

# Do Heterogeneous Firms Select their Right “Size” of Corporate Governance Arrangements?

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## ABSTRACT

That one-size-does-not-fit-all in corporate law and governance has been frequently raised to object corporate governance reforms, ISS’ voting recommendations, and recently, shareholder proposals. But do firms really choose their right “size” of governance as is conventionally assumed? This Article argues that not only that firms do not always choose their right size, but firms that need governance the most are frequently less likely to self-constrain (Resisting Firms).

The “one-size-does-not-fit-all” argument entails an inherent tension. Its logic suggests that firms whose managers are subject to weak market discipline will voluntarily come up with mechanisms to curtail managerial opportunism. But market discipline is required also to incentivize managers to tie their own hands. Furthermore, if differences among firms are not observable by outsiders, due to adverse selection, IPO pricing might not provide sufficient incentives either. Evidence from studies spanning a wide range of contexts suggests that firms frequently do not choose their right size. Independent directors seem to add more value to firms that were required to add them by law, rather than to firms that voluntarily chose to appoint them; firms’ inclination to cross-list on US exchanges is negatively correlated with controlling shareholders’ private benefits and with positive market response to cross-listing; Nevada’s lax fiduciary duties attract some firms that could benefit from more controls rather than less, and managers disproportionately contest shareholder proposals in firms with entrenched governance, and in firms that investors believed could benefit most from proxy access arrangements.

The Article details implications for data interpretation and policy, and for mandatory rules, SEC policies in awarding no-action letters, proxy advisory firms and hedge fund activists. First, evidence from voluntary adoption of governance terms might underestimate their value to shareholders. Second, policy makers should weigh the costs of inefficient self-selection against the costs of applying one-size policies. Third, SEC no-action letters’ policies should be minded of inefficient self-selection. Fourth, proxy advisory firms and hedge fund activists are shown to serve an overlooked role of pressuring Resisting Firms to adopt value-enhancing corporate governance changes.

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*One-size-fits-all is as bad in the corporate market as in the clothing market*

Frank H. Easterbrook, *Derivatives Securities and Corporate Governance*,  
69 U. CHI. L. REV. 733, 746 (2002)

## I. Introduction

It is often argued that one-size-does-not-fit-all in corporate law and governance (One-Size Argument). Independent directors, majority voting, proxy access, executive compensation and disclosure obligations benefit some firms more than others. The One-Size Argument is commonly used to support private ordering, which is presumably superior to legal intervention in tailoring governance arrangements to firms' particular needs.<sup>1</sup> More recently, along similar lines, the One-Size Argument has been raised against lighter forms of intervention – shareholder activists' proposals and proxy advisory companies' voting recommendations – as they arguably apply “one-size” governance policies to different firms. This Article, however, shows that the One-Size Argument may, in fact, call for more regulation, or intervention, rather than less. The intuition: firms do vary in their governance needs, but private ordering may result in firms that need governance the most selecting no governance constraints whatsoever (Resisting Firms).

The stakes of the argument that this Article raises are high. The assumption that firms choose their right “size”—that is, the governance terms that fit their particular needs—resulted in a fierce, and a highly influential, objection to one-size policies. The One-Size Argument has been advanced routinely against corporate reforms such as Sarbanes-Oxley Act of 2002 (SOX) and the exchanges' listing independence standards,<sup>2</sup> as well as Dodd-Frank Act's mandated shareholder advisory votes and disclosure

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<sup>1</sup> See e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (“No one set of terms will be best for all; hence the “enabling” structure of corporate law.”); Jonathan R. Macey, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* (PRINCETON UNIVERSITY PRESS 2008) [hereinafter Macey, *Promises*] (“An advantage of private sector ordering in determining the composition of boards is that private ordering can adjust board composition to reflect the efficacy of complementary corporate governance mechanisms”); Stephen M. Bainbridge, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* (OXFORD UNIVERSITY PRESS 2011) [hereinafter Bainbridge, *Financial Crisis*] (“one size does not fit all in corporate governance.”); Barry Baysinger & Henry Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 457 (1985) (“any imposition of uniformity – either liberal or strict- on the system of corporate law will be Pareto inefficient.”) [hereinafter Baysinger & Butler *Uniformity In Corporate Law*]; Letter from Cravath, Swaine & Moore LLP et al. to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 4–5 (Aug. 17, 2009) (“The strength of private ordering—its ability to accommodate and adapt to different circumstances and to provide flexibility for change—is the fatal weakness of a prescriptive rule.”), available at <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf>.

<sup>2</sup> See e.g., Bainbridge, *Financial Crisis*, *supra* note 1; Macey, *Promises*, *supra* note 1.

obligations.<sup>3</sup> The One-Size Argument is also influential in current policy debates. SEC plans to apply one-size, universal proxy access and disclosure of political contribution rules, were recently blocked by congress.<sup>4</sup> And the SEC is now reviewing comment letters that advocate cutting back on “one-size” prescriptive disclosure requirements in favor of principle based, flexible approach.<sup>5</sup> Furthermore, even shareholder proposals, which are presumably a form of private ordering, have been criticized for arguably applying one-size-fit-all governance terms to different firms.<sup>6</sup> Accordingly, *Whole Foods*’ management was hailed by the Business Round Table, for attempting to exclude a “one-size” proxy access shareholder proposal, and the SEC was criticized for withdrawing the no-action letter it previously awarded *Whole Foods* management for doing so.<sup>7</sup> If however, managers resist proposals exactly when they could benefit shareholders, as this Article argues, the SEC’s decision to limit *Whole Foods*’ management strategy would in fact improve, rather than harm, corporate governance tailoring. Or, in Congressional Hearings for The Corporate Governance Reform and Transparency Act of 2016 – that if passed, would limit the profitability and influence of proxy advisory firms – the U.S. Chamber of Commerce criticized the two most prominent advisors, Institutional Shareholder Services (“ISS”) and Glass Lewis, for arguably issuing “one-size” voting recommendations.<sup>8</sup> Yet, to the extent the Glass Lewis

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<sup>3</sup> See e.g., Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1798-99 (2011) (“Once again we see another one-size-fits-all model being forced on all public companies.”); Commissioner Daniel M. Gallagher, *Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance*. New Orleans, LA, March 27, 2014 (“[hereinafter Gallagher, Tulane CLI 2014] (“This mandated intrusion into corporate governance will impose substantial compliance costs on companies, along with a one-size-fits-all approach that will likely result in a one-size-fits-none model instead.”) [http://www.sec.gov/News/Speech/Detail/Speech/1370541315952#.VP0ZIUZ6\\_Nv](http://www.sec.gov/News/Speech/Detail/Speech/1370541315952#.VP0ZIUZ6_Nv)

<sup>4</sup> H.R.2995 - Financial Services and General Government Appropriations Act 2016; Financial Services and General Government Appropriations Act, 2017.

<sup>5</sup> <https://www.sec.gov/rules/concept/2016/33-10064.pdf>. See e.g., Letter from Davis Polk & Wardwell to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (July 22, 2016) (“a materiality-centered, principles-based disclosure framework will elicit more relevant and useful information than a strictly rule-based framework by providing more flexibility for registrants to use their judgment in disclosing information that they believe is material to investors depending on registrants’ unique facts and circumstances... “); Letter from Wachtell, Lipton, Rosen & Katz, to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (May 16, 2016) (“...“Issuers should also be provided with greater flexibility in the types of information required.”).

<sup>6</sup> See e.g. James R. Copland, *Companies Fight Back Against Chevedden; Unions and Social Investors Ramp Up Push on Corporate Political Spending*, PROXY MONITOR REPORT (2014) (“a case-by-case, as opposed to a one-size-fits-all, approach to board classification could be warranted”).

<sup>7</sup> See *infra* Part II.

<sup>8</sup> See Statement of the US Chamber of Commerce to the House Committee on Financial Services (May 17, 2016) (“But in making one-size-fits all recommendation that Say on Pay must be held every year for all companies, ISS and Glass Lewis thwarted the public policy choice made by Congress and cut off the ability of shareholders to debate and decide the issue.”); See also Martin Lipton, Wachtell, Lipton, Rosen & Katz, (January 21, 2012) *Disintermediating the Proxy Advisory Firms, The Harvard Law School Forum on Corporate Governance and Financial Regulation* (“We have long eschewed the one-size-fits-all model of corporate governance advanced by many of the proxy advisory firms.”) <http://blogs.law.harvard.edu/corpgov/2012/01/21/disintermediating-the-proxy-advisory-firms/>; David F. Larcker & Allan L. McCall, *Proxy Advisers Don't Help Shareholders*, WSJ OPINION (Dec 8 2013) (“Proxy Advisers Don't Help Shareholders. The 'best practices' they want companies to adopt are more accurately termed one-size-fits-all best guesses.”),

and ISS exert pressure on Resisting Firms, they actually may be contributing to efficient tailoring. Furthermore, ISS and Glass Lewis general “one-size” recommendations—to consider management responsiveness to shareholders in directors’ annual elections—might in fact be targeting exactly those Resisting Firms. Finally, another pending rule, The Brokaw Act, is intended to limit hedge fund activists, who disproportionately target firms with entrenching governance and unsatisfied shareholders, and thus might also be contributing to governance tailoring.

Despite its significant influence on policy, the assumption that under private ordering firms voluntarily choose their right “size”—that is, optimal, or close to optimal, governance arrangements, given their particular needs—has not been systematically assessed against available evidence. While the assumption entails clear testable predictions, until recently no study examined these predictions or even the basic question of who are the firms that under private ordering voluntarily adopt governance constraints, or, who are the firms that resist adopting them.<sup>9</sup> Rather, scholars, practitioners and policy makers merely pointed to non-uniform adoption of governance terms by different firms as an indication that firms choose their right “size”.<sup>10</sup> Similarly, the assumption has not been incorporated rigorously to corporate law theory, or thought through carefully. Rather, a typical argument by assertion holds that those firms that face weak market constraints, and therefore could benefit from additional governance constraints, will adopt them voluntarily.<sup>11</sup>

This Article argues that equating firms’ needs with their incentives to adopt constraints, as conventional wisdom has, is not only unwarranted, but rather involves an inherent tension. The lack of alternative constraints, which creates the need for governance terms, could be the very reason why managers might be reluctant to voluntarily adopt these terms. Granted, firms that face weak market discipline should decline in value if they do not adopt governance constraints.<sup>12</sup> Yet, at the same time, for

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<http://www.wsj.com/articles/SB10001424052702303497804579241842269425358>.

<sup>9</sup> For three recent exceptions see Tara Bhandari, Peter Iliev & Jonathan Kalodimos, *Public versus Private Provision of Governance: The Case of Proxy Access* (working paper 2016) (assessing private ordering tailoring for proxy access); Stephen Choi, Jill Fisch, Marcel Kahan & Edward Rock, *Does Majority Voting Improve Board Accountability* U. CHI. L. REV. (FORTHCOMING 2016) (finding differences between early and late adopters of majority voting rules); Sarath Sanga & Roberta Romano, *The Private Ordering Solution to Multiforum Shareholder Litigation*, J. EMP. LEG. STUD. (FORTHCOMING 2016) (assessing private ordering for midstream adoption of forum selection bylaws); See also discussion *infra* Part IV.D.

<sup>10</sup> See e.g., Easterbrook & Fischel, *Corporate Contract* *supra* note 1, at 1426 (“The agreements that have arisen are wonderfully diverse, matching the diversity of economic activity that is carried on within corporations.”).

<sup>11</sup> Bainbridge, *Financial Crisis*, *supra* note 1 (“[E]xternal markets for managerial services, the market for corporate control...are just some of the ways in which management is held accountable...The importance of the board’s monitoring role in a given firm depends in large measure on the extent to which these other forces are allowed to function.”); Baysinger & Butler, *Uniformity In Corporate Law*, *supra* note 1, at 459 (“corporate law will play a relatively more important role in those corporations in which market-oriented governance mechanism are relatively less important or influential and *vice versa*.”); Macey, *Promises*, *supra* note 1 (“This, in turn, suggests that companies that have substantial anti-takeover protective mechanisms, such as poison pills... and staggered boards of directors, are likely to have more independent, outside directors than companies lacking an arsenal of anti-takeover devices.”)

<sup>12</sup> See e.g., Vidhi Chhaochharia, Gusvavo Grullon, Yaniv Grinstein & Roni Michaely, *Product Market Competition and Agency Conflicts: Evidence from the Sarbanes-Oxley Act* MANAGEMENT SCIENCE (forthcoming 2016) (finding that SOX benefits are higher for firms in concentrated industries).

managers that face weak product market competition, or are entrenched by strong antitakeover device, the risk of a hostile takeover is low, and frequently outweighed, by the high private benefits these managers extract.<sup>13</sup> Take proxy access for example - some firms do not need a proxy access, it was argued, or could benefit from one that is more lenient than the SEC proposed proxy access rule. But would these managers, that are not sufficiently accountable to shareholders, also voluntarily adopt proxy access? Indeed, as explained below, recent evidence shows that it is exactly these managers - of firms that need proxy access - that fought shareholder proposals to implement it.<sup>14</sup>

The theoretical tension in the One-Size Argument further extends to the initial public offering (IPO) stage, when the manager presumably has incentives to offer optimal governance that maximizes the IPO price. Governance terms should add high premium to firms that face weak market forces. Yet, since variations in market forces are not fully observable, investors would often pay only an average value for these terms. As a result, due to adverse selection at the IPO, the Article argues, firms that could benefit most from governance constraints might not adopt them. This Article's first contribution thus is to develop a comprehensive theory of corporate law and heterogeneity.

The Article second contribution is to assess its theoretical predictions, as well as those that ensue from the assumptions that firms choose their right size, against currently available evidence. Evidence from myriad contexts and studies casts doubts on the assumption that firms select their right "size", and is consistent with the concerns raised here that firms that could benefit from governance constraints are often less likely to adopt them voluntarily. Take for example a highly researched governance mechanism— independent directors. In a series of studies, firms with independent directors did not perform better than their peers. For years thus, the consensus has been that independent directors do not add value to U.S. boards. Accordingly, when SOX and the exchanges' listing standards required listed firms to have a majority of independent directors, they were heavily criticized for acting with no supporting evidence and for applying a one-size-fits-all approach. But recent studies find that firms that were forced to add independent directors due to these mandates benefited from adding them more than the firms that added them voluntarily.<sup>15</sup>

A similar pattern emerges with respect to private ordering of foreign firms via cross-listing on U.S. exchanges. Firms in which controlling shareholders' voting power is high and share value is low, and therefore presumably have higher agency costs, are less likely to cross-list even though the market highly rewards them if they choose to do so. Firms that cross-list from countries with weak investor protections, disclosure obligations, and legal institutions—that is, countries in which controlling shareholders can extract high private benefits—exhibit a reduction of costs of capital that is significantly larger than that of firms that cross-list from countries with strong protections. Yet, they show a lower inclination to cross-list than firms from countries with strong legal protections. This

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<sup>13</sup> Managers who face weak market discipline likely have, as a result, opportunities to extract high private benefits, *See, e.g.*, Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463 (2001) (arguing that increased monopoly rents induce higher potential agency costs); Maria Guadalupe, Francisco Perez-Gonzalez & Fangzhou Shi, *Competition and Private Benefits of Control* (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=890814](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890814) (finding that competitive industries are associated with lower control premiums).

<sup>14</sup> *See Infra* Part II.

<sup>15</sup> *See Infra* Part III.A.

evidence on cross-listings also demonstrates that inefficient self-selection could result in significant inefficiency costs.<sup>16</sup>

Similarly, evidence on firms' choice of state of incorporation raises questions with respect to how firms self-select. When Nevada differentiated its law by narrowing significantly Delaware's mandatory duties of loyalty and good faith, state representatives were concerned that Nevada's relaxed laws would attract a disproportionate number of problematic firms.<sup>17</sup> If firms choose their right "size", however, Nevada should attract those firms whose agency costs are so low that they are better off with minimal mandatory legal constraints. As I have found in a separate work with David Smith, firms that choose to incorporate in Nevada, as compared to firms that incorporate in Delaware, have an exceptionally high frequency of accounting restatements, and are ranked high on aggressiveness in financial reporting.<sup>18</sup> Similarly, a recent study of foreign firms' reverse mergers into the U.S., finds that reverse mergers into Nevada are associated with the most egregious accounting restatements.<sup>19</sup> At the same time, however, there is no evidence that this behavior resulted in a lower value for Nevada's firms.<sup>20</sup> Yet, as this Part explains, results with respect to the effect of Nevada law on firm value should be interpreted with caution.<sup>21</sup> Finally, that Delaware's relatively strict law attracts firms with superior governance and performance, also is not supportive of the assumption that firms choose their right "size".

Furthermore, recent evidence from shareholder proposals to implement governance changes sheds light on inefficient self-selection practices. A contemporary study by two SEC officials finds that managers resisted proxy access proposals the hardest in firms that could benefit most from them.<sup>22</sup> More generally, a recent study, that covers all types of shareholder proposals, finds that managers contest shareholder proposals in firms with weak governance, measured by having a combined CEO chairperson and a large board—that is, firms that are more rather than less likely to benefit from governance constraints.<sup>23</sup> Similarly, a recent study of the proliferation of majority voting terms, private ordering's poster child, finds that early adopters of majority voting disproportionately did not experience significant withhold votes in previous years—that is, firms for which it

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<sup>16</sup> See *Infra* Part III.B.

<sup>17</sup> See Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935 (2012).

<sup>18</sup> See Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law*, 27 REV. FIN. STUD. 3593 (2014).

<sup>19</sup> Siegel, J.I., & Wang, Y. (2012) *Cross-Border Reverse Mergers: Causes and Consequences.* Harvard Business School Strategy Unit Working Paper No. 12-089, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2192472](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2192472).

<sup>20</sup> Barzuza & Smith, *supra* note 18, at 3598, 3618-20 & Tbl 11 (finding no statistically significant effect for the valuation of NV firms and stating that "Overall, our valuation findings are inconclusive and make it difficult to draw strong conclusions regarding the efficiency of the decision to incorporate in Nevada."). Results from other studies of NV valuation effects are mixed. See discussion *infra* Part IV.C.

<sup>21</sup> Studying the value of NV firms is complicated by their small size, high restatements and misstatements ratio, lack of trading data, high exit rate of NV firms from the Compustat sample, the need to find when NV started marketing its legal regime, and the lack of an appropriate instrument. See discussion *infra* Part IV.C.

<sup>22</sup> Bhandari, Iliev & Kalodimos, *supra* note 9.

<sup>23</sup> Eugene Soltes, Suraj Srinivasanand & Rajesh Vijayaraghavan. *What Else Do Shareholders Want? Shareholder Proposals Contested by Firm Management.* Harvard Business School Working Paper, No. 16-132 (May 2016) (studying all shareholder proposals between 2003-2013).

mattered less (Indifferent Firms).<sup>24</sup> Firms in which shareholders voted against directors in previous elections resisted implementing these terms for a while. Not surprisingly, in these latter firms, majority voting mattered more in annual elections results.

The Article also discusses evidence that is consistent with the assumption that firms choose their right “size”. To begin with, small firms that face relatively higher costs of implementation are less likely adopt governance constraints. Indeed, on the costs dimension, managers and shareholders’ interests are more aligned.<sup>25</sup> Second and more important, firms are more likely to be hit by a shareholder proposal, less likely to contest a shareholder proposal and more likely adopt governance constraints following abnormally poor performance. Thus, weakly performing firms were more likely to adopt independent directors, proxy access proposals and majority voting terms.<sup>26</sup> This evidence suggests that, consistent with Heramlin and Weisbach bargaining model, weak performance creates pressure on managers to satisfy shareholders. Abnormal weak performance however, could be transitory and is not necessarily aligned with firms’ needs for governance. Indeed, the evidence also shows these were not the firms that needed governance the most.

To sum, a significant body of evidence, spanning a broad array of applications including board independence, cross-listing on U.S. exchanges, voting, and choosing a firm’s state of incorporation raises doubts as to how efficient tailoring in corporate law is. Two caveats should be noted though. First, the argument is not that firms never choose their right size, but rather that with respect to agency costs they might not. Second, while this Article discusses a significant body of evidence casts doubt on the firms’ efficient self-selection account, none of it should be viewed as a conclusive proof as to how firms self-select, especially, but not only, since most of the evidence is indirect, in the sense that the many of these studies this Article discusses, were not designed to answer this question directly.

The Article proceeds as follows. Part II discusses the different contexts in which the One-Size Argument was raised to support private ordering. Part III develops a theoretical framework that incorporates heterogeneity in market forces (and as a result, in firms’ needs for governance) to corporate law theory. The framework analyzes separately the choice of governance terms by heterogeneous firms at the midstream stage (after the firm goes public) and at the IPO stage of a firm’s life. It shows that in the midstream stage, inefficient tailoring can exist even if investors have full and perfect information.<sup>27</sup> Thus it also addresses the potential argument that inefficient self selection does not matter if investors know what they buy: even if investors have full information and can accurately price firms, social costs are still borne in terms of suboptimal firms’ value. At the IPO stage, this Part shows, signaling could improve efficiency, but is possible only under certain assumptions, and noise from network externalities, boilerplating, inertia and other forms of random adoption obscures the informational value of the signal.<sup>28</sup> Part IV analyzes and synthesizes evidence from different contexts on how firms self-select into

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<sup>24</sup> Choi, Fisch, Kahan & Rock, *supra* note 9.

<sup>25</sup> On the other hand, it is possible that small firms avoiding regulation is also a form of inefficient self selection. See discussion *Infra* Part IV.E.

<sup>26</sup> See *infra* Parts IV.A. & IV.D.

<sup>27</sup> See Michal Barzuza *Lemon Signaling in Cross-Listing*, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1022282](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1022282)

<sup>28</sup> See Michal Barzuza, *Noise Adopters in Corporate Governance*, 3 COLUM. BUS. L. REV. 627 (2013).



governance arrangements. The evidence spans U.S. and international firms choosing particular governance terms, or entire legal regimes, and different contexts including shareholder proposals, cross-listings and incorporations. While in each case there is evidence that is consistent with the argument of this Article, there is not even one context when the evidence directly support that proposition that firms that need governance are more likely to adopt it, as the One-Size Argument would predict. Part V discusses implications for data interpretation and policy. The analysis suggests caution in drawing policy implications from evidence on voluntarily adopted governance terms. While in analyzing data, self-selection is frequently taken into account, inefficient self-selection of the form described here is rarely acknowledged. The Article argues that as a result of such overlooked self-selection, assessments of the value of corporate governance could suffer from a downward bias.

With respect to the trade-offs between mandatory corporate terms and private ordering, the analysis suggests that the One-Size Argument should not serve as a magic bullet against mandatory corporate law. While one-size mandatory approaches might impose costs on some firms, policy makers should weigh these costs against potential costs from inefficient self-selection. That is the costs of those firms that face weak governance, weak external constraints, and high private benefits—the firms that we have in mind when we design governance constraints, and whose shareholders could benefit most from these constraints—choosing lax constraints. The choice between mandatory law and private ordering, in Ronald Coase words, “has to come from a detailed investigation of the actual results of handling the problem in different ways. But it would be unfortunate if this investigation were undertaken with the aid of a faulty economic analysis.”<sup>29</sup> An informed policymaking would inquire into patterns of self-selection, the reasons why some firms did not adopt governance terms – for example, whether in these firms there was no shareholder support for these terms, or whether managers resisted shareholder proposals to implement them, the characteristics of these firms – their governance and performance, as well as the merits of a proposed regulation, and the extent to which mandatory law could apply selectively to firms with different needs.

Second, the analysis highlights the importance of shareholder proposals and the impediments to efficient self-selection in managers’ requests to exclude them. The analysis and data support the SEC’s recent decision to withdraw a no-action letter given to *Whole Foods’* management and to limit the use of Rule 14-a8(i)(9) to “direct conflicts”. The Article also argues that the SEC should reconsider the high rate of awarding no-action letters in 70% percent of requests since it may deny shareholders their right to vote on proposals that could benefit their firms. In particular, the SEC should be especially minded of management requests to exclude governance proposals, and, for example, interpret broadly the “added restrictions” qualification of a “substantially implemented” basis to exclude a proposal.

Third, the Article highlights an important overlooked role of proxy advisory firms in pressuring Resisting Firms to adopt governance terms. In weighing management responsiveness in annual elections, ISS and Glass Lewis limit managers’ incentives to exclude, or refuse to implement, a shareholder proposal that was support in a shareholder vote. If the Corporate Governance Reform and Transparency Act of 2016 passes, self-selection might worsen. Finally, hedge fund activism also pressure firms that would

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<sup>29</sup> Ronald H. Coase, *The Problem of Social Cost*, 3 J. OF L. & ECON. 1 (1960).

otherwise resist governance, to adopt constraints. Thus, with respect to the proposed Brakow Act, one overlooked dimension that should be taken into account is whether and to what extent hedge funds promote efficient tailoring. The conclusion follows.

