adequate and objective information concerning management.").

254. *See id.* at 171–72 (lamenting the fact that most directors are "closely tied to the chief executive" in part because of "they have been *selected* and indoctrinated by the chief executive and hold their seats at his pleasure" (emphasis added)); *cf.* Dallas II, *supra* note 162, at 1400–01 ("[T]he *selection* and socialization of board members assures cohesion on corporate boards, *often to a degree that interferes with the effective performance* of the relational and manager-monitoring functions of boards." (emphasis added)).

255. *See* Dallas II, *supra* note 162, at 1400–01.

Social psychology further explains why the selection process is so critical. Placing the exclusive nominating power in the hands of executive management ignores the fact that the efficacy of consensus-based decisionmaking depends upon genuine cognitive conflict[256] among the entity's members to avoid group decisionmaking perils, the most dangerous of which is "groupthink."[257] Groupthink is an impediment to group decisionmaking that significantly heightens the risk that a group will make poor decisions.[258]

Specifically, "groupthink causes members of a group to unconsciously generate shared illusions of superiority that hinder critical reflection and reality testing."[259] The most important condition to groupthink is cohesiveness.[260] Too much cohesiveness sterilizes cognitive conflict, the absence of which "may cause a group to avoid facing hard questions in order to avoid conflict so that the group quickly reaches a consensus."[261] Such groups "value consensus more than they do a realistic appraisal of alternatives."[262] Given that boards must exercise "critical evaluative judgment" to be effective,[263] groupthink poses a significant threat to the quality of corporate decisionmaking.[264]

A diversity of viewpoints, embodied in truly independent directors, add value to a board by minimizing the likelihood of groupthink.[265] Upper-echelon theory, which focuses on the board's demographics with respect to its corporate strategy and performance,[266] explains that an increase in social heterogeneity naturally increases cognitive conflict and may benefit corporate decisionmaking, enhancing corporate performance.[267] Heterogeneous groups facing complex decisions are likely to benefit from the cognitive conflict that flows from diversity.[268]

In sum, a board composed of qualified directors and which possesses a diversity of viewpoints is more likely to enhance corporate value

256. This derives from a heterogeneous group whose members "share conflicting opinions, knowledge, and perspectives that result in a more thorough consideration of a wide range of interpretations, alternatives, and consequences." *Id.* at 1391.

257. O'Connor, *supra* note 50, at 1238–39.

258. *Id.* at 1239.

259. *Id.* at 1238–39.

260. *Id.* at 1261.

261. *Id.*

262. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 32 (2002) [hereinafter Bainbridge IV].

263. *Id.* at 30.

264. *Id.* at 32.

265. *See* O'Connor, *supra* note 50, at 1306.

266. Dallas II, *supra* note 162, at 1389.

267. *See id.* at 1396.

268. *See id.* at 1398. Yet board diversity should not necessarily be pursued as an end in itself, but rather as a means to further cognitive conflict that flows from socially heterogeneous boards. *See* Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America*, 19 CARDOZO L. REV. 1, 40 (1997) (compilation of essays written by Warren E. Buffett). The goal should be the pursuit of qualified directors, succinctly defined by famed investor/manager Warren Buffett as those men and women who demonstrate "business savvy, interest in the job, and owner-orientation [i.e., the possession of long-term investor interests]." *Id.*

by increasing the quality of its decisionmaking through cognitive conflict than is a board composed of prominent, yet unqualified, outside directors nominated by executive management and stamped "independent" according to mechanical regulatory standards.[269] The point here is that while both insiders and outsiders add value to boards of directors, this mix is not readily reducible to a precise formula.

Thus, managers of public companies should have the economic freedom to determine their own optimal mix of insiders and outsiders to arrive at an appropriate balance of homogeneity/heterogeneity.[270] A mandatory board composition policy, on the other hand, takes this vital decision away from affected firms, thereby impeding the maximization of their corporate value. Moreover, the mere label of independence absent genuine cognitive conflict may do little to effect true board independence. Rather than improve corporate governance, therefore, the policy of required majority board independence is more likely to lead to inefficient decisionmaking at the expense of shareholders.[271]

Although required majority board independence lacks genuine benefits, its costs are very real. In addition, because the case for majority board independence rests to a great extent on the relative importance assigned to the board's function as conflicts monitor,[272] the assignment of greater importance to the board's advisory function logically results in

269. Cunningham, *supra* note 268, at 40 (Warren Buffett arguing that it is a significant "mistake" to select directors "simply because they are prominent or add diversity to the board," especially given that "[directorial] appointments are so hard to undo"); *cf.* Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, at 5–6 (Working Draft, Mar. 3, 2004) [hereinafter Bebchuk II], *at* http://www.sec.gov/spotlight/dir-nominations/bebchuk030304.pdf (last visited Mar. 10, 2004) ("The mere independence of directors from insiders ensures neither that directors are well selected nor that they have the right incentives to advance shareholder interests. . . . With due respect to the benefits of director independence, it should not lead us to accept a state of affairs in which self-perpetuating boards confront no meaningful threat of replacement."). However, board homogeneity does not *necessarily* impair effective decisionmaking. In fact, socially homogeneous boards possessing a moderate amount of cohesion are capable of reaching good decisions on "problems that have verifiably, correct answers." Dallas II, *supra* note 162, at 1391. Thus, homogeneity can actually be beneficial to a company, since cohesive groups can make decisions more quickly, and hence less costly, than can heterogeneous boards which are expected to be more deliberative. *Id.* at 1391–92.

270. *See* Dallas II, *supra* note 162, at 1398 ("[C]ompetitive situations confronting corporations are different and may change from time to time, resulting in a different assessment of the benefits of heterogeneity/homogeneity."); *see also* Bainbridge I, *supra* note 18, at 24–25 ("The critical mass of independent directors needed to provide optimal levels of accountability . . . will vary depending upon the types of outsiders chosen. Strong, active independent directors with little tolerance for negligence or culpable conduct do exist. A board having a few such directors is more likely to act as a faithful monitor than is a board having many nominally independent directors who shirk their monitoring obligations . . . . Because [however] monitoring by independent directors is an important source of accountability, market forces will lead management voluntarily to support the election of independent directors and to implement firm-specific mechanisms designed to ensure that their directors are able to carry out their monitoring function.").

271. *Cf.* Bainbridge I, *supra* note 18, at 14–15 (suggesting that "[i]nsofar as efficient decisionmaking is the goal of corporate governance, independence may not be desirable").

272. A point even Professor Eisenberg seems, at least tacitly, to concede. *See* EISENBERG, *supra* note 177, at 172 ("The problem is how to achieve that independence consistent with the best effectuation of the monitoring function and, to the extent possible, the board's remaining functions as well.").

less willingness to accept the high costs of this policy.[273] At a certain point, the costs of a particular accountability mechanism outweigh its likely benefits, and the mechanism is thus inefficient at minimizing the effects of the corporate-agency problem.[274] Overemphasizing conflicts monitoring at the expense of other legitimate board roles goes beyond that crucial point because it may actually "reduce the board's *overall* effectiveness."[275]

Even assuming that a minority of independent directors nominated by executive management can function effectively in a conflicts-monitoring capacity, requiring public companies to place a *majority* of independent directors on their boards will likely be an inefficient and costly policy. At the very least, managers of public companies should have the economic freedom to decide whether a majority of independent directors will maximize their own value. Applying the efficiency test of Part II.B.3 above,[276] therefore, required majority independence is a failed policy.

