Do Independent Directors Curb Financial Fraud? The Evidence and Proposals for Further Reform

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Do Independent Directors Curb Financial Fraud?  
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Abstract:

In this article, we argue that the U.S. corporate governance rules put too much faith in the independent board members and insufficient emphasis on the shareholders themselves to control and monitor the top management. Given the agency problem between the board of directors and the shareholders, outside directors can be captured by management, thereby leading to inadequate checks on management. The evidence presented in this paper shows that outside board members do not exercise sufficient controls on the management even when the management has gone awry. To solve this agency problem, we propose increasing the power of the principals: make shareholder resolutions binding on management, require a one share, one vote rule to increase the voting rights of shareholders, as well as give the shareholders the ability to directly nominate and/or actively vote against board members.

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Introduction

We are now nearly fifteen years down the road from the corporate scandals of the early 2000s, which wreaked havoc on the U.S. securities markets and prompted Congress to legislate federal corporate governance reforms. The Sarbanes-Oxley Act of 2002 (“SOX” or the “Act”), was passed by Congress in an effort “[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.” Prior to the enactment of SOX, a slew of corporate scandals involving fraud, including those at Enron, WorldCom, Global Crossing, and Adelphia Communications, among others, plagued capital markets and investor confidence.

In addition to increasing the potential criminal and civil fines and sentences for securities fraud, SOX attempted to rectify perceived corporate governance failures by legislating rules that shifted the power from management to corporate boards, including the requirement that certain board members be independent and competent audit committees be established. For example, SOX demands that the audit committee be comprised of entirely independent directors and include at least one financial expert. In addition, SOX includes rules requiring outside auditors be independent.

One would hope these independent watchdogs would reduce the incidents of securities fraud and result in better governance. Yet, our analysis of the number of class action settlements for claims of financial fraud for settlements greater than $10 million shows no significant decrease since the adoption of SOX. We presume that settlements of over $10 million indicate serious concern of the board evidencing the viability of the suit. The dollar amount for analysis was chosen to reduce the incidence of strike suits in our data. Thus, the lack of a significant decrease in these claims seems to indicate that it may have been unreasonable to expect independent directors – who almost by definition are not privy to the day-to-day affairs of the firm – to have enough incentives or information to ferret out complex, and likely hidden, fraud.

Moreover, and perhaps even more troubling, our data also shows that independent directors themselves are not necessarily immune from the temptations of financial fraud, particularly with the gains to be had from backdating stock options. SOX’s reliance on them may

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2 Id. Preamble
4 Id. at 46.
5 Id. at 38.
6 Id. at 38.
8 Id. at §404.
9 To exclude strike suits, we require a minimum settlement amount of $10 million. The years 2001-2002 appear to be anomalous due to the recession and cratering stock market. We find that between 1996 and 2000; 42.4 lawsuits per year for an average annual total of $3.3 billion were settled for $10 million or more, while the corresponding numbers between 2003 and 2008 are 42.4 lawsuits per year and average annual total of $3.1 billion. While there are no on-going cases from the pre-SOX period, the post-SOX numbers exclude a total of 13 on-going cases.
simply have transferred oversight responsibilities from compromised executives to compromised and ill-informed board members.

An alternative approach to the SOX mandates would have been to empower the shareholders directly and enable them to exercise a greater degree of direct oversight over the managers. In this article, we recommend that Congress take another look at this issue. Granted, shareholders are also not privy to the day-to-day affairs and unless the holding is substantial, may be rationally ignorant, there are shareholders with substantial holdings who could be further empowered to provide an effective check on both the managers and the board of directors. We thus propose that shareholder resolutions bind management, one share to be required to have one vote, as well as for shareholders to have the ability to directly nominate and/or actively vote against board members.

To address these issues this manuscript is organized as follows. Part I reviews some of the financial frauds giving rise to SOX followed in Part II by a discussion of the legislative response, focusing on the corporate governance provisions of the legislation. In Part III, we outline the role of directors and shareholders, and analyze impediments to the power of shareholders to oust board members. Our empirical study, demonstrating the ineffectiveness of SOX reforms for decreasing the number of viable class action suits for financial frauds as well as evidence of board complicity in the fraudulent backdating of stock options is presented in Part IV. Next, Part V offers proposals for reform to empower shareholders in the oversight role. Concluding remarks follow.

I. Prequel to SOX: Overview of the Financial Frauds of the Early 2000s

On July 25, 2002, Congress passed the Sarbanes-Oxley Act of 2002 (the “SOX Act” or “SOX”). Officially titled the Public Company Accounting Reform and Investor Protection Act, SOX was the federal government’s response to the highly publicized corporate scandals that followed the tech boom of the late 1990s. The seven months before SOX’s enactment saw four of the largest bankruptcies in U.S. history, most famously those of Enron and WorldCom. The reports that emerged in the aftermath attributed these bankruptcies to the fraudulent practices of top executives, with the help of corporate accounting firms, lawyers, and internal audit committees. These companies hid their debts and toxic assets from creditors and shareholders until their inability to meet financial commitments forced them to restate earnings and reveal massive losses. The financial collapse of these corporations created a domino effect that crippled a stock market already weakened by the tech busts of 2000 and investor uncertainty resulting from the September 11 attacks. Each succeeding bankruptcy and corporate scandal further destabilized the stock market and provided more fodder for public outrage. The collapse of WorldCom in the spring of 2002 created intense political pressure on legislators to prevent future corporate mishaps and to punish the individuals responsible. With the public clamoring for

\section*{A. Enron}

Before its collapse in 2001, Enron Corporation had been viewed by many as a poster child for American industry and innovation.\footnote{See, e.g., Marianne M. Jennings, A Primer on Enron: Lessons From A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures, 39 Cal. West. L. Rev. 163, 169 (2003) (describing Enron as “one of the world’s most admired companies”).} Founded as a traditional, asset-heavy gas-pipeline company, Enron saw an opportunity to move into the trading business when the production and supply of natural gas was deregulated in the 1980s.\footnote{William W. Bratton, Enron and the Dark Side of Shareholder Value, 76 Tul. L. Rev. 1275, 1278 (2002). In 1985, the Federal Energy Regulatory Commission changed its rules to permit utility companies to shop for gas and pipelines and to search for customers. Wendy Zellner et al., Enron’s Power Play, BLOOMBERG, Feb. 11, 2002, available at http://www.bloomberg.com/news/articles/2001-02-11/enrons-power-play.} The markets Enron pioneered promised drastically reduced transaction costs for utility companies that required fuel sources. By the 1990s, Enron had morphed into a market-maker and trader in energy commodities and related derivatives.\footnote{See Peter Coy et al., Enron: Running on Empty, BLOOMBERG (Dec. 10, 2008), available at http://www.bloomberg.com/news/articles/2001-12-09/enron-running-on-empty (noting that some viewed Enron as the “Goldman, Sachs & Co. of the energy business”). Enron publicly acknowledged its change in direction via its securities filings: in 2001 Enron described its principal business as “security brokers, dealers and flotation,” whereas it had previously said it was in the business of “wholesale-petroleum and petroleum products.” Id.} At its peak, Enron accounted for about one-quarter of all energy trading in the United States.\footnote{Kurt Eichenwald, Enron’s Collapse; Audacious Climb to Success Ended in a Dizzying Plunge, N.Y. Times, Jan. 13, 2002, available at http://www.nytimes.com/2002/01/13/us/enron-s-collapse-audacious-climb-to-success-ended-in-a-dizzying-plunge.html [hereinafter Eichenwald, Enron’s Collapse]; Jennings, supra note 12.} After the growth of the Internet allowed Enron to shift most of its trading online, Enron became widely recognized as the largest e-commerce company in the world, with a bubble-era stock price to match. Fifteen years after its initial formation, Enron had grown to rank as the seventh largest American company by market capitalization.\footnote{Eichenwald, Enron’s Collapse supra note 15; Peter Coy et al., supra note 15.}

In October of 2001, Enron disclosed that it was taking a $500 million after-tax charge against earnings and a $1.2 billion reduction of shareholders’ equity due to accounting revisions.\footnote{HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE’VE LEARNED, HOW TO FIX IT 5 (2006).} This news did not spark an immediate market reaction: utility and energy companies were still willing to do business with Enron,\footnote{Immediately after these disclosures, an executive of a major energy trader stated that it was not overly concerned about Enron’s financial health, as Enron’s own trading patterns in the electricity and gas markets did not suggest the sort of frenzied selling reminiscent of the collapse of Long-Term Capital Management in 1998. Alex Berenson and Richard A. Oppel Jr., Once-Mighty Enron Strains Under Scrutiny, N.Y. Times, Oct. 28, 2001, available at http://www.nytimes.com/2001/10/28/business/28ENRO.html} and investment rating agencies were reluctant to...
downgrade Enron’s bonds. But investors – who had paid little attention to the impenetrability of Enron’s books during the corporation’s boom years – began to clamor for explanations. Of particular concern were complex transactions with partnerships organized through Enron’s chief financial officer, Andrew Fastow, which had not been apparent in the company’s financial accounting statements. Mr. Lay’s attempts to assure the concerns of Wall Street were met with skepticism. The SEC, which had opened an informal investigation into Enron in August, launched a formal inquiry.

Any hopes of Enron’s survival were quickly quashed as further revelations about Enron’s accounting and business practices came to light. The two limited partnerships that induced the $1.2 billion write-off were just the tip of the iceberg: according to Enron’s 10-K filing, the company engaged in thousands of transactions using affiliates and separate special-purpose entities (SPEs) to insulate the company’s earnings from short-term volatility resulting from its trading activities. The accounting treatment afforded to SPEs allowed Enron to slough off its bad debts and toxic assets while simultaneously inflating profits, provided that enough of the SPE’s equity was held by an unrelated party. In many of Enron’s transactions with its SPEs, either Enron, an affiliate, or an Enron executive held the equity via a series of complex corporate structures and sham asset sales. When some of these transactions came under scrutiny in the fall

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19 See id. Some have argued that large credit rating agencies are themselves conflicted because they take fees from the corporations whose debt they rate. See Jerry Hirsch & Thomas Mulligan, Safeguards Failed to Detect Warnings in Enron Debacle, L.A. TIMES, December 14, 2001, available at http://articles.latimes.com/2001/dec/14/news/mn-14906. The head of the team at Standard & Poor that handled Enron also acknowledged that the firm faced pressure not to downgrade Enron precipitously. Id. (“we take care not to overreact to any developing situation so that we don't cause a deterioration [in a company's finances] rather than just opine on it”).

20 Id.

21 Id.


24 To summarize, the accounting treatment of SPEs would allow profits from transactions between Enron and its affiliate SPE to pass through to Enron’s income statement. Provided that certain requirements were met, Enron could also move debt into its affiliate SPEs and preserve its credit rating. An investment-grade credit rating was crucial to Enron’s trading and derivatives operations. Are Current Financial Accounting Standards Protecting Investors? Hearing Before the House Subcomm. on Commerce, Trade and Consumer Prot. of the Comm. on Energy and Commerce, 107th Cong. 21-22 (Feb. 14, 2002) (statement of Edmund L. Jenkins, Chairman, FASB), available at http://energycommerce.house.gov/107/action/107-84.pdf.

25 For an SPE to obtain off-balance-sheet treatment, it must satisfy particular rules of consolidation accounting. SEC accounting rules required that a) a majority of the entity’s equity be controlled by an unrelated party, and b) the debt-to-equity ratio of the SPE be capped at 33:1. Id. The debt-to-equity ratio test (also known as the “three percent test”) originated in a 1991 letter of the Chief Accountant of the SEC issued in respect of a leasing transaction. The GAAP authorities are EITF Topic D-14: Transactions Involving Special Purpose Entities; EITF 90- 15: Impact of Non Substantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions; EITF Issue 96-21: Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities. The SEC insists that there is no bright line three percent test and that the level of outside funding should follow from the nature of the transaction. Steven L. Schwarcz, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures, 70 CINN. L. REV. 1309, 1309 (2002); Neal Newman, Enron and the Special Purpose Entities - Use or Abuse? - The Real Problem - The Real Focus, 13 L. & BUS. REV. OF AM. 97, 97 (2007).

26 Bratton, supra note 13, at 1287.
of 2001, their previous accounting treatments were disqualified and Enron was forced to consolidate the financial statements.\(^\text{27}\)

Enron employed many other accounting tricks to give a false appearance of financial health. By characterizing borrowed funds as sale-and-purchase transactions\(^\text{28}\) and bootstrapping its own stocks,\(^\text{29}\) the company minimized losses and generated artificial gains. Enron also exploited mark-to-market accounting, an accounting method that required Enron to assign values to its derivative positions based on the positions’ real-time market values.\(^\text{30}\) Enron would use excessively optimistic assumptions and aggressive allocation judgments, assigning high asset values on exchanges and listing those amounts on the balance sheet with correspondingly high profits in the income statement.\(^\text{31}\) Similar accounting treatment, along with similar problems of speculative valuation, applied to Enron's long-term energy trading contracts.\(^\text{32}\)

As revelations of these questionable accounting practices piled up, the public’s attention turned to the cracks in Enron’s corporate governance. The spotlight on self-dealing transactions began with Enron’s disclosure that Andrew Fastow, then the CEO of Enron, had earned $30 million from compensation arrangements with respect to his management of the limited partnerships that gave rise to the $1.2 billion writeoff.\(^\text{33}\) Fastow was not alone in profiting from Enron’s accounting misdeeds: many members of Enron's board of directors, including members of its audit committee, received consulting fees or cash donations to their favored charities. These

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\(^{27}\) In the case of its infamous Chewco SPE, for example, Enron's earnings for 1997 through mid-2001 were retroactively reduced by $405 million and the consolidation increased its total indebtedness by $628 million. WILLIAM C. POWERS, JR. ET AL., ENRON CORP., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 42 (2002), available at 2002 WL 198018 [hereinafter POWERS REPORT]. Chewco was set up so that Enron could buy out a joint venture, JEDI, without turning it into a wholly owned subsidiary whose debt would have to be consolidated on Enron’s balance sheet. Enron constructed a sham transaction that took the form of a bank loan, disguised as an $11 million equity investment in Chewco. Id. at 41-47.

\(^{28}\) To expand on this accounting trick: loans to Enron from outside sources were often accounted for as revenue, and then “churned” by transfers to and from SPEs and booked again as profits by both Enron and the SPEs. See Id. at 32-35.

\(^{29}\) For example, Enron used one of its affiliates to house Enron shares, which the affiliate accounted for as trading securities. Unrealized gains on the stock thus flowed through to the affiliate’s income statement. Enron, accounting under the equity method with the approval of its auditor Arthur Andersen, then flowed fifty percent of that unrealized appreciation on its own stock over to its own income statement. In the first quarter of 2000, Enron used this method to bootstrap $126 million of fake revenue. Thus method backfired in 2001, when Enron’s stock fell, as no corresponding deductions flowed through. Bratton, supra note 13, at 1289-91.

\(^{30}\) Under mark-to-market accounting, even though the derivatives position remains open and gain or loss has not yet been realized, the firm’s income statement reflects the gain or loss implied by the contract’s current value. Id. at 1294.


\(^{32}\) It should be noted that the two partnerships in question, and Fastow’s role in them, were not completely hidden in the fall of 2001. They had been disclosed, albeit in extremely opaque terms, in a footnote to Enron's 2000 financials. See ENRON, 2000 ANNUAL REPORT 48 (2001); see also ENRON, 1999 ANNUAL REPORT 59 (2000).
“perks” were often funded by the same special-purpose entities that were being used to hide debt.\textsuperscript{34}

The self-enriching practices of Enron’s management did not stop there. Shortly before Enron filed for bankruptcy, the company had distributed significant amounts to high-level corporate officers and employees. Kenneth Lay, who had resigned from his position as Enron’s CEO just a few months earlier, received at least $67.4 million, and other senior directors and officers received payments of more than $10 million each.\textsuperscript{35} Others received “retention bonuses” of over a million dollars each to persuade them to remain with Enron.\textsuperscript{36} Deferred compensation plans for Enron’s senior executives were structured so that approximately forty top employees received their entire deferred compensation in cash just before Enron’s bankruptcy filing—an option that was not available to lower-level employees.\textsuperscript{37} Subsequently it was reported that Enron paid out a total of $681 million in cash payments and stock awards to its senior officers and executives in the period between its restatement of earnings and its bankruptcy filing.\textsuperscript{38}

These large sums generated outrage on the part of lower-level Enron employees who were offered severance payments capped at $13,500 per employee, and many of whom took home only the equivalent of two weeks’ pay.\textsuperscript{39} What made these favored-employee payments even more egregious was that Enron employees had invested their 401(k) funds in Enron stock at the recommendation of the corporation. However, Enron had blocked its employees from selling company shares during the four-week period immediately before the company restated its earnings, so that lower-level employees who had faithfully invested 401(k) funds in Enron stock could only watch from the sidelines as their retirement funds steadily declined in value.\textsuperscript{40} During this period, the media unfavorably contrasted the generous retention bonuses being received by upper-level officers and employees with the treatment being accorded lower-paid, rank-and-file employees.\textsuperscript{41} Lower-level employees accused executives of conducting $1.1 billion in insider stock sales during the blackout, dumping their shares in anticipation of negative news reaching the public.\textsuperscript{42}

\textsuperscript{34} Hirsch & Mulligan, supra notes 24, (describing some of the consulting fees, direct and indirect, that Enron provided to its board members).
\textsuperscript{38} Kranhold & Pacelle, Enron Paid Managers, supra note 36.
\textsuperscript{40} Id. In late October 2002, the SEC announced that it proposed to bar employees from selling stock during any “blackout” period that barred sales from retirement plans by rank and file employees. Id.
\textsuperscript{42} See Id.
On December 2, 2001, Enron filed for Chapter 11 bankruptcy. By that date Enron’s share price had fallen to sixty cents per share, and approximately $3.5 billion of its bonds were trading at just a quarter of their face value.\textsuperscript{43}

B. The Domino Effect: Global Crossing, Qwest, Adelphia, and WorldCom

The Enron scandal was the first in a wave of corporate debacles that filled news headlines and fueled public outrage. Many of the companies embroiled in scandal were household names such as AOL, Time Warner Inc., Rite Aid Corp. and Xerox Corp.\textsuperscript{44} Misleading accounting practices were particularly widespread in the telecom industry: between January and June 2002, at least 112 telecom companies were required to restate prior earnings even though public accounting firms had originally given stamps of approval to over 93\% of them.\textsuperscript{45} The scandals involving Global Crossing, Qwest, Adelphia, and WorldCom exemplify some of the fraudulent accounting practices and self-dealing that paved the road to the enactment of SOX.