## II. What Are the Stakes if Firms do Not Choose their Right Size?

The argument that since one-size-does-not-fit-all corporate law should be left to private ordering has been used widely and broadly, and garnered significant influence.

### A. The One-Size Argument and Mandatory Law

Following Easterbrook and Fischel's—the founders of economic analysis of corporate law—claim: “No one set of terms will be best for all; hence the “enabling” structure of corporate law,” scholars, judges, policy makers, and leading practitioners have repeatedly argued that firm heterogeneity poses a serious challenge for any mandatory corporate law.<sup>30</sup> Accordingly, this reasoning has been a major criticism against legal reforms including Sarbanes-Oxley and the listing standards directors’ independence requirements,<sup>31</sup> Dodd-Frank say-on-pay advisory votes,<sup>32</sup> Dodd-Frank disclosure obligations,<sup>33</sup> disclosure of political contributions,<sup>34</sup> and even the 33 and 34 Securities Acts.<sup>35</sup>

Similarly, when the SEC contemplated implementing a mandatory proxy access rule to remedy the fact that a startlingly low percentage of shareholders’ nominees ever appear on corporate ballots, opposition was quick to argue that the new rule should instead function as a default. A comment letter to the SEC from the law firm of Wachtell, Lipton, Rosen & Katz (“Wachtell”) on proxy access noted: “[U]niformity would do a serious harm in the area of shareholder access to the proxy. . . . This is simply not an area where ‘one size fits all’—and any attempt to fashion a single size for all will impose

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<sup>30</sup> See Easterbrook & Fischel, *supra* note 1.

<sup>31</sup> See e.g., Bainbridge, *Financial Crisis*, *supra* note 1; Macey, *Promises*, *supra* note 1.

<sup>32</sup> See e.g., Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on A Responsible Path Forward*, 63 BUS. LAW. 1079, 1107 (2008) (“state law discussion of executive compensation be less likely to yield rigid and costly one-size-fits-all mandates and more likely to enable flexible, company-specific solutions acceptable to investors and managers.”); John J. Castellani, President of Business Roundtable, Corporate and Financial Institution Compensation Fair of 2009, Jul. 31, 2009 (“Once again, the search for a one-size-fits-all solution to executive compensation has taken us down the wrong path... We remain concerned and encourage policy makers to take a more thoughtful and tailored approach with compensation issues.”).

<sup>33</sup> Gallagher, Tulane CLI 2014, *supra* note 3 (“This mandated intrusion into corporate governance will impose substantial compliance costs on companies, along with a one-size-fits-all approach that will likely result in a one-size-fits-none model instead. This stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.”)

<sup>34</sup> See, e.g., Larry Ribstein, *Should the SEC Regulate Corporate Political Speech?*, Truth on the Market (Aug. 4, 2011) (“[M]any corporations already [are] voluntarily disclosing political spending .... Why not continue the experimentation and evolution rather than locking down a one-size-fits-all rule?”).

<sup>35</sup> Donald C. Langevoort, *The Sec, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1065-66 (2009) (“The costs and benefits of disclosure rules are difficult to parse through, and vary considerably based on the size, structure, and business of the issuer. Many forms of governance are substitutes for each other; one size does not fit all.”).

inappropriate mandates on some companies . . .”<sup>36</sup> On October 7, 2009, Harvard Law School held a corporate law roundtable to discuss SEC proposed Rule 14a-11. The day’s first two sessions focused on whether the SEC should adopt Rule 14a-11 as a mandatory rule or rather should leave it to “private ordering on a company-by-company basis”.<sup>37</sup> Indeed, a common argument favored private ordering to a “one-size-fits-all” mandatory SEC rule.<sup>38</sup> During the second session, this author, raised the argument that under a private ordering solution firms might not choose their right size:

it is also possible that the corporations that opt-in are those that already have a stronger shareholder base... And they may actually need it less on the margin than the corporations that are not willing to opt-in.<sup>39</sup>

As former Dean Bob Clark suggested, inefficient self-selection resonates with observations from practice:

It actually squares very much with attitudes I’ve observed in certain boardrooms. One company I am on the board of could care less about all this. Its because the market loves them.<sup>40</sup>

Yet, the assumption that firms select their right size has remained dominant among policy makers, academics and practitioners. Accordingly, the One-Size Argument is playing an important role in current policy debates. For example, in its 2016 and 2017 spending bills, Congress exercised its power to limit SEC spending on its plans to adopt one-size universal proxy access, and disclosure of political contribution rules.<sup>41</sup> Or, in front of the SEC are now comment letters that advocate cutting back on one-size prescriptive disclosure obligations in favor of a flexible approach that will be better tailored to firms’ specific needs.<sup>42</sup> The comment letters submitted in response to SEC’s

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<sup>36</sup> Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Aug. 17, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-263.pdf>. *See also* Letter from Cravath, Swaine & Moore LLP; Davis Polk & Wardwell LLP; Latham & Watkins, LLP; Simpson Thacher & Bartlett LLP; Skadden, Arps, Slate, Meagher & Flom LLP; Sullivan & Cromwell LLP; and Wachtell, Lipton, Rosen & Katz, to Elizabeth Murphy, Secretary, SEC (August 17, 2009), *available at* <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf> [hereinafter, the “SevenFirm Letter”] (“a company and its stockholders would benefit from the flexibility to adopt the type and form of proxy access standard that best reflects the will of the stockholders, rather than a uniform, one-size-fits-all standard”). Finally the rule passed 3-2 with two dissenting commissioners criticizing the rule one size approach relative to a private ordering arrangement. The federal court struck it down and we were left with the Delaware private ordering approach under DGCL 112. See discussion *infra* section \_

<sup>37</sup> *See* Bebhuk & Hirst, *supra* note 242.

<sup>38</sup> *See Id.*, at 11-12, 34, 44-45, 43-44, 49-50.

<sup>39</sup> *Id.*, at 49.

<sup>40</sup> *Id.* As shown in *Infra* Part IV.D,

<sup>41</sup> Fiscal Year 2016 Financial Services Bill, section 625; Fiscal Year 2016 Financial Services Bill, section 625; *see also* Yin Wilczek, *Panelists at SEC Roundtable Spar Over Benefits of Universal Proxy Cards*, Bloomberg BNA’s Corporate Law & Accountability Report (February 20, 2015) (“Frederick Alexander, counsel at Morris, Nichols, Arshnt & Tunnell LLP in Wilmington, Del, suggested that enabling—but not mandating—universal ballots may be a better way to go...rather than requiring a one-size-fits-all for universal proxy cards, private ordering could be a way of addressing some of the concerns raised”). <http://www.bna.com/panelists-sec-roundtable-n17179923262/>

<sup>42</sup> *See e.g.*, Letter from The US Chamber of Commerce to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (July 20, 2016) (“In the SEC’s effort to modify Regulation S-K, we caution against the use of rigid, one-size-fits-all disclosure methods, which we believe would perpetuate existing problems

Concept Release S-K 2016, “Disclosure Effectiveness Initiative”, could result in relaxing longstanding disclosure mandates.<sup>43</sup>

## B. The One-Size Argument and Modern Corporate Governance

The assumption that firms voluntarily choose their right “size”—that is, the governance terms that fit their particular needs—has significant implications also for modern corporate governance, namely governance that is shaped less frequently by mandatory law and more frequently by the combined influence of market players - shareholder activists, who submit proposals for governance changes; hedge fund activist; and proxy advisory firms, that make recommendations to institutional investors how to vote, and rank companies on their governance quality.<sup>44</sup>

### *1. Proxy Advisory Firms, Voting Recommendations, and Pending Reform*

The One-Size Argument was apparent in recent congressional hearings for the Corporate Governance Reform and Transparency Act of 2016 (formerly known as the Proxy Advisory Reform Act), which if passed would limit the activities and influence of proxy advisory firms.<sup>45</sup> The U.S. Chamber of Commerce Statement, for example, supported the reform, arguing that:

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with lengthy disclosure that is of limited use to investors.”); Letter from Davis Polk & Wardwell to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (July 22, 2016)) (“a materiality- centered, principles-based disclosure framework will elicit more relevant and useful information than a strictly rule-based framework by providing more flexibility for registrants to use their judgment in disclosing information that they believe is material to investors depending on registrants’ unique facts and circumstances... “); Letter from Wachtell, Lipton, Rosen & Katz, to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (May 16, 2016) (...“Issuers should also be provided with greater flexibility in the types of information required.”).

<sup>43</sup> See Chair Mary Jo White, Statement at an Open Meeting on Regulation S-K Concept Release, April 13, 2016 (“In addressing these questions and others, the concept release takes a broad, “step-back” look at how we can make our disclosure regime better and more useful in 2016 and beyond.”); See also Jennifer Nejad Poer, Danielle Van Wert and Jason M. Halper, Regulation S-K Concept Release: Will the SEC Reform the Norm for Corporate Disclosures? May 3, 2016 (“we can expect that the SEC’s future rulemaking will heavily reflect the public feedback it receives in response to the release.. In the words of Chair White in discussing the release, the public should “stay tuned” as the SEC continues to develop recommendations to update and enhance the range of its disclosure requirements.”); Tom Zanki, SEC Disclosure Regs Primed For Cleanup, Not Renovation, Law360, New York (April 21, 2016, 5:38 PM ET) (“lawyers say the review provides a fresh opportunity to trim one-size-fits-all rules that have been accumulating for decades, but some doubt that the process will generate bold changes... The idea behind a principles-based approach is that companies can tailor their disclosures to better reflect their specific circumstances, making them more material to investors.”)

<http://www.law360.com/articles/786898/sec-disclosure-regs-primed-for-clean-up-not-renovation>.

<sup>44</sup> See e.g. Martin Lipton, Wachtell, Lipton, Rosen & Katz, (January 21, 2012) Disintermediating the Proxy Advisory Firms, The Harvard Law School Forum on Corporate Governance and Financial Regulation (“We have long eschewed the one-size-fits-all model of corporate governance advanced by many of the proxy advisory firms.”); David F. Larcker & Allan L. Mccall, Proxy Advisers Don't Help Shareholders, WSJ, Opinion (Dec 8 2013) (“Proxy Advisers Don't Help Shareholders. The 'best practices' they want companies to adopt are more accurately termed one-size-fits-all best guesses.”); J. Glassman and H. Peirce, *How Proxy Advisory Services Became So Powerful*, Mercatus on Policy (June 2014), at p. 2 (“One-size-fits-all recommendations miss the nuances of particular corporations”).

<sup>45</sup> H.R.5311: Corporate Governance Reform and Transparency Act of 2016

in making one-size-fits all recommendation that Say on Pay must be held every year for all companies, ISS and Glass Lewis thwarted the public policy choice made by Congress and cut off the ability of shareholders to debate and decide the issue.<sup>46</sup>

Similarly, supporting the reform, a former SEC commissioner, Daniel M. Gallagher, criticized proxy advisory firms' one-size voting policies in favor of shareholder proposals for de-staggering boards, removing poison pills, and other governance changes.<sup>47</sup> Statements from corporate representatives and corporate advisors in support of the reform echoed these concerns.<sup>48</sup>

Yet, if firms do not choose their right "size", then proxy advisory firms support of certain governance changes – such as de-staggering boards or removing poison pills– is needed to incentivize the managers of Resisting Firms, i.e. managers of firms that could benefit from these changes but wouldn't have adopted them voluntarily – to follow through. Consequently, even if they apply one-size policies, proxy advisory firms might be actually contributing to efficient tailoring in corporate governance. Furthermore, ISS and Glass-Lewis also explicitly recommend that shareholders consider withholding votes from management in annual elections if the management was not responsive to shareholders expressed preferences. For example, if the management fought vigorously a shareholder proposal, by either trying to inappropriately excluding it (not bringing it to shareholder approval) or if management did not implement a shareholder proposal that

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<sup>46</sup> A Statement of the US Chamber of Commerce to the House Committee on Financial Services (May 17, 2016). <http://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-tquaadman-20160517.pdf>.

<sup>47</sup> Testimony of Daniel M. Gallagher President Patomak Global Partners, LLC Before the United States House of Representatives Committee on Financial Services (May 17, 2016) ("they base some recommendations on a cookie-cutter approach to governance – i.e., in favor of all proposals of a certain type, like de-staggering boards or removing poison pills, even if there is a sound basis for challenging the assumption that an otherwise beneficial governance reform might not be appropriate for a given company."). <http://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-dgallagher-20160517.pdf>

<sup>48</sup> See e.g., Statement of the Society of Corporate Secretaries & Governance Professionals and the National Investor Relations Institute Before the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services ("The proxy advisory firms then apply these policies using a "one-size-fits-all" approach that imposes the same standards on all public companies, instead of evaluating the specific facts and circumstances of each company they evaluate."); A letter from WorldatWork the total reward association, to the Honorable Sean P. Duffy, Congressman, re: H.R. 5311 – Corporate Governance Reform and Transparency Act of 2016 (July 8, 2016) ("WorldatWork promotes principled pay practices and believes that business strategies and executive compensation program design are unique and should be tailored to the specific needs of individual organizations. Successfully aligning pay and performance is not achieved through a one-size-fits-all approach; rather, it benefits from flexibility in design"); Council of Institutional Investors on the other hand objected the reform, which, they argue, could expose proxy advisory firms to high litigation risk. See *Council of Institutional investors – the Voice of Corporate Governance* ("We strongly oppose HR 5311, which aims to tighten regulation of proxy advisory firms to the detriment of investors. We believe the bill could weaken public company corporate governance in the United States; lessen the fiduciary obligation of proxy advisors to investor clients; and reorient any surviving proxy advisors to serve companies rather than investors ... We believe that proxy advisory firms play an important and useful role in enabling effective and cost-efficient independent research, analysis and informed proxy voting advice. In our view, the bill could undermine advisory firms' ability to provide a valuable service to investors.") [http://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2016/06\\_13\\_16\\_FINAL\\_Letter\\_on\\_Proxy\\_Advisory\\_Firm\\_Bill.pdf](http://www.cii.org/files/issues_and_advocacy/correspondence/2016/06_13_16_FINAL_Letter_on_Proxy_Advisory_Firm_Bill.pdf)

received support from a majority of the shareholders' votes.<sup>49</sup> If, contrary to conventional assumptions, firms do not choose their right "size", management will tend to resist implementing shareholder proposals exactly when these proposals could benefit the firm. Thus, Proxy Advisory firms' policies to consider management responsiveness, again, improve tailoring rather than demote it. Ironically, also these policies, to take into account management responsiveness to shareholder concerns, were criticized based on the One-Size Argument:

This approach [one-size-fits-all] includes the potential for across-the-board "withhold votes" from directors if the directors fail to implement any shareholder proposal receiving a majority vote, even if directors believe that the proposal would be inconsistent with their fiduciary duties and the best interests of the company and its shareholders.

## 2. Shareholder Proposals and SEC No-Action Letters

Corporate governance is now shaped to a large extent by shareholder proposals—which are becoming a main catalyst for corporate governance changes. Shareholder proposals are commonly understood as a quintessential manifestation of private ordering—they must be both submitted and approved by shareholders who are presumably interested in making firm-specific improvements—and for this reason are often considered a superior means to a mandatory rule in implementing governance changes. Yet, recently, even these proposals, have become the target of the One-Size Argument.

This part will discuss the recent dynamics with respect to the most prevalent governance proposal of the last two proxy seasons – a proxy access shareholder proposal. The SEC's proxy access rule life was extremely short. Shortly after its adoption the U.S. Court of Appeals for the D.C. Circuit has struck down the rule, reasoning that the SEC acted capriciously and arbitrarily by not having sufficient evidence. What was left, then, is Delaware private ordering proxy access regime, which allows shareholders to submit proposals to implement a proxy access bylaw.

Several individual shareholders submitted such proposals to a number of Delaware firms during the 2015 proxy season. As part of the so-called *Boardroom Accountability Project*, one such shareholder, New York City Comptroller Scott Stringer, submitted proxy access proposals to seventy-five companies specifically picked based on known problems associated with compensation, diversity and environmental concerns. Despite the Comptroller's careful selection of firms, the Comptroller has drawn criticism for using a one-size-fits-all approach.<sup>50</sup> Each of the Comptroller's proposals sought to implement the same proxy access format: a "three-by-three" proposal termed as such because it allows any shareholder that has owned at least a three percent stake for at least three years, under certain circumstances, to add up to three (or 25% of the board size) directors nominees to the firm proxy materials. For this reason, critics have objected to it as one-sized in nature and thus inappropriately inflexible.<sup>51</sup>

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<sup>49</sup> See discussion *infra* Part V.D.

<sup>50</sup> See e.g., David A. Katz, Wachtell, Lipton, Rosen & Katz, *Proxy Access Proposals for the 2015 Proxy Season* (Friday November 7, 2014) ("We hope institutional investors will continue to be willing to take this case-by-case approach, despite the one-size-fits-all pressure being brought to bear by the New York City Comptroller.") available at <http://blogs.law.harvard.edu/corpgov/2014/11/07/proxy-access-proposals-for-the-2015-proxy-season/#more-66664>.

<sup>51</sup> See *id.*

Furthermore, in some firms management also resisted the proposals, by seeking to exclude them rather than bringing them to a shareholder vote. To that end, management relied on a rarely-used exception to SEC shareholder proposal rules. Under Rule 14a-8(i)(9), a proposal can be excluded if it “directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting.”<sup>52</sup> Relying on this exception, management at *Whole Foods* Company fought a three-by-three proxy access proposal submitted by James McRitchie, a shareholder activist. *Whole Foods*’ management submitted an alternative proposal that conditioned proxy access on holding a nine percent ownership stake for at least five years. *Whole Foods* then requested and received a no-action letter from the SEC to verify its ability to exclude McRitchie’s three-by-three proposal on the grounds that it conflicted with management’s nine-by-five proposal. Not one *Whole Foods*’ shareholder met the nine-by-five threshold. Shortly thereafter, Chipotle Mexican Grill, Inc. submitted a similar request to the SEC after submitting a similarly conflicting eight-by-five proposal, and management in twenty-four other companies have since followed.<sup>53</sup> Then, in a surprising move, the SEC reneged; it decided to further investigate the conflicting proposals exception and announced that it would not issue a no-action letter under this exception until its investigation concluded.<sup>54</sup> Opposition was quick to follow. The Business Roundtable, for example, applauded the piecemeal approach of the *Whole Foods* management team, stating that their “philosophy is that one-size-fits-all corporate governance is not a good public policy.”<sup>55</sup> And a former SEC commissioner reasserted his objection to the current system that facilitates shareholder proposals:<sup>56</sup>

I have already been advocating for a comprehensive review of Rule 14a-8 on shareholder proposals, the failings of which were highlighted in a speech I gave last year. . . . My concerns about the rule’s many deficiencies have subsequently been borne out, including through . . . the decision to withdraw the *Whole Foods* no-action letter pending review of 14a-8(i)(9).<sup>57</sup>

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<sup>52</sup> CFR § 240.14a-8(i)(9). Management could not rely on the more frequently used exceptions, 14a-8(i)(1) and 14a-8(i)(7) since the proposals did not violate applicable Delaware law—the Delaware General Corporate Law (“DGCL”) allowed them explicitly and they did not interfere with the board’s exclusive legal right to manage the company.

<sup>53</sup> See Chipotle letter to SEC <http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2015/comptrollernewyork010215-14a8-incoming.pdf>.

<sup>54</sup> <http://www.corporatefinancialweeklydigest.com/2015/01/articles/seccorporate-1/sec-chair-directs-staff-to-review-commission-rule-excluding-conflicting-proxy-proposals/>

<sup>55</sup> See John Surcio, *The Fight to Make Corporate America a Little More Democratic*, Vice (Mar. 10, 2015), available at <http://www.vice.com/read/can-corporate-america-really-be-democratized-310>.

<sup>56</sup> See also Gallagher, Tulane CLI 2014, *supra* note 5. In particular, Commissioner Gallagher has advocated two amendments to 14a-8, as well as changes to its enforcement mechanisms, that will raise the threshold of who can submit a shareholder proposal, narrow the types of proposals that can be submitted, and limit submission frequency. *Id*

<sup>57</sup> Opening Statement at the Proxy Voting Roundtable, Commissioner Daniel M. Gallagher, Feb. 19, 2015 available at [http://www.sec.gov/news/statement/opening-statement-proxy-voting-roundtable-gallagher.html#\\_VP-mA0KGm-Q](http://www.sec.gov/news/statement/opening-statement-proxy-voting-roundtable-gallagher.html#_VP-mA0KGm-Q); See also Gallagher, Tulane CLI 2014, *supra* note 5. In particular, Commissioner Gallagher has advocated two amendments to 14a-8, as well as changes to its enforcement mechanisms, that will raise the threshold of who can submit a shareholder proposal, narrow the types of proposals that can be submitted, and limit submission frequency. *Id*

In October 22, 2015 the SEC issued its policy on “conflicting proposal” exception, that *Whole Foods* management relied on, which limits its use to proposals that pose such a direct conflict that “a reasonable shareholder could not logically vote in favor of both proposals”.<sup>58</sup> If firms do not choose their right “size”, and if as this Article argues managers might resist exactly these proposals that could benefit shareholders, the SEC *Whole Food* decision was a step in the right direction. But the game is not over. Companies now may be turning to Rule 14a-8(i)(10), which allows exclusion of “substantially implemented” proposals, and was used by the management of General Electric to exclude a proxy access proposal. The question becomes then, how will the SEC interpret its test of whether or not the company implemented “additional restrictions” to the shareholder proposals.<sup>59</sup>

The forgoing examples demonstrate the significant influence of the assumption that firms choose their right “size” on corporate law and governance. The literature, however, has not subjected this assumption to a rigorous theoretical and empirical scrutiny, a task to which this Article now turns.

### III. Theoretical Framework for Heterogeneous Firms - Why Firms Might Not Choose their Right Size – the Emergence of Resisting Firms

This part introduces firms’ heterogeneity to the classic theory of corporate law – the contractual framework – and analyzes its applications. Following the classic theory, this Part will treat separately two stages in the firm’s life: the first section will discuss choice of law at the midstream stage, namely when the firm is publicly traded and the manager holds a small fraction of the shares, and the second section will take a step back and discuss choice of law at the IPO stage, right when the firm goes public.

#### A. One-Size-Does-Not-Fit-All: Why Some Firms might not Benefit from Adding Governance Constraints?

The gist of the One-Size Argument is that firms’ needs for specific legal constraints vary significantly. Why do some firms need legal constraints less than others? Corporate law and governance constraints such as fiduciary duties, independent boards, majority voting, proxy access rules, and non-classified boards are designed to reduce managerial agency costs. Since managers tend to hold only a small fraction of a given firm’s cash flow, theoretically they could be tempted to make inefficient decisions that benefit themselves at the shareholders’ expense. Corporate law and governance constraints limit private benefits for managers, and accordingly mitigate the resulting (often larger) harm

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<sup>58</sup> Whole Foods’ management proposal is not considered a conflicting proposal according to this standard since a shareholder who supports a proxy access rule, would have supported Whole Foods’ shareholder proposal and management proposal, if the latter were his only option. Division of Corporation Finance, Securities and Exchange Commission, Shareholder Proposals, Staff Legal Bulletin No. 14H (CF) (October 22, 2015).

<sup>59</sup> Michael Green, SEC Rule to Play Major Role in Proxy Access: Attorneys, Bloomberg News BNA (Jan 21) <http://www.bna.com/sec-rule-play-n57982066686/> (“At the webinar, Gumbs and Brown said companies may now be turning to Rule 14a-8(i)(10) to exclude shareholder proxy access resolutions partly as a response to SEC staff guidance that makes it more difficult to obtain no-action relief under the commission's “directly conflicts” exemption—Rule 14a-8(i)(9).”)



to shareholders. Yet, when a new governance term is introduced firms face varying degrees of other constraints – legal and non-legal ones, that in some cases, might obviate the need for additional governance terms.

To begin with, there are other sources, besides legal constraints, that discipline managers. In many firms, market forces—such as the market for corporate control, the market for capital, the product market, and the managerial labor market—provide significant discipline for managers. If managers spend their time playing golf, use the company jet to fly their dog to its next grooming appointment, or make excessive acquisitions, they could be replaced in a hostile takeover, harm their reputation and their future job prospects, or otherwise simply not withstand fierce competition from other firms. If these sorts of external constraints apply and cause managers to perform well, additional legal constraints will make either a small difference or none at all. For a given firm, then, the value of implementing legal constraints will depend on the strength of the market forces at work.