B. Accepting a Default Shareholder Access Mechanism

Despite this note's conclusion that managers of public companies should not be required to place a majority of independent directors on their boards, the composition of the board does matter.[277] Instead of focusing on the proportion of outside directors to inside directors, another regulatory approach to board composition would be to focus on the procedure by which directors are nominated to serve on the board.

Such an approach is warranted under the relational theory of the board, which supports regulation aimed at maximizing the benefit of the shareholders' bargain with the board.[278] Recall that, pursuant to the hypothetical bargain methodology, the board and the shareholders would strike a bargain for the shareholder wealth maximization norm to minimize the cost of capital and reduce the risk of shirking. Recall also that the extent to which such a norm accomplishes these purposes is condi-

273. *See*, *e.g.*, Lin, *supra* note 30, at 964–65 (discussing possible uncertainty and high costs in litigating "independence" of directors, given vast number of factors relevant to inquiry); *see also* Kimble Charles Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers After* Siliconix, Aquila *and* Pure Resources, 2003 COLUM. BUS. L. REV. 191, 208–13 (2003) (discussing the negative impact the Sarbanes-Oxley Act is likely to have with respect to companies remaining public due to increased compliance costs); Ribstein, *supra* note 11, at 35–45 (discussing in great detail the various costs associated with increased regulation as a whole, including agency costs, resource allocation, information costs, distrust, inducing cover-ups, collateral organizational effects, and costs associated with indeterminacy and mandatory rules).

274. *See* John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195, 199, 213–16 (1992).

275. *Id.* at 199.

276. *See supra* text accompanying notes 170–74.

277. *See* Proposed Rule: Security Holder Director Nominations, *supra* note 12, at 60,794 (stating that "the composition of the board of directors is critical to a corporation's functions").

278. *See supra* text accompanying notes 241–42.

tioned on their value to the shareholders as measured by efficient accountability mechanisms.

One significant, yet largely ceremonial, mechanism of accountability is the right of the shareholders to elect the directors to the board. Indeed, the significance of this right is demonstrated in that it represents the only genuine source of shareholder power.[279] Because the shareholders exercise little meaningful control over their franchise, however, the value of their bargain is impaired.

Accordingly, increasing the value of the bargained-for shareholder franchise should provide shareholders with a greater assurance of accountability, which, in turn, should reduce the board's cost of capital. As a result, overall corporate value should improve. Assuming that such a franchise-enhancing concept could be fashioned in an efficient manner, a careful balance needs to be struck between authority and accountability to ensure the preservation of board discretion inherent in the separation of ownership from control.

In fact, the shareholder access mechanism encapsulates this franchise-enhancing concept. This part, therefore, presents the case for and against adopting the SEC's proposal, embodied in Proposed Rule 14a-11.

1. The Case for Limited Shareholder Access to the Corporate Ballot

The SEC proposed a procedure whereby qualifying shareholders could place their nominee(s) to the board directly onto the corporate proxy. This proposal has caused sharp debate.[280] Perhaps the primary criticism of a shareholder access mechanism is that it presupposes the right of shareholders to dictate managerial conduct.[281] In other words, opponents claim that those who support a shareholder access mechanism "rely on the notion that, because shareholders 'own' the corporation, they have the intrinsic right to control it."[282] Since this "notion" is plainly contrary to the separation of ownership from control, opponents argue the shareholder access mechanism is wrought with theoretical error from the outset.[283]

Contrary to these observers, however, justification for the shareholder access mechanism does not necessarily rest on "shareholder em-

279. Dallas II, *supra* note 162, at 1366–67.

280. *See*, *e.g.*, Berman & Solomon, *supra* note 15 ("Depending on whom you ask, the [shareholder access] proposal helps bring shareholder liberation from entrenched managers or represents a dangerous rewriting of securities laws that substitute[s] mob rule for executive decisionmaking.").

281. Lipton & Rosenblum, *supra* note 17, at 70–74 (arguing that because proponents "seek to give large shareholders a disproportionate ability to control corporate decisionmaking," the shareholder access mechanism is "fundamentally misguided").

282. *Id.* at 70.

283. *See id.* at 94 ("[T]he shareholder as owner, principal-agent model is a flawed model as applied to the modern public company. It does not provide an affirmative basis for the adoption of these election contest proposals.").

powerment"[284] or on an outdated "shareholder primacy" theory of the firm.[285] Instead, the objective of such a mechanism can be framed solely in terms of the maximization of shareholder wealth,[286] which constitutes the legitimate end of corporate governance under current law.[287] Although the mechanism would empower shareholders to some extent, empowerment need not be the end in itself. Thus, the utility of the shareholder access mechanism should be judged according to the extent it effectively enhances corporate value, taking into account both its costs and benefits.

a. Restoring the Shareholder Franchise

The first major argument in favor of a shareholder access mechanism is that it would improve the exercise of the shareholder franchise when utilized. Indeed, the well-documented problems surrounding the corporate election alone should provide support for such reform.[288] Given that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests,"[289] a lack of meaningful shareholder power to select and/or replace directors should cause serious concern.[290]

No one can seriously maintain that shareholders exert more than symbolic influence in this context, as incumbent directors run unopposed in virtually every corporate election.[291] The enormous costs associated with running a proxy contest minimize any real risk to management that such a contingency will materialize.[292] This lack of electoral opposition exacerbates the problem of restraining the self-interest of directors.[293] Moreover, it matters little whether the CEO or an independent director controls the nominating committee because "incentives to serve the interests of those making nominations are not necessarily identical with incentives to maximize shareholder value."[294] Thus, the purported "underpinning" of directorial power, for all intents and purposes, has come

284. *See id.* at 72.
285. *See* Bainbridge III, *supra* note 76, at 10–11.
286. *See* Bebchuk I, *supra* note 4, at 44.
287. *See supra* text accompanying notes 165–67.
288. Bebchuk I, *supra* note 4, at 44–46.
289. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).
290. *See* Bebchuk I, *supra* note 4, at 44–46.
291. *Id.* at 45.
292. *See id.* at 45–46 (arguing that although 2002 saw approximately forty cases of contested proxy solicitations, most were conducted in the context of an attempted takeover, which does not implicate the "public good problem" with which shareholder access proposals are concerned); *see also id.* (concluding from a work-in-progress in which contested elections between 1996 and 2002 were analyzed that "[c]ontests over the team [i.e., management] that would run the (stand-alone) firm in the future occurred in about eighty companies, among the *thousands that are publicly traded*, during the seven-year period . . . ." (emphasis added)).
293. *See supra* text accompanying notes 210–11.
294. Bebchuk I, *supra* note 4, at 45.

undone.[295] Importantly, while shareholders are free to sell their shares when dissatisfied with current management, this ability is not an adequate remedy since those shareholders can never realize the full value of their investment.[296]

A shareholder access mechanism would combat the fundamental problem associated with the corporate election.[297] Such reform, focusing only on the selection and nomination of directors, is arguably just a moderate step toward improving internal corporate governance.[298] This is so primarily because such a mechanism, as proposed by the SEC, would not apply to shareholders seeking control of the corporation.[299] In addition, the mechanism would not entirely eliminate the costs associated with an effective campaign effort, and it would be restricted to ensure that "only those [nominees] whose support among shareholders is sufficient to indicate significant dissatisfaction with the incumbent directors" are nominated thereunder.[300] Finally, the availability would be conditioned on the happening of certain triggering events that signal widespread shareholder dissatisfaction with the proxy process as it relates to the nomination of directors and not mere disagreement with respect to corporate policy over which the board rightfully retains ultimate power.[301]

b. Improving Accountability

Perhaps the strongest argument in favor of a shareholder access mechanism is that it would provide shareholders with a proactive means to hold management accountable to its guarantee to maximize shareholder wealth.[302] Put another way, a well-functioning shareholder access mechanism would "reduc[e] incumbents' insulation from removal."[303] In this respect, a shareholder access mechanism would complement the primary intracompany monitoring mechanism already existing—the derivative suit.[304] Although the derivative suit is currently the primary means by which shareholders hold management accountable to its fiduciary duties,[305] the derivative suit is also a monitoring device of mere re-

295. *See id.*

296. Bebchuk II, *supra* note 269, at 5.

297. *See* Bebchuk I, *supra* note 4, at 47–48.

