Separation and Dependence: Explaining Modern Corporate Governance

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I. INTRODUCTION

I used the occasion of my inaugural Wiley lecture to set forth my understanding of corporate governance; this Essay sets forth the substance of that lecture. As might be expected from one who spent their practice career dealing with deviant corporate governance in Chapter 11, the views expressed here are somewhat different than most of the extant theory in the area.

For clarity, this Essay will refer to corporate governance as a "horizontal model" of governance, because the central argument of this Essay is that key aspects of corporate governance—which the model identifies as officers, directors, and shareholders—have a shared role in exercising corporate power. Each has a piece of the overall quantity of corporate power, but none can take significant corporate action independently.[1] That is, each of the players in corporate governance has an incomplete piece of corporate power. In this way, power is separated and also codependent.

In my lecture and in this Essay I explain this horizontal model of corporate governance by examining each of the three elements of governance, and explaining the implications of my conception of governance. But first, thorough analysis requires examination of some foundational questions. Namely, what is the purpose of corporate governance and whom does it involve?

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Both scholars and practitioners quite often neglect the goals and aims of corporate governance.[2] Perhaps the purpose of governance is

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[1] *See* Troy A. Paredes, *The Firm and the Nature of Control: Toward A Theory of Takeover Law*, 29 J. CORP. L. 103, 120 (2003).

[2] *E.g.,* ORG. FOR ECON. COOPERATION & DEV., OECD PRINCIPLES OF CORPORATE GOVERNANCE (2004), *available at* http://www.oecd.org/daf/corporateaffairs

seen as self-evident—the kind of question only an academic would ask—but only by understanding the purpose can one identify the key players.

For example, if one views the purpose of governance as enabling corporations to do "good" in society, however that might be defined, then it might be argued that the media is part of governance, inasmuch as they shame managers into taking certain actions. If so, then concern may exist about the tendency of the business press to get quite cozy with the business community, a form of capture that could undermine this conception of corporate governance. Of course, taking on the regulation of the business press expands corporate law and corporate governance in new, uncharted directions.

In the horizontal model the purpose of corporate governance is defined as providing structure to the exercise of power within a corporation, to ensure that power is used to achieve the firm's goals. This, of course, requires specification of the goal of corporations. This Essay focuses on for-profit, public corporations, and therefore assumes that the fundamental goal of the corporation is to increase its own value. Doing so benefits all of the participants, however defined. For example, while this analysis excludes employees or trade creditors from my conception of corporate governance, they are the indirect beneficiaries of corporate growth through more stable employment and product orders.

As a companion goal, this Essay posits that all firms must aim to survive. More precisely, they must increase their value in ways that minimize the risk that the firm will destroy its own value. This does not mean the firm should fear risk, but it does suggest that corporate governance should not aim to benefit diversified, risk-neutral shareholders above all else. That is, the firm must maximize its risk-adjusted growth, not its potential growth in the abstract.

Specifically, while this Essay conceives of corporate governance as a means of maximizing firm value, it expressly rejects the notion that governance must maximize share price. Indeed, the argument is made that managing to share price is one of the fundamental flaws of both recent corporate governance and many of the proposed reforms.[3] In this analysis, maximizing firm value, which will typically also be consistent with maximizing shareholder value, is distinct from maximizing share price, inasmuch as share price is but an imperfect

/corporategovernanceprinciples/31557724.pdf.

[3] William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 667 (2010).

representation of value.[4] This point is analyzed in greater detail below.

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Only by defining the purpose of corporate governance can one understand its features, since it is necessary to know what features are relevant to the discussion. The remainder of this Essay will focus on the three aspects of corporate governance and the ways in which these parts are both separate from and dependent on each other. It is this joint reality—separation and dependence—that gives modern American corporate governance its essential character.

In short, the analysis set forth by this Essay rejects the conception of corporate governance as a set of linear axes, as famously advanced by Stephen Bainbridge.[5] Instead, power within a corporation is balanced in three ways, with the officers holding the bulk of power, but monitored by a largely independent board, which itself is constrained at the outer margins by shareholders.