Consider, for example, the requirement to have a majority of independent directors on the board. Because independent directors are not beholden to management, they are well positioned to monitor management’s choices, thereby constraining the inefficient decisions that derive from agency problems. Yet, as Steve Bainbridge explains monitoring is less valuable when other constraints are in place:

[E]xternal markets for managerial services, the market for corporate control, incentive compensation systems, and auditing by outside accountants, are just some of the ways in which management is held accountable for its performance. The importance of the board’s monitoring role in a given firm depends in large measure on the extent to which these other forces are allowed to function.<sup>60</sup>

Nominating independent directors in a firm that has sufficient constraints could reduce shareholder value since independent directors also tend to lack the same degree of industry- and firm-specific knowledge and expertise that inside directors have.<sup>61</sup> Similar tradeoffs apply with respect to other governance terms. Fiduciary duties align managers’ incentives with those of shareholders, but they also encourage frivolous lawsuits and costly settlements. Disclosure rules subject managers to higher transparency, but they could result in high implementation and compliance costs. Legal constraints should be applied only in those firms in which their benefits are sufficiently large to outweigh their costs, that is, “in those corporations in which market-oriented governance mechanism are relatively less important or influential.”<sup>62</sup>

A second value-determinative characteristic that private ordering proponents point to is a given firm’s set of internal constraints and governance: “[M]anagers of a firm with strong takeover defenses are less subject to the constraining influence of the market for corporate control than are those of a firm with no takeover defenses. The former needs a

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<sup>60</sup> See Bainbridge, *Financial Crisis*, *supra* note 1; see also Macey, *Promises*, *supra* note 1 (“For example, companies that receive substantial outside scrutiny from the markets...may need less monitoring from directors”).

<sup>61</sup> *Id.* (“purported reforms that “reduce the board’s role to monitoring and constrain corporation’s ability to choose a managing board threaten to deprive corporations of the full opportunity to utilize the board of directors as a resource.”)

<sup>62</sup> See Barry Baysinger & Henry Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 459 (1985) [hereinafter *Uniformity In Corporate Law*].

strong monitoring board more than does the latter.”<sup>63</sup> Since different firms select widely divergent governance packages from the cornucopia of available terms, firms’ internal governance and constraints vary significantly. Accordingly, so does their need for any particular legal constraint.

Finally, firms also vary in how costly it is for them to implement and comply with the law. Since implementation and compliance costs frequently include a fixed component, they are often proportionally higher for smaller firms. Thus, to be desirable for small firms, these legal arrangements would need to create significant offsetting benefits. Proponents of private ordering, however, seems to be less worried about this difference, probably because they are observable and could be, and have been, accounted for by regulators. For example, SOX accommodates small firms—defined by applicable law as companies whose market capitalization does not exceed \$75 million—by exempting them from the § 404(b) requirement to retain an independent auditor to attest to the issuer’s internal control over financial reporting.<sup>64</sup> Similarly, Dodd-Frank makes a number of accommodations for small banks: Banks with under \$1 billion in assets need not comply with the Act’s employee incentive compensation provisions;<sup>65</sup> banks with total assets under \$10 billion are not subject to supervision by the Consumer Financial Protection Bureau;<sup>66</sup> and the same sub-\$10 billion banks need not conduct the stress tests that larger banks must commission.<sup>67</sup> These sorts of structural exemptions enable mandatory laws to accommodate certain observable, firm-specific differences.

#### B. Would Firms Choose their Right Size? The Shortcomings of Classic Theory

The previous part has shown that firms that face weak alternative constraints, are the ones that could benefit most from legal constraints. The next question, however, is whether these firms are also more likely to submit to governance constraints voluntarily, to add independent directors, separate the CEO chairman position, or add a proxy access bylaw as the one-size argument assumes.

The assumption that these firms are likely to adopt governance constraints voluntarily relies on an appealing intuition: Firms that face weak alternative constraints, since they stand to benefit most from governance constraints, are likely to adopt them voluntarily. Yet, while it is persuasive that governance is more valuable for firms with weak constraints, the second building block of the argument—that these firms will also voluntarily select constraints—this Article argues, is not that simple. In particular, it is not that clear why would the managers of these firms be the first in line to tie their hands and give up the high private benefits they chose to extract. Intuition might as well suggest that these managers would be the least likely to adopt additional ones.

On a more rigorous level, classic theory divides the analysis of choice of law and governance to two different stages – the IPO stage, when the firm first goes public, and

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<sup>63</sup> Bainbridge, *Financial Crisis*, *supra* note 1.

<sup>64</sup> See 15 U.S.C. § 7262(b)–(c) (2012) (describing the attestation requirement and providing that only “large accelerated filers” and “accelerated filers” must comply); 17 C.F.R. 240.12b-2(1)–(2) (defining “large accelerated filers” as companies with market capitalizations between \$75 million and \$700 million and “accelerated filers” as companies with market capitalizations above \$700 million, among other requirements).

<sup>65</sup> See 12 U.S.C. § 5641(f) (2012).

<sup>66</sup> See *id.* §§ 5481(24), 5516 (2012).

<sup>67</sup> See *id.* § 5365(i)(2)(A).

the Midstream stage, when the IPO is completed and the firm shares are being traded in the market—and analyzes managers’ incentives in each stage. This part will discuss the shortcomings of the analysis in each stage, as applied to heterogeneous firms. The following Sections describe the shortcomings of the analysis as applied to heterogeneous firms at the IPO stage and the Midstream stage respectively.

### *1. The Midstream Stage – Shortcomings in Classic Theory of Heterogeneous Firms*

When the firm is publicly traded, its manager typically holds only a small fraction of the firm’s cash flow rights. As a result, at this stage—the Midstream Stage (as opposed to the IPO stage when the firm goes public)—which spans most of the firm life, managers’ incentives are not perfectly aligned with those of shareholders. The manager may seek high inefficient compensation, may use the company jet excessively, and similarly may seek lax corporate law and governance terms.<sup>68</sup> For example, a manager may seek to institute a takeover defense against a hostile takeover even if shareholders find a takeover desirable. Or, a manager might not implement a newly introduced majority voting or proxy access bylaws, proposed by shareholders.<sup>69</sup>

Classic theory’s common answer to this problem focuses on market forces—the market for corporate control, the market for capital, the market for managerial labor and the market for products—penalize managers for poor management choice, for taking excessive perks, and also for making poor law and governance choices. For example, if managers choose a poor investment, or equivalently choose poor corporate law, their firms’ performance would suffer, share value would decline, and hostile bidders might identify them as fresh takeover opportunities.<sup>70</sup> Further, poor performance makes capital more costly to raise,<sup>71</sup> worsens managers’ hiring prospects,<sup>72</sup> and decreases the likelihood that the firm will survive fierce competition from other firms.<sup>73</sup> These market forces thus, incentivize managers to manage efficiently, avoid excessive perks and adopt appropriate governance constraints.

Applying this framework to heterogeneous firms, that is, firms with different needs for governance—classic theory holds that these market forces will also incentivize managers to choose the right “size” of governance, the one that best fits their firm’s particular needs:

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<sup>68</sup> See e.g., Lucian A. Bebchuk, *the Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

<sup>69</sup> See e.g., Easterbrook & Fischel, *The Corporate Contract*, *supra* note 1, at 1443.

<sup>70</sup> See e.g., Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965). Ralph K. Jr. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. OF LEG. STUD. 2 (1977); Daniel R. Fischel, *The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law*, 76 NW. U. L. REV. 913, 919-20 (1982).

<sup>71</sup> Frank H. Easterbrook, *Managers’ Discretion and Investors’ Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543-546 (1984); Winter, *supra* note 70, at 275.

<sup>72</sup> See *Id.*, at 554; Daniel R. Fischel, *The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law*, 76 NW. U. L. REV. 913, 919 (1982); Winter, *supra* note 70, at 256-57.

<sup>73</sup> Frank H. Easterbrook, *Managers’ Discretion and Investors’ Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 553-554 (1984); Winter, *supra* note 70, at 264. *Cf.*, Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition*, 105 HAR. L. REV. 1435, 1487 (1992) (arguing that market forces are limited, and analyzing their shortcomings in disciplining managers).

Markets lead managers to adopt the optimal mix of legal and market governance structures for their own firm. The optimal mix reflects the preferences of the firm's residual claimant.<sup>74</sup>

But therein lies an *inherent tension*. Recall that firms that need governance terms most are the ones that face weak constraints—due to weak market forces and/or strong entrenching devices. If market forces are not sufficiently strong to drive managers to perform at their best, why would they be sufficiently strong to drive managers to choose an effective governance regime? Furthermore, firms that face relatively weak market forces are more vulnerable to inefficient extraction of private benefits. Managers of these firms extract higher private benefits than managers in firms that are disciplined by markets, and thus have more to lose by committing to a strict law.<sup>75</sup> Given the combination of low market penalties and high private benefits consumption, managers facing weak market forces might as well be more likely to *avoid* legal constraints than to welcome them.

Put differently, the problem with the classic analysis as applied to heterogeneous firms, is that it relies on market forces to compensate for the lack of market forces.

## 2. *The IPO stage – Shortcomings in Classic Theory of Heterogeneous Firms*

When the firm goes public, at the IPO stage, unlike in the midstream stage, the manager and the investors hold all of the shares of the company, and therefore internalize the costs and benefits of her choices. If the manager offers a law or a governance mechanism that benefits her at the shareholders' expense her firm's shares will be devalued. When the firm first goes public thus, to maximize the IPO price, conventional wisdom holds that the manager has incentives to offer optimal governance.

The IPO stage's optimality, therefore, hinges on the assumption that capital markets value governance terms correctly. The assumption is reasonable if firms do not vary in their need for governance, professionals in the market - who could benefit from trading on their research - assess the value of governance terms such as proxy access and staggered board, based on information that is publicly available. That-one-size-does-not-fit-all however, implies that governance terms' value is firm-specific. The value of proxy access, or a staggered board, if implemented in firm A that needs governance, is different from the value of that same term, if implemented in firm B that does not need governance. Accordingly, for investors to price shares correctly at the IPO, they would need to know the value of staggered board and proxy access in each firm, in light of its specific circumstances. Yet, operative market forces and the extent to which they apply for each specific firm are often unobservable. Managers know the constraints that they expect to face better than investors. They might not be able to predict them exactly, but they are likely to have some private information about their firm-specific market constraints. They also have private information regarding other constraints they might face, e.g., how strict is their board chairperson, what opportunities they will have for self-

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<sup>74</sup> Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 182-183 (1985) [Baysinger & Butler, *The Role of Corporate Law*].

<sup>75</sup> See, e.g., Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463 (2001) (arguing that increased monopoly rents induce higher potential agency costs); Maria Guadalupe, Francisco Perez-Gonzalez & Fangzhou Shi, *Competition and Private Benefits of Control* (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=890814](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890814) (finding that competitive industries are associated with lower control premiums).

dealing and so forth. The One-Size Argument, in fact, holds this as a premise: mandatory law is undesirable since only managers know what's best for their firms.<sup>76</sup> Indeed, classic theory has acknowledged that market price will not reflect managers' private information about their firm-specific circumstances.

Prices do not reflect very well information that is not available to the public. They reflect the value of stock to public investors with scattered holdings rather than to insiders or others with the ability to control the firm's destiny. For any given firm, there will be an irreducible amount of error in the pricing—after all, information that increases the accuracy of prices is costly, and the “perfect price” may cost more to achieve than it is worth.<sup>77</sup>

However, classic theorists argue, as long as frictions and mistakes in the capital market do not result in a systemic bias – that is, as long as they sometimes undervalue and sometimes overvalue governance terms – managers still have the right incentives:

Unless prices are systematically wrong about the effects of features of governance, as opposed to being noisy and uninformative, managers still have appropriate incentives...We therefore treat even hard-to-value terms as contractual.<sup>78</sup>

And since regulators do not have perfect information either, they point out, mandatory law will also be affected by noise and mistakes.<sup>79</sup> Thus, private ordering remain superior to legal intervention even though prices are not perfect.<sup>80</sup>

Yet, according to conventional economic theory, asymmetric information with respect to each firm's specific needs, could easily lead to a systemic bias. If investors can assess the effect of proxy access on an average firm, but not its individual effect in particular firms, market prices of governance at the IPO could suffer from *adverse selection*. Adverse selection may bias governance prices downward, resulting in insufficient incentives for managers to adopt them. For example, assume that for firm A, a proxy access term adds \$6M in value. Assume also that firm B faces significant disciplining market forces and as a result, the added value of a proxy access is only \$1M for this firm. If investors do not know the exact market forces each firm is facing and as a result the exact value of proxy access in each firm, they will instead apply an average value to a proxy access term, namely, \$3.5M. Whether or not firm A will then adopt a governance term, a full analysis below will show, depends on different factors such as available signaling mechanisms and how much noise is involved.

This potential adverse selection, a basic economic concept and intuition, is a direct application of firm heterogeneity, which was overlooked by classic theory. While classic theorists recognized that a systemic bias in prices if existed could result in inappropriate incentives for managers. And while they assumed private information with respect to

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<sup>76</sup> See e.g. Joseph Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUSINESS LAWYER 361 (February 2010) (“Because I (and you) don't know how to structure a proxy access regime that is suitably tailored to address the individual circumstance of the almost 12,000 publicly traded corporations in the United States, it makes sense to support a fully enabling approach”).

<sup>77</sup> See Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1432-33 (1989)

<sup>78</sup> See *Id.*, at 1432-33 (1989).

<sup>79</sup> *Id.* (“it does not matter if markets are not perfectly efficient, unless some other social institution does better at evaluating the likely effects of corporate governance devices.”)

<sup>80</sup> *Id.* (“To say that the price of a stock reflects the value of the firm's governance and related rules is not necessarily to say that the price does so perfectly.... There may be surprises in store, for a firm or for all firms, that make estimates about the effects of governance provisions inaccurate.”)

firm-specific factors, they also mistakenly assumed that asymmetric information, and incorrect pricing, lead to mere noise as oppose to systemic bias.

### C. Midstream Stage Heterogeneity Analysis: Weak Market Forces Entail Weak Penalties and High Private Benefits

The analysis starts from the midstream stage, and will focus primarily on this stage as it spans the entire firm's life, and since most of the decisions about a firm's governance are made at this midstream stage. As explained above the classic analysis assumed that firms that face weak market forces are most likely to adopt alternative constraints, simply because they could benefit from them. As the analysis here will show, the effects of weak market forces on managers incentives are more complex. While on the one hand the potential increase in value provides incentives to managers to adopt governance constraints, on the other hand, due to the lack of market constraints, these anticipated changes in value may have little bite.<sup>81</sup>

To illustrate, let  $X$  denote the market forces that firm A faces, and let  $B(X)$  denote the private benefits that the manager of firm A extracts, via, for example, high compensation or perks. Assume that  $B(X)$  decreases in  $X$ , that is, the weaker the disciplining market forces, the higher the private benefits the manager can extract. Assume also that the extraction of private benefits reduces share value to shareholders of firm A by  $V(X)$ , and thus a governance term ("GT"), that limits the manager's extraction of private benefits, could increase firm's A share value by  $V(X)$ .  $V(X)$  decreases in  $X$  – that is, firms that face weak market forces will benefit more from adding GT.

Finally, assume that  $P(X)$  represents the manager's market penalty for not choosing GT. For example,  $P(X)$  could represent the likelihood that the manager will be replaced in a hostile takeover or targeted by a hedge fund activist.  $P(X)$  increases both in  $V(X)$  and in  $X$ .  $P(X)$  increases in  $X$  since by definition, the stronger the disciplining market forces, the higher the penalty they inflict.  $P(X)$  also increases in  $V(X)$  since the more the firm's could benefit from GT, the higher the incentives for hostile bidder to takeover the firm, replace management and implement GT. Put differently, A high  $V(X)$  implies that the shares of firm A are highly undervalued if the firm did not adopt GT, and the higher therefore the risk of a market penalty for the manager. For now thus assume (without loss of generality) that  $P(X) = X \cdot V(X)$ .

If  $V(X) > B(X)$ , then GT is efficient ("Efficient GT"), and if  $V(X) < B(X)$ , then GT is inefficient ("Inefficient GT"). As shown in Table 1, The manager will not always adopt an Efficient GT. Assuming that the manager holds a fraction  $a$  of the firm's shares, the manager will adopt GT if and only if ("iff")  $a \cdot V(X) + P(X) > B(X)$ , that is iff  $a \cdot V(X) + X \cdot V(X) > B(X)$ . Thus, the higher fraction  $a$  she holds, and the stronger the penalty  $P(X)$  she faces for not adopting an Efficient GT, the more likely is the manager to adopt an Efficient GT.

How will the strength of market forces  $X$  affect the manager's incentives? As this illustration shows the effect is ambiguous. Take for example a firm that faces weak market forces and thus could benefit from adopting GT. If market forces  $X$  are weak, the

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<sup>81</sup> For a full formal model of these effects, which this analysis builds on, see Michal Barzuza, *Lemon Signaling in Cross-Listing* Virginia Law and Economics Research Paper No. 2012-03. <http://ssrn.com/abstract=1022282>

decline in share value from not adopting the governance term  $V(X)$  is relatively large. Thus a hostile bidder who takes over the company or a hedge fund activist, could gain high profits by forcing management to implement GT. Put differently, a hostile bidder has stronger incentive takeover a company if GT could significantly increase firm value than in the case where the firm already faces constraints, and therefore GT could contribute only little to the firms' value. The classic intuition that managers that face weak discipline are likely to adopt legal constraints, thus, has some basis.

But the manager's calculus is more nuanced. Since  $P(X) = X*V(X)$ ,  $P(X)$  also increases in  $X$ . Put differently, that a firm faces weak market discipline means that something is lacking. For example, it could be that there are only few or no potential bidders for the firm's business. Or it could mean that the company has powerful defensive tactics like a poison-pill and a staggered board that enable its board to practically block any hostile bidder. Regardless of the large decline in market value, thus, the likelihood of a hostile takeover may be close to zero. Furthermore, managers of firms that face weak market competition extract relatively high private benefits  $B(X)$  and thus have more to lose from adopting GT.<sup>82</sup> The effects of facing only weak market forces  $X$  therefore, are inconclusive.

Table 1: A Benchmark for the Adoption of Corporate Governance Terms

Midstream	
Private Benefits	$B(X)$
Value to Shareholders	$V(X)$
Value to the Manager	$a*V(X) + X * V(X) - B(X)$
Optimal Governance Term	GT iff $V(X) > B(X)$
Manager Chooses a Governance Term	GT iff $a*V(X) + X*V(X) > B(X)$

To illustrate, assume for example that firm A faces strong market forces  $X_1 = 0.45$  and that as a result A's manager extracts 10 in private benefits. These 10 impose costs of 20 on the shareholders. Thus, if the manager of firm A does not adopt GT, there is a penalty of  $0.45*20 = 9$ . Assume also that firm B faces weak market forces,  $X_2 = 0.2$ , and that as a result firm B's manager extracts 20 in private benefits. Assume that this extraction causes a harm of 60 to shareholders (following a conventional assumption of increasing marginal costs of extraction). Thus, if the manager of firm B does not adopt GT, there is a penalty of  $0.2*60 = 12$ . Lastly, assume that  $a=0.1$ , that is, each manager holds a ten percent stake in their respective firms, so that if a firm value declines by a certain amount then the manager incurs ten percent of this loss. As shown below, in this case only the manager of firm A adopts GT. The manager of firm B, the firm that could benefit most from a GT, does not adopt it.

It is also possible, however, that due the large decline associated with weak market forces, the market penalty  $P(X_2)$  will be sufficiently high to incentivize managers who face weak market forces  $X_2$  to tie their hands. Thus, whether or not these firms adopt

<sup>82</sup> See, e.g., Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463 (2001) (arguing that increased monopoly rents induce higher potential agency costs); Maria Guadalupe & Francisco Perez-Gonzalez, *Competition and Private Benefits of Control* (working paper 2010) (finding that weak product market competition is associated with higher control premium) <http://ssrn.com/abstract=890814>

particular governance terms depends on their respective values, and their relationship to each other. To illustrate, assume that firm C also faces market forces  $X_2$ , but the extraction of private benefits in firm C is less efficient than the extraction of private benefits in firm B. In particular, assume that if the manager extracts private benefits  $B(X_2)=20$  from firm C, the value of firm C declines in  $V(X_2)=100$ . As a result, as shown in Table 2 below, the same market forces,  $X_2=0.2$ , that did not incentivize the manager of firm B to adopt GT, incentivize the manager of firm C to adopt GT.

Table 2: Midstream Self-Selection

	A	B	C
M's Private benefits of NGT	10	20	20
Value to SH of GT	20	60	100
Value to M of GT	2+9	6+12	10+20
Optimally	GT	GT	GT
M's Choice	GT	NGT	GT

When the assumption that one-size-does-not-fit-all is incorporated rigorously to classic theory, the forgoing has shown, private ordering could result in inefficient self-selection. Consistent with the argument of this Article, firm B that could benefit more from GT resists it, and firm A that benefits less, adopts GT. Notice also that the example assumed investors have full information. Thus, even if investors know exactly what they buy, self-selection is inefficient and imposes total inefficiency costs of  $C(X)=V(X)-B(X)$ .<sup>83</sup> Note also, that in this equilibrium, in which only firm A adopts GT, the value of GT in the market should be 20. Thus, if a researcher measures the effect of GT on firms, before and after implementation, overlooking this inefficient self-selection, the researcher would assess it to be 20, whereas the potential average effect of GT is 40 (20 for firm A and 60 for firm B). Thus the assumption that firms choose their “right” size could lead to underestimation of the effect of corporate governance on firm value.<sup>84</sup>

As the analysis also shows, however, firms that could benefit from governance might not always resist. Firm C, which benefits from GT more than both A and B do, chooses to adopt GT. What are the considerations that could lead these firms, firms that benefit from governance constraints, to adopt GTs? And how likely is it that Resisting Firms will end up adopting GT?

*Revealed Preference* In most cases managers of firms that need governance constraints, did not reach this point incidentally. They probably had options to apply governance GTs in the past, but chose to pass, or even to add entrenching terms. Since they chose to remain in a state where they could benefit from additional GTs, by *revealed preferences* we learn that the payoffs for these managers are probably close to the ones of firm B. Managers of firms that need GTs, therefore, almost by definition, are less likely to adopt a new GT, unless, as discussed below, the specific GT offers managers payoffs that were not covered by their previous options – either since their options were limited, or in the case of innovative GTs.

<sup>83</sup> See also Barzuza, *Lemon Signaling in Cross-Listing*, *supra* note (a formal model of firm heterogeneity results in inefficient midstream self-selection despite full information).

<sup>84</sup> See *infra* Section IV.A. (arguing that the assumption that firms choose their right size lead to underestimation of the effects of board independence).



*Exogenous Reasons for being in a State of Need for Governance* A relevant question thus, would ask why the firm could benefit from additional constraints. If the need was created and maintained by choice – for example, the firm has a poison pill and a staggered board – the same preferences that lead management to keep these devices, would lead them not to adopt a GT. If however, the firm simply did not have other options to tie its hand, then it is possible that this firm is more similar to firm C in its payoffs, namely, its managers would adopt GT when they have the option to do so. For example, a firm that operates in a country with weak legal regime and institutions, has limited options to commit to legal constraints. Yet, when cross-listing on US exchanges became a viable option it offered an option to bond effectively with new laws and legal institutions. These firms, whose need for GT was not a result of voluntary choice, but rather of lack of bonding mechanism, are more likely to adopt governance terms that benefit them.

*Innovative Terms* Even if the firm did have an option to adopt GTs, but not an option that is similar to the new one, they might adopt the new GT. Which brings us to discuss innovative terms. In particular, a new GT would be more likely to be adopted if it offers different payoffs than the ones offered by existing GTs. For example, if a new GT is sufficiently innovative that it offers improvements to value  $V(X)$  with less decline in private benefits  $B(X)$ , it is more likely to be adopted. Indeed, Lucian Bebchuk has shown that generally, terms that meet this relationships of large added value and relatively small loss of private benefits are more likely to be adopted.<sup>85</sup> This insight applies as well to resisting firms. As shown below, the success of majority voting terms, could be partially attributed to this virtue.<sup>86</sup>

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To sum, at the midstream stage, the examples above illustrate that the fact that firms need regulation, might not suffice for them to adopt efficient governance terms. If a governance term offers a new trade off, either since it is innovative, or since the firm's had a limited arsenal of governance tools, then these firms might adopt it. Otherwise however, by revealed preferences, from these firms' choice to reach a state in which they need additional governance constraints, we learn that their payoffs are such that they would probably resist adding governance terms.

Proponents of private ordering, have either overlooked the tension in their analysis of the midstream stage, or instead relied on the IPO stage to mitigate it. The following part will show that heterogeneity also affects the analysis of the IPO stage.

#### D. IPO Stage and Firm Heterogeneity – Adverse Selection in Corporate Governance

IPO governance analysis is considered a strong theoretical proposition, as it offers a robust account of optimality. In practice on the other hand, the IPO influence on governance has been highly limited. Contracts are incomplete, as it is virtually impossible to predict, assess and draft every future scenario in a constantly changing business world.