298. *See id.* at 47.

299. *Id.*

300. *Id.*

301. *Id.* at 47–48; *see also supra* text accompanying note 127.

302. Bebchuk I, *supra* note 4, at 64 ("[T]hese benefits from reduced insulation and increased accountability might well constitute the biggest payoff from the shareholder access reform.").

303. *Id.* at 61. Professor Bebchuk argues that "substantial evidence" exists to demonstrate the inverse correlation between "stronger insulation of management" and "lower stock market valuation." *Id.* (citing Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 144–45 (2003)).

304. RIBSTEIN & LETSOU, *supra* note 53, at 514.

305. *Id.* at 515.

active capability by design, arguably providing little, if any, actual net benefit to the public company.[306]

Notwithstanding the derivative suit, a shareholder access mechanism would improve existing intracompany monitoring. In contrast to the derivative suit, a shareholder access mechanism would provide shareholders with a proactive means to hold management accountable by strengthening their ability both to select and replace directors.[307] Since the enhanced threat of ouster would assist in aligning the interests of managers with those of the shareholders, the adoption of a shareholder access mechanism would constitute a legitimate accountability mechanism.[308] Importantly, this benefit would exist not merely in the exercise of the mechanism, but also in its availability.[309] Indeed, as discussed above,[310] the Disney experience suggests that some public companies would benefit significantly from an increase in directors' threat of removal. Thus, the benefits of a shareholder access mechanism would reach all affected corporations,[311] not only the few whose extraordinarily poor performance happens to trigger the mechanism's use.[312]

Finally, it should be pointed out that Proposed Rule 14a-11 is a default rule, not a mandatory one. According to contractarian theory, corporation law can be described in part as a collection of mainly default rules.[313] Corporation law essentially provides firms with standard form contract provisions that are voluntarily adopted by the board and its constituencies through negotiation.[314] Mandatory rules, on the other hand, sharply limit the economic freedom boards have to negotiate.[315] Al-

306. *Id.* at 516–17, 561–62, 583. Thus, the fiduciary duties owed to shareholders may actually provide little protection if the principal remedy for their violation, i.e., the derivative suit, is more costly than beneficial to the company. It is true that the right to vote on certain transactions also constitutes a contractual protection of risk capital. *See* Lipton & Rosenblum, *supra* note 17, at 79. However, it is the lack of meaningful participation in the election of directors that concerns proponents of a shareholder access mechanism. Because management controls the proxy process virtually without limitation, shareholders exercise only ceremonial voting power when electing directors. This serves to increase the costs of managerial insulation. Therefore, pointing out that shareholders retain the right to vote on transactions misses the mark because the authorizing board may be insulated from effective removal, which may depress share value. *See* Bebchuk I, *supra* note 4, at 61.

307. *See* Bebchuk I, *supra* note 4, at 44 (describing the positive relationship between the power of shareholders to remove failing directors and managerial incentives to serve the shareholders).

308. *See id.* at 61–63 (discussing empirical studies that find a correlation between the insulation of directors and lower firm value). Interestingly, some critics of the shareholder access mechanism seem to actually concede this point. *See* Lipton & Rosenblum, *supra* note 17, at 93 ("[T]he mere *threat* of an election contest has often been enough to push a company to negotiate with shareholders and agree on one or more mutually acceptable board nominees" (emphasis added)).

309. *See* Bebchuk I, *supra* note 4, at 50.

310. *See supra* text accompanying notes 1–8.

311. At least, the shareholder access mechanism would benefit those firms who choose *not* to opt out of it, even if they have the right to do so under relevant state law.

312. Bebchuk I, *supra* note 4, at 51.

313. Bainbridge II, *supra* note 58, at 578.

314. *Id.*

315. *See id.* at 577.

though the necessity of some mandatory rules is well established,[316] the obvious preference is for default rules.[317] Default rules still must reflect an efficient substitute to costly private ordering,[318] but they are presumptively more desirable than mandatory rules.

Unlike the new independence requirements discussed above,[319] the SEC's shareholder access mechanism would essentially contain both an opt-in requirement (the happening of a triggering event) and an opt-out option (the relevant inclusion of a charter amendment where state law so permits).[320] Thus, the fact that Proposed Rule 14a-11 is a default mechanism further demonstrates its desirability over the mandatory policy of required majority board independence as a regulatory approach to strengthening public company boards of directors.

Therefore, a case for a shareholder access mechanism can be advanced. Its two principal benefits would be the restoration of the shareholder franchise and the improvement of managerial incentives to act in furtherance of company interests. The net result would be an increase in overall firm value.[321]

2. *A Point/Counterpoint Critique*

The shareholder access mechanism has drawn significant opposition, as it marks a departure from management's historic control of the proxy process.[322] Accordingly, the following discussion examines these various concerns on a point/counterpoint basis to determine whether they constitute a sufficient basis for rejecting Proposed Rule 14a-11.[323]

a. The Abrogation of Board Discretion and Authority

Undoubtedly, the most significant concern opponents have with a shareholder access mechanism is the possible abrogation of board discre-

316. *Id.* at 584–86 (stating that "the law should not always facilitate private ordering," particularly "where there is a market failure" and arguing, as an example of an efficacious mandatory rule, that because companies project "negative externalities" onto shareholders due to the transaction-specific nature of their investment, which externalities constitute one source of market failure, corporation law rightfully intervenes by requiring companies to adhere to the shareholder wealth maximization norm).

317. *Id.* at 577–78 (citing Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 989–91 (1993)).

318. *Id.* at 578.

319. *See supra* text accompanying notes 42–51.

320. Companies would at least theoretically have the ability to opt out through the amendment of their charter or by-laws, provided that their state of incorporation also allows them to alter default voting and nominating rules. *See* Bainbridge III, *supra* note 76, at 6 (concluding that companies probably do have such a right to opt out of default voting rules, if done so clearly and unambiguously).

321. *See* Bebchuk I, *supra* note 4, at 63 (concluding that a shareholder access mechanism would be a "moderate step" toward reducing management's insulation, the existence of which is attributable to lower firm value).

322. *Id.* at 48.

323. These sub-sections draw heavily from the work of Professor Bebchuk. *See generally id.* at 48–61 (examining numerous critiques of a shareholder access mechanism).

tion and authority in managing the public company.[324] The key to corporate governance lies in maintaining a proper balance between authority and accountability. Moreover, "directors cannot be held accountable without undermining their discretionary authority."[325] Holding the decisionmaking body accountable to another group inevitably shifts some discretion to that other group.[326] Thus, the strongest argument in opposition to a shareholder access mechanism, as articulated by Professor Bainbridge, is that a shareholder access mechanism would weaken board discretion, if not destroy it completely, to the extent it "empowers shareholders to review board decisions."[327]

Professor Bainbridge rightly concedes, however, that the aim of a shareholder access mechanism is to grant shareholders power to nominate and potentially elect a short slate of directors, not to review board decisions.[328] The authority to manage the company would remain in the board irrespective of how each individual director is elected thereto. This fact takes much of the bite out of Professor Bainbridge's concern with board discretion.

