

INEFFICIENT TAILORING: THE PRIVATE ORDERING PARADOX IN CORPORATE LAW

MICHAL BARZUZA*

The conventional wisdom in corporate law posits that private ordering has an important virtue: it allows firms to efficiently tailor governance terms to their particular needs. This virtue is routinely advanced to justify the largely “enabling” structure of U.S. corporate law, and to oppose “one-size-fits-all” mandatory regulation.

This Article argues that private ordering frequently produces inefficient tailoring of corporate governance terms—firms that need governance constraints are precisely the ones that do not volunteer to implement them. In theory, the conventional approach assumes that these firms will implement constraints voluntarily because otherwise they would be disciplined by market forces. Yet such reliance on market discipline has an inherent paradox: the firms that would benefit most from governance constraints are precisely the ones that are subject to weak market discipline.

Evidence from myriad studies and contexts suggests that firms’ needs for constraints are often not, or negatively, correlated with having them. For example, the inclination to cross-list on US exchanges is negatively correlated with controlling shareholders’ private benefits, and with the cross-listing premium; firms that benefitted from independent directors were precisely the ones that did not have them prior to SOX; managers of firms that investors believed would benefit most from proxy access were precisely those who were most likely to contest them; Nevada’s lax fiduciary duties attract firms that are prone to financial reporting failures. The Article concludes with implications for data interpretation and corporate law policy.

| | | |
|--|--|-----|
| INTRODUCTION | | 132 |
| I. THE “VIRTUE” OF PRIVATE ORDERING – THE WIDE SUPPORT AND INFLUENCE OF THE EFFICIENT TAILORING ASSUMPTION . . | | 138 |
| II. THE PRIVATE ORDERING PARADOX—THEORETICAL FRAMEWORK | | 141 |
| A. <i>Midstream Adoption of Governance Terms – the Market Discipline Paradox</i> | | 141 |
| B. <i>Governance at the IPO and Firm Heterogeneity – Adverse Selection</i> | | 146 |

* Professor of Law and Nicholas E. Chimicles Research Professor of Business Law and Regulation, University of Virginia School of Law. For helpful comments and discussions I thank Bobby Bartlett, Lucian Bebchuk, Alma Cohen, Richard Craswell, Rob Daines, Steven Davidoff, John Duffy, Jill Fisch, Jesse Fried, Mike Gilbert, Jeff Gordon, Joe Grundfest, Assaf Hamdani, Sharon Hannes, Rich Hynes, Marcel Kahan, Ehud Kamar, Louis Kaplow, Kobi Kastiel, Michael Klausner, Reinier Kraakman, Michael Livermore, Justin McCrary, Dotan Oliar, Mitch Polinsky, Ariel Porat, Roberta Romano, Steve Shavell, Holger Spamman, Eric Talley, Yishai Yafeh and participants in faculty workshops at the Hebrew, Tel-Aviv and Virginia law schools and in law and economics workshops at Berkeley, Harvard, Stanford and Texas. For excellent research assistance, I thank Brian Mammarella and Scott Baird.

- III. THE EVIDENCE: DO FIRMS SELECT THEIR RIGHT “SIZE” OF CORPORATE LAW AND GOVERNANCE? 151
 - A. *Private Ordering with Shareholder Proposals: Proxy Access, Contested Shareholder Proposals, and Majority Voting* 152
 - 1. In Which Firms Do Managers Contest Shareholder Proposals? 153
 - 2. Proxy Access – Private Ordering and Shareholder Proposals 154
 - 3. Majority Voting – Early and Late Adopters 156
 - B. *Board Independence — Voluntary vs. Mandatory Independence* 158
 - C. *Controlling Shareholders’ Private Benefits and Inclination to Cross-List on U.S. Exchanges* 162
 - D. *State Competition* 166
 - 1. Nevada Lax Corporate Law 167
 - 2. Nevada Firms 169
 - a. *Nevada Firms’ Restatements and Reporting Aggressiveness* 170
 - b. *Nevada Firms’ Value* 173
 - E. *Exceptions – Size and Value* 175
 - 1. Small Firms are Less Likely to Adopt Governance Constraints 175
 - 2. Weak Performance Increases likelihood to Implement Governance Changes 176
- IV. IMPLICATIONS 177
 - A. *Implications for Data Interpretation* 177
 - B. *Assessment of Mandatory Regulation vs. Private Ordering* 178
 - C. *Implications for Shareholder Proposals and Proxy Advisory Firms* 179
- CONCLUSION 181

INTRODUCTION

According to conventional wisdom, private ordering in corporate law has an important virtue: it allows firms to tailor governance terms to their particular needs.¹ This virtue—*efficient tailoring*—arguably justifies the en-

¹ See, e.g., ROBERTA ROMAN, THE GENIUS OF AMERICAN CORPORATE LAW 1 (1993) (“The genius of American corporate law is in its federalist organization. . . . Firms . . . can particularize their charters under a state code, as well as seek the state whose code best matches their needs so as to minimize their cost of doing business.”); Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1098–99 (2008) (“That is corporate law apple pie and motherhood, with the kind of private ordering that is central to the American form of corporate

ture enabling structure of U.S. corporate law, which generally offers firms a set of default rules that they can adopt or reject.² Accordingly, this reasoning has been advanced routinely against corporate regulatory reforms such as the Sarbanes-Oxley Act of 2002 (SOX) and the Exchanges' board independence requirements, as well as the Dodd-Frank Act's mandated shareholder advisory votes and disclosure obligations.³ These "one-size-fits-all" mandatory regulations, it has been argued, apply governance constraints—such as independent directors or disclosure obligations—to all firms, including those that do not need them. Under private ordering on the other hand, only firms that need governance constraints (and all of these firms) will implement them.⁴ But do firms really choose their right "size" of corporate governance? What if firms that adopt governance constraints are often those that are least likely

lawmaking being preminent in the outcome . . . That is, the market . . . will have the most important role in establishing the norms, with flexibility for particular corporations to deviate from those norms in ways that work for them."); JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 103 (2008) [hereinafter MACEY] ("An advantage of private sector ordering in determining the composition of boards is that private ordering can adjust board composition to reflect the efficacy of complementary corporate governance mechanisms."); Letter from Alexander M. Cutler, Chairman & Chief Exec. Officer, Eaton Corp., and Chair, Corp. Leadership Initiative, Bus. Roundtable, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, at 45 (Aug. 17, 2009), <http://www.sec.gov/comments/s7-10-09/s71009-267.pdf> [hereinafter Business Roundtable Letter] ("[P]ermitt[ing] shareholders to propose amendments to a company's bylaws to facilitate proxy access would allow shareholders to take advantage of the opportunity that state law affords to tailor a system of proxy access to the needs of the individual company.").

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

³ See, e.g., Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1798–99 (2011) ("A study . . . finds support . . . that requiring a one-size-fits-all model separating the CEO and chairman positions may be counterproductive."); STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 129 (2011) [hereinafter BAINBRIDGE, FINANCIAL CRISIS] ("Once again we see another one-size-fits-all model being forced on all public companies."); Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014), <https://www.sec.gov/news/speech/2014-spch032714dmg.html> ("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."). It is also a cornerstone of President Trump's plan to deregulate the financial industry. On February 3, 2017 President Trump issued an executive order, which directs the Secretary of Treasury, within 120 days, to review regulations of the financial system under seven core principles, including making regulation "appropriately tailored." Exec. Order No. 13,772, 82 Fed. Reg. 9965, 9965–66 (Feb. 3, 2017).

⁴ See, e.g., Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 459 (1985) ("[C]orporate law will play a relatively more important role in those corporations in which market-oriented governance mechanism are relatively less important or influential and *vice versa*." [hereinafter *Uniformity*]; MACEY, *supra* note 1, at 103 ("This, in turn, suggests that companies that have substantial anti-takeover protective mechanisms, such as poison pills . . . and staggered boards of directors, are likely to have more independent, outside directors than companies lacking an arsenal of anti-takeover devices.").

to be affected by them? And what if firms that could benefit most from strict governance are precisely the ones who are least likely to constrain themselves?

Despite its significant influence on policy, the assumption that private ordering results in efficient tailoring, namely that firms voluntarily choose their right “size,” has not been systematically assessed against available evidence. While the assumption entails clear testable predictions, until recently no study examined these predictions or even the basic questions of which firms under private ordering voluntarily adopt governance constraints, and which firms resist adopting them.⁵ Rather, scholars, practitioners and policy makers merely pointed to non-uniform adoption of governance terms by different firms as an indication that private ordering results in efficient tailoring.⁶ Similarly, firm heterogeneity has not been incorporated rigorously into corporate law theory, or even thought through carefully.⁷

This Article challenges the assumption that private ordering results in *efficient tailoring*. Rather, it argues that private ordering suffers from a significant flaw: firms whose shareholders could benefit most from governance constraints are precisely those whose managers are often more likely to resist such constraints (“Resisting Firms”). The Article incorporates firm heterogeneity in agency-costs to the contractual theory of corporate law and shows that the conventional wisdom about private ordering contains an *inherent paradox*: firms subject to weak market discipline would benefit most from governance mechanisms that can curb managerial opportunism, but market discipline is precisely what is required to incentivize managers to adopt such governance mechanisms. The Article further reviews and analyzes empirical studies from a wide range of contexts which overall do not support the assumption that firms tend to tailor governance constraints efficiently. The Article then derives implications from these insights for data interpretation and corporate law policy.

Part I reviews the conventional assumption that private ordering results in efficient tailoring and its broad implications. The stakes of this Article’s argument are as high as ever. The new administration is moving to scale back financial regulation, and soon firms will likely be free to choose

⁵ For three recent exceptions, see generally Tara Bhandari et al., *Governance Changes through Shareholder Initiatives: The Case of Proxy Access* (Jan. 17, 2017) (unpublished manuscript), <https://ssrn.com/abstract=2635695> (assessing private ordering tailoring for proxy access terms); Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119 (2016) (assessing differences between early and late adopters of majority voting terms); Sarath Sanga & Roberta Romano, *The Private Ordering Solution to Multiforum Shareholder Litigation*, 14 J. EMP. LEG. STUD. 31 (2017) (assessing private ordering for mid-stream adoption of forum selection bylaws). See also discussion *infra* Part III.A.

⁶ See, e.g., Easterbrook & Fischel, *Corporate Contract*, *supra* note 2, at 1426 (“The agreements that have arisen are wonderfully diverse, matching the diversity of economic activity that is carried on within corporations.”).

⁷ Rather, a typical argument by assertion holds that those firms that face weak market constraints, and therefore could benefit from additional governance constraints, will adopt them voluntarily. See *supra* note 5.

whether to adopt constraints on a large set of issues. Dodd-Frank's requirements, such as advisory say-on-pay votes and disclosure obligations, and Sarbanes-Oxley's requirements, such as mandated majority of independent directors, are all on the table.⁸ Furthermore, corporate governance market players are also on the line. Shareholder activists' proposals and proxy advisory companies' voting recommendations—which were criticized for pressuring firms to conform to “one-size” governance norms—are likely to be targeted by limiting regulation.⁹

Part II illuminates the theoretical paradox involved in the assumption that firms choose their right governance “size.” The conventional approach assumes that firms, if allowed to choose governance structures, will make efficient choices because otherwise the market would discipline them. Yet it is precisely the firms that are subject to *weak* market discipline that would benefit most from governance mechanisms that can curb managerial opportunism, and for which market discipline is required to incentivize managers to adopt such governance mechanisms. Take proxy access, for example: some argue that many firms do not need proxy access or could benefit from one that is more lenient than the SEC proposed proxy access rule. But would managers that are not sufficiently accountable to shareholders, whose firms need proxy access, adopt it voluntarily?¹⁰ This, indeed, is the conventional approach *paradox*: it relies on market forces to create the governance structures needed to compensate for the lack of market forces. Part II further demonstrates that the theoretical tension in the private ordering argument extends to the initial public offering (IPO) stage. In particular, it shows that the conventional wisdom, which holds that IPO pricing provides incentives for optimal governance, holds only if variations in market forces are fully observable to investors. If investors do not know which firms will face weak market forces, adverse selection could impede IPO optimality. This Article's first contribution thus is to develop a comprehensive theory of corporate law with firm heterogeneity in agency-costs.

The Article's second contribution is to assess its theoretical predictions, as well as those that ensue from the conventional assumption that firms voluntarily tailor governance to match their particular needs, against currently available evidence. Evidence from myriad contexts and studies in which

⁸ See, e.g., Robert C. Pozen, *What Will Happen to Dodd-Frank under Trump's Executive Order?*, BROOKINGS INST. (Feb., 2017), <https://www.brookings.edu/blog/up-front/2017/02/06/what-will-happen-to-dodd-frank-under-trumps-executive-order> (“President Trump made clear: ‘We expect to be cutting a lot of Dodd-Frank, because frankly, I have so many people, friends of mine that had nice businesses, they can’t borrow money.’”).

⁹ See Elizabeth A. Diffley et al., *Proxy Advisory Firms in the Spotlight: Looking in the Crystal Ball*, NAT'L L. REV. (Dec. 2, 2016), <http://www.natlawreview.com/article/proxy-advisory-firms-spotlight-looking-crystal-ball> (“With a Republican-controlled Congress and a Securities Exchange Commission that will be under the leadership of a new Chair and new Commissioners, we anticipate that proxy advisory firms will be in the rule-making and regulatory spotlight.”).

¹⁰ Indeed, evidence shows that managers of firms that needed proxy access the most were most likely to fight shareholder proposals to implement it. See discussion *infra* Part III.A.

firms choose their governance constraints, analyzed in Part III, casts doubt on the assumption that firms select their right “size,” and is consistent with the concerns raised here that firms that could benefit most from governance constraints are often least likely to adopt them voluntarily.

Private ordering in corporate governance relies, in a large part, on shareholder power to submit proposals to implement governance changes to the bylaws. Yet, recent evidence from shareholder proposals reveals inefficient self-selection practices. As a contemporary study of shareholder proposals to implement proxy access finds, managers resisted proxy access proposals precisely in those firms that were most likely to benefit from them.¹¹ Similarly, a recent study finds that managers contest shareholder proposals in firms with weak governance, that is, firms that are more, rather than less, likely to benefit from governance constraints.¹² Finally, a recent study of the proliferation of majority voting terms, private ordering’s poster child, finds that early adopters of majority voting were less likely to experience withhold votes in previous years—that is, firms for which it did not likely to matter much were quick to adopt it.¹³ Firms for which majority voting could matter—namely, firms in which shareholders voted against directors in previous elections—resisted implementing majority voting for a while, and probably would not have succumbed if it was not for the pressure of proxy advisory companies.

Evidence from other contexts is similarly unsupportive of efficient tailoring. Take for example the mandated requirement to have a majority of independent directors on the board. Pre-SOX, when firms were free to choose whether to have a majority of independent directors, several studies found that firms who did so did not perform better than their peers. Thus, for years the consensus has been that independent directors do not add value to U.S. boards. Accordingly, when SOX and the exchanges’ listing standards required all listed firms to have a majority of independent directors, they were heavily criticized for acting with no supporting evidence and for applying a one-size-fits-all approach. But recent studies find that independent directors added value to firms that did not add them voluntarily, but rather were forced to add them by the listing mandates. Firms that benefited most from independent directors, thus, were precisely the ones that did not add them voluntarily, and would probably be the first to dismiss them if the new administration repeals SOX and the exchanges’ listing standards.

Or, consider the private ordering of foreign firms who cross-list on U.S. exchanges and are bound to their higher disclosure standards and robust enforcement mechanisms. Firms that cross-list from countries with weak gov-

¹¹ See Bhandari, *supra* note 5, at 34 (assessing private ordering tailoring for proxy access bylaw amendments).

¹² See Eugene Soltes et al., *What Else Do Shareholders Want? Shareholder Proposals Contested by Firm Management* 18–19 (Harvard Bus. Sch., Working Paper No. 16-132, 2016) (studying all shareholder proposals submitted between 2003–2013).

¹³ See Choi et al., *supra* note 5.

ernance constraints—that is, countries in which controlling shareholders can extract high private benefits—exhibit a positive market reaction that is significantly larger than that of firms that cross-list from countries with strong ones. Yet, the inclination to cross-list from the former countries is lower than from the latter ones. Similarly, firms in which controlling shareholders' voting power is high and share value is low, and therefore presumably have higher agency costs, are less likely to cross-list even though the market highly rewards them for doing so. This evidence from cross-listings demonstrates that inefficient tailoring could impose significant costs on shareholders.