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<sup>85</sup> Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1841 (1989) (“the effectiveness of market discipline in discouraging managers from proposing value-decreasing amendments depends on the size of the transfer involved (the redistributive element) relative to the reduction in overall value (the efficiency element).”)

<sup>86</sup> See *infra* Section IV.D.

Most of the choices with respect to a firm’s governance, rise after the company goes public and after managers have sold most of their shares. Furthermore, IPO drafting is affected by network externalities. Indeed, IPO governance is uniform and lacking – charters merely adopt the law of the state of incorporation, with very little variations, customization or innovation – virtually almost all governance choices are made after the IPO, at the midstream stage.<sup>87</sup>

This part incorporates heterogeneity in market forces to the IPO classic analysis. It shows that firm heterogeneity punctures holes in the optimality of the IPO stage for the following intuition: if investors have less information than managers on each firm’s particular needs for governance - that is, if managers know better than the market which constraints the particular firm is facing, and as a result what is the right “size” for their firm - due to *adverse selection* at the IPO stage firms that could benefit most from GT might not adopt it. The assumption of optimality of the IPO stage, thus, the Article shows, is highly sensitive to our assumptions with respect to informational asymmetries between managers and investors.

To demonstrate the different effects of asymmetric information on the optimality of IPO stage, the analysis will start with the benchmark case in which investors have full information, that is, investors know the exact value of GT for *each particular firm*.

*Example 1- IPO Heterogeneity when Firm Specific Information is Publicly Available*

Assume that firm A and firm B’s needs for governance vary. In particular, assume that while in firm A, a governance term GT would increase firm value by 50, firm B faces significant disciplining market forces and as a result if firm B adopted GT, it would increase its value by only 8. Assume also that the manager of firm A extracts 40 in private benefits, while the manager of firm B extracts 30 in private benefits. Thus, from efficiency perspective, while firm A should include a GT in its charter, firm B should not as its benefits will outweigh its costs. If investors have full information—that is, if they know the particular benefits of adopting GT for *each particular firm*— they will add 50 to the IPO price of firm A, if firm A adopts GT, but only 8 to the IPO price of firm B, if firm B adopts GT. Anticipating that, as shown in Table 3 below, firm A offers GT at its IPO, while firm B does not offer GT at its IPO. Under full information thus, both firm A and firm B, make optimal governance choices.

Table 3: IPO heterogeneity with symmetric information.

	A	B
Private benefit of adopting GT	40	30
Value to SH of adopting GT	50	8
Optimal governance	GT	NGT
IPO price return for adopting GT	50	8
IPO-offered governance	GT	NGT

<sup>87</sup> See e.g. Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1330 (2013) [hereinafter Klausner, *Fact*] (“Empirical evidence, however, shows that essentially no innovation or customization occurs in IPO charters and that these charters are virtually empty from a governance perspective”).

This next section will show, however, that if information about specific firms' needs is asymmetric, it could lead to a systemic downward bias of pricing governance terms and inappropriate incentives for managers. Optimality thus, is highly sensitive to assumptions of information asymmetries.

### *1. Asymmetric Information and Adverse-Selection*

The previous example assumed that investors accurately price the distinct value of governance terms in light of *firm-specific circumstances*. Operative market forces, however, to the extent they apply differently across firms, are often unobservable. Or at the very least, are less observable to investors than they are to the company's insiders: managers know the constraints that they expect to face better than investors. Classic theorists assumed that information imperfections of this type causes mere noise rather than bias in market price, and therefore IPO pricing would still provide appropriate incentives for managers. As the following shows, however, if investors know only the average value of a governance term, such as staggered board, and not its specific for each particular firm, adverse selection could result in suboptimal incentives for managers to adopt governance terms.

*Example 2 –IPO Heterogeneity when Firm-Specific Information is Privately held–Adverse Selection:* For the following example, like in example 1, assume that firm A faces weak market constraints, and that as a result GT if adopted, will add 50 worth of value to firm A and reduce the manager's private benefits by 40. Assume also that firm B faces strong market forces, and as a result a GT, if adopted, would add a mere 8 to firm B, and would also reduce the manager's private benefits by 30. Thus, firm B should not adopt GT since its costs outweigh its benefits, but firm A should adopt it. Yet, unlike example 1, now firm-specific information is *private*, that is each manager knows whether he manages A or B, but investors cannot distinguish between the two firms. As a result, investors who do not know the exact value of GT in each particular firm, apply instead an average value to GT, that is, 29. That is, investors will add 29 to the IPO price of any firm that offers a GT as part of its IPO package. Anticipating that, as shown in Table 4, both firm A and firm B will not offer a GT. Thus, in this example as a result of adverse selection, no firm adopts GT even though some firms could benefit from it. The following section will discuss potential signaling effect, and how they can improve on the adverse selection problem.<sup>88</sup>

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<sup>88</sup> In this example however, signaling is not a robust equilibrium. To be sure, that the manager of firm A is better off offering GT, if that could result in a signal to the market that this is a firm of A type. Since once investors know the firm type they would reward firm A in 50 for offering GT. Yet, in this case, signaling equilibrium is not robust to an acceptable economic concept - the Cho-Kreps intuitive criterion. Since the manager of firm B loses less private benefits from adopting GT (30), than the manager of firm A does (40). If only one manager offers GT, investors would identify him as the manager of firm B, rather than A. In-Koo Cho & David D. Kreps. *Signaling Games and Stable Equilibria*, 102 QUAR. J. ECON. 179 (1987). See also Lucian A. Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* Harvard Olin Discussion Paper No. 398 ("An equilibrium satisfies the Intuitive Criterion if there does not exist a non-equilibrium contract (i.e. a deviation) such that (i) one type (type-L) of owners would be made worse off by offering this contract (compared with this type's equilibrium payoffs) no matter how the market responds, but such that (ii) the other type (type-H) would be made better off (relative to this type's expected equilibrium payoffs) by offering this contract if the market believes that it

Table 4: IPO with Asymmetric Information- Adverse Selection

	A	B
M's Private benefits of NGT	40	30
Value to SH of GT	50	8
Optimal choice	GT	NGT
IPO Price	29	29
IPO Choice	NGT	NGT

The result that none of the firms adopts GT is consistent with empirical findings with respect to the striking lack of governance at IPO charters. While at the midstream stage investor fight to add governance constraints such as majority voting, proxy access, independent chairperson, and to remove entrenching terms such as staggered boards and poison pills, at the IPO stage firms do not feel the pressure to add any of these constraints, and very few do.<sup>89</sup> Rather, if at all, some firms include entrenching terms at the IPO stage, such as staggered boards (the equivalent of NGT), a result to which we turn in the following section.

## 2. Signaling and Noise

Under conventional economic analysis, adverse selection could be improved upon, if firms can signal their type to the market.<sup>90</sup> The following examples will discuss signaling effects at the IPO stage. It will also show how certain types of noise from arbitrary adoption and network externalities could obscure these signals.<sup>91</sup>

*Example 3 – Signaling & Pooling.* Assume that firm A faces weak market constraints, and that as a result GT would add 14 worth of value and reduce the manager's private benefits by 11. Assume also that firm B faces strong market forces,

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is this second type that has offered it.”)

<sup>89</sup> See Klausner, *Fact, supra* note 87 (finding close to zero innovation or customization in a hand collected sample of IPO charters and bylaws); see also Richard J. Sandler and Joseph A. Hall, *Corporate Governance Practices in IPOs* (2014) (“Despite pressure on US public companies to adopt certain governance practices, a review of the largest initial public offerings (in terms of deal size) shows that newly public companies continue to exercise a great deal of latitude in designing their governance structures, at least at the time of their IPO.”)

[https://www.davispolk.com/sites/default/files/sandler.hall\\_%20Corp.Gov\\_Advisor.article.aug14.PDF](https://www.davispolk.com/sites/default/files/sandler.hall_%20Corp.Gov_Advisor.article.aug14.PDF);  
Cf. Davis Polk, *Corporate Governance Practices in U.S. Initial Public Offerings (Excluding Controlled Companies)* (finding increased used of entrenching takeover defenses at the IPO, but also a rise in shareholder friendly board practices such as independent chairperson). <https://www.briefinggovernance.com/2016/06/ipo-governance-practices-a-davis-polk-survey/>

<sup>90</sup> See Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355 (1973)

<sup>91</sup> The analysis of noise role in obstructing signals in corporate governance, relies on Barzuzza, *Noise Adopters, supra* note 28. Lucian Bebchuk has shown that signaling effects could result in NGT at the IPO stage for a different reason than noise. In particular, if private benefits are correlated with value, firms might adopt lax governance terms at IPO to signal high value. See Lucian A. Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* Harvard Olin Discussion Paper No. 398

and as a result GT would only add 2, and reduce the manager's private benefits by 1. If investors do not have information to distinguish A and B, they will assess the value of GT at average 8 for all firms. As a result, however, the manager of firm B, who extracts only 1 in private benefits is better off offering GT. An equilibrium in which B offers GT and A does not offer GT, however, is also unstable. If A does not offer GT, while B offers it ("Separating Equilibrium"), the manager of A reveals its type to investors. Thus, investors now discount A's value by 14, rather than 8. A's manager thus, would rather adopt GT as well, and forgo private benefits of 11. Thus, both A and B adopting GT ("Pooling Equilibrium" on GT – Table 6, row 6) is the only stable equilibrium.

In this example thus—a pooling equilibrium in which all firms adopt GT—IPO results in optimal governance offerings. The result relies on the assumption that if A deviates, namely, does not offer GT, the market will clearly identify the firm as A and will therefore reduce its value in 14. In reality however, this signaling effect is rather noisy, since in real life the market cannot be one hundred percent positive that the firm with no GT is an A firm. As found in a line of studies, IPO governance is sometimes driven by boilerplates, advice of a local lawyer, network externalities, and other arbitrary reasons.<sup>92</sup> As a result, when investors observe a staggered board, for example, they might not know whether it resulted from a conscious choice by management (which then implies a type A firm) or from a more benign reason such as a boilerplate (which could then be either type A or type B firm).<sup>93</sup> As a result, as shown in Example 4 below, the market penalty that firms that could benefit from GT but do not adopt it suffer, is only partial. Which in turn, could lead to the emergence of Resisting Firms - firms that can benefit from GT but do not adopt it. At the IPO thus resisting firms could emerge if as a result of noise capital markets penalty for poor governance is partial.

*Example 4: Noise* (Table 6 rows 7-8). Assume now that investors believe that GT has a value of 14 for firm A and a value of only 2 for firm B. If there is no noise, observing separation they would reduce the value of firm A in 14. Yet, now assume investors believe that a third of the companies that did not adopt GT did so for some random reason such as a local lawyer advice or inertia. Thus, the average discount for not adopting GT should be 10 rather than 14.<sup>94</sup> Anticipating a penalty of 10, firm A will not offer GT. Thus, this equilibrium leads to the emergence of firm A as a Resisting Firm.

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<sup>92</sup> See Michal Barzuza, *Noise Adopters*, *supra* note 28 (surveying sources of arbitrary governance adoption); See also Michael Klausner *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 761 (1995) [hereinafter: Klausner, *Networks*] (arguing that IPO charters are affected by network externalities and boilerplating); John C. Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001) (finding that law firm geographic location predicted IPO takeover arrangements); Robert M. Daines, *The Incorporation Choices of IPO Firms (Initial Public Offerings)*, 77 N.Y.U. L. REV. 1559 (2002) (finding that firms advised by law firms with national practice were more likely to incorporate in Delaware) [hereinafter Daines, *IPO Firms*].

<sup>93</sup> See *id.* Supporting of this information to investors a study of UK firms, found that firms that opted out of "best governance practices" and explained specific reasons for the choices performed better than firms that did not opt out. Yet, those firms that opted out with no explanation whatsoever performed worse than both. See Sridhar R. Arcot & Valentina G. Bruno, *One Size Does Not Fit All, After All: Evidence from Corporate Governance*, (working paper 2006), at <http://ssrn.com/abstract=887947>.

<sup>94</sup>  $2/3 * 14 + 1/3 * 2 = 10$ .

Table 6: IPO Governance - Signaling, Pooling and Noise

		A	B	Stable Eq.?
1	M's Private benefits of NGT	11	1	
2	Value to SH of GT	14	2	
3	Optimal Choice	GT	GT	
4	IPO Price: pooling – NGT	8	8	NEq for B
5	IPO Price: Separating Equilibrium	14	2	NEq for A
6	IPO Choice: Pooling – GT	GT	GT	Eq.
7	IPO Price separating with <i>Noise</i>	33/3=10	2	
8	IPO Choice: Separating Equilibrium with <i>Noise</i>	NGT	GT	Eq.

To sum, as Example 4 demonstrated, boilerplating, inertia and other random sources at the IPO, which were documented extensively, confound potential signals. As a result, firms that could benefit from governance do not pay a full price if they avoid it. This is thus again an example of a downward bias in governance pricing that in turn results in suboptimal IPO incentives. In this example, again, firms that could benefit more from GT, namely, Resisting Firms, do not adopt it, and firms for whom GT hardly matters, namely, Indifferent Firms, adopt it.

The analysis of signaling and noise is consistent with and could help in explaining firms' choice of staggered boards at the IPO, and firms choice to stay in their home state rather than incorporate in Delaware.<sup>95</sup> Staggered board at IPO charter was driven by geographical location and identity of the advising law firm.<sup>96</sup> Thus, when a firm is offering IPO investors might not know if the managers are interested in it for entrenchment, or if this is the boilerplate their lawyers provided. Similarly, there could be different reasons for why a firm incorporates in its home state – e.g., legal environment that is favorable to local managers, mere inertia, or the advice of a local lawyer. Second, in both cases there is evidence for inefficient self selection - firms with higher private benefits are more likely to seek staggered boards, and to incorporate in their home state - that is to adopt relatively entrenching law and governance.<sup>97</sup>

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We have seen that adoption of governance terms at IPO can be assumed to be efficient only if one assumes no transaction costs. However, if one assumes, as is reasonable to, that managers know more than investors about various aspects of the firm, including how competitive the environment in which it operates, what is the magnitude of private benefits that managers can extract, the harm to the company of inefficient extraction etc' – then one can no longer assume that efficiency of the IPO stage. We have

<sup>95</sup> See *infra* Section IVC.

<sup>96</sup> See John C. Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001).

<sup>97</sup> See Barzuza, *Noise Adopters*, *supra* note 28; Laura C. Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857 (2002) (finding that firms with higher anticipated agency costs are more likely to have a staggered board at the IPO).

further seen that the midstream stage, in which virtually companies constantly are, is also prone to inefficiencies in the selection of governance terms.

Theory thus does not give us a basis to believe that managers should always pick optimal governance terms, namely tie their own hands when it is socially desirable. But the possibility remains that we might be living in a world with zero transaction costs, full information and no market failures, or that for this or some other reason managers always select optimal corporate governance terms in practice. To the examination of this empirical possibility we now turn.

#### IV. The Evidence – Do Firms Select their Right “Size” of Corporate Law and Governance?

The previous Part has shown that theoretical analysis does not lead to conclusive answer with respect to whether firms choose their right “size”. While they might choose their right “size”, they might also not choose it. In particular it could happen that firms that need legal constraints most would not adopt it, and firms for whom constraints hardly matter would adopt them. As theory suggests that self-selection could be either efficient or inefficient, policy determination requires assessment of empirical evidence with respect to self-selection patterns. While the assumption entails clear testable predictions, until recently no study examined these predictions or even the basic question of who are the firms that under private ordering choose governance constraints.<sup>98</sup> Rather, scholars, practitioners and policy makers merely pointed to non-uniform adoption of governance terms by different firms as an indication that firms choose their right “size”.<sup>99</sup>

This Part analyzes and synthesizes evidence from many studies, in different contexts in corporate law and governance, that could shed light on this question. Before proceeding, a qualification is in order. No evidence presented here is considered as a direct proof that firms do not choose their right “size”. To begin with, empirical testing of this question is fueled with endogeneity concerns. Moreover, most of these studies did not focus on this question and thus do not test it directly. Finally, for each context, it is probably possible to come up with an account other than inefficient self-selection to explain the results. At the same time however, the studies provide evidence that could shed some light on how firms self-select. And this evidence is not supportive of the assumption that firms always choose their right “size”. Rather, most of the evidence is at least consistent with the inefficient self-selection account that this paper promotes. At the

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<sup>98</sup> For three recent exceptions see Tara Bhandari, Peter Iliev & Jonathan Kalodimos, *Public versus Private Provision of Governance: The Case of Proxy Access* (working paper 2016) (finding that managers are more likely to fight shareholder proposals in firms that could benefit most from proxy access); Stephen Choi, Jill Fisch, Marcel Choi, Fisch, Kahan & Rock, *supra* note 9 (finding that late adopters of majority voting were more likely to have poison pills and votes withheld from their directors, relative to early adopters); Sarah Sanga & Roberta Romano, *The Private Ordering Solution to Multiforum Shareholder Litigation*, J. EMP. LEG. STUD. (FORTHCOMING 2016) (finding that firms with an independent chair and majority voting terms are more likely to adopt forum selection bylaws at midstream).

<sup>99</sup> See e.g., Easterbrook & Fischel, *Corporate Contract* *supra* note 1, at 1426 (“The agreements that have arisen are wonderfully diverse, matching the diversity of economic activity that is carried on within corporations.”); Cf. Michael Klausner, *Fact*, *supra* note 87, at 1330 (“A second reason the contractarian theory has failed to fit the facts is that the contractarians paid little attention to actual corporate contracts.”).

very least, thus, this body of evidence, should raise a concern that firms that need legal constraint most likely will not impose it upon themselves voluntarily.

#### A. Board Independence – Voluntary vs. Mandatory Independence

*“..the new rules fail to take into account the diversity and variance among firms. The new rules thus satisfy our definition of quack corporate governance. The one size fits all model they mandate should be scrapped in favor of allowing each firm to develop the particular mix of monitoring and management that best suits its individual needs.”*<sup>100</sup>

Board independence provides a unique context to assess private ordering as it was shaped both by private ordering and by statutory mandates. Which firms benefitted more from adding independent directors – those that added them voluntarily under a private ordering regime (“Voluntary Independence”), or those that were forced to do so by mandate (“Mandatory Independence”) – could shed some light on whether firms voluntarily chose their right “size” of board independence. During the 80s and the 90’s, board independence was regulated primarily by Delaware courts, which increasingly conditioned deference to the board and its committees on their independence, but did not mandate it.<sup>101</sup> During this time, in which boards were encouraged but not required to increase independence, most, but not all, firms voluntarily added independent directors to their boards. Researchers were quick to utilize these changes to board structure to test the effect of board independence on firms’ performance. The results, as confirmed by a rich body of studies, showed only limited effect of board independence on firms’ performance.<sup>102</sup>

Several studies found evidence that pre-SOX Voluntary Independence improved boards’ monitoring. For example, independence was positively correlated with sensitivity of CEO turnover to firm performance (that is, independent boards were more likely to fire the CEO if the firm did not perform well), and with fewer value-reducing acquisitions.<sup>103</sup> Yet, in assessing the bottom line, namely firm performance, studies consistently did not find significant evidence that independence contributed to firm profitability or market value. To be sure, event studies on changes to board composition found a positive response of 0.2% to the announcement of appointment of an independent director.<sup>104</sup> The economic magnitude is modest however, and might merely reflect a signaling effect. More important, Tobin’s Q of firms with a majority of independent directors was not statistically different from the Tobin’s Q of firms with no majority of independent directors.<sup>105</sup> Similarly, accounting performance measures were not

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<sup>100</sup> Bainbridge, *Financial Crisis*, *supra* note 1.

<sup>101</sup> *See e.g.*, *Zapata Corp. v. Maldonado* 430 A 2D 779 (DEL SUP 1979).

<sup>102</sup> For a survey of this literature *see* Benjamin E. Hermalin & Michael Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature* 9 *ECON. POL. REV.* 7, 14 (2003) [Hereinafter, Hermalin & Weisbach, *Endogenously Determined*].

<sup>103</sup> Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 *J. FIN. ECON.* 431 (1988).

<sup>104</sup> *See* Stuart Rosenstein & Jeffery G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*. 26 *J. FIN. ECON.* 175 (1990); Stuart Rosenstein & Jeffery G. Wyatt, *Inside Directors, Board Effectiveness, and Shareholder Wealth* 44 *J. FIN. ECON.* 229 (1997); *See also* Hermalin & Weisbach, *Endogenously Determined*, *supra* note 102.

<sup>105</sup> B.E. Hermalin & M. S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 *FIN. MGMT.* 101 (1991) [hereinafter Hermalin & Weisbach, *Effects of Board*



significantly different.<sup>106</sup> If at all, there was some evidence for negative relationship between independence and Tobin's Q.<sup>107</sup> Long-term performance of firms with a majority of independent directors also was not significantly different from the performance of other firms.<sup>108</sup> Yet, since pre-SOX firms self-selected independence, it was argued, it was still possible that independent directors added value. For example, if poorly performing firms were more likely to add independent directors, even if these directors added value, when comparing these firms, in a cross-section analysis, to firms that did not have independent directors, independence may be associated with no better, and even poorer performance.<sup>109</sup> Along these lines, Hermalin and Weisbach constructed a formal board bargaining model in which a non-successful CEO is pressured by the outsiders on the board to nominate additional independent directors.<sup>110</sup> Testing this hypothesis, Hermalin and Weisbach found that abnormal negative performance indeed increases the likelihood of appointing an independent director,<sup>111</sup> yet they found no support for the proposition that following their nomination, those independent directors contributed to firm value.<sup>112</sup> As a result, a conventional wisdom held that independent directors do not matter.<sup>113</sup>

Thus, when the regulatory response to corporate scandals of *Enron* and *WorldCom*, mandated independence, critics were quick to point out the lack of evidence for these mandates. In response to corporate scandals, the newly enacted SOX required audit committees to be entirely independent.<sup>114</sup> And former SEC commissioner, Harvey Pitt, guided NYSE and NASDAQ to enhance their independence requirements.<sup>115</sup> NYSE then

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*Composition*]; Sanjai Bhagat, & Bernard S. Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. (1999) [hereinafter Bhagat, & Black, *Uncertain Relationship*]; Sanjai Bhagat, & Bernard S. Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002) [ hereinafter Bhagat, & Black, *Non-Correlation*]

<sup>106</sup> See e.g., Hermalin & Weisbach, *Effects of Board Composition*, *supra* note 105.

<sup>107</sup> See e.g., A. Agrawal, & C. R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders*, 31 J. FIN. QUANT. ANAL. 377 (1996) (negative relationship to Tobin's Q).

<sup>108</sup> See Bhagat and Black, *Non-Correlation*, *supra* note 105; see also Hermalin & Weisbach, *Endogenously Determined*, *supra* note 102, at 14 (2003).

<sup>109</sup> See Hermalin & Weisbach, *Endogenously Determined*, *supra* note 102.

<sup>110</sup> Benjamin E. Hermalin & Michael Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998).

<sup>111</sup> See e.g., Hermalin & Weisbach, *Effects of Board Composition*, *supra* note 105.

<sup>112</sup> See e.g., Hermalin & Weisbach, *Effects of Board Composition*, *supra* note 105 (using lagged variable to control for abnormal firm performance); See also Bhagat, & Black, *Non-Correlation*, *supra* note 105 (same); James S. Linck, Jeffrey M. Netter & Wintoki M. Babajide, *Endogeneity and the Dynamics of Corporate Governance* 105 J. OF FIN. ECON. 581 (2012) (using Arellano-Bond GMM instruments in a 1991-2003 dynamic panel they find no casual relationship between board structure and firm performance between 1991-2003).

<sup>113</sup> See e.g., Bainbridge, *Financial Crisis*, *supra* note 1 (“The empirical evidence on the relationship between board composition and firm performance available when Sarbanes-Oxley was adopted was inconclusive, at best. If independent directors effectively constrain agency costs, one would have expected the evidence to show a correlation between the presence of independent outsiders on the board and firm performance. But it did not. “); Macey, *Promises*, *supra* note 1 (“Recent corporate governance initiatives, including Sarbanes-Oxley, are misguided because they erroneously assume corporate boards can be organized or incentivized successfully to monitor and manage the corporations they serve. All of the available theoretical and empirical evidence suggests this is not the case. “).

<sup>114</sup> SOX § 301 (3). It also required at least one of them to be a “finance expert.”