Moreover, although Professor Bainbridge criticizes Proposed Rule 14a-11 for its potential weakening of director primacy, accountability mechanisms by definition reduce the board's discretionary authority.[329] This is inevitably so because accountability and discretionary authority are antithetical.[330] Thus, if the efficacy of accountability mechanisms was tested according to whether the mechanisms reduced board discretion, each one would fail. Instead, their efficacy should be measured according to their ability to minimize managerial self-interest, discounted by the costs of such mechanisms.[331]

Under such an augmented cost-benefit analysis, the degree to which the board's discretion is reduced is not dispositive in opposition to an accountability mechanism but is rather subsumed in the cost calculus. At the same time, the degree to which a particular mechanism affects board authority can easily be examined as a discrete issue. Director primacy does accurately describe the public company, but it is precisely because of this fact that shareholders require directors to have proper incentives—to ensure that the board's discretion is exercised properly toward the maximization of shareholder wealth.

To the extent facilitating shareholder access to the corporate proxy materials removes some of the board's discretion in managing the corpo-

324. *See* Bainbridge III, *supra* note 76, at 14.
325. *Id.*
326. *Id.* (construing KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 78 (1974)).
327. *Id.* at 15.
328. *Id.* at 14.
329. *See id.*
330. A point with which Professor Bainbridge readily agrees. *See id.* at 14 ("Hence, directors cannot be held accountable without undermining their discretionary authority.").
331. *Id.*

ration, the solution lies in limiting its availability to prevent abuse.[332] In addition, given the fact that Proposed Rule 14a-11 would not apply to situations in which shareholders seek control of the corporation, there is little reason to fear that it would in any sense vest shareholders with the power to review managerial decisions, as Professor Bainbridge predicts,[333] because incumbent management would always retain ultimate control over the company.

In fact, the SEC's proposed initial eligibility requirements are actually quite conservative, indicating that the shareholder access mechanism's availability will be appropriately limited to clear situations of widespread shareholder dissatisfaction with the proxy process. Under Proposed Rule 14a-11, a direct access proposal must be submitted by a shareholder or group of shareholders owning at least one percent of the company's voting shares for at least one year as of the date the proposal was submitted, and the proposal must receive at least fifty percent of the votes cast to trigger the availability of the mechanism.[334] In addition, the "withhold vote" trigger would be predicated on an incumbent receiving at least a thirty-five percent withhold vote.[335]

The SEC concluded that the submission of shareholder proposals by shareholders who own one percent of stock is "currently relatively rare."[336] Even rarer is such a proposal receiving majority support.[337] At the same time, however, the SEC concluded that one percent is low enough so that, if necessary, shareholders could be expected to take advantage of the access mechanism.[338] While the SEC's proposed thirty-five percent withhold-vote trigger minimum is less than a majority, this is so because the SEC concluded that the "frequency of significant withhold votes is currently somewhat lower than that for majority votes on security holder proposals."[339] In fact, the SEC calculated that a mere 1.1% of public companies received withhold votes in excess of thirty-five percent.[340]

Moreover, the SEC thoughtfully concluded that, if and when the shareholder access mechanism becomes available to shareholders, a qualifying shareholder or shareholder group must beneficially own five percent of the corporation's stock in order to use the corporate ballot to

332. *Cf.* Bebchuk I, *supra* note 4, at 48 (arguing that if the SEC's initial eligibility requirements operate so as to cause "a substantial incidence of nominations that fail to attract significant support in the annual meeting," adjustments could be made thereto in order to minimize the abuse of the access mechanism).

333. *See* Bainbridge III, *supra* note 76, at 15.

334. Proposed Rule: Security Holder Director Nominations, *supra* note 12, at 60,789–90.

335. *Id.* at 60,789.

336. *Id.* at 60,790.

337. *Id.* at 60,791.

338. *Id.* at 60,790–91.

339. *Id.* at 60,790.

340. *Id.*

nominate a director.[341] In so concluding, the SEC recognized that "the composition of the board of directors is critical to a corporation's functions and, accordingly, [shareholders] should have to evidence a significant financial interest by satisfying a substantial ownership threshold in order to use a [shareholder access mechanism] that may impact that composition."[342] These requirements indicate that qualifying shareholders can be expected to nominate directors who represent the long-term interests of the company, greatly diminishing the concern over any negative impact on board consensus and efficiency.

Finally, the SEC will retain control over these eligibility requirements and thus will subsequently be able to adjust them according to the evidence.[343] This control reduces the risk of untoward shareholder activism. In addition, the SEC could propose a sunset date on the access mechanism. Because the mechanism would remain in effect for two years after the triggering process, which itself delays shareholder access for two years, a sunset date should not be less than five years and preferably somewhat longer, such as seven or eight, to allow sufficient evidence to accumulate from which to evaluate the mechanism's actual efficacy.

Therefore, it is evident that Proposed Rule 14a-11 is a narrowly construed shareholder access mechanism. Any reduction in board authority will be minimal. Professor Bainbridge's concern with respect to the abrogation of board authority is an insufficient basis to reject adopting Proposed Rule 14a-11. The critique now turns to a discussion of the various potential costs and purported lack of benefits of a shareholder access mechanism.

b. Costs of Producing Worse Boards

The principal objection to facilitating shareholder-nominated directors with respect to costs is that, if successful, the result would produce poorer functioning, balkanized boards due to either the election of special interest directors or directors who are objectively less qualified than board-nominated directors.[344] It is argued that a shareholder-nominated director would feel obliged to advance the special interests, social or otherwise, of the potentially small minority of shareholders that nominated him.[345]

341. *Id.* at 60,794.

342. *Id.*

343. Bebchuk I, *supra* note 4, at 48.

344. *See, e.g.*, Lipton & Rosenblum, *supra* note 17, at 83 ("There is no question that giving shareholders access to the corporate proxy machinery to run an election contest would facilitate the nomination and election of dissident and special interest directors"); *see also* Bainbridge III, *supra* note 76, at 15–16 (characterizing this problem as "a reduction in board effectiveness").

345. Bebchuk I, *supra* note 4, at 54–56 (describing this argument).

Similar to the concern over special-interest directors is the argument that the shareholder access mechanism would create a de facto cumulative voting system, facilitating the empowerment of potentially adversarial minority viewpoints which could negatively affect the efficacy of the consensus-based decisionmaking norm according to which the board functions.[346] It is argued, moreover, that shareholders are unlikely to choose well-qualified candidates, limiting the ability of management to assemble a cohesive board based on its own need-based assessment.[347] The sum result would inevitably "produce a balkanized, politicized, and dysfunctional board."[348]

These draconian "forecasts of doom and gloom,"[349] however, are unwarranted. Although a shareholder-nominated director might initially be the choice of a small minority within the firm, such a nominee would, nevertheless, need to garner a majority of the minority votes cast before being elected to the board.[350] In other words, a shareholder-nominee will still need to garner a plurality to get elected to the board. A nominee that represents some special interest is highly unlikely to attract sufficient support considering that money managers in charge of voting institutional blocks tend to support management.[351] Moreover, once elected, a shareholder-nominated director will be required to serve the interests of the company above those of his own—coincidently a fact on which critics themselves seem to rely when advancing the case for independent nominating committees.[352]

In addition, recall that a certain degree of cognitive conflict among board members is vital to avoid the group decisionmaking pitfall known

346. *See* Bainbridge III, *supra* note 76, at 15; *accord* Lipton & Rosenblum, *supra* note 17, at 81 (appealing to "human nature" for the argument that "executives are far more likely to listen to advice from directors they respect and trust than from directors they view as adversaries").