1. Global Crossing

Global Crossing was a mainstay of the telecom industry that first went public one year after its founding in 1997. It rapidly sported a market capitalization of nearly $40 billion; two years later it had become bankrupt amid evidence of accounting fraud. Global Crossing’s trick of choice was liberal use of “pro forma accounting,” a reporting technique that presents results on the basis that certain assumptions were made, allowing companies to stray significantly from GAAP.\textsuperscript{46} Using pro forma accounting, Global Crossing left off its financial statements many items that would be considered expenses by GAAP. The company dismissed concerns that certain cash amounts on Global Crossing’s financial statements were inflated, noting that its auditor, Arthur Andersen, had signed off on its annual reports that reflected the cash revenue.\textsuperscript{47}

The SEC eventually launched an investigation into Global Crossing.\textsuperscript{48} As Global Crossing later admitted, the company shredded documents even after the documents had been requested by the SEC as part of its investigation.\textsuperscript{49} Global Crossing filed for bankruptcy in April. In August, the bankruptcy court approved Global Crossing’s agreement with its creditors to sell the company to an investor group under terms planning for it to emerge from the formal bankruptcy process by 2003.\textsuperscript{50}

\begin{thebibliography}{9}
\bibitem{43} Peter Coy et al., \textit{supra} note 14.
\bibitem{44} Lawrence A. Cunningham, \textit{The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)}, 35 \textit{CONN. L. REV.} 915, 925 (2003).
\bibitem{47} Cunningham, \textit{supra} note 44, at 931.
\end{thebibliography}
Like the executives at Enron, Global Crossing’s executives profited from the inflated value of their company’s stock. During the three-year period before the company filed for Chapter 11 bankruptcy, Global Crossing CEO Gary Winnick made $735 million from sales of his personal holdings of Global Crossing stock.\(^{51}\) When the stock price of the company began to decline, Winnick purchased “collars” to lock in the value of his Global Crossing shares when they were at or near their high point in value.\(^{52}\) These “collars” preserved a significant portion of his shares’ value when the market for Global Crossing stock collapsed.\(^{53}\)

The Global Crossing board, which was responsible for assuring the accuracy of the company’s records, was full of conflicts of interest. Many of Global Crossing’s audit committee members were personal friends of Winnick. Maria Logamasiano, Winnick’s private banker who managed his personal finances, was appointed to Global Crossing’s audit committee. Logamasiano’s company, J.P. Morgan, loaned money to Global Crossing and underwrote its corporate initial public offering (IPO); Winnick also served as a member of J.P. Morgan’s Board of Advisors. A second member of the Global Crossing Board’s audit committee resigned due to potential conflicts related to his investments in a Global Crossing’s subsidiary. In the case of Winnick’s private banker, J.P. Morgan requested that she resign from the Global Crossing Board one month before Global Crossing filed for bankruptcy protection.\(^{54}\)

2. **Qwest**

On July 28, 2002, Qwest Communications International Inc. (Qwest) announced that it would restate its financial results for the period between 1999 and 2001 because it had improperly booked $1.16 billion as current profits rather than capital investments.\(^{55}\) This disclosure came on the heels of an announcement in April that it was cutting its revenue prediction for the following year by about $1 billion and writing down goodwill, or intangible assets, another $20 billion to $30 billion.\(^{56}\) Moreover, Qwest revealed that it was in jeopardy of violating stringent covenants in its bank loans that required it to maintain certain debt-to-EBITDA ratios. Following this succession of bombshells, Qwest entered into settlement negotiations with the SEC.\(^{57}\)

Qwest had emerged during the late ‘90s telecom boom and, like with other telecoms, Qwest suffered from excess investment in fiber optic cable and other resources. To artificially

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\(^{51}\) Romero, *supra* note 49.


\(^{53}\) *Id.*


\(^{57}\) Qwest Says, *supra* note 55.
inflated its financial statements, Qwest teamed up with other providers of domestic telephone services to create gimmick transactional accounting via “communications capacity swaps.” By developing communications capacity and swapping capacities with other telecom companies, Qwest and its swap partners were ostensibly able to fill gaps in the other’s networks. But they were also able to pad their financial statements by booking revenue based on the value of the swapped capacity, while capitalizing the costs of developing that capacity. These swaps became a mainstay of the industry, but – as the top executives at telecom companies realized – they were not sustainable.\(^59\)

The actions of the “bubble beneficiaries” – the insiders of telecom companies who were able to cash out before their stocks plummeted – were egregious examples of corporate greed. Months before it collapsed, Qwest announced that its executives had made about $500 million by selling Qwest shares in the period from 1999 to 2001.\(^60\) One former CEO alone had made about $227 million; Qwest’s largest single shareholder – a member of Qwest’s board of directors but not an officer – had made almost $1.5 billion by selling his shares in May 1999.\(^61\)

3. **Adelphia**

In late March 2002, Adelphia, the nation’s sixth-largest cable operator, disclosed that it had failed to report $2.3 billion in debt.\(^62\) This announcement caused the price of Adelphia stock to collapse and NASDAQ to delist the stock.\(^63\) Most of the previously undisclosed debt was attributable to loans Adelphia made to entities owned by the Rigas family – the founders of Adelphia. In May 2002, the company failed to satisfy the terms of several bond and bank loan agreements.\(^64\) Not long after, Adelphia filed for bankruptcy.

During the preparation of its 2001 year-end financial reports, Adelphia found that members of the Rigas family, several of whom remained on its board and held high-ranking positions within the company, had perpetrated numerous frauds and misappropriated company funds. All three family members resigned from the company in May. On June 11, 2002, the company announced that it had overstated revenues and cash flow by another $500 million over the previous two years.\(^65\) Following this announcement, two of the new board members resigned, stating that the “ongoing serial disclosures of wrongdoing” at Adelphia “have made it impossible

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59 See id.


61 Id.


65 Solomon, *supra* note 63.
to contribute meaningfully to the process."\(^{66}\) Shortly thereafter, the company announced that Deloitte had been dismissed as its auditor because it was “aware” of transactions between the company and the family-controlled entities that had not been disclosed to the new board members.\(^{67}\)

In July of 2002, founder John Rigas and his two sons were arrested and charged with corporate looting.\(^{68}\) They were also charged with bank, securities, and wire fraud in connection with operating a multibillion-dollar scheme to defraud investors and creditors.\(^{69}\) The Rigas family had been buying back company stock with their own private funds in order to reduce company debt, but the buyback was in turn funded with hundreds of millions of dollars borrowed from Adelphia.\(^{70}\) The Rigases also misappropriated company money to buy stock, build a $13 million golf course on land primarily owned by the family,\(^{71}\) and provide African safari vacations for family members.\(^{72}\) In June 2002, Adelphia filed for bankruptcy protection, listing $18.6 billion in debt.\(^{73}\)

4. **WorldCom**

WorldCom, which began as a local telecom outfit in 1983, had ballooned into the nation's second largest long-distance telecom carrier by 2000.\(^{74}\) The company based its expansion model on acquisitions of other telecom companies, often using its own stock.\(^{75}\) At the same time, the company – with the help of senior employees and officers – employed a number of accounting schemes to artificially boost earnings. For example, high-level accounting officials would aggregate batches of charge-off entries created by internal lower-level accountants, recording the


\(^{70}\) Id.

\(^{71}\) Id.

\(^{72}\) Sorkin, supra note 68.


lump sums as non-recurring events. In some periods the company over-estimated losses from charge-offs, which were then used to boost reported results during periods of poor performance. A similar trick applied to properties WorldCom obtained through its acquisitions: the company would intentionally “write down” the value of acquired properties to create a secret supply of potential earnings that were available to pad earnings if business began to lag.\footnote{76}

By 2000, WorldCom was suffering from the same problems that plagued many other telecom companies. It had overinvested in fiber optic cable, and the market excess undermined WorldCom's earnings by lowering the cost of its services.\footnote{77} Additionally, WorldCom’s strategy of buying growth was thwarted when U.S. regulators rejected the company’s bid to buy Sprint Corp.\footnote{78} With no new revenue streams and expenses mounting, WorldCom sought new accounting tricks to boost its financial statements.

In late 2000, WorldCom attempted to absorb its expenses by writing down reserves on the balance sheet. This maneuver saved $1.2 billion in the last half of 2000.\footnote{79} Its second move was to count “line costs,” disbursements made to other telecom players for the right to access their networks, as capital investments instead of routine business or operating expenses.\footnote{80} This trick allowed WorldCom to spread costs out over longer time periods, reducing WorldCom’s expenses in 2001 and the first quarter of 2002 by at least $2.6 billion.\footnote{81}

A member of the company’s internal audit team eventually discovered the jig. When John Sidgmore became WorldCom’s new CEO in April 2001, he ordered an internal audit of the company’s books.\footnote{82} Upon checking the company’s capital expenditure records, an internal auditor discovered that several billion dollars’ worth of line-costs were recorded in the capital expenditure accounts, as assets on the balance sheet (and thus not affecting the income statement), rather than as expenses.\footnote{83} Not only that: apparently the line costs had properly been recorded as expenses initially, but had been transferred to asset accounts during the account closing process.\footnote{84} Internal auditors reported these findings to the company’s audit committee.

\footnote{76}{Id.}  
\footnote{82}{Elstrom, supra note 80.}  
\footnote{83}{Id.}  
\footnote{84}{Id.; see also Frank E. Ryerson, Improper Capitalization and the Management of Earnings, 16 Proceedings of ASBBS (February 2009).}
chair, who was soon fired along with its CFO and controller. The fallout from this discovery was tremendous: even President Bush condemned the bookkeeping stunt as “outrageous.”

Like Enron, WorldCom had employed Big Five accounting firm Arthur Andersen as an external auditor. Andersen, in February 2002, issued a report to the company’s board audit committee containing assurances that there had been no significant transactions or changes in accounting policies in the past year, and that the company had strict internal controls in place to detect false financial reporting. As demonstrated by the line-cost characterization and WorldCom’s other accounting maneuvers, these statements proved to be patently untrue.

On June 26, 2002, WorldCom announced that it had overstated earnings by $3.8 billion in prior years due to treating expense items as capital investments. The resulting restatement of earnings was, at the time, was the largest restatement ever announced by an American corporation. The announcement also dragged the credit rating of the company’s common stock to “junk” status, as its stock dropped below one dollar per share. Upon a further internal review within WorldCom, the restatement was increased by the discovery of additional expense items that had been improperly classified as revenue, adding more than $3 billion to the downward restatement.

WorldCom’s failure devastated employees and shareholders alike. From 2001 to June 2002, WorldCom laid off more than 20,000 employees, reducing its workforce by ten percent in just over a year. Many of the suddenly unemployed were blue-collar workers that had been employed to build WorldCom’s extensive fiber optic network. By the time the NASDAQ delisted the company on July 30, 2002, WorldCom stock had fallen from its peak of over $60 per share to “junk” status, as its stock dropped below one dollar per share.

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89 See Jared Sandberg et al., WorldCom Investigations Shift Focus to Ousted CEO Ebbers, WALL ST. J., July 1, 2002, available at http://www.wsj.com/articles/SB1025473138934014760 (“Already, WorldCom’s planned accounting restatement is among the largest in U.S. history, six times as large as that of Enron Corp.”).
93 Id.
share in 1999 to less than a dollar per share.\textsuperscript{94} At the same time that thousands of blue-collar workers were being laid off, WorldCom paid out approximately $237 million to 558 top executives as part of a two-year bonus retention program.\textsuperscript{95} The cash-strapped WorldCom was initially unable to provide rank-and-file employees with reasonable severance packages.\textsuperscript{96} After petitioning the United States Bankruptcy Court in Manhattan, WorldCom was allowed to redirect $1.4 million in severance payments that were initially promised to executives, allowing 4250 former employees to receive approximately $9000 each.\textsuperscript{97} Even so, the court's decision covered fewer than half of the employees laid off by WorldCom.

\section*{II. The Congressional Response}
\subsection*{A. Legislative History of SOX}

As early as October 2001, members of Congress began introducing bills to provide heightened regulations of corporations and the accounting industry, enhance criminal penalties for certain types of fraud and securities violations and strengthen the SEC's enforcement authority.\textsuperscript{98} Attempts at legislative reform were met with resistance by the Bush administration and conservative members of Congress, however.\textsuperscript{99} Although mounting evidence of widespread corporate fraud fueled discussions between Congress and the Administration on potential reform measures, progress stalled due to disagreements over the measures' policy objectives.\textsuperscript{100} Bush's early reform proposal, a “ten-point plan” that focused on oversight, promised to make corporate balance sheets more comprehensible to average investors and to strengthen regulatory oversight of the accounting industry.\textsuperscript{101} The President's initial proposals were criticized as failing to provide "real teeth" that would hold corporate executives accountable for fraudulent business practices that hurt investors.\textsuperscript{102}

\begin{footnotesize}
\begin{enumerate}
\item [96] Id.
\item [102] David Greising, Bush 'reforms' sound good but won't stop fury, (Mar. 8, 2002), http://articles.chicagotribune.com/2002-03-08/business/0203080344_1_president-bush-accountability-financial-statements.
\end{enumerate}
\end{footnotesize}
The political dynamic did not fully shift until June 2002, when the WorldCom scandal led to an even bigger corporate implosion.\(^{103}\) By that point, the outcry had reached a fever-high pitch. Regulation of financial reporting and corporate governance were issues of peak salience and importance to the general American public. For example, a special edition of the USA Today “Money” section in June 2002 included an article entitled, *How Did Business Get So Darn Dirty?*, which cited “greed” as one of the primary answers to the title’s question.\(^{104}\) A Gallup poll conducted in July of 2002 found that thirty-eight percent of Americans considered “big business” to be a major threat to America’s future, a jump of fourteen points from two years earlier.\(^{105}\) The prospect of mid-term elections on the horizon increased the pressure on Republicans to act. Democrats were prepared to make the Enron and WorldCom scandals - which by now had produced widespread loss of jobs and billions in financial losses for investors - a major campaign issue in the November elections.\(^{106}\) In making his case for the necessity of comprehensive reform, Senator Leahy did not mince words:

Enron has become a symbol for the torrent of corporate fraud scandals that have hit the front pages and battered our financial markets. Tyco, Xerox, WorldCom, Adelphia, Global Crossings, the list goes on. The things that happened at Enron did not happen by mistake. They were not the result of one or two “bad apples.” Senior management at Enron, assisted by an army of accountants and lawyers spun an intricate web of deceit. They engaged in a systematic fraud that allowed them to secretly take hundreds of millions of dollars out of the company. This kind of fraud is not the work of a lone fraud artist. Rather, it is symptomatic of a corporate culture where greed has been inflated and honesty devalued. Unfortunately, as I have said and as the experts warned at our February 6 hearing, Enron does not appear to have been alone. Each week we read of corporation after corporation that has engaged in misconduct, and these are not small or marginal corporations. These are major mainstays of corporate America. The web of deceit woven by such publicly traded companies ensnares and victimizes the entire investing public who depend on the transparency and integrity of our markets for


everything from their retirement nest eggs to their children's college funds.\textsuperscript{107}

The House of Representatives introduced H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002,\textsuperscript{108} on February 14, 2002. The bill was sponsored by Republican House Representative Michael G. Oxley, Chair of the House Financial Services Committee. Like the reform proposals proposed by President Bush, the primary focus of H.R. 3763 was transparency in, and oversight of, corporate accounting practices.\textsuperscript{109} Unlike the final rule, it contained no provision for white-collar penalty enhancements – unsurprising, given that the House Financial Services Committee typically lacks jurisdiction over criminal matters.\textsuperscript{110} Even though H.R. 3763 contained provisions similar to those shaping the Public Company Accounting Oversight Board (“PCAOB”) in the Sarbanes proposal, the Oxley-sponsored bill was decidedly more friendly to corporate interests. The bill largely left the SEC to make key decisions about regulating auditors.\textsuperscript{111} It contained fewer curbs on consulting by auditors and would have permitted private groups to form one or more oversight boards for the accounting industry.\textsuperscript{112} House Democrats offered their own bill,\textsuperscript{113} as well as a set


\textsuperscript{109} A key feature of the bill was the requirement that auditors of publicly traded corporations “be subject to a system of review by a public regulatory organization,” which in turn would be subject to rules promulgated by the SEC. Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, H.R. 3763, 107th Cong. at § 2 (2002).

