“Adverse-Selection in Corporate Governance Choices”

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Note: It is expected that you will have reviewed the speaker’s paper before the seminar (though she will be given 30 minutes to discuss it at the seminar). Because it is longer than usual, here is a reader’s guide to what should be focused on if you do not have time to read the whole paper: read sections I, IIIC (new theoretical framework), IV (focusing on subsections A, D, and E).
Adverse-Selection in Corporate Governance Choices

Michal Barzuza*

It is commonly argued that one-size does not fit all in corporate law and governance. Independent directors, majority voting, proxy access, compensation structures and disclosure obligations benefit some firms more than others. While it is widely accepted that firms’ needs for governance vary, potential effects of such variations on firms’ choice of governance haven’t been analyzed rigorously.

This Article analyzes choice of governance terms by firms with heterogeneous needs, and shows a potential inefficient self-selection: Firms that could benefit most from governance constraints are precisely the ones that are less likely to adopt them. Governance constraints are most valuable for shareholders of firms that face weak market forces. Yet, at the midstream stage weak market forces would not suffice to incentivize managers, particularly ones that extract high private benefits, to voluntarily commit to strict governance. At the IPO stage, governance terms should add high premium to firms that face weak market forces. Yet, since variations in market forces are not fully observable, investors will pay only an average value for these terms. Due to adverse selection at the IPO, firms that could benefit most from governance constraint will not adopt them.

Evidence from a wide range of contexts and different studies is consistent with inefficient self-selection: firms that benefited most from a majority of independent directors did not have it pre-SOX; firms’ inclination to cross-list on US exchanges is negatively correlated with their potential benefits from it; firms that could benefit from legal constraints are more inclined to choose Nevada lax fiduciary duties, firms that were quick to adopt majority voting were the ones for whom voting rules did not matter much. Managers of firms that could benefit most from proxy were more likely to attempt to exclude a proxy access shareholder proposal, replace them with their proposals, and ask for no-action letters from the SEC.

Overlooking this inefficient self-selection pattern lead to misinterpretation of evidence regarding the effects of corporate law and governance. The Article discusses implications for data interpretation and policy. Since both theory and evidence analyzed here raise a concern that firms with lax external and internal controls opt for lax law and governance, a regime that requires firms to choose among alternative minimal packages of law and governance terms could potentially improve on private ordering.

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I. Introduction

It is commonly argued that in corporate law one size does not fit all. Independent directors, majority voting, proxy access, compensation structures, disclosure obligation, benefit some firms more than others. While heterogeneity had significant influence on corporate law theory and policy, its potential effects on firms’ choice of governance haven’t been analyzed rigorously. This Article analyzes choice of governance by firms with heterogeneous needs. It shows by both theory and evidence how adverse selection in choice of law and governance results in inefficient tailoring.

Firm heterogeneity has been an essential block of the theoretical framework of corporate law, the contractual theory of the firm, which asserts that corporate law should be left to private ordering. Under this approach, market forces and IPO pricing provide managers with incentives to offer corporate law and governance term that maximize firm value. And since no one contract fits all corporate law should be merely enabling. Heterogeneity thus provides the normative support for private ordering in corporate law.¹

This reasoning has been the major argument against corporate reforms such as Proxy access rule,² Sarbanes and the listing standards’ directors’ independence requirements,³

¹ See e.g., Jonathan R. Macey, Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective, 84 CORNELL L. REV. 1266, 1279 (1999) (“Corporate law should be enabling rather than mandatory because there are limits to the cookie-cutter approach reflected in the standard-form rules that constitute state corporate law.”)

² “a company and its stockholders would benefit from the flexibility to adopt the type and form of proxy access standard that best reflects the will of the stockholders, rather than a uniform, one-size-fits-all standard under proposed Rule 14a-11.”
http://www.sec.gov/comments/s7-10-09/s71009-212.pdf

“A company’s shareholders or its board reasonably could conclude, based on the company’s circumstances and a thoughtful weighing of the costs and benefits, that proxy access is not necessary or is not in the best interests of the company and its shareholders...”

Leo E. Strine, Jr., Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on A Responsible Path Forward, 63 BUS. LAW. 1079, 1098 (2008)

letter from Delaware Bar

“single [proxy access] rule would unnecessarily deprive Delaware corporations of the flexibility state law confers to deal effectively with myriad different circumstances that legislators and rulemakers cannot
Dodd-Frank disclosure obligations, and even the 33 and 34 securities acts. This reasoning arguably justifies the entire enabling structure of U.S. corporate law—why it primarily offers firms a set of rules that they can adopt or reject.

Yet, even though heterogeneity in firms’ needs for governance has always been a significant part of the theoretical framework, and despite its significant influence on policy, it hasn’t been incorporated rigorously to corporate law theory, or systematically assessed against the evidence. Particularly, potential effects of such variations on firms’ choice of governance haven’t been examined. Contractarians simply assume that market forces and IPO prices provide incentives to managers and founders to offer governance terms that best fit their own circumstances. For contractarians that is true regardless of whether firms are homogenous or heterogeneous.

Contractual theory has clear testable predictions for the particular choices that different firms should make. Yet, despite their heavy reliance on efficient self-selection, until recently no study examined these predictions, or even the basic question: who are the firms that under private ordering choose governance constraints. Rather, contractarians merely point to non-uniform adoption of governance terms by different firms as an indication that private ordering works.

This paper analyzes choice of governance by firms with heterogeneous needs and finds that it could result in inefficient self-selection: firms that could benefit most from legal constraints are precisely the ones that are less likely to adopt them. Firms that are more likely to adopt governance constraints are the ones for whom they do not matter anticipate, and would thereby undermine a key element of the state system of corporate governance that has been largely successful for decades.” The Delaware State Bar Association’s comment letter further noted that

3 See e.g., Jonathan R. Macey, Corporate Governance: Promises Kept, Promises Broken. (“Because not all firms are the same, and different companies have different corporate governance needs, some firms undoubtedly will be better-off with a hoard structure favoring directors who specialize in monitoring, while other hoards will be better-off with a hoard structure that favors directors who specialize in management. This, in turn, strongly implies that private contracting, rather than one-size-fits-all government regulation, should determine the lob description of corporate directors.”)

4 “This mandated intrusion into corporate governance will impose substantial compliance costs on companies, along with a one-size-fits-all approach that will likely result in a one-size-fits-none model instead. This stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.”

http://www.sec.gov/News/Speech/Detail/Speech/1370541315952

5 Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359, 2396 (1998). (“A default system would clearly be more desirable than the present one-size-fits-all regime, which is difficult to change because consensus must be developed among all participants regarding a new rule, even if their needs are quite different.”); Donald C. Langevoort, The Sec, Retail Investors, and the Institutionalization of the Securities Markets, 95 VA. L. REV. 1025, 1065-66 (2009) (“The costs and benefits of disclosure rules are difficult to parse through, and vary considerably based on the size, structure, and business of the issuer. Many forms of governance are substitutes for each other; one size does not fit all.”)


7 Cf. Michael Klausner, Fact and Fiction in Corporate Law and Governance, 65 STAN. L. REV. 1325, 1330 (“A second reason the contractarian theory has failed to fit the facts is that the contractarians paid little attention to actual corporate contracts.”).
much. Part III develops a theoretical framework for firms with heterogeneous needs. Governance terms such as independent directors, majority voting, proxy access, or disclosure obligations, are most valuable for firms that face weak market forces. For these firms governance terms would substitute for the lack of market discipline. Yet, at the midstream stage, managers who are subject to weak market forces would suffer only weak consequences for choosing lax terms. Furthermore, if the firm faces weak market discipline, its managers have high opportunities to extract private benefits, that is, more to lose from strict governance. At the IPO stage the uniform contractarian model does not hold either. At the IPO stage, governance terms should add high premium to firms that face weak market forces. Yet, since variations in market forces are not fully observable, investors will pay only an average value for these terms. Due to adverse selection at the IPO, firms that could benefit most from governance constraint will not adopt them. Signaling is available only under certain assumptions, and noise from network externalities, boilerplating, inertia and other forms of random adoption obscures the informational value of the signal. Second, in the midstream stage, inefficient tailoring, can result even if investors have full and perfect information. Thus, in a separating equilibrium, low agency costs firms signal their type by adopting governance terms they do not need much.

Part IV then synthesizes a significant body of evidence, from different studies, in a broad array of applications: board independence, executive compensation, voting, cross-listing on U.S. exchanges, and choosing a firm’s state of incorporation. The evidence is frequently not consistent with efficient self-selection. Rather, consistent with the theory proposed here, in different contexts, firms seem to adopt governance constraints when they do not matter much to them. Firms that need constraints, are the least likely to adopt them.

When SOX and the exchanges’ listing standards required listed firms to have a majority of independent directors, they were heavily criticized both for applying a one-size-fits-all approach, and even more so, for acting with no supporting evidence. Prior to SOX, studies did not find that a majority of independent directors was associated with a higher firm value. The critique implicitly assumed that firms that did not have majority of independent directors under private ordering, would not benefit more from it than the ones that already did. But recent studies show that the firms that were required to add independent directors due to SOX mandate improved their operational performance on several different measures. Thus, firms that benefited most form board independence are precisely the ones that did not adopt it voluntarily.

The proliferation of majority voting terms is the recent poster child of private ordering. Yet, a recent study finds significant differences between early adopters and late adopters of majority voting. Early adopters disproportionally included firms that did not experience significant withhold votes in previous years—that is, firms for which it did not really matter. Firms in which shareholders needed majority vote resisted as long as they could. Not surprisingly, in these latter firms, majority voting also mattered more in

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8 See, e.g., Mark J. Roe, Rents and Their Corporate Consequences, 53 STAN. L. REV. 1463 (2001) (arguing that increased monopoly rents induce higher potential agency costs).
that it. Similarly, evidence on proxy access shareholder proposals show that managers resist these proposals most, and adopt different techniques to exclude them in firms that could benefit most from proxy access. Likewise, ill designed compensation schemes that merely reward luck or otherwise fail to establish sufficient incentives for managers to achieve long-term success (for example, backdating options), were frequent in firms that face weak market and governance constraints, that is firms that could benefit from well designed compensation schemes.

Private ordering of foreign firms, via cross-listing on U.S. exchanges also is not consistent with efficient self-selection. Firms that cross-list from countries with weak investor protection, disclosure obligations, and legal institutions—that is, countries in which controlling shareholders can extract high private benefits—exhibit a reduction of costs of capital that is five times larger than that of cross-listed firms from countries with strong protections. Yet, the latter group shows a lower inclination to cross-list than firms from countries with strong legal protections. This evidence from cross-listing suggests that inefficient self selection imposes significant inefficiency costs.

Finally this part analyzes evidence from choice of state of incorporation. As this author showed in previous works, a decade and a half ago, Nevada has embarked on a strategy of attracting corporations with a shockingly lax corporate law. Nevada law narrows significantly the mandatory duty of loyalty and duty of good faith, which are cornerstones of Delaware corporate law. Nevada’s own politicians suspected that Nevada’s relaxed laws would attract a disproportionate number of problematic firms. As this author found in a joint work with David Smith firms that choose to incorporate in Nevada, as compared to firms that incorporate in Delaware (the winning state), turn out to have an exceptionally high frequency of accounting restatements. Similarly, a recent study found that foreign firms that conduct reverse mergers to Nevada tend to make especially egregious accounting restatements. At the same time, we did not find a discount for the valuation of Nevada companies. Evidence on incorporations tends to favor the inefficient self-selection theory when one compares incorporation in Delaware

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12 See e.g., Michael S. Weisbach & William A. Reese, Jr. Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings, 66 J. OF FIN. ECON. 65 (2002) (finding that firms from civil law countries are less likely to cross-list on U.S. exchanges than firms from common law countries).
13 Furthermore, contrary to efficient private ordering predictions, cross listing is associated with low control premiums and high value pre-listing. Craig C. Doidge, U.S Cross-listings and the Private Benefits of Control: Evidence from Dual-class Firms, 72 J. FIN. ECON. 519 (2004). Also, the inclination to cross-list decreases with the proportion of voting rights the controlling shareholder has, and, more importantly, with controllers’ ratio of voting rights to cash flow rights. Craig Doidge, G. Andrew Karolyi, & René M. Stulz, Why Are Foreign Firms Listed in the U.S. Worth More?, 71 J. OF FIN. ECON. 205 (2004)
to incorporation in firms’ home states.\textsuperscript{17}

One caveat should be noted before proceeding: In some scenarios, a firm’s self-selection can be efficient. While this Article focuses on the differences in the benefits each firm gains from governance, there are also differences in the costs governance terms impose. For example, small firms frequently face relatively higher costs of implementation, and on this dimension the evidence is consistent with small firms avoiding constraints.\textsuperscript{18} Yet mandatory law can and has done a reasonable job accommodating size-based differences.