Power is concentrated in the managers, who have not only day-to-day authority over the firm, but also a large ability to frame issues considered by the other branches of power, especially the board. But the board holds the ultimate power to change the identity of the managers, the ability to initiate most fundamental transactions under corporate law, and the authority to bind the corporation as a matter of agency law.[6] As such, the board checks any managerial inclination to ignore the interests of other stakeholders in the firm.[7]

But what if the board fails in its duties? Shareholders hold the means of preventing this through both voting rights and fiduciary duties, which prevent the board from acting with extreme malice or in the board members' self-interest. Shareholder power is intentionally limited to these extreme issues.

This is a conception of corporate governance that is in harmony with much of the existing academic literature. For example, in expressly rejecting the notion of shareholders as owners entitled as a

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[4] Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 n.12 (Del. 1989).

[5] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 548 (2003).

[6] *See, e.g.*, Thomas Earl Geu, *A Selective Overview of Agency, Good Faith and Delaware Entity Law*, 10 DEL. L. REV. 17, 31–32 (2008); Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 755 (2007); Joan MacLeod Heminway, *Enron's Tangled Web: Complex Relationships; Unanswered Questions*, 71 U. CIN. L. REV. 1167, 1170–71 (2003).

[7] *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 295–96 (1999).

matter of course to control the firm, the horizontal model adopts a contractual view of the corporation, which conceives of shareholders as one of many claimants in a firm.

On the other hand, the horizontal model rejects not only the shareholder supremacy model of the corporation,[8] but the director primacy and officer primacy versions as well. This Essay acknowledges the importance of each and concedes a central role to officers; however, unlike most, the horizontal model ultimately describes each as equivalent parts of corporate governance.

At the same time, the horizontal model also rejects the notion that other stakeholders—like employees or creditors—play an essential role in corporate governance.[9] These stakeholders are beneficiaries of the system, but have no direct governance role.

In short, the horizontal model conceives of governance as a self-reinforcing scheme to allow managers to do their jobs while guarding against managerial wrongdoing. Despite the common reference to "checks and balances," however, corporate governance is not such a system.[10] For example, the officers have no "check" over shareholders and indeed such power would make no sense. Thus, instead of operating as a circular structure of countervailing power, governance power in a corporation is largely concentrated with the officers. Yet, like a jigsaw puzzle, the board and—to a lesser degree—the shareholders, hold essential pieces of that power.

With that overview, this analysis first sets forth the understanding under the horizontal model of the role of officers in corporate governance.

II. MANAGEMENT

This analysis begins with the idea that managers—or officers—have the largest amount of power in a public corporation, although this does not necessarily mean they have the most important components of power.[11] While the corporate laws of most states literally provide that the business of the corporation is to be managed by or under the direction of the board of directors, it is clear that the

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8 Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001).

9 *Contra* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1226–28 (2006).

10 *Corporate Governance*, FIN. TIMES LEXICON, http://lexicon.ft.com/Term?term=corporate-governance (last visited Feb. 28, 2013).

11 Lyman Johnson & Robert Ricca, *Reality Check on Officer Liability*, 67 BUS. LAW. 75, 77–78 (2011).

board's function is not actually to manage, but rather to oversee the management of the company.

Under Delaware corporation law section 142(a), managers exercise delegated power from the board.[12] This Essay, however, argues that this delegation does not mean that officers are subordinate to the board as is often stated or implied. Such a conception of managers is rooted in the days when boards were largely comprised of inside directors. In such a case, it was easy to see the board as the elite of the managers. But today virtually all boards are independent of management, at least in a formal sense.