\textsuperscript{110} See generally Public Company Accounting Reform and Investor Protection Act of 2002, S. 2673, 107th Cong. (2002) (providing key improvements to current accounting system including creation of an independent oversight board with authority to set standards and investigate wrongdoing, restricting accounting firms from providing non-audit services such as consulting, requiring CEOs and CFOs to certify financial reports, requiring disgorgement of profits and bonuses earned related to misstatements, requiring reporting of inside stock sales in two days, ensuring separation of investment banking and brokerage services, and providing extra resources for SEC).


\textsuperscript{112} Bowman, \textit{supra} note 99, at 396. Other features of Oxley’s bill include:

- a prohibition against independent auditors of publicly traded companies offering certain kinds of non-audit services, a prohibition against exercising improper influence on the conduct of outside audits, a requirement of “real time” disclosure of financial information, a prohibition of insider trades during pension fund blackout periods, and a series of congressional mandates for “studies” of analyst conflicts of interest, corporate governance practices, SEC enforcement actions, and credit rating agencies.

\textit{Id.}

\textsuperscript{113} H.R. 3818, the Comprehensive Investor Protection Act of 2002, would have created a single national accounting oversight board under the SEC’s direct supervision with specific legislative grants of authority, heightened independence requirements for members of the board from the large public accounting firms, a wider ban on non-audit services by auditing firms for corporations they audit, a ban on tying investment analyst compensation to the performance of their employer bank, criminal penalties for destruction of audit records, and a substantial increase in the SEC’s enforcement budget. \textit{See generally} Comprehensive Investor Protection Act of 2002, H.R. 3818, 107th Cong. (2002) (introduced on Feb. 28, 2002).
of proposed amendments to Oxley’s bill, both of which the House majority rejected. The Republican-controlled House passed H.R. 3763 by a vote of 334 to 90 on April 24, 2002, and referred it to the Senate Committee on Banking, Housing and Urban Affairs on April 25, 2002.

Senator Paul Sarbanes, Chairman of Senate Committee on Banking, Housing and Urban Affairs, introduced his own bill in mid-June. Although S. 2673, The Public Accounting Reform and Investor Protection Act of 2002, provided more stringent measures compared to those in Senator Oxley’s bill, it too dealt primarily with accounting reform and not criminal sanctions. Like the House Financial Services Committee, the Senate Committee on Banking, Housing and Urban Affairs would typically not have jurisdiction over criminal penalties.

Sarbanes’s bill passed out of the Senate Banking Committee on a vote of 17-4 and reached the Senate floor in July, where it was subject to numerous amendments. In general, the Republicans in Congress favored the relaxed oversight and governance standards in the Oxley bill, while the Democrats pushed for more aggressive regulation of the markets. Both Democrats and Republicans eagerly embraced stronger criminal sanctions, however.

Ultimately, the Senate voted to incorporate its bill into the Oxley Act and sent that version to conference to resolve the differences between the House and Senate versions. A second House reform bill (the Corporate Fraud Accountability Act of 2002, H.R. 5118), providing for even greater criminal penalties for accounting and auditing improprieties at publicly traded

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116 Id.
117 The bill featured a single national accounting oversight board with a membership chosen by the SEC and significant regulatory authority. See S. 2673, 107th Cong. Title I (2002) (Public Company Accounting Oversight Board).
118 Note that Senator Sarbanes’s bill, as voted on by the committee, had already been modified by compromises with conservative Democrats and Republican Senator Mike Enzi. Conservative Democrats Evan Bayh of Indiana and Zell Miller of Georgia convinced Senator Sarbanes to 1) relax the proposed restrictions on consulting work that accounting firms could perform for their client companies and 2) remove a proposal to have the SEC study whether companies should count stock options issued to executives and employees as a business expense, which would erode profit figures. In a concession to Senator Enzi, Senator Sarbanes also provided that problems uncovered during proposed routine examinations of audit firms would be kept from the public for at least one year. Senator Enzi also influenced on the PCAOB provisions: in the end, Sarbanes and Enzi agreed that two of the new board’s four members would be accountants, that the board could adopt rules recommended by the industry, that accounting firms would be spared the expense of funding the board, and that disciplinary proceedings against accountants could remain confidential until appeals had run their course. Hilzenrath et al., supra note 111.
119 Bowman, supra note 99, at 398.
120 Id. at 400.
121 Although members of Congress were no longer eager to publicly display allegiance to corporate interests, industry lobbyists still managed to achieve significant concessions in the final version of the SOX Act. They focused on three aspects of Sarbanes’s bill: 1) a proposal to require corporate board chairmen and chief executive and financial officers to certify, personally, their companies’ financial statements; 2) a proposal to hold corporate officials liable not just for willfully misstating company financial statements but also for recklessly allowing inaccurate statements to be disseminated; and 3) a proposal to extend the statute of limitations for shareholder lawsuits against corporations. With the help of industry heavyweights and a personal friend of Senator Oxley, business alliances and tech-industry lobbies prevailed on the first two issues: the liability provision was applied only to chief executive and financial officers, and only for knowing or willful conduct. Hilzenrath et al., supra note 111.
companies, had been introduced by Representative F. James Sensenbrenner on July 15 and passed by a vote of 391-28 in the House the next day. In conference, the bill's stiffer penalties were incorporated into the Act. Congress also grafted the criminal provisions from the Leahy bill (S. 2010) onto the accounting reforms and implemented the modified WCCPA. The Sarbanes-Oxley Act, which emerged from conference on July 25, was the full text of the Senate's version of the reform bill. It was presented to the President on July 26 and signed into law on July 29.

B. SOX

In this Part, we focus on the corporate governance reforms required by SOX. These include the requirement that the boards of directors include a majority of outside directors and the mandate requiring an audit committee and the independence of all its members. In addition, the board must disclose whether the audit committee membership includes at least one financial expert – as further defined in the accompanying SEC regulations – and if not, why not. It also requires independence of the outside auditor. These provisions are discussed next.

1. Audit Committees

The audit committee requirements of the Act were meant to enhance the ability of the board of directors to monitor management and outside auditors. Most of these requirements, however, did not represent a significant departure from SEC and stock exchange requirements then in place. Despite its limited power to regulate the conduct of directors and officers, the Supreme Court has held that the SEC’s authority to regulate the conduct of officers and directors of public companies not involving “deception, misrepresentation, or nondisclosure” is limited. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 475 (1977). In Santa Fe, the Court was concerned about bringing within Rule 10b-5 “a wide variety of corporate conduct traditionally left to state regulation” which would not only expand the “danger of vexatious litigation,” but “would overlap and quite possibly interfere with state corporate law.” Id. at 479. The Court concluded, “[W]e thus adhere to the position that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.” Id.

125 See Conference Report to Accompany S. 3763, H. Rep. No. 107-610 (2002). According to Representative Oxley, “The Senate built on the House bill's chief objectives, strong oversight for accountants, increase corporate responsibility, and improved information for investors.” Transcript of Conference Report on H.R. 3763, Sarbanes-Oxley Act of 2002 (House of Representative - July 25, 2002) at H5462. The conference report also contains additional provisions offered only by the House, including provisions to require real-time disclosure of investor information; to toughen punishment for those convicted of corporate fraud; to return ill-gotten gains to investors; and to create a disgorgement fund real-time. Id.
126 Cunningham, supra note 44.
128 The Supreme Court has held that the SEC’s authority to regulate the conduct of officers and directors of public companies not involving “deception, misrepresentation, or nondisclosure” is limited. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 475 (1977). In Santa Fe, the Court was concerned about bringing within Rule 10b-5 “a wide variety of corporate conduct traditionally left to state regulation” which would not only expand the “danger of vexatious litigation,” but “would overlap and quite possibly interfere with state corporate law.” Id. at 479. The Court expressed its reluctance “to federalize the substantial portion of the law of corporations that deals with transactions in securities particularly where established state policies of corporate regulation would be overridden.” Id. at 479. The Court concluded, “[W]e thus adhere to the position that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.” Id.
SEC has shaped the corporate governance standards embodied in the SOX Act in two main ways: by imposing disclosure requirements directly on companies, and by encouraging national stock exchanges to develop listing standards.

As early as the 1970s, the SEC advocated the creation of audit committees as a mechanism “to make management more accountable to the board and to emphasize the function of the board in monitoring the activities of the management.” The SEC required public companies to disclose in certain proxy materials whether the company had an audit, nomination and compensation committee, together with the membership, number of yearly meetings, and functions of such committee, if they existed.

Around this same time period, national stock exchanges began imposing corporate governance standards as a condition to being listed and for continued listing. The Nasdaq Stock Market (Nasdaq) and the New York Stock Exchange (NYSE), the two largest stock exchanges in the world by market capitalization, have long required that a listed company have an audit committee composed of independent directors. Early versions of Nasdaq and NYSE listing standards imposed few requirements on the audit committee, however, and did little more than rehash state law in many of their provisions.

The revelation of major accounting fiascoes in 1998, particularly the widespread practice of “earnings management,” led the SEC to take a new look at the role of audit committees. Then-Chairman Levitt, emphasizing “the crucial role of boards of directors as representatives of the shareholders” and noting the audit committee's responsibility “to ensure that shareholders receive relevant and reliable financial information,” proposed that the audit

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134 BLOOMENTHAL, supra note 131, at § 4.1.
135 See Id.; Lawrence A. Cunningham, supra note 44, at 925 (2003). Some of these accounting issues included problems that also came to light in the Enron scandals: proper revenue recognition, appropriate creation and use of reserves and big bath restructuring charges. Id.
committee play a more active oversight role by meeting more frequently and asking tough questions.\(^\text{138}\)

As part of a larger plan to improve financial reporting quality, Chairman Levitt tasked the NYSE and the National Association of Securities Dealers (NASD) with forming a “blue ribbon” panel to “improve audit committee performance.”\(^\text{139}\) In response to recommendations issued by the Blue Ribbon Committee (BRC) in 1999,\(^\text{140}\) the NYSE and Nasdaq proposed and implemented substantial changes to their corporate governance and listing standards (the BRC revisions).\(^\text{141}\) The changes included requiring: that the audit committee consist of at least three “independent directors;”\(^\text{142}\) that each member of the audit committee be financially literate,\(^\text{143}\) and that at least

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\(^{140}\) BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES, REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999). The BRC recommendations included the following:

1. That the NYSE and NASD adopt a new definition of independence for purposes of the audit committee;
2. That the NYSE and NASD require that the audit committee be composed solely of independent directors;
3. That the NYSE and NASD require that listed companies' audit committees have a minimum of three directors, each of whom is “financially literate,” and that at least one member have accounting or related financial management experience;
4. That the NYSE and NASD require that listed companies' audit committees have a written charter, approved by the full board, that specifies the scope of the committee's duties, structure, processes and membership requirements;
5. That the SEC require audit committees make certain disclosures in the company's proxy statement relating to the audit committee’s written charter.
6-7. That the NYSE and NASD require that listed companies' audit committee charter address the relationship between the outside auditor and audit committee;
7. That Generally Accepted Auditing Standards require that the outside auditor “discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles.”
9. That the SEC require all reporting companies to include an audit committee letter in the Form 10-K containing certain disclosures;
10. That the outside auditor be required to discuss with the audit committee certain matters, including adjustments, management judgments and estimates, new accounting policies, and disagreements with management.


\(^{143}\) Id. 303.01(B)(2)(b).
one member have financial or accounting experience; that each audit committee have a written charter; and a description of a number of relationships between the company and a director or her family member that would foreclose a finding of independence.

To complement the BRC revisions, the SEC heightened its disclosure requirements with respect to audit committees. Each proxy statement had to disclose whether the company had an audit committee. Board audit committees were required to vouch for the accuracy of financial statements, disclose whether they signed off on the financial statements, state whether an audit committee’s written charter spells out the committee’s duties, and submit any charter to the SEC every three years.

Under § 301, SOX mandates that all public companies appoint an audit committee of the board of directors. The power to hire, fire, and compensate the external auditors must be held by the audit committee as opposed to the management or the board of directors as a whole; each audit committee is to be “directly responsible for the appointment, compensation, and oversight” of the external auditor, and the auditors are to report directly to the audit committee. This section requires the audit committee to implement an internal complaint system to receive complaints regarding audits, internal controls, and accounting matters from within the corporation, essentially bypassing management. To encourage financial reporting quality and

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144 Id. 303.01(B)(2)(c).
145 Id. 303.01(B)(1).
146 Id. 303.01(B)(3). See also BLOOMENTHAL, supra note 131, at § 4.2.
147 Each audit committee was required, on the issuer’s annual Form 10-K, to disclose whether its recommendation that the financial statements be included in the annual report was based on its discussions with management and the independent accountant. Cunningham, supra note 44, at 928.
148 Id. at 932.
149 See Exchange Act § 10A(m)(2). The section also directs the SEC to establish standards for audit committees; national securities associations are not to list any companies that fail to meet Section 301 requirements. See SOX Act § 301, 116 Stat. at 775 (codified at 15 U.S.C. § 78j-1) (adding § 10A(m) to the Exchange Act); Exchange Act § 10A(m)(1)(A)).
150 SOX offers the following definition: “The term “audit committee’ means a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer.” The Sarbanes-Oxley Act adds a new section 3(a)(58) to the Securities Exchange Act of 1934. § 205, 116 Stat. at 773-74 (to be codified at 15 U.S.C. § 78c).
151 SOX §301 explicitly requires that the audit committee have the authority to engage independent counsel and other advisers as it deems necessary to carry out its duties, and that the corporation adequately fund the audit committee. SOX Act § 301, 116 Stat. at 776 (codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(5) and (6)).
152 116 Stat. at 775 (to be codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(2)). See also Audit Committee Release, supra note 127, at § II(B)(1). One of the audit committee’s primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. The Commission has long recognized the importance of an auditor’s independence in the audit process . . . . One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor’s interests with those of shareholders.
153 116 Stat. at 776 (codified at 15 U.S.C. § 78j-1) (amending the Exchange Act § 10A(m)(4)). Management may not have the appropriate incentives to self-report all questionable practices . . . . The establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper
independent external auditing, Section 301(3) imposes an independence requirement on each member of the audit committee.\textsuperscript{154} To be independent, an audit committee member should not be an “affiliated person” with respect to the company, and should not “accept any consulting, advisory, or other compensatory fee” from the firm.

Section 301 grew out of a sense that public company boards had failed their oversight responsibilities and had become beholden to the whims of the top executives.\textsuperscript{155} The changes implemented by this section, and other sections addressing conflicts of interest and corporate governance, represented a significant change to basic corporate law and governance, which traditionally has been determined at the state (not federal) level, and which traditionally had given the full board of directors authority to delegate whatever authority over the audit firm relationship as it saw fit (including to management of a public company).\textsuperscript{156}

On April 25, 2003, the SEC promulgated its final rules “Standards Relating to Listed Company Audit Committees” (Audit Committee Release) and promulgated a new Rule 10A-3 under the Exchange Act. In the Audit Committee Release, the SEC directed each national securities exchange and national securities association to provide the SEC proposed listing rules or amendments to rules in compliance with section 301. In new Rule 10A-3, the SEC added only minor language to the definition of “independence” for purposes of directing the NYSE and Nasdaq to adopt rules.\textsuperscript{157} In addition, consistent with section 301, the SEC required only that

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\textsuperscript{154} See Exchange Act § 10A(m)(3); Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (amending the Exchange Act, § 10A(m)(3)). See also Audit Committee Release, supra note 127, at § II(A)(1) ("An audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer’s financial disclosure and the adequacy of internal controls than a committee that is affiliated with management.").


Over the past decade or more, at too many companies, the chief executive position has steadily increased in power and influence. In some cases, the CEO had become more of a monarch than a manager. Many boards have become gradually more deferential to the opinions, judgments and decisions of the CEO and senior management team. This deference has been an obstacle to directors’ ability to satisfy the responsibility that the owners—the shareholders—have delegated and entrusted to them.