Part V discusses implications for data interpretation and policy. The analysis here suggests caution when attempting to draw policy implications from this studies on voluntary adopted governance terms. A significant body of research analyzes the effect that various governance terms and packages thereof have on firms’ performance. These studies are often used to assess policy proposals. In analyzing the data self-selection is frequently taken into account. Yet, the inefficient self-selection that is described here rarely does. Second, while one-size mandatory approaches might impose costs on some firms worth considering, those costs should be weighed against the costs of private ordering, and in particular, the costs that firms facing weak governance, weak external constraints, and high private benefits—the firms whose shareholders could benefit most from legal constraints—are more likely to choose lax constraints absent regulation.

The choice between mandatory law and private ordering in Coase words “has to come from a detailed investigation of the actual results of handling the problem in different ways. But it would be unfortunate if this investigation were undertaken with the aid of a faulty economic analysis.”

To get a sense of the costs imposed by heterogeneity and adverse selection commentators and policymakers alike should examine data on the different choices that are made by different firms. Finally, the analysis offers considering two novel policy approaches: implementing market-based mandatory law and alternative minimal packages of governance terms.

II. Private Ordering in Corporate Law and Governance

A significant part of US corporate law is enabling, offering a set of optional, not binding, default rules. Firms can decide whether to adopt a staggered board,\textsuperscript{19} have a poison pill,\textsuperscript{20} grant shareholders proxy access,\textsuperscript{21} implement majority or plurality voting,\textsuperscript{22}

\textsuperscript{17} Firms that incorporate in their home state—the state in which their headquarters are located—have weaker corporate governance regimes and lower value than firms that choose Delaware law that is less favorable to management. See e.g., Robert Daines, \textit{Does Delaware Law Improve Firm Value?}, 62 J. Fin. ECON. 525, 525 (2001) [hereinafter Daines, \textit{Firm Value}].

\textsuperscript{18} See discussion \textit{Infra} Part


\textsuperscript{20} Several comments to the SEC objecting to a mandatory proxy access rule focused on private ordering. As a Wachtell Lipton comment notes: “[U]niformity would do a serious harm . . . This is simply not an area where ‘one size fits all.’” Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Aug. 17, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-263.pdf.

\textsuperscript{21} DGCL 216
allow an individual to serve as both chairman and CEO,\(^\text{23}\) opt out of the duty of care as well as significant parts of the duties of loyalty and good faith,\(^\text{24}\) and choose their state of incorporation.\(^\text{25}\) This freedom to choose, as two corporate giants explain, is justified by markets incentives coupled with firms’ heterogeneous needs:

Why does corporate law allow managers to set the terms under which they will govern corporate assets? . . . The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all; hence the "enabling" structure of corporate law.\(^\text{26}\)

That a corporation is a complex set of contracts, implies more than it seems from first sight. The contractual approach to the firm has both descriptive and normative implications. The description of the corporation as a set of contract is coupling an important argument, according to which managers have incentives, like any side to a contract, to adopt terms that maximize the surplus, that maximize firm value.

To be sure managers do not negotiate with shareholders as sides to contracts typically do. Yet, two mechanisms – share prices at the IPO stage, and market forces at the midstream stage – provide managers with incentives to offer law and governance that maximize firm value. At the IPO stage, when the firm first goes public, the firm’s founders internalize all of the costs and benefits of their choices through the IPO share price. If an entrepreneur offers a law that benefits her at the shareholders’ expense, her firm’s shares will be devalued. Thus, she will offer governance terms that maximize value, even if that means self-constraining her managerial discretion. At the midstream stage, after the firm goes public, and the manager holds only a small fraction of the shares, she could externalize costs on the other shareholders. For example, a manager may seek to institute takeover defensive within the firm’s governance documents or defend against a hostile takeover even if shareholders find a takeover desirable. Similarly, a manager might not implement a newly introduced majority vote or a proxy access bylaw.\(^\text{27}\) Yet, market forces—the market for corporate control, the market for capital, the market for managerial labor and the market for products—will penalize her for her poor choices. For example, if Delaware offered an inefficient law, and managers chose it, the firm’s performance numbers will suffer and so will the value of her shares. And when management fails to maximize share value, hostile bidders might identify firms governed by poor law as fresh takeover opportunities that result in management turnover.\(^\text{28}\) Further, poor performance makes capital more costly to raise,\(^\text{29}\) worsens managers’ hiring


\(^{24}\) Cf. DGCL 102b(7); NRS 78.138

\(^{25}\) See e.g., Baysinger & Butler, *Uniformity in Corporate Law*, supra note Error! Bookmark not defined., at 459 (1985); Bainbridge, *Financial Crisis*, supra note Error! Bookmark not defined.; GALAGHER,

\(^{26}\) See Easterbrook & Fischel, *The Corporate Contract*, supra note _ at 1418.

\(^{27}\) See e.g., Easterbrook & Fischel, *The Corporate Contract*, supra note _ , at 1443.


prospects, and decreases the likelihood that the firm will survive competition. To be sure, markets are limited, and while they mitigate agency costs they do not eliminate them. Yet, together they create significant threats and incentives for managers to choose efficient law and governance even if they hold a small fraction of the firm’s cash flow rights.

Contractarians do not argue that all will always be optimal. Frictions noise, mistakes and even agency costs have room in the contractual model. Yet, noise will wash out, mistakes will be corrected over time, and agency costs will be constrained by market forces. Contractarians believed that transaction costs are primarily drafting costs, which could be mitigated by efficient default corporate law. More important, even if there are some frictions and transaction costs regulation also has costs. For example, regulator has less information than the managers of which governance terms and legal regimes could maximize their value. Most notably, even if the regulator has sufficient information to know what is the optimal law for the average firm, this law will fit only the average firm.

A mandatory law main disadvantage is that it applies a one-size fit all corporate law to firms with different needs. Private ordering on the other hand, allows firms to choose the governance terms that best fit their particular needs and circumstances. Thus, firm heterogeneity provides significant support to private ordering in corporate law.

Those who have criticized the enabling structure of U.S. corporate law, especially in light of corporate scandals and the financial crisis, have met resistance from opponents wielding the One-Size Argument. Examples of this dynamic abound. First, SOX and various exchanges’ listing standards have been heavily criticized for requiring board independence under a one-size approach. Second, the Dodd-Frank Act was criticized for requiring shareholder votes on executive pay even though these votes would not bind management. Third, when the SEC contemplated implementing a mandatory proxy access rule to remedy the fact that a startlingly low percentage of shareholders’ nominees ever appear on corporate ballots, the law firm of Wachtell, Lipton, Rosen & Katz (“Wachtell”) wrote to the SEC and argued that the new rule should instead function as a

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32 Michael Klausner, facts and Fiction in Corporate La.

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

34 See e.g., Bainbridge, Financial Crisis, supra note Error! Bookmark not defined.

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

A Wachtell memo on proxy access notes: “[U]niformity would do a serious harm in the area of shareholder access to the proxy. . . . This is simply not an area where ‘one size fits all’—and any attempt to fashion a single size for all will impose inappropriate mandates on some companies . . . .”

Fourth, one size argument has also been applied to disclosure obligations. The SEC is currently considering how to implement several Dodd-Frank rules governing executive compensation. These rules include § 953 of the Act, which instructs the SEC to implement provisions regarding the disclosure of pay-for-performance provisions and the ratio of CEO pay to median employee pay; and § 954 of the Act, which instructs the SEC to require stock exchanges to adopt a listing standard under which listed firms will have to adopt and report a “clawback policy.” Clawback policies require managers to return bonuses that they received improperly based on incorrectly reported performance figures.

The wide support for private ordering therefore, relies on the assumption that firms self-select optimal levels of corporate governance, or that at the very least that firms choose better than the regulator, governance terms that fit their specific costs and benefits analysis.

Yet, despite the heavy reliance and significant implication of the assumption of heterogeneity in firm needs, heterogeneity was not incorporated rigorously into the contractual framework. Particularly, contractarians haven’t explored whether heterogeneity posses some particular challenges for private ordering. Whether heterogeneity results in particular forms of transactions costs.

The following part will show that heterogeneity creates frictions in efficient contracting and therefore possesses some challenges also to efficient contracting.

III. Theoretical Framework: Private Ordering and Firm Heterogeneity

36 Martin Lipton, Steven A. Rosenblum, & Karessa L. Cain, Proxy Access Revisited, 44 BANK AND CORP. GOV. L. REP. 499, 499 (2010), (“Even if one believed that proxy access could offer some benefits, the best way to conduct an experiment of the costs and benefits is not to usurp the traditional role of state corporate law through a federally mandated set of proxy access rules, but rather to permit proxy access on a state-by-state, case-by-case, company-by-company basis.”).
37 Id.
38 Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Aug. 17, 2009), available at . See also Letter from Cravath, Swaine & Moore LLP; Davis Polk & Wardwell LLP; Latham & Watkins, LLP; Simpson Thacher & Bartlett LLP; Skadden, Arps, Slate, Meagher & Flom LLP; Sullivan & Cromwell LLP; and Wachtell, Lipton, Rosen & Katz, to Elizabeth Murphy, Secretary, SEC (August 17, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-212.pdf [hereinafter, the “SevenFirm Letter”] (“a company and its stockholders would benefit from the flexibility to adopt the type and form of proxy access standard that best reflects the will of the stockholders, rather than a uniform, one-size-fits-all standard”). Finally the rule passed 3-2 with two dissenting commissioners criticizing the rule one size approach relative to a private ordering arrangement. The federal court struck it down and we were left with the Delaware private ordering approach under DGCL 112. See discussion infra section _
39 Private ordering proponents also dismiss mandatory laws’ ability to account for some degree of individual variation among firms as irrelevant. Private ordering is always superior, they argue, since mandatory law cannot take into account all of the differences among firms as some differences are unobservable or non-verifiable.
A. One size does not fit all

Corporate law and governance constraints such as fiduciary duties, independent boards, majority voting, proxy access rules, and non-classified boards are designed to reduce managerial agency costs. Since managers tend to hold only a small fraction of a given firm’s cash flow, they could be tempted to make inefficient decisions that benefit themselves at the shareholders’ expense. But corporate law is not the only force that disciplines managers. Rather firms face varying degrees of other constraints.

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

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

[E]xternal markets for managerial services, the market for corporate control, incentive compensation systems, and auditing by outside accountants, are just some of the ways in which management is held accountable for its performance. The importance of the board’s monitoring role in a given firm depends in large measure on the extent to which these other forces are allowed to function.40

Nominating independent directors in a firm that has sufficient constraints could reduce shareholder value since independent directors also tend to lack the same degree of industry- and firm-specific knowledge and expertise that inside directors have.41 Similar tradeoffs apply with respect to other governance terms. Fiduciary duties align managers’ incentives with those of shareholders, but they also encourage frivolous lawsuits and costly settlements. Disclosure rules subject managers to higher transparency, but they could result in high implementation and compliance costs. Legal constraints should be applied only in those firms in which their benefits are sufficiently large to outweigh their costs, that is, “in those corporations in which market-oriented governance mechanism are relatively less important or influential.”42

A second value-determinative characteristic that private ordering proponents point to is a given firm’s set of internal constraints and governance: “[M]anagers of a firm with

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40 Bainbridge, Financial Crisis, supra note Error! Bookmark not defined.
41 Id. (“purported reforms that “reduce the board’s role to monitoring and constrain corporation’s ability to choose a managing board threaten to deprive corporations of the full opportunity to utilize the board of directors as a resource.”)
strong takeover defenses are less subject to the constraining influence of the market for corporate control than are those of a firm with no takeover defenses. The former needs a strong monitoring board more than does the latter.”

Since different firms select widely divergent governance packages from the cornucopia of available terms, firms’ internal governance and constraints vary significantly. Accordingly, so does their need for any particular legal constraint.