Instead, under the horizontal model, management is considered the first of three parallel elements of corporate governance. On the trading floor or at the plant, managers make the day-to-day decisions that have extreme importance for the overall well-being of the corporation and its constituents.[13] Management also has a good deal of power to set the agenda for the corporation, given its control over the flow of information to the other elements of corporate governance.[14]

Thus, while it is common to dismiss managers as mere agents exercising delegated power, the horizontal model suggests that there is something more at work here. Namely, managers are more accurately Article II agents, rather than Article I agents. That is, unlike the Congress exercising specifically defined bits of power given to the legislature by the Constitution, the managers of a public company exercise a power more like that held by the President.

The nature of the grant is essentially open ended, subject to restraint only at the outer margins. And this makes a lot of sense, since management is the only element of corporate governance that has day-to-day involvement with the actual operation of the company. In this way, management is also like the President, who, unlike Congress or the Supreme Court, never goes on recess, never leaves to teach summer classes in Europe, and never ceases to exercise the executive authority granted by the people of the United States.

Boards meet maybe six, eight, or twelve times per year under normal conditions, and shareholders meet but once a year and even then mostly by proxy and not as a group.[15] The 2011 Public Company

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[12] DEL. CODE ANN. tit. 8, § 142(a) (West 2013).

[13] *See* Timothy P. Glynn, *Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329, 396 (2004).

[14] *See generally* Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1605–08 (2005).

[15] Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes*

Governance Survey of the National Association of Corporate Directors suggests that public company directors spent an average of over 225 hours performing board-related activities in 2011.[16] That is quite a bit, but it pales in comparison to the work of officers, and other senior managers, who likely exceed that in a single month. Only officers are present throughout and thus, it is they who have the broadest and least defined piece of corporate power.

In short, officers and other managers are agents, but the horizontal model rejects the implication that as a result they are unimportant and can be ignored. Thus, while there is merit in the assertions of Bainbridge, Blair, and Stout, among others, that the role of shareholders is too often overstated, the tendency to focus solely on the board-shareholder dynamic and promote hierarchical models of corporate governance is incorrect.[17]

The inclination to ignore officers or managers is understandable, in that managers are not governed by "law" as commonly understood by corporate law professors. Delaware corporate statutes focus almost exclusively on the board and the case law too has a heavy focus on directors.[18] Indeed, until recently the Delaware Chancery Court did not have personal jurisdiction over officers.[19]

Instead, the law that governs officers in most situations is agency law, which remains uncodified in most states. Thus, while corporate finance scholarship tends to find agents under every rock and bush, managers actually are agents.[20] But to the extent this is ever noted, it is typically only with regard to officers' ability to bind the corporation to a contract with some outside third party. The internal aspects of the relationship fly under the radar, probably because the board typically monitors this relationship away from the public eye.

That, of course, does not mean that officers do not wield tremendous power. It only explains why it so often goes unnoticed. Managers exercise the most basic aspects of corporate power and therefore play the largest role in corporate governance.[21]

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but Uncertain Benefits, 25 J. CORP. L. 349, 363 (2000).

[16] NAT'L ASS'N OF CORP. DIRS., NACD PUBLIC COMPANY GOVERNANCE SURVEY (2012–2013 ed., 2012).

[17] Hierarchies, of course, exist in corporations as well as within the elements of corporate governance that this Essay describes.

[18] For the rare exception, *see* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

[19] Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 462 n.28 (2004).

[20] *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

[21] *See* Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 827

III. BOARDS

If officer-managers exercise the greatest role in governance, corporate boards exercise the most important role.[22] The board exercises two broad forms of power. First, it has oversight responsibility with respect to managers and the corporation. Second, it has the power to initiate all significant corporate transactions and changes under Delaware corporate law.

Oversight responsibility means the board has the ability to fire managers who misbehave. But it also includes something more. It is now clear under Delaware and federal law that the board has an obligation to consider how the company operates and whether it is in compliance with relevant law.[23] That involves the board in a kind of monitoring and information-gathering that requires the board to work with management to understand the full picture. But the board also has to go beyond management to understand the perceptions of all employees regarding the culture of the corporation, including the level of fear of retaliation for reporting suspected misconduct and whether employees believe that management is committed to abiding by the law.