\textit{Id. See also} SEC Commissioner Cynthia A. Glassman, SEC Initiatives Under the Sarbanes-Oxley Act of 2002, Before the College of Business and Economics, California State University, Fullerton, California (Jan. 28, 2003) (stating “[t]oo often, we have seen examples of audit committees that failed abysmally in their oversight responsibilities”).


\textsuperscript{157} Exchange Act § 10A(m)(3)(b)(1), 17 C.F.R. § 240.10A-3(b)(1). The Rule provides:
audit committee members be independent (as opposed to the entire board). The SEC had determined allow the self-regulatory organizations (SROs) leeway to adopt more stringent governance requirements. The SROs responded by proposing and adopting significant changes that went far beyond the audit committee’s focus of section 301 and Rule 10A-3.

In addition, SOX Section 407 directed the SEC to issue rules requiring each public company to disclose “whether or not, and if not, the reasons therefore, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the SEC.” In defining “financial expert,” the Act considers a member’s qualifications through her “education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer.” An “understanding of GAAP, and experience in preparing or auditing of financial statements” can also be considered “financial expertise” according to the Act.

On March 3, 2003, the SEC promulgated an amendment to Item 401(h) of Regulation S-K (Item 401(h)), the rule implementing Section 407. Item 401(h) requires public companies to disclose whether they have at least one financial expert on their audit committee, and if not why not, in each annual report following July 15, 2003. Item 401(h) also defines “audit committee

In order to be considered to be independent for purposes of [the rule], a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or

(B) Be an affiliated person of the issuer or any subsidiary thereof.

See Exchange Act § 10A-3(b), 17 C.F.R. § 240.10A-3(b).
Id. § II(A)(1). Among others, commenters supporting this approach included the American Bar Association, the American Institute of Certified Public Accountants (AICPA), and the New York Stock Exchange. Id. at n.42

Section 407 Release, supra note 162, at §§ II(A)(2) and II(E). The company must also disclose the name of the audit committee financial expert.
financial expert,” including a listing of the means by which the person must have come to such expertise.\footnote{164}

The SEC’s definition of an audit committee financial expert utilized and expanded on the guidance provided by Congress in Section 407.\footnote{165} To ensure that the designated audit committee financial expert did not face greater liability than any other board members, the SEC clarified that the audit committee financial expert would not be subject to greater duties or obligations under the securities laws, and declared that such person is not deemed an “expert” for purposes of section 11 of the Securities Act of 1933.\footnote{166} The board of directors is charged with making the determination of whether a person qualifies as the audit committee financial expert.\footnote{167}

2. Auditor-Client Relationships

Under Section 201 of SOX, which adds § 10A(g) to the Exchange Act of 1934,\footnote{168} external auditors are prohibited from providing certain kinds of nonaudit services to their auditing clients. For example, they may not provide financial information systems design and implementation, bookkeeping services, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions or human resources, investment banking services, legal services, and other services that might be determined by regulation to be impermissible. Further, public companies are required to disclose the dollar value of audit and audit-related services versus permitted non-audit services.\footnote{169}

\footnote{164} Id. The SEC adopted the term “audit committee financial expert” rather than “financial expert,” as section 407 had used. \textit{Id.} § II(A)(1).
\footnote{166} Id.
\footnote{167} \textit{Id.} § II(A)(6).
\footnote{169} While SOX prohibited audit firms from providing many (but not all) types of consulting services to their audit clients, just before SOX, four of the (then) Big 5 audit firms spun off their consulting arms into separate entities in 2000 and 2001. Despite this drastic change in business models arising from the spin-offs, consulting services still
In addition, Section 203\textsuperscript{170} includes both term limits and restrictions on the external auditor. Although the original idea of having a mandatory periodic rotation of audit firms was dropped, SOX § 203 as enacted requires that audit engagement partners and audit reviewing partners – i.e., the highest-ranked auditing firm employees who deal with the executives of an auditing client – must be rotated off the engagement after five years. In addition, audit firm employees who have worked on an audit of a client company may not switch over and become employees of that client until a certain “cooling off” period has run.\textsuperscript{171}

In Section 202 all auditing and non-audit services provided to an issuer by its auditor be preapproved by the audit committee, except for certain de-minimis exceptions.\textsuperscript{172} Any approvals under this section must be disclosed in the company’s periodic reports under the Exchange Act.\textsuperscript{173}

C. Other Relevant Provisions

There are several other relevant provisions in SOX aimed at improving the governance of corporations. These are described briefly below.

1. Loans to Officers

Section 402 makes it illegal for public companies to directly or indirectly make loans to their officers, except for certain, limited reasons.\textsuperscript{174} Section 402 was self-executing and required no additional SEC rulemaking.

2. Code of Ethics Disclosure

Section 406 requires a public company to disclose whether it has adopted a code of ethics for senior financial officers and to disclose in public filings if its code of ethics changes or if any waivers from the code are granted by the company.\textsuperscript{175} On March 3, 2003, the SEC promulgated account for a large share of revenues for the big audit firms. Non-audit fees to audit clients as a proportion of total fees fell from almost 51 percent of fees in 2002 to about 21 percent in 2005 and have remained steady at that level since then till recently and were around 22 percent in 2012. But these services are now largely provided to companies that are not audit clients.

\textsuperscript{170} Exchange Act § 10A(j).
\textsuperscript{171} SOX § 206, adding Exchange Act § 10A(l).
\textsuperscript{173} Id. at 773 (amending Exchange Act § 10(A)(i)(2)).
\textsuperscript{174} Id. at 787 (amending Exchange Act §13(k)).

such standards as are reasonably necessary to promote—
(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
(3) compliance with applicable governmental rules and regulations.
rules implementing section 406, along with its rules implementing section 407. In the Section 407 Release, the SEC extended the requirements of section 406 to also include disclosure of whether a public company has adopted a code of ethics that applies to its CEO. 

3. Forfeiture of Certain Bonuses and Profits

Section 304 provides that, if a public company is required to prepare an accounting restatement due to material non-compliance with any financial reporting requirement under the securities laws, as a result of misconduct, then the principal executive officer and the principal financial officer(s) must reimburse the corporation for (i) any bonus or other incentive-based or equity-based compensation received by such person during the twelve-month period following the first public issuance of the defective report and (ii) any profits realized from the sale of securities of the corporation during that twelve-month period. This Section was intended to force the principal officers of the company to pay more attention to the company’s financial reporting and to dissuade management from focusing on short-term gain.

III. The Roles of the Board and the Shareholders

In the modern U.S. public company, corporate decision-making is centralized in its management; the chief executive officer (CEO) of the company is tasked with making most important corporate decisions. The centralization of corporate power is seen as necessary given the large, dispersed nature of share ownership in public corporations. But in these corporations,

The problems surrounding Enron Corp. and other public companies raise concerns about the ethical standards of corporations and their senior financial managers. The Committee believes that investors have a legitimate interest in knowing whether a public company holds its financial officers to certain ethical standards in their financial dealings.


176 17 C.F.R. § 229.406 (2003). See also Donaldson Testimony, supra note 155, at 17. “Given the role of the CEO in setting the ‘tone at the top,’ the [SEC] also included a company’s principal executive officer in its final rules.” Id. In addition, the SEC expanded on the definition of “code of ethics.” See Section 407 Release, supra note 127, § II(B)(2). The SEC resisted commenters’ suggestions to set forth additional ethical principles: “We continue to believe that ethics codes do, and should, vary from company to company and that decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company.” Id.

177 116 Stat. at 778.

178 See Cynthia A. Glassman, Address at the Conference on Bank Structure and Competition (May 9, 2003), at http://www.sec.gov/news/speech/ spch050903cag.htm. “[I]t should be clear from the recent scandals that there is a risk that some executives will manage to short-term performance goals to maximize their compensation. For its part, Sarbanes-Oxley provides an incentive against betting on short-term gain.” Id.

the interests of management may conflict with those of shareholders, and management thus cannot be automatically counted on to take actions that would serve shareholder interests.\textsuperscript{180} The separation of a corporation’s ownership from control leads to agency costs.\textsuperscript{181} Without adequate constraints and incentives, management might divert resources through excessive compensation, self-dealing, or other means. They may reject beneficial acquisition offers to maintain independence and private benefits of control, or engage in empire-building and wasteful investments.\textsuperscript{182}

A. The Board of Directors

The corporate laws of many states have generally required that “[t]he business and affairs of every corporation . . . be managed by or under the direction of a board of directors.”\textsuperscript{183} Although these provisions formally grant the board broad authority and power over corporate decision-making, most of the directors of publicly traded companies perform their board roles on a part-time basis. Due to time, information, and budget limitations, directors cannot effectively employ the control rights that state corporate law provides them and instead largely delegate this responsibility to the corporation’s officers to run the corporation.\textsuperscript{184} Nevertheless, the board performs a number of crucial functions.\textsuperscript{185} Directors have a fiduciary duty to the corporation and are expected to serve as the shareholders’ guardians; they are equipped, at least in theory, with the authority and responsibility to carry out their duty. The board selects the CEO and other top executives. The board sets the executives’ compensation arrangements and thereby shapes their incentives. After selecting and hiring executives, the board is supposed to monitor their strategy and performance, replacing them if necessary. Finally, major corporate decisions, such as how to respond to an acquisition offer, are made by the board, which has full power to accept or reject executives’ recommendations.\textsuperscript{186}

As evidence of the board’s influence over corporate governance practices, a study of 1500 S&P firms from 1998 to 2004 linked weak corporate governance and backdating.\textsuperscript{187} The study found that more inside and gray directors on the board and independent directors appointed by the incumbent CEO, director compensation in options and CEOs serving as the chair of the board

\begin{itemize}
  \item \textsuperscript{181}David Yermack, \textit{Shareholder Voting and Corporate Governance}, 2 Ann. Rev. Fin. Econ. 103, 104 (2010).
  \item \textsuperscript{183}DEL. CODE. ANN. tit. 8, § 141(a) (2006); see also MODEL BUS. CORP. ACT § 8.01(b) (2004).
  \item Edelman et al., supra note 179, at 1366.
  \item \textsuperscript{185}Bebchuk, \textit{Shareholder Franchise}, supra note 182. In addition to the powers and responsibilities listed, under state corporate law, the authority to determine distributions rests fully with the board. Management has full authority to determine distributions either in cash or in kind (for example, in the stock of a subsidiary in the case of a spin-off), without the need to obtain shareholder approval. Thus, with regard to distribution decisions, shareholders lack not only initiative power, but also a veto power
  \item \textsuperscript{186}Bebchuk, \textit{Shareholder Franchise}, supra note 182, at 680.
  \item \textsuperscript{187}Daniel W. Collins et al., \textit{Corporate Governance and Backdating of Executive Stock Options}, 26 CONTEMP. ACCT. RES. 403, 405 (2009).
\end{itemize}
were associated with higher levels of backdating. Another study found correlations between measures of CEO influence, such as lower numbers of independent directors and longer CEO tenure, and opportunistically timed grants.

B. Shareholders

In contrast, the shareholders’ role in corporate governance has traditionally been limited. Shareholders who oppose the business decisions of the board or management cannot affect change directly: they can only exit, sue, or vote. Courts have often highlighted the last option as the key mechanism for shareholders to keep management and the board accountable. For example, Delaware Chancellor William Allen has described shareholder voting as “the ideological underpinning that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.” Courts have also used shareholder voting power to justify insulating board decisions from judicial review (i.e. the business judgment rule), providing boards with the power to block tender offers, and limiting shareholder power to initiate major corporate decisions, on the ground that shareholders dissatisfied with the board's decisions with respect to such issues have the power to replace incumbent directors with a new team that would make different decisions. In theory, the fear of replacement is supposed to make directors accountable and provides them with incentives to serve shareholder interests. But the vast majority of commentators, including those who oppose increased shareholder power, recognize that in reality shareholders exert very little influence on the board.

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188 Id. at 406.
189 Lucian A. Bebchuk et al., Lucky CEOS and Lucky Directors, 65 J. Fin. 2363, 2365 (2010) [hereinafter Bebchuk, et al, Lucky CEOS]. The Bebchuk et al. study covered the time period 1996-2005. In this paper, we extend the analysis to 2015 to show that these practices are still on-going.
190 See, e.g., Mourning, supra note 179, at 1147.
191 Recent studies have increasingly focused on the impact of “exit” with respect to large, institutional investors. For a review of the literature, see Alex Edmans, Blockholders and Corporate Governance, 6 ANN. REV. FIN. ECON. 23, 24 (2014).
192 See Edelman et al., supra note 179, at 1376 for a discussion of factors limiting the efficacy of shareholder suit. Barriers to suit include high transaction costs (legal fees, e.g.), bylaws requiring arbitration, and choice of venue provisions. Id. Moreover, the remedy for most successful suits is often a payment out of the corporation’s coffers which does little to deter future wrongdoing by managers. Id. See also Robert B. Thompson & Randall S. Thomas, The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions, 57 VAND. L. REV. 133 (2004).
194 Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988). Similarly, Professor Lucian Bebchuk, one of the foremost proponents of increasing shareholder power, describes the U.S. corporation as “a representative democracy in which the members of the polity can act only through their representatives and never directly.” Bebchuk, The Case, supra note 193, at 836.
195 See In re Walt Disney Co. Derivative Litig, 907 A.2d 693,698 (Del. Ch. 2005) (stating that “redress for [directors'] failures ... must come ... through the action of shareholders ... and not from this Court”).
196 See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985) (observing that “[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out”).
197 Bebchuk, Shareholder Franchise, supra note 182, at 681.
In recent years, and particularly in the aftermath of the 2008 financial crisis, various efforts (described below) have been made to improve director elections. Empirical evidence suggests, however, that most of these changes have had a relatively modest effect, at best, both individually and taken together.\footnote{In a 2011 study, for example, Professors Becker & Subramanian observed that: 
• Only two incumbent directors who did not receive a majority of the votes cast under a majority vote regime have actually left the board, and one of these two was mandated to leave under state law; 
• Not a single insurgent candidate has made use of eProxy, at least in part because turnout among retail investors is thought to be lower when eProxy is used; 
• Only one director election outcome has been changed due to the elimination of broker voting of uninstructed shares.}\footnote{Bo Becker & Guhan Subramanian, Improving Director Elections, 3 HARVARD BUS. L. REV. 1, 3 (2013).} Proponents of activist hedge funds applaud them as leaders of shareholders, acting on behalf of shareholders that face more significant collective action problems.\footnote{John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 41 J. CORP. L. 545, 548 (2016).} Skeptics, on the other hand, view activist hedge funds as extracting short-term profit at the expense of long-term growth.\footnote{See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 COLUM. L. REV. 863, 916 (2013) (arguing intermediaries are powerful vehicles for economic intermediation and risk bearing).}

1. Shareholder Voting: An Overview

In all public companies, shareholders vote at annual meetings on the election of directors (discussed in further detail below) and a variety of other governance topics.\footnote{Under most state laws, shareholders themselves can themselves initiate action in a limited number of settings. Shareholders, at least in the abstract, have the power to call a special meeting, or to use the written consent procedure, to take any action that shareholders are permitted to take at a regular annual shareholders' meeting. See Yermack, supra note 181, at 105.} The agenda for these meetings is primarily set by state corporate law, but tax law, securities law and stock-exchange rules also confer on shareholders certain voting rights. When shareholder approval of an item such as an acquisition becomes time-critical, votes may be held at special shareholder meetings called in the middle of a year.\footnote{Rose A. Zukin, Comment, We Talk, You Listen: Should Shareholders’ Voices Be Heard or Stifled When Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance, 33 PEPPERDINE L. REV. 937, 955 (2006) See Carol Go forth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late, 379 AM. U. L. REV. 379, 386-87 (1994); Mourning, supra note 179, at 1148-49.} Because practical realities make it impossible for most shareholders to attend these meetings in person, proxies are solicited from shareholders authorizing another person to vote on their behalf.\footnote{Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a). See Carol Go forth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late, 379 AM. U. L. REV. 379, 386-87 (1994); Mourning, supra note 179, at 1148-49.} Proxies are governed by the SEC’s federal proxy rules implementing section 14(a) of the Securities and Exchange Act of 1934.\footnote{See Carol Goforth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late, 379 AM. U. L. REV. 379, 386-87 (1994); Mourning, supra note 179, at 1148-49.}

2. Shareholder Voting Rights
Shareholders have certain voting rights with respect to the corporate charter and the corporation’s bylaws, which shape the company’s basic governance structure. Under the Delaware General Corporations Law (DGCL), the state statute governing a majority of U.S. public companies, charter amendments must be initiated and brought to a shareholder vote after approval by the board. Thus, if management wishes to amend the corporate charter to implement certain pro-incumbent changes, such as a classified board of directors or a dual class recapitalization, they must receive the approval of a majority of the shares entitled to vote. On the other hand, shareholders may not vote on an amendment without the board’s electing to have such a vote. The DGCL also grants shareholders the concurrent authority with the board to amend the company’s bylaws, but bylaws are subordinate to the charter and cannot alter any of the charter’s arrangements. Furthermore, only the charter may opt out of various provisions of the DGCL.