Finally, firms also vary in how costly it is for them to implement and comply with the law. Since implementation and compliance costs frequently include a fixed component, they are often proportionally higher for smaller firms. Thus, to be desirable for small firms, these legal arrangements would need to create significant offsetting benefits. Proponents of private ordering, however, seems to be less worried about this difference, probably because they are observable and could be, and have been, accounted for by regulators. For example, SOX accommodates small firms—defined by applicable law as companies whose market capitalization does not exceed $75 million—by exempting them from the § 404(b) requirement to retain an independent auditor to attest to the issuer’s internal control over financial reporting. The Jumpstart Our Business Startups (“JOBS”) Act also exempts emerging growth companies with total annual gross revenues under $1 billion from § 404(b). As part of its stated goal of improving startup companies’ access to capital markets, the JOBS Act also reduces these companies’ disclosure requirements, enables them to submit draft registration statements to the SEC before their IPO, and reduces their financial reporting requirements. Similarly, Dodd-Frank makes a number of accommodations for small banks: Banks with under $1 billion in assets need not comply with the Act’s employee incentive compensation provisions; banks with total assets under $10 billion are not subject to supervision by the Consumer Financial Protection Bureau; and the same sub-$10 billion banks need not conduct the stress tests that larger banks must commission. These sorts of structural exemptions enable mandatory laws to accommodate certain observable, firm-specific differences.

While contractarians argued that firms need vary and provided some explanation to why this is the case, they did not explain why firms that need regulation most are also most likely to adopt it. The following part will discuss choice of law and governance by heterogeneous firms.

43 Bainbridge, Financial Crisis, supra note Error! Bookmark not defined..

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


46 See id. at pmbl.

47 Id. § 102.

48 Id. § 106.

49 E.g., id. § 102(b).


51 See id. §§ 5481(24), 5516 (2012).

52 See id. § 5365(i)(2)(A).
B. Choices of Firms with Varying Needs

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

Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and securities people value. The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. 53

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

a. IPO

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

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

53 See Easterbrook and Fischel, Corporate Contract, supra note Error! Bookmark not defined., at 1420.
on, adding a proxy access term to the company charter will increase the firm’s IPO price by exactly $30M for the company shares. In other words, at the IPO stage, the entrepreneur has optimal incentives to bind herself to the most efficient governance terms.

<table>
<thead>
<tr>
<th>Table 1</th>
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<tbody>
<tr>
<td>IPO</td>
</tr>
<tr>
<td>Private benefits</td>
</tr>
<tr>
<td>Harm to Shareholders</td>
</tr>
<tr>
<td>Costs to founder/manager</td>
</tr>
<tr>
<td>Optimally</td>
</tr>
<tr>
<td>Choice</td>
</tr>
</tbody>
</table>

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

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

b. Midstream Stage

After the firm goes public, the enterprenuer gradually sells her shares, and whether she manages the firm or hire new management, firm management typically only holds a small fraction of the firm’s cash flow rights. As a result, at this second stage—the Midstream Stage—managers’ incentives are not perfectly aligned with those of shareholders—a manager who creates value for the firm will not necessarily create value for herself. Thus, at this stage management may seek lax corporate law and governance

terms. For example, a manager may seek to institute takeover defensive within the firm’s governance documents or defend against a hostile takeover even if shareholders find a takeover desirable. Similarly, a manager might not implement a newly introduced majority vote or a proxy access bylaw.

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

| Table 2 |
|-----------------|-----------------|-----------------|
|                 | Midstream       | Midstream + market forces |
| Private benefits| 3M              | 3M               |
| Harm to Shareholders | 10M          | 10M              |
| Costs to founder/manager | -0.1M       | -0.1-penaltyX |
| Optimally       | Proxy Access    | Proxy access     |
| Choice          | No Proxy Access | Proxy Access if X>2.9 |


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

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56 See e.g., Easterbrook & Fischel, *The Corporate Contract*, supra note _, at 1443.
1. **IPO Stage**

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

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private benefits</td>
<td>3M</td>
<td>3M</td>
</tr>
<tr>
<td>Benefit to Shareholder</td>
<td>30M</td>
<td>1M</td>
</tr>
<tr>
<td>IPO price NPA</td>
<td>-30M</td>
<td>-1M</td>
</tr>
<tr>
<td>Optimally</td>
<td>Proxy Access</td>
<td>No Proxy Access</td>
</tr>
<tr>
<td>IPO Choice</td>
<td>Proxy Access</td>
<td>No Proxy Access</td>
</tr>
</tbody>
</table>

**Adverse Selection**

But, this efficient private ordering assumed investors accurately price distinct value of governance terms in light of *firm-specific circumstances*.61 Yet, operative market forces and the extent to which they apply for each specific firm, are often unobservable. Founders know the constraints that they expect to face better than investors. The One-Size Argument, in fact, holds this as a premise: mandatory law is undesirable since managers know best their firm’s needs:

Because I (and you) don’t know how to structure a proxy access regime that is suitably tailored to address the individual circumstance of the almost 12,000 publicly traded corporations in the United States, it makes sense to support a fully enabling approach.62

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

To answer this question, assume that in firm A that faces especially weak market constraints, a proxy access term will add $6M worth of value. Assume also that firm B faces significant market forces, and as a result, the added value from a proxy access in firm B will be only $1M. If investors do not know the exact market forces each firm is facing and as a result the exact value of proxy access in each of this firm, they will

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61 Cf. , (showing that IPO stage analysis hinges on the assumption that on average governance terms are being priced correctly). For limitations of this assumption when applies to new governance terms, and terms that have only small influence see sources cited at supra note Error! Bookmark not defined.

instead apply an average value to a proxy access term, that is $3.5M. Now assume that both entrepreneurs in firm A and in firm B derive $4M in private benefits from not having a proxy access term. As Table 3 shows lack of information about the specific firm changes the results in a significant way. While firm B should not offer proxy access since its costs outweigh its benefits, firm A should offer it. Yet, since investors reward firm A only in the average value of having proxy access, that is $3.5M, rather than the particular value for this firm, that is $6M, for a proxy access, it will not offer it.

Table 4

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private benefits</td>
<td>4M</td>
<td>4M</td>
<td>4M</td>
</tr>
<tr>
<td>Harm to Shareholder</td>
<td>6M</td>
<td>1M</td>
<td>3.5M</td>
</tr>
<tr>
<td>Optimaly</td>
<td>Proxy Access</td>
<td>No Proxy Access</td>
<td>Proxy Access</td>
</tr>
<tr>
<td>IPO Price</td>
<td>-3.5</td>
<td>-3.5</td>
<td>-3.5</td>
</tr>
<tr>
<td>IPO Choice</td>
<td>No Proxy Access</td>
<td>No Proxy Access</td>
<td>No Proxy Access</td>
</tr>
</tbody>
</table>

**Signaling**

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

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

Table 5

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private benefits</td>
<td>6M</td>
<td>1M</td>
</tr>
<tr>
<td>Harm to Shareholder</td>
<td>8M</td>
<td>2M</td>
</tr>
<tr>
<td>Optimaly</td>
<td>Proxy Access</td>
<td>Proxy Access</td>
</tr>
</tbody>
</table>

17
Now assume that the difference in firms’ types in private benefits has implications to shareholders. That is, since the manager of firm B faces more constraints on extracting private benefits firm B has higher value. In a separating equilibrium, by adopting proxy access, the manager also conveys this information to Investors. As shown below, as a result, a manager of firm B might choose to adopt a proxy access even if overall it is not efficient for her company to have it. Since a manager of firm A has incentives to deviate and adopt a proxy access too, the result will be that both firms have proxy access rule.  

### Table 6

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private benefits</td>
<td>8M</td>
<td>6.5M</td>
<td></td>
</tr>
<tr>
<td>Firm Value</td>
<td>-2M</td>
<td>+2M</td>
<td></td>
</tr>
<tr>
<td>Harm to Shareholder</td>
<td>9M</td>
<td>1M</td>
<td>8 or 2</td>
</tr>
<tr>
<td>Optimally</td>
<td>Proxy Access</td>
<td>No Proxy Access</td>
<td></td>
</tr>
<tr>
<td>IPO Price if pooling</td>
<td>-5M</td>
<td>-5M</td>
<td>NE for B</td>
</tr>
<tr>
<td>- NPA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IPO Price if separating</td>
<td>-9M -2M</td>
<td>0 +2M</td>
<td>NE for A</td>
</tr>
<tr>
<td>IPO Choice: Pooling</td>
<td>Proxy Access</td>
<td>Proxy Access</td>
<td></td>
</tr>
<tr>
<td>PA</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

### Noise

The previous section has demonstrated a potential signaling effect that could lead to a pooling equilibrium in which all firms adopt a proxy access rule. There are several limitations however for these signaling effects to operate in reality. To begin with, for different reasons adoption corporate law and governance terms, especially at the IPO stage, is associated with significant noise and as a result obscure signals. In particular, in some firms, certain governance terms only exist due to boilerplates, advice of a local lawyer, network externalities, or some arbitrary sources. 64 Thus when investors observe a weak governance regime, they might not know whether it resulted from a conscious

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63 A second separating equilibrium in which firm A has no proxy access and firm B has proxy access is not robust to the Cho Kreps Criterion.

64 See Michal Barzuza, *Noise Adopters in Corporate Governance*, 3 COLUM. BUS. L. REV. 627 (2013); See also Michael Klausner *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 761 (1995) (arguing that due to positive network externalities, frequently used legal terms have a value that is independent from their legal substance).
choice by firm management or from a more benign source. If investors do not know the exact costs and benefits, they will probably apply an average benefit to a strict term. As a result, the penalty for firms that could really benefit from this term is only partial. At the end, similar to a no signaling equilibrium, firms that can benefit most from regulation will be consistently less likely to do so because these benefits will be underestimated by capital markets.

Table 7

<table>
<thead>
<tr>
<th>Private benefits</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12M</td>
<td>1M</td>
<td>6 or 1</td>
<td></td>
</tr>
<tr>
<td>Harm to Shareholder</td>
<td>20M</td>
<td>2M</td>
<td>8 or 2</td>
<td></td>
</tr>
<tr>
<td>Optimally</td>
<td>Proxy Access</td>
<td>Proxy Access</td>
<td>Proxy access</td>
<td></td>
</tr>
<tr>
<td>IPO Price if pooling – NPA</td>
<td>-11M</td>
<td>-11M</td>
<td>NE for B</td>
<td></td>
</tr>
<tr>
<td>IPO Price if separating</td>
<td>-20M</td>
<td>0</td>
<td>NE for A</td>
<td></td>
</tr>
<tr>
<td>IPO Choice: Pooling</td>
<td>Proxy Access</td>
<td>Proxy Access</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IPO Price if separating with noise</td>
<td>-11M</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IPO Choice with Noise</td>
<td>No Proxy Access</td>
<td>Proxy Access</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Now let’s explore the effect of noise when a choice of governance also provides a signal regarding firm value. In particular, take the example from Table 6 above. Now assume again that half of the firms are noise adopters. The result would be a pooling equilibrium in which no firm adopts a proxy access rule.

Table 8

<table>
<thead>
<tr>
<th>Private benefits</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>8M</td>
<td>6.5M</td>
<td></td>
</tr>
</tbody>
</table>

65 See id.
66 Adverse selection, Barzuza noise adopters. Signaling will not work – see section _ below .
<table>
<thead>
<tr>
<th>Firm Value</th>
<th>-2M</th>
<th>+2M</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Harm to Shareholder</td>
<td>9M</td>
<td>1M</td>
<td>8 or 2</td>
</tr>
<tr>
<td>Optimally</td>
<td>Proxy Access</td>
<td>No Proxy Access</td>
<td></td>
</tr>
<tr>
<td>IPO Price if pooling – NPA</td>
<td>-5M</td>
<td>-5M</td>
<td>NE for B</td>
</tr>
<tr>
<td>IPO Price if separating</td>
<td>-9M -2M</td>
<td>0 +2M</td>
<td>NE for A</td>
</tr>
<tr>
<td>IPO Choice: Pooling PA</td>
<td>Proxy Access</td>
<td>Proxy Access</td>
<td></td>
</tr>
<tr>
<td>IPO Price if separating with noise</td>
<td>-11<em>0.5 – 5</em>0.5= -5.25M</td>
<td>1M</td>
<td>NE for B</td>
</tr>
<tr>
<td>IPO Choice with Noise</td>
<td>No Proxy Access</td>
<td>No Proxy Access</td>
<td></td>
</tr>
</tbody>
</table>

Thus, if the choice of governance also signals firm value, and this signal provides the motivation for the separation, the noise could result with none of the firms adopting a proxy access.

2. Midstream Stage

a. Weak Market Forces Impose Weak Penalties

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

“Markets lead managers to adopt the optimal mix of legal and market governance structures for their own firm. The optimal mix reflects the preferences of the firm’s residual claimant.”67

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

But therein lies a striking contradiction. There is an inherent tension in claiming both (1) that managers facing weak market forces will self-constrain because their firms are the ones that need it most, and (2) that those same weak market forces will sufficiently discipline directors into self-constraining. If operative market forces are not sufficiently

strong to drive managers to perform at their best, why would they be sufficient strong to drive managers to choose a constrictive governance regime?