Similarly, evidence from firms' choice of state of incorporation raises questions with respect to how efficient tailoring is under private ordering. When Nevada differentiated its law by narrowing significantly Delaware's mandatory fiduciary duties of loyalty and good faith, state representatives were concerned that Nevada's relaxed laws would attract a disproportionate number of problematic firms.¹⁴ If firms choose their right "size," however, Nevada should attract firms whose agency costs are so low, and internal constraints so strong, that they are better off with minimal fiduciary duties. As this author has found in a separate work with David Smith, firms that choose to incorporate in Nevada, as compared to firms that incorporate in Delaware, have an exceptionally high frequency of accounting restatements, and are ranked high on aggressiveness in financial reporting.¹⁵

To sum, a significant body of evidence, spanning a broad array of applications including board independence, cross-listing on U.S. exchanges, voting and choosing a firm's state of incorporation, raises doubts as to the efficiency of voluntary tailoring in corporate law. Part III also discusses evidence that is consistent with the assumption that firms choose their right "size": firms for which costs of implementation are relatively low, and firms that exhibit abnormally weak performance, are more likely to adopt governance constraints. Indeed, the argument of this Article is not that firms never choose their right size, but rather that with respect to agency costs they might not.

Part IV derives implications for data interpretation and corporate law policy. To begin with, the analysis suggests caution in drawing policy impli-

¹⁴ See Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 977 (2012) [hereinafter Barzuza, *Market Segmentation*].

¹⁵ See Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law*, 27 REV. FIN. STUD. 3593 (2014). Similarly, a recent study of foreign firms' reverse mergers into the United States finds that reverse mergers into Nevada are associated with the most egregious accounting restatements. Jordan Siegel & Yanbo Wang, *Cross-Border Reverse Mergers: Causes and Consequences* 26 (Harvard Bus. Sch., Working Paper No. 12-089, 2013) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2192472. At the same time, however, there is no evidence that this behavior resulted in a lower value for Nevada's firms. See, e.g., Barzuza & Smith, *supra*, at 3598, 3618–20, app. at 13 tbl.11 (finding no statistically significant effect for the valuation of Nevada firms and stating that, "[o]verall, our valuation findings are inconclusive and make it difficult to draw strong conclusions regarding the efficiency of the decision to incorporate in Nevada."). For a broader discussion, see *infra* Part III.D.

cations from evidence on voluntarily adopted governance terms. While in analyzing data, self-selection is frequently taken into account, inefficient self-selection of the form described here is rarely acknowledged. The Article argues that as a result of such overlooked, inefficient self-selection, assessments of the value of corporate governance could suffer from a downward bias, leading researchers and policy makers to conclude erroneously that governance does not matter, but only because it was adopted exclusively by those firms for whom it did not matter much, rather than by those firms who could have benefited from it.

Second, Part IV discusses implications for the choice between mandatory rules and private ordering in corporate law. The analysis suggests that a sweeping deregulation of the financial industry would not be desirable. While one-size mandatory approaches might impose costs on some firms, policy makers should weigh these costs against potential costs from inefficient tailoring, namely costs borne by firms that face weak internal and external discipline and choose lax legal constraints.¹⁶ An informed policymaking should consider evidence with respect to patterns of self-selection, the reasons why some firms did not adopt governance terms, the characteristics of these firms, and the merits of the proposed regulation. For example, the evidence from board independence suggests that repealing the exchanges' listing standards is not desirable, as firms that now benefit from board independence would probably opt out of it, as they did prior to SOX.

Third, the analysis also highlights the importance of shareholder proposals and the impediments to efficient self-selection in managers' requests to exclude them. In considering whether to provide no-action letters, the SEC should be reminded of the evidence that managers might contest shareholder proposals particularly when the proposed governance change could benefit shareholders. Fourth, the Article highlights an important overlooked role of proxy advisory firms in pressuring Resisting Firms to adopt governance terms. Thus, proxy advisory firms' potential positive effect on tailoring governance to Resisting Firms should be cast against limiting their power and influence.

I. THE "VIRTUE" OF PRIVATE ORDERING – THE WIDE SUPPORT AND INFLUENCE OF THE EFFICIENT TAILORING ASSUMPTION

According to conventional wisdom, private ordering in corporate law has a significant virtue: it allows firms to choose the governance terms that best fit their unique needs and circumstances.¹⁷ This virtue of private order-

¹⁶ Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 18–19 (1960) (stating that the choice between mandatory law and private ordering "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.").

¹⁷ See, e.g., Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 8–9 (2005) ("An enabling corporation law, found in

ing is considerably important since as commonly asserted—one-size-does-not-fit-all in corporate law and governance—not all firms would benefit from a majority of independent directors, majority voting, proxy access and other governance constraints.¹⁸ Presumably, conventional wisdom assumes, under private ordering, firms that stand to benefit from these terms, and only those firms, will adopt them.¹⁹ The faith in this assumption is so strong, that the virtue of private ordering arguably disqualifies any mandatory “one-size-fits-all” provision in corporate law, regardless of its merits.²⁰ Any imposition of uniformity is considered Pareto inefficient—that is, that managers and shareholders should prefer choice over any mandatory uniform system.²¹ Indeed, according to the founding fathers of economic analysis of corporate law—Easterbrook and Fischel—this virtue justifies the entire enabling structure of American corporate law: “No one set of terms will be best for all; hence the ‘enabling’ structure of corporate law.”²² Accordingly, this reasoning has been a major criticism against legal reforms including SOX,²³ the Dodd-Frank Act and the ’33 and ’34 Securities Acts.²⁴ For example, Dodd-Frank say-on-pay advisory votes were described as “rigid and costly one-

both Delaware and the Model Act, offers corporations a degree of flexibility from a menu of reasonable alternatives that can be tailored to companies’ business sectors, markets, and corporate culture.”); Joseph A. Grundfest, *The SEC’s Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 361–62 (2010) (“Because I (and you) do not know how to structure a proxy access regime that is suitably tailored to address the individual circumstances of the almost 12,000 publicly traded corporations in the United States, it makes sense to support a fully enabling approach to proxy access that allows every publicly traded corporation, easily and cheaply, to determine by majority vote the rules governing shareholder access to the corporate proxy.”); David A. Katz & Laura A. McIntosh, *Populists’ Wish Lists Offer Legislative Parade of Horribles*, 242 N.Y.L.J., July 23, 2009, <https://www.law.com/newyorklawjournal/almID/1202432451430> (“Delaware’s private-ordering approach, which can be effected by carefully drafted company bylaws, enables companies and their shareholders to tailor proxy access to their own specific circumstances and keeps the issue of proxy access in the proper realm of state law.”); see also *supra* note 1.

¹⁸ See, e.g., Easterbrook & Fischel, *Corporate Contract*, *supra* note 2, at 1428 (“Just as there is no right amount of paint in a car, there is no right relation among managers, investors, and other corporate participants.”); BAINBRIDGE, *FINANCIAL CRISIS*, *supra* note 3 (“[O]ne size does not fit all in corporate governance.”).

¹⁹ See *supra* note 5.

²⁰ See, e.g., Letter from Cravath, Swaine & Moore LLP et al. to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 4–5 (Aug. 17, 2009), <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf> [hereinafter Seven Firm Letter] (arguing that proxy access should be governed by private ordering regardless of how desirable it is); see also Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329 (2010) (“A central argument put forward repeatedly by the Proposal Opponents is that, even assuming that access is beneficial for many public companies, the optimal approach is to retain no-access as the default arrangement.”).

²¹ *Uniformity*, *supra* note 4, at 456.

²² Easterbrook & Fischel, *Corporate Contract*, *supra* note 2, at 1418.

²³ See, e.g., BAINBRIDGE, *FINANCIAL CRISIS*, *supra* note 3, at 124; MACEY, *supra* note 1, at 103.

²⁴ See Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1065 (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.”).

size-fits-all mandates,”²⁵ and a former SEC commissioner criticized Dodd-Frank disclosure obligations for applying “a one-size-fits-all approach that will likely result in a one-size-fits-none model.”²⁶

These days, the issue has become as prominent as ever. On February 3, 2017 President Trump issued an executive order, which directs the Secretary of Treasury, within 120 days, to review financial regulations under seven core principles, including making regulation “appropriately tailored.”²⁷ Dodd-Frank, SOX, and the Securities ’33 and ’34 Acts could be repealed in whole or in part.²⁸ Advisory shareholder votes on executive compensation, independent directors mandates, disclosure requirements of hedging, pay ratio rules, and split chair/CEO, clawback policies requirements, and SEC authority to adopt a proxy access rule, are all on the table.²⁹ If repealed, these requirements will be governed by private ordering.

Furthermore, the new administration is also likely to move forward with regulating and limiting proxy advisory firms—who advise institutional investors on how to vote on myriad governance issues, including board elections, say on pay votes, and shareholder proposals.³⁰ Allegedly, proxy advisory firms—the largest of which are Institutional Shareholder Services (“ISS”) and Glass Lewis—interfere with pure private ordering by pressuring firms to conform to “one-size” governance norms. For example, ISS typically recommends voting in favor of shareholder proposals that seek to replace a firm’s plurality voting regime with a majority voting regime.³¹ Indeed, the conventionally held wisdom, that some firms chose not to adopt a majority voting term, is an indication that they do not stand to benefit from

²⁵ See, e.g., Strine, *supra* note 1, at 1107 (“A vigorous state law discussion of executive compensation [would] be less likely to yield rigid and costly one-size-fits-all mandates and more likely to enable flexible, company-specific solutions acceptable to investors and managers.”).

²⁶ Gallagher, *supra* note 3 (“This mandated intrusion into corporate governance will impose substantial compliance costs on companies, along with a one-size-fits-all approach that will likely result in a one-size-fits-none model instead. This stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.”).

²⁷ Exec. Order No. 13,772, *supra* note 3, at 9965–66 (Feb. 3, 2017), <https://www.federalregister.gov/documents/2017/02/08/2017-02762/core-principles-for-regulating-the-united-states-financial-system>.

²⁸ See Pozen, *supra* note 8.

²⁹ See, e.g., *Trump To Sign Executive Action on Dodd-Frank Today*, RIVEL RESEARCH GRP. (Feb. 3, 2017), <http://rivel.com/executive-action-on-dodd-frank-today>.

³⁰ See Diffley et al., *supra* note 9 (“With a Republican-controlled Congress and a Securities Exchange Commission that will be under the leadership of a new Chair and new Commissioners, we anticipate that proxy advisory firms will be in the rule-making and regulatory spotlight.”).

³¹ They also might recommend withholding votes from management who inappropriately refused to implement such a proposal or bring it to a shareholder vote. See discussion *infra* Part III.D.

it. Pressure on firms to conform to this “one-size” norm, by assumption, could not be beneficial.³²

The objection to proxy advisory firms’ policies has led to proposed regulatory reform: The Corporate Governance Reform and Transparency Act of 2016 (formerly known as the Proxy Advisory Reform Act).³³ The rule, which is likely to pass under the new administration, would limit proxy advisory firms’ power and influence, and probably result in more firms resisting governance changes.

The forgoing demonstrated the wide support for the efficient tailoring assumption and its significant influence on corporate law policy. The literature, however, has not subjected this assumption to a rigorous theoretical and empirical scrutiny, a task to which this Article will turn.

II. THE PRIVATE ORDERING PARADOX – THEORETICAL FRAMEWORK

This part introduces firms’ heterogeneity to the classic theory of corporate law—the contractual framework—and analyzes its theoretical implications. Part A discusses the market forces paradox, focusing on the midstream stage, when the firm is publicly traded and when the vast majority of decisions about governance are being made. Part B demonstrates that also the IPO stage, when the firm forms its initial charter and bylaws, could result in inefficient tailoring if managers have more information than investors with respect to their firm’s particular needs.

A. *Midstream Adoption of Governance Terms – the Market Discipline Paradox*

The midstream stage starts right after the company has conducted its IPO with its initial IPO charter and bylaws, and spans the entire life of the firm as a publicly traded company. It is the stage when most decisions about governance are being made, and thus is the most significant stage for the core argument of this Article, and for assessing private ordering in corporate governance.³⁴ At this stage, the manager typically holds only a small fraction

³² See, e.g., Martin Lipton, *Disintermediating the Proxy Advisory Firms*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 21, 2012), <https://corpgov.law.harvard.edu/2012/01/21/disintermediating-the-proxy-advisory-firms/> (“We have long eschewed the one-size-fits-all model of corporate governance advanced by many of the proxy advisory firms.”); David F. Larcker & Allan L. McCall, *Proxy Advisers Don’t Help Shareholders*, WALL ST. J. (Dec. 8, 2013), <http://www.wsj.com/articles/SB10001424052702303497804579241842269425358>; James K. Glassman & Hester Peirce, *How Proxy Advisory Services Became So Powerful*, MERCATUS ON POLICY 2 (June 18, 2014), <https://www.mercatus.org/sites/default/files/Peirce-Proxy-Advisory-Services-MOP.pdf> (“[O]ne-size-fits-all recommendations miss the nuances of particular corporations.”).

³³ Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. (2016).

³⁴ See generally Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325 (2013) [hereinafter Klausner, *Fact and Fiction*].

of the firm cash flow. Thus, on its face, the manager has few incentives for self-constraint. For example, to protect her position in the company, the manager might adopt entrenching governance devices that could impose inefficiency costs, resulting in a decline to firm value.³⁵ Similarly, the manager might not implement newly introduced majority voting or proxy access bylaws, though they could increase firm value.

The conventional approach response to the midstream agency problem posits that market forces incentivize managers to adopt efficient governance, regardless of how few shares of the firm they hold.³⁶ The markets for corporate control, capital, managerial labor, and products all penalize managers for poor management choice, including poor law and governance choices. If the manager chooses poor corporate law, and the firm's share value declines as a result, she could be replaced in a hostile takeover,³⁷ harm her reputation and her future job prospects,³⁸ receive lower compensation, find it costly to raise capital for new investments,³⁹ or otherwise simply not withstand fierce competition in the product market.⁴⁰ Due to the combined effect of these market forces, the argument goes, managers would pick the governance package that best fits the firm's particular needs, namely, the one that maximizes shareholder value.⁴¹

But therein lies an *inherent paradox*. It is precisely those firms, that are subject to *weak* market discipline that would benefit most from governance mechanisms that can curb managerial opportunism, and for which market discipline is required to incentivize managers to adopt such governance mechanisms. If managers are exposed to robust market forces, which provide significant discipline for managers, additional legal constraints will make either a small difference or none at all.⁴² When market forces are weak,

³⁵ See, e.g., Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

³⁶ See generally Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEG. STUD. 251, 256 (1977); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919–20 (1982); cf. Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition*, 105 HARV. L. REV. 1435, 1464 (1992) [hereinafter Bebchuk, *Desirable Limits*] (arguing that market forces are generally limited and analyzing their shortcomings in disciplining managers).

³⁷ See, e.g., Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965); Fischel, *supra* note 36, at 919–20.

³⁸ See, e.g., Fischel, *supra* note 36, at 919; Winter, *supra* note 36, at 256–57.

³⁹ See, e.g., Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543–46 (1984); Winter, *supra* note 36, at 275–76.

⁴⁰ See, e.g., Easterbrook, *supra* note 39, at 543–46; Winter, *supra* note 36, at 264.

⁴¹ Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 182–83 (1985) [hereinafter Baysinger & Butler, *The Role of Corporate Law*] ("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.").

⁴² The benefits from governance constraints do not come without costs. 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

however, legal constraints are needed to compensate for the lack of external constraints. Indeed, firms that operate in concentrated industries, evidence shows, benefited more from SOX, than firms that face fierce market competition.⁴³ In fact, conventional approach proponents have frequently argued that legal constraints are needed precisely in those firms that face weak market discipline.⁴⁴ Overlooking the tension in their argument, however, they simply assumed that these companies would also adopt these constraints, without explaining why and how that should happen.⁴⁵ The conventional approach to private ordering thus contains a paradox: it relies on market forces to create the governance structures needed to compensate for the lack of market forces. If market forces are not sufficiently strong to drive managers to perform at their best, how would they be sufficiently strong to drive managers to choose an effective governance regime?

management's choices, thereby constraining the inefficient decisions that derive from agency problems. Yet, they also tend to lack the same degree of industry- and firm-specific knowledge and expertise that inside directors have. 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.

⁴³ See, e.g., Vidhi Chhaochharia et al., *Product Market Competition and Agency Conflicts: Evidence from the Sarbanes-Oxley Act*, 63 MGMT. SCI. 1405 (2017).

⁴⁴ See e.g., BAINBRIDGE, FINANCIAL CRISIS, *supra* note 3, at 65 (“[M]anagers of a firm with strong takeover defenses are less subject to the constraining influence of the market for corporate control than are those of a firm with no takeover defenses. The former needs a strong monitoring board more than does the latter.”); MACEY, *supra* note 1, at 203 (“For example, companies that receive substantial outside scrutiny from the markets . . . may need less monitoring from directors”); see also BAINBRIDGE, FINANCIAL CRISIS, *supra* note 3, at 65 (“[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.”).