This is a change from the past, when the board was largely an advisor to senior management.[24] But since Sarbanes-Oxley, that role has changed and should be acknowledged. Further, Dodd-Frank suggests that there will be no return to the "good old days."

The board's oversight responsibility also requires that the board keep the corporation in sight of its goals of self-preservation, thus increasing its value. In light of recent events, it is easy to dismiss this as a problem only for financial institutions, but the automakers, particularly General Motors (GM), were slow to address problems that had been obvious since at least the 1980s.[25] And British Petroleum's (BP) recent troubles in the Gulf of Texas show that failures in risk management have serious consequences, the full extent of which are still unknown, as the government tries to prove gross negligence on BP's part.[26]

(2011).

[22] *See* Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 668 (2003).

[23] Stone v. Ritter, 911 A.2d 362 (Del. 2006).

[24] Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 930–31 (2010).

[25] Levine v. Smith, 591 A.2d 194, 197 (Del. 1991).

[26] *See generally BP Trial*, FIN. TIMES, http://www.ft.com/indepth/bp-trial (last visited Mar. 14, 2013).

This is not to say that the board is the corporation's risk and compliance manager. That power belongs with management. The directors should determine the company's reasonable risk appetite—for example, financial, safety, reputation, and a myriad of other risks—and satisfy themselves that the risk management processes designed and implemented by managers are consistent with the company's goals. The board must also make sure that these systems are functioning as described and that necessary steps have been taken to foster a culture of risk-adjusted decision-making throughout the firm.

The board provides the check on the Chief Executive Officer (CEO) in this context, the only other party with governance power that is likely to have a clear view of any substantial part of the operation of a large company.

Under Delaware corporate law, the board is also the holder of the power to initiate any significant corporate transaction. The idea will often come from management, but be it an asset sale or a merger, only the board can start the corporation down that path.[27] This means that the board has a veto over the exercise of power by either of the other two elements of corporate governance. Similarly, it is only the board, and not the shareholders or management, that has the power to bind the corporate entity as a matter of agency law, further providing a check on the exercise of power by the other aspects of the firm.

In short, under the horizontal conception of corporate governance, the board is not primary. Rather, it holds a high degree of power, but that power is limited to specific, high importance topics. The difference between this and director primacy is subtle and mostly turns on the role allocated to managers, as discussed, and shareholders, discussed below.

IV. SHAREHOLDERS

Shareholders have three rights:

1) The right to vote, unless they hold nonvoting shares[28]
2) The right to a dividend, unless the board does not declare one[29]
3) The right to a proportionate share of capital upon

[27] DEL. CODE ANN. tit. 8, § 251(b) (West 2013).
[28] DEL. CODE ANN. tit. 8, §§ 151, 212 (West 2013).
[29] DEL. CODE ANN. tit. 8, § 170 (West 2013).

dissolution, unless the company is insolvent.[30]

These are not the indications of ownership, as commonly understood. They are signs of weakness. And this Essay submits that this weakness is by design.

At heart, a share is a measure of one's interest in a corporation and nothing more. Any remaining rights are extremely fragile. For example, if you are a holder of Google class A shares—the primary publicly traded kind—you receive one-tenth the voting rights of the majority shareholders[31] and no dividends.[32] Fortunately, the company is not insolvent, so you still retain your right to a distribution on dissolution. Despite this dissipated basket of rights, investors seem quite eager to buy Google shares. After all, as of this writing it has a market capitalization of about $270 billion.[33]

Most publicly traded corporations do not go this far. Instead, shareholders retain voting rights under the typical "one share one vote" regime and they have a right to any dividends paid. For large companies, these dividends tend to result in small, steady payouts each quarter.

The voting rights give shareholders a yes/no vote on board membership. With regard to incumbent members, shareholders are essentially passing on the members' past actions. Only in extreme cases will the shareholder know if a board member's performance was lacking. With regard to new members, shareholders' votes are essentially a commentary on the actions of the existing board in selecting the candidate.