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

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

There is another reason why firms that face weak constraints are less likely to opt for strict law. Firms that face relatively weak market forces are more vulnerable to the inefficient extraction of private benefits. Managers of these firms extract higher private benefits than managers in firms that are disciplined by markets.\(^{68}\) Recent evidence confirms the notion that extent to which managers extract private benefits depends upon the market forces at work. In particular, findings suggest that in firms that face weak market forces, private benefits are higher.\(^{69}\)

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

Given the combination of facing low market penalties and having more benefits to lose, insiders facing weak market forces are more likely to avoid legal constraints than welcome them.\(^{70}\) And as our theoretical analysis shows, this inefficient tailoring can result in significant inefficiency costs. Even high inefficiency costs, though, might not discipline managers subject to the above combination of circumstances. The higher the possible private benefits, the higher the efficiency gains would have to be to lure them to adopt legal constraints.

<table>
<thead>
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<th>A</th>
<th>B</th>
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<tbody>
<tr>
<td>Private benefits</td>
<td>3M</td>
<td>3M</td>
</tr>
<tr>
<td>Harm to Shareholders</td>
<td>10M</td>
<td>4M</td>
</tr>
<tr>
<td>Costs to founder/manager</td>
<td>-0.7M – 1M</td>
<td>-0.7M-3M</td>
</tr>
<tr>
<td>Optimally</td>
<td>Proxy Access</td>
<td>Proxy access</td>
</tr>
<tr>
<td>Choice</td>
<td>No Proxy Access</td>
<td>Proxy Access</td>
</tr>
</tbody>
</table>

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

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\(^{68}\) Extracting high private benefits will trigger weaker penalties in firms that face weak market forces. See, \(e.g.,\) Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463 (2001) (arguing that increased monopoly rents induce higher potential agency costs).

\(^{69}\) See Maria Guadalupe & Francisco Perez-Gonzalez, *supra* note 19 at ___.

\(^{70}\) For a formal model that shows this results see Michal Barzuza, *Lemon Signaling in Cross-Listing* Virginia Law and Economics Research Paper No. 2012-03.
The presence of weak internal governance structures also make it unlikely that firms who can benefit most from legal constraints will in fact adopt them. Firms with more controls in place differ from firms lacking similar controls in their need for additional controls. For example, a poison pill is less necessary for a board that is staggered than for a board that is not staggered. Similarly, a board that is not staggered does not need independent directors as much as a board that is staggered. Similarly on an international level, some firms are governed by strict law, while some are governed by weak law, or weak institutions. Thus, in theory, if private ordering proponents are right, firms with fewer disciplining governance terms in place, or firms from weak legal regimes, will be more likely to adopt additional constraints.  

Managers that face weak legal constraints, however, can extract more private benefits of control and thus will be more reluctant to constrain their own ability to extract. Moreover, entrenching governance terms frequently reduce the effectiveness of potential penalties from market forces. For example, implementing a staggered board or incorporating in a state that allows a dead hand pill significantly decreases, and can even eliminate, the likelihood of a takeover. Thus, managers of firms with staggered boards are significantly less exposed to the potential discipline of the market for corporate control.  

Similarly, in firms with no independent directors, there is less pressure to award less compensation, or even fire, a manager who underperforms.

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

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Private benefits</td>
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<td>3M</td>
</tr>
<tr>
<td>Harm to Shareholders</td>
<td>10M</td>
<td>4M</td>
</tr>
<tr>
<td>Costs to founder/manager</td>
<td>-0.7M – 1M</td>
<td>-0.7M-3M</td>
</tr>
<tr>
<td>Optimally</td>
<td>Proxy Access</td>
<td>Proxy access</td>
</tr>
<tr>
<td>Choice</td>
<td>No Proxy Access</td>
<td>Proxy Access</td>
</tr>
</tbody>
</table>

3. Signaling at Midstream

Signaling at midstream should be less confounded by knowledge than signaling at IPO – there is a conscious proactive decision and vote by management, and solicitation of shareholders votes.

Yet, as a result of the separation of ownership and control, signaling, even if working properly, will not necessarily affect management choices. At the midstream stage the managers holds only a small fraction of the firm, and therefore benefits only marginally from signaling that the firm should have a higher value. As a result, firms that could

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71 Bainbridge, Financial Crisis, supra note Error! Bookmark not defined.
72 See e.g., Lucian A. Bebchuk & Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers From Takeovers 99 CLM. L. REV. 1168, 1180 (1999) (arguing that legal developments such as the poison pill significantly impeded the disciplining power of the market for corporate control).
73 See Bebchuk
improve their governance significantly and thereby produce efficiency gains and benefits for their shareholders might nevertheless choose not to do so in order to make comparatively smaller gains that land directly in managers’ pockets. Given to the central role of the midstream stage in firms governance, and as subsequent discussion of the evidence confirms, these sorts of inefficiency losses can be significant.

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IV. The Evidence – How do Firms Self-Select Governance?

A. Private Ordering Testable Predictions

Some firms have less agency costs, either because they face fierce market forces, have other governance constraints implemented, or for other reasons. For these firms the benefit of an additional constraint is smaller and therefore is less likely to outweigh its costs. Similarly, some firms have higher costs, typically small firms will have proportionally higher compliance costs, and therefore governance terms will have to add high value to be efficient for these firms.

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

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

Nominating independent directors in a firm that has sufficient constraints could reduce shareholder value since independent directors also tend to lack the same degree of industry- and firm-specific knowledge and expertise that inside directors have.

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74 For a formal model that demonstrates this result see Barzuza, Lemon Signaling, supra note _.
75 See also evidence from cross-listing infra section _.
76 Bainbridge, Financial Crisis, supra note Error! Bookmark not defined..
77 Id. (“purported reforms that “reduce the board’s role to monitoring and constrain corporation’s ability to choose a managing board threaten to deprive corporations of the full opportunity to utilize the board of directors as a resource.”")
Similar tradeoffs apply with respect to other governance terms. Fiduciary duties align managers’ incentives with those of shareholders, but they also encourage frivolous lawsuits and costly settlements. Disclosure rules subject managers to higher transparency, but they could result in high implementation and compliance costs. Legal constraints should be applied only in those firms in which their benefits are sufficiently large to outweigh their costs.

One-Sizers argue that governance restrictions are needed “in those corporations in which market-oriented governance mechanism are relatively less important or influential. If companies face fierce competition, a significant risk of acquisition, and so forth, its managers are disciplined by these forces. Adding proxy access, or independent board members would not change their behavior significantly. Consistent with this intuition, several studies found evidence that governance terms are less valuable where market forces are strong.

Assuming that firms that face weak alternative constraints could stand to benefit most from governance, contractarians predict these firms would be more likely to adopt legal contractarians. This Part analyzes and synthesizes a large body of evidence from numerous studies on a wide range of governance terms and laws, all of which speaks directly to this question. The body of evidence is not consistent with optimal self-selection.

A. Director Independence

"By establishing a highly restrictive definition of director independence and mandating that such directors dominate both the board and its required committees, the new rules fail to take into account the diversity and variance among firms. The new rules thus satisfy our definition of quack corporate governance. The one size fits all model they mandate should be scrapped in favor of allowing each firm to develop the particular mix of monitoring and management that best suits its individual needs."

SOX and the exchanges listing standards, which replaced a private ordering board composition arrangement, with a mandatory, board independence requirement, provide a useful setting to evaluate firms’ self selection. Pre-SOX firms were free to choose whether to nominate independent directors, and what should be their proportion on the board. SOX and the exchanges listing standards required all listed companies to have a majority of independent directors. As a result in some firms board independence was a product of private ordering and in others a product of mandatory requirements.

Contractarian theory has clear testable predictions for these two different groups. If firms self select optimally, as contractarians predict, those firms that nominated voluntarily a majority of independent directors were the ones who stood to benefit most.

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80 Bainbridge, Financial Crisis, supra note Error! Bookmark not defined..
from having them. Firms that chose not to have a majority of independent directors, should probably suffer from the change, or at the very least benefit less from the former group. Adverse selection approach produces different predictions: firms that did not nominate a majority of independent directors voluntarily but rather were required to do so by law probably benefited more from the added independent directors, than firms that self-selected independence voluntarily prior to SOX.

What is the evidence on pre sox and post sox board independence?

**Board Independence Pre-SOX**

Pre-SOX firms had the option to place as many independent directors they would like on the board and its different committees. Through private ordering alone, over the years, boards have gradually adopted the independence model. While in the 60’s most boards had a majority of inside directors, at the end of the 90’s a vast majority of US board had a majority of independent directors.

There are different accounts for the triggers and causes for this dramatic change. And probably several different factors played a role in the proliferation of board independence. Among them, encouragement by Delaware courts, by conditioning deference to the board and its committees on their independence. Other contributing factors, offered by Jeff Gordon, include a rise in the shareholder maximization norm combined with parallel changes to stock market informativeness. At the beginning of the 90’s independence was viewed as a central component of good governance. ALI principle of good governance recommended boards to have a majority of independent directors. The underlying conventional wisdom has been that a board that is dominated by insiders could not function as effective monitor on management.

The changes to board independence provided opportunities to test independent directors’ monitoring, and its effects on firm value. The results, however, as confirmed by a rich body of studies, were pretty disappointing. Board independence was found to improve monitoring with respect to non routine decisions: CEO replacements and firm’s acquisitions. Independence was positively correlated with sensitivity of CEO turnover to firm performance, and with more efficient acquisitions. Yet, there was no strong evidence for other monitoring effects.

More important, for assessing the overall contribution of independence, studies found no evidence that independence contributed to firm performance. There was no significant positive correlation of board independence to firm market value, or other performance measures. If it all, there was some evidence for negative relationship between independence and performance.

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81 Zapata Corp. v. Maldonado
Since Pre-SOX firms’ self-selected independence, however, it was still possible that independence matters, yet, being endogenous to firm performance, it is not reflected in a cross-section analysis. Developing such an account Hermalin and Weisbach constructed a bargaining model in which a non successful CEO is pressured by the outsiders on the board to nominate additional independent directors. If poorly performing firms were more likely to add independent directors, even if these directors added value, when comparing these firms, in a cross-section analysis, to firms that did not have independent directors, independent may be associated with no better, and even poorer performance.

Employing instrumental methods, Bhagat and Black, as well as Bhagat and Bolton, found support for the proposition that poorly performing firms were more likely to nominate independent directors. Yet, they found no support for the proposition that those independent directors added value to these firms. Event studies found only weak market response when firms announce appointing new independent director. Speculating on the lack of positive effects of independent directors, Black and Bhagat suggested that firms added independent directors to conform with conventional wisdom, or to get better treatment from Delaware courts. Pre-Sox, evidence that supports the proposition that a majority of independent directors contributed to firm value was weak to non-existent.

**Board Independence Post-Sox**

Following the Corporate scandals of Enron and WorldCom SOX required audit committees to be entirely independent, and former SEC commissioner, Harvey Pitt, guided the exchanges to enhance governance-listing standards. As result, NYSE-listed firms were required to have a majority of independent directors on their boards, to place only independent directors on their audit, compensation and nomination committees, and to hold periodic executive sessions in which independent directors meet with no firm insiders present. NASDAQ adopted similar requirements. Independence requirements were tightened as well.

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

86 See Hermalin & Weisbach (providing this insight and developing a bargaining model that supports it. In their bargaining model in firms that performed less well, the outside directors gained power vis a vis management, and therefore could push for more independent directors on their boards.)

87 Instrumental methods, Bhagat and Black. Bhagat and Bolton.

88 See Stuart Rosenstein & Jeffrey G. Wyatt, Outside Directors, Board Independence, and Shareholder Wealth, 26 J. Fin. Econ. 175 (1990). (stock price increase of only 0.2% on average)

89 Bhagat & Black, supra note _, at 239 (“More plausibly, the large long-term shift in board structures responds to changes in conventional wisdom and perhaps also to legal pressures. The Delaware Supreme Court, for example, has long encouraged majority-independent boards by giving greater deference to decisions by these boards.”)

