

TOWARD A TRUE CORPORATE REPUBLIC: A TRADITIONALIST RESPONSE TO BEBCHUK'S SOLUTION FOR IMPROVING CORPORATE AMERICA

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I am honored to have this chance to comment on Professor Lucian Bebchuk's typically thoughtful article, *The Case for Increasing Shareholder Power*.¹ In that article, Bebchuk sets out a reform proposal designed to meet some of the objections of skeptics who doubt the desirability of increasing shareholder power to influence corporate decisionmaking.

As a judge who decides corporate law cases, my essay responding to Professor Bebchuk is necessarily constrained. I will not enter the debate with my own vision of the appropriate role of stockholders in the governance of corporations. Instead, lest my essay be devoid of anything but platitudes, I present a critique of Bebchuk's proposed reform from a particular viewpoint. That viewpoint should not be confused as representing my own. Instead, I adopt the perspective of what I will call an open-minded corporate law "traditionalist." My description of this perspective attempts to describe fairly a school of thought about the American corporate governance system that not only has many adherents among investors, but also pervades the two major political parties whose members populate Congress and state legislatures. The substantial influence of the traditionalist perspective in our society means that in order to be successful, a proposal for the reform of corporate law such as Bebchuk's must address traditionalist views.

This essay proceeds in four steps. Initially, I summarize Bebchuk's policy proposal. Then, I describe in colloquial terms the perspective many traditionalist investors have about corporate governance. From there, I identify why Bebchuk's policy proposal likely would not find favor with such investors. Finally, I set forth, for illustrative purposes, the type of proposal to increase stockholder clout that might serve as the basis for a responsible reform that would address the legitimate

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¹ Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

concerns of traditionalists. This proposal would periodically bolster the ability of stockholders to run a competing slate of directors against an incumbent board they believe is performing poorly.

Reform along these lines would strengthen the hand of stockholders, but only insofar as institutional investors are serious about being active, involved long-term, and willing to devote reasonable efforts to improving the overall integrity and performance of American operating companies. Of course, in and of itself, any reform of corporate law is unlikely to promote a more rational focus by managers and stockholders on fundamental, long-term earnings growth. Absent changes in economic, tax, and disclosure practices at the federal level and, equally as important, absent behavioral changes by institutional investors to align their actions with the interests of the individual investors whose capital they invest, American corporations will have suboptimal incentives to concentrate on sustainable wealth creation. But the approach to reform outlined here channels stockholder activism in that direction.

I. PROFESSOR BEBCHUK'S REFORM PROPOSAL

To refresh the reader, Bebchuk's basic proposal is that stockholders should be given the power to initiate changes in the equivalent of the corporate constitution: the certificate of incorporation or charter.² Permeating Bebchuk's proposal is his belief that stockholders should have the affirmative power to set corporate policy in important areas, not simply the rights to veto major transactions (such as mergers) and to replace the board through the electoral process.³ He would not permit stockholders to amend the charter to demand that the board of directors make any specific business decision, such as merging with a particular corporation.⁴ But he would permit stockholders to establish "rules of the game" under which the board would be required to undertake certain actions — such as enabling stockholders to decide whether to accept a tender offer or requiring the board to pay a dividend — when triggering conditions in the charter are met.⁵ Likewise, Bebchuk would permit stockholders to amend the charter to repeal a staggered board or to establish a more open system of corporate elections.⁶ To address the argument that important social institutions like public corporations should not have their policies dictated by transient stockholders whose interests might be inconsistent with the best inter-

² See *id.* at 865–75.

³ See *id.* at 851–70.

⁴ See *id.* at 892–95.

⁵ See *id.* at 895–902.

⁶ See *id.* at 851–61.

ests of long-term investors concerned with the sound accretion of corporate wealth through fundamental economic growth, Bebchuk takes a page out of the Delaware Constitution's playbook, requiring stockholder-initiated charter amendments to receive support from a majority of the outstanding shares at two successive annual meetings.⁷ In other words, he contends that stockholders should have the option of retaining the current managers while changing the rules by which those managers govern the corporation.⁸ Bebchuk argues that granting stockholders this power will cause managers to bend frequently to the prevailing wind from stockholders and voluntarily adopt policy changes themselves, obviating the need for any actual electoral battle.⁹

Bebchuk justifies his proposal by citing to empirical research indicating that boards have been resistant to adopting reforms (particularly, eliminating staggered boards) that are associated with better returns for investors.¹⁰ He also reiterates his longstanding view that permitting directors to thwart consideration of noncoercive, all shares, all cash takeover bids through the dual use of a staggered board and poison pill poorly serves investors.¹¹