347. Bebchuk I, *supra* note 4, at 56 (describing this argument); *see also* E-mail from Henry A. McKinnell, Ph.D., Chairman and CEO, The Business Roundtable, to Jonathan G. Katz, Secretary, SEC (June 13, 2003) (on file with the University of Illinois Law Review), *at* http://www.sec.gov/rules/other/s71003/brt061303.htm (last visited Feb. 1, 2004) [hereinafter The Business Roundtable]; Letter from Stephen F. Gates, Senior Vice-President and General Counsel, ConocoPhillips, to Jonathan G. Katz, Secretary, SEC (Oct. 3, 2003) (on file with the University of Illinois Law Review), *at* http://www.sec.gov/rules/proposed/s71903/conocophillips100303.htm (last visited Nov. 23, 2003) (stating that an independent nominating committee "is best positioned to assess the skills and qualities desirable in new directors in order to maximize the board's effectiveness").

348. Bebchuk I, *supra* note 4, at 58 (summarizing this critique); *accord* Lipton & Rosenblum, *supra* note 17, at 82–83.

349. E-mail from Les Greenberg, Chairman, Committee of Concerned Shareholders, to Jonathan G. Katz, Secretary, SEC (Oct. 8, 2003) (on file with the University of Illinois Law Review), *at* http://www.sec.gov/rules/proposed/s71903/ccs100803.htm (last visited Nov. 23, 2003).

350. Bebchuk I, *supra* note 4, at 55.

351. *Id.* Furthermore, experience with shareholder proposals under Rule 14a-8 corroborates this conclusion: "[The] resolutions that focus on social or special interest issues uniformly fail to gain a majority, receiving little support from mutual funds." *Id.* Rather, "[t]he only resolutions that gain such [majority] support are those motivated by enhancing share value through dismantling takeover defenses." *Id.*

352. *See* Bebchuk I, *supra* note 4, at 55.

as groupthink.[353] Social homogeneity among board members contributes to cohesiveness, which in turn can lead to groupthink.[354] In fact, it has been noted that "both (1) the motives and rewards that encourage directors to serve on boards, and (2) *the process used to select independent directors* interact to form cohesive groups."[355] Limited facilitation of independent directors nominated by shareholders would thus help promote a healthy degree of heterogeneity among board members because those directors would be sufficiently disconnected from executive management.[356] The result of this heterogeneity will be to increase the efficacy of board deliberations, thereby increasing the efficacy of board decisions.[357] More informed decisions should benefit the company as a whole.

To the extent critics of the shareholder access mechanism argue shareholder-nominees will result in adversarial conflict instead of the more healthy cognitive conflict, their critique rests entirely on the misplaced notion that the access mechanism will facilitate cumulative voting.[358] Yet the shareholder access mechanism will not alter the voting system of the corporate election, since a majority of the minority of voting shareholders will be required to elect any shareholder-nominee. This critique, therefore, is unfounded. The only change, albeit significant, shareholder access will present to the corporate election is the adjustment of the historically exclusive control over the nomination process by executive management.

Furthermore, the argument that shareholders will invariably make bad choices in selecting nominees seems to run directly afoul of the Supreme Court's admonishment not to "attribute to investors a child-like simplicity."[359] Although nominating committees should be expected to select nominees who represent the interests of the company in most situations, it is still possible that considerations other than corporate interests could influence the committees' decisions "because the interests of an agent and principal do not always fully overlap."[360]

353. *See supra* text accompanying notes 262–68.

354. Bainbridge IV, *supra* note 262, at 31–32; O'Connor, *supra* note 50, at 1262.

355. O'Connor, *supra* note 50, at 1262 (emphasis added).

356. *Cf.* Deborah Solomon, *Moving the Market*: *SEC May Temper Plan to Boost Shareholders' Powers*, WALL ST. J., Apr. 19, 2004, at C3 (quoting Sarah Teslik, executive director of the Council of Institutional Investors: "The real goal [of a shareholder access mechanism] is for shareholders to be able to signal in a way that has teeth that the board-selection process is flawed.").

357. Dallas II, *supra* note 162, at 1406 (concluding that "[h]eterogeneous groups tend to make higher quality decisions in matter involving creative and judgmental decisionmaking"); *see also* O'Connor, *supra* note 50, at 1306 (arguing that "diversity may enhance board effectiveness because different life experiences may lead to different perceptions of social reality").

358. *See*, *e.g.*, Bainbridge III, *supra* note 76, at 15. *But cf.* Lipton & Rosenblum, *supra* note 17, at 85 (predicting that adversarial conflict will result from the "significant increase in election contests" purported to arise from shareholder access to company proxy materials).

359. Basic Inc. v. Levinson, 485 U.S. 224, 234 (1988) (quoting Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987)).

360. Bebchuk I, *supra* note 4, at 57.

Shareholders who can demonstrate a sufficient commitment to the long-term success of the company, on the other hand, can be expected to serve the interests of the company in this limited capacity because they are its residual owners and thus naturally seek to maximize the return on their investment.[361] The only legitimate concern in the context of selecting qualified nominees is the informational asymmetries that exist between management and shareholders, but this should not alone quash the ability of shareholders to select and nominate a director, considering that those who vote put their money on the line when doing so.[362]

Finally, although the potential for balkanized boards represents a real risk to effective corporate governance, "[i]t is far from clear that the election of a shareholder nominee would produce such division and discord."[363] This is so because directors representing special interests are unlikely to be elected in the first place.[364] In fact, shareholder-nominated directors elected to the board should be expected to represent broad corporate interests, having garnered the support of a majority of the minority of voting shareholders.[365] There simply would be no reason for other directors to be suspicious of shareholder-nominated directors' intentions for serving on the board other than the enhancement of corporate value.[366] The type of collegiality that fosters healthy consensus, i.e., the presence of cognitive conflict, should therefore be strengthened, not weakened.

c. Other Potential Costs

Critics are also concerned with other various potential costs associated with the shareholder access mechanism.[367] For purposes of clarity, this critique will be separated into two sections. First, this part discusses the potential costs that might arise regardless of the outcome of an elec-

361. *Id.* A counterargument here is that shareholders constitute a "far-flung, diverse and ever-changing group" encouraged to "act purely in their self-interest." Lipton & Rosenblum, *supra* note 17, at 73. It *cannot*, therefore, be legitimately assumed that shareholders will act in the best interests of the company as a whole. *See* Bainbridge III, *supra* note 76, at 12–13. However, the realities of equity liquidity and shareholder self-interest are tempered by the shareholder access mechanism's ownership and durational requirements, which will help ensure that only those shareholders with a stake in the long-term success of the company are given the added "teeth" of the shareholder access mechanism.

362. Bebchuk I, *supra* note 4, at 57.

363. *Id.* at 58.