90 SOX § 301 (3). It also required at least one of them to be a “finance expert.”


93 NYSE Listed Company Manual § 303A.04-05.

94 NYSE Listed Company Manual § 303A.03.

95
Given the studies on Pre-Sox independence, when the mandatory requirements were adopted the evidence for independence was considered very weak at best. Now, more than a decade after the standards were implemented, a body of evidence accumulated to assess the effects the mandatory imposed independent directors had on firms that did not have them pre-Sox (“Non complying firms”). Early studies assessed the market response to the passage of the rules. Following the announcement, large non-complying firms exhibited relatively high positive abnormal returns, while small non-complying firms experienced a negative market response. The announcement that the firm nominates independent directors to comply with SOX triggered a positive market response. Investors therefore, believed the changes to be good for the large firms, but too costly for the small firms.

How did firms performed over the long term? Employing a Diff and Diff design, several studies found significant effects of SOX and the listing standards for noncomplying firms. Most importantly, firms that were required to add independent directors to comply with the new listing standards improved their operating performance following the changes to their boards.

Do these results suggest that independence Post-Sox has different effects from board independence Pre-Sox? To answer this question, Bhagat & Bolton separated their sample to pre- and post-Sox years, and employed IV methods to deal with selection effects. They findings show that post-Sox independence clearly improved operational performance, as measured by returns on assets (ROA), while pre-Sox, voluntary independence, harmed performance. Furthermore, ROA improvements, for each year after SOX, were driven by the firms that increased their number of independent directors from the previous year. Thus, directly comparing firms that nominated independent directors pre-Sox (by voluntary private ordering) with those that nominated independent directors post-Sox (by regulatory mandate) Bhagat and Bolton find clear and strong evidence for added value from mandatory independence post-Sox, and no, or even reduced value from voluntarily independence pre SOX.

Similar results emerge with respect to other performance measures that Bhagat and Bolotn examine. Consistent with previous studies, Bhagat & Bolton find that the higher turnover sensitivity to performance that was associated with pre-Sox independence. The also found that this sensitivity, which is indicative of effective monitoring, has increased significantly post-Sox, again due to the changes to the boards of the non complying firms. Similarly pattern emerged with respect to independence’s effects on acquisition decisions, which on average are associated with negative returns for the acquiring

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96 Vidhi Chhaochharia & Yaniv Grinstein, Corporate Governance and Firm Value - The Impact of the 2002 Governance Rules 62 J. OF FIN. 1789 (2007) (finding higher abnormal returns surrounding the passes of the listing standards, for firms that increased the number of their independent directors). Similarly, appointing a director with accounting expertise to the board resulted in a positive stock market reaction (DeFond, Hann & Hu 2005).
97 See id. at 122. Tbl 5 (finding positive abnormal return around the date of the filling of the annual proxy statement for firms that change from being non compliant to being compliant with SOX).
98 Typically in studies that examine the effects of the mandated board independence, firms that already had a majority of independent directors served as the control group in a difference-in-difference test.
99 Affected firms experienced a rise in return on assets (“ROA”) relative to firms that did not add directors.
101 See id. at 129 & Tbl 9 panel C
firms. Bhagat and Bolton found that that board independence is associated with fewer acquisitions both pre-and post-SOX, but compared to pre-SOX independence, post-SOX independence is associated with a significant decrease in acquisition levels.

**Efficient Contracting vs. Adverse Selection**

If contractarians are right, board independence should have been associated with better performance in the pre-listing-standards era, when it was adopted voluntarily, relative to the post-listing-standards era.

Available evidence is not supportive of this account. The body of evidence suggests that in firms in which board independence was mandated by law, there were clear long-term operating performance and benefits for the shareholders. If SOX and the major exchanges did not implement independence standards, shareholders would not have received the efficiency gains associated with independence. Thus, as a first step the evidence suggests that some firms for which it optimal to have a majority of independent directors did not adopt it nevertheless. Second, to the extent that the IV methods employed in the different studies were valid, one can deduce that mandatory independence created more value than voluntary independence, which resulted in zero or even negative effect. That firms that benefited most from board independence did not choose to have a majority of independent directors, is consistent with the adverse selection hypothesis. Finally, there is no evidence to the contractarins predictions that voluntary adoption is better tailored, and therefore more beneficial, than mandatory implementation of board independence.

Under the inefficient selection account, why did some firms add independent directors? Firms increased independence to conform with conventional wisdom, and to get better treatment in courts, and maybe sometimes to get a small monitoring benefits. Yet, these were the firms for whom otherwise it did not matter much. Possibly since their managers were operating under strong discipline from outside competition, or other forces, and did not extract high private benefits. They adopted it nevertheless since it made them look better. Firms that could really benefit from monitoring were the firms whose managers faced less constraints from markets and other sources. Yet, these firms were less likely to nominate independent directors under private ordering, possibly since their insiders had more to lose from doing so.

Further supporting this interpretation, is the evidence of increased monitoring from SOX and the listing standards, and their effects on executive compensation. Following changes to their boards, non-complying firms decreased the size of their executive compensation in 17% on average. The effect was primarily driven by changes to comply with a majority requirement. The effect was particularly pronounced in firms

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103 See id. at 132 & Tbl 10 panel C.

104 Vidhi Chhaochharia & Yaniv Grinstein *CEO Compensation and Board Structure* 64 JOURNAL OF FINANCE 231 (2009). The results were not driven by CEO turnover, increase in information available to investors, differential treatment by proxy advisory firms, or classaction lawsuits. Id., at 250-251.

105 Id., at 244. The study examined mandated changes to the board majority, compensation committee and nomination committee. Only the coefficient on the firms that did not comply with the majority
that had no blockholder director, and relatively low institutions holding their shares, namely firms that had weak alternative monitoring sources. A block holder director’s incentives are different from the other directors incentives as he is more aligned with shareholders. The 34 non complying firm, with a director who holds at least 5% of the shares, did not reduce their CEO compensation. Complying firms with no blockholder director reduced their compensation by as much as 23% on average. Similarly, in firms with high concentration of institutional ownership, which tend to have lower and more efficient compensation, the drop was not statistically significant from zero. The decrease in compensation is attributed mainly to drops in stock-based, and bonus compensation. Proxy statements of non complying firms that had the largest drop in compensation, showed that in some of them the drop in compensation resulted from the board reevaluating the equity based compensation.

B. Executive Compensation

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

Unsurprisingly, executive compensation is another area where the One-Size Argument has been dominant. CEO compensation schemes in the U.S. have drawn significant attention in the last two decades, drawing fire for providing extravagant salaries and failing to create efficient performance incentives. Yet, the prevailing conventional wisdom has been that since boards know better then courts what their firms need to offer in order to attract and retain top talent, markets should determine board compensation. The NYSE’s requirement to have a compensation committee comprised

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106 Id., at 232.
108 Id., at 254 . It is possible that the firms with the blockholder, did not add independent directors to protect controlling shareholder agency costs, which manifest themselves in dimensions other than compensation (e.g., self dealing transactions).
109 Id., at 254 . It is possible that the firms with the blockholder, did not add independent directors to protect controlling shareholder agency costs, which manifest themselves in dimensions other than compensation (e.g., self dealing transactions).
110 Hartzell and Starks found high concentration to be associated with lower compensation. Hartzell, Jay C., and Laura T. Starks, 2003, Institutional investors and executive compensation, Journal of Finance 58, 2351–2374. Concentration of institutional holdings is defined by the ratio of the combined holdings of the five largest institutional holdings, to the total institutional holdings.
111 Id. At 256.
112 Id., 248
113 Id., at 246
114 Bainbridge, Financial Crisis, supra note Error! Bookmark not defined.
solely of independent directors, Dodd-Frank’s provision that grants shareholders non-binding say-on-pay votes, and enhanced disclosure requirements were all criticized for their one-size approach. Critics have raised the same concern for forthcoming SEC rules—in particular, with respect to three areas of executive compensation that Dodd-Frank instructs the SEC to regulate: payment ratio disclosures, incentive-based compensation disclosure, and requirements for firm “clawback” provisions. And critics have chimed in to posit the same general refrain for each: a one-size concern.

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

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

1. Pay for Luck

What sorts of companies reward CEOs for luck as opposed to superior performance? Sure enough, the firms that rewarded luck tended to perform worse and have relatively weaker corporate governance arrangements.

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

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115 NYSE Listed Company Manual § 303A.05.
2. Backdating Options

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

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

Which companies, then, tend to give managers backdated options? All studies find they are the ones with insubstantial controls and otherwise weak governance.\(^\text{120}\) In particular, classifying an option as being backdated if its vesting price was the lowest price of the month, the likelihood for backdating was found to be correlated with “lack of a majority of independent directors, a long-serving CEO, or a lack of a block-holder with a ‘skin in the game’ on the compensation committee.”\(^\text{121}\) Similarly, using a slightly different definition for backdating, another study found that firms with high proportion of insiders, outside directors that were appointed by the current CEO, and board members that interlock with backdating firms had higher incidence of backdating.\(^\text{122}\) The evidence with respect to backdating therefore also suggests that the firms that can benefit most from efficient compensation were more likely to implement distorted compensation practices.

D. Voting

Voting is governance safe valve. Shareholders’ right to vote drove, for example, the Delaware General Assembly to delegate a great deal of power to management between elections and Delaware courts to approve the revolutionary poison pill.\(^\text{123}\) Yet, in reality, shareholder participation in voting was limited to filling the proxy card, if at all. The vast

\(^{120}\) Lucian A. Bebchuk, Yaniv Grinstein, & Urs Peyer, *Lucky CEOs and Lucky Directors* 65 J. Fin. 2363 (2010). 2009 OP-EDS

\(^{121}\) Id.


\(^{123}\) See e.g., Moran
majority of annual meeting elections were uncontested—that is, management candidates were the only candidates.\textsuperscript{124} Nominating a board member is extremely expensive and does not make sense for the small, dispersed shareholders of U.S. companies. Delaware plurality standards provide the board seats to the top candidates, that is, the candidates that received the largest number of supporting votes, regardless of the number of opposing (withhold) votes.\textsuperscript{125} Thus directors can be elected when the votes against them, namely “withhold votes,” are overwhelmingly larger than the votes for them.

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

### 1. Majority Voting

Private ordering has been at work in recent years in the very area before us today: the election of directors. Market discipline has resulted in shareholder empowerment and enhanced accountability. The past few years have witnessed a notable trend away from plurality voting toward majority voting for directors, even in the absence of legislative or regulatory mandates. Over 50 percent of the S&P 500 companies now have some form of majority voting.\textsuperscript{126}

Supporters of private ordering frequently point to the proliferation of majority voting as an example of why there is no need for mandatory law. Majority voting terms, adopted via a bylaw amendment, aim to give more weight to shareholders’ withhold votes. While terms vary across firms, under a typical majority vote term, in the event that a director nominee receives more withhold votes than supporting votes, that director will submit his resignation to the board. The board will then have discretion to accept or reject the resignation. Since the board has the power not to accept resignation, the main criticism of majority voting is that as a practical matter it did not change much. Consistent with this skeptical approach, a recent study shows that directors almost never step down as a result of withheld votes, and even fewer do so in firms with majority voting regimes. While it is rare for these directors to step down, however, withheld votes are found to have an indirect effect on the board’s responsiveness to shareholders’ needs and proposals.\textsuperscript{127}

What sorts of firms have adopted majority voting? A recent study finds a significant difference between early of majority voting, to late adopters who presumably resisted but eventually succumbed to pressure from proxy advisory firms, shareholders and the vast majority of firms that already switched. Relative to late adopters, early adopters had a significantly low likelihood that at least one of its director nominees would receive a

\textsuperscript{124} See Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 VAR. L. REV. 675 (2007) (finding that only a handful number of annual votes are contested).
\textsuperscript{125} DGCL 21
\textsuperscript{126} Speech by SEC Commissioner: Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations
that a significant proportion of withhold votes, or any withhold vote, in previous years.\textsuperscript{128} That is, firms that were early to adopt majority voting were the ones for which it mattered less, if at all — probably the ones which also needed it less. Not surprisingly late adopters, that resisted majority-voting most, were also the most likely to be affected by it. Late adopters were also more effected by the semi forced implementation of majority voting: following majority voting they became more responsive to shareholders and received significantly less withhold votes for their directors nominees.