Through the reform he proposes, Bebchuk seeks to permit a majority of stockholders of a corporation that persists for two years to establish firm-specific rules limiting the board's ability to prevent stockholders from deciding whether to accept a premium offer.¹² In Bebchuk's world, stockholders, not boards or even the corporate code or common law, would determine the extent to which directors can dictate their firms' options in the mergers and acquisitions (M&A) marketplace. Bebchuk also expresses the view that stockholders might be well served by adopting rules of the game that prevent the board from acquiring other companies or assets without stockholder assent.¹³ Thus, Bebchuk hopes to give stockholders the tools to police overpriced acquisitions, as well as those that conglomerate nonsynergistic assets for the sake of aggrandizing management rather than increasing

⁷ *Id.* at 872. The General Assembly may amend the Delaware Constitution only if two successive (i.e., two separately elected) General Assemblies pass an identical bill by a two-thirds majority of each House. DEL. CONST. art. XVI, § 1. Notably, changes to statutory corporate law require the same two-thirds majority of each House, but without the two successive years requirement. *Id.* art. IX, § 1. Features of this type are common in Delaware's system of government. They are designed to ensure that a momentary majority impulse does not displace fundamental aspects of our system of government. Instead, Delaware requires evidence of deep support for the proposed change in the form of durable and supermajority support (in the case of the Constitution) or supermajority support alone (in the case of corporate law).

⁸ Bebchuk, *supra* note 1, at 857-58.

⁹ *See id.* at 869-70.

¹⁰ *See id.* at 852-56.

¹¹ *See id.* at 853, 896-98.

¹² *See id.* at 872, 895-97.

¹³ *See id.* at 903-07.

investor returns. Overall, under Bebchuk's system shareholders would have the ability to establish rules of the game governing all corporate M&A transactions, regardless of whether the corporation is the pursuer or the target.

II. THE CORPORATE LAW TRADITIONALIST'S PERSPECTIVE

A. The Virtues of Managerial Flexibility

The perspective of the corporate law traditionalist is one that recognizes there is great value to the American — that is, the Delaware — approach to corporation law. This approach invests corporate managers¹⁴ with a great deal of authority to pursue business strategies through diverse means, subject to a few important constraints. These constraints — that stockholders approve certain important transactions such as mergers,¹⁵ vote for directors annually,¹⁶ and have access to books and records;¹⁷ that stockholders can hold managers accountable for failing to fulfill their fiduciary duties; and that state and federal policies give independent directors the clout and duty to police corporate insiders — are vital. They provide assurance that managers will not abuse the powers granted them, thereby instilling confidence in investors that capital may be safely entrusted to corporations run by centralized management. Importantly, potent federal laws requiring accurate accounting and periodic reporting of material financial information and subjecting corporate insiders to criminal and civil liability for fraud supplement state protections for public companies.¹⁸ The traditionalist recognizes the need for protections of this kind and the reality that developments in the business world might give rise to a need to strengthen or modify them.¹⁹

¹⁴ In his separate reply, Professor Bainbridge correctly points out the dangers of failing to recognize the distinction between the roles of corporate officers and corporate directors. See Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006). I refer to those who manage the firm collectively, as managers merely as a matter of linguistic economy.

¹⁵ DEL. CODE ANN. tit. 8, § 251(c) (2001 & Supp. 2004). Without dilating on it further, Bebchuk's concern about stockholder ability to veto acquisitions might be addressed in a more traditionalist manner simply by increasing the scope of transactions that require a buy-side stockholder vote.

¹⁶ *Id.* § 211(b). Stockholders may also remove directors between annual meetings, although they may only remove the members of a staggered board for cause unless the charter provides otherwise. *Id.* § 141(k).

¹⁷ *Id.* § 220.

¹⁸ See, e.g., Securities Exchange Act of 1934 §§ 13(a), 13(i), 32(a), 15 U.S.C. §§ 78m(a), (i), 78ff(a) (2000 & Supp. II 2004); White Collar Crime Penalty Enhancement Act of 2002, 18 U.S.C. § 1350 (Supp. II 2004).