Certain major corporate decisions also require a shareholder vote. Under the DGCL, mergers, consolidations, sales of all assets, and dissolutions require approval by a majority of the shares entitled to vote. But, as with amendments to the corporate charter, the shareholder power is only a veto power; the board must first consent to the action. Only the board may bring to a shareholder vote a proposal to have a merger, consolidation, sale of all assets, or dissolution. The DGCL even explicitly authorizes the board to abandon a proposed merger or sale of assets that received prior approval from the shareholders.

Federal securities and tax laws provide additional opportunities for shareholder voting, although usually only of an advisory nature. For example, the Dodd-Frank Act mandates an advisory vote on executive compensation (“Say on Pay”). Shareholder approval is generally necessary for stock option plans if the company is seeking to qualify the options for preferential

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207 Del. Code Ann. Tit. 8, § 242(b) (West 2014). The company’s state of incorporation can also be changed subject to shareholder vote, but also requires initiation by management. Id.
209 Stock exchange rules will limit this type of recapitalization for existing listed public companies. See New York Stock Exchange Listed Company Manual §§ 313.00 et seq. Dual class recapitalizations may have other adverse consequences for shareholders besides the loss of voting control. See Steven M. Davidoff, Thorny Side Effects in Silicon Valley Tactic to Keep Control, N.Y. TIMES DEALBOOK, Sept. 4, 2013, at B8 (pointing out that technology companies with dual class structures may have trouble sustaining themselves once founders leave and control remains in management’s hands).
211 See Id.
212 Id. § 109.
213 Cox & Hazen § 13.01.
214 Bebchuk, Shareholder Franchise, supra note 182, at 681.
215 Del. Code Ann. Tit. 8, § 251(c) (West 2014). (mergers); Id. § 271 (sale of all or substantially all assets).
216 Id. § 251(b) (2001) (providing that “[t]he board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability”).
217 Id.
218 See Id.
federal tax treatment. And SEC Rule 14a-8 enables shareholders to express their sentiments in favor of a given charter amendment or a reincorporation through precatory proposals. Even shareholders with a very small stake may initiate shareholder resolutions, including resolutions that call for management to initiate a charter amendment or a reincorporation or urge that management adopt a certain policy or take a certain course of action. These resolutions are not binding, however: under state corporate law, directors have discretion whether to follow precatory proposals that receive substantial or majority support, and directors' freedom to disregard such resolutions is protected under the business judgment rule. Many boards have in fact used their freedom to disregard shareholder resolutions.

Delaware case law, while not requiring shareholder approval of self-dealing transactions or executive compensation, provides a variety of inducements for it. Under New York Stock Exchange (NYSE) rules, shareholder approval is required if a transaction involves the issuance of stock that increases the number of outstanding shares (or voting power) by 20% or more. In addition, NYSE listing requirements and the federal tax code encourage shareholder votes on executive compensation. Under I.R.C. § 162(m), for an incentive-compensation plan to qualify for optimal tax treatment, it must be approved by the shareholders. Similarly, and without regard to tax treatment, the NYSE Listing Requirements require that equity-compensation plans be approved by the shareholders of listed companies.

3. Director Elections

Under Delaware law, shareholders elect the board of directors. While a director has generally been elected by a plurality of the votes cast, as discussed further below, many companies have recently opted to require the vote of a majority of the shares cast. In the board election, the company will typically nominate exactly the number of candidates to fill the available seats up for election. The incumbents are then able to use company funds to solicit the

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221 For precatory proposals, an affirmative vote of shares “present” is needed. DEL. CODE ANN. § 216(2) (providing that “[i]n all matters other than the election of directors, the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders”).
222 Bebchuk, Shareholder Franchise, supra note 182, at 682.
223 Id.
227 NYSE, Inc., Listed Company Manual § 303A.08 (2004); Id. § 312.03(a) (2007).
228 DEL. CODE ANN. tit. 8, §211(b); Id. § 216.
229 Id. § 216(3).
230 Delaware permits companies, for these and other matters, to adopt a higher approval threshold than the one provided by Delaware law. See Id. § 216. Delaware also made changes to its statute regarding director elections. See Id. § 141(b) (“A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable.”); Id. § 216 (“A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.”).
shareholders for their proxies, which give the incumbents the right to vote the shareholders’ shares at the annual meeting in favor of the incumbent slate.231

Any shareholder may propose a nominee to the board’s nominating committee, but – as will typically be the case – if the board refuses to put the shareholder’s candidate on the company’s slate, the shareholder would need to engage in a time-consuming and expensive “proxy contest” in order to get their candidate seated.232 Insurgents can seek to unseat the entire board of directors (“full slate contests”) or they can nominate a minority of directors in an effort to gain a voice on the board (“short slate contests”). In either case, a nominating shareholder would have to file Schedule 14A with the SEC, hire a proxy solicitor, and often engage in an expensive public campaign to support their nominee or nominees.233 In contrast to the incumbents’ proxy solicitation expenses, which are paid for directly by the company, an insurgent’s expenses are only reimbursed if the shareholder is successful in getting his or her candidate seated on the board.234 Even in this scenario, the shareholder must then share the benefits of any improvement in corporate performance pro rata with the other shareholders.235

4. Factors Undermining Democratic Shareholder Voting

Even when shareholder dissatisfaction with board actions and decisions is substantial, challengers face considerable impediments to replacing boards.236 Year after year, incumbent directors nominate themselves to run in the election, and shareholders, as a practical matter, find themselves unable to nominate anyone else.237 The entrenchment of incumbent boards is reflected in the data: a 2011 survey of Russell 3000 companies reported that of 16,822 candidates nominated for board seats, only 26 candidates were proposed by shareholders. The success rate for incumbent candidates was 99.9%, compared to 46% for the candidates proposed by shareholders. Professors Becker and Subramanian calculated that only 69 director seats, or 0.4% of total director elections, presented a choice for shareholders of U.S. companies in 2011.238

a. Financial Costs

Often, a rival team seeking to replace incumbents faces significant financial expense. To begin, even assuming that all shareholders recognize the rival team’s superiority and are willing to vote for it, the rival team would have to incur hefty “procedural” costs. Because rival teams cannot place the names of their director candidates on the corporate ballot, they must prepare and disseminate proxy materials, an expensive endeavor.239 In addition, rivals must incur additional

231 Becker & Subramanian, supra note 199, at 9.
232 Id.; see also Edelman et al., supra note 179, at 1368; Zukin, supra note 205; Mourning, supra note 179, at 1153.
233 Becker & Subramanian, supra note 199, at 9.
234 Id.
235 Mourning, supra note 179, at 1153.
236 Bebchuk, Shareholder Franchise, supra note 182, at 688.
237 See id.
238 Becker & Subramanian, supra note 199, at 2.
239 Bebchuk, Shareholder Franchise, supra note 182, at 689.
costs in persuading shareholders that they offer a superior alternative to incumbents.\textsuperscript{240} Communications with shareholders are further complicated by the fact that many shareholders hold shares in “street names” and are thus not automatically known and accessible.\textsuperscript{241} To identify and reach such shareholders, challengers may have to use the expensive services of proxy solicitors as well as incur significant travel expenses.\textsuperscript{242}

The issue of costs is especially difficult because of the existence of a "free-rider" problem.\textsuperscript{243} At first glance, it might be thought that, while the presence of the above costs will discourage some contests, it will not deter those that would produce benefits exceeding these costs. This is not necessarily the case, however, because potential rivals would not fully internalize the potential benefits from a contest. Although challengers must bear their full costs, they can capture only a fraction of the benefits that the contest confers on the shareholders collectively.\textsuperscript{244}

As previously mentioned, the problem of costs is exacerbated by the asymmetric treatment of challengers and incumbents by existing legal arrangements. Although challengers get no reimbursement in the event that they lose,\textsuperscript{245} incumbents can charge their full expenses to the company regardless of the outcome.\textsuperscript{246} As a result, incumbents facing a meaningful chance of ouster will be prepared to spend substantial amounts. While potential challengers have insufficient incentive to invest in mounting a proxy contest, incumbents have excessive incentive to invest in opposing a challenge: they have an incentive to spend more than is optimal from the shareholders’ collective perspective.\textsuperscript{247} The incumbents’ ability to access the company’s coffers further increases the amount that challengers must spend to counter incumbents' campaigning.\textsuperscript{248}

b. Uncertainty

Even when a rival team would be better at leading the firm, convincing shareholders that this is the case would likely require significant efforts with no guarantee of success. Shareholders would be making their choices under conditions of uncertainty: to vote for the rival team, they must be convinced not only that the incumbents' performance is sub-par, but also that the rival team would likely perform better. But shareholders cannot infer from a rival team's mounting a challenge that the rival directors would perform better. To begin, even a rival team that believes it would perform better may be acting out of hubris. Furthermore, and very important, a rival's decision to mount a challenge does not even imply that the rival itself believes it would perform better. After all, a challenge could be motivated instead by a desire to obtain the private benefits

\textsuperscript{240} The rival team needs to communicate with shareholders, develop and present its strategy and plans for the company, address questions or concerns that shareholders may have, and respond to the incumbents' criticism of its plans and candidates. Bebchuk, Shareholder Franchise, supra note 182, at 689.


\textsuperscript{242} Id. at 1241; Bebchuk, Shareholder Franchise, supra note 182, at 689.

\textsuperscript{243} Bebchuk, Shareholder Franchise, supra note 182, at 689.

\textsuperscript{244} Id.

\textsuperscript{245} Mourning, supra note 179, at 1153.

\textsuperscript{246} Bebchuk, Shareholder Franchise, supra note 182, at 689; Edelman et al., supra note 179, at 1377.

\textsuperscript{247} Edelman et al., supra note 179, at 1377.

\textsuperscript{248} Bebchuk, Shareholder Franchise, supra note 182, at 689-90.
associated with control. Thus, a challenger that knows it would in fact perform better may still need to do a significant amount of work – and may still fail – to convince shareholders to vote its way.

Adding to the difficulty of convincing shareholders is the fact that many shareholders pay little or limited attention to the question of how to vote. While one externality problem leads rivals to underinvest in launching contests and running them, another externality problem leads shareholders to underinvest in assessing which slate of directors would be better: a shareholder would have to bear the full costs of such an investment in decision-making, but would share the benefits from an improved decision with fellow shareholders.\textsuperscript{249} One difficulty rivals have in this regard is that they generally are unable to give as complete a picture of their plans as the incumbents can. For shareholders assessing a slate of directors, one important consideration is the identity of the person who would serve under the directors as CEO.\textsuperscript{250} Shareholders know who the CEO chosen by the incumbents is, but rival teams may have difficulties specifying their CEO candidates in advance. Potential candidates for the CEO position may be executives in other companies. When incumbents wish to attract a new CEO, they can hold confidential discussions with such candidates. The willingness of the candidate to take the CEO position will be made public only when the board offers and the candidate accepts the position. In contrast, if a rival team of directors approaches such a candidate, the candidate may be reluctant to be named even if he or she is in fact willing to become CEO in the event of the rival's victory.\textsuperscript{251}

On a related note, many shareholders fail to vote at all.\textsuperscript{252} This failure to vote accords with rational choice theory: the likelihood that one vote will alter the election is miniscule, while the tangible benefit of the outcome of an election is modest for any given individual, so if the act of voting entails any cost at all, it will be inefficient to cast a ballot.\textsuperscript{253} The collective action/free-riding problem described above comes into play here as well. For shareholders to vote, they typically need enough economic incentive. Shareholders can increase their incentive to participate in the voting process by accumulating shares, thereby increasing voting’s expected benefits and reducing its uncertainties. This can make voting economically rational if its costs are not too high. This strategy only helps to a point, though: shareholders have finite wealth, which limits their ability to buy shares, while legal obstacles, such as the poison pill rules, may further effectively limit share ownership.\textsuperscript{254}

Finally, the traditional reluctance of certain institutional investors to vote against incumbents has also made it difficult for even highly qualified rival teams to attract sufficient support. Banks interested in attracting business from companies, for example, may be concerned that voting for a challenger may make it more difficult for them to get business from incumbents

\footnotesize{\textsuperscript{249} Id. at 692; Edelman et al., supra note 179, at 1379.}
\footnotesize{\textsuperscript{250} Bebchuk, \textit{Shareholder Franchise}, supra note 182, at 692.}
\footnotesize{\textsuperscript{251} Julian Velasco, \textit{The Fundamental Rights of the Shareholder}, Scholarly Works Paper 311, pg. 407, at pg. 423 (2006).}
\footnotesize{\textsuperscript{252} Edelman et al., supra note 179, at 1384.}
\footnotesize{\textsuperscript{253} Id.}
\footnotesize{\textsuperscript{254} Edelman et al., supra note 179, at 1387.}
in general or from the incumbents of the target company in particular. All of the above factors make it difficult for a rival slate of directors to win, and as a result, these factors also discourage rivals from mounting challenges in the first place. Given that rivals must bear the costs of running the challenge themselves if they fail, anything that operates to reduce the likelihood of winning also affects challengers’ willingness to initiate contests. Thus, the difficulties that even a superior rival slate faces in persuading shareholders to vote for it reinforce the current cost barriers to mounting challenges.

c. Administrative Issues

Professors Kahan and Rock have identified numerous weaknesses and inconsistencies in election administration that undermine the democracy of the shareholder voting system, including inaccurate shareholder lists, delays and omissions in ballot distribution, and incomplete vote tabulation by the subcontractor firms that run elections on behalf of public companies. Many of these problems are artifacts of an archaic voting system that was created early in the twentieth century when share ownership was based on physical possession of stock certificates and nearly all elections were uncontested. When the United States reorganized the formalities of share ownership in the 1960s and 1970s, on the basis of electronic registration, voting procedures were not modernized at the same pace.

Professors Kahan & Rock caution that without substantial improvements in election administration, growing conflict and uncertainty over the outcome of corporate elections seems inevitable, given the increasingly aggressive voting practices of major shareholders. They further note that even if an election’s outcome is not in doubt, managers and shareholders pay attention not only to the identity of the victor, but also to the vote totals on both sides. If votes are not counted accurately, then voting totals become noisier signals of shareholders’ preferences, undermining the value of corporate elections as a form of communication.

5. Recent Changes Facilitating Shareholder Voice

a. The Decline of Staggered Boards

255 Julian Velasco, The Fundamental Rights of the Shareholder, 40 U.C. DAVIS L. REV. 407, 417 (2006); Coffee & Palia, supra note 200, at 553 (noting that “large banks-both commercial and investment-did not want to alienate corporate clients”). The recent growth of institutional investor activism, particularly in the case of hedge funds, is explained by the funds’ holding in concentrated blocks in a limited number of companies (rather than a broadly diversified portfolio). Concentrated ownership makes shareholder activism rational from a cost/benefit standpoint, because larger holdings imply larger returns that can justify the costs of activism. Id.

256 Bebchuk, Shareholder Franchise, supra note 182, at 693.

257 For an overview of the voting administrative system, see Kahan & Rock, Hanging Chads, supra note 241, at 1232-49.

258 See Id. at 1253-55.

259 Id. at 1249-53.

260 Id. at 1251-53.

261 Id. at 1260-62.

262 Yermack, supra note 181, at 106.
A pro-incumbent practice that has declined in recent years is staggered boards. In a staggered board, directors are typically divided into three classes, and only one class comes up for reelection each year. To gain control of a company whose directors are protected by a three-class staggered board, a rival needs to win two elections, held at least one year apart. The need to win two elections discourages and impedes electoral challenges in two ways. First, it makes mounting a challenge costlier. Rivals need to run a slate of directors twice, which increases costs, and be prepared to sustain a campaign for more than a year. Furthermore, having to win two elections before gaining control makes it all the more difficult to specify during the campaign the identity of the CEO whom the rival directors will appoint if they gain control. That individual will have to sit on the sidelines for more than a year. Second, assuming that a rival team did mount a challenge to incumbents protected by a staggered board, the very existence of the staggered board makes it less likely that the rival will be able to win. In the first round, shareholders will recognize that a victory by the rival would lead to a period of at least a year in which the incumbents would still be in control but the board would have internal divisions and friction. As a result, shareholders may be reluctant to vote for the rival in the first round even if they view the rival's candidates as superior to the incumbents.

Although once popular, staggered boards have declined significantly in the past decade. In 2000, 300 of the S&P 500 had staggered boards, but as of the end of 2013, only 60 did. The decline is attributable both to a campaign led by Professor Lucian Bebchuk, whose Harvard Law School Shareholder Rights Project has sponsored numerous shareholder resolutions calling on boards to eliminate the staggered board, and to the growing influence of proxy advisors (and most notably Institutional Shareholder Services (“ISS”), which regularly supports proposals seeking to declassify the board and may oppose the board nominees of companies that maintain staggered boards).

b. Majority Voting

Under plurality voting — which, until fairly recently, was the default standard under most state laws — the candidate with the plurality of votes “for” is elected. In uncontested elections,
the plurality voting standard means that one vote “for” is sufficient for a nominee to be elected, irrespective of the number of votes “withheld.” The plurality voting standard, combined with the paucity of contested elections, has led to the observation that “corporate democracy in America has most often been a lot like Soviet democracy: the votes didn't really matter, because only one candidate was on the ballot and was assured of winning, whatever the voters thought.”