2. Proxy Access

“The strong agnostic position in theology is that “I don’t know whether god exists. And neither do you.”\textsuperscript{129} The strong agnostic position in the proxy access debate is that “I don’t know whether proxy access is a good or bad idea at every corporation in America, and if it is a good idea at some, many, or every corporation, I don’t know how to structure the access rules for every corporation. And neither do you.” I am a strong proxy access agnostic. And you should be too.”\textsuperscript{129}

Given the lack of shareholder director nominees, the SEC has considered a proxy access rule that would allow large long-term shareholders to add director nominees to the firm proxy materials. The proxy access rule was designed to reduce the costs of running a nominee which include, among other things: the costs of filling with the SEC, hiring an outside counsel, and sending proxy materials to all shareholders. In particular, under proposed 14a-11, a shareholder who held at least three percent of the firm shares for at least three years could add his director nominees to the firm’s proxy materials. The proposal reflected a balance between the goal of giving shareholders a voice and being careful not to overburden the firm and the board with frequent proxy fights. The SEC received numerous comments opposing the proposal, primarily on the grounds that that the one-size-fits-all approach of 14a-11 is inferior to a private ordering approach which Delaware has just adopted, partly in an attempt to preempt the need for a federal mandatory proxy access rule. The SEC passed the rule eventually in a three to two decision. In his comments, dissenting Commissioner Parades stated that an enabling law would be superior to the SEC’s mandatory “one size fits all proxy access rule” as it “allows the internal affairs of each corporation to be tailored to the firm’s unique attributes and qualities.”\textsuperscript{130}

The SEC’s proxy access rule has never become effective. Instead, shortly after its adoption, it was placed it on stay in response to a lawsuit from the Business Roundtable and the Chamber of Commerce.\textsuperscript{131} The U.S. Court of Appeals for the D.C. Circuit has since struck down the rule, reasoning that the SEC acted capriciously and arbitrarily by

\textsuperscript{128} Stephen Choi, Jill Fisch, Marcel Kahan & Edward Rock, \textit{Does Majority Voting Improve Board Accountability} working paper (20115).
\textsuperscript{129} Grundfest, supra note _ at 1.
\textsuperscript{131}
not having sufficient evidence. In its opinion, the court referred to comments made by the two dissenting commissioners. What is left, then, is to observe which firms adopted proxy access via private ordering.

Initially, very few companies adopted a proxy access rule. Yet, since the proposals that were submitted gained shareholder support, gradually more and more firms received such proposals. Further, in November 2014 the NYC Comptroller announced that Boardroom Accountability Project, an initiative to submit proxy access proposals in seventy-five companies that were specifically picked based on known problems associated with compensation, diversity, and environmental impact and policies, might be the watershed for proxy access proposals as we are now in the midst of a significant wave of proposals, most of which receive majority support from shareholders.

Unlike majority voting proposals, proxy access proposals have garnered significant resistance from management, who have attempted to exclude them from the firms’ proxy materials rather than bringing them to a shareholder vote. To that end, management relied on a not frequently used exception to the shareholder proposal rule. Under 14a-8(i)(9), a proposal can be excluded if it “directly conflicts with one of the company’s own proposals to be submitted to shareholders at the same meeting.” Management at Whole Foods Company used this provision to fight the proxy access proposal—they submitted an alternative proposal, with a nine percent threshold for at least five years. There is not even one shareholder in Whole Foods that meets this threshold. They then requested and received a no action letter from the SEC to verify their ability to exclude the three-by-three shareholder proposal, which resultantly conflicts with a management proposal. Chipotle submitted a similar request to the SEC based on a conflicting proposal with an eight percent threshold for at least five years, limited to one director. Then, in a surprising move, the SEC reneged; it decided to further investigate the conflicting proposals exception and announced that it would not issue a no action letter under this exception until its investigation concluded. On October 22, 2015 the SEC limited the use of this exception.

While it is a bit early to reach a conclusion on private ordering from the proxy access proposals, a recent SEC study finally attempts to ask exactly the question raised in this article: How well does private ordering operate with respect to proxy access? Do the firms that adopt proxy access under private ordering are really the ones that stood to benefit most from it?

The study relies on market responses to the passage of the proxy access, to its subsequent placing on stay, and to the NYC Comptroller announcement, to assess

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132 Despite this careful selection, the comptroller was criticized for his one-size-fits-all approach since each of his proposals sought to implement the same proxy access format—a “three-by-three” proposal termed as such because it allows any shareholder that has owned at least a three percent stake for at least three years, under certain circumstances, to add his director nominee to the firm proxy materials.

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


136 Bo Subramanian
differential benefits from proxy access implementation. Firms that were likely to be affected by the 2010 proxy access rule, showed an average positive (negative) abnormal returns, in response to the passage (stay) of the rule. The abnormal returns were not uniform, rather, some firms’ abnormal returns were significantly higher, both the passage and the stay of the rule. Using these variations in firms’ abnormal returns to the announcements, the study finds which firms, in the market eyes, stood to benefit most from proxy access. The results are consistent with variations in abnormal returns in response to the NYC comptroller announcement. The same firms that the market viewed as needing proxy access, showed relatively strong abnormal returns to the comptroller announcement.

Asking whether these firms, which in the eyes of the market stood to gain most from proxy access, were also the ones who were more likely to adopt proxy access, the study has several interesting findings. First, it finds that the firms that are being targeted are not necessarily the ones that were viewed by the market as the ones that could benefit most from proxy access. The researchers attribute that to other goals or interests of activists that submit shareholder proposals. Even more interesting is the self selection of firm that resist proxy access proposals. Firms in which managers chose the relatively aggressive Whole foods strategy, requesting the SEC to issue a no action letter based on a conflicting proposal, were precisely the firms that investors expected to benefit more from proxy access, both in the market response to the stay, and to the NYC comptroller announcement. And more generally, firms in which managers took one of the following actions that could somewhat impede implementations of proxy access – adopting a stricter proposal, bringing a conflicting proposal to vote, or promising to propose or adopt a proxy access in the future – were all firms that were expected to benefit more from proxy access.

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

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

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

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

138 Id., at 32
cross-listing is a form of private ordering. Since by now a significant body of evidence has accumulated on cross-listing it serves as a good context to evaluate the private benefits hypothesis. Also, by cross-listing, firms opt for a whole package of legal terms. Thus, it is easier to determine whether they increased their commitment than when we observe only a change of one governance term.

1. Controlling Shareholders and Cross-Listing

Foreign firms are different from U.S. companies in that they are frequently controlled by a large shareholder. Thus, unlike US firms foreign firms have a significant owner who has incentives to monitor managers. Yet, although generally interested in their firms’ success, controlling shareholders often have interests that are not perfectly aligned with the interests of the other, dispersed, minority shareholders. In other words, in firms with controlling shareholders the manager vs shareholder agency problem discussed above is replaced with a controlling shareholder, vs minority shareholders agency problem.

If they choose to cross-list on U.S. exchanges, controlling shareholders have to obey stricter disclosure obligations, become subject to U.S. robust enforcement mechanisms, and are more visible to U.S. analysts. A significant body of evidence supports the hypothesis that cross-listing and subjecting themselves to these mechanism controlling shareholders commit to extract less private benefits then the ones they extracted before cross-listing. First, cross-listing decrease controlling shareholders’ control premium—that is, the difference between the price per share paid for a controlling block of shares and the price per share for minority shares. Moreover, the magnitude of the hit to the

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141 See Coates (challenging the usefulness of assessing the effect of a change in an individual corporate governance term on the basis that corporate governance terms interact)( http://hls.harvard.edu/faculty/directory/10170/Coates/bibliography); see Bhagat et al., supra note 52 (criticizing governance indices on the basis that corporate governance terms interact).
142 The common manifestations of the agency problem are also somewhat different. While managerial agency problem manifest in for example high executive compensation or excessive takeover defenses, controlling shareholders extract private benefits via self-dealing or going private transactions.
144 Doidge et. al., supra note 26. When a controlling shareholder sells her block she typically gets a control premium for it, that is the price per share a buyer pays for her block is typically higher than the price of the minority publicly traded shares. Arguably, the control premium reflects the value of the future private benefits that the controlling shareholder is giving up by selling the block, and the new controlling
control premium increases with the level of the legal commitment they choose. Depending on whether it involves IPOs, trading on exchanges, or merely conducting a private placement, cross-listing triggers different levels of regulatory burdens. While private placements result in almost no legal obligations, listing on a major U.S. exchange exposes firms to scienter-based liability under Section 10b-5, and a full IPO on the U.S. exchanges would trigger a strict liability standard for filling the IPO registration statement. IPO cross-listing generates the largest positive market reaction, followed by non-IPO cross-listing, and lastly by private placement, which sometimes fails to move the market at all. Similarly, the magnitude of the positive market response to cross-listing increases alongside the level of commitment firms adopt. Finally, cross-listing on other exchanges with lower disclosure obligations, does not trigger the same response. For example, cross-listing on the Alternative Investment Market (“AIM”), of the London Stock Exchange, which is designed for small companies and applies only minimal disclosure requirements, is not associated with any positive premium.

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

What would be an efficient private ordering for controlling shareholders, that is, which controlling shareholders would cross-list according to private ordering proponents? Cross-listing is expensive, complying with disclosure is expensive. Thus, controlling shareholders should cross-list when the benefits to shareholders from the legal constraints are larger than these costs. Like managers, controlling shareholders who face weak market forces, and weak internal controls, extract high private benefits. For example, a recent study finds that in firms that face significant competition, control premiums are lower than in firms that operate in less competitive industries. Firms that face weak constraints, from which the controlling shareholders extract high private would benefit most from cross-listing. Yet, control premiums in firms who eventually cross-list, prior to listing, is significantly lower than control premium in firms that did not list. Accordingly, prior to cross-listing these firms have higher Tobin’s Q values, than firms that do not cross-list. These patterns support the idea that the controlling shareholders who choose to cross-list are the ones that probably extract fewer private benefits from their firms, possibly due to other constraints.

shareholder will consume. Consistent with this hypothesis, an international cross-country study found that control premium values are negatively associated with the amount of legal protections minority shareholders have. Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparison, 59 J. OF FIN. 537 (2004).


Id.


Doidge + explain how control premium is measured.

Doidge et. al., supra note 19.


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

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

Cross-listing is most valuable for firms in countries with weak legal regimes as it substitutes for the lack of constraints at home. Accordingly, the positive market reaction to cross-listing announcements is significantly higher if a firm cross-lists from a country with weak investor protections, disclosure obligations, and legal institutions than if a firm cross-lists from a country with a robust legal regime.151 Thus, private ordering proponents would predict that firms from these countries would be the most likely to cross-list. Yet, studies consistently show that firms from countries with weak minority protections, disclosure obligations, and legal institutions are significantly less likely to cross-list than firms from countries with strong legal regimes.152 The results are striking not only since they indicate that controlling shareholders forgo a significant increase in share value in order to maintain their private benefits, but mainly due to the significant inefficiency losses they expose.153 For instance, one study found that for firms that cross list on U.S. exchanges from countries weak legal regimes, costs of capital savings are around five times larger than for firms that cross-list from countries with strong legal regimes.154

Finally, inefficient self selection, and the efficiency costs it impose, are also demonstrated in the decision to de-list. Firms have the option to reverse their decision and de-list, that is, to leave the U.S. exchanges and go back to their lax legal regime. Examining the price reaction to Rule 12h-6, which eases delisting, a recent study found that it was negative and stronger in countries with weak minority protection, consistent with the idea that shareholders in these countries benefit most from cross-listing.155

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151 See Hail & Leuz, supra note _ (finding that cross-listing on US exchanges results in a stronger cost of capital effect for firms from countries with low disclosure requirements, weak securities law enforcement or weak investor protection); Craig G. Doidge, Andrew Karolyi, & René M. Stulz, Why are foreign firms listed in the U.S. worth more?, 71 J. OF FIN. ECON. 205 (2004); Miller 1999 (emerging markets).

152 See e.g., Michael S. Weisbach & William A. Reese, Jr. Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings, 66 J. OF FIN. ECON. 65 (2002) (finding that firms from civil law countries are less likely to cross-list on U.S. exchanges than firms from common law countries).

153 Thus, the argument that shareholders know which shares they are buying is not helpful. Shareholders and society as a whole bear significant inefficiency costs for these poor choices. We also have some evidence on the potential magnitude of these costs.

154 See Hail & Leuz, supra note , tbl 5.

155 Nuno Fernandes, Ugur Lel, & Darius P. Miller, Escape from New York: The Market Impact of Loosening Disclosure Requirements, 95 J. FIN. ECON. 129, ___(2010). This price reaction also could have reflected investors’ beliefs that firms from these countries will use the opportunity to delis in larger proportions.
Consistent with inefficient self-selection, however, firms from these countries have a higher inclination to delist from U.S. exchanges.  