⁴⁵ See, e.g., *Uniformity*, *supra* note 4, at 459 (“Liberal corporation laws, it is hypothesized here, survive because they allow certain corporations to economize on the costs of political or legal control of managers [C]orporate law will play a relatively more important role in those corporations in which market-oriented governance mechanisms are relatively less important or influential, and *vice versa*.”); Baysinger & Butler, *The Role of Corporate Law*, *supra* note 41, at 182–83 (“Markets lead managers to adopt the optimal mix of legal and market governance structures for their firm. The optimal mix reflects the preferences of the firm's residual claimants.”); MACEY, *supra* note 1, at 103 (“This, in turn, suggests that companies that have substantial anti-takeover protective mechanisms, such as poison pills . . . and staggered boards of directors, are likely to have more independent, outside directors than companies lacking an arsenal of anti-takeover devices.”); see also BAINBRIDGE, FINANCIAL CRISIS, *supra* note 3, at 103 (“Congress's refusal to permit private ordering means that those firms where those costs are highest are unable to opt out of the one size fits all straightjacket.”); Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1035 (1998) (“Firms for which participatory management works well tend to stick with it, while those for whom it does not work tend to move on to other forms of industrial relations, allowing for the possibility that the faddish nature of participatory management may cause a certain amount of stickiness.”).

And the problem is not only that managers who are subject to weak market forces will not be penalized for making poor choices of governance.⁴⁶ As a result of the weak discipline they face, managers of firms that face weak market forces also extract relatively high private benefits.⁴⁷ Thus, they have more to lose from constraining themselves than managers who are anyway exposed to robust market forces that do not allow them to extract high private benefits of control. Given the combination of low market penalties and high private benefits consumption, managers facing weak market forces are likely to *avoid* legal constraints rather than welcome them.

To illustrate, assume, for example, that firm A faces strong market forces, $X1 = 0.45$, and that, as a result, A's manager extracts 10 in private benefits, which impose costs of twenty on the shareholders. Assume that, as a result, if the manager of firm A does not adopt a governance term (GT), there is a penalty of 9 ($0.45 * 20$).⁴⁸ Assume also that firm B faces weak market forces, $X2 = 0.2$, and that, as a result, firm B's manager extracts 20 in private benefits. Assume that this extraction causes a harm of 60 to shareholders (following a conventional assumption of increasing marginal costs of extraction). Thus, if the manager of firm B does not adopt GT, there is a penalty of 12 ($0.2 * 60$). Lastly, assume that each manager holds a ten percent stake in their respective firms, so that if a firm value declines by a certain amount then the manager incurs 10% of this loss. As shown below, as a combined result of the low penalty (relative to the decline in value) and high private benefits he extracts, the manager of firm B, the firm that could benefit most from a GT, does not adopt it.⁴⁹

⁴⁶ On the one hand, the potential increase in value provides incentives to managers to adopt governance constraints. On the other hand, due to the lack of market constraints, these anticipated changes in value may have little bite.

⁴⁷ See, e.g., Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463, 1463 (2001) (arguing that increased monopoly rents induce higher potential agency costs); Maria Guadalupe & Francisco Perez-Gonzalez, *Competition and Private Benefits of Control* (July 18, 2011) (working paper), <http://ssrn.com/abstract=890814> (finding that weak product market competition is associated with higher control premium).

⁴⁸ The penalty to the manager is a function of the strength of the market forces and the decline in firm value, since a large decline in value increases other risks, such as the risk of a hostile takeover.

⁴⁹ Notice also that the example assumed investors have full information. Thus, even if investors know exactly what they buy, self-selection is inefficient and imposes inefficiency costs. For a full formal model of these effects, which this analysis builds on, see Michal Barzuza, *Lemon Signaling in Cross-Listing* (Law & Legal Theory Working Paper Series, Working Paper No. 2012-03, 2012), <http://ssrn.com/abstract=1022282>.

TABLE 1: MIDSTREAM SELF-SELECTION

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

As this example illustrates, the firm that needs GT will not adopt it even when the decline to firm value in avoiding GT is relatively large.⁵⁰ To be sure, firms that could benefit from governance might not always resist GT.⁵¹ In particular, Lucian Bebchuk has shown that terms that provide large added value relative the loss of private benefits they impose on managers are more likely to be adopted.⁵² Yet, in the context of private ordering, there is another consideration that makes it less likely that firms that need governance constraints will adopt them. In most cases, managers of firms that need governance constraints did not reach this point incidentally. They probably had options to apply GTs in the past, but chose to pass. Or alternatively, they face weak market forces since they adopted entrenching mechanisms that weaken market forces' disciplining power.⁵³ Thus, by their *revealed preferences* we learn that these managers probably extract relatively high private benefits.⁵⁴ Managers of firms that need GTs, therefore, almost by definition, are less likely to adopt a new GT, unless the specific GT offers managers payoffs that were not covered by their previous options. If, for example,

⁵⁰ As a result, the absolute penalty to the manager of firm B is relatively large, but not the proportion of penalty-to-value, which is smaller given the weaker market force that firm B is exposed to.

⁵¹ To illustrate, assume that firm C also faces market forces X_2 , but the extraction of private benefits in firm C is less efficient than the extraction of private benefits in firm B. In particular, assume that if the manager extracts private benefits 20 from firm C, the value of firm C declines by 100. As a result, the cost to the manager of firm C, from not adopting GT, would be 30 (20 in penalty, plus 10 that he suffers from the decline in firm value). The same market forces, $X_2 = 0.2$, that did not incentivize the manager of firm B to adopt GT, would incentivize the manager of firm C to adopt GT.

⁵² See Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1841 (1989) ("The effectiveness of market discipline in discouraging managers from proposing value-decreasing amendments depends on the size of the transfer involved (the redistributive element) relative to the reduction in overall value (the efficiency element).").

⁵³ Market forces could be weak either for external reasons, or due to entrenching governance mechanisms that limit their disciplining power. See Bebchuk, *Desirable Limits*, *supra* note 36, at 1468 (arguing that managers could weaken the effect of the market for corporate control by adding entrenching anti-takeover devices such as a poison pill and a staggered board).

⁵⁴ In particular, from their revealed preferences, we learn that the payoffs for these managers are probably similar to the payoffs of firm B, rather than the payoffs of firm C.

managers' options were limited, so that the need for governance was not a result of management choices,⁵⁵ or if a newly introduced GT is innovative, in the sense that it offers a new solution with a relatively low decline to private benefits, then it might be adopted. Other than these two exceptions, however—limited options, or innovative GTs—managers that have not constrained themselves despite options to do so, and managers that entrenched themselves, by their revealed preference, are further less likely to adopt a newly introduced governance constraint.

To sum, at the midstream stage, as the forgoing illustrates, firms' need for regulation, will not make managers adopt efficient governance terms. If a governance term offers a new trade off, either since it is innovative, or since the firms had a limited arsenal of governance tools, then these firms might adopt it. Otherwise however, their managers would probably resist adding governance terms. Proponents of private ordering, however, have utterly overlooked the tension in their analysis of private ordering in the midstream stage.

B. Governance at the IPO and Firm Heterogeneity – Adverse Selection

This part incorporates heterogeneity in market forces to the theory of the IPO stage—when the firm constructs its initial charter and bylaws and goes public. In practice, the IPO influence on governance has been highly limited—IPO charters merely adopt the law of the state of incorporation, with very little variations, customization or innovation—virtually almost all governance choices are made after the IPO, at the midstream stage.⁵⁶ While this part is less important for the Article's core argument, the IPO governance analysis is considered a strong theoretical proposition, as it offers a robust account of optimality. As this Part will show however, the main problem that this Article identifies, one of inefficient tailoring, arises also at the IPO stage. The Article thus punctures holes in the widely held optimality of the IPO stage.

⁵⁵ For example, when cross-listing on U.S. exchanges became a viable option it offered firms that operated in countries with weak legal regimes and institutions, a new option to tie their hands. The firms that were the first to cross-list, whose need for GT was not a result of voluntary choice, but rather of lack of bonding mechanism, are more likely to adopt governance terms that benefit them.

⁵⁶ See, e.g., Klausner, *Fact and Fiction*, *supra* note 34, at 1329 (“Empirical evidence, however, shows that essentially no innovation or customization occurs in IPO charters and that these charters are virtually empty from a governance perspective.”). While in theory, in this stage managers should tie their hands to good governance, one that would maximize the IPO price, in practice it is virtually impossible to predict, assess and draft every future scenario in a constantly changing business world.

The intuition for the IPO inefficient tailoring is the following: since investors might have less information than managers on each firm's particular needs for governance—due to *adverse selection* at the IPO stage, firms that could benefit most from GT might not adopt it. To illustrate this intuition, this part will first discuss what happens when investors have full information, namely, the classical model of IPO optimality. Under this conventional approach, since at the IPO stage (unlike in the midstream stage) the manager/founders hold all of the shares of the company, they internalize the costs and benefits of their choices. If the managers offer a law or a governance mechanism that benefits them at shareholders' expense, their firm's shares will be devalued. When the firm first goes public to maximize the IPO price, conventional wisdom holds that the managers have incentives to offer optimal governance. The following example 1 will illustrate this effect.

Example 1 – IPO Heterogeneity when Firm Specific Information is Publicly Available. Assume that firm A and firm B's need for governance varies. In particular, assume that while in firm A, a governance term GT would increase firm value by 50, firm B faces significant disciplining market forces and as a result if firm B adopted GT, it would increase its value by only 8. Assume also that the manager of firm A extracts 40 in private benefits, while the manager of firm B extracts 30 in private benefits. Thus, from efficiency perspective, while firm A should include a GT in its charter, firm B should not as its benefits will outweigh its costs. If investors have full information—that is, if they know the particular benefits of adopting GT for *each particular firm*—they will add 50 to the IPO price of firm A, if firm A adopts GT, but only 8 to the IPO price of firm B, if firm B adopts GT. Anticipating that, as shown in Table 2 below, firm A offers GT at its IPO, while firm B does not offer GT at its IPO. Under full information thus, both firm A and firm B, make optimal governance choices.

TABLE 2: IPO HETEROGENEITY WITH SYMMETRIC INFORMATION.

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

The IPO stage's optimality, however, hinges on the assumption that capital markets value governance terms correctly. This assumption is valid, it has been argued: professionals in the market—who could benefit from trading on their research—assess the value of governance terms such as

proxy access and a staggered board, based on information that is publicly available. That one-size-does-not-fit-all formula, however, implies that governance terms' value is firm specific. Thus, to price them correctly, professionals need to know the specific value of staggered board and proxy access for each firm, in light of its specific circumstances. This assumption indeed was driving the efficient tailoring result from Example 1. Yet, this assumption might not always be realistic. Operative market forces and the extent to which they apply for each specific firm are often unobservable, or at the very least, are less observable to investors than they are to the company's managers. Managers might know the constraints that they expect to face better than investors: The competition they face, how strict their board chairperson is, what opportunities they will have for self-dealing, and so forth. The conventional approach, in fact, holds this as a premise: mandatory law is undesirable since only managers know their firm's particular needs.⁵⁷ Conventional theory, however, assumed that information imperfections of this type causes mere noise rather than bias in market price, and therefore, do not distort managers' "appropriate incentives."⁵⁸ Yet, according to accepted economic theory, asymmetric information with respect to each firm's specific needs, could easily lead to a systemic bias and distort incentives. In particular, if investors can assess the effect of proxy access on an average firm, but not its individual effect in each particular firm, market prices of governance at the IPO could suffer from *adverse selection*, which in turn could distort managers' incentives and lead to inefficient tailoring patterns. Example 2 will illustrate this adverse selection effect, and show how it could distort tailoring.

Example 2 – Adverse Selection. For the following example, assume the same firms A and B from example 1. Yet, unlike in example 1, assume that firm-specific information is *private*, that is, investors cannot distinguish between firm A and firm B and as a result, they apply an average value to GT, that is, 29, to both firms. Anticipating that, as shown in Table 3, both firm A and firm B will not offer a GT. Thus, in this example as a result of adverse selection, no firm adopts GT even though firm A should have it. This result, that none of the firms adopts GT is consistent with empirical findings with respect to the striking lack of governance at IPO charters.⁵⁹

⁵⁷ See, e.g., Grundfest, *supra* note 17.

⁵⁸ See Easterbrook & Fischel, *Corporate Contract*, *supra* note 2, at 1432–33. In addition, they point out regulators do not have perfect information either. *Id.* (“[I]t does not matter if markets are not perfectly efficient, unless some other social institution does better at evaluating the likely effects of corporate governance devices.”).

⁵⁹ See Klausner, *Fact and Fiction*, *supra* note 34 (finding close to zero innovation or customization in a hand collected sample of IPO charters and bylaws); see also Richard J. Sandler & Joseph A. Hall, *Corporate Governance Practices in IPOs*, 24 CORP. GOVERNANCE ADVISOR 17, 17 (2014) (“Despite pressure on US public companies to adopt certain governance practices . . . newly public companies continue to exercise a great deal of latitude in designing their governance structures.”).

TABLE 3: IPO WITH ASYMMETRIC INFORMATION – ADVERSE SELECTION

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

This potential adverse selection, a basic economic concept and intuition, is a direct application of firm heterogeneity to the IPO stage. To be sure, under conventional economic analysis, adverse selection could sometimes be improved upon, if firms can signal their type to the market.⁶⁰ Yet, in the case of private ordering, signaling does not meet an accepted condition for a signaling equilibrium to emerge and survive the Cho-Kreps intuitive criterion.⁶¹ In addition, signaling could be affected by confounding, sometimes opposite, signals.⁶² Finally, as this section will show, noise from a widely documented arbitrary adoption of GT and from network externalities GTs impose could obscure signaling in GT adoption.⁶³ To demonstrate these effects Example 3 will start from the case in which signaling is not obscured by noise, and the required conditions for signaling are met.

Example 3 – Signaling & Pooling. Assume that firm A faces weak market constraints, and that as a result GT would add 14 worth of value and reduce the manager's private benefits by 11. Assume also that firm B faces strong market forces, and as a result GT would only add 2, and reduce the manager's private benefits by 1. If investors do not know which is A and which is B, they will assess the value of GT at average 8 for all firms. As a result, however, the manager of firm B, who extracts only 1 in private benefits is better off offering GT. An equilibrium in which B offers GT and A does not offer GT, however, is also unstable. If A does not offer GT, while B

⁶⁰ See generally Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973).

⁶¹ See In-Koo Cho & David M. Kreps, *Signaling Games and Stable Equilibria*, 102 Q.J. ECON. 179, 202 (1987). The manager of firm A is better off offering GT, if that could result in a signal to the market that this is a firm of A type. Yet, since the manager of firm B loses less private benefits from adopting GT (30), than the manager of firm A does (40), if only one manager offers GT, investors would assume him to be the manager of firm B, that is the manager for whom signaling is less costly, rather than as the manager of firm A.

⁶² For example, Lucian Bebchuk has shown that other signaling effects could result in NGT for all firms at the IPO stage. In particular, if private benefits are correlated with value, firms might adopt lax governance terms at IPO to signal high value. See Lucian A. Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* 4 n.3, 11–23 (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Discussion Paper No. 398, 2002), http://lsr.nellco.org/harvard_olin/398.

⁶³ The analysis of noise's role in obstructing signals in corporate governance relies on Michal Barzuza, *Noise Adopters in Corporate Governance*, 2013 COLUM. BUS. L. REV. 627 (2013).

offers it (“Separating Equilibrium”), the manager of A would reveal his type to investors. Thus, investors would discount A’s value by 14, rather than 8. A’s manager thus, would rather adopt GT as well, and forgo private benefits of 11. Thus, both A and B adopting GT (“Pooling Equilibrium” on GT – Table 4, row 6) is the only stable equilibrium. In this example, therefore, a pooling equilibrium in which all firms adopt GT-IPO results in optimal governance offerings.

In reality however, this signaling effect is rather noisy: IPO governance is sometimes driven by boilerplates, advice of a local lawyer, network externalities, and other arbitrary reasons.⁶⁴ As a result, when investors observe a staggered board, for example, they might not know whether it resulted from a conscious choice by management (which implies a type A firm) or from a more benign reason such as a boilerplate (which could be either type A or type B firm).⁶⁵ As Example 4 illustrates, this type of noise could lead to inefficient self-selection.

