“No-Size-Fits-None”: Adverse-Selection in Private Ordering of Corporate Law and Governance

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Private ordering is the corner stone of US corporate law. Mandatory law is flawed, so the argument goes, since it applies a one-size-fits-all approach to different firms. Under private ordering, market forces and IPO pricing lead managers to adopt governance that best suits their firm’s needs. This argument, which justifies the enabling structure of US corporate law, is now the center of heated debates over pending policies such as Dodd-Frank mandated disclosures of political contributions, incentive compensation, and proxy access.

This Article argues that the assumption that private ordering results in each firm selecting governance terms that are best tailored to its particular needs lacks both empirical and theoretical support. Developing a theory of firm heterogeneity, the Article exposes a potential inefficient pattern in firms’ private ordering: firms with high agency costs that could benefit most from legal constraints, are the least likely to adopt them. As it demonstrates, adverse selection at the IPO stage often results in governance terms that are adopted, if at all, only when they are less valuable. Empirical studies covering a wide range of topics, including independent directors, executive compensation, shareholder voting, cross-listing on U.S. exchanges and state of incorporation choice find time and again that firms with high private benefits of control are disproportionally drawn to weak and permissive legal regimes, at the price of significant efficiency losses.

The analysis suggests that mandatory law that applies market adopted terms—such as Delaware fiduciary duties, majority voting—to all firms, could potentially create value and should be considered. Second, since both theory and evidence analyzed here raise a concern that firms with lax external and internal controls opt for lax law and governance, firms should be required to choose among alternative minimal packages of law and governance terms.

Preliminary Draft – Please Do Not Distribute or Cite.

[*] Professor of Law, University of Virginia School of Law. For excellent research assistance I thank Brian Mammarella and Scott Baird. For helpful comments and discussions I thank Lucian Bebchuk, Jeff Gordon, Dotan Oliar, Michael Klausner, Ariel Porat, Holger Spamman..

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The move to impose prudential regulation on our capital markets, in particular by applying a one-size-fits-all approach to capital requirements, is nothing short of an existential threat to those markets.

Commissioner Daniel M. Gallagher, The Securities and Exchange Commission — The Next 80 Years: The 15th Annual A.A. Sommer Jr. Lecture on Corporate, Securities and Financial Law, Fordham Law School New York, N.Y. Oct. 16, 2014

I. Introduction

In June 2015, the U.S. House Appropriations Committee approved a Bill that prohibits the SEC from implementing a requirement that firms disclose their political contributions.[1] Disclosure of political contributions should be addressed in a private ordering regime in which firms can choose whether and what to disclose. For similar reasons, a sharply divided SEC is yet to implement compensation disclosure policy requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[2] Dissenting commissioners voted against the terms since they objected replacing a private ordering regime with a "'one-size-fits-all' standard for calculating corporate performance.[3]

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[1] Fiscal Year 2016 Financial Services Bill, section 625.

[2] Setting Forth Goals for 2015: Address to Practicing Law Institute's SEC Speaks in 2015 Program, Commissioner Luis A. Aguilar, Feb. 20, 2015 ("Unfortunately, the Commission has adopted some of the Dodd-Frank rules, it has yet to propose or finalize many of the corporate governance, such as rules on disclosures about pay-for-performance, the disclosure of the ratio between the CEO's compensation and the median of all other company employees, disclosure by large investment managers of their "say-on-pay" votes, and prohibiting the exchange listing of securities of issuers that have not implemented claw-back policies.") [*hereinafter* Aguilar, *SEC Speaks*] available at http://www.sec.gov/news/speech/022015-spchclaa.html#.VQIHrEKGm-R

[3] http://www.npr.org/sections/thetwo-way/2015/04/29/403114428/sec-rule-would-link-executive-pay-to-performance; Setting Forth Goals for 2015: Address to Practicing Law Institute's SEC Speaks in 2015 Program, Commissioner Luis A. Aguilar, Feb. 20, 2015 ("Unfortunately, the Commission has adopted some of the Dodd-Frank rules, it has yet to propose or finalize many of the corporate governance, such as rules on disclosures about pay-for-performance, the disclosure

A common, well accepted, proposition is reflected in these recent policy debates: regardless of the merits of a specific regulation, corporate law should be left exclusively to private ordering.[4] Mandatory law is inevitably flawed, so the argument goes, since it applies a one-size-fits-all approach to different firms.[5] Under private ordering, on the other hand, market forces and prices at the IPO lead "managers to adopt the optimal mix of legal and market governance structures for their firm."[6] This reasoning arguably justifies the entire enabling structure of U.S. corporate law—why it merely offers firms a set of rules that they can adopt or reject.[7]

The implicit assumption of this approach has been that under private ordering firms choose (possibly with some noise, but no systemic bias) the governance package that best

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of the ratio between the CEO's compensation and the median of all other company employees, disclosure by large investment managers of their "say-on-pay" votes, and prohibiting the exchange listing of securities of issuers that have not implemented claw-back policies.") [*hereinafter* Aguilar, *SEC Speaks*] available at http://www.sec.gov/news/speech/022015-spchclaa.html#.VQIHrEKGm-R

[4] See e.g., Matthew Lepore, *A Case for the Status Quo: Voluntary Disclosure*, 3 Harvard Business Law Review 414, 418 (2013) ("A one-size-fits-all approach is not the best solution."); Lucian A.Bebchuk & Robert J. Jackson Jr., *Shinning Light on Corporate Political Spending*, 101 GEORGETOWN L. J. 923, 947 (2013) ("many commentators who oppose the Petition have made this argument, noting that allowing private ordering to address the issue would avoid the imposition of a one-size-fits-all rule on public companies"); 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 ").

[5] *See*, *e.g.*, 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*]; STEPHEN M. BAINBRIDGE,, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS (OXFORD UNIVERSITY PRESS 2011) ("one size does not fit all in corporate governance")[*hereinafter* Bainbridge, *Financial Crisis*]; Remarks at The SEC Speaks in 2015; Commissioner Daniel M. Gallagher (Feb. 20, 2015) ("One size fits all regulation, in practice, tends to end up as one size fits none"), [*hereinafter* Gallagher, *SEC Speaks 2015*], available at http://www.sec.gov/news/speech/022015-spchcdmg.html#.VQc2p0KGm-Q; Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law* 65 Business Lawyer 361, 363 (2010) ("one size does not fit all: corporations differ in their circumstances, attributes, and needs"); Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Aug. 17, 2009) ("[U]niformity would do a serious harm . . . . This is simply not an area where 'one size fits all.'"), *available at* http://www.sec.gov/comments/s7-10-09/s71009-263.pdf.

[6] 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*].

[7] *See* Frank H, Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (claiming that "No one set of terms will be best for all; hence the 'enabling' structure of corporate law."); *see also* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 2 (1996).

fits their needs. This Article questions the assumption that private ordering in corporate law and governance does not suffer from a systematic bias. Developing a theory of firm heterogeneity, and analyzing relevant data from an extensive line of studies, the Article exposes a potential inefficient pattern in firms' private ordering: firms with high agency costs that could benefit most from legal constraints, are the least likely to choose them.

The Article proceeds as follows. Part II of the Article demonstrates the widespread reliance on, various applications of, and broad reach of the One-Size Argument. Part III develops a theoretical framework that incorporates variations in exogenous market forces, and as a result in firms' agency costs, to private ordering in corporate governance. As the analysis shows firms facing weak market forces, would most benefit from substituting weak controls with strict governance terms, but for a number of reasons, their managers are *less likely* to voluntarily adopt these terms. First, these managers face weak internal and external penalties for choosing the wrong law and governance terms. Second, as a result of the weak constraints, these managers extract high private benefits and thus face high costs for self-constraining.[8] Third, weak governance breeds more weak governance since it weakens shareholder power and market forces.[9] Finally and importantly, if managers have more information than shareholders on the exact constraints they are facing, pricing of IPO shares will not incentivize them to adopt legal constraints. With no specific information on the firm's constraints and need for governance, investors would value governance terms such as proxy access or staggered board, according to their average contribution to firms' value. As a result, this part shows, managers that face weak constraints, will pay only partial price for their choices. Put differently, adverse selection at the IPO stage will result in governance terms adopted, if at all, only when they are less valuable. Finally, Part III addresses the potential objection that self-selection has the benefit of providing information to investors about a firm's type, or, similarly, that there is no problem since investors know what they are buying. First, while a choice of weak law could signal a firm's management type, significant noise in the market obscures the informational value of the signal.[10] Second, since many choices are made midstream, inefficient tailoring, and thus significant inefficiency costs, can result even if investors have full and perfect information.

Despite their heavy reliance on efficient self-selection, private ordering proponents have not left the armchair to see which firms are choosing strict law.[11] Part IV discusses and synthesizes empirical evidence from a broad array of applications: board independence, executive compensation, voting, cross-listing on U.S. exchanges, and choosing a firm's state of incorporation. This body of evidence is not consistent with the premise that firms that face weak constraints are likely to substitute them with strong ones voluntarily, quite the contrary. Covering a large range of choices, the picture that emerges suggests that firms adopt constraints when they do not matter much to them.

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[8] Extracting high private benefits will trigger weaker penalties in firms that face weak market forces. *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).

[9] *See* Lucian Bebchuk,

[10] *See* Michal Barzuza, *Noise Adopters in Corporate Governance*, 3 COLUM. BUS. L. REV. 627 (2013).

[11] *Cf.* Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1330 ("A second reason the contractarian theory has failed to fit the facts is that the contractarians paid little attention to actual corporate contracts.").

When SOX and the exchanges' listing standards required listed firms to have a majority of independent directors, they were heavily criticized both for applying a one-size-fits-all approach, and even more so, for acting with no supporting evidence. Prior to SOX, studies did not find that a majority of independent directors was associated with a higher firm value. But recent studies show that the firms that were required to add independent directors due to SOX benefitted from the change. Thus, board independence was more valuable in those firms that did not adopt it voluntarily than in firms that did.

The proliferation of majority voting terms is the recent poster child of private ordering. Yet, according to a recent study, majority voting provisions were more likely to be adopted in firms that did not experience significant withhold votes in previous years—that is, in firms for which it does not really matter. In other words, majority voting was unlikely to be adopted in firms in which it was most needed socially. Similarly, Ill designed compensation schemes that merely reward luck or otherwise fail to establish sufficient incentives for managers to achieve long-term success (for example, backdating options), were frequent in firms that face weak market and governance constraints.

Private ordering of foreign firms, via cross-listing on U.S. exchanges, and committing to higher disclosure obligations conforms to inefficient pattern. The foreign firms that choose to Cross-list, are the ones with relatively low private benefits, and high value.[12] The evidence also suggests that the efficiency costs associated with self-selection are significant. Firms that cross-list from countries with weak investor protection, 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 five times larger than that of cross-listed firms from countries with strong protections.[13] Yet, the latter group shows a lower inclination to cross-list than firms from countries with strong legal protections.[14]

Finally evidence from choice of state of incorporation, which is frequently hailed by private ordering proponents, is consistent with inefficient self-selection. As this authors showed in previous works, a decade and a half ago, Nevada has embarked on a strategy of attracting corporations with a shockingly lax corporate law. Nevada law narrows significantly the mandatory duty of loyalty and duty of good faith, which are cornerstones

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[12] Cross listing is associated with low control premiums and high value pre-listing. Craig C. Doidge, *U.S Cross-listings and the Private Benefits of Control: Evidence from Dual-class Firms*, 72 J. FIN. ECON. 519 (2004). Also, the inclination to cross-list decreases with the proportion of voting rights the controlling shareholder has, and, more importantly, with controllers' ratio of voting rights to cash flow rights. 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)

[13] *See* Luzi Hail & Christian Leuz*, Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-listings*, 93 J. OF FIN. ECON., 400, 428, tbl. 5 (2009) (finding that cross-listing on U.S. exchanges results in a stronger cost of capital effect for firms from countries with low disclosure requirements, weak securities law enforcement, or weak investor protection); Doidge *et. al.*, *supra* note 26.

[14] *See e.g.*, 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) (finding that firms from civil law countries are less likely to cross-list on U.S. exchanges than firms from common law countries).

of Delaware corporate law.[15] And firms that choose to incorporate in Nevada, as compared to firms that incorporate in Delaware (the winning state), turn out to have an exceptionally high frequency of accounting restatements.[16] Similarly, foreign firms that conduct reverse mergers to Nevada tend to make especially egregious accounting restatements.[17] Nevada's own politicians suspected that Nevada's relaxed laws would attract a disproportionate number of problematic firms. Further, the evidence on incorporations tends to favor the inefficient self-selection theory when one compares incorporation in Delaware to incorporation in firms' home states.[18]

One caveat should be noted before proceeding: In some scenarios, a firm's self-selection can be efficient. While this Article focuses on the differences in the extractability of benefits, there are also differences in the costs of compliance with the law: for example, the costs of implementation and potential for frivolous litigation. One evidence-based difference relates to firm size. Small firms frequently face relatively higher costs of implementation, and on this dimension the evidence is consistent with small firms avoiding constraints.[19] Yet mandatory law can and has done a reasonable job accommodating size-based differences.