364. *Id.*

365. *Id.*

366. *Id.* Moreover, sophisticated voters such as institutional shareholders would likely consider the effects a shareholder-nominated director might have on board effectiveness. *Id.* Thus, it is likely that a shareholder-nominated director would be elected only if truly desirable overall—the potential for board disunity notwithstanding—which in and of itself bolsters the utility of having such a shareholder access mechanism. *Id.*

367. *See*, *e.g.*, Lipton & Rosenblum, *supra* note 17, at 82 (arguing that "the costs of [facilitating shareholder access to the corporate ballot] are numerous").

tion of which shareholder-nominees take part.[368] Second, this part discusses potential costs, other than those associated with the feared production of worse boards, that might arise assuming a shareholder-nominated director actually gets elected to the board.[369]

i. Costs of Elections Regardless of Outcome

The concern here centers on the broad fear that a shareholder access mechanism would turn most corporate elections into devastating proxy contests.[370] Opponents claim the costs associated with defending such an election would be tremendous, as management would be forced to launch "a full-scale election contest . . . replete with multiple mailings, institutional investor road shows and full page newspaper fight letters."[371] Thus, corporate assets would be diverted and wasted.[372] Critics argue that the result of such a norm "would be very unhealthy for our nation's companies."[373]

It is more likely, however, that full-scale election contests that require much attention from management would be the exception, not the norm, occurring only in those companies "where performance . . . [is] poor and shareholder dissatisfaction widespread."[374] First, public companies that are well-governed should expect to be secure in the reelection of incumbents even in the midst of shareholder-nominees since institutional voters rarely vote against management.[375] Absent a lack of support from these blockholders, there would be little justification for management wasting corporate assets on a full-scale campaign.[376]

Second, even if the mere inclusion of shareholder-nominees on the corporate proxy would lead management to engage in a costly campaign, opponents' fear would still lack foundation because, as discussed above, a narrowly construed shareholder access mechanism would not be triggered too easily.[377] Thus, the concern over costly proxy contests will largely be offset by ensuring that the threshold ownership requirement

368. *See infra* text accompanying notes 370–87.
369. *See infra* text accompanying notes 388–402.
370. Bebchuk I, *supra* note 4, at 51 (describing this fear).
371. E-mail from Robert Todd Lang, Co-Chair, Task Force on Shareholders Proposals, and Charles Nathan, Co-Chair, Task Force on Shareholders Proposals, ABA Section of Business Law, to the SEC 11 (June 13, 2003) (on file with the University of Illinois Law Review), *at* http://www.sec.gov/rules/other/s71003/aba061303.htm (last visited Feb. 7, 2004) [hereinafter ABA].
372. Lipton & Rosenblum, *supra* note 17, at 83–85.
373. E-mail from Wachtell, Lipton, Rosen & Katz, to Jonathan G. Katz, Secretary, SEC 2 (June 11, 2003) (on file with the University of Illinois Law Review), *at* http://www.sec.gov/rules/other/s71003/wachtell061103.htm (last visited Feb. 7, 2004).
374. Bebchuk I, *supra* note 4, at 52.
375. *Id.*
376. *Id.*
377. *See supra* text accompanying notes 334–43.

for shareholders is set at an optimal level.[378] Certainly this fear over proxy contests does not warrant maintaining the status quo.[379]

Moreover, the fact that only a small number of firms may actually take advantage of the shareholder access mechanism is largely besides the point.[380] This is so because, as described above, perhaps the most important benefit flowing from the mechanism will be the mere option of exercising the mechanism as a proactive means to hold the board accountable to the bargained-for shareholder wealth-maximization norm.[381]

Another potential cost associated with a shareholder access mechanism is that it might further deplete the director pool, which already may be suffering from the effects of the Sarbanes-Oxley Act.[382] In addition, there is the concern that threatening directors with ouster will lead to excessive risk aversion to the detriment of corporate performance.[383] Critics argue that facilitating the inclusion of shareholder-nominees on the corporate proxy "would dissuade from board service individuals who would be excellent directors but who are not prepared to stand for election in a contested election."[384]

Despite the fact that providing any position with complete security from removal might very well increase the pool of those willing to serve, "[f]irms elect not to grant most employees such security . . . [because] employers find that the benefits of retaining the power to replace employees—the ability to make desirable replacements and the provision of incentives to perform well—exceed its costs."[385] Indeed, given the great discretion under which directors execute their managerial duties once elected to the board, it would be highly valuable to improve their selection as well as their incentives for serving.[386] Furthermore, rather than endowing directors with virtually limitless freedom, any adverse effect a shareholder access mechanism might have on the desirability of a directorship could be countered with increased cash or stock compensation.[387]

ii. Costs of Successfully Electing Shareholder-Nominated Director

In addition to the purported costs associated with producing worse boards,[388] critics argue that the election of shareholder-nominees might

378. *See* Bebchuk I, *supra* note 4, at 52 (arguing that "there would likely be some intermediate level of ownership requirement at which contests would become more frequent [than practically never] but would remain far from being the norm").

379. *See id.* at 53.

380. *Id.*

381. *See id.*; *see also supra* text accompanying notes 307–12.

382. *See* Lipton & Rosenblum, *supra* note 17, at 86.

383. *Id.* at 86–87.

384. ABA, *supra* note 371, at 20.

385. Bebchuk I, *supra* note 4, at 54.

386. *Id.*

387. *See id.*

388. *See supra* text accompanying notes 344–66.

prove costly to stakeholders, such as creditors and employees, because management may become too attentive to shareholder interests.[389] Although management's fiduciary duties run to the shareholders alone, the board must still balance the interests of all stakeholders.[390] This balance might be disrupted, it is argued, if the nomination of shareholder-nominees puts greater pressure on boards to satisfy shareholder interests above those of the stakeholders.[391]

Again, this claim is speculative at best. The interests of stakeholders are arguably better protected either by the specificity of their contracts or by targeted legislation, not open-ended fiduciary duties.[392] Thus, the benefits of the board's fiduciary obligation and, hence, the focus of its discretionary authority, flow to the shareholders alone.[393] The board will consider stakeholder interests beyond that which is required only when doing so will also increase shareholder wealth in the long run.[394] To the extent the concern over shareholder attentiveness underlies a theory of the firm that emphasizes stakeholder interests above those of the shareholders, it should be rejected for its inaccurate theoretical assumption.[395]

In addition, consider whether decreasing accountability to shareholders would actually benefit stakeholders. Not likely, concludes Professor Bebchuck, who argues that since management's interests are typically less aligned with those of stakeholders than they are aligned with those of shareholders, "insulating boards from shareholder nominations would [probably not] benefit stakeholders."[396] Thus, reducing accountability to shareholders by maintaining the status quo would likely not translate into an increase of attentiveness to stakeholder interests—even if an increase of attentiveness to stakeholder interests were desirable as a corporate governance matter.[397] On the other hand, further insulating directors from the responsible exercise of their discretion would very likely prove "costly to *both* shareholders and stakeholders."[398]

Finally, opponents are concerned with the costs associated with requiring all public companies to provide shareholders with access to the corporate proxy, considering the vast diversity that exists among the nation's firms.[399] In other words, similar to mandating majority board independence, it is argued that "[o]ne size . . . does not fit all."[400] This con-