In the mid-2000s, shareholder activists began submitting non-binding shareholder proposals under SEC Rule 14a-8 calling for firms to adopt a majority voting standard. Initially, many issuers adopted a director resignation policy -- a board policy requiring each member or board nominee to submit a conditional offer to resign if the director did not receive a majority of the votes cast at the next election. Later on, issuers amended their bylaws or charters to adopt a majority standard for uncontested director elections. Under the strict majority standard, even in uncontested elections a director is not elected unless the majority of votes are cast in her favor.

Amendments to the DGCL in 2006 clarified that “[a] resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable.” This amendment permitted Delaware corporations to implement a majority vote regime by requiring its directors to submit an irrevocable resignation letter effective if the director does not receive a majority of the votes cast and the board accepts the resignation. The Delaware legislature also adopted changes permitting shareholders to adopt a bylaw, not subject to further amendment or repeal by the board, proscribing the voting standard for director elections. At approximately the same time, the ABA Committee on Corporate Laws adopted changes to the Model Business Corporate Act (MBCA) similarly facilitating majority voting.

by proxy at the meeting and entitled to vote on the election of directors”). See also Yonca Ertimur et al., Does the Director Election System Matter? Evidence from Majority Voting, 1 (2013).

<sup>271</sup> Under SEC rule 14a-4(b) shareholders can either vote “for” a director nominee or “withhold” their support.

<sup>272</sup> See, e.g., Lee Harris, Missing in Activism: Retail Investor Absence in Corporate Elections, COLUM. L. REV. 104, 120–21 (2010) (reporting that, over the time period from 1996 to 2008, the average number of contested elections at public companies was about thirty-six per year).

<sup>273</sup> Ertimur et al, supra note 270, at 2.


<sup>275</sup> Notably, even the strictest standard requires only that a director candidate receive a majority of votes cast. In contrast, some corporate issues, such as approval of a merger, require an affirmative vote by a majority of outstanding shares. See, e.g., DEL. GEN. CORP. L. §262.

<sup>276</sup> DEL. GEN. CORP. L. § 141(b)

<sup>277</sup> Becker & Subramanian, supra note 199, at 10.

<sup>278</sup> DEL. GEN. CORP. L. § 216.

Thanks in large part to these amendments, the move from plurality to majority voting for corporate directors has been a highly successful corporate governance reform effort. As recently as 2005, only nine of the S&P 100 companies used majority voting in director elections. The shift since then has been dramatic. By the end of 2007, about two-thirds of the S&P 500 had adopted some form of majority voting standard. As of January 2014, almost 90% of S&P 500 companies have adopted some form of majority voting.

The efficacy of majority voting has been questioned, however. Its proponents argue that “[m]ajority voting ensures that shareowners’ votes count and makes directors more accountable to the shareowners they represent.” Yet, the figures demonstrate that directors of companies with majority voting rarely fail to receive majority approval—as more rarely, in fact, than directors of companies with plurality voting. Moreover, even under a majority standard, a failure to be elected does not automatically mean that the nominee will be removed from the board. Under the default rule of Delaware and many other states, an incumbent director continues as a holdover director until his or her successor is elected or the director resigns or is removed. Thus, if an incumbent director fails to secure a majority of “for” votes, the director

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281 See, e.g., The United Brotherhood of Carpenters: A Record of Responsible and Productive Corporate Ownership Activism, undated white paper at 8, avail. at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=12&ved=0CCMQFjABOAo&url=https%3A%2F%2Fwww.carpenters.org%2FLibraries%2FCorporate_Affairs%2FUBC_Record_of_Responsible_Ownership_Activism_lri1.slfb.ashx&ei=zS1-ViaCSVpjASPkoCIAw&usg=AFQjCNyXQyExhS3Pzu08EcjpyJ7riSg3xQ&sig2=_y7Hxwrh_a1bg2waS3qCw (describing “‘private-ordering’ effort to establish majority voting [as] an overwhelming success.”). A provision calling for mandatory adoption of majority voting by all US publicly traded firms was included in the Senate version of the financial reform bill, but eventually dropped in the final version of the Dodd-Frank Act passed in 2010.
283 Marc S. Gerber, US Corporate Governance: Boards of Directors Face Increased Scrutiny, Skadden’s 2014 Insights – Governance, Jan. 16, 2014, http://www.skadden.com/insights/us-corporate-governance-boardsdirectors-face-increased-scrutiny. The implementation of the MV standard, however, was not uniform across firms. Some firms, particularly among the early adopters, following the example of Pfizer, introduced a “plurality plus” standard (plurality plus mandatory resignation) whereby a director failing to win a majority vote is elected (hence, the plurality standard is maintained) but must resign, with the board deciding whether to accept her resignation. Other firms, following the example of Intel, adopted a “majority plus” standard (majority plus mandatory resignation). Under this system, a director failing to win a majority vote is elected (hence, the “plurality plus” standard is maintained) but must resign, with the board deciding whether to accept her resignation. Moreover, even under a majority standard, a failure to be elected does not automatically mean that the nominee will be removed from the board. Under the default rule of Delaware and many other states, an incumbent director continues as a holdover director until his or her successor is elected or the director resigns or is removed. Thus, if an incumbent director fails to secure a majority of “for” votes, the director resigns or is removed.
284 Cai et al., supra note 275, at 119 (finding that “the adoption of majority voting has little effect on director votes, director turnover, or improving firm performance”).
286 Stephen J. Choi et al., Does Majority Voting Improve Board Accountability? 4 (working paper no. 310/2016, Mar. 2016). Under plurality voting, the likelihood that a director fails to receive a majority “for” vote is 20 times higher than under majority voting (0.6% versus 0.03%). Of over 24,000 director nominees at S&P 1500 companies who were subject to the majority voting rule in elections between 2007 and 2013, only eight (0.033%) failed to receive a majority of “for” votes. In fact, of the eight directors at majority voting firms who failed to receive a majority, only three actually left the board following the election.
287 See Mary Siegel, The Holes in Majority Voting, 2011 COLUM. BUS. L. REV. 364 (2011). Even when a director fails to receive a majority, that director may not actually leave the board. Rather, such a director stays on until a successor is elected, the director resigns, or is removed.
288 See, e.g., DEL. GEN. CORP. L. §141(b); but see Model Bus. Corp. Act §§ 8.05 & 10.22 (providing an abbreviated holdover period of ninety days for directors who are not reelected in a company that has adopted majority voting).
stays in office until the vacancy is filled or the director resigns. State statutes generally provide that, at least as a default matter, the board of directors has the authority to fill vacancies on the board. As a legal matter, nothing prevents the board from appointing the very person who failed to receive a majority of “for” votes to fill the vacancy. Thus, some commentators have described majority voting rules as “smoke and mirrors” because ultimately the board often has the power to retain a losing director.

Empirical studies have drawn mixed conclusions about the impact of majority voting standards on firm performance and corporate governance. An early study by Professors Sjostrom and Kim looked at stock price reactions to a firm’s adoption of majority voting and found no statistically significant market reaction. The study suggests that the lack of impact was due, in part, to failure of majority voting to give “shareholders veto power over incumbent directors.” Professors Cai and colleagues found that early adopters of majority voting experienced positive abnormal returns, but that this effect diminished over time. The study further found that the “adoption of majority voting has little effect on director votes, director turnover, or improving firm performance.” Importantly, although poorly performing firms were more likely to adopt a majority voting rule, their performance continued to deteriorate after adoption of majority voting. On the other hand, another study found that firms that adopted majority voting were more likely to implement shareholder proposals that, in turn, positively impacted stock price.

Professors Choi and colleagues identify several other factors may explain the persistence of board entrenchment even after adopting a majority voting standard. One possibility is self-selection – companies with “good” corporate governance self-select into adopting majority voting. Another is that majority voting makes directors more responsive to shareholder interests. A third possibility is that companies that have adopted majority voting may engage in more campaigning (“electioneering”) in close elections, whether by lobbying ISS not to issue a “withhold” or “against” recommendation or by targeting shareholders directly, since the implications of receiving a majority withhold votes are more severe. Finally, shareholders may be more reluctant to cast a negative vote when a failure to get a majority of “for” votes could result in the ouster of the nominee. Shareholders may perceive that a failed election at a company with a majority voting rule may interfere with board functioning or impact stock price and therefore be reluctant to cast a “no” vote.

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289 See, e.g., DEL. GEN. CORP. L. §223.
290 Id. at 487.
291 William K. Sjostrom, Jr. & Young Sang Kim, Majority Voting for the Election of Directors, 40 CONN. L. REV. 459 (2007) (conducting event study and finding no statistically significant market reaction to a company’s adoption of majority voting).
292 Id. at 463.
293 Id. at 486.
294 Cai et al., supra note 275, at 134.
295 Id. at 21.
296 Id. at 3.
297 Id. at 23-24.
Choi and colleagues find evidence that early adopters of majority voting (that is, companies who adopted majority voting between 2007 and 2009) had greater ex-ante electoral success and shareholder-responsive governance than companies that retained a plurality standard. Late adopters (2011-2013), on the other hand, tended to avoid the adoption of majority voting when they had sufficient ability to resist shareholder pressure. Although both early and late adopters saw an uptick in incumbent-friendly election results after switching to majority voting, Choi and colleagues suggest that the reasons for the effect may differ. For late adopters, they conclude that adoption of majority voting led to more shareholder-friendly governance either because of the heightened threat that a majority withhold vote would lead to ouster from the board or because the adoption of majority voting may have made boards more sensitive to shareholder concerns. For early adopters, by contrast, they find significant evidence of electioneering or shareholder restraint.

c. SEC Proxy Rules

For many years, the restrictive SEC proxy rules imposed significant costs on potential insurgents and chilled shareholder speech. Since 1992, however, the SEC has been gradually relaxing its proxy requirements. In 2007, the SEC promulgated its “eProxy” rules, which were designed to further reduce proxy costs to insurgents by eliminating the need to mail any proxy statement to shareholders. Instead, consistent with the SEC’s earlier-adopted “access-equals-delivery” model for registration statements in the public offering context, the proxy contestant needed only to email a short “Notice of Internet Availability of Proxy Materials” to shareholders that their proxy materials were available online at a website or at the SEC in order to comply. Thus, a proxy statement would be filed, but not mailed, and the proxy contestant saved significant costs, but could still file and seek proxy authority if the contest went the full distance to a vote. Then-SEC Commissioner Annette Nazareth stated that the cost savings generated by the eProxy rules would “help level the playing field between management and dissenting shareholders.”

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299 Factors demonstrating lack of responsiveness to shareholder concerns included managements’ view of existing board members as being at risk of receiving an ISS withhold recommendation and the presence of a poison pill. Choi et al., supra note 286, at 20.
300 Id. at 22.
301 Id. at 49.
302 Id. at 49-50.
303 See Coffee & Palia, supra note 200, at 559 (describing in brief the evolution of SEC proxy rules).
304 Instead, the proxy contestant could simply email a Notice of Internet Availability of Proxy Materials and leave it to the shareholder to seek out its proxy statement on the dissident’s website. See Securities Exchange Act Release No. 55, 146 (“Internet Availability of Proxy Materials”), 72 Fed. Reg. 4148, 4150-60 (January 29, 2007). The insurgent will have to mail or otherwise send its proxy statement to requesting shareholders, but such requests are few. This policy change followed the SEC’s earlier and similar decision in 2005 to move the distribution of prospectuses to a “notice equals access” model. See Securities Act Release No. 8591, 70 Fed. Reg. 44, 722, 44, 782-86 (August 3, 2005).
Some early commentators predicted that eProxy would lead to more contested director elections. Professor Jeffrey Gordon, for example, argued that shareholder activists should abandon their campaign for shareholder proxy access and dedicate their time instead to figuring out the nuts and bolts of conducting eProxy contests.\textsuperscript{309} According to Gordon, eProxy could provide a direct and effective substitute for shareholder proxy access.\textsuperscript{310} eProxy could also provide a meaningful substitute for withhold-vote campaigns, which (as described above) are given bite through majority vote requirements.

In contrast, Professors Becker and Subramanian found that out of the 148 insurgent candidates proposed at 41 different companies between 2009 and 2011, none made use of the eProxy method of solicitation.\textsuperscript{311} They attribute this result to retail investor behavior: investors are less likely to respond to proxy solicitations conducted via eProxy.\textsuperscript{312} According to Broadridge, the largest provider of brokerage processing services, 4.6% of retail accounts that received notice only via mail voted in 2010; 13% of retail accounts that received e-delivery voted; and 25.4% of retail accounts that received full packages voted. Although investors have gained more experience with eProxy and Internet voting in general, these trends did not change meaningfully in 2011–2012.

According to Becker and Subramanian, the Broadridge figures explain why insurgents have not taken up eProxy to run proxy contests “on the cheap.” Insurgents already face an uphill battle in any campaign against the incumbents, with many shareholders defaulting to management, and eProxy only makes the task harder by reducing response rates.\textsuperscript{313} Hard copies are less likely to be ignored; shareholders use the fact that someone has engaged in a costly mailing rather than a cheap email as a sorting mechanism to determine what they should pay attention to. In considering whether to use eProxy, insurgents must weigh the benefits of lower proxy solicitation costs against the costs of reduced turnout. The analysis by Becker and Subramanian suggests that the calculation has not weighed in favor of using eProxy.\textsuperscript{314}

d. Changes in Broker Rules

The majority of shares are held in “street name” by custodians, such as banks and brokerage firms, on behalf of their clients, the “beneficial owners” of the shares.\textsuperscript{315} When a company wants to solicit proxies for its annual meeting, it sends its proxy materials to the broker, who then must send the materials on to the beneficial owners for their votes.\textsuperscript{316} If beneficial owners do not return their vote preferences in time (so-called “uninstructed shares”), the broker


\textsuperscript{310} Id. at 487.

\textsuperscript{311} Becker & Subramanian, \textit{supra} note 199, at 14.

\textsuperscript{312} Id.

\textsuperscript{313} Id.

\textsuperscript{314} See Id. at 15.

\textsuperscript{315} Kahan & Rock, \textit{Hanging Chads}, \textit{supra} note 241, at 1234-35.

\textsuperscript{316} Id.; Becker & Subramanian, \textit{supra} note 199, at 16.
can vote the shares on behalf of the beneficial owner for “uncontested” issues. Historically, the election of directors with no opposing candidates was considered to be an “uncontested” issue. Brokers would routinely vote the uninstructed shares, virtually always for the incumbents, thereby increasing turnout and boosting support for the incumbent slate. Institutional shareholders would still vote their own shares in order to comply with the policies on voting of the Department of Labor and the SEC.

Then, in 2010, both the NYSE and the Dodd-Frank Act acted independently to change this landscape. In January 2010, the NYSE amended Rule 452, such that director elections would no longer be considered an uncontested issue. Because NYSE Rule 452 applies to all brokers that are members of the NYSE, this change applies to virtually all public companies, not just companies listed on the NYSE. Similarly, Section 957 of the Dodd-Frank Act bars brokers from voting shares held in their names without shareholder instructions in most circumstances.