Part VI draws policy implications from the inefficient patterns of self-selection. To begin with, it clearly dismantles the use of one-size as a silver bullet against mandatory regulation. While one-size mandatory approaches might impose costs on some firms worth considering, those costs should be weighed against the costs of private ordering, and in particular, the costs that firms facing weak governance, weak external constraints, and high private benefits—the firms whose shareholders could benefit most from legal constraints—are more likely to choose lax constraints absent regulation. Second, the One-Size Argument is especially weak when raised against proxy advisory companies and shareholder proposals since both shareholder empowerment mechanisms tend to specifically target the right firms: firms facing weak constraints who can therefore benefit from regulation.

Present analysis also bears on the manner in which users might properly interpret past studies that examine the effect of various corporate governance terms. Several studies found no effect for voluntarily adopted terms. These results, it has been argued, suggest that the particular terms studied (and even corporate governance in general) do not matter. This Article, by contrast suggests that past evidence might not help us assess the desirability of mandatory law because the observed "no-effect" phenomenon has a different cause: the firms adopting various governance terms are the "good" ones for which improving governance changes little.

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[15] *See* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction,* 98 Va. L. Rev. 935 (2012).

[16] *See* Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law*, 27 REV. OF FIN. STUD. 3593 (2014).

[17] 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.

[18] Firms that incorporate in their home state—the state in which their headquarters are located—have weaker corporate governance regimes and lower value than firms that choose Delaware law that is less favorable to management. *See e.g.*, Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 525 (2001) [hereinafter Daines, *Firm Value*].

[19] *See* discussion *Infra* Part

Finally, the analysis lends support to two novel policy proposals: implementing market-based mandatory law and alternative minimal packages of governance terms. First, The analysis suggests that mandatory law that applies market adopted terms—such as Delaware fiduciary duties, majority voting, and any term that companies adopt in large proportions—to all firms, could create value and should be considered. Second, since the analysis raises a concern that some firms may operate with almost no external, internal, or legal constraints and therefore subject shareholders to significant agency costs, a potential solution would be to require firms to meet a certain mandatory minimum, which they could choose from several optional packages. For example, one rule might prohibit firms with staggered boards from adopting poison pills; another might require firms without majority voting provisions to adopt proxy access. This would simultaneously provide flexibility and minimize the potential that firms that need legal constraints the most would avoid them completely. In fact, the SEC is currently considering a similar solution for pay ratio disclosures. On September 18, 2013, the SEC approved, by a vote of three votes to two, a proposal to require firms to disclose the ratio of the CEO's pay to the median employee's pay. In order to avoid a one-size approach and instead allow firms to economize on their expenses given their particular characteristics, the SEC is considering allowing firms several optional ways to disclose this ratio. As critics have argued correctly, this may result with firms also being able to strategically present the information in a way that is favorable to them. Thus, this approach is less effective than mandatory market-based terms. Nevertheless, the SEC's proposal, which provides the benefits associated with flexibility while establishing a regulatory floor beneath which firms may not cross, demonstrates again that the One-Size Argument does not always provide good reason to dispense with mandatory corporate law.

II. Private Ordering in Corporate Law and Governance

US corporate law is in its most part enabling, namely, it offers a set of optional default rules. Firms can decide whether to adopt a staggered board,[20] have a poison pill,[21] grant shareholders proxy access,[22] implement majority or plurality voting,[23] allow an individual to serve as both chairman and CEO,[24] opt out of the duty of care as well as significant parts of the duties of loyalty and good faith,[25] and choose their state of incorporation.[26] This

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[20] Richard H. Koppes, Lyle G. Ganske & Charles T. Haag, *Corporate Governance Out of Focus: The Debate over Classified Boards*, 54 BUS. LAW. 1023, 1041-42 (1999).

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[22] Several comments to the SEC objecting to a mandatory proxy access rule focused on private ordering. As a Wachtell Lipton comment notes: "[U]niformity would do a serious harm . . . . This is simply not an area where 'one size fits all.'" 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.

[23] DGCL 216

[24] Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1798-99 (2011).

[25] *Cf.* DGCL 102b(7); NRS 78.138

[26] *See e.g.*, Baysinger & Butler, *Uniformity in Corporate Law*, supra note **Error! Bookmark not defined.**, at 459 (1985); Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**; GALAGHER,

freedom to choose, as two corporate giants explain, is justified by markets incentives coupled with firms' heterogenous needs:[27]

> Why does corporate law allow managers to set the terms under which they will govern corporate assets? . . . The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all; hence the "enabling" structure of corporate law.[28]

Proponents of private ordering believe that the One-Size Argument disqualifies any mandatory provision in corporate law, regardless of its merits.[29] They argue that whereas the one-size approach of mandatory law inevitably imposes costs on some firms, private ordering results in firms choosing the governance terms that best fit their unique needs and circumstances.[30] This premise of efficient self-selection is so strong among private ordering proponents that two scholars have argued that any imposition of uniformity will be Pareto inefficient—that is, that managers *and* shareholders should prefer choice over any mandatory uniform system.[31]

Resultantly, those who have criticized the enabling structure of U.S. corporate law, especially in light of corporate scandals and the financial crisis, have met resistance from opponents wielding the One-Size Argument. Examples of this dynamic abound. First, SOX and various exchanges' listing standards have been heavily criticized for requiring board independence under a one-size approach.[32] Second, the Dodd-Frank Act was criticized for requiring shareholder votes on executive pay even though these votes would not bind management.[33] Third, 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, the law firm of Wachtell, Lipton, Rosen & Katz ("Wachtell") wrote to the SEC and argued that the new rule should instead function as a

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[27] *See, e.g.*, Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185, 189 (1993) (stating that "Mandatory rules prohibit investors and issuers from customizing their operating environments to meet the specific needs of the relevant parties").

[28] *See* Easterbrook & Fischel, *The Corporate Contract*, supra note _ at 1418.

[29] *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 developed by private ordering process based on opting in); ABA Letter, *supra* note 9, at 4.

[30] *See e.g.,* Easterbrook & Fischel, *The Corporate Contract*, *supra* note _ at 1418

[31] Baysinger & Butler, *Uniformity in Corporate Law, supra* note 58, at 456.

[32] *See e.g.*, Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**.

[33] *See e.g.*, Leo E. Strine Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term*, 66 Bus. Law. 1, 9-10 (2010) ("[T]o be consistent with the private ordering approach that has served to create so much wealth from the corporate form, stockholder input on executive compensation should proceed only if the stockholders of a particular corporation have decided that such input is good for their specific corporation."): Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731 (2013) ("Dodd-Frank's reforms eliminate the potential for issuer-specific tailoring and experimentation, while mandating procedures that are unlikely to provide investors with meaningful value.")

default[34] because "this is the approach that has successfully driven the development of corporate law throughout our history."[35] A Wachtell memo on proxy access notes: "[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 inappropriate mandates on some companies . . . . ."[36]

Private ordering proponents also dismiss mandatory laws' ability to account for some degree of individual variation among firms as irrelevant. Private ordering is always superior, they argue, since mandatory law cannot take into account all of the differences among firms as some differences are unobservable or non-verifiable.

Finally, supporting private ordering lends itself to applauding the existence of competition in the interstate market for firm incorporations. Because firms can choose to incorporate in any state regardless of where they conduct their business, individual firms can choose the state legal regime that best fits their unique needs and circumstances.[37] Here, then, is yet another context in which the One-Size Argument rears its head.

III. Theoretical Framework: Private Ordering and Firm Heterogeneity

A. Efficient Private Ordering Theory

1. Managers Will Choose Legal Constraints that Maximize Their Firm's Value

Contractual approach to corporate law relies on a straightforward intuition: Choosing law and governance is the same as choosing an investment, a business strategy or any other decision affecting the company's bottom line. The better law managers select, the more investors will be willing to pay for the company's shares.

> Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of

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[34] Martin Lipton, Steven A. Rosenblum, & Karessa L. Cain, *Proxy Access Revisited*, 44 BANK AND CORP. GOV. L. REP. 499, 499 (2010), ("Even if one believed that proxy access could offer some benefits, the best way to conduct an experiment of the costs and benefits is not to usurp the traditional role of state corporate law through a federally mandated set of proxy access rules, but rather to permit proxy access on a state-by-state, case-by-case, company-by-company basis.").

[35] *Id.*

[36] 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 _

[37] *See* Gallagher, Tulane CLI 2014, *supra* note **Error! Bookmark not defined.** ("This stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.")

> firm, governance structure, and securities people value. The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. People who seek resources to control will have to deliver more returns to investors. Those who promise the highest returns-and make the promises binding, hence believable-will obtain the largest investments.[38]

More rigorously, private ordering proponents focus on two main mechanisms, in two different stages of the firm's life, that arguably create these incentives. The following sections will discuss these mechanisms in order. First, the pricing of the shares before the firm's initial public offering ("IPO Stage"). Second, second following the IPO, when the firm is publicly traded ("Midstream Stage") - the discipline from the different market forces.

a. IPO

At the IPO stage, when the firm first goes public, the firm's founders, it is argued, internalize all of the costs and benefits of their choices through the IPO share price. If an entrepreneur offers a law that benefits her at the shareholders' expense, her firm's shares will be devalued. Thus, she will offer governance terms that maximize value, even if that means self-constraining her managerial discretion.

To illustrate, assume that the entrepreneur expects to manage the company and has to choose whether to include a proxy access term in the firm's charter. For job security reasons, she would like to avoid adopting the proxy access term, or at least construct a weak one that will not enable an active shareholder to easily control board composition. Assume that, given the likelihood of her being replaced in such a scenario and her alternative job opportunities in that event, the current expected value for her, of not having a proxy access charter term, is around $3M. Assume also that the expected benefits from a proxy access charter term are around 1% of firm value, which translates to $30M in expected value. A proxy access charter term is clearly efficient in this case since the total benefits it will create are larger than the total harm to the entrepreneur. After the entrepreneur sells most of her shares and is managing the company, however, she will not be interested in installing a proxy access charter term since she would suffer $3M worth of harm and any benefits will be minimal. Thus at this stage she will not implement one voluntarily and attempt to exclude shareholder proxy access proposals. Investors, who anticipate this behavior, will pay less for the IPO shares, if the charter does not include a proxy access term. In particular, private ordering proponents argue, because a huge number of analysts and other professional traders devote considerable time, effort, and resources to accurately appraising the firm's value, assuming that investors believe the entrepreneur could block a proxy access shareholder proposal later on, adding a proxy access term to the company charter will increase the firm's IPO price by exactly $30M for the company shares. In other words, at the IPO stage, the entrepreneur has optimal incentives to bind herself to the most efficient governance terms.

Table 1

[38] *See* Easterbrook and Fischel, *Corporate Contract*, supra note **Error! Bookmark not defined.**, at 1420.

	IPO	Midstream
Private benefits	3M	3M
Harm to Shareholders	30M	30M
Costs to founder/manager	-30M	-0.3M
Optimally	Proxy Access	Proxy Access
Choice	Proxy Access	No Proxy Access

The IPO stage hinges on the assumption that capital markets value governance terms precisely. This assumption might not always apply, for example, it has been argued that for new governance terms, or for governance terms that do not have a high value, the market price may not be accurate.[39] Nevertheless, as long as in most cases, on average, prices get it right, the IPO argument remains a strong theoretical proposition.

Many decisions with respect to firm governance, however, are made after the company goes public and after entrepreneurs have sold most of their shares. The business world and the laws that govern it are dynamic. Frequent legal innovations that could not be possibly anticipated at the IPO stage often arise, and affect the desirability of other governance terms. For example, the introduction and approval of poison pills in 1985, fundamentally changed the implication of previously implemented staggered boards. Private ordering proponents themselves understand that this descriptive tenet of corporate governance limits the extent to which the sensitivity of IPO valuations discipline managers, but they believe that also after the IPO, managers will have incentives to adopt efficient corporate laws and governance terms.

b. Midstream Stage

After the firm goes public, the enterprenuer gradually sells her shares, and whether she manages the firm or hire new management, firm management typically only holds a small fraction of the firm's cash flow rights. As a result, at this second stage—the Midstream Stage—managers' incentives are not perfectly aligned with those of shareholders—a manager who creates value for the firm will not necessarily create value for herself. Thus, at this stage management may seek lax corporate law and governance terms.[40] For example, a manager may seek to institute takeover defensive within the firm's governance documents or defend against a hostile takeover even if shareholders find a takeover desirable. Similarly, a manager might not implement a newly introduced majority vote or a proxy access bylaw.[41]

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[39] *See, e.g.*, Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition,* 105 HAR. L. REV. 1435, 1487 (1992); Lucian A. Bebchuk, *Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law,* Harvard Program in Law and Economics Discussion Paper No. 46 (1988), (explaining that with respect to terms that have little influence the costs of learning the information might be too high to make it profitable to be informed); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,* 89 COLUM. L. REV. 1618, 1676-77 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1569-73 (1989).