¹⁹ For that reason, the traditionalist is likely conflicted about the recent Sarbanes-Oxley Act and the changes in the rules of the major stock exchanges, recognizing the need to address failures

But the traditionalist is as concerned, or more concerned, about protecting the core element of the Delaware way: the empowerment of centralized management to make and pursue risky business decisions through diverse means. To the traditionalist, this empowerment has an important temporal and procedural element. In the governance of a polity, it is thought valuable to have braking mechanisms on quick changes in direction. This guarantees that important changes in public policy are well thought out and reflect more than a momentary majority impulse.²⁰ By contrast, in the business world, the ability to react adroitly to emerging developments and opportunities is considered more important. The ingenuity and skill of talented managers is what ultimately produces corporate wealth, and the law should facilitate managers' ability to make good-faith business decisions with the speed and efficiency modern commerce demands. Likewise, distractions from value-creating tasks should be minimized, so that managers can spend more time improving the company's products and services to increase profits.

The traditionalist is not blind to the reality that not every manager is as good as those who have run Coca-Cola or Johnson & Johnson and that managers often make decisions that do not turn out well. Some managers misuse their offices. The traditionalist has no tolerance for self-dealing and welcomes the tighter scrutiny that Delaware law gives to managers when they resist noncoercive takeover bids. But the traditionalist realizes that there is a difference between a bad result and a decision made in bad faith, and believes that it is counterproductive to deter failure by adopting regulatory requirements that hamstring management. The larger benefits of managerial flexibility, as demonstrated by the success of our economy and the strength of our capital markets, far outweigh the costs of the decisions gone wrong. Put bluntly, the traditionalist will gladly suffer the failures of empowered centralized managers in order to reap the larger benefits of their decisions.

This risk tolerance is, the traditionalist would say, even more sensible when another factor is considered. Unlike the citizen of a nation

in honest accounting but fearing that an overbroad and hastily crafted reaction might impose more costs than benefits. In other work, I have commented on the debate over the utility of these initiatives. See William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. LAW 673 (2005).

²⁰ Although it is true that polities often separate authority (for example, in different branches of government) in order to weaken the chief executive's authority to act, polities often permit the government to act without specific voter approval. In corporate law, stockholder voting power over a number of major transactions counterbalances the stronger unicameral governance structure.

who cannot easily diversify away the risk that her nation's chief executive will make poor judgments if given broad leeway to act without prior restraint, an investor can diversify away the risk that particular management teams will make decisions that result in poor or even disastrous results. The primary goal of corporate law, therefore, is not to prevent failure at each and every firm to the fullest extent possible, but to facilitate the maximum creation of durable societal wealth by all firms. The way to do that, the traditionalist believes, is to free up managers to manage. When that is done, over time, corporations will generate good returns for patient investors with diversified portfolios.

B. Institutional Investors and the Dangers of Direct Shareholder Control

Given these benefits of managerial flexibility, the traditionalist harbors concern over the potential adverse effects of giving shareholders more influence over corporate governance, fearing that it is an overreactive and poorly designed means to generate better corporate performance. She recognizes that institutions, such as mutual and pension funds, control a majority of shares²¹ and that their incentives are not identical to those of the individual investors whose capital they control. She perceives that the increasing sway of institutional investors over corporations, and the institutions' laser-beam focus on quarter-to-quarter earnings, helped create managerial incentives that contributed to the debacles at corporations like Enron, WorldCom, HealthSouth, and Adelphia.²² The traditionalist understands, but does not admire, the self-interest that drives institutions to vote no on the buy side, and yes on the sell side, of a merger between two companies of roughly equal market capitalization.²³ But she does not believe these selfish interests ought to be given primacy in shaping corporate law.²⁴

²¹ See, e.g., Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95, 95 n.2 (2003) (noting that institutional investors held 55.8% of publicly traded equities in the United States in 2001).

²² See, e.g., Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 7-8 (2004) (discussing institutional investors' contribution to Enron's focus on quarterly performance).

²³ Money managers at a prominent institutional investment firm that manages index funds indicated to me that the firm voted its indexed Compaq shares for Compaq's merger with Hewlett-Packard (HP) because of the premium HP was paying, and at the same time voted its indexed HP shares against the merger because it believed the merger was likely to destroy value in the long run. Given the roughly equal market capitalizations of HP and Compaq, such voting behavior is difficult to rationalize as sound fiduciary or investing behavior.