Example 4 — Noise. This is demonstrated in Table 4, rows 7-8, which follows. As in Example 3 assume that GT has a value of 14 for firm A and a value of only 2 for firm B. If there is no noise, observing separation investors would reduce the value of firm A in 14. Yet, unlike in Example 3, assume that a third of the companies that did not adopt GT did so for some random reason such as a local lawyer’s advice or inertia. Thus, observing separation, the discount investors attach for not adopting GT would be 10 rather than 14.⁶⁶ Anticipating a penalty of 10, firm A will not offer GT. Thus, this equilibrium leads to the emergence of firm A as a Resisting Firm. This result is exactly the inefficient tailoring pattern this Article warned could happen—Firm A that needed governance the most would not adopt GT, and firm B that needed it less would adopt GT.

⁶⁴ See *id.* (surveying arbitrary sources of governance adoption); see also John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1337–38, 1363 (2001) (finding that law firm geographic location predicted IPO takeover arrangements); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1594–95 (2002) (finding that firms advised by law firms with national practice were more likely to incorporate in Delaware); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774–89 (1995) [hereinafter Klausner, *Networks*] (arguing that IPO charters are affected by network externalities and boilerplating).

⁶⁵ See Klausner, *Networks*, *supra* note 64, at 800–01. Supporting the importance of this information to investors, a study of UK firms found that firms that opted out of “best governance practices” and explained specific reasons for the choices performed better than firms that did not opt out. Yet, those firms that opted out with no explanation whatsoever performed worse than both. See Sridhar R. Arcot & Valentina G. Bruno, *One Size Does Not Fit All, After All: Evidence from Corporate Governance* 19 (Jan. 15, 2007) (unpublished paper), <http://ssrn.com/abstract=887947>.

⁶⁶ $2/3 * 14 + 1/3 * 2 = 10$.

TABLE 4: IPO GOVERNANCE – SIGNALING, POOLING AND NOISE

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

In sum, as Example 4 demonstrated, boiler-plating, inertia and other random sources at the IPO, which were documented extensively, confound potential signals. The analysis of signaling and noise is consistent with and could help in explaining firms' choice of staggered boards at the IPO, and firms' choice to stay in their home state rather than incorporate in Delaware. Both choices were driven by geographical location and identity of the advising law firm.⁶⁷ Thus, when a firm incorporates in its home state, or has a staggered board, investors might not know if the managers are interested in it for entrenchment, or if this is the boilerplate their lawyers provided.

We have seen that adoption of governance terms at IPO can be assumed to be efficient only if one assumes zero transaction costs and full information. However, if one assumes, as is reasonable to, that managers sometimes know more than investors about various aspects of the firm, then one can no longer assume the efficiency of tailoring at the IPO stage. We have further seen that the midstream stage, in which virtually companies constantly are, is prone to inefficient tailoring, even if investors have full information on the firm's particular circumstances. Theory thus does not give us a basis to believe that private ordering results in efficient theory as is wildly assumed.

III. THE EVIDENCE: DO FIRMS SELECT THEIR RIGHT "SIZE" OF CORPORATE LAW AND GOVERNANCE?

This Part will review, analyze, and synthesize evidence from a wide range of studies, spanning different contexts in corporate law and governance, which could shed light on whether firms efficiently tailor governance to their particular needs. To be sure, the evidence this Part reviews is not

⁶⁷ See Coates, *supra* note 64, at 1368.

considered as a direct proof that firms do not choose their right “size”.⁶⁸ And for each context, it is probably possible to come up with an account other than inefficient self-selection to explain the results. Overall, however, this rich body of evidence from numerous studies is more consistent with the inefficient tailoring account that this paper promotes, than with the conventional, efficient tailoring approach. At the very least, thus, this Part raises a real concern that firms that need legal constraints the most are also the ones that are least likely to adopt them voluntarily.

A. Private Ordering with Shareholder Proposals: Proxy Access, Contested Shareholder Proposals, and Majority Voting

The support for private ordering relies in part on shareholder power to submit shareholder proposals to implement governance changes to their firm’s bylaws. If shareholders believe that majority voting, proxy access, or any other governance term best fits a particular company’s need, they may submit a proposal that would be brought to shareholder vote, to implement the desirable governance term in that company’s bylaws.⁶⁹ Indeed, during the last decade, shareholder proposals have become a major mechanism to implement governance changes. Majority voting and proxy access terms, for example, have been implemented widely via shareholder proposals.

Under SEC Rule 14a-8, submitted shareholder proposals should be included in the firm proxy materials, and brought to a shareholder vote.⁷⁰ After the proposal is submitted, however, relying on one of the exceptions to the rule, managers may seek to exclude the proposal from the firm’s materials, requesting a “no-action” letter from SEC. If the SEC provides such a letter, which typically indicates that the SEC staff will not recommend an enforcement action against the firm for excluding the proposal will not be brought to a shareholder vote. To avoid hitting the exceptions to this Rule, shareholders typically structure their proposals to be precatory, that is, not binding even if they receive support from majority of shareholders. Thus, even if a proposal was voted favorably, managers still have the option to ignore it. Which firms amend their bylaws as a result of this process thus, depends on managers’ level of resistance in each firm. The following will discuss recent evidence on the type of firms whose managers contest shareholder proposals in general, and proxy access proposals in particular, as well as evidence on

⁶⁸ To begin with, empirical testing of this question is fueled with endogeneity concerns. Moreover, most of these studies did not focus on this question and thus did not test it directly.

⁶⁹ See, e.g., Strine, *supra* note 1, at 1098 (“Stockholders, exercising their state law rights, will present bylaws about the important subject of election reform.”); Business Roundtable Letter, *supra* note 1, at 45 (“[P]ermitting shareholders to propose amendments to a company’s bylaws to facilitate proxy access would allow shareholders to take advantage of the opportunity that state law affords to tailor a system of proxy access to the needs of the individual company.”).

⁷⁰ Including the proposal in the firm’s proxy materials saves costs of filing with the SEC and distributing materials to the firm’s shareholders.

firms that were quick to implement majority voting terms and firms that resisted their implementation.

1. *In Which Firms Do Managers Contest Shareholder Proposals?*

A recent study, which examines managers' requests for SEC no-action letters with respect to shareholder proposals, finds that managers ask SEC permission to exclude 40% of the shareholder proposals they receive, out of which SEC provides a no-action letter in more than 70% of the cases.⁷¹ Thus, close to a third of shareholder proposals submitted are not even brought up to a shareholder vote.

The most common basis for seeking exclusion relates to procedural requirements that the proposal arguably does not meet. The SEC provided a no-action letter for 73% of these requests. Second to it is the claim that the proposal contains misleading or false information, for which the SEC granted a no-action letter only in 20% of the cases.⁷² For the third common basis for exclusion that "the proposal deals with a matter relating to the company's ordinary business operations," the SEC grants a no-action letter in 70% of the cases.⁷³ And for the fourth basis, which relies on Rule 14a-8(i)(10) which allows management to exclude a proposal, if the company has "substantially implemented" the shareholder proposal, the SEC has granted a no-action letter in 55% of cases.⁷⁴ Managers seek to exclude proposals of all types of issues including voting, executive compensation, antitakeover measures and environmental issues.⁷⁵

In which type of firms are managers more likely to request a no-action letter? Managers are likely to contest a proposal in firms that have a large board and a combined CEO and chairperson, that is, firms with relatively entrenched governance, that are more, rather than less, likely to benefit from governance constraints.⁷⁶ Managers resist proposals even from large, reputable long-term shareholders, but are less likely to contest a proposal in firms with high institutional holdings.⁷⁷

In sum, in contesting shareholder proposals managers do not seem to choose the right size for their firm. An exception though arises for firms with weak performance, possibly since negative abnormal performance creates pressure on managers not to resist shareholders' preferences. The study finds that weakly performing firms—firms with worse market performance and operating performance (measured by ROA)—are more likely to be hit by

⁷¹ See Soltes et al., *supra* note 12, at 28.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ See *id.* at 18.

⁷⁷ See *id.* at 19.

a shareholder proposal, and less likely to have their managers contest the proposal.

2. Proxy Access – Private Ordering and Shareholder Proposals

Proxy access, which typically allows a large, long-term, shareholder to submit her directors' nominees with the company proxy materials, is intended to remedy the fact that a startlingly low percentage of shareholders' nominees ever appear on corporate ballots. For a while, following corporate scandals of Enron and Worldcom and the 2008 financial crisis, the SEC contemplated implementing a mandatory proxy access rule for all firms. Opposition was quick to argue that proxy access should instead be governed by private ordering. Again, opposition presumed that under private ordering firms that need proxy access, and only those firms, will adopt it.⁷⁸ The SEC eventually passed a proxy access rule, but shortly after its adoption the rule was struck down by the U.S. Court of Appeals for the D.C. Circuit.⁷⁹

How well is private ordering working with respect to tailoring proxy access to firms' needs? The 2015 proxy season marked the beginning of a proxy access proposals wave. As part of the so-called *Boardroom Accountability Project*, New York City Comptroller Scott Stringer submitted proxy access proposals to seventy-five companies specifically picked based on known problems associated with compensation, diversity and environmental concerns. Each of the Comptroller's proposals sought to implement the same proxy access format: a "three-by-three" proposal termed as such because it allows any shareholder that has owned at least a three percent stake for at least three years, under certain circumstances, to add up to three (or 25% of the board size) directors' nominees to the firm proxy materials.⁸⁰ Several individuals submitted similar proposals in other firms. In some firms, relying on a previously rarely used exception to SEC shareholder proposal rules, management attempted to exclude the proposals rather than bringing them to a shareholder vote. In particular, under Rule 14a-8(i)(9), a proposal can be excluded if it "directly conflicts with one of the company's own proposals to

⁷⁸ See Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, 7–10 (Aug. 17, 2009), <http://www.sec.gov/comments/s7-10-09/s71009-263.pdf>; see also Seven Firm Letter, *supra* note 20, at 6–7 ("[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").

⁷⁹ *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (striking down the SEC proxy access rule and reasoning that the SEC acted capriciously and arbitrarily by not having sufficient evidence.).

⁸⁰ Despite the Comptroller's careful selection of firms, the Comptroller has drawn criticism for using a one-size-fits-all proposal to all targeted firms. See, e.g., David A. Katz, *Proxy Access Proposals for the 2015 Proxy Season*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Nov. 7, 2014), <https://corpgov.law.harvard.edu/2014/11/07/proxy-access-proposals-for-the-2015-proxy-season/#more-66664> ("We hope institutional investors will continue to be willing to take this case-by-case approach, despite the one-size-fits-all pressure being brought to bear by the New York City Comptroller.").

be submitted to shareholders at the same meeting.”⁸¹ Relying on this exception, management at Whole Foods fought a three-by-three proxy access proposal submitted by James McRitchie, a shareholder activist. Whole Foods’ management submitted an alternative proposal that conditioned proxy access on holding a *nine percent* ownership stake for at least *five years*. Not one Whole Foods shareholder met the nine-by-five threshold. Whole Foods then requested and received a no-action letter from the SEC to verify its ability to exclude McRitchie’s three-by-three proposal on the grounds that it conflicted with management’s nine-by-five proposal. Shortly thereafter, Chipotle submitted a similar request to the SEC after submitting a similarly conflicting eight-by-five proposal,⁸² and management in twenty-four other companies have since followed. 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.⁸³ In October 22, 2015 the SEC issued a new policy that narrowed the “conflicting proposal” exception, and denied Whole Foods’ request.⁸⁴ But the game is not over. Companies are now turning to Rule 14a-8(i)(10), which allows exclusion of “substantially implemented” proposals.⁸⁵

A recent study has attempted to assess whether this process of private ordering resulted in efficient tailoring.⁸⁶ To that end, the study investigated whether firms that adopted proxy access under private ordering in the 2012 through 2015 proxy seasons are the ones that according to market assessments stood to benefit most from it. Utilizing several events, the study finds that the market response, which on average was positive for proxy access

⁸¹ 17 C.F.R. § 240.14a-8(i)(9) (2017). Management could not rely on the more frequently used exceptions, 17 C.F.R. § 240.14a-8(i)(1), (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.

⁸² See Chipotle Mexican Grill, Inc., SEC No-Action Letter, 2015 WL 66516 (Feb. 5, 2015).

⁸³ Mark D. Wood et al., *SEC Chair Directs Staff to Review Commission Rule Excluding Conflicting Proxy Proposals*, CORP. FIN. WKLY. DIG., Jan. 23, 2015, <http://www.corporatefinancialweeklydigest.com/2015/01/articles/sec-corporate-1/sec-chair-directs-staff-to-review-commission-rule-excluding-conflicting-proxy-proposals>.

⁸⁴ The new policy limits the “conflicting proposal” exception use to proposals that pose such a direct conflict that “a reasonable shareholder could not logically vote in favor of both proposals”. Whole Foods’ management proposal is not considered a conflicting proposal according to this standard since a shareholder who supports a proxy access rule, would have supported Whole Foods’ shareholder proposal and management proposal, if the latter were his only option. SEC Staff Legal Bulletin No. 14H (CF) (Oct. 22, 2015), <https://www.sec.gov/inters/legal/cfslb14h.htm>.

⁸⁵ Michael Greene, *SEC Rule to Play Major Role in Proxy Access: Attorneys*, BLOOMBERG BNA, Jan. 21, 2016, <http://www.bna.com/sec-rule-play-n57982066686>. (“At the webinar, Gumbs and Brown said companies may now be turning to Rule 14a-8(i)(10) to exclude shareholder proxy access resolutions partly as a response to SEC staff guidance that makes it more difficult to obtain no-action relief under the commission’s “directly conflicts” exemption—Rule 14a-8(i)(9).”) The question becomes then, how the SEC will interpret whether or not the company implemented “additional restrictions” to the shareholder proposals.

⁸⁶ See generally Bhandari et al., *supra* note 5.

implementation, varied in magnitude across firms.⁸⁷ Using these variations, the study identified which firms increased most in value in response to the news, and therefore stood to benefit most from proxy access according to the market. To assess the efficiency of the private ordering process, the study then asked whether these firms, which showed the strongest market response to these proxy access related events, were also the ones that were more likely to be targeted by a proxy access shareholder proposal, and eventually adopt proxy access bylaw, and whether their managers were less likely to resist these proposals (potentially motivated by the relative strong market response).

The study's first finding suggests that these firms were neither more likely nor less likely to be targeted by shareholder proposals. Conversely, however, which managers resisted these proposals was not random. As the study finds, firms in which managers chose the relatively aggressive Whole Foods' strategy—namely requesting the SEC to issue a no-action letter based on a conflicting proposal—were precisely the firms that investors expected to benefit *most* from proxy access, as evidenced by the positive, relatively large, market response to the news.⁸⁸ Similarly, firms in which managers took one of three actions that could somewhat impede the implementation of proxy access—adopting a stricter proposal, bringing a conflicting proposal to a shareholder vote, or promising to propose or adopt a proxy access in the future—were the ones that were more likely to benefit from a proxy access proposal. As the authors conclude, “Management is more likely to resist proposals in firms that stand to benefit more from proxy access, providing further evidence that the private ordering process may struggle to deliver proxy access where the market believes it to be most valuable.”⁸⁹

3. *Majority Voting – Early and Late Adopters*

As the previous sections demonstrate, managers are most likely to fight shareholder proposals in firms that could benefit most from them. Focusing on the stage in which managers contest shareholder proposals, however, does not provide the entire picture. Some firms adopt governance terms voluntarily to pre-empt shareholder proposals. Others adopt governance terms as a result of unobserved negotiations with shareholders. Finally, as explained above, managers do not always implement shareholder proposals that received support from a majority of shareholders. In an attempt to qual-

⁸⁷ The market responded to news about the passage of the SEC proxy access rule, its subsequent placement on stay, as well as the NYC Comptroller's announcement to submit shareholder proposals to seventy-five firms. See generally Bo Becker et al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge*, 56 J.L. & ECON. 127 (2013) (finding positive market response to proxy access news for affected firms).

⁸⁸ *Id.* at 32.

⁸⁹ *Id.* at 37.

ify the firms which self-select with respect to governance term proposals, the section below discusses evidence about the types of firms that eventually implement governance terms.

This recent work studies implementation patterns of a wildly successful governance terms—majority voting terms—intended to give weight and bite to shareholders’ withhold votes.⁹⁰ Under Delaware default plurality standards—which nominate the candidates with largest number of supporting votes—directors could be elected when the votes against them, namely “withhold votes,” were overwhelmingly larger than the votes for them. Majority voting terms typically determine that a director nominee that receives more withhold votes than supporting votes should submit his resignation to the board. To be sure, the board has the power not to accept the resignation, and indeed it is pretty rare for these directors to step down. However, it turns out that withheld votes, nevertheless, create sufficient pressure on boards to improve its responsiveness to shareholders’ needs and proposals.⁹¹

The proliferation of majority voting terms (“MV”) is considered the poster-child of efficient private ordering, as they were adopted by a vast majority of S&P 500 firms. Yet, even this seemingly smooth and uniform adoption was affected by self-selection. As the study finds, a significant difference exists between the firms that were the first to adopt majority voting terms (“early adopters”) and “late adopters,” who adopted majority voting after 2009. Firms that were early to adopt MV, the study finds, were less likely to have a poison pill in place, and more importantly, were less likely to face withhold votes from shareholders—the problem that MV were designed to treat. In the two years prior to adopting MV, early adopters had a significantly lower likelihood to receive an ISS recommendation to withhold votes to any of its directors and a significantly lower proportion of board nominees that received a withhold votes recommendation.⁹² Thus, firms that were early to adopt majority voting were the ones for which majority voting made a small difference.⁹³ Accordingly, relative to late adopters, early adopters were also less likely to be effected by the implementation of MV. Late adopters, on the other hand, had less support for their directors prior to MV implementation, and accordingly were affected by the change in their voting regime, once MV was implemented.⁹⁴

⁹⁰ See generally Choi et al., *supra* note 5.