[40] *See e.g.,* Lucian A. Bebchuk*, the Debate on Contractual Freedom in Corporate Law,* 89 COLUM. L. REV. 1395 (1989).

[41] *See e.g.,* Easterbrook & Fischel, *The Corporate Contract*, *supra* note _ , at 1443.

Yet, market forces—the market for corporate control, the market for capital, the market for managerial labor and the market for products —will penalize them for their poor choices. For example, as Winter famously argued, if Delaware offered an inefficient law, and managers chose it, the firm's performance numbers will suffer and so will the value of her shares. And when management fails to maximize share value, hostile bidders might identify firms governed by poor law as fresh takeover opportunities that result in management turnover.[42] Further, poor performance makes capital more costly to raise,[43] worsens managers' hiring prospects,[44] and decreases the likelihood that the firm will survive competition.[45] To be sure, markets are limited, and while they mitigate agency costs they do not eliminate them. Yet, together they create significant threats and incentives for managers to choose efficient law and governance even if they hold a small fraction of the firm's cash flow rights.

2. One Size does Not fit All - Firms' Needs for Legal Constraints Vary

An important component of the support for private ordering is the proposition that firms' needs for specific legal constraints vary significantly. 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. But corporate law is not the only force that disciplines managers. Rather firms face varying degrees of other constraints.

To begin with, for 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 mangers. 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 will be replaced in a hostile takeover, harm their reputation and thus their future job prospects, or otherwise will simply not withstand fierce competition from other firms. If these sorts of external constraints apply and cause managers to perform well, mandatory regulations 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

[42] *See* 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). .

[43] Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence,* 9 DEL. J. CORP. L. 540, 543-546 (1984); Winter at 275.

[44] Frank H. Easterbrook*, Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 554 (1984); 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 4, at 256-57.

[45] Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 553-554 (1984); Winter at 264.

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.[46]

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.[47] Similar tradeoffs apply with respect to other governance terms. Fiduciary duties align mangers' 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.[48]

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 strong monitoring board more than does the latter."[49] 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.[50] The Jumpstart Our Business Startups ("JOBS") Act also exempts

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[46] Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**.

[47] *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.")

[48] 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*].

[49] Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**.

[50] 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)

emerging growth companies with total annual gross revenues under $1 billion from § 404(b).[51] As part of its stated goal of improving startup companies' access to capital markets,[52] the JOBS Act also reduces these companies' disclosure requirements,[53] enables them to submit draft registration statements to the SEC before their IPO,[54] and reduces their financial reporting requirements.[55] 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;[56] banks with total assets under $10 billion are not subject to supervision by the Consumer Financial Protection Bureau;[57] and the same sub-$10 billion banks need not conduct the stress tests that larger banks must commission.[58] These sorts of structural exemptions enable mandatory laws to accommodate certain observable, firm-specific differences.

B. New Theoretical Framework: Who Will Opt for Strict Law?

As the previous Part showed, a central block of the support for private ordering relies on differences in firms' needs for governance. This part takes this proposition seriously by introducing heterogeneity in non-legal constraints, to the contractual framework.

1. *IPO Stage*

Assume that firm A and firm B needs for governance vary. In particular assume that while in firm A a proxy access would have an added value of 30M, firm B faces significant market forces, and as a result a proxy access term is less needed and would have an expected value of only $2M. Assume also that both entrepreneurs, of Firm A and B derive a benefit of $3M from not having a charter-adopted proxy access. As table 2 demonstrates, while firm A should include a proxy access term in its charter, firm B should not have it as its benefits are outweighed by its costs. If investors know exactly the costs for firm A and B, as shown in Table 2, this will also reflect their corresponding IPO choices. Since each founder internalize the expected costs for his firm, firm A will include a proxy access term and firm B will not.

Table 2

	A	B
Private benefits	3M	3M
Benefit to Shareholder	30M	1M

(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).

[51] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 103, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

[52] *See id.* at pmbl.

[53] *Id.* § 102.

[54] *Id.* § 106.

[55] *E.g., id.* § 102(b).

[56] See 12 U.S.C. § 5641(f) (2012).

[57] See *id.* §§ 5481(24), 5516 (2012).

[58] See *id.* § 5365(i)(2)(A).

IPO price NPA	-30M	-1M
Optimally	Proxy Access	No Proxy Access
IPO Choice	Proxy Access	No Proxy Access

Adverse Selection

But, this efficient private ordering assumed investors accurately price distinct value of governance terms in light of *firm-specific circumstances*.[59] Yet, operative market forces and the extent to which they apply for each specific firm, are often unobservable. Founders know the constraints that they expect to face better than investors. The One-Size Argument, in fact, holds this as a premise: mandatory law is undesirable since managers know best their firm's needs:

> 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. [60]

What happens, if investors know the effect on the average firm, or even the average firm in the industry, but have no information, or less information than managers, on the expected effects for each firm?

To answer this question, assume that in firm A that faces especially weak market constraints, a proxy access term will add $6M worth of value. Assume also that firm B faces significant market forces, and as a result, the added value from a proxy access in firm B will be only $1M. 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 of this firm, they will instead apply an average value to a proxy access term, that is $3.5M. Now assume that both entrepreneurs in firm A and in firm B derive $4M in private benefits from not having a proxy access term. As Table 3 shows lack of information about the specific firm changes the results in a significant way. While firm B should not offer proxy access since its costs outweigh its benefits, firm A should offer it. Yet, since investors reward firm A only in the average value of having proxy access, that is $3.5M, rather than the particular value for this firm, that is $6M, for a proxy access, it will not offer it.

Table 3

	A	B	Average
Private benefits	4M	4M	4M
Harm to Shareholder	6M	1M	3.5M
Optimally	Proxy Access	No Proxy Access	
IPO Price	-3.5	-3.5	
IPO Choice	No Proxy Access	No Proxy Access	

[59] Cf. , (showing that IPO stage analysis hinges on the assumption that on average governance terms are being priced correctly). For limitations of this assumption when applies to new governance terms, and terms that have only small influence see sources cited at supra note 39.

[60] Joseph Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law,* 65 BUSINESS LAWYER 361 (February 2010).

Signaling

So far the analysis assumed no variations in the private benefits than the different entrepreneurs derive from not having a proxy access. Yet in a firm that faces weak market forces it is likely that a manager could extract high private benefits, and therefore has more to lose from having a proxy access rule. To introduce this additional variation, assume that the value of not having a proxy access for the manager in firm A, who extracts high private benefits, is $6M, while for managers of firm B that anyway does not extract high private benefits the value of not have proxy access is only $1M. Assume also that the value from proxy access for firm A is $8M and the value for firm B is $2M. Now if both firms do not adopt a proxy access rule investors do not know who is who, and asses an average for both, will reward each firm with $5M for adopting a proxy access rule. If that is the price, the manager of firm B will adopt a proxy access and the manager of firm A will not. This is however, not an equilibrium. Investors could realize that the manager of firm B did not adopt proxy access since his private benefits are high, and so is the harm to shareholders from not having a proxy access. Thus, if some firms adopt a proxy access and some do not, investors will discount firms that did not in 8M rather than the average 5M. Yet, with a discount of 8M the manager of firm A is better off adopting a proxy access rule. Both firms, thus, will have a proxy access rule.

This result is due to a signaling effect, by not adopting a proxy access rule the manager that extracts higher private benefits would reveal his type and also the large costs for shareholders. Signaling thus, could result in all firms adopting a proxy access rule.

Table 4

	A	B	Average
Private benefits	6M	1M	3 M
Harm to Shareholder	8M	2M	5M
Optimally	Proxy Access	Proxy Access	
IPO Price if pooling	-5M	-5M	
IPO Price if separating	-8M	-2M	
IPO Choice: Pooling	Proxy Access	Proxy Access	

Noise

The previous section has demonstrated a potential signaling effect that could lead to a pooling equilibrium in which all firms adopt a proxy access rule. There are several limitations however for these signaling effects to operate in reality. To begin with, for different reasons adoption corporate law and governance terms, especially at the ipo stage, is associated with significant noise and as a result obscure signals. In particular, in some firms, certain governance terms only exist due to boilerplates, advice of a local lawyer,

network externalities, or some arbitrary sources.[61] Thus when investors observe a weak governance regime, they might not know whether it resulted from a conscious choice by firm management or from a more benign source.[62]

To summarize, as the forgoing analysis demonstrated, if investors do not know the exact costs and benefits, they will probably apply an average benefit to a strict term. As a result, the penalty for firms that could really benefit from this term is only partial. At the end, firms that can benefit most from regulation will be consistently less likely to do so because these benefits will be underestimated by capital markets.[63]

Second, adopting certain governance terms could provide different, and sometimes conflicting signals. For example, by adopting strict governance firms may also convey a negative signal with respect to the value of their future projects.[64] These interfering signaling effects may change the equilibrium above.

2. Midstream Stage

a. Weak Market Forces Impose Weak Penalties

At the midstream stage, proponents of private ordering rely on market forces to incentivize management to adopt the governance package that best suits their firm particular needs:

> "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."[65]

Recall that under the One-Size argument, one-size does not fit all since firms' external constraints vary. Firms that face significant discipline from the market and other forces will not benefit from additional regulation. Firms that face only weak internal and external constraints are the ones that could benefit form regulation. In these firms, the managers' interests are not aligned with those of shareholders, and due to the lack of market constraints, they extract high private benefits and impose high inefficiency costs. Under the One-Size Argument, these firms that could benefit most from regulation are most likely to adopt it.

But therein lies a striking *contradiction*. There is an *inherent tension* in claiming both (1) that managers facing weak market forces will self-constrain because their firms are the ones that need it most, and (2) that those same weak market forces will sufficiently

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[61] *See* Michal Barzuza, *Noise Adopters in Corporate Governance*, 3 COLUM. BUS. L. REV. 627 (2013): *See also* Michael Klausner *Corporations, Corporate Law, and Networks of Contracts,* 81 VA. L. REV. 757, 761 (1995) (arguing that due to positive network externalities, frequently used legal terms have a value that is independent from their legal substance).
[62] *See id.*
[63] Adverse selection, Barzuza noise adopters. Signaling will not work – see section _ below .
[64] E.g., Bebchuk , Iacobucci
[65] Baysinger & Butler, *The Role of Corporate Law*, *supra* note 43, at 182-83.

discipline directors into self-constraining. If operative market forces are not sufficiently strong to drive managers to perform at their best, why would they be sufficient strong to drive managers to choose a constrictive governance regime?

In other words, market forces are supposed to discipline managers to adopt legal restrictions to substitute for the very same weak market forces that fail to discipline them to manage the company well. Proponents of private ordering, have either overlooked or this significant tension in their analysis, or instead relied on the IPO stage to mitigate it.

b. Weak Market Forces Create Opportunities to Extract High Private Benefits

There is another reason why firms that face weak constraints are less likely to opt for strict law. Firms that face relatively weak market forces are more vulnerable to the inefficient extraction of private benefits. Managers of these firms extract higher private benefits than managers in firms that are disciplined by markets.[66] Recent evidence confirms the notion that extent to which managers extract private benefits depends upon the market forces at work. In particular, findings suggest that in firms that face weak market forces, private benefits are higher.[67]

When managers opt into strict legal constraints, however, they limit their opportunities to extract private benefits of control. Accordingly, market forces have to be strong enough to outweigh managers' temptation to extract private benefits. Yet, since they extract higher private benefits than managers in firms that face strong market forces, they have more to lose by committing to strict law.

Given the combination of facing low market penalties and having more benefits to lose, insiders facing weak market forces are more likely to *avoid* legal constraints than welcome them.[68] And as our theoretical analysis shows, this inefficient tailoring can result in significant inefficiency costs. Even high inefficiency costs, though, might not discipline managers subject to the above combination of circumstances. The higher the possible private benefits, the higher the efficiency gains would have to be to lure them to adopt legal constraints.

c. Weak Governance results in Weak Market Forces and High Private Benefits

The presence of weak internal governance structures also make it unlikely that firms who can benefit most from legal constraints will in fact adopt them. Firms with more controls in place differ from firms lacking similar controls in their need for additional controls. For example, a poison pill is less necessary for a board that is staggered than for a board that is not staggered. Similarly, a board that is not staggered does not need independent directors as much as a board that is staggered. Similarly on an international

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[66] Extracting high private benefits will trigger weaker penalties in firms that face weak market forces. *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).

[67]*See* Maria Guadalupe & Francisco Perez-Gonzalez, *supra* note 19 at ___.

[68] For a formal model that shows this results see Michal Barzuza, *Lemon Signaling in Cross-Listing* Virginia Law and Economics Research Paper No. 2012-03.

level, some firms are governed by strict law, while some are governed by weak law, or weak institutions. Thus, in theory, if private ordering proponents are right, firms with fewer disciplining governance terms in place, or firms from weak legal regimes, will be more likely to adopt additional constraints.[69]

Managers that face weak legal constraints, however, can extract more private benefits of control and thus will be more reluctant to constrain their own ability to extract. Moreover, entrenching governance terms frequently reduce the effectiveness of potential penalties from market forces.[70] For example, implementing a staggered board or incorporating in a state that allows a dead hand pill significantly decreases, and can even eliminate, the likelihood of a takeover. Thus, managers of firms with staggered boards are significantly less exposed to the potential discipline of the market for corporate control.[71] Similarly, in firms with no independent directors, there is less pressure to award less compensation, or even fire, a manager who underperforms.