389. Bebchuk I, *supra* note 4, at 58–59 (describing this critique).
390. *Id.* at 59.
391. *Id.*
392. *See* Bainbridge II, *supra* note 58, at 592.
393. *See id.*
394. *Id.* at 600.
395. *See supra* text accompanying notes 166–69.
396. Bebchuk I, *supra* note 4, at 59.
397. *Id.*
398. *Id.* (emphasis in original).
399. *Id.* (describing this critique).
400. *Id.* (summarizing this argument).

cern is wholly without merit, however, since Proposed Rule 14a-11 is a default mechanism, not a mandatory one.[401] Because of the default nature of Proposed Rule 14a-11, the shareholder access mechanism would not be available regularly to every public company. Instead, management would have some control over the availability of the mechanism, contingent on its performance. Thus, the misplaced "one size does not fit all" concern should obviously not provide a basis for preventing shareholder access to the corporate proxy.[402]

d. A Lack of Benefits

Although the sting of potential costs articulated by opponents may be more fantasy than reality, critics also argue that a shareholder access mechanism would have no material benefits.[403] Critics first maintain that facilitating shareholder-nominations would be useless in the wake of competent independent nominating committees.[404] Indeed, the SEC has recently sought to further empower these committees by requiring enhanced disclosure to shareholders regarding their operation.[405] In addition, the new NYSE and Nasdaq listing standards approved by the SEC include a requirement that nominating committees be composed solely of independent directors.[406] Thus, because these committees would theoretically be open to shareholder input, "concern about nominations should lead [at most] to the adoption of rules that encourage nominating committees to give adequate consideration to shareholder suggestions."[407]

Surely it cannot be maintained, however, that requiring independence in nominating committees will nullify the possibility of those directors acting out of their own self-interest, particularly in the absence of meaningful pressure not to do so.[408] Although it is likely that an independent nominating committee will further the interests of its company in most cases, it is precisely the case, albeit rare, when such a committee is likely to fail to replace an incumbent director that shareholder access would be necessary.[409] Thus, a safety valve is still a good idea.[410] Indeed,

401. *See supra* text accompanying notes 319–20.
402. Bebchuk I, *supra* note 4, at 59–60.
403. *See* Lipton & Rosenblum, *supra* note 17, at 82 (characterizing any benefits of the shareholder access mechanism as "doubtful").
404. *See* The Business Roundtable, *supra* note 347.
405. *See generally* Final Rule: Disclosure Regarding Nominating Committee Functions, *supra* note 63.
406. SEC Release No. 34-48745, *supra* note 12, at 64,158.
407. Bebchuk I, *supra* note 4, at 49 (articulating opponents' argument).
408. *Id.*
409. *Id.* ("Suppose that there is a widespread concern among shareholders that a board with a majority of independent directors is failing to serve shareholder interests. It is precisely under such circumstances that the nominating committee cannot be relied on to make desirable replacements of members of the board or even of members of the committee itself.").
410. *Id.*

independent nominating committees may be more inclined to serve the best interests of the corporation when the threat of shareholder access is lurking.[411] Although the shareholder access mechanism might not actually be utilized in such a case, it would still play a beneficial role and "would nicely complement the future operation of independent nominating committees."[412]

Another argument of critics is that a shareholder access mechanism would have no practical effects in actually facilitating the election of shareholder-nominees because the costs of running a successful campaign would still exist.[413] Moreover, institutional investors tend to be passive in seeking changes in a firm's corporate governance, and thus it would be difficult to attract enough support for a successful election.[414]

In fact, the voting record of institutional investors might actually provide support for the usefulness of a shareholder access mechanism.[415] This is so because shareholders can expect to attract the vote of money managers for their dissident short slate when doing so would increase share value.[416] When management appears to be engaging in value-decreasing behavior, money managers tend to support change.[417] Since the shareholder access mechanism would likely be available only when dissatisfaction with firm performance is widespread, the success of shareholder-nominations in those rare occasions should be more than minimal.[418] Furthermore, even if the exercise of the mechanism would not lead to the election of shareholder-nominees in most cases, the benefit of increasing the incentives of directors to act in accordance with the shareholder wealth-maximization norm would nonetheless exist.[419]

Furthermore, although the actual costs associated with running an effective campaign would still exist to some degree, they obviously would be lessened by giving space on the corporate proxy card to those shareholders who are able to utilize the mechanism. The remaining costs would help counter abuse of the shareholder access mechanism.[420] Finally, even if the mechanism as proposed will restore only minimally the shareholder franchise, this concern would justify only more expansive at-

411. *Id.* at 49–50; *cf.* Bainbridge I, *supra* note 18, at 20 (discussing the "there but for the grace of God go I" mentality of independent director-members of Special Litigation Committees as evidence of their structural bias in favor of their "fellow directors") (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981)).

412. Bebchuk I, *supra* note 4, at 50.

413. *Id.* (describing this critique).

414. *See id.* (stating that shareholder access would have no practical effect because of its passive nature).

415. *Id.*

416. *Id.*

417. *Id.*

418. *Id.*

419. *Id.* at 51.

420. *Cf. id.* (arguing that "[i]f shareholder access would not noticeably change the current reality in which directors face a negligible threat of removal," no reason exists to be opposed to the shareholder access mechanism).

tempts at reform, not the maintenance of the status quo.[421] Thus, critics fail to counter sufficiently the material benefits a shareholder access mechanism would provide a public company, i.e., the restoration of the shareholder franchise, improvement of directors' incentives, and, hence, the enhancement of overall firm value.

e. Now Is Not the Time

As a last resort, opponents criticize the timing of introducing a shareholder access mechanism, given the recent expansive regulatory efforts embodied in the Sarbanes-Oxley Act and the new NYSE and Nasdaq listing standards.[422] Critics argue that because these new regulations largely "address the composition, independence, and qualifications of the public company board of directors," firms should be given substantial time to adapt to them, at which future time the proposed justifications for a shareholder access mechanism will likely be nonexistent.[423]

As thoroughly discussed above, however, one of the fundamental problems with these other regulatory efforts is their reliance on board independence—particularly the failed policy of required majority board independence.[424] Far from rendering futile the actual justifications for a shareholder access mechanism, these new regulations may provide another compelling justification in favor of such reform.[425] In fact, the SEC should retreat from its relentless focus on required majority board independence. Thus, the Sarbanes-Oxley Act and the new listing standards do not provide a sufficient basis for rejecting a shareholder access mechanism.[426]

Therefore, as Professor Bebchuck concludes, "the case for shareholder access is strong."[427] Even if a shareholder access mechanism would greatly change corporate governance in the United States, still "the scale of reforms would not be disproportionate to the magnitude of perceived problems."[428] Applying the efficiency test of Part II.B.3 above,[429] the shareholder access mechanism is a sound accountability mechanism.

421. *Id.*
422. *See*, *e.g.*, Lipton & Rosenblum, *supra* note 17, at 88–91.
423. *Id.* at 90.
424. *See supra* text accompanying notes 196–276.
425. *Cf.* Bebchuk I, *supra* note 4, at 61 ("[T]he independent nominating committee is not a substitute for shareholder access.").
426. *Id.*
427. *Id.* at 44.
428. *Id.* at 60.
429. *See supra* text accompanying notes 170–74.