⁹¹ See, e.g., Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 U. VA. L. REV. 1347, 1420–25 (2011).

⁹² Choi et al., *supra* note 5, at 1135, 1141 tbl.3. Early adopters were also less likely to have a poison pill, which is consistent with them not facing a threat of replacement. See *id.*

⁹³ *Id.* at 1146–47 (“Companies do not appear to adopt majority voting if they perceive their existing board members as being at risk of receiving an ISS withhold recommendation and if they are generally less responsive to shareholder concerns (as proxied by the presence of a poison pill).”).

⁹⁴ Late adopters became more responsive to shareholders and received significantly less withhold votes for their directors nominees following an MV implementation. See *id.*

While majority voting was clearly successful, it was not applied in all firms. By the end of 2015, 32% of the S&P 1500 firms still did not have majority voting. Some firms thus resist until today. As the evidence on late adopters suggest, these could be the firms for whom majority voting would have mattered the most. Furthermore, proxy advisory firms have contributed to the adoption by late adopters. Thus, if proxy advisors were limited by proposed regulation Resisting Firms might not succumb to future governance changes.

B. Board Independence – Voluntary vs. Mandatory Independence

“[T]he 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.”⁹⁵

With the intentions to repeal Sarbanes-Oxley mandates, listing requirements that mandate a majority of independent directors might be repealed as well. If the administration scales back on these requirements, which firms are less likely to maintain a majority of independent directors on their boards? The ones that have not benefited from them or the ones that have benefited from them the most? Pre-2002 mandates, many firms have had a majority of independent directors on their boards, which they nominated voluntarily. If we can learn from past experience, firms that are likely to decrease the proportion of independent directors are the ones that did not have them voluntarily, but rather were forced to add them due to the 2002 mandates. Which firms then benefitted more from adding independent directors—those that added them voluntarily under a private ordering regime (“Voluntary Independence”), or those that were forced to do so by mandate (“Mandatory Independence”) and would probably dismiss them if they could?

During the 80s and the 90s, board independence was regulated primarily by Delaware courts, which increasingly conditioned deference to the board and its committees on their independence, but did not mandate it.⁹⁶ During this time, in which boards were encouraged but not required to increase independence, most, but not all, firms voluntarily added independent directors to their boards. Researchers were quick to utilize these changes to board structure to test the effect of board independence on firms’ performance. The results, as confirmed by a rich body of studies, showed only lim-

⁹⁵ BAINBRIDGE, FINANCIAL CRISIS, *supra* note 3, at 102.

⁹⁶ See, e.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

ited effects of board independence on firms' performance.⁹⁷ Several studies found evidence that pre-SOX Voluntary Independence improved boards' monitoring. For example, independence was positively correlated with sensitivity of CEO turnover to firm performance (that is, independent boards were more likely to fire the CEO if the firm did not perform well), and with fewer value-reducing acquisitions.⁹⁸ Yet, in assessing the bottom line, namely firm performance, studies consistently did not find significant evidence that independence contributed to firm profitability or market value. Tobin's Q, a commonly used measure to assess the value of governance terms of firms with a majority of independent directors, was not statistically different from the Tobin's Q of firms with no majority of independent directors.⁹⁹ If at all, there was some evidence for negative relationship between independence and Tobin's Q.¹⁰⁰ Similarly, accounting performance measures were not significantly different.¹⁰¹ Long-term performance of firms with a majority of independent directors also was not significantly different from the performance of other firms.¹⁰² Yet, since pre-SOX firms self-selected independence, it was argued, it was still possible that independent directors added value. For example, if poorly performing firms were more likely to add independent directors, even if these directors added value, when comparing these firms, in a cross-section analysis, to firms that did not have independent directors, independence may be associated with no better, and even poorer, performance.¹⁰³ Along these lines, Hermalin and Weisbach constructed a formal board bargaining model in which a non-successful CEO is pressured by the outsiders on the board to nominate additional independent directors.¹⁰⁴ Testing this hypothesis, Hermalin and Weisbach found that ab-

⁹⁷ For a survey of this literature, see Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 *ECON. POL. REV.* 7, 14 (2003) [hereinafter Hermalin & Weisbach, *Endogenously Determined*].

⁹⁸ See Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 *J. FIN. ECON.* 431 (1988).

⁹⁹ See, e.g., Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 *FIN. MGMT.* 101 (1991) [hereinafter Hermalin & Weisbach, *Effects of Board Composition*]; Sanjai Bhagat & Bernard S. Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 *BUS. LAW.* 921 (1999); Sanjai Bhagat, & Bernard S. Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 *J. CORP. L.* 231 (2002) [hereinafter Bhagat & Black, *Non-Correlation*].

¹⁰⁰ See, e.g., Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 *J. FIN. QUANT. ANAL.* 377, 394 (1996).

¹⁰¹ See, e.g., Hermalin & Weisbach, *Effects of Board Composition*, *supra* note 99, at 109 (describing accounting performance measures in line with negative relationship to Tobin's Q).

¹⁰² See Bhagat & Black, *Non-Correlation*, *supra* note 99, at 581; see also Hermalin & Weisbach, *Endogenously Determined*, *supra* note 97, at 231.

¹⁰³ See Hermalin & Weisbach, *Endogenously Determined*, *supra* note 97, at 8 (describing board bargaining model where CEO is induced to appoint outside directors).

¹⁰⁴ See generally Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 *AM. ECON. REV.* 96 (1998).

normal negative performance indeed increases the likelihood of appointing an independent director, yet they found no support for the proposition that following their nomination, those independent directors contributed to firm value.¹⁰⁵ As a result, conventional wisdom held that independent directors do not matter.¹⁰⁶

In response to corporate scandals, however, the newly enacted SOX required audit committees to be entirely independent,¹⁰⁷ and former SEC commissioner, Harvey Pitt, guided NYSE and NASDAQ to enhance their independence requirements.¹⁰⁸ NYSE then required its listed firms to have a majority of independent directors on their boards,¹⁰⁹ to place only independent directors on their audit, compensation and nomination committees,¹¹⁰ and to hold periodic executive sessions in which independent directors meet with no firm insiders present.¹¹¹ NASDAQ adopted similar requirements.¹¹² Critics were quick to point out the lack of evidence for these mandates. The rush to apply one-size to all firms, when there is not even evidence that independence has value to any firm, critics argued, is a testimony to the weakness of these rules—which were designed primarily to satisfy public opinion—a paradigm of populist “Quack Corporate governance”.¹¹³

Yet, the Pre-SOX data was based only on voluntary adoption. Indeed, the growing body of post-SOX empirical studies, show that firms that were forced to add independent directors actually derived more benefits from them, as this Article would suggest. To begin with, early studies that assessed the market response to the passage of the rules found that firms that

¹⁰⁵ See Hermalin & Weisbach, *Effects of Board Composition*, *supra* note 99, at 103 (using lagged variable to control for abnormal firm performance); see also Bhagat & Black, *Non-Correlation*, *supra* note 99, at 231 (same); M. Babajide Wintoki et al., *Endogeneity and the Dynamics of Corporate Governance*, 105 J. FIN. ECON. 581, 582 (2012) (using Arellano-Bond GMM instruments in a 1991–2003 dynamic panel to find no causal relationship between board structure and firm performance between 1991–2003).

¹⁰⁶ See, e.g., BAINBRIDGE, *FINANCIAL CRISIS*, *supra* note 3, at 90 (“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, *supra* note 1, at 101 (“Recent corporate governance initiatives, including Sarbanes-Oxley, are misguided because they erroneously assume corporate boards can be organized or incentivized successfully to monitor and manage the corporations they serve. All of the available theoretical and empirical evidence suggests this is not the case.”).

¹⁰⁷ See 15 U.S.C. § 78j-1 (2012). It also required at least one of them to be a “finance expert.” 15 U.S.C. § 7265 (2012).

¹⁰⁸ Press Release, U.S. Sec. & Exch. Comm’n, Pit Seeks Review of Corporate Governance, Conduct Codes (Feb. 13, 2002), <https://www.sec.gov/news/press/2002-23.txt>.

¹⁰⁹ NYSE LISTED CO. MANUAL § 303A.01 (N.Y. STOCK EXCH., INC. 2009); Self-Regulatory Organizations, Exchange Act Release No. 48,745, 68 Fed. Reg. 64154, 64157 (Nov. 4, 2003).

¹¹⁰ NYSE LISTED CO. MANUAL § 303A.04–05 (N.Y. STOCK EXCH., INC. 2009).

¹¹¹ NYSE LISTED CO. MANUAL § 303A.03 (N.Y. STOCK EXCH., INC. 2009).

¹¹² See BAINBRIDGE, *FINANCIAL CRISIS*, *supra* note 3, at 81. Independence requirements were tightened as well. See *id.* at 84.

¹¹³ See *id.* at 41.

had to add independent directors to comply with the mandates (“Noncomplying Firms”) experienced positive abnormal returns, with the exception of small Noncomplying Firms that experienced a negative market response.¹¹⁴ Thus, investors viewed the requirement as positive except for small firms.¹¹⁵

Furthermore, studies of long-term performance of these directors suggest that they added more value than directors that were added voluntarily pre-SOX. Employing a Difference-in-Differences design, Guo and Masulis found that Noncomplying Firms that added independent directors to comply improved their sensitivity of CEO turnover to performance.¹¹⁶ Adding independent directors to the board, and especially to the nominating committee, resulted in boards that were more willing to pull the trigger on an underperforming CEO. Directly comparing this effect for Voluntary Independence (firms that nominated independent directors pre-SOX) with the effects for Mandatory Independence (firms that were forced to nominate independent directors post-SOX), Bhagat and Bolton found that the effect is more pronounced among firms that were mandated, post-SOX, to add independent directors.¹¹⁷

Similarly, studying the differences between pre- and post-SOX independence, almost to their surprise, Bhagat and Bolton found evidence for added value from Mandatory Independence (while confirming that pre-SOX, voluntary independence harmed performance).¹¹⁸ In particular, Bhagat and Bolton found that post-SOX Mandatory Independence improved operational performance as measured by returns on assets (ROA).¹¹⁹ A similar pattern emerged with respect to independence’s effects on acquisitions.¹²⁰ Compared

¹¹⁴ Vidhi Chhaochharia & Yaniv Grinstein, *Corporate Governance and Firm Value: The Impact of the 2002 Governance Rules*, 62 J. FINANCE 1789, 1791 (2007) (finding higher abnormal returns surrounding the passes of the listing standards for firms that increased the number of their independent directors).

¹¹⁵ Duchin et al. found that in non-complying firms, SOX’s effect was positive for firms with high access to information, but negative in firms with asymmetric information. See Ran Duchin et al., *When are Outside Directors Effective?*, 96 J. FIN. ECON. 195, 196 (2010). Duchin et al. could suggest that some firms rightfully did not add independent directors, since high information costs could limit their effectiveness. The study however measured changes between 2000 and 2005, *id.* at 198, and thus included changes that were not mandated, though they could have been adopted in anticipation of SOX’s mandate.

¹¹⁶ See Lixiong Guo & Ronald W. Masulis, *Board Structure and Monitoring: New Evidence from CEO Turnovers*, 28 REV. FIN. STUD. 2770, 2770 (2015).

¹¹⁷ See Sanjai Bhagat & Brian Bolton, *Director Ownership, Governance, and Performance*, 48 J. FIN. & QUANT. ANAL. 105, 128–29 tbl.9(C) (2013).

¹¹⁸ See *id.* at 106 (“While we confirm the negative relationship between board independence and firm performance (that most prior research has identified) for the pre-2002 period, this result is reversed for the post-2002 period. During the years 2003–2007, greater board independence is positively correlated with operating performance.”).

¹¹⁹ See *id.* at 117.

¹²⁰ See *id.* at 129, 130–31 tbl.10(D); see also Sara B. Moeller et al., *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FINANCE 757 (2005).

to pre-SOX Voluntary Independence, post-SOX Mandatory Independence is associated with a significant decrease in value decreasing acquisitions.¹²¹

Finally, studies on what predicts independent director appointments find, by and large, that CEO power and entrenchment predict less independent directors, rather than more.¹²² These associations are all consistent with firms that face little constraints, that have relatively entrenched CEOs, and that could benefit from additional monitoring, are less likely to appoint independent directors.

Board independence provides a unique context to assess private ordering, as it was shaped both by private ordering and by statutory mandates. If firms chose their right “size”, that is, self-selected efficiently, board independence should be associated with better performance in the pre-listing-standards era, when it was adopted voluntarily, relative to the post-listing-standards era. Bhagat and Bolton find the opposite is true, though the differences they find could result from differences in research design options pre- and post-SOX.¹²³ Other studies found added value from post-SOX independence and no study found added value from pre-SOX independence. Thus, there is no evidence to support the assumption that firms chose their right size of board independence, if at all the evidence is more consistent with the hypothesis that firms that voluntarily nominated independent directors, where the ones for whom independence did not matter much. Firms that stood to benefit from board independence resisted it until they were required to do so by law. If it were not for SOX and the listing standard requirements, these potential gains would have been wasted, and if SOX and the listing standard were repealed, they would likely diminish.

C. Controlling Shareholders’ Private Benefits and Inclination to Cross-List on U.S. Exchanges

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

¹²¹ See Bhagat & Bolton, *supra* note 117, at 130–31 tbl.10(C), 132.

¹²² Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FINANCE 1829, 1829 (1999) (finding that CEO involvement likelihood increases with CEO tenure, founder’s status and equity ownership, and a five percent blockholder serving as an independent director on the board); see also Audra L. Boone et al., *The Determinants of Corporate Board Size and Composition: Empirical Evidence*, 85 J. FIN. ECON. 66 (2007).

¹²³ Post-SOX studies had the advantage of using an exogenous shock. See Bhagat & Bolton, *supra* note 117, at 109.

evidence from firm-specific and cross-country variations. Finally, it also provides evidence for the size of the costs that ensue when firms do not choose their right size. Since the type of insiders that extract private benefits in foreign firms, and the kind of private benefits they extract, are somewhat different than in US firms, this part will start with some background on controlling shareholder structures and the effects that cross-listings on U.S. exchanges has on controlling shareholders' private benefits.

Unlike U.S. firms, which typically have a dispersed ownership structure, foreign firms are frequently controlled by a large shareholder. Similar to US managers, foreign firms' controlling shareholders often have interests that are not perfectly aligned with those of the other dispersed (or minority) shareholders.¹²⁴ Controlling shareholders, for example, could benefit from dealings with other companies they control. Or they may take the company private, buying out the minority shareholders at a low price. Thus, controlling shareholder ownership structure gives rise to another, somewhat different, agency problem, one between controlling shareholders and minority shareholders.¹²⁵

By cross-listing on US exchanges foreign firms adopt stricter disclosure obligations, become subject to U.S. robust enforcement mechanisms, and are more visible to U.S. analysts, all of which, as Professor John Coffee pointed out, constrain the ability of the controlling shareholder to extract private benefits from the company.¹²⁶ Consistent with Coffee's "bonding hypothe-

¹²⁴ Thus, the theoretical framework in *supra* Part II is extendable for controlling shareholders.

¹²⁵ Since the controlling shareholder monitors, the extraction of private benefits by managers who are not controlling shareholders is limited in foreign firms. See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006) ("[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held."). Agency manifestations are also somewhat different. While managerial agency problems manifest in for example high executive compensation or excessive takeover defenses, controlling shareholders extract private benefits via self-dealing or going private transactions. See, e.g., Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1283–84 (2009).