Thus, firms with weak governance face a double-difficulty: managers (1) can extract high private benefits worth holding on to and (2) face only weak penalties for failing to select a strong governance regime that would prevent them from misbehaving in the manner described in (1).

Midstream Signaling

IV. The Evidence

Proponents of private ordering point to the successful track record in U.S. corporate law as supportive of the One-Size Argument.[72] It is common to hear that as "this is the approach that has successfully driven the development of corporate law throughout our history"[73] and "has served to create so much wealth from the corporate form."[74] They also point to the commonly-observed variations in firms' governance as support of their argument that private ordering results in firms choosing the governance that best fits their

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[69] Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**.

[70] *See e.g.,* Lucian A. Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers From Takeovers* 99 CLM. L. REV. 1168, 1180 (1999) (arguing that legal developments such as the poison pill significantly impeded the disciplining power of the market for corporate control).

[71] *See* Bebchuk

[72] This one-size-fits-all approach to corporate governance is much reviled among corporate law scholars and practitioners who believe that a very important reason why corporate law is wealth enhancing is because it allows for private-ordering. That is, company officials and investors are in a much better position to determine the optimal corporate governance arrangements of their company than public officials. *See* Bernard S. Sharfman, *Why Proxy Access Is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 389 (2012).

[73] *Id.*

[74] Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 9-10 (2010).

own circumstances. Thus, a Wachtell memo explains that variations in majority voting adoption is the "predicted outcome" of private ordering.[75] Similarly, variations across states are considered in line with private ordering theory.[76] Surprisingly, however, there was never testing or even assessment of *which* firms are choosing to adopt legal constraints and *which* do not. While the argument hinges significantly on the extent to which this selection is efficient, proponents have never examined the evidence to verify that.

This Part analyzes and synthesizes a large body of evidence from numerous studies on a wide range of governance terms and laws, all of which speaks directly to this question. The body of evidence is not consistent with optimal self–selection. In fact, the evidence shows quite clearly that, consistent with theoretical predictions, Firms that could benefit most from legal constraints are the least likely to adopt it under the private ordering system.

A. Director Independence

> *"By establishing a highly restrictive definition of director independence and mandating that such directors dominate both the board and its required committees, 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."*[77]

Of the different regulatory interventions in firms' governance that followed the Enron and WorldCom corporate scandals, the requirements for higher and more effective board independence, were perhaps the most significant and intrusive ones. Exchanges-listed firms were required to have a majority of independent directors on their boards,[78] to place only independent directors on their audit committees,[79] and to hold periodic executive sessions in which independent directors meet with no firm insiders present.[80] NYSE-listed firms' had to structure also their compensation and nomination committees to include only independent directors[81]

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[75] *See* Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Aug. 17, 2009) ("That companies have not uniformly adopted majority voting is not an indictment of enabling corporate law. To the contrary, diversity among corporations is the predicted outcome. The virtue of private ordering is that it does not force all corporations into the same governance box. Instead, it fosters the value of allowing a company to tailor its internal affairs. In yielding to the unique circumstances of different companies, enabling corporate law expects firms to follow different paths to achieving the best results for the enterprise."), *available at* http://www.sec.gov/comments/s7-10-09/s71009-263.pdf.

[76] *See* Baysinger & Butler, ("Summarizing, stricter corporation laws survive because in some instances market oriented governance mechanism 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")

[77] Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**.

[78] NYSE Listed Company Manual § 303A.01; Exchange Act Rel. No. 48,745.

[79] SOX § 301 (3). It also required at least one of them to be a "finance expert."

[80] NYSE Listed Company Manual § 303A.03.

[81] NYSE Listed Company Manual § 303A.04-05.

These rules were heavily criticized, for replacing a private ordering regime, in which companies chose varying levels of independence, with a mandatory "one-size-fits-all" approach to all exchange listed firms.[82] While the rules assumed that independent directors bring monitoring value, critics argued, they ignored significant costs of replacing inside directors with independent directors. To begin with, independent directors tend to have less knowledge about the firm, and the industry it operates in than insiders have.[83] Second, it is arguably difficult to create meaningful incentives for independent directors to invest significant time and resources in the company.[84] While they care about their companies, they are not as invested in it as the insiders are. Even worse, critics argued, the rules did not rely on any evidence that support the proposition that a majority of independent directors adds value, and ignored evidence to the contrary. While prior studies found that board independence correlated positively with one dimension of board performance - sensitivity of CEO turnover to firm performance - [85] they found no significant, and in some cases a negative, relationship between board independence and firm performance.[86]

If One-Sizers were right, firms that added independent directors to meet regulatory requirements should not have benefited from them. Yet, studies on SOX and the exchanges mandated independence standards find significant positive effects for firms that increased the ratio of independent directors to meet the mandated majority requirement.[87]

Firms that added independent directors to comply with the new listing standards exhibited relatively high positive abnormal returns after the announcement of the rule changes,[88] performed better following the changes to their boards,[89] and decreased the size

[82] *See e.g.*, Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.** ("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.") Bainbridge, Stephen M. (2011-12-28). Corporate Governance after the Financial Crisis (Kindle Locations 1898-1899). Oxford University Press, USA. Kindle Edition.
[83] *Id.*
[84] *Id.*
[85] Michael S. Weisbach, Outside Directors and CEO Turnover, 20 J. Fin Econ. 431 (1988).
[86] *See e.g.,* B.E. Hermalin & M. S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101 (1991) (no relationship to value); A. Agrawal, & C. R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders*, 31 J. FIN. QUANTITATIVE ANALYSIS, 377 (1996) (negative relationship); Sanjai Bhagat, & Bernard S. Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002), (no relationship); Sanjai Bhagat, & Brian Bolton*, Corporate Governance and Firm Performance,* 14 J. CORP. FIN. 257 (2008) (negative relationship).
[87] Typically in studies that examine the effects of the mandated board independence, firms that already had a majority of independent directors served as the control group in a difference-in-difference test.
[88] 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). Similarly, appointing a director with accounting expertise to the board resulted in a positive stock market reaction (DeFond, Hann & Hu 2005).
[89] (Bhagar & Bolton 107)

of their executive compensation following the changes to their board.[90] At the very least, these results suggest that, contrary to private ordering proponents' predictions, not all firms that could have benefited from independence voluntarily adopted it.

But they could suggest more than that. Directly comparing firms that nominated independent directors pre-SOX (by voluntary private ordering) with those that nominated independent directors post-SOX (by regulatory mandate) Bhagat and Bolton find that mandatory added independent directors post-SOX improved performance while pre-SOX voluntarily adopted independent directors harmed performance. [91] Affected firms experience increases in return on assets ("ROA") relative to firms that did not add directors. Finally, the researchers found that announcing plans to hire more independent directors to comply with SOX triggers a positive market response.[92]

Similar results emerge with respect to other performance measures. Consistent with previous studies, Bhagat & Bolton find that the higher turnover sensitivity to performance that was assopciated with pre-SOX independence, has increased significantly post-SOX, for affected firms.[93] Similarily, examining independence's effects on acquisition decisions, which on average are associated with negative returns for the acquiring firms,[94] Bhagat and Bolton found that that board independence is associated with fewer acquisitions both pre- and post-SOX, but compared to pre-SOX independence, post-SOX independence is associated with a significant decrease in acquisition levels.[95]

Why does mandated independence appear to have strong positive results, whereas voluntary independence does not? The difference is most likely a result of differences among firms that chose to voluntarily have a majority of independent directors to firms that chose not to, under private ordering regime. In other words, evaluating the results from pre-SOX studies is complicated by endogeneity concerns.[96]

Under one account in firms that performed less well, the outside directors gained power vis a vis management, and therefore could push for more independent directors on their boards. 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, independent may be associated with no better, and even poorer performance. Attempting to control for endogneity, emplying instrumental methods, Bhagat and Black, as well as Bhagat and Bolton, find support for the proposition that poorly performing firms were more likely to nominate

[90] Vidhi Chhaochharia & Yaniv Grinstein *CEO Compensation and Board Structure* 64 JOURNAL OF FINANCE 231 (2009).

[91] *See* Sanjai Bhagat, & Brian Bolton, *Director Ownership, Governance, and Performance*, 48 (1) J. FIN. & QUANT. ANAL. 105 (2013).

[92] *See id.* at 122. Tbl 5 (finding positive abnormal return around the date of the filling of the annual proxy statement for firms that change from being non compliant to being compliant with SOX).

[93] *See id.* at 129 & Tbl 9 panel C

[94] *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).

[95] *See id.* at 132 & Tbl 10 panel C.

[96] *See e.g.,* .E. Hermalin & M. S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101 (1991). If boards increased independence following weak performance, it is possible that independence did improve value, though a cross-section comparison would not reveal that.

independent directors but no support for the proposition that these independent directors added value. Speculating on the lack of positive effects of independent directors, Black and Bhagat suggested that firms added independent directors to conform with conventional wisdom, or to get better treatment from Delaware courts.[97]

While it is impossible to rule out the forgoing efficient endogenity account, a second, inefficient selection account is also, and maybe even more, consistent with the evidence. Under the inefficient selection account, firms that increased independence to conform with conventional wisdom , and to get better treatment in courts were also firms for whom otherwise it did not matter much. For example, firms in which the insiders were operating under strong discipline from outside competition, did not need additional monitoring. They adopted it nevertheless since it made them look better. Firms that could really benefit form monitoring, were less likely to nominate independent directors since their insiders had more to lose from doing so.

If the private ordering proponents are right, board independence should have been associated with better performance in the pre-listing-standards era, when it was adopted voluntarily, relative to the post-listing-standards era. Available evidence is not consistent with this account. On the contrary, the body of evidence suggests that in firms in which board independence was mandated by law, the positive effects for shareholders were stronger than in firms in which independence was implemented voluntarily. Evidently, the firms that benefited most from the independent directors did not adopt them when they had the choice to do so. If SOX and the major exchanges did not implement independence standards, shareholders would not have received the efficiency gains associated with independence.

B. Executive Compensation

> *"[B]ecause individualized review of compensation schemes at the 10,000-odd U.S. reporting companies will be prohibitively expensive, activist institutional investors will probably insist on a narrow range of compensation programs that will force companies into something close to a one-size-fits-all model."*[98]

Unsurprisingly, executive compensation is another area where the One-Size Argument has reared repeatedly. CEO compensation schemes in the U.S. have drawn significant attention in the last two decades, drawing fire for providing extravagant salaries and failing to create efficient performance incentives. Yet, the prevailing conventional wisdom has been that since boards know better then courts what their firms need to offer in order to attract and retain top talent, markets should determine board compensation. The NYSE's requirement to have a compensation committee comprised solely of independent directors,[99] Dodd-Frank's provision that grants shareholders non-binding say-on-pay votes, and enhanced disclosure requirements were all criticized for their one-size approach. Critics have raised the same concern for forthcoming SEC rules—in particular, with respect

[97] Bhagat & Black, supra note _, at 239 ("More plausibly, the large long-term shift in board structures responds to changes in conventional wisdom and perhaps also to legal pressures. The Delaware Supreme Court, for example, has long encouraged majority-independent boards by giving greater deference to decisions by these boards.")
[98] Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**.
[99] NYSE Listed Company Manual § 303A.05.

to three areas of executive compensation that Dodd-Frank instructs the SEC to regulate: payment ratio disclosures, incentive-based compensation disclosure, and requirements for firm "clawback" provisions.[100] And critics have chimed in to posit the same general refrain for each: a one-size concern.

Well-designed executive compensation regimes enable firms to mitigate agency costs, align management's and shareholders' incentives, and discipline management in a manner similar to legal rules. Incentive-based compensation, however, can also impose costs. For example, compensation that depends on share performance imposes risk aversion costs and therefore should be implemented only to the extent it is needed to create incentives and substitute for other controls. Consistent with the argument that one size does not fit all, a recent study found that incentive-based compensation had positive effects on CEOs with short tenures, but negative effects on CEOs with long tenures.[101] Thus, in this area, inflexible standards might impose costs on firms.

If private ordering operates efficiently, firms less disciplined by market forces and internal governance provisions should rely more on incentive based compensation to properly align incentives than firms subject to stronger controls. Firms with monitoring boards created to scrutinize managerial performance, for example, would benefit less from a strong compensation structure.

1. Pay for Luck

To test the efficiency of executive pay, two economists examined what sorts of companies reward CEOs for luck as opposed to superior performance. Sure enough, the firms that rewarded luck tended to perform worse and have relatively weaker corporate governance arrangements.[102]

Furthermore, upon examining the aftereffects of changes in several states' takeover laws, researchers found that changes in governance had the same effect on compensation—that is, less constraints resulted in more pay for luck. In particular, different states have passed different antitakeover rules, some of which broadly insulate management from the risk of hostile takeovers and their disciplining effects. Given the decrease in discipline and increase in job security, one would expect compensation to decrease and rely more on performance. Yet, the opposite has happened. Compensation in these states increased by 1–2% following the passage of the rules. [103] Thus, also with respect to compensation the evidence is not consistent with the idea that efficient self-selection is taking place. Instead, firms with the most to gain from efficient compensation structures are the least likely to adopt them.