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

Third, controlling shareholders also vary on how the amount of voting rights and cash flow rights they hold, and the difference between the two. A controlling shareholder that holds a block of more than fifty percent of outstanding shares holds control of the voting rights and also has high cash flow rights if the shares provide one vote per share. Yet, there are ways to substantial voting rights with only a small fraction of the company’s cash flow rights. For example, some shares provide more than one vote per share. Thus, if the controlling shareholder receives shares with high voting rights, he can have control with only a small fraction of the company cash flow. Similarly, through pyramids, that is a chain of holding companies, controlling shareholders can effectively control companies without owning substantial cash flow rights. Assume for example a pyramid, in which a controlling shareholder holds a 50% ownership stake in firm A which, holds 50% of firm B, which holds 50% of firm C. By controlling A’s board, our controller can effectively control both B and C even though his ownership in C is only 12.5%. In longer pyramids, ownership of downstream firms might amount to just a few percentage points. Indeed, in these firms, the control premium is significantly higher. These structures, that effectively separate ownership from control, and are quite common in many countries, contribute to high agency costs. The controlling shareholder controls firm C but has only a low ownership in it. Thus, he may make decisions that harm firm C but benefit himself. For example, the controlling shareholder would support a self-dealing transaction in which Firm C buys something from firm A, in which he holds a large fraction of the shares, at an excessive price.

When cash flow rights are significantly lower than voting rights, shareholders will benefit most from cross-listing. If private ordering were efficient, therefore, controlling shareholders would show a higher inclination to cross-list when the cash rights they hold are significantly lower than their voting rights. The evidence, however, suggests the opposite is happening. The inclination to cross-list decreases alongside the ratio of voting rights to cash flow rights. Thus, when the ownership structure does not provide sufficient incentives, controlling shareholders do not compensate for it with better law. To the contrary, they are more reluctant to commit themselves to extract less private benefits of control.

F. State Competition

“Summarizing, stricter corporation laws survive because in some instances market oriented governance mechanism do not provide some classes of shareholders with the explicit legal controls they prefer. More liberal corporation laws survive because they allow certain firms to economize on the costs of political or legal control of managers, without interfering with the operation of market controls.”

156 Marosi & Massoud, supra note 29.
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U.S. system of state corporate law, has also been praised for allowing firms to select whichever state’s corporate law they desire. Accordingly Dodd was criticized as it “stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.”

Yet, in this context, just as in every context reviewed above, there has been little analysis on what sorts of firms tend to choose lax law and which ones opt for strict law. This is partly because conventional wisdom has been that corporate law is relatively uniform across states. However, as this author found in a separate work, during the last few decades Nevada has distinguished itself as clearly lax corporate law regime. Utilizing these variations in a joint work David Smith and I researched the type of firms that Nevada attracts.

1. Nevada Lax Corporate Law

For years, conventional wisdom has been that Nevada copied Delaware corporate law and followed closely changes to it. Yet, Nevada corporate law is significantly different from Delaware corporate law. Around a half decade ago Nevada has begun offering and vigorously marketing remarkably lax corporate law in order attract incorporations. Nevada’s strategy involved limiting directors’ and officers’ exposure to liability for breaches of the fiduciary duties that are the cornerstones of Delaware law—the duties of loyalty and good faith. Section 102(b)(7) of the DGCL does allow companies to opt out liability under the duty of care so long as shareholders approve, but that statute has several exceptions:

1. Nevada Lax Corporate Law

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

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158 See Gallagher, Tulane CLI 2014, supra note
159 But see Bsysinger Butler Maryland Reits
160 By adopting this strategy, Nevada intended to economize on corporations’ diverging preferences for weak legal constraints. Nevada is also utilizing its competitive advantage; its reputation as a provider of lax law in other fields provides it with the credibility and commitment to maintain the lax regime. See Barzuza, Market Segmentation, supra note 14 (analyzing the reasons for the success of Nevada’s strategy).
162 “The certificate of incorporation may also contain any or all of the following matters: (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.”
NRS § 78.138 omits each 102(b)(7) exception except the last one: Intentional misconduct, fraud, or knowing violation of law.\textsuperscript{163}

[A] director or officer is not individually liable to the corporation or its stockholders or creditors for any damages as a result of any act or failure to act in his or her capacity as a director or officer unless it is proven that

(a) The director’s or officer’s act or failure to act constituted a breach of his other fiduciary duties as a director or officer; \textit{and}

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

As a result, under Nevada law, neither duty of loyalty nor duty of good faith breaches trigger liability unless they also involve intentional misconduct, fraud, or knowing violation of law.\textsuperscript{164}

In 2001, Nevada made § 78.138 mandatory. In 2003, it relaxed it by making it a default rule. But once § 78.138’s provisions first attached, they could be changed only with management approval. In addition, while Delaware law protects only directors, Nevada law protects both directors and officers.

The legislative history of Nevada’s new corporate law system eliminates any remaining doubt that Nevada intended to differentiate itself from Delaware by providing its corporations with minimal liability exposure. Amendments in 2001 were intended to function as a toll that would increase incorporation revenues. In order to accomplish this end, the Nevada Chairman of the House, Senator Mark A. James, explained to the to the Senate Committee on the Judiciary, “Nevada ought to offer some liability protection to directors of corporations.”\textsuperscript{165} A local Nevada attorney, Michael J. Bonner, also spoke in favor of providing more protection from liability than Delaware:

When we look at our Nevada corporate business statute we have to recognize that…it is Delaware versus home state versus Nevada, if it is a

\textsuperscript{163} \textsc{nev. rev. stat.} § 78.138(7) (2010); see also Keith Paul Bishop, \textit{Silver Standard}, Los Angeles Lawyer, November 2008, 32 (noting that Nevada automatically relieves directors and officers from liability unless both conditions are met).

\textsuperscript{164} Keith Paul Bishop, \textit{Silver Standard}, Los Angeles Lawyer, November 2008, 32 (noting that Nevada automatically relieves directors and officers from liability unless both conditions are met). Similarly proxy solicitations of firms that reincorporate to Nevada, explain the legal differences. “reincorporation will result in the elimination of any liability of a director for a breach of the duty of loyalty unless arising from intentional misconduct, fraud, or a knowing violation of law.” See, e.g., ITIS Holdings Inc, proxy statement, filed on 09/16/2002 (explaining the differences between Delaware and Nevada law). Reincorporations require shareholder approval, in soliciting shareholder vote firms must disclose to shareholders the legal differences between the two states; see also Proxy Statement of ATSI Communications Inc/DE, filed 03/26/2004 (noting the lack of liability for breach of duty of loyalty under Nevada law); Daleco Resources Corp. filed on 02/06/2002 (same).

\textsuperscript{165} Bill Draft Request 7-1547, introduced as Senate Bill 577, \textit{Hearing on S.B. 277 Before the Senate Comm. on the Judiciary}, 2001 Leg., 71st Sess., (Nev. 2001) (statement of Senator Mark James). Senator James further explained that since “Directors are the ones who decide where to incorporate… this will be a major incentive[].”\textit{Id.} at 10-11. Taxes were raised in 2003, not by as much as originally anticipated. See Barzuza, \textit{Market Segmentation, supra} note 14. Indeed, in 2003 Nevada increase its maximum incorporation fee from 80 to 12000. Taxes were raised in 2003, not by as much as originally anticipated. \textit{Id.}
tie, if the corporate laws of these jurisdictions are equally favorable… typically, they are going to select Delaware. That is just the way it is…if Nevada can enhance the liability protection for [directors and officers] and strike the proper balance to not protect those who have participated in criminal activity or fraud, the state will go a long way to making Nevada an attractive place in which to incorporate.\(^{166}\)

Finally, Nevada has supplemented its strategy by aggressively marketing its unique product, and it does so by highlighting the greater protections afforded to managers under Nevada law. For example, the Nevada Secretary of State’s website explains, under the heading “Why Nevada?” that “Nevada Provides Stronger Personal Liability Protection to Officers and Directors.”\(^{167}\]

2. Nevada Firms

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

On the other hand, if private ordering is not working efficiently Nevada lax law may attract problematic, and even shady firms. Indeed, some representatives in Nevada were concerned by this fairly intuitive possibility that their new laws might attract shady companies. For example, Senator Dina Titus warned that the State might just as well hang up a sign reading, “Sleaze balls and rip off artists are welcome here.”\(^{168}\) Senator Bob Coffin echoed these concerns, warning that “reputable companies [were] not going to want to come here to save a few dollars”\(^{169}\) and that Nevada would become:

[T]he place where Butch Cassidy and Sundance Kid would go, the Hall in the Wall… Make no mistake, these subtle changes are significant. Scoundrels can move here, and there are scoundrels in the mutual fund business and in the pension business and in many corporations. If I was one of them I might consider moving here now.\(^{170}\)

In a recent work, this Author, together with David Smith, compared the reporting behavior of Delaware and Nevada firms.\(^{171}\) The study focused on accounting

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\(^{166}\) See id. at 13.
^{167}\ Secretary of State Barbara K. Vegaske, WHY NEVADA? Commercial Recordings
If you press on the pdf link you find a summary of the legal differences which include “Although Nevada generally requires both intentional misconduct, fraud or a knowing violation of the law and a breach of a fiduciary duty to impose liability on a director, under Delaware and California law, a director may be held liable for a breach of a fiduciary duty absent intentional misconduct, fraud or a knowing violation of the law.”Secretary of State Barbara K. Vegaske, WHY NEVADA? Commercial Recordings, Legal Advantages: A comparison with Delaware and California, Lionel Sawyer & Collins and Parsons Behle & Latimer Law Firms https://www.nvsilverflume.gov/documents/CorporateLawComparison.pdf
Cf. Kahan & Kamar, supra note 3, at 717-21 (reporting that prior to 2001 Nevada marketing efforts were focused primarily on attracting close corporations, stressing confidentiality and tax benefits for close corporations that incorporate in Nevada)
^{168}\ Id. at 159.
^{169}\ Id.
^{170}\ Id. Ultimately the opponents supported the law since it was promised to then that the projected $30 million in revenues will be used to increase salaries of public school teachers. Id. at 158.
^{171}\ See Barzuza & Smith, supra note 31.
restatements—that is, the process by which firms amend their reported performance figures retroactively, typically to admit that they performed worse than they originally reported. Since accounting restatements result from previous misstatements, they draw a significant negative market response, adversely affect managers’ credibility, and are associated with weak internal and external controls.\footnote{See e.g., Michael Ettredge et al., How Do Restatements Begin? Evidence of Earnings Management Preceding Restated Financial Reports, 37 J. Bus. Fin. & Acct. 332, 334, 351 (2010) (showing that restatements are preceded by balance-sheet bloating especially, but not only, when fraud is involved); Jap Efendi et al., Why do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors, 85 J. Fin. Econ. 667, 670, 700, 703 (2007); See Jennifer H. Arlen & William J. Carney, Vicarious Liability for Fraud on Securities Market: Theory and Evidence, 1992 U. Ill. L. Rev. 691, 701 (1992); Coffee, supra note 147, at 201–04 (arguing that restatements are motivated by management desire to increase the value of their option packages); Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, 35 Conn. L. Rev. 1125, 1130–31 (2003); see also Oren Bar-Gill & Lucian A. Bebchuk, Misreporting Corporate Performance 2–3 (Harvard Law and Econ. Discussion Paper No. 400, 2002, revised 2003), available see also Bar-Gill & Bebchuk, supra note 150, at 1–5, 33 (developing a formal model of misreporting and showing how incentive-based compensation may incentivize managers to misreport).}

Our study finds that firms that choose to incorporate in Nevada tend to make far more accounting restatements than firms that choose to incorporate in Delaware or other states.\footnote{See Barzuza & Smith, supra note 31.} Moreover, our study shows that a higher proportion of Nevada firms’ accounting restatements involve fraud or trigger regulatory investigations.\footnote{A.J. Cataldo II, Thomas Miller, Lori Fuller & Brian J. Halsey, The U.S. State of Nevada Consumes a Disproportionate Share of U.S. Securities and Exchange Commission Regulatory Resources, 5(8) Int. Res. J. of App. Fin. 1222 (2014).} We also find that Nevada firms ranked as aggressive on an accounting metric constructed by Audit Integrity.