¹²⁶ For this bonding hypothesis, see John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 692 (1999); John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1759, 1780 (2002) [hereinafter Coffee, *Racing*]; John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXFORD REV. ECON. POL. 198, 205 (2005) [hereinafter Coffee, *Corporate Scandals*]; John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 230, 285 (2007) [hereinafter Coffee, *Law and the Market*]. But see Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT'L. L. 141, 142–43 (2003) (questioning the extent of legal bonding); Siegel & Wang, *supra* note 15, at 6 (questioning SEC enforcement on foreign firms); Kate Litvak, *The Impact of the Sarbanes-Oxley Act on Non-U.S. Companies Cross-Listed in the U.S.*, J. CORP. FIN. 195, 195–96 (2007) (finding that listing premium decreases over time); Luigi Zingales, *Is the U.S. Capital Market Losing its Competitive Edge?* 5 (European Corp. Governance Inst., Working Paper No. 192/2007, 2007),

sis,” controlling shareholders’ control premium—that is, the difference between the price per share paid for a controlling block and the price per share for minority shares—declines upon cross-listing announcement.¹²⁷ Moreover, the magnitude of the hit to the control premium is positively related to the level of the legal commitment they choose.¹²⁸ Similarly, cross-listing triggers a positive market response, which, consistent with bonding, increases alongside the level of commitment firms adopt.¹²⁹ Cross-listing on exchanges with lower disclosure obligations does not trigger the same response.¹³⁰

If firms choose their right “size” then highly expropriated firms—firms from which controlling shareholder private benefits extraction results in high inefficiency costs—should be more inclined to cross-list.¹³¹ Some controlling structures, other things equal, are more conducive to extraction of inefficient private benefits, and imposition of high agency costs. In particular, if the controlling shareholder cash flow rights are significantly lower than her voting rights, her ownership is separated from control, which gives rise to high agency costs. In these cases, if the controlling shareholder has an opportunity to extract private benefits, she will have incentives to do so even in the price of high costs to the firm. To illustrate, assume first that the controlling

pers.cfm?abstractid=1028701 (finding a decline in proportion of firms that list on US exchanges).

¹²⁷ Craig C. Doidge, *U.S. Cross-Listings and the Private Benefits of Control: Evidence from Dual-Class Firms*, 72 J. FIN. ECON. 519, 521, 544–50 (2004) [hereinafter Doidge, *Dual Class Firms*]; see also Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FINANCE 537, 538 (2004) (finding that across countries control premiums are lower in strong legal regimes with strong minority protections).

¹²⁸ See generally Darius P. Miller, *The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts*, 51 J. FIN. ECON. 103 (1999).

¹²⁹ Depending on whether it involves IPOs, trading on exchanges, or merely conducting a private placement, cross-listing triggers different levels of regulatory burdens. While private placements result in almost no legal obligations, listing on a major U.S. exchange exposes firms to scienter-based liability under Section 10b-5, and a full IPO on the U.S. exchanges would trigger a strict liability standard for filling the IPO registration statement. See Coffee, *Racing*, *supra* note 126, at 1780, 1787–88 (discussing the different types of cross-listing and the legal burdens they trigger); cf. Litvak, *supra* note 126, at 196 (finding that listing premium decreases over time).

¹³⁰ See Craig Doidge et al., *Private Benefits of Control, Ownership, and the Cross-Listing Decision*, 64 J. FINANCE 425 (2009) [hereinafter Doidge et al., *Ownership*].

¹³¹ *Id.* Not all extractions are inefficient. Extraction of private benefits, to a certain degree, could be efficient. See, e.g., Gilson, *supra* note 125, at 1663–64 (controlling shareholders may extract non-pecuniary private benefits, such as the pride of controlling a successful organization that does not impose costs on shareholders); Ronald J. Gilson & Jeffery N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785 (2003) (“Because there are costs associated with holding a concentrated position and with exercising the monitoring function, some private benefits of control may be necessary to induce a party to play that role.”); Paul G. Mahoney, *The Public Utility Pyramids*, 41 J. LEG. STUD. 37 (2012) (conducting an event study around the passage of the Public Utility Holding Company Act, and finding that positive news about the passage of the Act decreased market value of affected firms); Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 J. INST. & THEO. ECON. 160, 168 (2013); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 25 YALE L.J. 560, 590, 605 (2016) (controlling shareholder power is valuable if the controlling shareholder has a value-increasing project that shareholders might underestimate).

shareholder holds 50% of both the firm's cash flow and voting rights. Assume further that she can self-deal with the company and extract 100 in private benefits, which will impose costs of 300 on the company. The deal is not efficient, as its net value is -200. The controlling shareholder bears only half of the costs, 150, but it is enough to prevent her from pursuing the inefficient deal. Now assume that the company has a dual-class stock, that is different classes of shares with different voting rights, and that the controlling shareholder holds shares with five votes per share.¹³² Assume that as a result, while the controlling shareholder holds half of the voting rights, she holds only 10% of the firm's cash flow rights. In this case the controlling shareholder bears only one tenth of the costs, or 30, and therefore will pursue the inefficient transaction. The larger the wedge between the controlling shareholder cash flow rights and voting rights, the larger the problem of inefficient expropriation from minority shareholders. Accordingly, the size of the wedge was found to be negatively associated with firm value.¹³³

Since a wedge is associated with inefficiency costs, firms in which the controlling shareholder's cash flow rights are significantly smaller than its voting rights should benefit more from cross-listing. Indeed, Doidge et al. find that cross-listing premium increases in the size of the wedge, i.e., firms with large wedge are significantly rewarded by markets if they cross-list.¹³⁴ One might assume then that controlling shareholders would show a higher inclination to cross-list when their cash flow rights are significantly lower than their voting rights. The evidence, however, suggests the opposite is true. Doidge et al. find that the inclination to cross-list on US exchanges decreases alongside the wedge, despite the relatively high potential reward for cross-listing by controlling shareholders with a large wedge.¹³⁵

Second, whether firms choose their right size could be evaluated on another dimension—the countries from which controlling shareholders tend to cross-list on US exchanges. Cross-listing should be more valuable for firms in countries with weak legal regimes as it substitutes for the lack of domestic constraints. Indeed, the positive market reaction to cross-listing announcements is significantly higher for cross-listings coming from countries with weak corporate governance regimes (i.e., weak minority protections, disclosure obligations, and legal institutions) than for those coming from countries with a robust legal regime.¹³⁶ Thus, from an efficiency perspective

¹³² See Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity*, in CONCENTRATED CORPORATE OWNERSHIP 445, 448 (R. Morck ed., 2000) (noting that a wedge could be created by other structures, such as pyramid or cross-holding).

¹³³ Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FINANCE 2741, 2764 (2002).

¹³⁴ Doidge et al., *Ownership*, *supra* note 130, at 463–64.

¹³⁵ *Id.* at 444 (finding that a “1% increase in the control wedge is associated with a 2% decline in the probability of listing”).

¹³⁶ See Craig G. Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. FIN. ECON. 205, 235 (2004) [hereinafter Doidge et al., *Foreign Firms*] (finding that cross-listing valuation premium “is negatively related to the level of investor protection in the firm's

firms from weak legal regime countries should exhibit high inclination to cross-list. Yet, according to most studies, firms from countries with weak corporate governance characteristics are significantly less likely to cross-list than firms from countries with strong ones.¹³⁷ Furthermore, the significant potential increase in share value that is lost indicates potentially high inefficiency costs.¹³⁸ The evidence from cross-listing therefore demonstrates that inefficient tailoring results in significant costs.¹³⁹

Finally, on one dimension, compliance costs, firms seem to choose their right size in cross-listing. Cross-listing on U.S. exchanges, which triggers compliance, imposes compliance and implementations costs. As these costs typically include a fixed component, they are disproportionately large for small firms. Accordingly, firm size is positively correlated with cross-listing.¹⁴⁰

D. State Competition

“[S]tricter corporation laws survive because in some instances market oriented governance mechanisms do not provide some classes of shareholders with the explicit legal controls they prefer. More liberal corporation laws survive because they allow certain firms to economize on the costs of political or legal control of

country”); Luzi Hail & Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-Listings*, 93 J. FIN. ECON. 428, 429 (2009) (finding larger decline in costs of capital for firms from countries with weak disclosure and self-dealing regulations); see also Doidge, *Dual Class Firms*, *supra* note 127, at 519 (finding that the decline of control premium in dual class firms, following cross listing, decreases with the legal protection at the origin country); Darius Miller & Ugur Lel, *International Cross-Listing, Firm Performance, and Top Management Turnover: A Test of the Bonding Hypothesis*, 63 J. FINANCE 1897, 1898 (2008) (finding an “increased relation between CEO turnover and poor performance” which is “strongest in countries with weak investor protections,” using legal origin, and self-dealing index); cf. Holger Spamann, *The “Antidirector Rights Index” Revisited*, 23 REV. FIN. STUD. 467, 468 (2010).

¹³⁷ See, e.g., Doidge et al., *Ownership*, *supra* note 130 (civil law, antidirector index and the investor protection index less likely to list on US exchanges); Coffee, *Law and the Market*, *supra* note 126, at 291; see also Doidge et al., *Foreign Firms*, *supra* note 136, at 231 (“firms from countries with poorer investor protection cross-list when their growth opportunities are greater than those of firms from countries with better investor protection”); cf. Michael S. Weisbach & William A. Reese, Jr., *Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings*, 66 J. FIN. ECON. 65 (2002) (after controlling for relevant firm characteristics (but not prior to), firms from civil law countries were less likely to cross-list on U.S. exchanges than firms from common law countries).

¹³⁸ See Hail & Leuz, *supra* note 136, at 446 tbl.5.

¹³⁹ Moreover, one might dismiss the inefficient tailoring problem on the basis that shareholders know the type of firm they invest in. But, as this evidence shows, this response to the inefficient tailoring problem is not satisfying regardless of whether shareholders know what they are buying, firms’ self-selection results in real inefficiency costs that could be saved with efficient tailoring.

¹⁴⁰ See, e.g., Doidge et al., *Foreign Firms*, *supra* note 136, at 227.

managers, without interfering with the operation of market controls."¹⁴¹

This sub-Part discusses evidence from choice of corporate law regime among U.S. states. Firms may choose in which state to incorporate, and as a result which corporate law to adopt. While most firms incorporate either in their home state, or in Delaware, in recent years the state of Nevada has increased its market share of out of state incorporations, by offering a particularly lax law. Utilizing these state law variations in a joint work, David Smith and I researched the type of firms that Nevada attracts. Part 1 will discuss the corporate law that Nevada offers, and how it differs from Delaware corporate law. Part 2 will discuss the type of firms that are attracted to Nevada lax regime.

1. *Nevada Lax Corporate Law*

For years, conventional wisdom held that Nevada copied Delaware corporate law and even followed closely changes to it.¹⁴² Yet, as I found and described in detail in a separate work, Nevada's corporate law is significantly different from Delaware's as it limits directors' and officers' exposure to liability for breaches of the fiduciary duties that are the cornerstones of Delaware law—the duties of loyalty and good faith.¹⁴³

In 1985 Delaware adopted its exculpation statute, section 102(b)(7) of the DGCL, which allows companies to opt out of directors' liability for duty of care breaches. The statute explicitly prohibits opting out of liability for breach of the duty of loyalty, duty of good faith, transactions from which the director derived improper personal benefits and acts that involve intentional misconduct or knowing violation of law.¹⁴⁴ Nevada adopted an exculpation

¹⁴¹ Baysinger & Butler, *The Role of Corporate Law*, *supra* note 41, at 182.

¹⁴² See, e.g., Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 UNIV. CIN. L. REV. 1061, 1067 (2000) (surveying literature and cases that argue that Nevada follows Delaware law closely). *But see* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 UNIV. PA. L. REV. 1795, 1856 (2002) ("Nevada provides extremely broad director indemnification provisions, allowing companies to eliminate or limit the personal liability of directors and officers for breach of fiduciary duty."); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 726 n.168 (2002) ("Despite occasional claims to the contrary, Nevada does not imitate Delaware."). For the assumption that Nevada follows Delaware law, literature typically refers back to the seminal paper, which opened the state competition debate by William Cary. Yet the paper does not argue that Nevada copied Delaware law. Rather all it says is that Nevada attempted to become the Delaware of the West. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 665 (1974) ("Nevada has attempted to become the western Delaware but not with comparable success.").

¹⁴³ See Barzuza, *Market Segmentation*, *supra* note 14, at 935. *But see* Jens Dammann, *How Lax is Nevada Corporate Law? A Response to Professor Barzuza*, 99 VA. L. REV. 1 (2013) (arguing that Nevada law is not materially different from other states' corporate law).

¹⁴⁴ DEL. CODE ANN. tit. 8, § 102(b)(7) (2015) ("[T]he 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

statute in 1987, which already then was significantly lax. NRS section 78.037 (1987) included only one (slightly modified) exception of the Delaware statute. In particular, under Nevada 1987 exculpation statute firms could opt out of liability for breaches of all of directors' fiduciary duties (including care, loyalty and good-faith), unless directors' acts or omissions *also* "involve intentional misconduct, fraud or a knowing violation of law."¹⁴⁵ Furthermore, unlike Delaware's exculpation statute that applied to directors but not to officers, Nevada's exculpation statute allowed firms to release both directors and officers from liability for fiduciary duties' breaches.¹⁴⁶

In 2001 Nevada mandated these protections on all firms incorporated in Nevada.¹⁴⁷ In 2003, Nevada followed up by adding an opt-out provision of these protections via charter amendment (which would require management initiation), and extended the protection to apply not only against shareholders' but also against *creditors'* lawsuits.¹⁴⁸ As a result, currently under Nevada's NRS section 78.138(7), *by default*, neither duty of loyalty nor duty of good faith breaches trigger liability for directors and *officers*, unless they *also* "involve intentional misconduct, fraud, or knowing violation of law."¹⁴⁹

As the legislative history of Nevada's new corporate law system shows, Nevada clearly intended to differentiate itself from Delaware by providing

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.") (emphasis added).

¹⁴⁵ 1987 NEV. STAT. 80, <https://www.leg.state.nv.us/Statutes/64th/Stats198701.html#Stats198701page80> (providing Nevada's 1987 exculpation statute).

¹⁴⁶ *Id.*

¹⁴⁷ See, e.g., Keith Paul Bishop, *Silver Standard*, L.A. LAW., Nov. 2008, at 32 (noting that Nevada automatically relieves directors and officers from liability unless both conditions are met); see also Barzuza, *Market Segmentation*, *supra* note 14 (citing reincorporation proxy materials which state that as a result of reincorporation to Nevada directors will not be liable anymore for duty of loyalty breaches). The 2001 amendment also added several specific violations and prohibitions from Nevada law that could not have the protection of the statute, such as violations of securities trading limitations under Nevada law. Interestingly the exceptions include also breaches of liability of an agent to a principal under NRS 91.250, which possibly could apply to broaden directors' liability. Yet, Nevada legislative intent, marketing efforts, and the common perception in practice are not consistent with such an interpretation. For Nevada's 2001 amendment, see 2001 Nev. Stat. 3171, <https://www.leg.state.nv.us/Statutes/71st/Stats200121.html#Stats200121page3171>.

¹⁴⁸ For Nevada's 2003 amendment, see 2003 Nev. Stat. 3084, <https://www.leg.state.nv.us/Statutes/72nd/Stats200325.html#Stats200325page3084>.

¹⁴⁹ NEV. REV. STAT. § 78.138(7) (2003), <https://www.leg.state.nv.us/nrs/NRS-078.html#NRS078Sec300> ("Except as otherwise provided in NRS 35.230, 90.660, 91.250, 452.200, 452.270, 668.045 and 694A.030, or unless the articles of incorporation or an amendment thereto, in each case filed on or after October 1, 2003, provide for greater individual liability, a director or officer is not individually liable to the corporation or its stockholders or creditors for any damages as a result of any act or failure to act in his or her capacity as a director or officer unless it is proven that: (a) The director's or officer's act or failure to act constituted a breach of his or her fiduciary duties as a director or officer; and (b) The breach of those duties involved intentional misconduct, fraud or a knowing violation of law.").

its corporations with minimal liability exposure. Accordingly, Nevada has been marketing its services by highlighting the greater protections afforded to managers, directors and officers under Nevada law. For example, the Nevada Secretary of State's website explains under the heading "Why Nevada?" that Nevada provides stronger personal liability protection to officers and directors.¹⁵⁰

2. *Nevada Firms*

Which firms should be attracted to Nevada lax corporate regime? If firms choose their right "size," Nevada should attract firms that are so disciplined and that already face significant market or governance constraints, that they are better off with almost no directors' and officers' liability.¹⁵¹ If private ordering is not working efficiently, however, Nevada's lax law may attract firms that face lax constraints and have particularly high agency costs. Indeed, some representatives in Nevada were concerned by this fairly intuitive possibility. For example, speaking against the 2001 amendment, Senator Dina Titus warned that the state might just as well hang up a sign reading, "[s]leaze balls and rip off artists are welcome here."¹⁵² Senator Bob Coffin echoed these concerns, warning that "reputable companies [were] not going to want to come here to save a few dollars"¹⁵³ and that Nevada would become:

[T]he place where Butch Cassidy and Sundance Kid would go, the Hole 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.¹⁵⁴

¹⁵⁰ BARBARA K. VEGASKE, WHY NEVADA? LEGAL ADVANTAGES: A COMPARISON WITH DELAWARE AND CALIFORNIA 2 (2012), available at <https://www.nvsilverflume.gov/documents/CorporateLawComparison.pdf> ("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."); cf. Kahan & Kamar, *supra* note 142, at 717 (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).