Chancellor Allen, now Professor Allen, famously proclaimed that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[34] This premise remains true, but only if it is understood that directorial legitimacy is probably more dependent on informal boundaries. The shareholder franchise proscribes but a broad frame on managerial and board power.

The wisdom of shareholder primacy is doubtful, instead

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[30] DEL. CODE ANN. tit. 8, §§ 275, 281(a) (West 2013).

[31] GOOGLE, FOURTH AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF GOOGLE INC. (2012), *available at* http://investor.google.com/pdf/google-fourth-amended-and-restated-certificate-of-incorporation.pdf.

[32] *Google Inc.*, GOOGLE, https://www.google.com/finance?client=ob&q=NASDAQ:GOOG (last visited Mar. 11, 2013).

[33] *Google Market Cap*, YCHARTS, http://ycharts.com/companies/GOOG/market_cap (last visited Mar. 14, 2013).

[34] Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

governance should advance corporate interests, which often, but not always, correspond with shareholder interests in some general sense. Those who would advance shareholder primacy have some obligation to explain which shareholder should be prime: the retiree investor, the thirty-something investor, the index mutual fund, or the hedge fund that owns the shares as part of a larger basis trade. It is also likely that their interests are only aligned when considered at a very general level.

Given the disparate interests of the shareholders, it makes sense that their power is limited to policing the edges of directorial power. While their interests are diverse, it seems likely that none would countenance dishonest board members.

Too often the weakness of the shareholder franchise is denounced by some false analogy to political voting rights. When an investor buys a share, he or she buys an interest in a corporation that comes with weak voting rights. There is no similarity between that investment interest and the denial of a person's political rights on the basis of race, protected by the Fifteenth Amendment,[35] or sex, protected by the Nineteenth Amendment,[36] or age, protected by the Twenty-Sixth Amendment.[37] Among other things, share ownership is a choice, entered into with knowledge of the rights that come in exchange for the investment.

Shareholders are interest holders in the firm—holding a distinct kind of interest that comes with specified powers. They are not owners and they have no democratic entitlement to vote.

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One may note that this analysis has yet to even mention fiduciary duties. This is intentional, as it is not the shareholders who are the beneficiary of these duties, but rather the corporation.[38] In the original English corporate cases, dating back to the middle of the Nineteenth Century, shareholders had no power to enforce such corporate obligations.[39] Rather, it was a power that rested in the board alone.

[35] U.S. CONST. amend. XV, § 1.

[36] U.S. CONST. amend. XIX.

[37] U.S. CONST. amend. XXVI.

[38] Lewis v. Knutson, 699 F.2d 230, 237–38 (5th Cir. 1983) ("When an officer, director, or controlling shareholder breaches a fiduciary duty to the corporation, the shareholder has 'no standing to bring [a] civil action at law against faithless directors and managers,' because the corporation and not the shareholder suffers the injury. Equity . . . , however, allow[s] him to step into the corporation's shoes and to seek in its right the restitution he could not demand on his own." (citation omitted)).

[39] Foss v. Harbottle, (1843) 67 Eng. Rep. 189; 2 Hare 461.

In modern times, shareholders enforce the duties in but limited circumstances, and do so on behalf of the corporation as a whole.[40] Essentially, the shareholders are limited to acting as a backstop to the board, protecting corporate interests only when the board fails to do so. In this respect, the derivative suit acts as a supplemental check on board corruption or incompetence. But it is necessary to keep in mind the limits. Not only are shareholder actions limited by the demand requirements,[41] but the subject of such actions is limited to breaches of the duty of loyalty.

Duty of care violations are typically protected by the twin pillars of the business judgment rule and, in most states, strong exculpation provisions.[42] The only duty of care claims that survive are those so egregious that they amount to *de facto* duty of loyalty violations.