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[100] See *Corporate Governance Issues, Including Executive Compensation Disclosure and Related SRO Rules*, U.S. SEC. AND EXCH. COMM'N, http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml (last visited Mar. 13, 2015).

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[102] Marianne Bertrand & Sendhil Mullainathan *Are CEOs Rewarded for Luck? The Ones without Principles Are*, 116 Q. J. ECON. 901 (2001).

[103] Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999).

2. Backdating Options

The emergence of backdating options presents the clearest example of the market's failure to devise effective compensation schemes. Initially, companies provided these options to encourage management to perform well in the long term. Options are typically awarded "at the money," that is, the exercise price of a normal option usually equals the share price on the day the option is awarded. When the manager is allowed to exercise the option—typically a year or more in the future—she will have to pay the exercise price to gain ownership of the shares. Thus, with at the money options, if the future price of the share is lower than the shares' price when the option was awarded, the option's value is zero. Conversely, if its future price exceeds the vesting price, the option's value equals the difference between the share price on the day the option was awarded and the current share's market price. The options thus incentivize the manager to increase the value of the company for the shareholders.

Backdating options refers to a practice in which firms managers and/or board members change the option awarding date retroactively in order to lower the exercise price, and as a result, to increase the value of their options. Backdating options commonly involves false disclosures, inappropriate fabrication of board minutes, and other breaches of law. Even when it does not involve illegalities, however, backdating options presents a serious failure of compensation design as it eviscerates efficient incentives. Initially, companies provided options to encourage management to perform well in the long term. But because firms can now opportunistically lower the options' exercise price post hac, the incentives the options create are weak at best.

Which companies, then, tend to give managers backdated options? All studies find they are the ones with insubstantial controls and otherwise weak governance.[104] In particular, classifying an option as being backdated if its vesting price was the lowest price of the month, the likelihood for backdating was found to be correlated with "lack of a majority of independent directors, a long-serving CEO, or a lack of a block-holder with a 'skin in the game' on the compensation committee."[105] Similarly, using a slightly different definition for backdating, another study found that firms with high proportion of insiders, outside directors that were appointed by the current CEO, and board members that interlock with backdating firms had higher incidence of backdating. [106]The evidence with respect to backdating therefore also suggests that the firms that can benefit most from efficient compensation were more likely to implement distorted compensation practices.

C. Shareholder Advisory Votes and a Note on Proxy Advisory Firms

> *Proxy Advisers Don't Help Shareholders. The 'best practices' they want companies to adopt are more accurately termed one-size-fits-all best guesses.*[107]

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[104] Lucian A. Bebchuk, Yaniv Grinstein, & Urs Peyer, *Lucky CEOs and Lucky Directors* 65 J. FIN. 2363 (2010). 2009 OP-EDS

[105] *Id.*

[106] Daniel W. Collins, Guojin Gong, Haidan Li, *Corporate Governance and the Backdating of Executive Stock Options*, 26 CONTEMPORARY ACCOUNTING RESEARCH 403 (2009).

[107] David Larcker, WSJ Dec 8 2013 , *available at* http://www.wsj.com/articles/SB10001424052702303497804579241842269425358.

Dodd-Frank's most significant change with respect to executive compensation was to require firms to implement say-on-pay—shareholder votes to approve or disapprove compensation packages of the company's top executives. Because the votes are only advisory, managers do not have to act on them. In the past, these kind of advisory votes probably would change nothing. Shareholders had no information or interest in voting at all, and even less interest when the vote is merely advisory. Yet, the emergence of proxy advisory companies during the last decade and a half has increased the effectiveness of shareholder votes.

For several reasons, in advising institutions how to vote, proxy advisory companies became a coordination point and by some accounts a force driving institutions to vote against directors and in support of shareholder proposals. Critics argued that proxy advisory firms also apply a "one-size" ill approach to corporate governance.[108] Thus, when Dodd-Frank applied say on pay votes, skeptics argued that it would result in a one-size approach to companies with different compensation needs. [109]

Research on these say-on-pay votes does not support the One-Size Argument for at least two reasons. First, shareholder votes against payment packages happen rarely, and shareholders do not blindly follow the proxy advisory firms recommendations. Second, no evidence substantiates the concern that ISS and other proxy advisory firms will make one-size-fits-all recommendations for say-on-pay votes.

To begin with, proxy advisors' voting recommendations, and in particular say-on-pay recommendations, are particularized and often advise firms to make token decisions based on context and specific situational cues. For example, in its 2015 voting guidelines, ISS recommends that shareholders considering whether to approve equity-based compensation plans base their votes on three "pillars" of information: the plan's cost, the plan's features, and any relevant grant practices.[110] And because ISS explicitly recommends that shareholders weigh positive factors against negative ones, its recommendation is far from a one-size, inflexible directive.[111] Rather, it is structurally context-dependent.

Further, a recent paper conducted a systematic assessment of proxy advisory firms' recommendations on say-on-pay votes. The study finds that, consistent with the widely accepted sentiment, proxy advisory firms have significant influence on these votes. Nevertheless, shareholders do not follow their recommendations blindly. Rather, institutions are more likely to follow a recommendation to vote against a compensation package for smaller and poorly performing firms, and when the proxy advisory presents a particular rationale for the recommendation.[112] Thus, even if proxy advisory firms provide

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[108] "Rule-based approaches, such as those developed by proxy advisory firms, tend to be based on "best practices"—better termed "one-size-fits-all best guesses"—that have little or no relation to the specific strategic, competitive or management situations facing individual companies." David Larcker , WSJ Dec 8 2013 , available at http://www.wsj.com/articles/SB10001424052702303497804579241842269425358.

[109] *See e.g.*, Jeffrey N. Gordon, "*Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in,* 46 HARV. J. LEGIS. 323, 325 (2009); Bainbridge, *Financial Crisis, supra* note **Error! Bookmark not defined.**.

[110] *United States Proxy Voting Guideline Updates: 2015 Benchmark Policy Recommendations*, INSTITUTIONAL S'HOLDER SERVS. 7–8 (Nov. 6, 2014) http://www.issgovernance.com/file/policy/2015USPolicyUpdates.pdf.

[111] *Id.* at 8.

[112] Ertimur, Yonca, Fabrizio Ferri, and David Oesch. *Shareholder Votes and Proxy Advisors:*

one-size recommendations, institutions apply them by taking firm-specific factors into account.

Second, the study finds that the proxy advisory recommendation—either encouraging shareholders to vote "For" or "Against"—depended on firm-specific characteristics. In particular, they found that "[proxy advisers] are more likely to issue an Against recommendation at firms with poor performance and higher levels of CEO pay and do not appear to follow a 'one-size-fits-all' approach."[113] Thus, despite arguments to the contrary, increased shareholder empowerment derived from proxy advisory firms probably results in better firm-specific tailoring than private ordering. In compensation, one size does not fit all, and the companies that need constraints most will receive them only with help from proxy advisory companies and other shareholder empowerment mechanisms.

It is still not clear, however, that say on pay votes create the right discipline. While the study also found that firms implemented changes following the votes, the evidence does not suggest that the response was effective, as there was no statistically significant market response to these changes. Focusing on changes made prior to say on pay votes, presumably to avoid a negative recommendation, another study found a negative market response to these pre-vote changes.[114]

D. Voting

Shareholder voting power is supposed to be one of the cornerstones of good governance; it is a critical mechanism to ensure board and management accountability. Shareholders' right to vote drove, for example, the Delaware General Assembly to delegate a great deal of power to management between elections and Delaware courts to approve the revolutionary poison pill.[115]

Yet, in reality, voting does not function in commonly expected ways for several reasons. To begin with, nominating a board member is extremely expensive and does not make sense for the small, dispersed shareholders of U.S. companies. Indeed, the vast majority of annual meeting elections were uncontested—that is, management candidates were the only candidates.[116] Second, and relatedly, Delaware's default majority requirement—which crowns as winners the candidates who receive a plurality of supporting votes—gave no bite to shareholder power to withhold votes. Delaware plurality standards provide the board seats to the top candidates, that is, the candidates that received the largest number of supporting votes, regardless of the number of opposing (withhold) votes.[117] Thus directors can be elected when the votes against them, namely "withhold

Evidence from Say on Pay 51 (5) J. OF ACCOUNT. RES. 951 (2013).

[113] Larcker D. F., A. L. McCall and G. Ormazabal, 2012. *The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies* Working Paper, Stanford University.

[114] *Id.* This is not to suggest that there are no other problems with proxy advisory firms. To be sure, there might be a problem of self interest, which may bias them in favor of too many recommendation, but it is not clear that this will result in less good self selection.

[115] *See e.g.,* Moran

[117] *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise,* 93 VAR. L. REV. 675 (2007) (finding that only a handful number of annual votes are contested).

[117] DGCL 21

votes," are overwhelmingly larger than the votes for them. In fact, since most directors elections are uncontested, board members can be elected with one vote supporting them and thousands of votes withheld from them.

This part will focus on two recent developments – majority voting and proxy access bylaw amendments—the former has spread fairly easily while the latter is the subject to fights and drama in the corporate governance world.

1. Majority Voting

Private ordering has been at work in recent years in the very area before us today: the election of directors. Market discipline has resulted in shareholder empowerment and enhanced accountability. The past few years have witnessed a notable trend away from plurality voting toward majority voting for directors, even in the absence of legislative or regulatory mandates. Over 50 percent of the S&P 500 companies now have some form of majority voting.[118]

Supporters of private ordering frequently point to the proliferation of majority voting as an example of why there is no need for mandatory law. Majority voting terms, adopted via a bylaw amendment, aim to give more weight to shareholders' withhold votes. While terms vary across firms, under a typical majority vote term, in the event that a director nominee receives more withhold votes than supporting votes, that director will submit his resignation to the board. The board will then have discretion to accept or reject the resignation. Since the board has the power not to accept resignation, the main criticism of majority voting is that as a practical matter it did not change much. Consistent with this skeptical approach, a recent study shows that directors almost never step down as a result of withheld votes, and even fewer do so in firms with majority voting regimes. While it is rare for these directors to step down, however, withheld votes are found to have an indirect effect on the board's responsiveness to shareholders' needs and proposals.[119]

What sorts of firms have adopted majority voting? A recent study finds the firms that switched to majority voting, prior to the switch, had a significantly lower likelihood that at least one of its director nominees would receive a significant proportion of withhold votes, or any withhold vote, in previous years. [120] That is, firms that were likely to adopt majority voting were the ones for which it mattered less—and probably ones that needed it less. Thus, even the poster child of private ordering teaches us that firms are more likely to adopt legal constraints when these constraints are less likely to matter. Firms that could be threatened by the majority vote provision avoided it.

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[117] Speech by SEC Commissioner: Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations

[118] Speech by SEC Commissioner: Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations *by* Commissioner Troy A. Paredes *U.S. Securities and Exchange Commission* Washington, D.C. (May 20, 2009) *available at* http://www.sec.gov/news/speech/2009/spch052009tap.htm

[119] See Marcel Kahan & Edward B. Rock, *Symbolic Corporate Governance Politics*, 94 B.U. L. REV. 1997 (2014)

[120] Stephen Choi, Jill Fisch, Marcel Kahan & Edward Rock, *Does Majority Voting Improve Board Accountability* working paper (20115).

By now, however, approximately 90% of the Fortune 500 firms have a majority vote term. Why couldn't companies that were threatened by the change keep resisting? Probably, at some point a tipping point is passed, after which not switching to majority voting would have been exceptional and therefore could also send a negative signal. Yet, that begs the question: what brought us to this tipping point? Over time, proxy advisory firms—firms that advise institutional shareholders on how to vote, and who are also frequently criticized for using a one-size-fits-all approach in their recommendations—have increasingly pressured firms to adopt majority voting. As a result of the proxy advisory firms' pressure, the companies whose shareholders could probably benefit most from majority voting since they already were dissatisfied with some board members and pronounced their dissatisfaction in election, have also switched to majority voting. Absent the proxy advisory firms' pressure, however, these firms probably would not have switched from plurality voting. Thus, despite the criticism that proxy advisory companies apply a one-size fits all in their recommendation, it is more likely that proxy advisory companies' pressure resulted in a better tailoring of majority voting to firms needs—firms for which it did matter , whose directors faced the risk of not getting support, had to adopt it due to the Proxy Advisory firms' pressure.