¹⁵¹ See *Uniformity*, *supra* note 4 (arguing that firms that states will liberal law will attract firms that are exposed to strong market forces).

¹⁵² *Id.* at 159.

¹⁵³ *Id.*

¹⁵⁴ *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.

a. Nevada Firms' Restatements and Reporting Aggressiveness

In a recent work, David Smith and I conducted the first systematic research into the kind of firm that chose to incorporate in Nevada. Using panel data between 2000–2011, we researched the reporting behavior of Nevada firms relative to firms in Delaware and in other states.¹⁵⁵ The study focused on accounting restatements—that is, the process by which firms amend their reported performance figures retroactively, typically downwards—as a proxy for firms' agency costs. There are several reasons for why accounting restatements serve as a good proxy for agency costs in examining Nevada firms. To begin with, until recently, and during our sample time period, managers could have benefited significantly from misstating their earnings.¹⁵⁶ Bonuses were awarded based on performance, clawback provisions—which required managers to pay back bonuses that were paid based on misstatements—were not enforced robustly through most of the sample time period. Accordingly, accounting restatements, and the misstatements they amend, drew a significant negative market response.¹⁵⁷ Restatements harm managers' credibility¹⁵⁸ and are associated with weak internal and external controls.¹⁵⁹

¹⁵⁵ See Barzuzza & Smith, *supra* note 15.

¹⁵⁶ Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 701 (1992); Coffee, *Corporate Scandals*, *supra* note 126; Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1130–31 (2003); Oren Bar-Gill & Lucian A. Bebchuk, *Misreporting Corporate Performance* 2–3 (John M. Olin Ctr. for Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 400, 2003), <http://ssrn.com/abstract=354141>.

¹⁵⁷ See, e.g., Zoe-Vonna Palmrose et al., *Determinants of Market Reactions to Restatement Announcements*, 37 J. ACCT. & ECON. 59 (2004) (finding the negative response to restatements announcement that is related to the likelihood of fraud involved, the number of accounts and decrease in reported income); Joseph H. Golec et al., *Litigation Risk and Market Reaction to Restatements*, 3 J. FIN. RES. 19 (2013) (finding that about half of the average -9.2% market reaction to restatements is due to expected litigation cost).

¹⁵⁸ See Kirsten L. Anderson & Teri Lombardi Yohn, *The Effect of 10K Restatements on Firm Value, Information Asymmetries, and Investors' Reliance on Earnings* (Sept. 2002) (working paper), <http://ssrn.com/abstract=332380>; Wendy M. Wilson, *An Empirical Analysis of the Decline in the Information Content of Earnings Following Restatements*, 83 ACCT. REV. 519 (2008) (finding that the decline in ERC lasts only for three quarters after the restatement announcement); cf. Xia Chen et al., *Is the Decline in the Information Content of Earnings Following Restatements Short-Lived?*, 89 ACCT. REV. 177, 177 (2014) (“[M]aterial restatement firms experience a significant decrease in the ERC over a prolonged period—close to three years after restatement announcements. In contrast, other restatement firms experience a decline in the ERC only for one quarter after restatement announcements.”).

¹⁵⁹ See, e.g., Michael Ettredge et al., *How Do Restatements Begin? Evidence of Earnings Management Preceding Restated Financial Reports*, 37 J. BUS. FIN. & ACCT. 332, 334, 351 (2010) (finding that restatements are preceded by balance-sheet bloating especially, but not only, when fraud is involved); Jap 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) (finding that restatements are related to incentive based compensation); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Market: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 701 (1992) (arguing that fraud in reporting is an agency problem); Coffee, *Corporate Scandals*, *supra* note 126, at 201–04 (arguing that restatements are motivated by management desire to increase the value of their option pack-

Consistent with managerial motives for misstatements, restatements are associated with a high component of option-based compensation.¹⁶⁰ To be sure, restatements could sometimes result from mere errors in interpretation or judgment rather than fraudulent behavior. Yet, negligence, laziness, or aggressive reporting also reflect agency costs, as not all managers in all firms could afford this slack. Moreover, in addition to investigating restatements, we also measured Nevada firms on a separate metric for aggressiveness in reporting, developed by GMI Ratings, finding results consistent with Nevada firms being exceptionally aggressive in their reports.

Our study finds that firms that choose to incorporate in Nevada are significantly more likely to restate their earnings than firms in Delaware or elsewhere.¹⁶¹ On average, the proportion of Nevada firms in our sample that restated financials each year (12.5%) is almost double their proportion in Delaware (7.4%) and in other states (7%). After controlling for various firm and industry variables, we find that Nevada firms are twenty to thirty percent more likely to restate their financials in a given year than firms incorporated in Delaware or other states. The results hold for earning reduction restatements and for restatements that involve fraud or trigger regulatory investigations. Consistent with the findings with respect to Nevada law, we found that the restatements' effects are driven by firms that moved to Nevada after the 1987 amendment. We did not find evidence that restatements are higher for firms that incorporated after the 2001 amendment, but this could be due to the shorter time span in our sample for some of these firms. Using a matched sample that matches Nevada firms to similar Delaware firms, our results remained robust and were consistent with regression coefficients.¹⁶² Finally, the aggressive reporting behavior by Nevada firms is not limited to restatements. GMI Ratings created an accounting metric that ranks firms' overall reporting quality. Our study finds that Nevada firms ranked as aggressive on this metric as well.¹⁶³

ages); Gordon, *supra* note 156, at 1130–31; *see generally* Bar-Gill & Bebchuk, *supra* note 156 (developing a formal model of misreporting and showing how incentive-based compensation may incentivize managers to misreport).

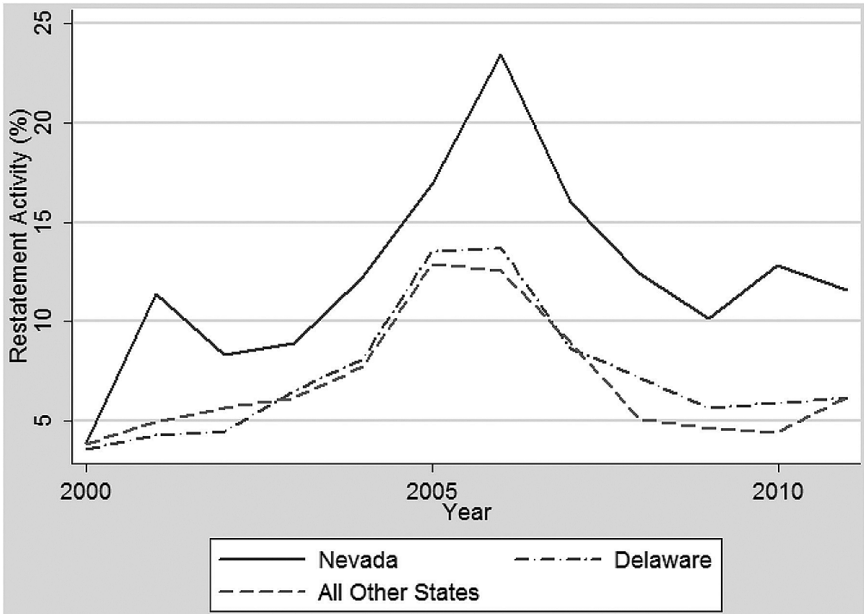
¹⁶⁰ *See* Efendi et al., *supra* note 159, at 667 (“[T]he likelihood of a misstated financial statement increases greatly when the CEO has very sizable holdings of in-the-money stock options.”); Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 36 J. FIN. ECON. 35, 35 (2006) (“[S]ensitivity of the CEO’s option portfolio to stock price is significantly positively related to the propensity to misreport.”). In those cases in which clawback provisions were implemented, the likelihood for restatements declined and investors’ responses to earnings improved. *See generally* Lillian H. Chan et al., *The Effects of Firm-Initiated Clawback Provisions on Earnings Quality and Auditor Behavior*, 54 J. ACC. & ECON. 180 (2012).

¹⁶¹ *See generally* Barzuza & Smith, *supra* note 15.

¹⁶² Since our different tests compare Nevada firms with Delaware firms, our effect is clearly a Nevada effect and not an out of state effect. *See* Kate Litvak, *How Much Can We Learn from Regressing Corporate Characteristics Against the State of Incorporation?* (Jul. 11, 2011) (unpublished manuscript) (stressing the importance of distinguishing a Delaware or Nevada effect from an out of state effect).

¹⁶³ Our findings suggest some evidence for causation. *See* Barzuza & Smith, *supra* note 15 (A geographical instrument produced evidence for causation, while firm fixed effects did not

FIGURE 1: FINANCIAL RESTATEMENTS 2000–2011 IN NEVADA, DELAWARE, AND OTHER STATES (AS A PERCENTAGE OF THE NUMBER OF PUBLICLY TRADED COMPANIES)¹⁶⁴



Several other studies have documented aggressive, and even fraudulent reporting behavior of Nevada firms. In a line of studies Catadelo et al. found that a disproportionately high number of Nevada firms were subject to SEC trading suspensions, driven by concern for potential inaccurate reporting or market manipulation.¹⁶⁵ For example, out of 17 firms for which the SEC

produce a significant relationship, possibly due to the limited number of reincorporations in the sample.). Second, our findings are consistent with Nevada managers attracted to Nevada lax law—firms who have their HQ in pro-managerial states, that is states that provide managers with different protections, are significantly less likely to incorporate in Nevada. Managers choose Nevada thus only if their home state protection is not likely to meet their preference for particularly strong protection.

¹⁶⁴ Barzuza & Smith, *supra* note 15, at 35 fig.1.

¹⁶⁵ See Anthony J. Cataldo II et al., *What Happens in Vegas Doesn't Always Stay in Vegas: Nevada Corporations Enjoy a Disproportionate Share of SEC Trading Suspensions*, 58 OIL GAS & ENERGY Q. 55 (2009) (finding that Nevada firms were overrepresented (and Delaware firms underrepresented) in naked shorting complaints, SEC 2004 suspensions and SEC 2007 “operation spamalot” (companies that were subject to repeated spam email campaigns)); Anthony J. Cataldo II et al., *The U.S. State of Nevada Consumes a Disproportionate Share of U.S. Securities and Exchange Commission Regulatory Resources*, 5 INT'L. RES. J. APPLIED FIN. 1222, 1222 (2014) (finding Nevada firms overrepresented in SEC trading suspensions for each and every month during 2012 and 2013); Anthony J. Cataldo II et al., *Nevada Continues to Lead Delaware and All Other States and Jurisdictions in 2014 Securities and Exchange Commission Trading Suspension*, 6 INT'L. RES. J. APPLIED FIN. 679 (2015) (finding Nevada firms represent 35.9% of SEC trading suspensions during 2014); see also *Investor Bulletin: Trading*

suspended trading on June 7, 2011, in an attempt to combat microcap stock fraud, two were from Delaware and ten were from Nevada. Nevada firms were also overrepresented in a sample of DOJ and FBI actions to arrest executives for stock manipulation. The authors argue that Nevada firms' executives engaged in pumping and dumping shares, that is, inflating the company share price based on false information, only to sell and issue a large amount of shares at the inflated price.¹⁶⁶

The choice of Nevada law is also associated with inaccurate reporting among foreign companies. A recent study examined the relatively recent practice of cross-mergers by foreign companies into U.S. shells.¹⁶⁷ A company that merges into a publicly traded U.S. company does not have to file an initial public offering registration statement.¹⁶⁸ Apparently, foreign companies increasingly use shell U.S. companies, that is, companies that were established for that purpose only and have no other activities, to circumvent IPO reporting obligations and relatively high liability exposure.¹⁶⁹ Out of 1,139 reverse-mergers between 1996–2012, 606 companies merged into Nevada shells, and 309 into Delaware shells.¹⁷⁰ The study found that “[a]doption of Nevada’s corporate law is associated with some of the most serious restatements involving real corporate governance and data manipulation problems.”¹⁷¹

b. Nevada Firms’ Value

Despite what one might expect given Nevada firms’ high ratios of reporting irregularities, our study did not find conclusive evidence that firms in Nevada were traded in a lower value relative to firms in other states.¹⁷²

Suspensions, U.S. SEC. & EXCH. COMM’N, OFFICE INV’R EDUC. & ADVOCACY (May 2012), <https://www.sec.gov/investor/alerts/tradingsuspensions.pdf>.

¹⁶⁶ Anthony J. Cataldo II et al., *More Evidence of the Nevada Effect: SEC, DOJ, FBI, and IRS Regulatory Enforcement Actions*, 7 J. FORENSIC & INVESTIGATIVE ACCT. 307, 313 (2015). In one notable example that the authors report, Universal Express’ CEO, who was promoting the company shares based on false information, filed a complaint with the SEC that a naked short selling is causing the company share price to decline. The SEC found it was the CEO himself, who was selling billions of unregistered shares. Anthony J. Cataldo II et al., *An Analysis of SEC and PCAOB Enforcement Actions against Engagement Quality Reviewers: A Comment and Extension in Support of the Nevada Effect*, 6 J. FORENSIC & INVESTIGATIVE ACCT. 157, 166 (2014); see also SEC v. Universal Express, Inc., 646 F. Supp. 2d 552 (S.D.N.Y. 2009).

¹⁶⁷ Siegel & Wang, *supra* note 15, at 1.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ Siegel & Wang, *supra* note 15, at 1.

¹⁷² Barzuza & Smith, *supra* note 15, at 3618–20 (finding no statistically significant effect for the valuation of Nevada firms); see also *id.* at 3598 (“Overall, our valuation findings are inconclusive and make it difficult to draw strong conclusions regarding the efficiency of the decision to incorporate in Nevada.”). Results from other studies of Nevada valuation effects are mixed. See e.g., Litvak, *supra* note 126 (finding significantly higher Tobin’s Q for firms incorporated in Nevada); Ofer Eldar, Can Lax Corporate Law Increase Shareholder Value? Evidence from Nevada (Aug. 9, 2017) (unpublished manuscript) (on file with author) (finding

Several other studies, described below, have attempted to assess the effect of Nevada law, Nevada 2001 legal reforms, and reincorporations to Nevada, on Nevada firms' market value. Results with respect to the effects of Nevada law on Nevada firms' value however, should be interpreted cautiously. Nevada firms are exceptionally small which affects firms Tobin's Q. Moreover, inaccurate reporting could have inflated the value of some of these firms, as the Universal Express and several other case studies demonstrate. Third, the rate of firms that exit the Compustat sample is especially high in Nevada, suggesting that a survivorship bias could affect the results.¹⁷³ Fourth, Nevada firms come disproportionately from OTC, which provides only thin trading data. For OTC firms, there are many days with no price data. Fifth, as the literature demonstrates, there were many misconceptions with respect to Nevada law and it is not clear that the market had full information with respect to Nevada legal regime and its effects on firms. Sixth, Nevada has embarked on marketing its legal regime, and at some point in time, which has not been clearly identified yet, this marketing could also affect the market value of Nevada firms.¹⁷⁴ With these caveats in mind, the following turns to discuss these studies.

Testing the effects of Nevada's 2001 law on Nevada firms, Donelson and Yust found that the law had a negative effect on the value of Nevada firms that were traded on OTC.¹⁷⁵ They interpret that result to suggest that the law is more harmful for firms with weaker governance, as OTC firms do not have to comply with listing standards requirements. Eldar studied the effect of the law's passage on the thirty-five Nevada firms that did not opt into the 1987 default protection and found no significant change.¹⁷⁶ Furthermore, Nevada is now marketing its regime vigorously, via secretary of state

higher Tobin's Q for small firms incorporated in Nevada but not for large ones) (both studies do not account for the high proportion of Nevada firms that exit the Compustat sample, and the resulting survivorship bias); A.J. Cataldo II et al., *Building and Testing a Portfolio of Marijuana Stocks: Why U.S. SEC Trading Suspensions Might Cause Some to Crash Before (or After) Reaching New High*, 5 INT'L. RES. J. APPLIED FIN. 1131, 1131 (2014) (finding that Nevada incorporation is associated with lower returns in a sample of marijuana firms); Dain Donelson & Christopher G. Yust, *Litigation Risk and Agency Costs: Evidence from Nevada Corporate Law*, 57 J.L. & ECON. 747, 757 (finding a negative effect for the 2001 amendment); Eldar, *supra* (finding that the 2001 reform has "no significant effect on the shareholder value of Nevada firms").