<sup>115</sup> Securities and Exchange Commission press release 2002–23, February 13, 2002.

required its listed firms to have a majority of independent directors on their boards,<sup>116</sup> to place only independent directors on their audit, compensation and nomination committees,<sup>117</sup> and to hold periodic executive sessions in which independent directors meet with no firm insiders present.<sup>118</sup> NASDAQ adopted similar requirements.<sup>119</sup> The rush to apply one-size to all firms, when there is not even evidence that independence has value to any firm, critics argued, is a testimony to the weakness of these rules – which were designed primarily to satisfy public opinion - a paradigm of populist “Quack Corporate governance”.<sup>120</sup>

Indeed, if firms select their right “size” of governance, as conventional wisdom holds, firms that could have benefited from independence had previously adopted it voluntarily. The growing body of post-SOX empirical studies however, tells a different story. To begin with, early studies that assessed the market response to the passage of the rules, found that firms that had to add independent directors to comply with the mandates (“Noncomplying Firms”), experienced positive abnormal returns, with the exception of small Noncomplying firms that experienced a negative market response.<sup>121</sup> Thus, investors viewed the requirement as positive except for small firms. Then, with more years of data, subsequent studies measured real long-term effects of SOX on board actions, and firms’ operational and financial performance. Employing a Difference-in-Differences design, Guo and Masulis found that Noncomplying firms, that added independent directors to comply, improved their sensitivity of CEO turnover to performance.<sup>122</sup> Adding independent directors to the board, and especially to the nominating committee, resulted in boards that were more willing to pull the trigger on an underperforming CEO. Directly comparing this effect for Voluntary Independence (firms that nominated independent directors pre-SOX) with the effects for Mandatory Independence (firms that were forced to nominate independent directors post-SOX), Bhagat and Bolton found that the effect is more pronounced among firms that were mandated, post-SOX, to add independent directors.<sup>123</sup>

Furthermore, in studying the differences between pre, and post-SOX independence, that is, between Voluntary and Mandatory Independence, almost to their surprise, Bhagat and Bolton found evidence for added value from Mandatory Independence (while confirming that pre-SOX, voluntary independence harmed performance).<sup>124</sup> In particular, Bhagat and Bolton found that post-SOX Mandatory Independence improved operational

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<sup>116</sup> NYSE Listed Company Manual § 303A.01; Exchange Act Rel. No. 48,745.

<sup>117</sup> NYSE Listed Company Manual § 303A.04-05.

<sup>118</sup> NYSE Listed Company Manual § 303A.03.

<sup>119</sup> See Bainbridge, *Financial Crisis*, *supra* note 1. Independence requirements were tightened as well, *see Id.*

<sup>120</sup> See Bainbridge, *Financial Crisis*, *supra* note 1.

<sup>121</sup> Vidhi Chhaochharia & Yaniv Grinstein, *Corporate Governance and Firm Value - The Impact of the 2002 Governance Rules* 62 J. OF FIN. 1789 (2007) (finding higher abnormal returns surrounding the passes of the listing standards, for firms that increased the number of their independent directors).

<sup>122</sup> See Guo Masulis, *supra* note 15.

<sup>123</sup> See *id.* at 129 & Tbl 9 panel C.

<sup>124</sup> See Bhagat & Bolton, *supra* note 15 (“While we confirm the negative relationship between board independence and firm performance (that most prior research has identified) for the pre-2002 period, this result is reversed for the post-2002 period. During the years 2003–2007, greater board independence is positively correlated with operating performance.”)

performance as measured by returns on assets (ROA).<sup>125</sup> A similar pattern emerged with respect to independence's effects on acquisition.<sup>126</sup> Board independence is associated with fewer value-reducing acquisitions both pre and post-SOX, but compared to pre-SOX Voluntary Independence, post-SOX Mandatory Independence is associated with a significant decrease in value decreasing acquisitions.<sup>127</sup>

Finally, recent studies find additional benefits from independence mandates. Focusing on management overconfidence—measured by CEO's depictions in press, and CEO's holding on to their options after they vest—a recent study found that for firms with overconfident managers, SOX and the listing standards mandated independence led to a decline in inefficient investments, and improvements to market value and performance.<sup>128</sup>

There is also evidence that, consistent with inefficient self-selection, entrenched CEOs nominate less independent directors under private ordering. Shivdasani and Yermack find that CEO involvement in the appointment process – measured by CEO service on nomination committee, or lack of a separate nomination committee (namely, the entire board decides on nominations) – predicts lower proportion of independent directors, higher proportion of grey directors, and a lower stock market reaction to appointment announcements.<sup>129</sup> Similarly, Baker and Gompers find that CEO tenure is positively related to the number of insiders on the board, while reputation of the venture capitalist financing the firm is negatively related to this number. Finally, tracking board development from firms' IPO through 10 years later for IPOs between 1988-1992, Boone et al. find that board independence is negatively related to CEO power and positively related to constraints on this power. In particular, measures of CEO bargaining power, tenure, and the CEO's share holdings are negatively correlated with board independence while directors' ownership, investment bank reputation and having a venture capitalists on board, are positively related to independent directors' proportion.<sup>130</sup> These

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<sup>125</sup> See Bhagat & Bolton, *supra* note 15.

<sup>126</sup> See *id.* at 129 & Tbl 10 Panel D; See also Sara Moeller, Frederik Schlingemann, & Rene Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*. 60 J. FIN. 757 (2005).

<sup>127</sup> See *id.* at 132 & Tbl 10 panel C.

<sup>128</sup> See Suman Banerjee, Mark Humphery-Jenner & Vikram Nanda, *Restraining Overconfident CEOs through Improved Governance: Evidence from the Sarbanes-Oxley Act*, 28 REV. FIN. STUD. 2812 (2015). Studies from other countries find evidence that mandated board independence increases value. See e.g., Bernard S. Black & Woochan Kim, *The Effect of Board Structure on Firm Value: A Multiple Identification Strategy Approach Using Korean Data*, 104 J. FIN. ECON. 203 (2012) (finding that a legal reform in Korea, that mandated a majority of outside directors and audit committees, for large firms, had a positive effect on the value of affected firms); Bernard S. Black and Vikramaditya S. Khanna, *Can Corporate Governance Reforms Increase Firms' Market Values? Event Study Evidence from India*, 4 J. EMP. L. STUD. 749 (2007) (finding positive effects on firms' value for a 2001 legal reform in India that mandated, among other things, a minimum number of independent directors); Dhammika Dharmapala & Vikramaditya S. Khanna *Corporate Governance, Enforcement, and Firm Value: Evidence from India* 29 J. L. ECON. & ORG. 1056 (2013) (finding positive effects for the Indian 2001 reform and for a following 2004 sanctions enhancement).

<sup>129</sup> David Yermack and Anil Shivdasani, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis* 54 J. OF FIN. 1829 (1999) (finding also that CEO involvement likelihood increases with CEO tenure, founder's status and equity ownership, and a five percent blockholder serving as an independent director on the board.)

<sup>130</sup> Audra L. Boone, Laura C. Field, Jonathan M. Karpoff & Charu G. Raheja *The Determinants of Corporate Board Size and Composition: Empirical Evidence*, 85 J. FIN. ECON. 66 (2007).;

associations are all consistent with firms that face little constraints, that have relatively entrenched CEOs, and that could benefit from additional monitoring, are less likely to appoint independent directors.

Finally there is also some evidence for efficient self-selection. In particular, Duchin et al. studied how the contribution of independent audit committee members varies with their access to information. They found that in non-complying firms, SOX's effect was positive for firms with high access to information, but negative in firms with asymmetric information. Duchin et al. could suggest that some firms rightfully did not add independent directors, since high information costs could limit their effectiveness. The study however measured changes between 2000 and 2005, and thus included changes that were not mandated, though they could have been adopted in anticipation of SOX's mandate.

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If firms chose their right “size”, that is, self-selected efficiently, board independence should be associated with better performance in the pre-listing-standards era, when it was adopted voluntarily, relative to the post-listing-standards era. Bhagat and Bolton find the opposite is true, though the differences they find could still be effected by the differences in research design options pre and post SOX.<sup>131</sup> Other studies found added value from post-SOX independence and no study found added value from pre-SOX independence. Thus, there is no evidence to support the assumption that firms chose their right size of board independence, if at all the evidence is more consistent with the hypothesis that firms that voluntarily nominated independent directors, where the ones for whom independence did not matter much. Firms that could benefit from board independence resisted it till they were required to do so by law.

The benefits from mandated independence provide some, albeit limited, indication for the potential costs from inefficient self-selection. If it weren't for SOX and the listing standard requirements, these potential gains would have been wasted. We now turn to our next example, cross-listing, where there is more evidence that inefficient self-selection results in significant inefficiency costs.

#### B. Controlling Shareholders' Private Benefits and Inclination to Cross-List on U.S. Exchanges

This sub-Part discusses evidence on foreign firms' opting into U.S. legal constraints by cross-listing on U.S. exchanges. Since by now a significant body of evidence has accumulated on cross-listing it serves as a good context to evaluate the assumption that firms choose their right “size”.<sup>132</sup> Furthermore, the cross-listing literature is particularly useful since it provides evidence from firm-specific and cross-country variations. Finally,

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<sup>131</sup> *Studies post SOX had the advantage of using an exogenous shock.*

<sup>132</sup> Also, by cross-listing, firms opt for a whole package of legal terms. Thus, it is easier to determine whether they increased their commitment than when we observe only a change of one governance term. *See e.g., Coates, supra note* (challenging the usefulness of assessing the effect of a change in an individual corporate governance term on the basis that corporate governance terms interact); *see Bhagat et al., supra note 52* (criticizing governance indices on the basis that corporate governance terms interact).

it also provides evidence for the size of the costs that ensue when firms do not choose their right size.

By cross-listing on US exchanges foreign firms adopt stricter disclosure obligations, become subject to U.S. robust enforcement mechanisms, and are more visible to U.S. analysts, all of which constrain the ability of the firms' insiders to extract private benefits from the company. Since the type of insiders that extract private benefits, and the kind of private benefits they extract, are somewhat different than in US firms, this part will start with some background on controlling shareholder structures and their option cross-list and bond.

Unlike U.S. firms, which typically have a dispersed ownership structure, foreign firms are frequently controlled by a large shareholder. Since the controlling shareholder monitors managers, managers' extraction of private benefits is limited in foreign firms.<sup>133</sup> Yet, similar US managers, foreign firms' controlling shareholders often have interests that are not perfectly aligned with those of the other dispersed (or minority) shareholders.<sup>134</sup> Controlling shareholders, for example could benefit from dealings with other companies they control. Or they may take the company private, buying out the minority shareholders, in a low price. Thus, controlling shareholder ownership structure gives rise to another agency problem, one between controlling shareholders and minority shareholders.<sup>135</sup>

By cross-listing on US exchanges, voluntarily adopting parts of the US legal regime, as Professor John Coffee pointed out, controlling shareholders bond to limit their extraction of private benefits.<sup>136</sup> Consistent with his "bonding hypothesis", controlling shareholders' control premium—that is, the difference between the price per share paid for a controlling block and the price per share for minority shares—declines upon cross-

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<sup>133</sup> See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1652 (2006) ("[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held.")

<sup>134</sup> Agency manifestations are also somewhat different. While managerial agency problem manifest in for example high executive compensation or excessive takeover defenses, controlling shareholders extract private benefits via self-dealing or going private transactions. See e.g., Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest For Global Governance Standards*, 157 PENN. L. REV. 1263 (2009).

<sup>135</sup> The theoretical framework in supra Part III thus, is extendable for controlling shareholders, where B(X) represents private benefits that the controlling shareholder extract from the firm at the expense of the minority shareholders, and a represents the controlling shareholder's cash flow from the firm.

<sup>136</sup> For the bonding hypothesis See John C. Coffee Jr., *The Future as a History: The Prospects for Global Corporate Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999); John C. Coffee Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002); John C. Coffee Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXF. REV. ECON. POL. 198 (2005); John C. Coffee Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PENN. L. REV. 229 (2007). But see Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT. L. 141 (2003) (questioning the extent of legal bonding); Siegel (questioning sec enforcement on foreign firms); Litvak, *The Impact of the Sarbanes-Oxley Act on Non-U.S. Companies Cross-Listed in the U.S.* J. CORP. FIN. 195 (2007) (finding that listing premium decreases over time); Luigi Zingales, *Is the U.S. Capital Market Losing its Competitive Edge?* (ECGI – Finance Working Paper No. 192/2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1028701](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1028701). (finding a decline in proportion of firms that list on US exchanges).

listing announcement.<sup>137</sup> Moreover, the magnitude of the hit to the control premium is positively related to the level of the legal commitment they choose.<sup>138</sup> Similarly, cross-listing triggers a positive market response which, consistent with bonding, increases alongside the level of commitment firms adopt.<sup>139</sup> Cross-listing on other exchanges with lower disclosure obligations does not trigger the same response. For example, cross-listing on the Alternative Investment Market (“AIM”), of the London Stock Exchange, which is designed for small companies and applies only minimal disclosure requirements, is not associated with any positive premium.<sup>140</sup>

Cross-listing provides several dimensions to evaluate whether firms choose their right “size”. If firms choose their right “size” then highly expropriated firms – firms from which controlling shareholder private benefits extraction results in high inefficiency costs - should be more inclined to cross-list. Yet, in these firms the controlling shareholder, who controls the cross-listing decision, might be reluctant to forgo the high private benefits she extracts. Thus, an equally plausible hypothesis would predict inefficient self-selection. This was the hypothesis of three finance scholars who published a line of leading papers on cross-listing. Consistent with private benefits as a reason not to cross-list, they found that controlling shareholder’s high voting rights are associated with lower inclination to list on U.S. exchanges.<sup>141</sup> The same association is not found for cross-listing with weak or no bonding, that is in over the counter (“OTC”), and private placements.<sup>142</sup> Yet, these findings are not necessarily indicative of inefficient self-selection. Controlling shareholder’s voting power, as well as the private benefits she extracts, have a positive side as well. First, not all private benefits impose costs on shareholders. For example, controlling shareholders may extract non pecuniary private benefits, such as the pride of controlling a successful organization.<sup>143</sup> These private benefits do not come at shareholder expense and are overall inefficient. Second, the controlling shareholder incurs costs for her monitoring activities and for holding a large undiversified block in one firm. A certain amount of private benefits is required to

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<sup>137</sup> Craig C. Doidge, *U.S. Cross-listings and the Private Benefits of Control: Evidence from Dual-class Firms*, 72 J. FIN. ECON. 519, 544-550 (2004). See also Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. OF FIN. 537 (2004) (finding that across countries control premiums is lower in strong legal regimes with strong minority protections).

<sup>138</sup> Darius P. Miller, *The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts*, 51 J. FIN. ECON. 103 (1999).

<sup>139</sup> Depending on whether it involves IPOs, trading on exchanges, or merely conducting a private placement, cross-listing triggers different levels of regulatory burdens. While private placements result in almost no legal obligations, listing on a major U.S. exchange exposes firms to scienter-based liability under Section 10b-5, and a full IPO on the U.S. exchanges would trigger a strict liability standard for filling the IPO registration statement. See John C. Coffee Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002) (discussing the different types of cross-listing and the legal burdens they trigger); Cf Litvak,

<sup>140</sup> Craig Doidge, A. Karolyi, K. Lins, D. Miller, and R. Stulz, *Private benefits of control, ownership, and the cross-listing decision*, 64 Journal of Finance, 425 (2009) [hereinafter, Doidge et al., *Private Benefits and Ownership*].

<sup>141</sup> *Id.* (“The coefficient for U.S. listings corresponds to a 0.74% lower probability of a listing for a 1% increase in control rights. This constitutes an economically large decrease relative to the average probability of a U.S. exchange listing, which is 3.04% ”)

<sup>142</sup> *Id.*

<sup>143</sup> See e.g., Gilson, *supra* note 133, at 1663-64.

incentivize her to continue hold her block and exert monitoring efforts.<sup>144</sup> Third, controlling shareholder power is necessary and valuable if the controlling shareholder has value increasing project, that shareholders might underestimate.<sup>145</sup>

Some controlling structures however, other things equal, are more conducive to extraction of inefficient private benefits, and imposition of high agency costs. In particular, a controlling shareholder's incentives are more aligned when she holds not only a large fraction of the voting rights, but also a large fraction of the cash flow rights. In the benchmark case, the controlling shareholder holds one share one vote shares, and thus her fraction in the voting rights is identical to her fraction of cash flow rights. Yet, frequently, the controlling shareholder cash flow rights fraction is significantly lower than her voting rights fraction. In these cases, if the controlling shareholder has an opportunity to extract private benefits, she will have incentives to do so even in the price of high costs to the firm. To illustrate, assume first that the controlling shareholder holds 50% of both the firm's cash flow and voting rights. Assume further that she can self deal with the company and extract 100 in private benefits, which will impose costs of 300 on the company. The deal is not efficient, as its net value is -200. The controlling shareholder bears only half of the costs, 150, but it is enough to prevent her from pursuing the inefficient deal. Now assume that the company has a dual class stock, that is different classes of shares with different voting rights, and that the controlling shareholder holds shares with five votes per share.<sup>146</sup> Assume that as a result, while the controlling shareholder holds half of the voting rights, she holds only 10% of the firm's cash flow rights. In this case the controlling shareholder bears only one tenth of the costs, or 30, and therefore will pursue the inefficient transaction. The larger the wedge between the controlling shareholder cash flow rights and voting rights, the larger the problem of inefficient expropriation from minority shareholders. Accordingly the size of the wedge was found to be negatively associated with firm value.<sup>147</sup>

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<sup>144</sup> See e.g., Ronald J. Gilson & Jeffery N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003) ("Because there are costs associated with holding a concentrated position and with exercising the monitoring function, some private benefits of control may be necessary to induce a party to play that role."); Paul G. Mahoney, *The Public Utility Pyramids*, 41 J. LEG. STUD. 37 (2012) (conducting an event study around the passage of the Public Utility Holding Company Act, and finding that positive news about the passage of the Act decrease market value of affected firms.); Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 J. INST. & THEO. ECON. 160 (2013)

<sup>145</sup> See Assaf Hamdani & Zohar Goshen, *Corporate Control and Idiosyncratic Vision*, 25 YALE L. J. 560 (2016).

<sup>146</sup> A wedge could be created by other structures such as pyramid or cross-holding. For example, if a controlling shareholder holds a 50% ownership stake in firm A which, holds 50% of firm B, which holds 50% of firm C. By controlling A's board, the controller can effectively control both B and C even though his ownership in C is only 12.5%. In longer pyramids, ownership of downstream firms might amount to just a few percentage points. The controlling shareholder controls firm C but has only a low ownership in it. Thus, he may make decisions that harm firm C but benefit himself. For example, the controlling shareholder would support a self-dealing transaction in which Firm C buys something from firm A, in which he holds a large fraction of the shares, at an excessive price. For a theoretical model see Bebchuk, Lucian A., Reiner H. Kraakman, and George G. Triantis, 2000, *Stock Pyramids, Cross-Ownership, and Dual Class equity*, in Randall K. Morck, ed.: *Concentrated Corporate Ownership* (University of Chicago Press, Chicago, Ill.).

<sup>147</sup> Stijn Claessens, Simeon Djankov, Joseph P. H. Fan & Larry H. P. Lang, *Disentangling the incentive and entrenchment effects of large shareholdings*, 57 J. FIN. 2741 (2002)

Since a wedge is associated with inefficiency costs, firms in which the controlling shareholder's cash flow rights are significantly smaller than its voting rights should benefit more from cross-listing. Indeed, Doidge et al. find that cross-listing premium increases in the size of the wedge, i.e. firms with large wedge are significantly rewarded by markets if they cross-list.<sup>148</sup> If firms choose their right "size" then, controlling shareholders would show a higher inclination to cross-list when the cash rights they hold are significantly lower than their voting rights. The evidence, however, suggests the opposite is happening. Doidge et al. find that the inclination to cross-list on US exchanges decreases alongside the wedge, despite the relatively high potential reward in it.<sup>149</sup> Consistently, they also find separately, that the inclination to cross-list is positively associated with the controlling shareholder cash flow rights.<sup>150</sup>

Third, whether firms choose their right size could be evaluated on another dimension – the countries from which controlling shareholders tend to cross-list on U.S. exchanges. Cross-listing should be more valuable for firms in countries with weak legal regimes as it substitutes for the lack of domestic constraints. Indeed, the positive market reaction to cross-listing announcements, and the decline in costs of capital of cross-listed firms, are significantly higher for cross-listings coming from countries with weak corporate governance regimes (i.e. weak investor, and in particular minority, protections, disclosure obligations, and legal institutions) than for those coming from countries with a robust legal regime.<sup>151</sup> Firms from weak legal regime countries should exhibit high inclination to cross-list. Yet, in these countries, due to the weak legal regime, controlling shareholders also extract relatively high private benefits of control.<sup>152</sup> Since the controlling shareholder controls the decision to cross-list, if she extracts high private benefits she will be reluctant to give them up for the benefits of cross-listing. The controlling shareholder's calculus gives rise to a plausible prediction of inefficient self-selection: holding other motivations for cross-listing (such as finance needs) equal, firms from countries with weak legal regimes would be less likely to cross-list. According to

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<sup>148</sup> Craig Doidge, A. Karolyi, K. Lins, D. Miller, and R. Stulz, *Private benefits of control, ownership, and the cross-listing decision*, 64 J. FIN. 425 (2009)

<sup>149</sup> *Id.* (finding that "1% increase in the control wedge is associated with a 2% decline in the probability of listing").

<sup>150</sup> *Id.*

<sup>151</sup> See Luzi Hail & Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-listings*, 93 J. OF FIN. ECON. 428, tbl. 5 (2009) (finding lower cost of capital for exchanges cross-listed firms, but the effect was weaker for firms from countries with weak disclosure and self dealing regulations. Other differences – legal origin, private benefits and capital market development – were directionally consistent but not statistically significant); Craig C. Doidge, *U.S. Cross-listings and the Private Benefits of Control: Evidence from Dual-class Firms*, 72 J. FIN. ECON. 519, 544-550 (2004) (the decline of control premium in dual class firms, following cross listing, decreases with the legal protection at the origin country). Craig G. Doidge, Andrew Karolyi, & René M. Stulz, *Why are foreign firms listed in the U.S. worth more?*, 71 J. OF FIN. ECON. 205 (2004) (finding that cross-listing valuation premium "is negatively related to the level of investor protection in the firm's country"); Darius Miller & Ugur Lel, *International Cross-listing, Firm Performance, and Top Management Turnover: A Test of the Bonding Hypothesis*, 2008, 63 J. FIN. (finding an "increased relation between CEO turnover and poor performance for cross-listed" which is "strongest in countries with weak investor protections", using legal origin, and self dealing index); Cf Spamann, Holger, *The 'Antidirector Rights Index' Revisited*, 23 REV. FIN. STUD. 467 (2010).

<sup>152</sup> Dyck & Zingales



most studies, firms from countries with weak corporate governance characteristics are significantly less likely to cross-list than firms from countries with strong ones.<sup>153</sup>

The significant potential increase in share value that is lost indicates potentially high inefficiency costs.<sup>154</sup> The evidence from cross-listing is therefore important, since it gives an idea of the costs firms incur when they do not choose their right “size”. Moreover, one could dismiss the inefficient self selection problem on the basis that if shareholders know the type of firm they invest in, it is not important whether firms choose their right size or not. But, as this evidence shows, while we might not need to worry about fairness to shareholders, if we are efficiency minded this response to the inefficient self-selection problem is not satisfying - regardless of whether shareholders know what they are buying, firms’ self-selection results in real inefficiency costs that could be saved.

Finally, there is one dimension in which firms seem to choose their right size in cross-listing – the costs dimension. Cross-listing on U.S. exchanges which triggers compliance, imposes costs. As these costs typically include a fixed component they are disproportionately large for small firms. Indeed firm size is positively correlated with cross-listing. Firms that need capital would find it especially valuable to utilize bonding to increase the value of their shares. Indeed, Needs or plans for raising capital are also associated with cross-listing.<sup>155</sup>

### C. State Competition

*“[S]tricter corporation laws survive because in some instances market oriented governance mechanisms do not provide some classes of shareholders with the explicit legal controls they prefer. More liberal corporation laws survive because they allow certain firms to economize on the costs of political or legal control of managers, without interfering with the operation of market controls.”<sup>156</sup>*

This sub-Part discusses evidence from choice of corporate law regime among U.S. states. In this context too, there has been little analysis into what sort of firms tend to

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<sup>153</sup> See e.g., Doidge et al., Ownership, supra note (civil law, antidirector index and the Investor protection index less likely to list on US exchanges); John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 291 (2007); see also Craig Doidge, G. Andrew Karolyi, & René M. Stulz, *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. OF FIN. ECON. 205 (2004) (finding that “firms from countries with poorer investor protection list when their growth opportunities are greater than those of firms from countries with better investor protection”); Cf Michael S. Weisbach & William A. Reese, Jr. *Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings*, 66 J. OF FIN. ECON. 65 (2002) (only after controlling for relevant firm characteristics, firms from civil law countries were less likely to cross-list on U.S. exchanges than firms from common law countries).