2. Proxy Access

> *"The strong agnostic position in theology is that "I don't know whether god exists. And neither do you."1 The strong agnostic position in the proxy access debate is that "I don't know whether proxy access is a good or bad idea at every corporation in America, and if it is a good idea at some, many, or every corporation, I don't know how to structure the access rules for every corporation. And neither do you." I am a strong proxy access agnostic. And you should be too."*[121]

Given the lack of shareholder director nominees, the SEC has considered a proxy access rule that would allow large long-term shareholders to add director nominees to the firm proxy materials. The proxy access rule was designed to reduce the costs of running a nominee which include, among other things: the costs of filling with the SEC, hiring an outside counsel, and sending proxy materials to all shareholders. In particular, under proposed 14a-11, a shareholder who held at least three percent of the firm shares for at least three years could add his director nominees to the firm's proxy materials. The proposal reflected a balance between the goal of giving shareholders a voice and being careful not to overburden the firm and the board with frequent proxy fights. The SEC received numerous comments opposing the proposal, primarily on the grounds that that the one-size-fits-all approach of 14a-11 is inferior to a private ordering approach which Delaware has just adopted, partly in an attempt to preempt the need for a federal mandatory proxy access rule.[122] The SEC passed the rule eventually in a three to two decision. In his comments, dissenting Commissioner Parades stated that an enabling law would be superior to the SEC's mandatory "one size fits all proxy access rule" as it "allows the internal affairs of each corporation to be tailored to the firm's unique attributes and qualities."[123]

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[121] Grundfest, supra note _ at 1.

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[123] *See* Speech by SEC Commissioner:
Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations ("Proxy Access") *By* Commissioner Troy A. Paredes *U.S. Securities and Exchange*

The SEC's proxy access rule has never become effective. Instead, shortly after its adoption, it was placed it on stay in response to a lawsuit from the Business Roundtable and the Chamber of Commerce.[124] The U.S. Court of Appeals for the D.C. Circuit has since struck down the rule, reasoning that the SEC acted capriciously and arbitrarily by not having sufficient evidence. In its opinion, the court referred to comments made by the two dissenting commissioners.[125] What is left, then, is to observe which firms adopted proxy access via private ordering.

Initially, very few companies adopted a proxy access rule. Recently, however, several shareholders submitted proxy access proposals in a few firms, and more significantly the New York City Comptroller submitted shareholder proposals in seventy-five companies that were specifically picked based on known problems associated with compensation, diversity, and environmental impact and policies. Despite this careful selection, the comptroller was also criticized for his one-size-fits-all approach since each of his 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 his director nominee to the firm proxy materials. Unlike majority voting proposals, proxy access proposals have garnered significant resistance from management, who have attempted to exclude them from the firms' proxy materials and avoid bringing them to a shareholder vote. To that end, management relied on an obscure exception to the shareholder proposal rule. Under 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."[126] Management at Whole Foods Company used this provision to fight the proxy access proposal—they submitted an alternative proposal, with a nine percent threshold for at least five years. There is not even one shareholder in Whole Foods that meets this threshold.[127] They then requested and received a no action letter from the SEC to verify their ability to exclude the three-by-three shareholder proposal, which resultantly conflicts with a management proposal.[128] Chipotle submitted a similar request to the SEC based on a conflicting proposal with an eight percent threshold for at least five years, limited to one director.[129] 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.[130]

But now a major power is influencing the process—proxy advisory firms. On February 2, ISS released their clarification on proxy access shareholder proposals. ISS and Glass

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Commission Washington, D.C. (August 25, 2010) *available at* http://www.sec.gov/news/speech/2010/spch082510tap.htm.

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126 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.

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

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Lewis have also threatened to vote against directors who exclude shareholders' proxy proposals [131] Several large institutions, announced their support in the proxy access proposals. On February 13, 2015 Black Rock announced that it will vote against directors that attempt to exclude proxy access proposals. In sum, it certainly looks like proxy access is going to be a battleground. On February 20, Wachtell distributed a client announcing that ISS is clarifying its policies with respect to proxy access proposals and noting that "[t]hese ISS policies clearly require careful consideration."[132] Others call on companies not to follow the proxy advisory firms' one-size approach.[133] While it is not clear if the ISS policy will create a tipping point similar to the majority voting rules,[134] its influence is nothing short of significant.

While it is too early to reach a conclusion on private ordering from the proxy access proposals, the recent developments are telling. To begin with, proponents of private ordering have vigorously objected to the proxy access rule on the grounds that a private ordering will be inferior. Yet, rather then supporting the shareholders' private ordering proposals, they object them based on the same argument. It does not matter that the firms were selected carefully. Thus, they stretch the private ordering argument to reach any uniformity, even if minimal. As a result, by private ordering, what they really mean is that management will have the option to implement their desirable governance.

Second, proxy advisory firms have a crucial role in supporting a private ordering system. The support of the proxy advisory firms creates a significant pressure on firms that otherwise wouldn't adopt proxy access proposals even if they could benefit their shareholders. Finally, proxy advisory firms do not apply a one-size approach to companies. Rather, their pressure is likely to be related to firms' potential benefits from proxy access.

E. International Firms' Cross-Listing on U.S. Exchanges

> *Given the costs associated with public company disclosure requirements and the voluminous reporting they lead to, however, it is important to be willing to consider setting aside the one-size-fits-all approach in favor of more tailored requirements for different-sized companies.*[135]

Another context in which private ordering could be tested is how foreign firms opt in to the U.S. legal regime. By establishing an ADR firms can be traded in US exchanges and become subject to the US legal system, that is, listing standards, disclosure obligations, enforcement systems and analyst coverage. By providing firms from countries with lax law

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[131] *E.g.*, "Glass Lewis will review the rationale provided by the company regarding its reaction to the shareholder proposal, including explanation for the difference in the terms of the management proposal compared to the shareholder proposal's terms, and in limited cases may recommend against certain directors if the management proposal varies materially from the shareholder proposal without sufficient rationale."

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[133] We continue to believe that a company's analyses of the myriad of issues presented by proxy access should be based on its particular facts and circumstances as compared to a one-size-fits-all approach. http://www.jdsupra.com/legalnews/proxy-access-developments-iss-issues-fa-25808/.

[134] http://www.jdsupra.com/legalnews/proxy-access-developments-iss-issues-fa-25808/.

[135] Remarks at FIA Futures and Options Expo, Commissioner Daniel M. Gallagher, Chicago, Illinois Nov. 6, 2013, available at http://www.sec.gov/News/Speech/Detail/Speech/1370540289361#.VQBmqkKGm-Q

and weak institutions the option to opt into the U.S. legal systems cross-listing is a form of private ordering.[136] Since by now a significant body of evidence has accumulated on cross-listing it serves as a good context to evaluate the private benefits hypothesis. 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.[137]

Cross-listing could have been the poster child for private ordering if controlling shareholders that extracted high private benefits chose to commit themselves to stricter laws voluntarily to maximize firm value. Yet, a closer look reveals that the self-selection that in fact happens is quite different. Despite the significant market premiums that cross-listing commonly triggers, many firms choose not to list. More relevant to the question at hand, though, are the differences between the firms that choose to cross-list and those that do not. This Section argues that, based on available evidence on this subject, it appears that that the firms who can benefit most from legal constraints are the least likely to cross-list.

1. Controlling Shareholders and Cross-Listing

Foreign firms are different from U.S. companies in that they typically have a controlling shareholder—that is, a large shareholder that holds a significant portion of the firm's voting rights. Thus, unlike US firms foreign firms have a significant owner who has incentives to monitor managers. Yet, although generally interested in their firms' success, controlling shareholders often have interests that are not perfectly aligned with the other shareholders' interests. In particular, controllers may have opportunities to extract private benefits that other shareholders cannot via self-dealing transactions, going private transactions and other measures, that could harm firm value. In other words, in firms with controlling shareholders the manager vs shareholder agency problem discussed above is replaced with a controlling shareholder, vs minority shareholders agency problem.

When a controlling shareholder sells her block she typically gets a control premium for it, that is the price per share a buyer pays for her block is typically higher than the price of the minority publicly traded shares. Arguably, the control premium reflects the value of the future private benefits that the old controlling shareholder is giving up by selling the block, and the new controlling shareholder is getting. Indeed, a cross-country international cross-country study found that control premium values are negatively associated with the amount of legal protections minority shareholders have.[138] Thus a control premium is a measure for the private benefits that the controlling shareholder extracts.

If they choose to cross-list on U.S. exchanges, controlling shareholders have to obey stricter disclosure obligations, become subject to U.S. robust enforcement mechanisms, and are more visible to U.S. analysts. A significant body of evidence supports the hypothesis that cross-listing and subjecting themselves to these mechanism controlling

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[136] *See e.g.,* 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).

[137] *See* Coates (challenging the usefulness of assessing the effect of a change in an individual corporate governance term on the basis that corporate governance terms interact)(http://hls.harvard.edu/faculty/directory/10170/Coates/bibliography); *see* Bhagat *et al.*, *supra* note 52 (criticizing governance indices on the basis that corporate governance terms interact).

[138] Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. OF FIN. 537 (2004).

shareholders commit to less private benefits then the ones they extracted before cross-listing.[139] First, cross-listing decrease controlling shareholders' control premium—that is, the difference between the price per share paid for a controlling block of shares and the price per share for minority shares.[140] Moreover, the magnitude of the hit to the control premium increases with the level of the legal commitment they choose.[141]. Depending on whether it involves IPOs, trading on exchanges, or merely conducting a private placemen, 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.[142] IPO cross-listing generates the largest positive market reaction, followed by non-IPO cross-listing, and lastly by private placement, which sometimes fails to move the market at all.[143] Similarly, the magnitude of the positive market response to cross-listing increases alongside the level of commitment firms adopt. Finally, 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.

2. Firm that Cross-list have Lower Control Premiums and Higher Tobin's Q

What would be an efficient private ordering for controlling shareholders, that is which controlling shareholders would cross-list according to private ordering proponents? Cross-listing is expensive, complying with disclosure is expensive. Thus, controlling shareholders should cross-list when the benefits to shareholders from the legal constraints are larger than these costs. Like managers, controlling shareholders who face weak market

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[139] 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 OXFORD REV. ECON. POL'Y. 198 (2005); John C. Coffee Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PENN. L. REV. 229 (2007). To be sure, bonding is by no means perfect or absolute for several reasons. First, the effect of listing is limited. Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding*?, 4 CHI. J. INT. L. 141 (2003); Second, the bonding premium decreases over time., *See The Impact of the Sarbanes-Oxley Act on Non-U.S. Companies Cross-Listed in the U.S.* J. CORP. FIN. 195 (2007). Also, some argue that bonding might have become excessive, deterring some companies from cross-listing, or sending them to the AIM where bonding is minimal. 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.

[140] Doidge *et. al.*, *supra* note 26.

[141] Darius P. Miller, *The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts*, 51 J. FIN. ECON. 103 (1999).

[142] 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 triggered by each).

[143] *Id.*

forces, and weak internal controls, extract high private benefits. For example, a recent study finds that in firms that face significant competition, control premiums are lower than in firms that operate in less competitive industries.[144] Firms that face weak constraints, from which the controlling shareholders extract high private would benefit most from cross-listing. Yet, control premiums in firms who eventually cross-list, prior to listing, is significantly *lower* than control premium in firms that did not list.[145] Accordingly, prior to cross-listing these firms have higher Tobin's Q values, than firms that do not cross-list. [146] These patterns support the idea that the controlling shareholders who choose to cross-list are the ones that probably extract fewer private benefits from their firms, possibly due to other constraints.

3. Inefficiency Costs – Firms from Weak Regimes are Less Likely to Cross-List

Even more importantly, the legal constraints imposed on controlling shareholders vary significantly depending on their home countries. First, countries' laws vary in the extent to which they protect minority shareholders from controlling shareholders' extraction of private benefits. Controllers can extract private benefits in a number of different ways, including through self-dealing, going-private transactions, and so forth. Some countries' laws apply more limitations on self-dealing and going-private transactions than others. Some countries require more disclosure than others. Finally, countries vary in how robust their legal institutions are. Thus, in some countries, even if the law on the books is relatively strict, enforcement is so lax that private benefits are high nonetheless.

Cross-listing is most valuable for firms in countries with weak legal regimes as it substitutes for the lack of constraints at home. Accordingly, the positive market reaction to cross-listing announcements is significantly higher if a firm cross-lists from a country with weak investor protections, disclosure obligations, and legal institutions than if a firm cross-lists from a country with a robust legal regime.[147] Thus, private ordering proponents would predict that firms from these countries would be the most likely to cross-list. Yet, studies consistently show that firms from countries with weak minority protections, disclosure obligations, and legal institutions are significantly less likely to cross-list than firms from countries with strong legal regimes.[148] The results are striking because they indicate that controlling shareholders forgo a significant increase in share value in order to maintain their private benefits. More importantly, these results demonstrate that inefficient self-

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[144] Maria Guadalupe & Francisco Perez-Gonzalez, Competition and Private Benefits of Control, AFA 2007 Chicago Meetings Paper, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890814.

[145] Doidge + explain how control premium is measured.

[146] Doidge *et. al.*, *supra* note 19.

[147] See Hail & Leuz, *supra* note _ (finding that cross-listing on US exchanges results in a stronger cost of capital effect for firms from countries with low disclosure requirements, weak securities law enforcement or weak investor protection); 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); Miller 1999 (emerging markets).