V. IMPLICATIONS

Under the horizontal conception of corporate governance, managers have the bulk of corporate power, but not the most important bits. Those belong to the board, which has important powers over a limited set of key issues. Shareholders provide boundaries to the exercise of power by both the board and management. Shareholders are a disorganized bunch that typically only unite to exercise this power in extreme situations, but otherwise, the ability of shareholders to control board action is quite limited.[43] This is by design, allowing management and the board to exercise the discretion with which they have been vested and to run the business of the corporation.

This horizontal conception of corporate governance also explains the rather limp duty of care, particularly in Delaware. A more robust duty of care, enforceable by shareholders, would allow the shareholders to intrude on the power of managers and the board. But if one accepts this understanding of corporate governance, as this analysis does, then it leads to several other important implications.

First off, because this conception of governance is based on a

[40] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("[A] court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose."').

[41] Derivative Actions by Shareholders, Del. Code Ann. tit. 8, § 327 (West 2013); *see also* Shareholder Derivative Actions, CAL. CORP. CODE § 800 et seq. (West 2013).

[42] DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2013) (contents of certificate of incorporation); *see also* CAL. CORP. CODE § 12371 (West 2013) (standards of performance).

[43] *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 679–94 (2007).

balance of powers, things that undermine that balance should be approached with skepticism. Not to say that change is impossible, or that the status quo is perfect, but rather, such changes should be examined carefully before proceeding. Some recent changes have been enacted without careful study.[44] For example, recent decades have seen a move away from salary toward share-based compensation. Salary has dropped to less than twenty percent of total executive pay in the United States (from forty-two percent as recently as 1993).[45]

But share based compensation can blur lines between centers of power and provide incentives that would not normally exist. Under generally accepted accounting principles (GAAP), profits can be manipulated in a way that will not become clear for years and bonuses are quite often paid out for shorter-term improvements in earnings or share price. Therefore, share-based compensation merely drives short-termism and manipulation.

Shareholder empowerment moves, which have been quite common in recent years, similarly risk disrupting the system and allowing shareholders to intrude into the separate space the law has traditionally given to officers and directors. The trade-off between short- and long-term growth is particularly plain when hedge funds and other shareholders press boards for stock buybacks, special dividends, spin-offs, and other transactions. The board and management must have some degree of space to achieve overall corporate objectives, which are often not the same thing as maximizing the share price here and now.

Too much of corporate governance has been driven, even co-opted, by the faith in modern finance—that is, post-war finance. In the world of corporate finance, share prices represent company value perfectly.

But this is also a world in which all investors have the same understanding and beliefs about share value, investors can buy stocks on margin at the same rate the government pays on money investors deposit in Treasury securities, and returns are symmetric and investors are equally adverse to up and down movements in share price.[46] To varying degrees, none of this is true, so should there be so much faith in the notion that capital markets are efficient all of the time either?

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[44] Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1585 (2005).

[45] M. Alix Valenti & Michael Wolfe, *From 1993 to 2003: Changes to Executive Pay*, 23 J. OF COMPENSATION & BENEFITS 6 (2007).

[46] STEPHEN J. LUBBEN, CORPORATE FINANCE (forthcoming 2014).

There is no real assurance that observed prices are a meaningful indication of long-term company value, rather than the current supply and demand for the shares. Of course, supply and demand are somewhat affected by expectations of long-term value, but they are also affected by additional considerations, such as whether the company is included in an index in which many funds invest, and whether the company is a good proxy for another firm in the industry that is part of a large arbitrage strategy.

For example, I was told that during the GM bankruptcy one common trade was to buy GM debt and short Ford stock. That gave the shareholder the return GM was paying in its Chapter 11 plan, but took out the general auto industry risk associated with the trade. It also likely had an affect on Ford share prices that revealed nothing about the value of Ford as a corporation.