The net impact is that the shares held by retail shareholders are less likely to be voted (as they tend toward passivity), thus giving greater relative weight to the voting preferences of institutional shareholders. In effect, in a vote to approve a merger or a vote on a shareholder proposal, management loses its previously built-in advantage based on brokers voting the shares of passive retail shareholders for management. Moreover, if the corporation’s own bylaws require a director to submit his resignation if the director fails to receive a majority of the votes cast (and such “majority vote” provisions are now widely prevalent), broker votes can no longer be counted for this purpose, thus increasing the insurgents’ chances to unseat an incumbent in a “withhold the vote” campaign.

e. Proxy Access

Traditionally, insurgent shareholders who wished to challenge management had to conduct a proxy contest to elect their own nominees to the corporation’s board. Although hedge funds increasingly wage proxy contests, they are an expensive proposition which deters most shareholders, including institutional shareholders, who do not themselves want to control (or risk

317 Becker & Subramanian, supra note 199, at 16.
318 For the old rule, see NYSE LISTED CO. MANUAL § 402.06, Rule 452 (N.Y.S.E. List. Co. Man.), 2003 WL 23737133 (permitting brokers to vote shares held in their name on an uninstructed, discretionary basis on routine matters). The New York Stock Exchange voted to change this practice even before the 2008 financial crisis but had to await SEC approval of its rule change. Approval came in 2009 and was effective for shareholder meetings occurring after January 1, 2010. See Kahan & Rock, Embattled CEOs, supra note 282, at 1015-18 (discussing discretionary voting by brokers on matters NYSE have determined to be routine); Kahan & Rock, Hanging Chads, supra note 241.
319 Kahan & Rock, Hanging Chads, supra note 241, at 1250.
320 Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08, 74 Fed. Reg. 33,293 (July 10, 2009).
321 Becker & Subramanian, supra note 199, at 18.
322 Section 957 of the Dodd-Frank Act amended section 6(b) of the Securities Exchange Act of 1934 to prohibit discretionary voting by brokers with respect to director elections and with respect to "any other significant matter" as determined by the SEC. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 957, 124 Stat. 1376 (2010).
323 Coffee & Palia, supra note 200, at 495.
324 Id.
being deemed to control) the target corporation, even if they might desire to change corporate policies. Thus, proponents of shareholder voice have long sought “proxy access,” which would grant shareholders holding a sufficiently large stake in a company the right to put their own candidates on the company’s own proxy statement.\footnote{Becker & Subramanian, supra note 199, at 3.}

Advocates of proxy access argue that allowing shareholder access to the ballot helps align shareholder desires with managerial incentives;\footnote{See, e.g., Lucian A. Bebchuk & Scott Hirst, Private Ordering and the Proxy Access Debate, 65 BUS. LAW. 329, 340 (2009).} its detractors denounce it as ineffective\footnote{Stephen Davis & Jon Lukomnik, Proxy Access: Don’t Get Caught Up in the Hype, COMPLIANCE WEEK (Nov. 1, 2010), at 501; Marcel Kahan & Edward B. Rock, The Insignificance of Proxy Access, 97 VA. L. REV. 1347, 1347 (2011) [hereinafter Kahan & Rock, Insignificance]. See, e.g., Martin Lipton & Steven A. Rosenblum, Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come, 59 BUS. LAW. 67 (2003).} or value-destroying.\footnote{See, e.g., Lucian A. Bebchuk & Scott Hirst, Private Ordering and the Proxy Access Debate, 65 BUS. LAW. 329, 340 (2009).} The shareholder activists and scholars describe proxy access as the most practical option and principal method to address the “shortcomings in corporate democracy,” namely the considerable obstacles to director removal and to holding directors accountable for decisions unfavorable to maximizing shareholder value.\footnote{Robert Sprague & Aaron J. Lyttle, Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy, 16 Stan. J.L. BUS. & FIN. 1, 19 (2010); see also Lucian A. Bebchuk, The Case, supra note 193, at 856.} There is longstanding disagreement, however, about the optimal vehicle for shareholder proxy access.\footnote{See generally Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 HARVARD L. REV. 1735, 1758 (2006) [hereinafter Bainbridge, Director Primacy] (advocating the status quo of limited shareholder voting rights, or a noaccess default); Jack Gravelle, Proxy Access for All Shareholders, 12 TRANSACTIONS: TENN. J. BUS. L. 173, 178 (2011) (promoting proxy access for all shareholders, not just majority holders); Brett H. McDonnell, Setting Optimal Rules for Shareholder Proxy Access, 43 ARIZ. ST. L.J. 67, 112-15 (2011) (discussing no-proxy-access default rules, penalty default rules, and altering rules as potential options); Reed T. Schuster, Rule 14a-11 and the Administrative Procedure Act: It's Better to Have Had and Waived, Than Never to Have Had at All, 95 MINN. L. REV. 1034, 1055 (2011) (advocating a Rule 14a-11 mandate to increase shareholder rights and improve corporate governance).} Two of the most debated options are a “private ordering” regime – essentially, allowing shareholders to propose a proxy access rule, with the default being no proxy access – and a “default” rule requiring proxy access.

Professor Bebchuk argues that the first option, private ordering, will fail to advance the end goal of increased shareholder involvement in director nominations. This is due to the power differential between management and shareholders with respect to employing governance initiatives.\footnote{Lucian A. Bebchuk & Assaf Hamdani, Optimal Defaults for Corporate Law Evolution, 96 NW. U. L. REV. 489, 492 (2002).} In particular, shareholders largely submit precatory proposals, rather than binding bylaw amendments; as mentioned above, management has the final say with regard to enactment of precatory proposals.\footnote{Lucian A. Bebchuk & Scott Hirst, Private Ordering and the Proxy Access Debate, 65 Bus. Law. 329, 340, 345 (2010).} Furthermore, with final implementation power, management may also place shareholders between a rock and a hard place by adopting a distortion of a submitted shareholder proposal and enacting a rule significantly more restrictive than those favored by the shareholders.\footnote{Id. at 347.} Thus, Bebchuk advocates an access default rule that would grant to shareholders
who meet certain minimum thresholds direct access to the proxy statement. Countering the argument that a SEC-chosen default rule will not be optimal for all companies, he argues that it is “more difficult for shareholders favoring proxy access to opt out of a no-access default than it would be for shareholders favoring no-access to opt out of a federal access regime.”\footnote{334}{Id. at 333-34. See also Bebchuk, The Case, supra note 193, at 868.}

In contrast, Professor Grundfest argues that an opt-in private ordering regime is preferable, because it allows shareholders to construct individualized proxy access proposals that fit their company’s needs.\footnote{335}{Joseph A. Grundfest, The SEC’s Proposed Proxy Access Rules: Politics, Economics, and the Law, 65 BUS. LAW. 361, 366 (2009).} Professor Grundfest is particularly critical of allowing the SEC, which has “no particular insight as to the preferences of the shareholder majority that might be viewed as value-maximizing at each company subject to the proxy access rules,” to decide the appropriate default rule.\footnote{336}{Id. at 366.} Rather, as stated directly by former SEC Commissioner Paredes, permitting shareholders to “include in the company’s proxy materials a bylaw proposal that would allow shareholders proxy access” would allow tailoring to company specifications in addition to any specific jurisdictional restrictions.\footnote{337}{Id. at 367 (citing Troy A. Paredes, Comm’r, SEC, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), available at www.sec.gov/news/speech/2009/spch052009tap.htm).}

On October 14, 2003 the SEC issued for public comment Proposed Rule 14a-11, the Security Holder Director Nominations Rule (the “Proposed Rule”).\footnote{338}{Patty M. DeGaetano, The Shareholder Access Teeter-Totter: Will Increased Shareholder Voice in the Director Nomination Process Protect Investors?, 41 CAL. W. L. REV. 361, 393 (2005).} The purpose of the rule was to “‘improve the ability of security holders to participate meaningfully in the nomination and election of directors . . . without unduly burdening companies . . . where . . . the proxy process may be ineffective.’”\footnote{339}{Id. at 393–94 (quoting Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,786 (proposed Oct. 23, 2003) (codified in 17 C.F.R. pts. 240, 249, 274)).} The concern driving the proposal of the rule was that the operation of the proxy rules did not provide shareholders an adequate voice in the election of the directors who were to represent their interests.\footnote{340}{See id. at 390.} Taking plurality voting under state law as given, the SEC planned to use the Proposed Rule to dismantle the other force contributing to the
lack of shareholder voice in the election of directors: the inability of shareholders to “bypass the nominating committee” and nominate their own directors in the company’s official proxy statement without having to wage a proxy contest and therefore without paying the associated expenses. In order to foster this proxy statement access, the Proposed Rule essentially allowed qualified shareholders—upon the occurrence of certain triggering events—to nominate less than a full slate of directors by placing his or her nominees directly into the company’s official proxy statement. The effect of the rule was to allow shareholders to initiate an election contest without having to prepare and distribute a proxy statement, which, as noted previously, entails a substantial cost.

Opponents of the Proposed Rule—including corporate directors, executives, law firms, and business groups—vociferously attacked it, on the basis that it was costly and unnecessary. Ultimately, the 2003 Proposed Rule was never enacted. But following the 2008 Financial Crisis, the SEC again attempted to introduce a proxy access rule. The SEC explained: “The nation and the markets have recently experienced, and remain in the midst of, one of the most serious crises of the past century. This crisis has led many to raise serious concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders, and has resulted in a loss of investor confidence.”

Under the proposed Rule 14a-11, a shareholder or shareholder group that owned more than 1% of a large U.S. public company, more than 3% of a midsize public company, or more than 5% of a small public company would have the ability to place nominees on the company’s proxy statement for up to one-quarter of the total board seats. In an effort to preempt or at least shape the SEC’s consideration of the proposed federal rule, Delaware amended its corporate code to confirm that shareholders could amend the company’s bylaws to permit proxy access. Section 112 of the DGCL, enacted in May 2009, provides that: “The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required . . . to include in its proxy solicitation materials . . . or more individuals nominated by a stockholder.”

342 DeGaetano, supra note 338, at 390.
343 The Proposed Rule defined a qualifying shareholder as one who beneficially owned five percent or more of the issuer’s equity securities, in addition to satisfying other holding-period and filing requirements. DeGaetano, supra note 338, at 396–97.
344 The “triggering events” were designed to target those companies at which there existed “evidence of ineffectiveness or security holder dissatisfaction with [the] company’s proxy process.” Id. at 395 (quoting Security Holder Director Nominations, 68 FR at 60,789–90). The triggering events were the following: (1) any of the company’s directors’ receipt of thirty-five percent or more withhold votes of those cast in a director election; or (2) a shareholder proposal submitted under Rule 14a-8 asking for the invocation of the Proposed Rule at the next annual meeting of the company, where the proposal received a majority of the votes cast by shareholders at the annual meeting. Id. at 395.
346 Mourning, supra note 179, at 1158–59.
347 Facilitating Shareholder Director Nominations, 74 FR
348 The proposed Rule defined a large public company as one with a market capitalization greater than $700 million, a midsized public company as one having market capitalization $75–$700 million, and a small public company as one with market capitalization less than $75 million.
350 DEL. CODE. ANN. tit. 8 § 112 (2009).
Section 112 reflects one application of the Delaware Supreme Court’s holding in CA v. AFSCME, handed down in July 2008, which permits shareholders to regulate procedural aspects of corporate governance (e.g., how decisions are made) but not substantive aspects, which are left to the board.\(^{351}\) Thus Section 112 provided for private ordering of proxy access, in line with Grundfest’s proposal.

The Dodd-Frank Act sought to empower institutional investors by authorizing a new system of “proxy access” under which a group of shareholders, who had held a defined percentage of the company's stock for a defined period, could add their own nominees to the corporation's own proxy statement and thus seek to elect a minority of the board at low cost.\(^{352}\) Responding to this new authority, the SEC adopted Rule 14a-11, a “default” proxy access rule, in 2011. Under the new Rule 14a-11, any shareholder or shareholder group that held more than 3% of a U.S. public company’s shares for more than three years would have been eligible to nominate candidates for up to 25% of the company’s board seats.\(^{353}\) But this rule was challenged by the Business Roundtable and promptly struck down by the D.C. Circuit Court of Appeals in 2011 on the ground that the SEC had not conducted an adequate cost-benefit analysis in adopting the rule.\(^{354}\)

The SEC chose not to appeal the D.C. Circuit Court decision.\(^{355}\) Instead, the SEC adopted an amendment to Rule 14a-8, effective from September 14, 2011, prohibiting companies from excluding from proxy materials shareholder proposals seeking to establish procedures for director nomination or election. As amended, Rule 14a-8 allows eligible shareholders\(^{356}\) to establish proxy access standards on a company-by-company basis. While companies can still exclude shareholder proposals to remove directors or include specific nominees in the company’s proxy statement, shareholders now can submit a precatory proposal to amend the company’s governance documents to provide for proxy access or that requests the board to implement proxy access.\(^{357}\) Since its amendment, there have been heated debates on the viability of Rule 14a-8 to actually enable shareholder access to the ballot.\(^{358}\)

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\(^{351}\) See CA Inc. v. AFS CME, 953 A.2d 227 (Del. 2008).


\(^{354}\) See Bus. Roundtable Inc. v. SEC, 647 F.3d 1144, 1146 (D.C. Cir. 2011).


\(^{356}\) Eligible shareholders are shareholders with 1% of the company’s shares or $2,000 of the company’s market value for 1 year. 17 C.F.R. § 240.14a-8(b) (2016).

\(^{357}\) Id. § 240.14a-8(a).

Rule 14a-8 specifies that “[u]nder a few specific circumstances, the company is permitted to exclude [the shareholder’s] proposal, but only after submitting its reasons to the Commission.”

But analyses of 2012 SEC no-action letters, addressing management requests to exclude shareholders’ proxy access proposals from the ballot, suggest that – at least initially – management had little trouble defeating shareholders’ attempts at implementing proxy access.

Rule 14a-8(i) embeds certain management exclusion powers, whereby management may exclude a shareholder proposal, if, for example, the company has “substantially implemented” them; “the proposal directly conflicts with one of the company’s own proposals;” or the proposal “deals with substantially the same subject matter as another proposal . . . previously included in the company’s proxy materials within the preceding 5 calendar years.”

Because of SEC adherence to Rule 14a-8(i) precedents, some have argued, management has a systematic advantage that in effect strips shareholders of any meaningful opportunity. On the other hand, another analysis of recent SEC no-action letters issued under Rule 14a-8 show that the number of proxy access proposals excluded by no-action requests declined significantly between 2012 and 2014.

f. Proposed Reforms – “Against” Votes

Professor Bebchuk has proposed a number of reforms aimed at increasing shareholder voice. Among them is the use of “for,” “withhold” and “against” votes in director elections.

Under current SEC rules, shareholders have the choice only between a “for” and a “withhold” vote in plurality-voting regimes, and between “for,” “withhold” and “against” in majority-voting regimes. “Withhold” votes, which were established to “provide greater opportunities for shareholders to exercise their right of suffrage,” were traditionally symbolic: in a plurality voting regime, a candidate with a single “for” vote and a hundred “withhold” votes could be elected. When the SEC first introduced the “withhold” category, its primary aim was to decouple director elections from shareholder votes on other corporate matters.

In 1979, the commission proposed to establish a “vote against” category that “would not change state law,” but “would nevertheless permit shareholders to express their opposition to candidates more clearly than is
provided for under the current rules.” The SEC retreated from this proposal, however, on the grounds that “an ‘against’ vote may have questionable legal effect and therefore could be confusing and misleading to shareholders.” Instead, it revamped SEC Rule 14-a4(b)(2) to permit shareholders to withhold votes against individual directors. It also added that

If applicable state law gives legal effect to votes cast against a nominee, then in lieu of, or in addition to, providing a means for security holders to withhold authority to vote, the registrant should provide a similar means for security holders to vote against each nominee.

Currently, companies employing a plurality voting standard should allow shareholders to cast either a “withhold” or “for” vote, while companies using a majority voting standard should allow a “withhold,” “against,” or “abstain” vote. According to the SEC, how an “abstain” vote impacts a director’s election is up to the company, but each company must disclose how “abstain” or “withhold” votes affect an election in its proxy statement. Companies have often failed to follow these guidelines in drafting proxy statements, however, leading to confusing and inaccurate disclosures. Proposals using a plurality voting standard have erroneously offered an “against” option when the only options should have been “for” and “withhold;” proposals using a majority voting standard have erroneously omitted an “against” option; some companies have failed to explain the effect of a “withhold” vote; and some companies have referred to their “plurality-plus” voting standard as a majority standard. The SEC is considering whether to promulgate a rule addressing voting standard disclosures in proxy statements.

Although majority voting rules typically seek to prevent or constrain the election of directors who receive more “against” than “for” votes, Professor Bebchuk argues that, in addition to a majority voting approach, companies should be required to provide for “for,” “against” and “withhold” votes on their proxy statements. Allowing only “for” and “against” votes, or “for” and “withhold” votes, would ignore the possibility that shareholders voting “against” or “withhold” on a candidate might be seeking to register a signal of dissatisfaction rather than prevent the candidate’s election. In a system allowing both “withhold” and “against” votes, Professor Bebchuk argues, shareholders wishing to register dissatisfaction but willing to allow the candidate to serve will cast a “withhold” vote, whereas shareholders who prefer to block the

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370 Legal commentators argued that “shareholders might be misled into thinking their ‘against’ votes should have an effect when, as a matter of substantive law, such is not the case since such votes are treated simply as abstentions.” 44 FR 68764, 68765.
373 Id.
376 Bebchuk, Shareholder Franchise, supra note 182, at 701.
director’s election will cast an “against” vote. Under Professor Bebchuk’s proposed arrangement, directors will be prevented from serving only when a majority of the voting shareholders clearly prefers that outcome over merely sending a warning signal to the board.

IV. Empirical Evidence

This section presents our hypotheses, data, methodology and empirical evidence regarding the role of outside shareholders in preventing stock option manipulation. Our evidence shows that the presence of outside directors did not reduce the either corporate fraud or malfeasance by the board itself during our sample period extending from 1996 to 2015.

A. Securities Class Action Lawsuits

We start by examining the number of securities class action lawsuits that were either settled, dismissed or are on-going. We obtain this evidence from the Stanford Class Action Clearing House (SCAC). A securities class action contains allegations of violations of federal or state securities laws.