[148] *See e.g.*, 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) (finding that firms from civil law countries are less likely to cross-list on U.S. exchanges than firms from common law countries).

selection results in significant *inefficiency losses*. Thus, the argument that shareholders know which shares they are buying is not helpful. Shareholders and society as a whole bear significant inefficiency costs for these poor choices. We also have some evidence on the potential magnitude of these costs. For instance, one study found that the costs of capital decrease following listing on U.S. exchange is around five times larger from these countries than from countries with strong legal regimes.[149]

Firms also have the option to reverse their decision and de-list, that is, to leave the U.S. exchanges and go back to their lax legal regime. Examining the price reaction to Rule 12h-6, which eases delisting, a recent study found that it was negative and stronger in countries with weak minority protection, consistent with the idea that shareholders in these countries benefit most from cross-listing.[150] Consistent with inefficient self-selection, however, firms from these countries have a higher inclination to delist from U.S. exchanges. [151]

4. Cross-Listing is Negatively Correlated with the Difference between Cash Flow and Control Rights

Third, controlling shareholders also vary on how the amount of voting rights and cash flow rights they hold, and the difference between the two. A controlling shareholder that holds a block of more than fifty percent of outstanding shares holds control of the voting rights and also has high cash flow rights if the shares provide one vote per share. Yet, there are ways to substantial voting rights with only a small fraction of the company's cash flow rights. For example, some shares provide more than one vote per share. Thus, if the controlling shareholder receives shares with high voting rights, he can have control with only a small fraction of the company cash flow. Similarly, through pyramids, that is a chain of holding companies, controlling shareholders can effectively control companies without owning substantial cash flow rights. Assume for example a pyramid, in which 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, our 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. Indeed, in these firms, the control premium is significantly higher. These structures, that effectively separate ownership from control, and are quite common in many countries, contribute to high agency costs. 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.

When cash flow rights are significantly lower than voting rights, shareholders will benefit most from cross-listing. If private ordering were efficient, therefore, 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

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[149] *See* Hail & Leuz, *supra* note , tbl 5.

[150] Nuno Fernandes, Ugur Lel, & Darius P. Miller, *Escape from New York: The Market Impact of Loosening Disclosure Requirements*, 95 J. FIN. ECON. 129, ___(2010). This price reaction also could have reflected investors' beliefs that firms from these countries will use the opportunity to delis in larger proportions.

[151] Marosi & Massoud, *supra* note 29.

opposite is happening. The inclination to cross-list decreases alongside the ratio of voting rights to cash flow rights. Thus, when the ownership structure does not provide sufficient incentives, controlling shareholders do not compensate for it with better law. To the contrary, they are more reluctant to commit themselves to extract less private benefits of control.

F. State Competition

> *"Summarizing, stricter corporation laws survive because in some instances market oriented governance mechanism 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"*[152]

Private ordering proponents praise the U.S. system of state corporate law, which, unlike the one-size-fits-all federal securities laws, allows firms to select whichever state's corporate law they desire. In criticizing the Dodd frank they remind that it "stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes."[153]

As any student of corporate law knows, Delaware has won this race; it has attracted more than half of all publicly traded firms.[154] Delaware offers efficient courts, a familiar and well-developed body of law, and network benefits associated with the large number of firms that are already incorporated there. Further, Delaware judges are considered the most experienced and knowledgeable in the country.

But in this context, just as in every context reviewed above, none have examined what sorts of firms tend to choose lax law and which ones opt for strict law. This is partly because conventional wisdom has been that corporate law is relatively uniform across states.[155] Nevada, however, has recently distinguished itself as clearly unique corporate law regime. Over the last two decades, Nevada has embarked on a strategy of attracting incorporations by offering firms a shockingly lax body of corporate law. Nevada's bold separation from the pack as a haven for managers seeking to minimize their legal obligations presents an opportunity to examine whether firms self-select efficiently.

1. Nevada Lax Corporate Law

As this author exposed in a previous work, a decade and a half ago, Nevada has begun offering and vigorously marketing remarkably lax corporate law in order attract incorporations.[156] Nevada's strategy involved vastly limiting directors' and officers'

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[153] *See* Gallagher, Tulane CLI 2014, *supra* note **Error! Bookmark not defined.**

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[156] By adopting this strategy, Nevada intended to economize on corporations' diverging preferences for weak legal constraints. Nevada is also utilizing its competitive advantage; its reputation as a provider of lax law in other fields provides it with the credibility and

exposure to liability for breaches of the fiduciary duties that are the cornerstones of Delaware law—the duties of loyalty and good faith. Section 102(b)(7) of the DGCL does allow companies to opt out liability under the duty of care so long as shareholders approve, but that statute has several exceptions:[157]

(1) Breach of the duty of loyalty,
(2) Breach of the duty of care,
(3) Behavior that is not in good faith,
(4) Improper personal benefits, and
(5) Intentional misconduct, fraud, or a knowing violation of law.

When we teach law school Corporations classes, we typically explain that the duty of care might cause directors to make inefficient investments and avoid taking risks.[158] The same cannot be said for the duties of loyalty and good faith, which deal primarily with conflict of interest situations. Conflicts of interest, if left unchecked, could create significant harm to shareholders, as well as inefficiency costs. Accordingly, these duties are mandatory under the Delaware's otherwise enabling corporate law. Nevada, however, has limited these duties significantly. In particular, NRS § 78.138 omits each 102(b)(7) exception except the last one: Intentional misconduct, fraud, or knowing violation of law.[159]

> [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 other fiduciary duties as a director or officer; *and*
> (b) The breach of those duties involved intentional misconduct, fraud or a knowing violation of law

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commitment to maintain the lax regime.*See* Barzuza, *Market Segmentation*, *supra* note 15 (analyzing the reasons for the success of Nevada's strategy).

[157] 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."

[158] Section 102(b)(7) was passed following the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), where non-interested directors who sold their company in more than fifty percent premium were found liable for breaching the duty of care for selling the company with no sufficient information and deliberations.

[159] NEV. REV. STAT. § 78.138(7) (2010); *see also* 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).

As a result, under Nevada law, neither duty of loyalty nor duty of good faith breaches trigger liability unless they also involve intentional misconduct, fraud, or knowing violation of law.[160] That being the case, self-dealing transactions, for example, do not trigger liability under Nevada law. Nor do such categories of director misconduct as acting on conflicts of interest, extracting improper personal benefits, and consciously disregarding their duties as directors.[161]

In 2001, Nevada made § 78.138 mandatory. In 2003, they relaxed it by making it a default rule. But once § 78.138's provisions first attached, they could be changed only with management approval. And there's more: While Delaware law protects only directors, Nevada law protects both directors and officers. In addition to creating these offerings, Nevada has supplemented its strategy by aggressively marketing its unique product, and it does so by highlighting the greater protections afforded to managers 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"[162]

The legislative history of Nevada's new corporate law system eliminates any remaining doubt that Nevada intended to differentiate itself from Delaware by providing its corporations with minimal liability exposure. Amendments in 2001 were intended to function as a toll that would increase incorporation revenues. In order to accomplish this end, the Nevada Chairman of the House, Senator Mark A. James, explained to the to the

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[160] 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). Similarly proxy solicitations of firms that reincorporate to Nevada, explain the legal differences.
"reincorporation will result in the elimination of any liability of a director for a breach of the duty of loyalty unless arising from intentional misconduct, fraud, or a knowing violation of law." *See, e.g.,* ITIS Holdings Inc, proxy statement, filed on 09/16/2002 (explaining the differences between Delaware and Nevada law). Reincorporations require shareholder approval, in soliciting shareholder vote firms must disclose to shareholders the legal differences between the two states; *see also* Proxy Statement of ATSI Communications Inc/DE, filed 03/26/2004 (noting the lack of liability for breach of duty of loyalty under Nevada law); Daleco Resources Corp. filed on 02/06/2002 (same).

[161] Conscious disregard of duties constitute breach of duty of good faith under Delaware law. *See* In re The Walt Disney Company Derivative Litigation, 907 A.2d 6 93 (Del. Ch. 2005).

[162] 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 which include"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 3, 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)

Senate Committee on the Judiciary, "Nevada ought to offer some liability protection to directors of corporations."[163]

A local 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.[164]

2. Nevada Firms

Nevada strategy has been to offer a differentiated product, and cater to a nich of firms. Proponents of private ordering might argue that Nevada lax law is consistent with private ordering, since it would serve firms with needs that Delaware law cannot accommodate. Under this theory, firms that choose Nevada are firms that face excellent controls and therefore do not need corporate law, even not fiduciary duties.

On the other hand, if private ordering is not working efficiently Nevada lax law may attract problematic, and even shady firms. Indeed, some representatives in Nevada were concerned by the this fairly intuitive possibility that their new laws might attract shady companies. 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."[165] Senator Bob Coffin echoed these concerns, warning that "reputable companies [were] not going to want to come here to save a few dollars"[166] 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.[167]

In a recent work, this Author, together with David Smith, compared the reporting behavior of Delaware and Nevada firms.[168] The study focused on accounting restatements—that is, the process by which firms amend their reported performance figures

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[163] 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, *Market Segmentation*, *supra* note 15.

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.*

[164] *See id.* at 13.

[165] *Id*. at 159.

[166] *Id.*

[167] *Id*. Ultimately the opponents supported the law since it was promised to then that the projected $30 million in revenues will be used to increase salaries of public school teachers. *Id.* at 158.

[168] *See* Barzuza & Smith, *supra* note 31.

retroactively, typically to admit that they performed worse than they originally reported. Since accounting restatements result from previous misstatements, they draw a significant negative market response, adversely affect managers' credibility, and are associated with weak internal and external controls.[169]

Our findings show that firms that choose to incorporate in Nevada tend to make far more accounting restatements than firms that choose to incorporate in Delaware or other states.[170] Moreover, our study shows that a higher proportion of Nevada firms' accounting restatements involve fraud or trigger regulatory investigations.[171] We also find that Nevada firms ranked as aggressive on an accounting metric derived from individual firms' audit integrity.

Nevada firms' increased incidence of financial restatements relative to firms in other states is consistent with the theory that Nevada attracts firms with higher agency costs. Two recent studies also support this theory. In the first study, researchers found that a disproportionately high number of Nevada firms were subjected to SEC trading suspensions in 2013 and SEC trading suspensions of marijuana stock at the beginning of 2014.[172] In the second, Professor Jordan Siegel examined a relatively new phenomenon: cross-mergers of foreign companies into U.S. shells. Siegel 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."[173]

However, while we find significant differences in restatement ratios between Nevada firms and firms other states, we do not find similar differences in firms' valuations. While Nevada firms do not exhibit the same premiums as Delaware firms, they are not traded at a discount. This result could suggest, however, that investors are not sufficiently informed about the legal reforms in Nevada, or otherwise that incorporating in Nevada sends a mixed

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[169] *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) (showing that restatements are preceded by balance-sheet bloating especially, but not only, when fraud is involved); Jap Efendi et al., Why do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors, 85 J. Fin. Econ. 667,
670, 700, 703 (2007); *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Market: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 701 (1992); Coffee, supra note 147, at 201–04 (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 Oren Bar-Gill & Lucian A. Bebchuk, Misreporting Corporate Performance 2–3 (Harvard Law and Econ. Discussion Paper No. 400, 2002, revised 2003), available see also Bar-Gill & Bebchuk, supra note 150, at 1–5, 33 (developing a formal model of misreporting and showing how incentive-based compensation may incentivize managers to misreport).

[170] *See* Barzuza & Smith, *supra* note 31.

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[172] 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).

[173] 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.

signal.[174] Finally, it is also possible that the market still has not incorporated information on Nevada law. As a recent paper shows, determining the value of governance terms takes at least a decade. [175] Thus, we ought to compare Nevada firms to Delaware firms by examining returns, not value. While no study has done this yet, one recent study has examined the effect of the 2001 Amendment on Nevada firms' returns and found that it caused a decrease.[176] Another study compared returns of Nevada-incorporated and Delaware incorporated-firms, but only for a particular subset of firms—issuing of marijuana stock. Researchers found that Nevada firms had the lowest returns.[177]

Overall, the evidence is consistent with the Nevada Senators' concerns that Nevada lax law attracts at least some questionable firms. Admittedly, it is still possible that Nevada attracts firms with strong internal constraints, external constraints, or an exceptionally moral management team. But this is unlikely for at least two reasons. First, it is not consistent with the evidence on frequent restatements, frequent fraudulent restatements, and otherwise aggressive accounting practices. Second, the duty of loyalty and duty of good faith are not considered, and are not shown by evidence, to create a costly, litigious environment for firms. [178]

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.[179] 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. Generally speaking, firms' home states are more likely than Delaware to provide protection to management. Indeed, many states have passed antitakeover statutes to protect local firms from imminent hostile takeovers. This Subsection shows that available evidence supports the idea that better firms tend to choose Delaware's strict law, and more problematic firms tend to choose their home state's comparatively less restrictive law.