<sup>154</sup> See Hail & Leuz, supra note 151, Tbl 5. To be sure, since fewer firms cross-list from these countries, the results could reflect unique characteristics of, or beliefs with respect to, these firms. For example, investors may interpret the decision to cross-list by these firms, as a signal of particularly high growth expectations. Hail and Leuz conduct several robustness tests to control for self selection in general and changes to growth expectations in particular. See *id* (using firm fixed effects in a large panel data, and different controls including changes in expected long term growth and changes to analysts growth forecasts).

<sup>155</sup> William A. Reese, Jr & Michael S. Weisbach, *Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings*, 66 J.FIN. ECON. 65 (2002).

<sup>156</sup> Baysinger & Butler, *Uniformity in Corporate Law*, supra note 1.

choose lax law and which ones opt for strict law.<sup>157</sup> This is partly because conventional wisdom suggested that corporate law is relatively uniform across states. However, as I have shown in separate work, Nevada rather distinguishes itself from Delaware by offering a very lax corporate law regime. Utilizing these state law variations in a joint work, David Smith and I researched the type of firms that Nevada attracts.

### *1. Nevada Lax Corporate Law*

For years, conventional wisdom suggested that Nevada copied Delaware corporate law and even followed closely changes to it.<sup>158</sup> Yet, as I found and describe in detail in separate work, Nevada's corporate law is significantly different from Delaware's as it limits directors' and officers' exposure to liability for breaches of the fiduciary duties that are the cornerstones of Delaware law—the duties of loyalty and good faith.<sup>159</sup> The following will summarize the main differences in the states' fiduciary law.

In 1985 Delaware adopted its exculpation statute, section 102(b)(7) of the DGCL, which allows companies to opt out of directors' liability for duty of care breaches. The statute explicitly prohibits opting out of liability for breach of the duty of loyalty, behavior that is not in good faith, transactions from which the director derived improper personal benefits and acts that involve intentional misconduct or knowing violation of law.<sup>160</sup> Nevada adopted an exculpation statute in 1987, which already then was significantly different from Delaware's. NRS section 78.037 (1987) included only one

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<sup>157</sup> For a notable exception see Baysinger & Butler, *Uniformity in Corporate Law*, *Id.* Baysinger & Butler predict that in state competition for charters firms will choose their right "size". In particular they predict that firms that are exposed to weak market forces will incorporate in states with strict corporate law and firms that are exposed to strong market forces will incorporate in states with lax corporate law. See *id.*; see also Baysinger & Butler, *The Role of Corporate Law*, *supra* note 74.

<sup>158</sup> See e.g., Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1067 (2000) (surveying literature and cases that argue that NV follows DE law closely); *But See* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1856 & n. 206 (2002) ("Nevada provides extremely broad director indemnification provisions, allowing companies to eliminate or limit the personal liability of directors and officers for breach of fiduciary duty"); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 726 n.168 (2002) ("Despite occasional claims to the contrary, Nevada does not imitate Delaware."). For the assumption that NV follows DE law, literature typically refers back to the seminal paper, which opened the state competition debate by William Cary. Yet the paper does not argue that Nevada copied Delaware law. Rather all it says is that Nevada attempted to become Delaware of the West. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 665 (1974) ("Nevada has attempted to become the western Delaware but not with comparable success.").

<sup>158</sup> Both statutes also included an exception for unlawful distribution of dividends. For Nevada 1987 exculpation statute see <https://www.leg.state.nv.us/Statutes/64th/Stats198701.html#Stats198701page80>

<sup>159</sup> See Barzuza, *Market Segmentation*, *supra* note 17; *But see* Jens Dammann, *How Lax is Nevada Corporate Law? A Response to Professor Barzuza*, 99 VA. L. REV. IN BRIEF 1–10 (2013) (arguing that Nevada law is not materially different from other states' corporate law)

<sup>160</sup> DEL. CODE. ANN. tit. 8, §102(b)(7):

"The certificate of incorporation may also contain any or all of the following matters: (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, *provided that such provision shall not eliminate or limit the liability of a director*: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit."

(slightly modified) exception of the Delaware statute. In particular, under Nevada 1987 exculpation statute firms could opt out of liability for breaches of all of directors' fiduciary duties (including care, loyalty and good-faith), unless directors' acts or omissions also "involve intentional misconduct, fraud or knowing violation of law."<sup>161</sup> Furthermore, unlike Delaware's exculpation statute that applied to directors but not to officers, Nevada's exculpation statute allowed firms to release both directors and officers from liability for fiduciary duties' breaches.<sup>162</sup>

In 2001 Nevada mandated these protections on all firms incorporated in Nevada.<sup>163</sup> In 2003, Nevada followed up by adding an opt-out provision of these protections via charter amendment, which would require management initiation.<sup>164</sup> As a result, currently under Nevada's NRS section 78.138.7, *by default*, neither duty of loyalty nor duty of good faith breaches trigger liability for directors and *officers*, unless they *also* involve intentional misconduct, fraud, or knowing violation of law.<sup>165</sup>

As the legislative history of Nevada's new corporate law system shows, Nevada clearly intended to differentiate itself from Delaware by providing its corporations with minimal liability exposure. Promoting the 2001 amendment, Nevada Chairman of the House, Senator Mark A. James, explained to the to the Senate Committee on the Judiciary, that in order to attract corporations, and to increase incorporation taxes "Nevada ought to offer some liability protection to directors of corporations."<sup>166</sup> A local

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<sup>161</sup> Both statutes also included an exception for unlawful distribution of dividends. For Nevada 1987 exculpation statute see <https://www.leg.state.nv.us/Statutes/64th/Stats198701.html#Stats198701page80>

<sup>162</sup> *Id.*

<sup>163</sup> See e.g., Keith Paul Bishop, *Silver Standard*, Los Angeles Lawyer, November 2008, 32 (noting that Nevada automatically relieves directors and officers from liability unless both conditions are met). See also Barzuza, *Market Segmentation*, *supra* note 17 (citing reincorporation proxy materials which state that as a result of reincorporation to Nevada directors will not be liable anymore for duty of loyalty breaches). The 2001 amendment also added several specific violations and prohibitions from NV law that could not have the protection of the statute, such as violations of securities trading limitations under NV law. Interestingly the exceptions include also breaches of liability of an agent to a principal under NRS 91.250, which possibly could apply to broaden directors' liability. Yet, NV legislative intent, marketing efforts, and the common perception in practice are not consistent with such an interpretation.

For NV 2001 amendment see

<https://www.leg.state.nv.us/Statutes/71st/Stats200121.html#Stats200121page3171>

<sup>164</sup> For NV 2003 amendment see

<https://www.leg.state.nv.us/Statutes/72nd/Stats200325.html#Stats200325page3084>

The 2003 amendment extended NV exculpation from shareholder lawsuits, to protect directors and officers also from creditors' lawsuits.

<sup>165</sup> NEV. REV. STAT. § 78.138(7) (2010):

7. Except as otherwise provided in NRS 35.230, 90.660, 91.250, 452.200, 452.270, 668.045 and 694A.030, or unless the articles of incorporation or an amendment thereto, in each case filed on or after October 1, 2003, provide for greater individual liability, a director or officer is not individually liable to the corporation or its stockholders or creditors for any damages as a result of any act or failure to act in his or her capacity as a director or officer unless it is proven that:

(a) The director's or officer's act or failure to act constituted a breach of his or her fiduciary duties as a director or officer; and

(b) The breach of those duties involved intentional misconduct, fraud or a knowing violation of law.

Available at <https://www.leg.state.nv.us/nrs/NRS-078.html#NRS078Sec300>

<sup>166</sup> Bill Draft Request 7-1547, introduced as Senate Bill 577, *Hearing on S.B. 277 Before the Senate Comm. on the Judiciary*, 2001 Leg., 71st Sess., (Nev. 2001) (statement of Senator Mark James). Senator James further explained that since "Directors are the ones who decide where to incorporate... this will be a major incentive[]." *Id.* at 10-11. Taxes were raised in 2003, not by as much as originally anticipated. See Barzuza,

Nevada attorney, Michael J. Bonner, also spoke in favor of providing more protection from liability than Delaware:

When we look at our Nevada corporate business statute we have to recognize that...it is Delaware versus home state versus Nevada, if it is a tie, if the corporate laws of these jurisdictions are equally favorable... typically, they are going to select Delaware. That is just the way it is...if Nevada can enhance the liability protection for [directors and officers] and strike the proper balance to not protect those who have participated in criminal activity or fraud, the state will go a long way to making Nevada an attractive place in which to incorporate.<sup>167</sup>

Accordingly, Nevada has been marketing its services by highlighting the greater protections afforded to managers, directors and officers under Nevada law. For example, the Nevada Secretary of State's website explains, under the heading "Why Nevada?" that "Nevada Provides Stronger Personal Liability Protection to Officers and Directors"<sup>168</sup>

## 2. Nevada Firms

Nevada's strategy, to offer a differentiated product to attract incorporations, builds on firm heterogeneity. Thus, the case of Nevada provides an additional setup to assess whether firms select their right "size". In particular, one could argue, that some firms' needs for constraints are so small that overall they are better off with almost no directors and officers' liability, even not for breaches of the duty of loyalty.<sup>169</sup> If firms choose their right "size" thus, Nevada should attract firms that already face significant market or governance constraints.<sup>170</sup> If private ordering is not working efficiently, however, Nevada's lax law may attract firms that face lax constraints and have particularly high

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*Market Segmentation*, *supra* note 17. Indeed, in 2003 Nevada increase its maximum incorporation fee from 80 to 12000. Taxes were raised in 2003, not by as much as originally anticipated. *Id.*

<sup>167</sup> *See id.* at 13.

<sup>168</sup> Secretary of State Barbara K. Vegaske, WHY NEVADA? Commercial Recordings <https://www.nvsilverflume.gov/whyNevada>.

If you press on the pdf link you find a summary of the legal differences, including: "Although Nevada generally requires both intentional misconduct, fraud or a knowing violation of the law and a breach of a fiduciary duty to impose liability on a director, under Delaware and California law, a director may be held liable for a breach of a fiduciary duty absent intentional misconduct, fraud or a knowing violation of the law." Secretary of State Barbara K. Vegaske, WHY NEVADA? Commercial Recordings, Legal Advantages: A comparison with Delaware and California, Lionel Sawyer & Collins and Parsons Behle & Latimer Law Firms <https://www.nvsilverflume.gov/documents/CorporateLawComparison.pdf>

*Cf.* Kahan & Kamar, *supra* note 158, at 717-21 (reporting that prior to 2001 Nevada marketing efforts were focused primarily on attracting close corporations, stressing confidentiality and tax benefits for close corporations that incorporate in Nevada)

<sup>169</sup> The evidence in favor of opting out of duty of loyalty however, is not supportive of this claim, since unlike Duty of care, and securities class action lawsuits duty of loyalty cases do not provide substantial evidence for a frivolous lawsuits. *See* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Orientated Class Actions*, 57 VAND. L. REV. 133, 207-08 (2004) ("more so than in . . . securities fraud suits, the merits appear to matter."); *see also* Barzuza, *Market Segmentation*, *supra* note 17, at 983; *Cf.* James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 979-81 (1996) (presenting evidence of frivolous suits in securities class actions); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991); Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

<sup>170</sup> *See* Baysinger & Butler, *Uniformity in Corporate Law*, *supra* note 1 (arguing that firms that states will liberal law will attract firms that are exposed to strong market forces).

agency costs. Indeed, some representatives in Nevada were concerned by this fairly intuitive possibility. For example, Senator Dina Titus warned that the state might just as well hang up a sign reading, “Sleaze balls and rip off artists are welcome here.”<sup>171</sup> Senator Bob Coffin echoed these concerns, warning that “reputable companies [were] not going to want to come here to save a few dollars”<sup>172</sup> and that Nevada would become:

[T]he place where Butch Cassidy and Sundance Kid would go, the Hall in the Wall... Make no mistake, these subtle changes are significant. Scoundrels can move here, and there are scoundrels in the mutual fund business and in the pension business and in many corporations. If I was one of them I might consider moving here now.<sup>173</sup>

#### a. Nevada Firms’ Restatements and Reporting Aggressiveness

In a recent work, David Smith and I conducted the first systematic research into the kind of firm that choose to incorporate in Nevada. Using panel data between 2000-2011 we researched the reporting behavior of Nevada firms relative to firms in Delaware and in other states.<sup>174</sup> The study focused on accounting restatements—that is, the process by which firms amend their reported performance figures retroactively, typically downwards – as a proxy for firms’ agency costs. There are several reasons for why accounting restatements serve as a good proxy for agency costs in examining Nevada firms. To begin with, until recently, and during our sample time period, managers could have benefited significantly from misstating their earnings.<sup>175</sup> Bonuses were awarded based on performance, clawback provisions – which required managers to pay back bonuses that were paid based on misstatements – took time to take off, and were robustly enforced only recently. Accordingly, accounting restatements, and the misstatements they amend, drew a significant negative market response.<sup>176</sup> Restatements harm managers’ credibility,<sup>177</sup> and are associated with weak internal and external controls.<sup>178</sup> Consistent

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<sup>171</sup> *Id.* at 159.

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* Ultimately the opponents supported the law since it was promised to them that the projected \$30 million in revenues will be used to increase salaries of public school teachers. *Id.* at 158.

<sup>174</sup> See Barzuza & Smith, *supra* note 18.

<sup>175</sup> Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Market: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 701 (1992); John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXFORD REV. ECON. POLY 198 (2005); Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1130-31 (2003); Oren Bar-Gill & Lucian A. Bebchuk, *Misreporting Corporate Performance* 2-3 (Harvard Law and Econ. Discussion Paper No. 400, 2002, revised 2003), available at <http://ssrn.com/abstract=354141>.

<sup>176</sup> See e.g., Palmrose, Z., V. Richardson, and S. Scholz, S. *Determinants of market reactions to restatement announcements*. 37 J.ACC. & ECON. 59 (2004) (finding the negative response to restatements announcement that is related to the likelihood of fraud involved, the number of accounts and decrease in reported income); Joseph H. Golec, Katsiaryna S. Bardos and John Harding, *Litigation Risk and Market Reaction to Restatements* 3 J. FIN. RES., 19 (2013) (finding that about half of the average -9.2% market reaction to restatements is due to expected litigation cost).

<sup>177</sup> Anderson, K. L., and Yohn, T. L. 2002. *The effect of 10K restatements on firm value, information asymmetries, and investors’ reliance on earnings*. Working Paper, available at <http://ssrn.com/abstract=332380>; Wilson, W. 2008. *An empirical analysis of the decline in the information content of earnings following restatements*. 83 ACC. REV. 519 (finding that the decline in ERC lasts only for three quarters after the restatement announcement); Cf. X Chen, Q Cheng, & AK Lo, *Is the decline in the*

with managerial motives for misstatements, restatements are associated with high component of option-based compensation.<sup>179</sup> Indeed, in those cases in which clawback provisions were implemented the likelihood for restatements declined and investors' responses to earnings improved.<sup>180</sup> To be sure, restatements could sometimes result from mere errors in interpretation or judgment rather than fraudulent behavior.<sup>181</sup> Yet, negligence, laziness, or aggressive reporting, also reflect agency costs, as not all managers in all firms could afford this slack. Moreover, in addition to investigating restatements, we also measured Nevada firms on a separate metric for aggressiveness in reporting, developed by GMIRatings, finding results consistent with Nevada firms being exceptionally aggressive in their reports.

In particular, our study finds that firms that choose to incorporate in Nevada are significantly more likely to restate their earnings than firms in Delaware or elsewhere.<sup>182</sup> On average the proportion of Nevada firms in our sample that restated financials each year (12.5%) is almost double their proportion in Delaware (7.4%) and in other states (7%). After controlling for various firm and industry variables we find that Nevada firms are twenty to thirty percent more likely to restate their financials in a given year than firms incorporated in Delaware or other states. The results hold for earning reduction restatements, and for restatements that involve fraud or trigger regulatory investigations.

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*information content of earnings following restatements short-lived?* 89 ACC. REV. 177 (2014) (finding that “material restatement firms experience a significant decrease in the ERC over a prolonged period – close to three years after restatement announcements. In contrast, other restatement firms experience a decline in the ERC only for one quarter after restatement announcements.”)

<sup>178</sup> See e.g., Michael Ettredge et al., *How Do Restatements Begin? Evidence of Earnings Management Preceding Restated Financial Reports*, 37 J. BUS. FIN. & ACCT. 332, 334, 351 (2010) (finding that restatements are preceded by balance-sheet bloating especially, but not only, when fraud is involved); Jap Jap Efendi, A. Srivastava, & E. P. Swanson, *Why do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667,670, 700, 703 (2007) (finding that restatements are related to incentive based compensation); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Market: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 701 (1992) (arguing that fraud in reporting is an agency problem); John C. Coffee, *A Theory of Corporate Scandals: Why the U.S. and Europe Differ*. 21 OXF. REV. OF ECON. POL. 198, 201-204 (2005) (arguing that restatements are motivated by management desire to increase the value of their option packages); Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1130–31 (2003); see also Bar-Gill & Bebchuk, *supra* note 175 (developing a formal model of misreporting and showing how incentive-based compensation may incentivize managers to misreport).

<sup>179</sup> See Efendi, Srivastava & Swanson, *supra* note 178 (“the likelihood of a misstated financial statement increases greatly when the CEO has very sizable holdings of in-the-money stock options”); N Burns, & Simi Kedia, *The impact of performance-based compensation on misreporting*. 36 J. FIN. ECON. 35 (2006). (“sensitivity of the CEO's option portfolio to stock price is significantly positively related to the propensity to misreport.”)

<sup>180</sup> Kevin C. W. Chen, Tai-Yuan Chen, L. Chan & Y. Yu, *The Effects of Firm-initiated Clawback Provisions on Earnings Quality and Auditor Behavior*, 54 J. OF ACC. & ECON. 180 (2012).

<sup>181</sup> Using restatements to assess Nevada firms has other advantages relative to other measures of corporate governance, such as: frequent variations over time, broad coverage of NV Firms (G-Index for more than 1,500 publicly traded companies, covers only 20 companies incorporated in Nevada) and the fact that restatements are regulated primarily by federal law. See Barzuza & Smith, *supra* note 18 (“while our paper focuses on cross-state differences in corporate law, our measure itself is independent of the law because restatements are enforced at the federal level”). Also, as discussed below, utilizing Tobins Q as a measure for the performance of Nevada firms faces significant challenges.

<sup>182</sup> See Barzuza & Smith, *supra* note 18.

Consistent with the findings with respect to Nevada law we found that the restatements effects are driven by firms that moved to Nevada after the 1987 amendment. We did not find evidence that restatements are higher for firms that incorporated after the 2001 amendment, but this could be due to the shorter time span in our sample for some of these firms.

Our study did not rely only on regression controls, rather we also constructed a matched sample of Nevada and Delaware firms. In particular, using a propensity score estimator that matches Nevada firms to Delaware firms in a multidimensional matching model, our results remained robust and were consistent with regression coefficients.<sup>183</sup> We also found that the different reporting behavior by Nevada firms is not limited to restatements. GMIRatings created an accounting metric that ranks firms' overall reporting quality. Nevada firms ranked as aggressive on this metric as well. Finally, a geographical instrument produced some evidence for causation, while firm fixed effects did not produce a significant relationship, possibly due to the limited number of reincorporations in our sample.<sup>184</sup>

Several other studies have documented aggressive, and even fraudulent reporting behavior of Nevada firms. In a line of studies Catadelo et al. found that a disproportionately high number of Nevada firms were subject to SEC trading suspensions, driven by concern for potential inaccurate reporting or market manipulation.<sup>185</sup> For example, out of 17 firms for which the SEC suspended trading on June 7, 2011, in an attempt to combat microcap stock fraud, 2 were from Delaware and ten from Nevada. Nevada firms were also overrepresented in a sample of DOJ and FBI actions to arrest executives for stock manipulation. As the authors argue executives of Nevada executives were engaged in pumping and dumping shares, that is, inflating the company share price based on false information, only to sell and issue large amount of shares in the inflated price.<sup>186</sup> In one notable example that the authors report, Universal

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<sup>183</sup> Since our different tests compare NV firms with DE firms, our effect is clearly a NV effect and not an out of state effect. See Kate Litvak, *How Much Can We Learn from Regressing Corporate Characteristics Against the State of Incorporation?* (working paper 2011) (stressing the importance of distinguishing a DE or NV effect from an out of state effect.)

<sup>184</sup> We also find evidence consistent with NV managers attracted to Nevada lax law – firms who have their HQ in pro managerial states, that is states that provide managers with different protections, are significantly less likely to incorporate in NV. Managers choose Nevada thus, only if their home state protection is not likely to meet their preference for particularly strong protection.

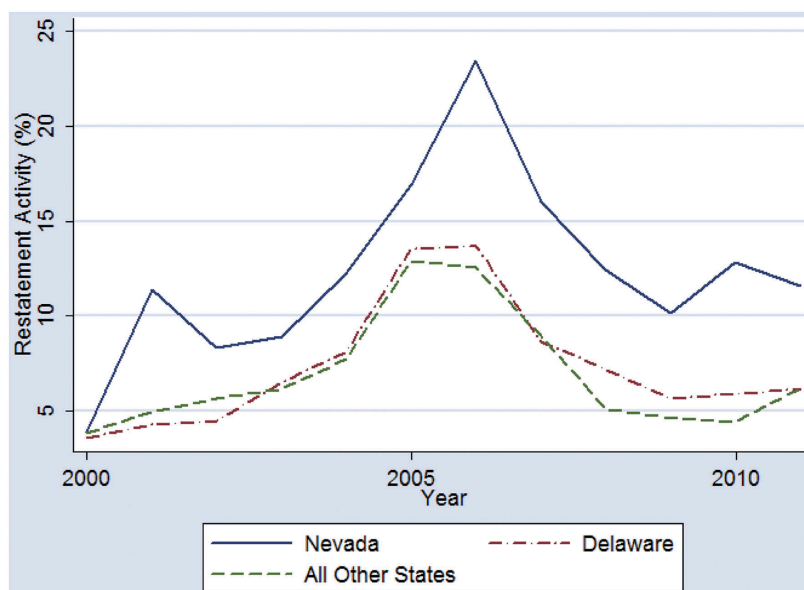
<sup>185</sup> See Anthony J. Cataldo II, Peter F. Oehlers, & Robert C. Scanlon, *What Happens in Vegas Doesn't Always Stay in Vegas: Nevada Corporations Enjoy a Disproportionate Share of SEC Trading Suspensions*. 58 OIL, GAS & ENER. QUAR. 55 (2009) (finding that Nevada firms were over represented (and Delaware firms under represented) in naked shorting complaints, SEC 2004 suspensions and SEC 2007 “operation spamalot” (companies that were subject to repeated spam email campaigns)); A.J. Cataldo II, Thomas Miller, Lori Fuller & Brian J. Halsey, *The U.S. State of Nevada Consumes a Disproportionate Share of U.S. Securities and Exchange Commission Regulatory Resources*, 5(8) INT. RES. J. OF APP. FIN. 1222 (2014) (finding Nevada firms overrepresented in SEC trading suspensions for each and every month during 2012 and 2013); Anthony J. Cataldo II, Lori Fuller, Brian J. Halsey & Thomas Miller, *Nevada Continues to Lead Delaware and All Other States and Jurisdictions in 2014 Securities and Exchange Commission Trading Suspension*, 6 . REV. APP. FIN. 679 (2015) (finding Nevada firms represent 35.9% of SEC trading suspensions during 2014); see also SEC Investor Bulletin: Trading Suspensions <https://www.sec.gov/investor/alerts/tradingsuspensions.pdf>;

<sup>186</sup> Anthony J. Cataldo II, Thomas Miller & Lori Fuller, *More Evidence of the Nevada Effect: SEC, DOJ, FBI, and IRS Regulatory Enforcement Actions* 7 J. FOREN. & INVEST. ACC., 3077 (2015).

Express' CEO, who was promoting the company shares based on false information, filled a complaint with the SEC that a naked short selling is causing the company share price to decline. The SEC found it was the CEO himself, who was selling billions of unregistered shares.<sup>187</sup>

The choice of Nevada law is associated with inaccurate reporting also among foreign companies. A recent study examined the relatively recent practice of cross-mergers by foreign companies into U.S. shells. A company that merges into a publicly traded US company does not have to file an initial public offering registration statement. Apparently, foreign companies increasingly use shell US companies, that is, companies that were established for that purpose only and have no other activities, to circumvent IPO reporting obligations and relatively high liability exposure. Out of 1139 reverse mergers between 1996-2012, 606 companies merged into Nevada shells, and 309 into Delaware shells. The study found that “[a]doption of Nevada’s corporate law is associated with some of the most serious restatements involving real corporate governance and data manipulation problems.”<sup>188</sup>

Figure 1: Financial Restatements 2000–2011 in Nevada, Delaware, and other States (as a percentage of the number of publicly traded companies)<sup>189</sup>



<sup>187</sup> Anthony J. Cataldo II, Lori Fuller & Thomas Miller, *An Analysis of SEC and PCAOB Enforcement Actions against Engagement Quality Reviewers: A Comment and Extension in Support of the Nevada Effect*, 6 J. FOREN. & INVEST. ACC. 157 (2014); See also U.S. Securities and Exchange Commission, Plaintiff, v. Universal Express, Inc., et al., Defendant. United States District Court for the Southern District of New York, 1:04-cv-2322(GEL). June 24-25, 2008.