IV. RECOMMENDATION

Conventional wisdom espouses the efficacy and necessity of the independent board. That wisdom is largely based on the monitoring theory of the board, which posits that the board is "uniquely suited" to monitor conflicts of interest between executive managers and shareholders.[430] To monitor executive management effectively, traditional reformers stress that the board must be independent of executive management, which in turn supposedly requires that boards be composed of a majority of independent directors. The SEC has now embraced this conventional wisdom by blessing the new NYSE and Nasdaq listings standards, which require their listed companies to have, among other things, a majority of independent directors serve on their boards.[431]

This conventional wisdom, however, is demonstrably weak. If the addition of independent directors to boards actually strengthened those boards' monitoring capability, one should expect there to be a positive correlation between board independence and firm performance.[432] Instead, the best that can be said is that the evidence is decidedly mixed. Recent and thoroughly robust evidence indicates that not only does the addition of more independent directors not definitively correlate with improved firm performance, but also it may actually correlate with worsened firm performance.[433]

One reason for a lack of support for the independent board is that boards function in numerous relational roles, not merely in a conflicts monitoring one. Thus, the attribution of more value to the board's advisory function results in a decreased willingness to accept the costs of required majority board independence. Another reason is that inside directors add significant value to boards. Monitoring theory not only fails to explain accurately the board, but it also fails to acknowledge accurately the board's role in the public company as the centralized decisionmaking authority. Because of its theoretical shortcomings, monitoring theory translates into poor policy. On the other hand, director primacy theory accurately explains the board's managing position within the company and provides a normative model for corporate governance.

Independent directors are undoubtedly important to public companies, but there are several practical limitations on their ability to monitor effectively that should not be overlooked. Furthermore, because evidence indicates that the value independent directors provide to boards is of mere diminishing returns,[434] mandating majority board independence is simply bad policy. This evidence further corroborates the director primacy theory, which posits that the board makes decisions according to

430. EISENBERG, *supra* note 177, at 162.
431. SEC Release No. 34-48745, *supra* note 12, at 64,180.
432. Bainbridge I, *supra* note 18, at 17.
433. *See supra* text accompanying notes 217–18.
434. *See supra* text accompanying note 245.

consensus, which requires its members to have comparable interests and equal access to information. However, there also is a limit to the value insiders can add to the board. Specifically, too much cohesion can lead to ineffective decisionmaking and increased risk of entrenchment.

Unfortunately, it appears that the implications of social psychology with respect to the perils of groupthink largely are being ignored by corporate regulators, since the appointment of truly independent nominees is unlikely to occur pursuant to the policy of required majority board independence. As long as executive management retains exclusive control over the nomination process, many independent directors elected thereunder will very likely continue to suffer from the various structural biases described above.[435]

In addition, although a certain level of homogeneity may be valuable to boards, public companies are now refused the right to identify a proper allocation of insiders to outsiders under the new listing standards. For these reasons, the policy of required majority board independence is a failed one. The NYSE and Nasdaq should therefore reconsider and repeal their decisions to impose these new listing standards onto their listed companies.

By contrast, however, the shareholder access mechanism has the potential to introduce genuine elements of board heterogeneity by facilitating shareholder-nominees to the board when there is serious reason to believe that shareholder dissatisfaction with the proxy process is widespread. Rejecting the policy of majority board independence does not mean that board composition is unimportant to sound corporate governance. Indeed, because of the board's preeminent authority within the public company, its composition is vital to a healthy corporate economy. The shareholder access mechanism's approach to regulating board composition seeks to restore the shareholder franchise by strengthening their role in the selection process as well as improve incumbents' incentives for serving.

A limited, yet well-functioning, shareholder access mechanism could help accomplish both these goals. First, by allowing certain shareholders access to company proxy materials when widespread dissatisfaction with the proxy process is evident, the historically ceremonial shareholder franchise becomes more meaningful. Second, because of a more meaningful shareholder franchise, and hence a more meaningful threat of ouster, incumbents' incentives for maximizing shareholder wealth will be improved. Improved accountability to the shareholder wealth-maximization norm should reduce the corporate cost of capital. These material benefits, the value of which accrue to both managers and shareholders alike, are not outweighed by Proposed Rule 14a-11's potential costs.

435. *See supra* text accompanying notes 209–13, 256–68.

The most serious concern over the efficacy of a shareholder access mechanism is its potential abrogation of board authority. Although no precise test for measuring the proper mix of authority and accountability exists, it can be stated in general terms that "[a]ccountability mechanism[s] must be capable of correcting errors but should not be such as to destroy the genuine values of authority."[436] Applying this general test to the public company, Professor Bainbridge makes a compelling case against the role of shareholder activism to the extent such activism directly or indirectly controls corporate decisionmaking.[437]

The immediate implication, therefore, is that the SEC should reject the nonimplementation trigger discussed above.[438] Recall that under this triggering event, the failure to implement a precatory shareholder proposal that garnered majority support would put the shareholder access mechanism into effect. Because the content of such a proposal could theoretically include any matter of general policy, social or otherwise, this trigger would come too close to providing shareholders with control over the decisionmaking process. The nonimplementation trigger's relationship with the shareholder franchise is tenuous. It is instead premised on the perceived right of shareholders to control, not merely influence, corporate policy. Consequently, the nonimplementation trigger would most likely weaken the separation of ownership from control and should therefore be rejected.

The remaining concern over the abrogation of board discretion is minimal for several reasons. First, the two triggering events the SEC ought to adopt contemplate limiting the availability of shareholder access to situations of clear shareholder dissatisfaction with the proxy process. Thus, the SEC is mindful of sustaining the decisionmaking power of the board. Second, once triggered, the access mechanism would be in effect for only two election cycles. This limitation essentially opts-out a corporation after two years, thereby preventing shareholder use of the corporate proxy materials from becoming a regular occurrence.

Third, and most importantly, actual use of the mechanism will be limited to those shareholders demonstrating significant investment and long-term commitment through ownership and durational eligibility requirements, who do not seek control of the corporation. These shareholders should be expected to nominate directors seeking to increase corporate value, rather than represent some special interest. Shareholder-nominees must still receive a majority of the minority of votes cast to get elected. Shareholder-nominees will likely provide the board with genuine cognitive conflict among its members, which, in turn, will strengthen the quality of corporate decisionmaking.

436. Bainbridge III, *supra* note 76, at 14 (quoting ARROW, *supra* note 326, at 78).
437. *Id.*
438. *See supra* text accompanying notes 94–97.

In sum, the SEC's proposed shareholder access mechanism appears to be sufficiently narrow to ensure a proper balance of authority and accountability.[439] Moreover, its material benefits outweigh its potential costs. Therefore, the SEC should adopt Proposed Rule 14a-11.

V. CONCLUSION

Corporate governance remains highly relevant as lawmakers struggle to reduce the perceived prevalence of massive corporate fraud. But this legitimate concern should not blind regulators to the consequences sweeping reform will likely have on the governance of public companies and the potential adverse effects on economic efficiency. Still, unlike required majority board independence, the SEC's proposed shareholder access mechanism is a sound accountability mechanism that likely will effect beneficial change. Indeed, those who oppose shareholder access yet advocate for majority board independence might do well to reexamine their (biased) motivations in light of this discussion. In any event, the SEC should not be deterred by those who declare the sky will fall upon adoption of Proposed Rule 14a-11. Rather, now is the time to change the status quo. Thus, a limited shareholder access mechanism should be adopted.

439. Indeed, the requirements may be too conservative. To the extent the triggering process unnecessarily delays shareholder access under exigent circumstances, for example, the SEC should consider including a "safety valve" in which a shareholder or shareholder group could nominate a director under the access mechanism at the very next shareholder meeting upon satisfying a heightened stock ownership requirement, such as fifteen percent. *See* Bebchuk I, *supra* note 4, at 48.