Several studies support the view that Delaware firms outperform others. One such study conducted by Professors Murali Jagannathan and Adam Pritchard focused directly on whether Delaware firms tend to have better corporate governance. Jagannathan and Pritchard's research revealed differences in the corporate governance of Delaware versus non-Delaware firms:[180] To wit, Delaware directors have higher pay, shorter tenure, and serve on smaller boards; Delaware firms have greater institutional ownership and a lower likelihood of combining the Chairman and CEO positions into one; and the CEO forced

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[174] Barzuza, *Market Segmentation*, *supra* note 15.

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[176] Dain Donelson and Christopher G Yust. 2014. Litigation Risk and Agency Costs: Evidence from Nevada Corporate Law. *Journal of Law and Economics* 57(3), 747.

[177] 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).

[178] *See* Barzuza, Market Segmentation

[179]

[180] *See* Murali Jagannathan & Adam C. Pritchard, *Does Delaware Entrench Management?* (Univ. of Mich. L. Sch., Olin Working Paper No. 08-024, 2008), *available at* http://ssrn.com /abstract=1313274.

turnover rate is higher in Delaware than in other states.[181] The researchers interpreted their results as indicating that Delaware firms have better management and better corporate governance.

Second, in a seminal paper on the state competition debate, Professor Rob Daines showed that firms in Delaware have higher Tobin's Q values than firms in other states.[182] 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. In other words, it could be the case that better law increases firms' value *and* attracts better firms.

Daines carefully examined possible selection biases. For instance, he focused only on mature firms that never reincorporated under the assumption that these firms have a fixed domicile—that is, they do not have real choice regarding the state of incorporation and thus their state of incorporation is to some extent exogenous.[183] He also scrutinized firms that reincorporated and found that they were not more valuable than their peers before reincorporating.[184] Indeed, his findings suggest that selection cannot explain all of Delaware's premium: Delaware law instead both attracts better firms and increases firm value. At the same time, he notes, it is still possible that selection affects part of his results.[185] In particular, as Daines recognizes, it is possible that Delaware attracts firms with lower agency costs.[186] Further, Ishii, Gompers, and Metrick ran Daines' test while controlling for the governance index they developed. And, consistent with the selection theory, the Delaware effect disappeared.

In a follow-up study, Professor Guhan Subramanian demonstrated that the difference in Tobin's Q values between Delaware and non-Delaware firms has been decreasing over the years. This result is consistent with both accounts—that both law and selection matters. Delaware law became more favorable to managers during the 1980s in a variety of ways.[187] Accordingly, managers that were not attracted to Delaware before since it did not provide them with sufficient protection suddenly found Delaware to be an attractive place for incorporation. Both effects should have, in theory, resulted in Delaware's average premium decreasing. The shifting nature of Delaware firms might explain why the decrease in the Tobin's Q appeared not in the late 1980s when Delaware decisions became more favorable to managers, but rather during the 1990s. In a recent paper that Subramanian co-authored, researchers found that the Delaware premium eventually re-emerged. Among a sample of

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[181] *See id.* at 3.
[182] Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 525 (2001) [hereinafter Daines, *Firm Value*].
[183] *See id.* at 550-51.
[184] *See id.* at 551-52.
[185] *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.").
[186] *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.")
[187] *See* Michal Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127 (2004).

firms examined between 2000 and 2008, Delaware firms had significantly higher Tobin's Q levels.[188]

G. Exceptions – Size and Value

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.

Size matters for the desirability of legal constraints since costs of implementation of compliance might be disproportionally large for small firms. This results when compliance and implementation costs have a fixed costs component, which represents a higher percentage of a small firm's revenues. For example, small firms' compliance with § 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.[189] 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 list on U.S. exchanges, more likely to list on AIM, (which offers lax disclosure standards[190]), more likely to incorporate in Nevada than large firms, [191] and less likely to adopt governance constraints such as majority voting terms.[192] 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 could be also 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 the full price, in terms of share market value, for their governance choice. Second, size is an observable component that could be taken, and has been taken, into account in mandatory regulation, Indeed, as discussed in infra Part _ Sox and Dodd-Frank include exceptions for small firms.

The second measure that at first glance seems to operate efficiently is firm market value, and how it interacts with firms' choice of governance. In particular, some evidence shows that firms that do not perform well are more likely to add governance constraints, and firms that perform at the top of their industry, are significantly less likely to add them. For example, firms in the top five percent of abnormal stock returns were significantly less likely to adopt majority voting. Similarly, pre sox, firms that performed weakly were more likely to add independent directors. These results however, again are not a sufficient justification for private ordering. The results suggest that firms that perform poorly feel the pressure to do something to satisfy shareholders, yet firms have a wide range of actions to choose from, some of which are less effective than others, and there is no evidence that they choose a solution that is effective. On the contrary, as the body of evidence discussed in this part suggests, voluntary adoption on average amounts to no more than window

[188] *See* Barzuza & Smith, *supra* note 31.
[189] *See* Peter Lliev, *The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices,* 65 Journal of Finance, 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.
[190] Doidge et al. see *infra* section
[191] *See* Barzuza & Smith
[192] *See* Choi et all, *supra* note

dressing. Firms adopt majority voting and hire independent directors when they are not likely to matter much.[193]

V. Implications

A. The One-Size Argument is not a Silver Bullet Against Mandatory Regulation, and is a Weak Argument Against Proxy Advisors and Shareholders Proposals

The One-Size Argument has been the most frequently provoked and influential argument against mandatory corporate law. But although firms do vary considerably, the presence of heterogeneity is not a silver bullet that necessarily renders mandatory regulation inappropriate. While a one-size approach may impose costs on some firms, these costs should be weighed, in every instance, against the potential costs of relying solely on private ordering.[194] Rather than assuming that each firm will choose the package of governance terms that will maximize shareholder value, commentators and policymakers alike should examine data on the choices that firms actually make under the two different regimes. And the body of literature reviewed in this Article suggests that when self-selection occurs, it is often inefficient. We have observed, for example, that firms subject to weak external and internal constraints, weak markets, weak law, and weak corporate governance are often the least likely to self-constrain. The efficiency losses for the shareholders of these sorts of firms, as has been demonstrated in the context of cross-listing, can be significant.

Accounting for these costs clearly reveals not only that the One-Size Argument should not categorically bar mandatory regulation, but also that firm heterogeneity occasionally creates a need for such regulation. If firms that need regulation the most fail to adopt it through private ordering, a mandatory law could actually improve the extent to which firms adopt the governance terms that best accommodate their specific needs. Recall, for example, the example of board independence discussed in Part IV. There, available evidence suggested that hiring independent board members added the most value to firms that did not hire them voluntarily and rather were forced to adopt them the comply with mandatory requirements.

Preceding analysis further shows that the One-Size Argument is especially weak when raised against proxy advisory companies' recommendations and shareholder proposals because in both contexts companies tend to receive tailored, firm-specific advice. Proxy advisory companies attempt to take into account firms' differences and target firms that need regulation most, and the same is true for activist shareholders who submit proposals. Indeed evidence from voting suggests that pressure from proxy advisors and shareholders' proposals contributed to governance improvements in those firms that could benefit from these changes but resisted them most.

B. Implications for Evidence Interpretation: How to Interpret the No Effect Result

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. Frequently research on voluntarily adopted governance terms finds no

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[193] *See* discussion *infra* parts

[194] Mahoney, Wasting a Crisis (2016)

significant effects on performance. For example, firms who voluntarily hired independent directors pre-SOX did not tend to perform better as a result. Many have interpreted these sorts of results to suggest that director independence and other internal corporate governance terms and structures do not matter, and even more generally that governance does not matter. [195]

While it is possible that governance did not matter for these firms, we should be cautious when attempting to draw policy implications from this research. The cumulative body of evidence shows that the firms that voluntarily adopt governance constraints are often the least likely to exhibit resultant changes in performance. The firms that could benefit most from constraints, by contrast, are often the least likely to adopt it voluntarily. Research on independent directors provides a helpful illustration of this dynamic: Independent directors proved more valuable and effective in the firms that only hired them after SOX and the exchanges listing standards required them to.

Thus, in assessing governance for policy considerations it is not sufficient to rely on results from voluntary adoption. Voluntary adoption is more likely when it matters less. Second, in assessing whether corporate governance matter, due to the enabling character of US law, there could be a bias against results.

C. Novel Policy Proposals

These theoretical and empirical observations inspire two novel policy proposals to correct for inefficient self-selection: market based mandatory standards, and minimal governance packages.

1. Market Based Mandatory Standards

The analysis suggests that a main problem with private ordering regime is not that no firm adopts good governance, but rather that the firms that could benefit most from governance constraints tend not to adopt them. The analysis thus provides support for mandatory law that applies existing law and governance to all firms. For example, mandatory law that applies Delaware 102(b)(7) to all firms. Or a mandatory law that applies proxy access that some firms adopt to all firms.

The analysis suggests that by merely mimicking market adopted good governance standards mandatory law can create significant efficiency gains. Second, part of the private ordering argument against mandatory law has been lack of information on the regulator side relative to market participants. Similarly, a critique of Federal regulation has been focused on the lack of information and experience of the federal government has relative to Delaware.[196] Also it was argued Delaware gets feedback for mistakes– as corporations may leave the state- while federal government does not.[197] Yet, by piggybacking on market

[195] Mariana , Kahan

[196] *See, e.g.,* Winter, *Shareholder Protection*, supra note _ , at 291 ("Because federal legislation does not face direct competition with other legal systems, the behavior of investors under differing rules cannot be observed and we can only theorize about which rules optimize the underlying economic relationships.").

[197] *See .e.g.*, Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913, 922 (1982).

participants-governance terms adopted by individual firms, legal standards applied by Delaware - the regulator is minimizing the costs of inferior information.

Furthermore, the analysis suggests that if a significant number of firms adopt a governance term, that should be a sufficient condition to inquire whether this term is efficient and could benefit other firms, and why the other firms do not adopt it. Such an inquiry could check the governance of the firms that do not adopt it, whether it is stronger or weaker than firms that did. Similarly, Delaware law and standards should be considered as minimal standards for all firms. [198]

2. Minimal Governance Packages

The findings also lend support for a second solution: Creating a number of minimal packages of legal constraints and requiring firms to choose the one that best suits them. 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. 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 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 those two amounts.[199]. On September 18, 2013, by a 3-2 vote, the SEC proposed such a rule that does not set forth any single method companies must use to calculate each of these figures.[200] Indeed, SEC Chairwoman Mary Jo White has highlighted the fact that the SEC's proposed rule "provide[s] companies significant flexibility in in complying with the disclosure requirement" instead of creating a one-size-fits-all disclosure regimen.[201] In particular, companies would have the option to determine total compensation amounts using existing executive compensation rules,

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[198] In a previous paper this author suggested a policy proposal in this spirit for standards applied to management use of antitakeover defenses. See Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 2032-2038 (2009) (proposing to adopt Delaware Unocal, Revlon and Blasius standards and minimal federal standards). While others have advocated federal minimum standards in the past, no one has proposed to adopt Delaware standards as federal minimal standards. For studies that advocate federal minimal standards *see, e.g.*, Bebchuk, Desirable Limits, supra note _, at 1510 (proposing to adopt federal rules, or at least federal minimum standards, with respect to, among other things, takeover law); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 701 (1974).

[199] *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).

[200] 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.

[201] *Id.*

amounts in payroll or tax records, or any other "methodology that is appropriate to the size and structure of [the firm's] own business[]."[202] Companies could choose whether to calculate the median based on all employees salaries, or through statistical sampling.[203] They would simply have to disclose the operative methodologies and assumptions used to determine each figure.[204]

As critics point out, however, this flexibility might enable firms to make strategic calculations and thereby disclose ratios that appear more egalitarian than they in fact are.[205] 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.[206] Thus, this approach may not be sufficient for some mandatory standards, which should apply to all firms. Nevertheless, the SEC's proposal which provides the benefits associated with flexibility while establishing a regulatory floor beneath which firms may not cross, demonstrates again that the One-Size Argument is not a persuasive argument against mandatory corporate law.

VI. Conclusion

This Article has challenged the assumption that firm self-select efficiently into corporate law and governance. Rather it showed that firms that could benefit most from regulation are least likely to adopt it.

Taking heterogeneity seriously, a theoretical analysis shows that asymmetric information and adverse selection affect governance choice. Evidence on different governance terms—independent directors, executive compensation, shareholder voting, shareholder proposals, proxy access companies, state corporate law, and international listing—all of which raise a significant concern that firms that could benefit most from constraints are least likely to adopt it.

Rather than assuming that private ordering is superior to one size fits all mandatory law we should weigh the costs and benefits of the alternative relative to the self-selection that is adopted in reality. Especially we should be aware of the possibility that firms that need the regulation most do not benefit from it. Second, the Article put forward two potential approaches for regulation: Mandatory law that mimics market created standards, and mandatory law that offers a menu of minimal governance packages.

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[202] *Id.*
[203] *Id.*
[204] *Id.*
[205] *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 ("With all the wiggle room that is expected to be allowed, companies may devise ratio numbers that are largely irrelevant.").
[206] *See, e.g., id.*