<sup>188</sup> Jordan I. Siegel, & Wang, Y., *Cross-border reverse mergers: Causes and consequences* (2012) Harvard Business School Strategy Unit Working Paper No. 12-089, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2192472](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2192472).

<sup>189</sup> Figure 1 is taken from Barzuza & Smith, *supra* note 18.



## b. Nevada Firms' Value

Despite what one might expect given the high ratios of reporting irregularities of Nevada firms, our study did not find conclusive evidence that firms in Nevada were traded in a lower value relative to firms in other states.<sup>190</sup> Several other studies, described below, have attempted to assess the effect of Nevada law, Nevada 2001 legal reforms, and reincorporations to Nevada, on Nevada firms' market value. Results with respect to the effects of Nevada law on the value of Nevada firms however, should be interpreted cautiously. Nevada firms are exceptionally small which affects firms Tobin's Q. Moreover, inaccurate reporting could have inflated the value of some of these firms, as the Universal Express and several other case studies demonstrate. Third, the rate of firms that exist the Compustat sample is especially high in Nevada suggesting that a survivorship bias could affect the results.<sup>191</sup> Fourth, Nevada firms come disproportionately from OTC, which provides only thin trading data. For OTC firms there are many days with no price data. Fifth, as the literature demonstrates there were many misconceptions with respect to Nevada law, so it is not clear that the market had full information with respect to Nevada legal regime and its effects on firms. Sixth, at some point Nevada has embarked on marketing its legal regime, and this point in time, which hasn't been clearly identified yet, could also effect the market value of NV firms. Seventh, finding an instrument to study the value of NV firms that satisfies the exclusion restriction is challenging.<sup>192</sup> With these caveats in mind the following turns to discuss these studies.

Testing the effects of Nevada's 2001 law on Nevada firms Donelson and Yust found that the law had a negative effect on the value of Nevada firms that were traded on OTC.<sup>193</sup> They interpret that to suggest that the law is more harmful for firms with weaker governance, as OTC firms do not have to comply with listing standards requirements. Since many firms already had the liability protections implemented as a result of the 1987 exculpation statute, Eldar studied the effect of the law's passage on the 35 Nevada firms

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<sup>190</sup> Barzuza & Smith, *supra* note 18, at 3598, 3618-20 & Tbl 11 (finding no statistically significant effect for the valuation of NV firms and stating that "Overall, our valuation findings are inconclusive and make it difficult to draw strong conclusions regarding the efficiency of the decision to incorporate in Nevada."). Results from other studies of NV valuation effects are mixed. *See e.g.*, Litvak, *supra* note 183 (finding significantly higher Tobin's Q for firms incorporated in NV); Ofer Eldar, *Nevada Corporate Law and Shareholder Value* (working paper 2016, on file with author) (finding higher Tobin's Q for small firms incorporated in NV but not for large ones) (both studies do not account for the high proportion of NV firms that exit the compustat sample, and the resulting survivorship bias); A.J. Cataldo II, Thomas Miller, Glenn Soltis & Brian J. Halsey, *Building and Testing a Portfolio of Marijuana Stocks: Why U.S. SEC Trading Suspensions Might Cause Some to Crash Before (or After) Reaching New High*, 5(9) INT. RES. J. OF APP. FIN. 1131 (2014) (Finding that NV incorporation is associated with lower returns in a sample of marijuana firms); Dain Donelson and Christopher G Yust, *Litigation Risk and Agency Costs: Evidence from Nevada Corporate Law*, 57 J. OF L. & ECON. 747 (finding a negative effect for the 2001 amendment); Eldar, *Id* (finding that the 2001 reform has "no significant effect on the shareholder value of Nevada firms").

<sup>191</sup> *See* Barzuza & Smith, *supra* note 18, at 3599-3601 & Tbl. 2 (Nevada firms account "for roughly 10% of all Compustat exits from 2007 to 2011")

<sup>192</sup> As explained above, we used a geographical instrument for our study of NV restatements. When the dependent variable is Tobin's Q however, a geographical instrument is less likely to meet the exclusion restriction.

<sup>193</sup> Donelson & Yust, *supra* note 190. The 2001 amendment has changed the 1987 opt in protections, to be mandatory (and late default).

that did not opt into the 1987 default protection, and found no significant effect.<sup>194</sup> Elder results might be driven by the size of the sample combined with the fact that the statute also affected all firms in Nevada.<sup>195</sup> Furthermore, Nevada is now marketing its regime vigorously, via secretary of state web site and other venues. When did these marketing efforts turned significant is important question for evaluation of the effects of the law.

Event studies of reincorporation effects on Nevada firms are highly limited, as reincorporations are infrequent, endogenous, potentially reflecting confounding events, and more important lack pricing data for many days around the event. Studying reincorporation to Nevada Kobayashi and Ribstein identified only one case of incorporation for which they have full price data, and found no significant effect.<sup>196</sup> Eldar uses a larger sample but he chooses to complete missing dates data with a trade to trade method. Eldar finds no significant results for the sample of reincorporation in and out of Nevada. Only when he drops out of the sample firms that accompanied the reincorporation with a reverse stock split, or issuance of new shares, he finds some weak positive results. Yet, excluding the problematic firms results in clear selection effects. Furthermore, since many firms combine reincorporation with a reverse stock split, investors could interpret not doing so as a positive signal. Indeed for the firms that reverse split their shares or issued new shares the results are negative and statistically significant.

To sum, the literature hasn't yet produced conclusive results with respect to the effect of NV law on firm value. Furthermore, any such effect should be interpreted with caution. It is possible that choosing Nevada reflects a value maximizing equilibrium.<sup>197</sup> It is also possible that, for example, investors are not sufficiently informed about the legal reforms in Nevada and their potential effect. Indeed, as a recent paper shows, for investors to determine and incorporate the value of governance terms to share price could take as long as a decade.<sup>198</sup>

### 3. Delaware Firms Compared to Home-State Firms

Almost every firm that does not incorporate in Delaware or Nevada chooses to incorporate in the state in which its headquarters are located—in other words, its home state.<sup>199</sup> Comparing firms that choose to incorporate in Delaware with those that choose to incorporate in their home state might shed additional light on how firms self-select. Home states are inclined to provide, and have provided in the past, protection to local managers. Delaware on the other hand provides specialized judges, efficient judicial

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<sup>194</sup> See Eldar, *supra* note 190, at 19 (“The results show that the 2001 law reform had no material impact on firm value.”)

<sup>195</sup> For example, the 2001 amendment could provide a signal of Nevada intentions with respect to interpreting and enforcing its managerial protective regime. See Barzuza *Market Segmentation*, *supra* note 16

<sup>196</sup> Bruce H. Kobayashi & Larry E. Ribstein *Nevada and the Market for Corporate Law*, 35 SEAT. UNI. L. REV. 1165 (2012).

<sup>197</sup> See e.g. Barzuza *Market Segmentation*, *supra* note 16.

<sup>198</sup> Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Learning and the Disappearing Association between Governance and Returns*, 108 J. FIN. ECON. 323 (2013).

<sup>199</sup> See Daines, *IPO Firms*, *supra* note 92; Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate* 46 J. L. & ECON. 383 (2003).

system, a rich body of case law, reputation, and a broad familiarity with its law.<sup>200</sup> Which firms choose to incorporate in their home state and which firms choose to incorporate in Delaware?

As Rob Daines found, firms in Delaware have higher Tobin's Q values than firms in other states.<sup>201</sup> Two possible theories might explain Daines's results. First, Delaware's superior law might improve firm value—Daines defended this view in his paper. Second, the difference might stem in part from a selection effect: it could be that better law increases firms' value *and* attracts better firms. Daines carefully examined possible selection biases. For instance, his study tested separately the effect for mature firms that never reincorporated under the assumption that these firms have a fixed domicile—that is, they did not make a deliberate choice regarding the state of incorporation and thus their state of incorporation is to some extent exogenous.<sup>202</sup> Indeed Daines' findings are consistent with selection not explaining all of Delaware's premium. At the same time, as Daines notes, it is still possible that selection affects part of his results.<sup>203</sup> Put differently, it is still possible that Delaware law *both* attracts better firms and increases firm value.<sup>204</sup> For example, it is possible that Delaware attracts firms with lower agency costs, which further decline after they move to Delaware.<sup>205</sup> Supporting this interpretation, Ishii, Gompers, and Metrick ran Daines' find that Delaware effect turns insignificant, if they control for the governance index they developed. Thus, firms that choose Delaware tend to be better firms, prior to moving to Delaware.<sup>206</sup>

The results are consistent (though not exclusively) with inefficient self-selection, as Delaware's relatively strict law attracts better firms, rather than worse firms that could probably benefit more from Delaware law. Managers that face weak constraints tend to stay in their relatively protective home state. To be sure, for some firms, the choice of home state is probably driven by factors other than a preference for a pro-managerial system – for example, an advise from local lawyer, or mere inertia.<sup>207</sup> These firms thus create noise that camouflages a potentially bad signal of staying at home for management protections. Investors do not know if firm A stayed at its home state Massachusetts since it wanted to benefit from its staggered board rule, or just because she never thought about moving to Delaware. Accordingly the discount they attach to the home state is limited at

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<sup>200</sup> See e.g., Roberta Romano, *THE GENIUS OF AMERICAN CORPORATE LAW* (AEI PRESS, 1993); Klausner, *Networks*, *supra* note 92; Brian Broughman, Daria Ibrahim & Jesse Fried, *Delaware Law as Lingua Franca: Theory and Evidence*, 57 J. L. & ECON. 865 (2014)

<sup>201</sup> Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 525 (2001) [hereinafter Daines, *Firm Value*].

<sup>202</sup> See *id.* at 550-51.

<sup>203</sup> See *id.* at 553 (“It is impossible to exclude the possibility that Delaware simply attracts valuable firms. Although selection bias may explain some of the effect I observe, it seems unlikely that selection bias explains it all.”).

<sup>204</sup> But see Guhan Subramanian *The Disappearing Delaware Effect*, 20 J. OF L. ECON. & ORG. 32 (2004).

<sup>205</sup> See *id.* (arguing that this story is consistent with the result that Delaware law improves firm value. “Note that there is one endogeneity account that is consistent with the evidence. If Delaware law facilitates the sale of the firm, good managers might be more likely to incorporate there because they have less reason to fear a disciplinary takeover. Poor managers, or those valuing private benefits, would thus avoid Delaware incorporation because it would be more costly.”)

<sup>206</sup> See also Litvak, *supra* note 190 (finding that firms that incorporate out of their home state have higher Tobin's Q)

<sup>207</sup> Bebchuk & Cohen, *Reincorporation Choices*, *supra* note 198, Daines, *IPO Firms*, *supra* note 92.

best. Home state incorporation, which is typically an IPO decision, thus, corresponds to an IPO “noise” equilibrium in our theoretical analysis.<sup>208</sup>

#### D. Modern Corporate Governance: Proxy Access, Contested Shareholder Proposals, and Majority Voting

This Part will focus on two recent governance changes that diffused among firms in recent years—majority voting, and proxy access—the former is in the mid of its diffusion process and the latter has spread to almost all S&P 500 firms. Both were intended to give shareholders more voice in directors’ elections, which in reality, was highly limited. Both waves were initiated and partially diffused by shareholder proposals and supported by proxy advisory firms’ recommendations.

Before getting into analyzing diffusion patterns some background is in due. Shareholder may submit a proposal for shareholder vote under SEC Rule 14a-8.<sup>209</sup> While this mechanism existed for a long time, its rise as a governance influential tool is attributed to other forces at play. Most notably, proxy advisory companies, in recommending institutions how to vote on these proposals, provide information, research and function as a coordination point. Whether or not proxy advisory firms actually influence votes or merely provide recommendation that reflect shareholder interest, by collecting and analyzing information for shareholders, they facilitate shareholder participation, mitigate collective action problems and increase shareholder influence.<sup>210</sup> That shareholders are more likely to vote, provides incentives to submit proposals. Second, lurking in the background is an additional assisting factor - the threat of hedge fund activists. As managers know well by now, hedge fund activists - who need cooperation from other shareholders - thrive on shareholder dissatisfaction, which could result if management is resisting shareholders’ proposals. After the proposal is submitted managers may seek to exclude the proposal, requesting a “no-action” letter from SEC. If the SEC provided the letter, which typically indicates that the SEC staff will not recommend an enforcement action against them for doing so, the proposal will not be brought to a shareholder vote. Alternatively, they could draft a competing proposal and submit both to a shareholder vote, or negotiate the proposal with the shareholder who submitted it. Finally, to avoid hitting any of Rule 14a-8’s nine exceptions, shareholders typically structure their proposals to be precatory, that is, not binding even if they receive support from majority of shareholders. Thus, after the proposal was voted favorably, managers still have the option to ignore it. The following will discuss self-selection in, as reflected in the dynamics of proxy access and majority voting shareholder proposals, and their implementation.

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<sup>208</sup> See *supra* Part IIB. Consistent with a noise signaling equilibrium, Bebchuk and Cohen found that a local lawyer advice and several other factors explain partially, but not fully, home state incorporation. See *Id.*

<sup>209</sup> Rule 14a-8 permits a qualifying shareholder to implement her proposal in the firm’s proxy materials.

<sup>210</sup> See Stephen Choi, Jill E. Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L. J. 869 (2010); See also Ertimur, Yonca, Fabrizio Ferri, and David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay* 51 (5) J. OF ACCOUNT. RES. 951 (2013).

### 1. Proxy Access – Private Ordering and Shareholder Proposals

How well is private ordering working with respect to proxy access shareholder proposals? Recently an SEC study has finally attempted to ask a question along the lines of this article.<sup>211</sup> In particular, the study investigated whether firms that adopted proxy access under private ordering, during the 2015 proxy season, are the ones that according to market assessments stood to benefit most from it? How did the researchers know which companies could benefit most from proxy access in the view of stock market investors? The market responded to news about the passage of the SEC proxy access rule, its subsequent placement on stay, as well as the NYC Comptroller’s announcement to submit shareholder proposals.<sup>212</sup> On average, according to most studies, the market responded in favor of proxy access implementation, but the magnitude of the response varied across firms. Using these variations in firms’ abnormal returns to the announcements, the study finds which firms, according to the market, stood to benefit most from proxy access.<sup>213</sup> To assess the efficiency of the private ordering process, the study then asked whether these firms, which showed the strongest market response to these proxy access related events, were also the ones who were more likely to be targeted by a proxy access shareholder proposal, and eventually adopt proxy access bylaw.<sup>214</sup>

The study’s first finding suggests that these firms were neither more likely or less likely to be targeted by shareholder proposals. While the results could reflect special goals or interests of the activists in general and the NYC Comptroller in particular, it is also possible that investors predicted that these firms will resist more, and preferred to start with the “easier” cases.<sup>215</sup> Indeed, the latter explanation is consistent with the study’s intriguing findings with respect to the managers that resisted proxy access proposals.

As discussed in details above, managers in different firms, most notably *Whole Foods*, attempted to resist shareholder proposals based on Rule 14a-8(i)(9) exception, which allows firms to exclude a shareholder proposal that “directly conflicts with one of the company’s own proposals to be submitted to shareholders at the same meeting.”<sup>216</sup> Managers in these firms drafted proxy access proposals that were significantly more restrictive than the submitted shareholder access proposal. The study finds that out of the 75 firms that received proposals from the NYC comptroller office, 18 firms followed the *Whole Food* strategy. In 16 other companies managers submitted the proposal to a vote

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<sup>211</sup> See Bhandari, Iliev & Kalodimos, *supra* note 9.

<sup>212</sup> Bo Becker, Daniel Bergstresser & Guhan Subramanian. *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge*, 56 J.L. & ECON. 127 (2013).

<sup>213</sup> The results are consistent with variations in abnormal returns in response to the NYC comptroller announcement. The same firms that the market viewed as needing proxy access, showed relatively strong abnormal returns to the comptroller announcement.

<sup>214</sup> With respect to the terms of the proposals, the study finds little initial variations, that eventually converged to the three by three, proxy access rule based proposal.

<sup>215</sup> See Bhandari, Iliev & Kalodimos, *supra* note 9, at 13 (“shareholders might not use private ordering at firms where they expect proxy access to be value-enhancing if success is unlikely or distant.”); Choi, Fisch, Kahan & Rock, *supra* note 9 (“Shareholder activists, instead, could have targeted the least shareholder responsive firms with their MVR campaigns as a way of improving the governance of the firms that, in their eyes, needed it most, ignoring the firms that were already responsive. But this is inconsistent with our result that early adopters are more responsive to shareholders and thus does not seem to have been what happened.”).

<sup>216</sup> See discussion *infra* Part II.

but too different actions in an attempt to reduce support for the shareholder proposal. Thus, in more than half of the targeted firms, in addition to recommending shareholders to vote against the proposal, managers pro-actively fought the shareholder proxy access proposal.

As the study find, firms in which managers chose the relatively aggressive *Whole Foods*' strategy – namely requesting the SEC to issue a no action letter based on a conflicting proposal – were precisely the firms that investors expected to benefit most from proxy access, as evidenced in the market response to the stay and to the NYC Comptroller's announcement.<sup>217</sup> Similarly, firms in which managers took one of the other actions that could somewhat impede the implementation of proxy access – adopting a stricter proposal, bringing a conflicting proposal to vote, or promising to propose or adopt a proxy access in the future, were more likely to benefit from a proxy access proposal. As the authors conclude “managers appear to impede private ordering where it is most valuable, implying that the private provision of proxy access might face the most frictions where it is most necessary.”<sup>218</sup>

## 2. *In Which Firms Managers Contest Shareholder Proposals?*

As the previous Part discuss, it turns out that managers resisted shareholder proposals most in firms that investors thought to be most in need of implementing a proxy access term. The problem that the proxy access study exposed apparently is not unique to proxy access proposals. A recent study, which examines managers requests to exclude shareholder proposals of all types, finds that managers ask SEC permission to exclude 40% of the shareholder proposals they receive, out of which SEC provides a no-action letter in more than 70% of the cases.<sup>219</sup> Thus, almost third of shareholder proposals submitted are not being brought to shareholder vote.

The most common basis for seeking exclusion relates to procedural requirements that the proposal arguably does not meet, second to it is the claim that the proposal contains misleading or false information, for which the SEC grants a no action letter only in 20% of the cases. For the third common basis for exclusion that “the proposal deals with a matter relating to the company's ordinary business operations.” the SEC grants a no-action letter in 70% of the cases. And the fourth relies on Rule 14a-8(i)(10) which allows management to exclude a proposal, if the company has “substantially implemented” the shareholder proposal, for which the Sec granted a no-action letter in 55% of cases. Managers seek to exclude proposals of all types of issues including voting, executive compensation, antitakeover measures and environmental issues.

The study finds that weakly performing firms - firms with worse market performance and operating performance (measured by ROA) - are more likely to be hit by a shareholder proposal, and less likely to have their managers contest the proposal. Importantly, managers are likely to contest a proposal in firms that have a large board, and a combined CEO and chairperson, that is, firms with relatively entrenched governance, that are more, rather than less likely, to benefit from governance constraints.<sup>220</sup> Finally,

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<sup>217</sup> *Id.*, at 32

<sup>218</sup> *Id.*, at 5

<sup>219</sup> See Soltes, Srinivasan & Vijayaraghavan. *Supra* note 219.

<sup>220</sup> *Id.*

managers resist proposals even from large, reputable long-term shareholders, but are less likely to contest a proposal in firms with high institutional holdings.<sup>221</sup>

To sum, in contesting shareholder proposals managers do not seem to choose the right size for their firm.

### 3. *Majority Voting – Early and Late Adopters*

As the previous sections demonstrate managers are most likely to fight shareholders proposals in firms that could benefit from them. Focusing on the stage in which managers contest shareholder proposals however does not provide the entire picture. Some firms adopt governance terms voluntarily to pre-empt shareholder proposals. Others adopt governance terms as a result of unobserved negotiations with shareholders. Finally, as explained above managers do not always implement shareholder proposals that received support from a majority of the shareholders. To get a grasp with respect to self-selection on these dimensions as well, thus, this part discusses evidence with respect to the bottom line – which firms actually ended up implementing a governance term.

A recent work studies implementation patterns of a wildly successful governance terms - majority voting terms - intended to give weight and bite to shareholders' withhold votes. Under Delaware default plurality standards – which nominate the candidates with largest number of supporting votes – directors could be elected when the votes against them, namely “withhold votes,” were overwhelmingly larger than the votes for them. Majority voting terms typically determine that a director nominee that receives more withhold votes than supporting votes should submit his resignation to the board. To be sure, the board has the power not to accept the resignation, and indeed it is pretty rare for these directors to step down. However, it turns out that withheld votes, nevertheless, create sufficient pressure on boards to improve its responsiveness to shareholders' needs and proposals.<sup>222</sup>

The proliferation of majority voting terms (“MV”) is considered the poster-child of efficient private ordering, as they were adopted by a vast majority of S&P 500 firms. Yet, even this seemingly smooth and uniform adoption was effected by self-selection. As a recent study finds, a significant difference exists between the firms that were the first to adopt majority voting terms (“early adopters”), and “late adopters”, who adopted majority voting after 2011—the year with the highest rate of majority vote implementations.<sup>223</sup> Firms that were early to adopt MV, the study finds, were less likely to have a poison pill in place, and more important, were less likely to face withhold votes from shareholders – the problem that MV were designed to treat. In the two years prior to adopting MV, early adopters had a significantly lower likelihood to receive an ISS recommendation to withhold votes to any of its directors and a significantly lower proportion of board nominees that received a withhold votes recommendation.<sup>224</sup> Thus, firms that were early to adopt majority voting were the ones for which majority voting

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<sup>221</sup> *Id.*

<sup>222</sup> See e.g., Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 U. VA. L. REV. 1347, 1420-25 (2011)

<sup>223</sup> Choi, Fisch, Kahan & Rock, *supra* note 9.

<sup>224</sup> *Id.*, at 18 & tbl.3 Early adopters were also less likely to have a poison pill, which is consistent with them not facing a threat of replacement.

made a small difference.<sup>225</sup> Accordingly, relative to late adopters, early adopters were also less likely to be effected by the implementation of MV. Following majority voting late adopters became more responsive to shareholders and received significantly less withhold votes for their directors nominees. Early adopters on the other hand, did not change their behavior significantly after majority voting implementation, and shareholder support of the board has not changed much.<sup>226</sup>

While majority voting was clearly successful, it is not applied in all firms. By the end of 2015 32% of the S&P 1500 firms still did not have majority voting. Some firms thus resist till today. As the evidence on late adopters suggest, these could be the firms for whom majority voting would have mattered the most.

#### 4. *Proxy Advisory Firms and Hedge Fund Activists – Pressure on Resisting Firms*

Two major players – proxy advisory firms and hedge fund activists – have contributed to the diffusion and implementation of majority voting and proxy access terms. As this part shows, by exerting direct and indirect pressure on resisting firms they sometimes contribute to efficient tailoring. Thus, if pending regulations limit their activities’, however, inefficient self-selection might dominate future patterns, as their pressure could have promoted efficient tailoring.

To begin with, proxy advisory firms recommend voting in favor of shareholder proposals for governance changes they support. For example, ISS and Glass Lewis recommended voting in favor of a majority voting term, and a proxy access three by three term.<sup>227</sup> Even if they apply the same recommendation and policies to all firms, a general recommendation to vote in favor of these proposals create pressure on Resisting firms hence promote efficient tailoring.<sup>228</sup> Second, both ISS and Glass Lewis create pressure on managers who are tempted to resist shareholder proposals, as they recommend investors to take into account management responsiveness in their votes for board candidates at annual election. ISS for example, recommend considering withholding votes for directors if management inappropriately excluded a shareholder proposal, or did not implement a non-binding proposal that received support from majority of the shareholders.<sup>229</sup> Since managers are more likely to contest proposals in firms that could benefit from them, imposing costs on these behavior is likely to improve tailoring.

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<sup>225</sup> *Id.*, (“Companies do not appear to adopt majority voting if they perceive their existing board members as being at risk of receiving an ISS withhold recommendation and if they are generally less responsive to shareholder concerns (as proxied by the presence of a poison pill).”)

<sup>226</sup> The only change was less likelihood to miss meetings.