Nevada firms’ high incidence of financial restatements relative to firms in other states is consistent with the theory that Nevada attracts firms with higher agency costs. Two recent studies also support this theory. In the first study, researchers found that a disproportionately high number of Nevada firms were subjected to SEC trading suspensions in 2013 and SEC trading suspensions of marijuana stock at the beginning of 2014.\footnote{Siegel, J.I., & Wang, Y. (2012). “Cross-border reverse mergers: Causes and consequences.” Harvard Business School Strategy Unit Working Paper No. 12-089, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2192472.} In the second, Professor Jordan Siegel examined a relatively new phenomenon: cross-mergers of foreign companies into U.S. shells. Siegel found that “[a]doption of Nevada’s corporate law is associated with some of the most serious restatements involving real corporate governance and data manipulation problems.”\footnote{Barzuza, Market Segmentation, supra note 14.}

However, while we find significant differences in restatement ratios between Nevada firms and firms other states, we do not find similar differences in firms’ valuations. While Nevada firms do not exhibit the same premiums as Delaware firms, they are not traded at a discount. This result could suggest, however, that investors are not sufficiently informed about the legal reforms in Nevada, or otherwise that incorporating in Nevada sends a mixed signal.\footnote{Barzuza, Market Segmentation, supra note 14.} As a recent paper shows, determining the value of governance
terms takes at least a decade. The relevant question thus, is what are the returns of Nevada firms during these years. A recent study found that the 2001 amendment was followed by a decline to firms returns. Another study compared returns of Nevada-incorporated and Delaware incorporated firms, but only for a particular subset of firms—issuing of marijuana stock. Researchers found that Nevada firms had the lowest returns.

3. Delaware Firms Compared to Home State Firms

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

As Rob Daines found firms in Delaware have higher Tobin’s Q values than firms in other states. Two possible theories might explain Daines’s results. First, Delaware’s superior law might improve firm value—Daines defended this view in his paper. Second, the difference might stem in part from a selection effect. In other words, it could be the case that better law increases firms’ value and attracts better firms. Daines carefully examined possible selection biases. For instance, he focused only on mature firms that never reincorporated under the assumption that these firms have a fixed domicile—that is, they do not have real choice regarding the state of incorporation and thus their state of incorporation is to some extent exogenous. He also scrutinized firms that reincorporated and found that they were not more valuable than their peers before reincorporating. Indeed, his findings suggest that selection cannot explain all of Delaware’s premium: Delaware law instead both attracts better firms and increases firm value. At the same time, he notes, it is still possible that selection affects part of his results. In particular, as Daines recognizes, it is possible that Delaware attracts firms with lower agency costs. Further, Ishii, Gompers, and Metrick ran Daines’ test while

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181 See id. at 550-51.
182 See id. at 551-52.
183 See id. at 553 (“It is impossible to exclude the possibility that Delaware simply attracts valuable firms. Although selection bias may explain some of the effect I observe, it seems unlikely that selection bias explains it all.”).
184 See id. (arguing that this story is consistent with the result that Delaware law improves firm value. “Note that there is one endogeneity account that is consistent with the evidence. If Delaware law facilitates the sale of the firm, good managers might be more likely to incorporate there because they have less reason to
controlling for the governance index they developed. And, consistent with the selection theory, the Delaware effect disappeared.

In a follow-up study, Professor Guhan Subramanian demonstrated that the difference in Tobin’s Q values between Delaware and non-Delaware firms has been decreasing over the years. This result is consistent with both accounts—that both law and selection matters. Delaware law became more favorable to managers during the 1980s in a variety of ways. Accordingly, managers that were not attracted to Delaware before since it did not provide them with sufficient protection suddenly found Delaware to be an attractive place for incorporation. Both effects should have, in theory, resulted in Delaware’s average premium decreasing. The shifting nature of Delaware firms might explain why the decrease in the Tobin’s Q appeared not in the late 1980s when Delaware decisions became more favorable to managers, but rather during the 1990s. In a recent paper that Subramanian co-authored, researchers found that the Delaware premium eventually re-emerged. Among a sample of firms examined between 2000 and 2008, Delaware firms had significantly higher Tobin’s Q levels.

G. Exceptions – Size and Value

There are two exceptions to the inefficient self-selection rule: Size and Market Value. On both dimensions there is some evidence that is consistent with efficient self-selection.

Size matters for the desirability of legal constraints since costs of implementation of compliance might be disproportionally large for small firms. This results when compliance and implementation costs have a fixed costs component, which represents a higher percentage of a small firm’s revenues. For example, small firms’ compliance with § 404 of SOX was assessed to be approximately two million dollars per year, which translates to approximately five percent of small firms’ average market value. Thus, for small firms, shareholder legal constraints might be too expensive and therefore not profitable. Indeed, evidence suggests that to some extent firms self select efficiently on this dimension. Size is a significant factor in cross-listing, incorporation, and governance terms. Small firms are less likely to list on U.S. exchanges, more likely to list on AIM, (which offers lax disclosure standards), more likely to incorporate in Nevada than large firms, and less likely to adopt governance constraints such as majority voting terms. While this evidence could suggest that self-selection on this dimension is efficient, size by itself is not a sufficient justification for private ordering. To begin with, there could be also inefficient reasons for why small firms tend to choose lax law. For example, small firms are less followed by analysts, and therefore might not pay the full price, in terms of

fear a disciplinary takeover. Poor managers, or those valuing private benefits, would thus avoid Delaware incorporation because it would be more costly.”)

188 See Barzuza & Smith, supra note 31.
189 See Peter Lliev, The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices, 65 Journal of Finance, 1163, 1180-1181 (2010). If the costs are permanent the cumulative effect could reach even 30% of value. Id. Yet recent evidence suggests costs have gone down over time. Coates.
190 Doidge et al. see infra section
191 See Barzuza & Smith
192 See Choi et all, supra note
share market value, for their governance choice. Second, size is an observable component that could be taken, and has been taken, into account in mandatory regulation. Indeed, as discussed in infra Part _ Sox and Dodd-Frank include exceptions for small firms.

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

V. Implications

A. Implications for Data Interpretation

A significant body of research analyzes the effect that various governance terms and packages thereof have on firms’ performance. These studies are often used to assess policy proposals. In analyzing the data self-selection is frequently taken into account. Yet, the inefficient self-selection that is described here rarely does.

Take for example the evidence from voluntary adoption of independent directors pre SOX. While several selection account were considered, on counterfactual, that firms that did not adopt it might benefit more from it, was never even raised. Rather, conventional wisdom has been that SOX mandated independence despite evidence that independence does not add value.

The analysis here suggests caution when attempting to draw policy implications from this research. The cumulative body of evidence shows that the firms that voluntarily adopt governance constraints are often the least likely to exhibit resultant changes in performance. The firms that could benefit most from constraints, by contrast, are often the least likely to adopt it voluntarily. Research on independent directors provides a helpful illustration of this dynamic: Independent directors proved more valuable and effective in the firms that only hired them after SOX and the exchanges listing standards required them to. Relying on results from voluntary adoption, could underestimate the potential effects of governance, and cast doubt on whether governance matter at all.

193 See discussion infra parts
194 Bainbridge, Stephen M. . Corporate Governance after the Financial Crisis (“The empirical evidence on the relationship between board composition and firm performance available when Sarbanes-Oxley was adopted was inconclusive, at best. If independent directors effectively constrain agency costs, one would have expected the evidence to show a correlation between the presence of independent outsiders on the board and firm performance. But it did not. “); Macey
195 Mariana, Kahan
B. Assessment of Mandatory Regulation vs Private Ordering Should Examine Forms of Self-Selection and Adverse Selection Inefficiency Costs

The One-Size Argument has been the most frequently provoked and influential argument against mandatory corporate law. But although firms do vary considerably, the presence of heterogeneity is not a silver bullet that necessarily renders mandatory regulation inappropriate. While a one-size approach may impose costs on some firms, these costs should be weighed, in every instance, against the potential costs of relying solely on private ordering.\(^1\) One category of costs, includes frictions created by heterogeneity in market forces and firms’ needs for regulation.

As Coase famously noted, the choice between private ordering and regulation “has to come from a detailed investigation of the actual results of handling the problem in different ways. But it would be unfortunate if this investigation were undertaken with the aid of a faulty economic analysis.”

To get a sense of the costs imposed by heterogeneity and adverse selection commentators and policymakers alike should examine data on the different choices that are made by different firms. Who are the firms that choose strict law and how they differ from the firms that choose lax law. Put differently, one question we should ask is to what extent self selection is efficient with respect to each governance term. And if its not what are the inefficiency costs that result.

C. Novel Approaches to Policy

The theoretical and empirical observations developed here inspire two novel approaches to policy: market based mandatory standards, and minimal governance packages.

1. Market Based Mandatory Standards

The analysis developed here points to overlooked advantages in applying commonly used governance terms to all firms. For example, mandatory law that applies Delaware 102(b)(7) to all firms, or a mandatory law that applies proxy access to all firms, could provide higher potential gains than a third not yet adopted mandatory rule.

Part of the private ordering argument against mandatory law has been lack of information on the regulator side relative to market participants. Similarly, a critique of Federal regulation has been focused on the lack of information and experience of the federal government has relative to Delaware.\(^2\) Also it was argued Delaware gets feedback for mistakes– as corporations may leave the state - while federal government does not.\(^3\) Yet, by piggybacking on market participants-governance terms adopted by individual firms, legal standards applied by Delaware - the regulator is minimizing the costs of inferior information.

If a significant number of firms adopt a governance term, It will be worthwhile to inquire whether this term is efficient and could benefit other firms, and why the other

\(^{1}\) Mahoney, Wasting a Crisis (2016)

\(^{2}\) See, e.g., Winter, Shareholder Protection, supra note _ , at 291 (“Because federal legislation does not face direct competition with other legal systems, the behavior of investors under differing rules cannot be observed and we can only theorize about which rules optimize the underlying economic relationships.”).

\(^{3}\) See e.g., Daniel R. Fischel, The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law, 76 Nw. U. L. Rev. 913, 922 (1982).
firms do not adopt it. Such an inquiry could check the governance of the firms that do not adopt it, whether it is stronger or weaker than firms that did. Similarly, Delaware law and standards should be considered as minimal standards for all firms. 199

2. Minimal Governance Packages

The findings also lend support for a second solution: Creating a number of minimal packages of legal constraints and requiring firms to choose the one that best suits them. For example, if a firm chooses to incorporate in Nevada it should also have to adopt both proxy access and majority voting to ensure board accountability. Or if a firm chooses to maintain a staggered board, it should not be allowed to also have a poison pill. This policy approach allows firms to take into account specific circumstances while simultaneously preventing the sort of race-to-the-bottom self-selection possible in a law-free private ordering regime.

In fact, the SEC has recently used a similar approach to craft a new “pay ratio” rule, required under the Dodd-Frank Act, that would require firms to disclose several new compensation figures: the median of all firm employees’ total annual compensation, the CEO’s total annual compensation, and the ratio of those two amounts. 200 On September 18, 2013, by a 3-2 vote, the SEC proposed such a rule that does not set forth any single method companies must use to calculate each of these figures. 201 Indeed, SEC Chairwoman Mary Jo White has highlighted the fact that the SEC’s proposed rule “provide[s] companies significant flexibility in in complying with the disclosure requirement” instead of creating a one-size-fits-all disclosure regimen. 202 In particular, companies would have the option to determine total compensation amounts using existing executive compensation rules, amounts in payroll or tax records, or any other “methodology that is appropriate to the size and structure of [the firm’s] own business[].” 203 Companies could choose whether to calculate the median based on all employees salaries, or through statistical sampling. 204 They would simply have to disclose the operative methodologies and assumptions used to determine each figure. 205

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


202 Id.

203 Id.

204 Id.

205 Id.
As critics point out, however, this flexibility might enable firms to make strategic calculations and thereby disclose ratios that appear more egalitarian than they in fact are.\footnote{See, e.g., Andrew Ross Sorkin, \textit{S.E.C. Has Yet to Set Rule on Tricky Ratio of C.E.O.’s Pay to Workers’}, \textit{N.Y. Times Dealbook} (Jan. 26, 2015, 8:17 PM), available at \url{http://dealbook.nytimes.com/2015/01/26/tricky-ratio-of-chief-executives-pay-to-workers/?_r=0} (“With all the wiggle room that is expected to be allowed, companies may devise ratio numbers that are largely irrelevant.”).} Relatedly, they argue, investors that the new disclosure requirements aim to benefit might find themselves completely unable to interpret the pay ratio in light of whatever complex methodology produced it.\footnote{See, e.g., id.} Thus, this approach may not be sufficient for some mandatory standards, which should apply to all firms. Nevertheless, the SEC’s proposal which provides the benefits associated with flexibility while establishing a regulatory floor beneath which firms may not cross, demonstrates again that the One-Size Argument is not a persuasive argument against mandatory corporate law.

VI. Conclusion

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

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

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