[Please insert Table 1 here]

SCAC keeps track of about 4,000 class action lawsuits since the Private Securities Litigation Reform Act of 1995 has been passed. The total number of cases filed, settled, dismissed or on-going is shown in Table 1. The total number of lawsuits filed is 1,407 for the 1996-2000 time period, while the number of cases settled is 588 or 64.1% of the total. The number of cases settled for $10 million or more equals 212 or 23.1% of the total.

Looking at the post-SOX period between 2002 and 2008, we see that the total number of lawsuits decided is 1,116, and the number of cases settled is 580 or 52.0% of the total cases decided. The number of cases settled for $10 million or more equals 254 or 22.8% of the total cases decided, which is very similar to the pre-SOX period. The dollar volume of settlements shows similar patterns. All settlements average $3.6 billion per year pre-SOX and $3.3 billion post-SOX period. For large settlements (more than $10 million), the corresponding figures are $3.3 billion per year in the pre-SOX period and $3.1 billion in the post-SOX period. Hence, there is no sign of abatement in the number or dollar amount of settled cases during the post-SOX period. Consequently, SOX does not appear to be leading to better corporate governance.

B. Malfeasance of the Board

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377 Id. at 702.
378 Id.
379 We restrict our post-SOX time period to 2003-2008 to abstract from the large number of on-going cases during the post-SOX period.
Next, we investigate whether malfeasance by the board itself has declined following SOX. To explore this issue, we revisit the options backdating scandal of 2006 and extend our time period to 2015. We explore whether executives manipulate the timing of option grants or timing of information flows to benefit themselves during the post-SOX period. If executives have positive information around their option grants, they can delay the public announcement of news until after executive options are granted in order to benefit their compensation. This activity is called spring-loading. If executives possess negative information around their option grant time, they can expedite the release of negative information to a date earlier than information release in order to benefit their compensation. The early release of negative information reduces the stock price and thus the exercise price of the options. This activity is called bullet-dodging.

The dating hypothesis is linked to backdating and forward-dating of stock options. Backdating suggests that executives change the date of options grants to an earlier date when stock price was at minimum. It is straightforward to test this hypothesis, because if there is a change in the grant date, grant date will be reported with delays. There is a positive relationship between the length of delays and the amount of stock price bounce since the grant date. Forward-dating suggests that if the stock price has been falling since grant date, executives may the incentives to wait to see if the price will fall further. Forward dating is more difficult to test, since there is automatic bounce in price between the grant date and the reporting date. Nevertheless, forward dating hypothesis also predicts a stock price decline prior to option grant date.

To test these hypotheses, we obtain option grant data from Thompson Reuters database, which contains all option grants to executives and directors including inside and outside directors in all publicly listed firms in the United States. The database contains identifying information of firms, identifying information of executives, number of shares granted, underlying security of the option, grant date and reporting date. Since the Thompson Reuters Table 2 database starts at 1996, we limit analysis period to January 1, 1996 to December 31, 2015. We collect daily returns of underlying company stocks and value weighted market index from CRSP.

We analyze three sub-periods that represent different eras in executive compensation literature. The first sub-period is the pre- SOX period, between January 1, 1996 to August 31, 2002. There is no regulation about stock option backdating in this period. The second period, scandal-period, is between September 1, 2002 to December 31, 2006. The feature of this period is the high number of backdating scandals. The last period is January 1, 2007 to December 31, 2015 period, which is named as post- scandals period.

Table 2 shows number of grants, number of firms and number of options granted for top executives and inside and outside directors. We report these numbers separately for promptly reporting and delayed reporting for each group. Total number of options granted for inside directors and top executives is 40,914.5 million, and for outside directors is 8,460.4 million for

381 Avci, Schipani & Seyhun, supra note 380.
the whole sample period. Of these totals, 21,697.3 million options were granted in the pre-SOX period; 9,713.5 million options were granted in the backdating scandals period; and 17,964.10 million options were granted in the post-scandal period. Also, 29,885.8 million options were reported promptly, while 19,489.10 million options were reported late during the whole sample period.

[Please insert Table 2 here]

In the pre-SOX period, delayed reported number of grants, number of firms and number of options are much higher than those for promptly reporting option grants. Only one fifth of top executives and inside directors report their options promptly while this ratio is one third for outside directors. This relationship reverses after SOX. The number of promptly reported grants, firms and options inflates while number of delayed grants, firms and options mitigates in post-SOX period. Prompt reporting increased up to 90% of all option grants for both insiders and outsiders. This trend continues in the post-scandal period. Nevertheless, even in the post-scandal period, about 3% of all option grants are late reported.

We use event methodology to measure the abnormal returns around event dates. Event dates are option grant dates. We measure 90 days of cumulative market-adjusted abnormal daily stock returns (CAR) before the event date and 90 days of CAR after the event date. For all summary statistics, the unit of observation is the individual grant.

We define abnormal returns as the difference between the daily returns for firms with the option awards to executives and the value weighted index of NYSE, AMEX, NASDAQ, and ARCA. This approach controls for market movements and implicitly assumes the average beta or risk-exposure is one. Our sample contains more than 6,000 firms; therefore, we can safely claim that this assumption is satisfied. Abnormal return $AR_{it}$ for stock $i$ and day $t$ is computed by a market adjusted model as:

$$ AR_{it} = (R_{it} - R_{mt}) $$

For each firm $i$ and day $t$, where $R_{it}$ is the simple daily return on the stock option $i$ awarded to insiders on day $t$. $R_{mt}$ is the daily return on the value weighted index of stock market. For each event date $t$, these returns are first averaged across all option granting firms $i$ to compute average abnormal returns:

$$ AAR_t = \frac{1}{n_t} \sum_{i=1}^{n_t} AR_{it} $$

The average abnormal returns are the cumulated across the event dates as follows:

$$ CAR_t = \sum_{t=1}^{T} AAR_t $$

These cumulative abnormal returns are then graphed to examine the behavior of abnormal returns around option granting dates. In Figures 1 through 6, abnormal returns are computed using market adjusted model. Day 0 refers to grant day. Day 90 refers to the ninetieth trading day after the grant date, while day -90 refers to the ninetieth trading day before the grant date.
We group insiders into two groups: Executives and inside-directors; and outside-directors. Inside-directors are those who combine the title of director with the title of office. An example is OD (officer-director). The title of outside directors is directors is simply given as D. To highlight the emphasis by SOX, on outside directors, we combine executives and inside-directors in one group called executives and contrast this group with non-executive outside-directors.

Figure 1 shows the mean CARs from 90 trading days prior to the grant date (date 0) to 90 days after the grant date for executives and inside directors (insiders) versus outside directors during the pre-SOX period (January 1996- August 2002). As can be seen from Figure 1, stock prices form a V-pattern for all insiders’ option grants, either prompt or late reported. The presence of the V-pattern indicates that option timing games were prevalent during the pre-SOX period.

Furthermore, Figure 1 indicates that the late reported options have higher post-grant returns than promptly reported options. This pattern holds for both executives and outside directors. This finding indicates that backdating was also prevalent prior to SOX.

Finally, Figure 1 shows that the post-grant returns are much smaller for outside directors than for insiders. This pattern holds true to both prompt and late reported option grants. This finding indicates that outside directors are involved with manipulative compensation games to a lesser extent than the executives during the pre-SOX period.

The specific numbers are as follows: Executives enjoy a post-grant bounce of 7.8% and 9.2% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 1.4% can be attributed to option-timing games, while 7.8% can be attributed to information timing games.

The comparable figures for the outside-directors are as follows: Outside-directors enjoy a post-grant bounce of 3.7% and 7.0% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 3.3% can be attributed to option-timing games, while 3.7% can be attributed to information timing games. Overall, this evidence is consistent with the hypothesis that outside directors were involved in compensation manipulation games albeit to a slightly lesser degree than executives themselves. Furthermore, more of the compensation games involved manipulating information flows than blatant backdating of option grant dates.

The remaining titles include the chairman of the board (CB), vice chairman (VC), assistant vice president (AV), chief executive officer (CEO), chief financial officer (CFO), chief investment officer (CI), chief operating officer (CO), chief technology officer (CT), executive vice president (EVP), officer (O), officer and treasurer (OT), divisional officer (OX), president (P), senior vice president (SVP), vice president (VP), secretary (S), controller (C), controlling person (CP), indirect shareholder (DS), founder (F), former (FO), general manager (GM), general partner (GP), limited partner (LP), managing partner (M), managing director (MD), other executive (OE), treasurer (TR), and members of the various board members.
Figure 2 shows the abnormal profits of insiders and outsider-directors for during the post-SOX, options option-dating scandal period of September 2002 to December 2006. We notice that the post-grant stock price bounce is much higher here for all groups: Executives enjoy a post-grant bounce of 4.6% and 14.9% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 10.3% can be attributed to option-timing games, while 4.6% can be attributed to information timing games. Thus, option timing games appear to be much more prevalent during this time period.

The comparable figures for the outside-directors are as follows: Outside-directors enjoy a post-grant bounce of 4.6% and 10.3% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 5.7% can be attributed to option-timing games, while 4.6% can be attributed to information timing games. Overall, this evidence is consistent with the hypothesis that outside directors were involved albeit to a slightly lesser degree than executives in compensation manipulation games.

This evidence flies in the face of the intended purpose of SOX, which designated the outside directors as the gatekeepers to serve as a check on the top management. The outside directors clearly do not appear to fulfill this purpose. Instead of acting as a check on the top management, outside directors appear to benefit from both information-flow as well as option grant timing games almost as much as the top executives themselves.

We now turn to the post-scandal period of 2007 to 2015. Figure 3 shows abnormal profits of insiders and outsiders for the post-scandal period. Figure 3 shows the compensation games continue during the most recent, post-scandal period. Executives still enjoy a post-grant bounce of 3.8% and 4.1% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 0.3% can be attributed to option-timing games, while 3.8% can be attributed to information timing games. Thus, once-again, information-timing games appear to be much more prevalent during this time period.

The comparable figures for the outside-directors are as follows: Outside-directors enjoy a post-grant bounce of 3.8% and 7.5% abnormal returns following the grant date for promptly-reported and late-reported option grants, respectively. The difference between these two groups, or 3.7% can be attributed to option-timing games, while 3.8% can be attributed to information timing games. Overall, this evidence is consistent with the hypothesis that outside directors were involved as much if not more so than the executives in compensation manipulation games.

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383 We call this period as post-scandal period because the scandals were revealed in 2006.
Once again, the significant post-grant returns that are captured by the outside-directors indicate that SOX has not worked as intended. Outside-directors are not providing sufficient checks and balances on the top management to prevent option timing games even in the post-scandal period. To investigate the extent of these games, we now restrict our attention to very large option grants involving more than 100,000 shares. The evidence for large grants are shown in figures 4, 5 and 6.

[Please insert Figures 4, 5 and 6 here]

Our evidence for the large grants shows similar but higher abnormal returns. The fact that the post-grant date abnormal returns increase even more for larger grants further corroborates the conclusion that these stock return patterns are not random, but rather they are deliberate and planned. On net, our evidence does not corroborate outside-directors as providing checks and balances on the top management either before or after SOX.

V. Proposals for Reform

Our evidence shows that SOX has not been effective in improving corporate governance. It has not reduced the overall fraudulent activity. The number of class action lawsuits has not decreased significantly since SOX was passed. Furthermore, the large volume of large settlements has not declined. Our evidence also shows that SOX has not reduced manipulative activity by the board itself. Overall, our evidence indicates that the responsibilities placed by SOX on the outside directors do not appear to work as intended.

Our recommendation is placing more emphasis and power on the shareholders themselves. Instead of placing almost exclusive emphasis on the board of directors as the gatekeepers for the top management, we need to strengthen corporate governance by strengthening the monitoring role of the shareholders. While not all shareholders will be interested in providing a monitoring role, large shareholders will certainly benefit from enhanced shareholder rights.

We suggest a number of reforms that can enhance shareholder rights. First, the recent trend towards multi-class control structures with unequal voting rights should be checked. Some recent IPOs have involved giving zero shares to outside shareholders. Firms that have recently adopted multi-class shareholder structure with unequal voting rights include Berkshire Hathaway, Google, LinkedIn, Zynga, Groupon and Facebook. There is also evidence that the shareholder returns suffer in controlled firms.384

Second, shareholder voting rights can be strengthened by making shareholder by-law resolutions binding on the board of directors. Currently, SEC requires that public companies

include shareholder proposals in its proxy statements.\textsuperscript{385} However, these proposals are non-binding recommendations to the board of directors. Furthermore, corporations typically exclude these proposals under any one of 12 specific reasons, such as “improper under state law.”\textsuperscript{386} Even if passed by the shareholders, these resolutions may not be adopted by the board of directors for any number of reasons. Binding by-law resolutions would give direct control to the shareholders to assert their interests over the board of directors and top management.

Another important recommendation is majority-vote requirement for the election of the board, instead of the current plurality rule. The current rule does not permit shareholders to vote against a nominee. They can only withhold their vote if they are unhappy with the candidate. Theoretically, if there is no competing nominee, a person can be elected to the board with a single vote. Majority voting can be further strengthened by requiring that if any director does not receive majority of the votes, that the director must resign immediately and a new proxy must be held to determine the replacement director. Having an effective majority requirement however would eliminate these outcomes and increase shareholder power over the election of the board.

Conclusion

In this study we examine the monitoring role of outside directors. SOX has placed special emphasis on independent board members to control and monitor the top management. Our evidence presented in this article has shown that outside directors are not fulfilling this requirement as SOX intended.

First, we investigate the number of class action lawsuits and the dollar value of settlements from 1996 to 2015. We find no sign of abatement in either the number settled cases or the dollar amount of settlements during the post-SOX period as compared to the pre-SOX period. Consequently, the specific provisions of SOX do not appear to be leading to better corporate governance – by reducing lawsuits against the corporations.

Second we examine direct malfeasance by the board itself. In this regard, we investigate the timing and backdating of executive compensation options between 1996 and 2015. In this study, we find that outside directors receive manipulated their option grants like the top executives do. Similar to options given to the top managements, outside directors use dating and timing techniques to manipulate stock options granted. Our evidence shows that they employ back-dating, spring-loading and bullet dodging games to increase the value of their options. Back-dating among other techniques provides remarkable profits to outside directors. Application of these techniques for late reported grants increase outside directors’ compensation by substantial amounts. Specifically, management received extra compensation amounts of 9.2%, 14.9% and 4.1% for the 1996-2002 period, 2003-2006 period; and the 2007-2014 period, respectively. For outside directors, the comparable numbers are 7.0%, 10.3%, and 7.5%, respectively. For large late reported option grants, abnormal returns increase even further.

\textsuperscript{385} See SEC Rule 14a-8.
Our evidence strongly suggests that outside directors are not fulfilling the monitoring responsibility placed on them by SOX. We recommend that the solution lies not in strengthening the board of directors, but by strengthening the power of the shareholders. We make three specific recommendations: First, we recommend that multi-class voting structures should be eliminated. The multi-class voting structures exacerbate the conflict between shareholders and the management and lead to inferior outcomes. Our second recommendation is to make the shareholder resolutions binding on the board of directors. Currently, management typically ignores the non-binding shareholder resolutions. Finally, we recommend that plurality voting be eliminated and replaced by majority voting for the board of directors. Majority voting shifts the relative power to elect the directors away from the management to the shareholders themselves.
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<th>Number of On-going Cases</th>
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Table 2: Sample Characteristics of Insider Trading by Periods

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<td>Pre-SOX Period 1/1996 - 8/2002</td>
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<td>Delayed Reporting</td>
<td>26,902</td>
<td>1,576</td>
</tr>
</tbody>
</table>
Figure 1: Abnormal returns around option grant days, pre-SOX, by title and reporting delays

- Executives, late reported
- Executives, Promptly reported
- Outside Directors, late reported
- Outside Directors, promptly reported
Figure 2: Abnormal returns around option grant days, 2002-2006, by title and reporting delays

- Executives, late reported
- Executives, promptly reported
- Outside Directors, late reported
- Outside Directors, promptly reported
Figure 3: Abnormal returns around option grant days, 2007-2015, by title and reporting delays

Abnormal returns around executive option grants

Days relative to option grant date

-12.00%
-10.00%
-8.00%
-6.00%
-4.00%
-2.00%
0.00%
2.00%
4.00%
6.00%
8.00%
10.00%

-90 -80 -70 -60 -50 -40 -30 -20 -10 0 10 20 30 40 50 60 70 80 90

Executives, late reported
Executives, Promptly reported
Outside Directors, late reported
Outside Directors, promptly reported
Figure 4: Abnormal returns around option grant days, pre-SOX, large grants, by title and reporting delays

- Executives, late reported
- Executives, Promptly reported
- Outside Directors, late reported
- Outside Directors, promptly reported
Figure 5: Abnormal returns around option grant days, 2002-2006, large grants, by title and reporting delays
Figure 6: Abnormal returns around option grant days, 2007-2015, large grants, by title and reporting delays