¹⁷³ See Barzuza & Smith, *supra* note 15, at 3600 tbl.2, 3601 (finding that Nevada firms account "for roughly 10% of all Compustat exits from 2007 to 2011").

¹⁷⁴ Finding a valid instrument to study the value of Nevada firms that would satisfy the exclusion restriction is also challenging. As explained above, we used a geographical instrument for our study of Nevada restatements. When the dependent variable is Tobin's Q however, a geographical instrument is less likely to meet the exclusion restriction.

¹⁷⁵ Donelson & Yust, *supra* note 172, at 757. The 2001 amendment has changed the 1987 opt-in protections, to be mandatory (and late default). *Id.* at 753.

¹⁷⁶ See Eldar, *supra* note 172, at 19 ("The results show that the 2001 law reform had no material impact on firm value."). Eldar's results might be driven by the size of the sample combined with the fact that the statute also affected all firms in Nevada. For example, the 2001 amendment could provide a signal of Nevada intentions with respect to interpreting and enforcing its managerial protective regime. See generally Barzuza, *Market Segmentation*, *supra* note 14.

web site and other venues. When these marketing efforts turned significant is important for both studies' attempts to evaluate the effects of the 2001 amendment on firms' market value.

Event studies of reincorporations' effects on Nevada firms are highly limited, as reincorporations are infrequent, endogenous, potentially reflective of confounding events, and more importantly lacking pricing data for many days around the event. Studying reincorporation to Nevada, Kobayashi and Ribstein identified only one case of incorporation for which they have full price data, and found no significant effect.¹⁷⁷ Eldar uses a larger sample but he chooses to complete missing dates data with a trade-to-trade method. Eldar finds no significant results for the sample of reincorporation in and out of Nevada. Only when he drops firms that accompanied the reincorporation with a reverse stock split or issuance of new shares out of the sample does he find some weak positive results. Yet, excluding the problematic firms results in clear selection effects. And indeed for those firms that reverse split their shares or issued new shares, the results are negative and statistically significant.

To sum, the literature has not yet produced conclusive results with respect to the effect of Nevada law on firm value. Furthermore, any such effect should be interpreted with caution because, for a while, investors were not sufficiently informed about the legal reforms in Nevada and their potential effects. Indeed, as a recent paper shows, it could take as long as a decade for investors to determine and incorporate the value of governance terms into share price.¹⁷⁸

E. Exceptions – Size and Value

The previous examples suggest that firms might not be choosing the right size, and in particular, that firms that need governance constraints most are often the least likely to adopt them. Firms that adopt governance constraints first are typically the ones to whom the constraints do not matter much. There are two exceptions to the inefficient self-selection rule: size and market value. On both dimensions there is some evidence that is consistent with efficient self-selection.

1. Small Firms are Less Likely to Adopt Governance Constraints

Size matters for the desirability of legal constraints since the costs of compliance might be disproportionately large for small firms. This happens when compliance and implementation costs have a large fixed costs component, which represents a higher percentage of a small firm's revenue. For

¹⁷⁷ Bruce H. Kobayashi & Larry E. Ribstein, *Nevada and the Market for Corporate Law*, 35 SEATTLE U. L. REV. 1165, 1184 (2012).

¹⁷⁸ See Lucian A. Bebchuk et al., *Learning and the Disappearing Association between Governance and Returns*, 108 J. FIN. ECON. 323, 324 (2013).

example, small firms' compliance with section 404 of SOX was assessed to cost approximately two million dollars per year, which translates to approximately five percent of small firms' average market value.¹⁷⁹ Thus, for small firms, shareholder legal constraints might be too expensive and therefore not profitable. Indeed, evidence suggests that to some extent firms self-select efficiently on this dimension. Size is a significant factor in cross-listing, incorporation and governance terms. Small firms are less likely to cross-list on U.S. exchanges, more likely to list on AIM (which offers lax disclosure standards)¹⁸⁰ more likely to incorporate in Nevada than large firms,¹⁸¹ and less likely to adopt governance constraints such as majority voting terms.¹⁸² However, while this evidence could suggest that self-selection on this dimension is efficient, size by itself is not sufficient to reach such a conclusion. In particular, there can also be inefficient reasons why small firms tend to choose lax law. For example, small firms are less followed by analysts, and therefore might not pay (or receive) the full price, in terms of share value, for their poor (or excellent) governance choices. Furthermore, efficient tailoring on size alone should not lead to support for private ordering since size is an observable component that could be, and has been, taken into account in mandatory regulation, including SOX and Dodd-Frank, which both include exceptions for small firms.

2. *Weak Performance Increases likelihood to Implement Governance Changes*

The second measure that seems to operate efficiently is firm market value and performance. Firms that undergo abnormally weak performance are more vulnerable to pressure for governance changes. Relative performance matters as well. For example, firms that perform at the top of their industry are significantly less likely to add governance constraints. This vulnerability appears in different dimensions of the corporate governance dynamics. To begin with, weakly performing firms are more likely to be hit by shareholder proposals, and their managers are less likely to contest a shareholder proposal.¹⁸³ Similarly, pre-SOX, firms that performed poorly were more likely to add independent directors. Or, among late adopters of majority voting, firms in the top five percent of abnormal stock returns were significantly less likely to adopt majority voting. That this performance effect appears primarily for resisting firms supports the notion that weak perform-

¹⁷⁹ See Peter Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices*, 65 J. FINANCE 1163, 1180–81 (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. See generally Coates, *supra* note 64.

¹⁸⁰ See *infra* Section IV.B.

¹⁸¹ See Barzuza & Smith, *supra* note 15, at 3606.

¹⁸² See Choi et al., *supra* note 5, at 1127.

¹⁸³ See Bhandari et al., *supra* note 5.

ance creates pressure on management to implement constraining governance, as predicted by the Hermalin and Weisbach bargaining model.

To a certain extent this selection could contribute to efficient tailoring. Yet, recall that while independent directors were more likely to be nominated in weakly performing firms, they did not add value to these firms. Likewise, the firms that were likely to get hit by proxy access shareholders' proposals were not the firms that, in the market eyes, stood to benefit most from these proposals. Indeed, a relatively weak performance might merely reflect a temporal fluctuation in market prices. Indeed, supporting this interpretation, empirical evidence that takes transitory fluctuations into account does not show a positive effect for these governance changes, while empirical methods that do not take these circumstances into account do find positive results.¹⁸⁴ To sum up, while self-selection on this dimension—abnormally or relative weak performance—seems to work, it does not seem to indicate overall efficient tailoring.

IV. IMPLICATIONS

A. *Implications for Data Interpretation*

A significant body of research analyzes the effect that various governance terms and packages thereof have on firms' performance. These studies are often used to assess policy proposals. In analyzing the data, different forms of self-selection are often taken into account, except for one form—the inefficient self-selection that is described here is rarely considered. Take for example the evidence from voluntary adoption of independent directors pre-SOX. While several selection accounts were considered, one account, that firms that did not adopt independent directors might benefit more from having them, was not even raised.¹⁸⁵ As a result, studies erroneously concluded that independent directors do not matter.

The analysis here suggests caution when attempting to draw policy implications from research on the effect of governance terms that were adopted voluntarily. The cumulative body of evidence shows that the firms that voluntarily adopt governance constraints could be the least likely to exhibit re-

¹⁸⁴ See, e.g., James S. Linck et al., *Endogeneity and the Dynamics of Corporate Governance*, 105 J. FIN. ECON. 581, 582 (2012) (finding a positive effect for board independence when using firms fixed effect, but not when using Arellano-Bond GMM instruments).

¹⁸⁵ See, e.g., BAINBRIDGE, FINANCIAL CRISIS, *supra* note 3, at 90 (“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, *supra* note 1, at 171 (“Recent corporate governance initiatives, including Sarbanes-Oxley, are misguided because they erroneously assume corporate boards can be organized or incentivized successfully to monitor and manage the corporations they serve. All of the available theoretical and empirical evidence suggests this is not the case.”).

sultant changes in performance.¹⁸⁶ Relying on results from voluntary adoption could underestimate the potential effects of governance, and lead to an erroneous conclusion that governance does not matter. Thus, for example, interpretation of studies that examine the effect of SOX on foreign firms that cross-listed on US exchanges should consider the possibility that SOX could have had contributed more to firms that had not cross-listed than to firms that had. Similarly, interpretation from shareholder proposals should take this self-selection into account. If managers had not excluded exactly those proposals that would have benefited firms, proposals would have probably resulted in stronger positive market response to firm value than research currently shows.

B. Assessment of Mandatory Regulation vs. Private Ordering

The presumed virtue of private ordering in tailoring governance to firms' needs has been frequently provoked against mandatory corporate law. The argument was used categorically to object to any mandatory regulation regardless of its subject matter, or its merits.¹⁸⁷ It also did not seem to matter that mandatory law could create distinctions for observable variables such as firm size. The argument is now used to support a sweeping deregulation of the financial system.

First, this Article shows that such a far-reaching use of the assumption of efficient tailoring is misguided. Granted, a one-size mandatory law might impose costs on some firms, as in the case of high compliance costs for small firms, or adding independent directors to firms with high information asymmetry.¹⁸⁸ Yet, that firms that need governance do not adopt it, also imposes inefficiency costs, as evidenced from cross-listing, independent directors, proxy access, and other examples. Policymaking in corporate law, this Article suggests, is more complicated than simply choosing categorically between private ordering or mandatory law. Rather, it requires an assessment, in each case, of the costs of applying a one-size mandatory law to different firms against the costs of relying solely on private ordering. The particular governance term's merits, the likelihood of inefficient self-selection, and whether mandatory law could apply selectively, thus, should all be taken into account.¹⁸⁹ To get a sense of the costs imposed by inefficient self-selec-

¹⁸⁶ See, e.g., Choi et al., *supra* note 5.

¹⁸⁷ See Seven Firm Letter, *supra* note 20 (arguing that even if proxy access is desirable it should be left to private ordering); see also Bebchuk & Hirst, *supra* note 20, at 334 ("A central argument put forward repeatedly by the Proposal Opponents is that, even assuming that access is beneficial for many public companies, the optimal approach is to retain no-access as the default arrangement . . ."); Easterbrook & Fischel, *Corporate Contract*, *supra* note 2, at 1418 (claiming that this virtue justifies the entire enabling structure of American corporate law).

¹⁸⁸ See discussion of evidence *infra* Part III.A.

¹⁸⁹ For example, SOX and Dodd-Frank applied size-based exceptions, under the assumption that compliance would be relatively costly for firms of small size. See 15 U.S.C. § 7262(b)–(c) (2012) (noting that SOX accommodates small firms—companies whose market

tion, researchers and policymakers should examine data on adopting and non-adopting firms. For example, the evidence from board independence suggests that repealing the exchanges' listing standards is not desirable, as firms that now benefit from board independence might opt out of it, as they did prior to SOX.

Second, the findings also lend support to a novel policy approach: creating a menu of minimal governance *packages* for firms to choose from. For example, if a firm chooses to incorporate in Nevada it should also have to adopt both proxy access and majority voting to ensure board accountability. So, a Nevada package will include a proxy access and a majority voting term. Alternatively, if a firm chooses to maintain a staggered board, it should not be allowed to also have a poison pill. This policy approach allows firms to take into account their specific circumstances while simultaneously preventing the sort of race-to-the-bottom self-selection possible in a law-free private ordering regime.¹⁹⁰

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

C. Implications for Shareholder Proposals and Proxy Advisory Firms

During the last decade and a half, corporate governance has been shaped less frequently by regulation and more frequently by the combined influence of market entities and mechanisms—shareholder activists' proposals and proxy advisory firms. The Article highlights an overlooked role of these mechanisms—in improving efficient tailoring. Modern governance mechanisms create pressure on Resisting Firms to adopt governance. This Part thus derives implications for shareholder proposals and for proxy advisors.

Shareholder activists' proposals are becoming a central mechanism for corporate governance changes. Majority voting, proxy access, independent chairperson, disclosure of political contributions, and disclosure of diversity

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); 12 U.S.C. §§ 5481(24), 5365(i)(2)(A) (2012) (noting that banks with total assets under \$10 billion are not subject to supervision by the Consumer Financial Protection Bureau, and need not conduct the stress tests that larger banks must commission).

¹⁹⁰ In fact, the SEC has recently used a similar approach to craft a new "pay ratio" rule, required under the Dodd-Frank Act. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 953, 124 Stat. 1376 (2010); *Corporate Governance Issues, Including Executive Compensation Disclosure and Related SRO Rules*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml> (last modified July 13, 2015).

policies have been submitted and implemented via shareholder proposals. As we learn from recent findings however, almost a third of shareholder proposals submitted are not being brought to shareholder vote. More important, shareholders are denied voting on a proposal, exactly when the governance term the proposal promotes, if implemented, is likely to benefit their firm.¹⁹¹ This Article arguments and findings suggest that the SEC should reconsider the high rate of no-action letters currently awarded to managers requesting proposal exclusion. Especially with respect to corporate governance proposals, the SEC should avoid awarding no-action letters that could result in managers excluding proposal in those firms that could benefit from them. The Article supports the SEC decision to withdraw the Whole Foods no-action letter, despite the harsh criticism that followed.¹⁹² Interpreting broadly the “conflicting proposal” exception under Rule 14a-8(i)(9) would practically allow managers to exclude all shareholder proposals that matter, and replace them with alternative, less restrictive, proposals with close to zero effectiveness. Accordingly, as now managers are diverting to a different exception—“substantially implemented” proposals—in deciding whether to award a no-action letter the SEC should remain minded of the self-selection problem. For example, boards now implement an alternative proxy access, that follows the common shareholder proposals, with one important difference—they do not allow for the nomination of a candidate to happen at the same annual meeting. Yet, postponing the nomination in a year could be significant: waiting a whole year is risky and might not provide management with appropriate incentives. If there is a need for some limitations on shareholder proposals, restrictions on shareholder proposals that do not depend on management power, such as the proposal to raise the shareholder ownership threshold, which currently stands on \$2,000, should be preferred.¹⁹³

The Article also highlights the importance of proxy advisory firms’ voting recommendations and governance rankings. In supporting certain governance changes, proxy advisory firms contribute to pressure resisting firms to adopt governance terms. Furthermore, if managers do not implement a precatory proposal or if they inappropriately exclude a proposal, ISS and Glass Lewis will recommend a withhold vote against the board. Thus, man-

¹⁹¹ See discussion *supra* Part III.D.

¹⁹² See, e.g., Daniel M. Gallagher, Comm’r, U.S. Sec. & Exch. Comm’n, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors’ College (Jun. 23, 2015) [henceforth Gallagher, Stanford Speech] (“The recent *Whole Foods* blow-up, in which by fiat a previously-granted no-action letter was withdrawn, and consideration of all similar letters was deferred, shows just how broken the system is for both proponents and companies.”).

¹⁹³ Steven Davidoff Solomon, *Grappling with the Cost of Corporate Gadflies*, N.Y. TIMES, Aug. 19, 2014; John Engler, *How Gadfly Shareholders Keep CEOs Distracted*, WALL ST. J., May 26, 2016; Gallagher, Stanford Speech, *supra* note 192; Chamber of Commerce of the United States of America et al., Petition for Rulemaking Regarding Resubmission of Shareholder Proposals Failing to Elicit Meaningful Shareholder Support (2014), <https://www.sec.gov/rules/petitions/2014/petn4-675.pdf>; David Larcker & Brian Tayan, *Gadflies at the Gate: Why Do Individual Investors Sponsor Shareholder Resolutions?* (Aug. 11, 2016) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2821755.

agers' power to fend off shareholder proposals is limited by proxy advisory firms. Second, proxy advisory voting recommendations support shareholder proposals and increases incentives to vote and submit them. Overall, without the pressure of proxy advisory firms, it is possible that majority voting terms would not have been adopted by late adopters, who were more affected by them. On top of that, proxy advisory firms frequently take into account the firm's whole governance package, both for ranking and for voting recommendation. Thus, in considering different arguments for and against the proposed Proxy Advisory Reform, proxy advisors' effect on tailoring governance to Resisting Firms should be cast against limiting their power and influence.

CONCLUSION

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

This Article showed that the theoretical support of private ordering relies on an inherent paradox, as market forces are required to discipline managers precisely in those firms in which market forces are weak. An analysis that incorporated firm heterogeneity resulted in inefficient tailoring of governance terms to firms. Similarly, evidence on different governance terms— independent directors, cross-listing, state corporate law, majority voting and proxy access proposals—casts doubt on the conventional wisdom that private ordering results in efficient tailoring. Rather, most of the evidence is consistent with this Article's account that the firms that could benefit most from constraints are frequently the ones least likely to adopt them.

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

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