It is often argued that maximizing shareholder wealth by maximizing share price is a sensible objective only if we have some belief that prices are meaningful[47]—there are real reasons to doubt this. Thus, the idea of increasing shareholder power to make directors and management more sensitive to maximizing share price, gives reason for pause.

Again, this does not mean all is right with the status quo. For example, boards have done a particularly poor job of tackling the problem of underperforming directors. Indeed, sometimes they seem to encourage underperformance.

Too often boards seem to be risk adverse in their selections, picking the same directors that every other big corporation has on its board. But if one sits on four or five big corporate boards, and has a full-time job, there is reason to believe that they will not have adequate time or attention to devote to all. This is particularly true because the board members that also have full-time jobs are generally not working on a nine-month academic calendar and are in roles that go beyond a nine-to-five workday.

The responsibilities and time commitments required for board service today, as well as the complexity of risk management, reporting, and other issues that directors must oversee, has raised the bar for effective board service. The time has come for boards to think outside the box with regard to membership.

As a result, they might also address, however unintentionally, the other legitimate concerns many have with regard to the diversity of

[47] *See* Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 1008 (1995).

current S&P 500 boards. If for nothing else, doing so might reduce the equally troubling tendency toward groupthink that too many financial institution boards have exhibited in the past decade. Expertise is important, but not if it comes at the price of directors not asking the hard questions.

This is an area where boards have only themselves to blame for misguided provisions like Dodd-Frank's proxy access rule, which would require companies to give investors a right to place their nominees to the board of directors on the company's proxy materials,[48] making it easier for shareholders to trigger contested elections. The provision undermines the balance of power in the horizontal model of corporate governance—but it is a natural response to the board as insider club phenomena.

The rule is on hold due to the Court of Appeals for the D.C. Circuit's ruling in *Business Roundtable v. SEC*.[49] But the composition of the D.C. Circuit is not static, and the SEC will undoubtedly try again. Therefore, boards will have a limited amount of time to fix the problem themselves.

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The horizontal conception of corporate governance provides a good description of the current reality of American corporate governance. Shareholders do not have anything like ownership power, so the practice of calling them "owners" should be discontinued. The board is powerful, but it is not a full-time institution. Its power is limited to those high-level functions that must be trusted to someone other than management. And management, too often neglected, is really a key source of much day-to-day power, and consequently the holder of most, but not all, corporate power.

Beyond the descriptive, should there also be normative changes? That is, should corporate governance be different than it is? While there is unquestionably opportunities for improvement, future attempts to address the issue must be more thoughtful. After all, the current model seems to have worked fairly well since its introduction almost a century ago here in New Jersey.[50] Others, like those used in England and the Netherlands, have worked quite well too—there is no need to be parochial about reform.

To be sure, the horizontal model does not always work to its

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[48] *See* 15 U.S.C. § 78n (West 2012).

[49] 647 F.3d 1144, 1146 (D.C. Cir. 2011).

[50] Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev. 588, 609 (2003).

own, internal potential. Companies, particularly in the pharmaceutical industry, continue to acknowledge compliance violations again and again.[51]

The recent problems at Chase, both in trading and in money transfers, Citibank's recent settlement of post-Lehman mortgage underwriting problems, and even the New York Stock Exchange's favorable treatment of insiders, suggest that that industry still has a long way to go in developing a new culture.[52] Nonetheless, the financial industry seems to be expending a lot of effort fighting regulation, when it would have more credibility in this regard if it got its own house in order. Rather than tinkering with the model itself, this may be the most rational place to begin.

[51] *GlaxoSmithKline Corporate Integrity Agreement*, OFFICE OF INSPECTOR GENERAL (June 28, 2012), *available at* http://oig.hhs.gov/fraud/cia/agreements/GlaxoSmithKline_LLC_06282012.pdf.

[52] James Quinn, *Stephen Hester: Banking Culture Change 'Will Take a Generation'*, TELEGRAPH (Sept. 29, 2012, 10:30 PM), http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9576646/Stephen-Hester-Banking-culture-change-will-take-a-generation.html.