<sup>227</sup> While it is hard to assess whether ISS shifts opinions, or merely aggregates information for shareholders, there is evidence that managers, at the very least, believe that ISS’ recommendations matter, as they either effect or reflect, voting outcome, and act to convince the ISS to vote in support of them. See e.g.,

<sup>228</sup> ISS policies are frequently taking into account firm-specific factors. For example, in its 2015 voting guidelines, ISS recommends that shareholders considering whether to approve equity-based compensation plans base their votes on each plan’s features *and* any relevant firms’ grant practices *United States Proxy Voting Guideline Updates: 2015 Benchmark Policy Recommendations*, INSTITUTIONAL S<sup>H</sup>OLDER SERVS. 7–8 (Nov. 6, 2014) <http://www.issgovernance.com/file/policy/2015USPolicyUpdates.pdf>.

<sup>229</sup> See e.g., *United States Summary Proxy Voting Guideline* section 2.1, INSTITUTIONAL S<sup>H</sup>OLDER SERVS. (recommending considering, on a case by case basis, to vote against directors if the board did not to implement a shareholder proposal that was voted favorably by shareholders) <https://www.issgovernance.com/file/policy/2016-us-summary-voting-guidelines-dec-2015.pdf>.



Finally, in some of their policy recommendations and governance rankings proxy advisory firms explicitly take into account firm specific characteristics.

Pressure on firms to implement governance changes and to satisfy shareholder demands reflected in the proposals they submit and support, is also assisted by the luring threat of an intervention from a hedge fund activist, which also in turn contribute to efficient tailoring.

To begin with, shareholder dissatisfaction and ISS recommendation to consider voting against the board nominees, are some of the considerations that hedge fund activists may take into account when choose their targets. Hedge fund activists increasingly seek board nominations, and while they have been successful in many proxy fights, they also lost some.<sup>230</sup> If the ISS recommends shareholders to vote against management, it will be more likely that the hedge fund candidates will win the proxuy fight for board sits. Thus, the threat of hedge fund activists constraint managers of resisting firms in their fights to contest shareholder proposals.

Furthermore, to a certain extent, hedge funds seem to target specifically firms who could benefit most from governance constraints. To be sure, hedge funs may have other own agenda, that might be not perfectly aligned with shareholders infests. Yet, an important overlooked dimension in their contribution, is that they promote efficient tailoring. For example, firms that face weak product market competition, that is weak external controls, are more likely to be targets of hedge fund activism.<sup>231</sup> Hedge funds are also more likely to target firms with weak shareholder rights, strong takeover defenses, staggered boards, large number of board members, older directors and directors with long tenure.<sup>232</sup> Finally, more generally, they promote governance changes.<sup>233</sup> And like proxy advisory firms, even if their approach applies uniform recommendations to different firms, it disproportionately target firms that could benefit from governance, since these are frequently the resisting firms, who haven't adopted these policies voluntarily.

#### E. Exceptions – Size and Value

The previous examples suggest that firms might not be choosing their right size, and in particular, that firms that need governance constraints most are often the least likely to adopt them. Firms that adopt governance constraints first are typically the ones to whom

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<sup>230</sup> Ian D. Gow, Sa-Pyung Sean Shin, and Suraj Srinivasan. "Activist Directors: Determinants and Consequences." Harvard Business School Working Paper, No. 14-120 (June 2014)

<sup>231</sup> Xavier Giroud & Holger M. Mueller, *Corporate Governance, Product Market Competition, and Equity Prices*, 66 J. FIN. 563 (2011); *See also* Michal Barzuza & Eric Talley, *Short-Termism and Long-Termism* Columbia Law and Economics Working Paper No. 526 (2016) (arguing that hedge funds short-term bias interacts with management long-term bias).

<sup>232</sup> Ian D. Gow, Sa-Pyung Sean Shin, and Suraj Srinivasan. "Activist Directors: Determinants and Consequences." Harvard Business School Working Paper, No. 14-120, June 2014; Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) (finding that Target firms have significantly higher G index); CfKlasuner (criticizing the importance and relevance of the G index); see also [http://www.law.harvard.edu/programs/corp\\_gov/activist-interventions-roundtable-2014-materials/2014\\_03\\_shareholder-activism-impact-on-na-corporates.pdf](http://www.law.harvard.edu/programs/corp_gov/activist-interventions-roundtable-2014-materials/2014_03_shareholder-activism-impact-on-na-corporates.pdf) (citing weak corporate governance as reasons for targeting companies in oil and high tech industries)

<sup>233</sup> *See* Lipton, the Activist white paper, ("Change in governance: ..., separate the positions of CEO and Chair, declassify the board, remove poison pill and other shark repellants, permit shareholders to call a special meeting (or lower thresholds for same) and act by written consent")

the constraints do not matter much. There are two exceptions to the inefficient self-selection rule: size and market value. On both dimensions there is some evidence that is consistent with efficient self-selection.

### *1. Small Firms are Less Likely to Adopt Governance Constraints*

Size matters for the desirability of legal constraints since the costs of compliance might be disproportionately large for small firms. This happens when compliance and implementation costs have a large fixed costs component, which represents a higher percentage of a small firm's revenue. For example, small firms' compliance with section 404 of SOX was assessed to be approximately two million dollars per year, which translates to approximately five percent of small firms' average market value.<sup>234</sup> Thus, for small firms, shareholder legal constraints might be too expensive and therefore not profitable. Indeed, evidence suggests that to some extent firms self-select efficiently on this dimension. Size is a significant factor in cross-listing, incorporation and governance terms. Small firms are less likely to cross-list on U.S. exchanges, more likely to list on AIM that offers lax disclosure standards,<sup>235</sup> more likely to incorporate in Nevada than large firms,<sup>236</sup> and less likely to adopt governance constraints such as majority voting terms.<sup>237</sup> While this evidence could suggest that self-selection on this dimension is efficient, size by itself is not a sufficient justification for private ordering. To begin with, there can also be inefficient reasons for why small firms tend to choose lax law. For example, small firms are less followed by analysts, and therefore might not pay (or receive) the full price, in terms of share value, for their poor (or excellent) governance choices. Second, size is an observable component that could be taken, and has been taken, into account in mandatory regulation, including Sox and Dodd-Frank, which both include exceptions for small firms.

### *2. Weakly Performing Firms are more likely Implement Governance Changes*

The second measure that seems to operate efficiently is firm market value and performance. Firms that undergo through abnormal weak performance are more vulnerable to pressure for governance changes. Relative performance matters as well, for example, firms that perform at the top of their industry are significantly less likely to add governance constraints. This vulnerability appears in different dimensions of the corporate governance dynamics. To begin with, weakly performing firms are more likely to be hit by shareholder proposals, and their managers are less likely to contest a shareholder proposal.<sup>238</sup> Weak performance is also likely to result in implementation. For example, pre-SOX, firms that performed poorly were more likely to add independent directors. Or, among late adopters, firms in the top five percent of abnormal stock returns were significantly less likely to adopt majority voting. That the effect appear primarily for resisting firm supports the notion that weak performance creates pressure on

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<sup>234</sup> See Peter Lliev, *The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices*, 65 J. FIN., 1163, 1180-1181 (2010). If the costs are permanent the cumulative effect could reach even 30% of value. Id. Yet recent evidence suggests costs have gone down over time. Coates.

<sup>235</sup> Doidge et al. see *infra* section

<sup>236</sup> See Barzuza & Smith

<sup>237</sup> See Choi et al, *supra* note

<sup>238</sup> See Bhandari, Lliev & Kalodimos, *supra* note 9.

management to implement constraining governance, as predicted by Hermalin and Weisbach bargaining model.

To a certain extent this selection could contribute to efficient tailoring. Yet, one might recall that directors were not found to add value to these firms. Likewise, the firms that were likely to get hit by a proxy access shareholders proposals, were not the firms that, in the market eyes, stood to benefit most from these proposals. Indeed, while at first glance targeting weak performance could produce efficient self-selection, after consideration, it is not necessarily the optimal criterion for governance changes. In particular, not only that a relatively weak performance is not necessarily related to governance, it might merely reflect a temporal fluctuation in market prices. Indeed, supporting this interpretation empirical evidence that takes transitory fluctuations into account, such as controlling for lagged variables or applying GMM methods, does not show a positive effects for these governance changes, while empirical methods that do not take these circumstances into account do find positive results.<sup>239</sup> To sum, while self-selection on this dimension – abnormally or relative weak performance - is not clearly distorted, there is also no evidence to suggest that it is close to optimal.

## V. Implications

### A. Implications for Data Interpretation

A significant body of research analyzes the effect that various governance terms and packages thereof have on firms' performance. These studies are often used to assess policy proposals. In analyzing the data, different forms of self-selection are often taken into account, except for one form - the inefficient self-selection that is described here is rarely considered. Take for example the evidence from voluntary adoption of independent directors pre-SOX. While several selection accounts were considered, one account, that firms that did not adopt independent directors might benefit more from having them, was not even raised.<sup>240</sup>

The analysis here suggests caution when attempting to draw policy implications from research on the effect of governance terms that were adopted voluntarily. The cumulative body of evidence shows that the firms that voluntarily adopt governance constraints could be the least likely to exhibit resultant changes in performance.<sup>241</sup> Relying on results from voluntary adoption could underestimate the potential effects of governance, and cast

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<sup>239</sup> See e.g., James S. Linck, Jeffrey M. Netter & Wintoki M. Babajide, *Endogeneity and the Dynamics of Corporate Governance* 105 J. OF FIN. ECON. 581 (2012) (a positive effect for board independence when using firms fixed effect, but not when using Arellano-Bond GMM instruments).

<sup>240</sup> See e.g., Bainbridge, *Financial Crisis*, *supra* note 1 (“The empirical evidence on the relationship between board composition and firm performance available when Sarbanes-Oxley was adopted was inconclusive, at best. If independent directors effectively constrain agency costs, one would have expected the evidence to show a correlation between the presence of independent outsiders on the board and firm performance. But it did not. “); Macey, *Promises*, *supra* note 1 (“Recent corporate governance initiatives, including Sarbanes-Oxley, are misguided because they erroneously assume corporate boards can be organized or incentivized successfully to monitor and manage the corporations they serve. All of the available theoretical and empirical evidence suggests this is not the case.”).

<sup>241</sup> See also Choi, Fisch, Kahan & Rock, *supra* not (“in evaluating the effects of corporate governance reforms on firm value, it may be necessary to separate early and late adopters. While the overall effects of a particular change on firm value may be positive or negative, the incidence may be quite different among different firms.”)

doubt on whether governance matters at all. Thus, for example, interpretation of studies that examine the effect of SOX on foreign firms that cross-listed on US exchanges should be sufficient cautious to consider the possibility that SOX could have had contributed more to firms that had not cross-listed than to firms that had. Similarly, interpretation from votes on shareholder proposals, should take this self-selection into account. If managers hadn't excluded exactly those proposals that would have benefited firms, would have probably observed higher voting support for shareholder proposals than the one we observe today. Put differently, since managers disproportionately contest the proposals that are likely to receive high voting support, the average rate of voting support for shareholder proposals might be downward biased.

#### B. Assessment of Mandatory Regulation vs. Private Ordering

The One-Size Argument has been frequently provoked against mandatory corporate law. The argument was used categorically to object any mandatory regulation regardless of its subject matter, or its merits.<sup>242</sup> It also did not seem matter that mandatory law could create distinctions for observable variables such as firm size. As this Article shows, such a far-reaching use of the One-Size Argument is misguided. Although firms do vary considerably, the presence of heterogeneity does not necessarily support private ordering. Granted, a one-size mandatory law might impose costs on some firms, as in the case of high compliance costs for small firms, or adding independent directors to firms with high information asymmetry.<sup>243</sup> Yet, that firms that need governance do not adopt it, also imposes inefficiency costs, as evidence from cross-listing<sup>9</sup>, independent directors, and proxy access suggests.

Policymaking in corporate law, thus, is more complicated than simply choosing categorically between private ordering or mandatory law. Rather, it requires an assessment, in each case, of the costs of applying a one-size mandatory law to different firms, against and the costs of relying solely on private ordering. The particular governance term's merits, the likelihood of inefficient self-selection, and whether mandatory law could apply selectively, thus, should all be taken into account. To get a sense of the costs imposed by inefficient self-selection, commentators and policymakers alike should examine data on adopting and non-adopting firms, and their differences. For example, if non-adopters tend to have weak performance and entrenched governance, and no other distinctive variables seem to justify their choice, more weight should be given to the possibility that these are firms that could benefit from governance. Also, there needs to be an inquiry into the reason why some firms adopted and some did not. Whether the lack of adoption in some firms is due to low shareholder support of the proposals, which could suggests efficient self-selection, or is it because managers of these firms successfully contested the proposal, which is more likely to suggest an inefficient self-

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<sup>242</sup> See e.g., Letter from Cravath, Swaine & Moore LLP et al. to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 4-5 (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf> [*hereinafter* Seven Firm Letter] (arguing that even if proxy access is desirable it should be left to private ordering); see also Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 THE BUSINESS LAWYER 329 (2010) ("A central argument put forward repeatedly by the Proposal Opponents is that, even assuming that access is beneficial for many public companies, the optimal approach is to retain no-access as the default arrangement"); Easterbrook & Fischel, *supra* note (claiming that the One-Size Argument justifies the entire enabling structure of American corporate law).

<sup>243</sup> See discussion of evidence *infra* Section IV.A

selection pattern, as was the case with respect to proxy access proposals. If a significant number of firms adopt a governance term, or if a governance term did receive support in some firms, especially in firms in which managers initially resisted it, it might be worthwhile to inquire whether this term is efficient and could benefit other firms, and why these other firms do not adopt it. Such an inquiry could check the governance of the firms that do not adopt it, similar to the recent approach reflected in the SEC proxy access study.<sup>244</sup> Finally, mandatory law does not have to apply to all firms. For example, SOX and Dodd-Frank applied size-based exceptions, under the assumption that compliance would be relatively costly for firms of small size.<sup>245</sup>

Second, the findings also lend support to a novel policy approach: creating a menu of minimal governance *packages* for firms to choose from. For example, if a firm chooses to incorporate in Nevada it should also have to adopt both proxy access and majority voting to ensure board accountability. So a Nevada package will include a proxy access and a majority voting term. Or if a firm chooses to maintain a staggered board, it should not be allowed to also have a poison pill. This policy approach allows firms to take into account their specific circumstances while simultaneously preventing the sort of race-to-the-bottom self-selection possible in a law-free private ordering regime. In fact, the SEC has recently used a similar approach to craft a new “pay ratio” rule, required under the Dodd-Frank Act, that would require firms to disclose several new compensation figures: the median of all firm employees’ total annual compensation, the CEO’s total annual compensation, and the ratio of these two amounts.<sup>246</sup> <sup>247</sup> Under the SEC proposed Rule, companies would have the option to determine total compensation amounts using existing executive compensation rules, amounts in payroll or tax records, or any other “methodology that is appropriate to the size and structure of [the firm’s] own business[.]”<sup>248</sup> Companies could choose whether to calculate the median based on all employees salaries, or through statistical sampling.<sup>249</sup> They would simply have to disclose the operative methodologies and assumptions used to determine each figure.<sup>250</sup> SEC Chairwoman Mary Jo White has highlighted the fact that the SEC’s proposed rule “provide[s] companies significant flexibility in complying with the disclosure requirement” instead of creating a one-size-fits-all disclosure regimen. To be sure, as critics point out, this flexibility might enable firms to make strategic calculations and

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<sup>244</sup> See *infra* note \_ and text accompanied.

<sup>245</sup> See 15 U.S.C. § 7262(b)–(c) (2012) (SOX accommodates small firms—companies whose market capitalization does not exceed \$75 million—by exempting them from the § 404(b) requirement to retain an independent auditor to attest to the issuer’s internal control over financial reporting); §§ 5481(24), 5365(i)(2)(A) (banks with total assets under \$10 billion are not subject to supervision by the Consumer Financial Protection Bureau, and need not conduct the stress tests that larger banks must commission).

<sup>246</sup> See The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 953, 124 Stat. 1376 (2010); *Corporate Governance Issues, Including Executive Compensation Disclosure and Related SRO Rules*, U.S. SECS. AND EXCH. COMM’N, <http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml> (last visited Mar. 13, 2015).

<sup>247</sup> Press Release, U.S. Secs. and Exch. Comm’n., SEC Proposes Rules for Pay Ratio Disclosure (Sept. 18, 2013), *available at* <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817895#.VQMT44HF89Y>.

<sup>248</sup> *Id.*

<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

thereby disclose ratios that appear more egalitarian than they in fact are.<sup>251</sup> Relatedly, they argue, investors that the new disclosure requirements aim to benefit might find themselves completely unable to interpret the pay ratio in light of whatever complex methodology produced it.<sup>252</sup> Yet, in some cases this could be the best solution to the forgoing trade offs.

Finally and importantly, mandatory law is not the only tool to improve on inefficient tailoring. As the following part discusses, other mechanisms — proxy advisory firms, shareholder activists’ proposals and hedge fund activism — pressure management of Resisting firms, to adopt, or refrain from contesting, certain governance restrictions. The Article thus turns to discuss implications for these mechanisms.

### C. Implications for Shareholder Proposals, Proxy Advisory Firms and Hedge Fund Activism

During the last decade and a half, corporate governance has been shaped less frequently by regulation and more frequently by the combined influence of several market entities and mechanisms — shareholder activists’ proposals, hedge fund activists, and proxy advisory firms. The Article highlights an overlooked role of these mechanisms — in improving efficient tailoring. Modern governance mechanisms create pressure on resisting firms to adopt governance. It also has implications for how to support this function.

Shareholder activists’ proposals are becoming a central mechanism for corporate governance changes. Majority voting, proxy access, independent chairperson, disclosure of political contributions, and disclosure of diversity policies, have been submitted and implemented via shareholder proposals. As we learn from recent findings however, many of these proposals do not get to be voted on. Managers contest 40% of shareholder proposals by asking the SEC for permission to exclude them, out of which SEC provides a no-action letter in more than 70% of the cases.<sup>253</sup> Thus, almost third of shareholder proposals submitted are not being brought to shareholder vote. More important, shareholders are denied voting on a proposal, exactly when the governance term the proposal promotes, if implemented, is likely to benefit their firm.<sup>254</sup>

The Article arguments and findings suggest that the SEC should reconsider the high rate of no-action letters currently awarded to managers requesting proposal exclusion. Especially with respect to corporate governance proposals, the SEC should avoid awarding no action letters that could result in managers excluding proposal in those firms that could benefit from them. The Article supports the SEC decision to withdraw the *Whole Foods*’ no-action letter, despite the harsh criticism that followed.<sup>255</sup> Interpreting

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<sup>251</sup> See, e.g., Andrew Ross Sorkin, *S.E.C. Has Yet to Set Rule on Tricky Ratio of C.E.O.’s Pay to Workers*, N.Y. TIMES DEALBOOK (Jan. 26, 2015, 8:17 PM), available at [http://dealbook.nytimes.com/2015/01/26/tricky-ratio-of-chief-executives-pay-to-workers/?\\_r=0](http://dealbook.nytimes.com/2015/01/26/tricky-ratio-of-chief-executives-pay-to-workers/?_r=0) (“With all the wiggle room that is expected to be allowed, companies may devise ratio numbers that are largely irrelevant.”).

<sup>252</sup> See, e.g., *id.*

<sup>253</sup> See Soltes, Srinivasan & Vijayaraghavan. *Supra* note 219.

<sup>254</sup> See discussion *infra* Part IV.D.

<sup>255</sup> See e.g., Commissioner Daniel M. Gallagher, *Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors’ College* June 23, 2015 (“The recent *Whole Foods* blow-up, in which by fiat a previously-granted no-action letter was withdrawn, and consideration of all similar letters was

broadly the “conflicting proposal” exception under Rule 14a-8(i)(9) would practically allow managers to exclude all shareholder proposals that matter, and replace them with alternative, less restrictive, proposals with close to zero effectiveness. Yet, as now managers are diverting to a different exception – i.e., “substantially implemented” proposals – in deciding whether to award no action letter the SEC should remain minded of the self-selection problem. The SEC approach to Rule 14a-8(i)(10) “substantially implemented” exception has been to allow managers excluding a shareholder proposal only if the company’s implemented proposal hasn’t imposed “additional restrictions” on the proposal submitted by the shareholder. The SEC hasn’t award no-action letters if management proposal uses a different ownership requirement than the one in the shareholder proposal, but other differences, such as with respect to the number of directors a shareholder could nominate were allowed. In interpreting the no “additional restrictions” requirements the SEC should be minded of the potential self-selection problem, as management in different companies are now looking for restrictions that could weaken proxy access effectiveness. For example, boards now implement an alternative proxy access, that follows a three by three structure, with one important difference – they do not allow for the nomination of a candidate to happen at the same annual meeting. Yet, postponing the nomination in a year could be significant: waiting a whole year is risky and might not provide management with appropriate incentives.

More generally, due to the findings that managers fight proposals in firms that could benefit from them, restrictions on shareholder proposals, that do not depend on management power, are preferable. For example, critics of shareholder proposals advocated raising the shareholder ownership threshold, which currently stands on \$2,000.<sup>256</sup> If there is a need for some limitations on shareholder proposals, this would be a superior strategy to awarding managers power to resist proposals.

The Article also highlights the importance of proxy advisory firms’ voting recommendations and governance rankings. Proxy advisory firms contribute to pressure on resisting firm to adopt governance terms. If managers do not implement a precatory proposal or if they inappropriately exclude a proposal ISS and Glass Lewis will recommend a withhold vote against the board. Thus, managers power to fend off shareholder proposals is limited by proxy advisory firms. Second, proxy advisory voting recommendation support shareholder proposals, increase incentives to vote and submit them. Overall, without the pressure of proxy advisory firms, it is possible that majority-voting terms would not have reached the late adopters, who were more effected by them. On top of that, proxy advisory firms frequently take into account the firm’s whole

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deferred, shows just how broken the system is for both proponents and companies”); *see also* Testimony of Daniel M. Gallagher President Patomak Global Partners, LLC Before the United States House of Representatives Committee on Financial Services, Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability.

<sup>256</sup> Steven Davidoff Solomon, *Grappling with the Cost of Corporate Gadflies*, The New York Times (August 19, 2014); John Engler, *How Gadfly Shareholders Keep CEOs Distracted*, The Wall Street Journal (May 26, 2016); Commissioner Daniel M. Gallagher, *Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors’ College* June 23, 2015; In re Exclusion of Resubmitted Shareholder Proposals 17 C.F.R. §240.14a-8(i)(12), Petition for Rulemaking Proposals Failing to Elicit Meaningful Shareholder Support <https://www.sec.gov/rules/petitions/2014/petn4-675.pdf>; David Larcker, Brian Tayan, *Gadflies at the Gate: Why Do Individual Investors Sponsor Shareholder Resolutions?* (2016) [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2821755](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2821755)

governance package, both for ranking and for voting recommendation.<sup>257</sup> Thus, in considering different arguments against or in favor of the proposed Proxy Advisory Reform. The One-Size argument should be cast against limiting their power and influence. Finally, hedge fund activists also exert pressure on Resisting firms. Low responsiveness to shareholders, and shareholder dissatisfaction, could increase the likelihood to become a target of hedge fund activists. Furthermore, hedge funds seem to target firms that could benefit from governance changes. Thus, the otherwise inefficient self selection should be taken into account in considering the proposed Brokaw Act.

## VI. Conclusion

This Article has challenged the assumption that firms self-select efficiently into corporate law and governance. Rather it argued and showed that frequently firms that could benefit from governance terms do not adopt them, and firms for whom they did not matter much are the first in line to have them.

The Article showed that a theoretical analysis that incorporates firm heterogeneity could, under plausible assumptions, result in inefficient tailoring of governance terms to firms. Similarly, evidence on different governance terms—independent directors, cross-listing, state corporate law, majority voting and proxy access proposals—raises a doubt that firms that could benefit most from constraints are not likely to adopt them under private ordering.

The Article showed that researchers policy makers and practitioners did not take firm heterogeneity seriously enough, not in theory, research or practice. Evidence was interpreted assuming explicitly or implicitly that firms choose their right size, and policy was designed with that assumption.

Rather than assuming that firms choose their right size, the possibility that firms that could benefit from governance do not adopt it should be considered and investigated. Thus, there is no way around weighing and assessing evidence with respect to the costs and benefits of firms' self-selection. Additionally SEC should be minded of which firms contest shareholder proposals, and the pressure created on resisting firms by proxy advisors and hedge funds should be valued and supported. Limiting the influence of proxy advisors and hedge funds could bring us back to corporate governance adoption only in firms that are not affected by it.

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<sup>257</sup> *Id.* This is not to suggest that there are no other problems with proxy advisory firms, but rather to highlight one dimension that this paper focuses on – firms' self selection.