²⁴ The common pursuit by mutual funds of trading strategies involving rapid portfolio turnover is unsettling given the unlikelihood that such strategies will result in returns superior to a more passive, less costly indexing strategy. See generally WILLIAM J. CARNEY, CORPORATE FINANCE 121-37 (2005) (explaining that the semi-strong efficient capital markets hypothesis is

Compounding these concerns is the reality that the conflicts facing institutional investors are not only deep, but also diverse.²⁵ Those institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest. By contrast, those institutional investors one might think are best situated to make wise voting decisions — the money managers who operate mutual funds, particularly index funds — have little desire to spend money on stockholder activism or offend corporate management. For that reason, many rely heavily on the advice of yet another level of agency, firms like Institutional Investor Services (ISS) that provide advice on how to vote on corporate ballot issues, to satisfy their legal obligation to vote in an informed manner on behalf of their investors.²⁶ The influence of ISS and its competitors over institutional investor voting behavior is so considerable that the traditionalist will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind — firms even more unaccountable than their institutional investor clients. Thus, the separation of “ownership from ownership” created by the emergence of institutional investors is further exacerbated by the willingness of institutional investors to defer to other agents. Unlike corporate managers, neither institutional investors as stockholders nor ISS as a voting advisor owe fiduciary duties to the corporations whose policies they seek to influence. And unlike the individual investors whose capital they use to wield influence, institutional investors and their advisors bear far less of the residual risk of poor voting decisions, as their compensation turns more on short-term factors than on long-run growth.

The traditionalist has no illusions that the interests of mutual fund managers are identical to those of their shareholders, most of whom are not invested in pursuit of short-term quick hits but to build wealth to send children to college or sustain themselves after retirement — the

premised on the idea that even sophisticated investors without nonpublic information are unlikely to be able to develop a trading strategy that will deliver returns in excess of the stock market's overall growth). The increase in portfolio turnover as the mutual funds industry has matured is striking and suggestive of agency conflicts. See John C. Bogle, *Mutual Fund Directors: The Dog That Didn't Bark* (Jan. 28, 2001), http://www.vanguard.com/bogle_site/january282001.html (asserting portfolio turnover has leaped from 17% annually during the 1950s to 108% in 2000); Douglass C. Lyon, *The Lyon Letter: Portfolio Turnover* (Spring 2002), http://lyoncapital.com/news_02_sp.html (recounting average mutual fund turnover rate as 110%).

²⁵ For a provocative article touching on many of the conflicting desires and incentives of institutional investors, see Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, (UCLA Sch. of Law, Law & Econ. Research Paper No. 05-16, 2005), available at <http://ssrn.com/abstract=783044>.

²⁶ ISS is so successful that it has spawned a California rival, Glass Lewis & Co.

sort of wealth that comes only from a diverse portfolio, containing corporations that deliver profits by producing useful products and services. Stockholders of this kind do not desire managers to use accounting gimmickry to show misleadingly rosy results; they know such gimmicks are eventually found out. Diversified investors are not impressed by receiving a giant merger premium in one pocket that was paid out of their other. What matters to them is whether the resulting entity will generate more wealth over time than the companies would have produced separately.

Similarly, these diversified investors are not interested in corporations becoming a therapy couch for politically-motivated institutional investors to vent their causes of the moment. Diversified investors also are skeptical that the same institutional investors that failed to discern obvious rot at firms like Enron, pursued ideas du jour with no proven relationship to creating sustainable wealth, and helped fuel the rapid expansion in CEO option compensation have suddenly taken, as a state senator friend is wont to say, their "smart pills."

C. Traditionalist Criteria for Corporate Reform

Despite these views, the traditionalist is disquieted by the corporate status quo. She finds troubling the self-enriching and aggrandizing behavior of CEOs. She does admire the genuine risk-taking and ingenuity of founding CEOs like Bill Gates, Steve Jobs, and Michael Dell, and she recognizes that even some established companies are blessed with particularly adroit CEOs whose unique talents help mature companies thrive or just survive in circumstances in which mediocre top leadership would generate materially poorer results. But, overall, the traditionalist is likely to be skeptical that the talent of CEOs alone drives corporate performance, as opposed to the collective talents of managers and labor. She fears that the cult of the CEO is diverting an unreasonable amount of funds from better uses and thwarting the ability of firms to retain and develop quality managers internally. She believes that, in a real sense, the institution is larger than any individual, and that it is the corporation's ability as an organization to foster ongoing managerial excellence that ultimately determines how much wealth the corporation will deliver.²⁷ In that vein, a CEO who views himself as indispensable and who does not create a responsible management succession strategy based on fostering talent within the organization is perceived by the traditionalist as more hubristic than value-creating. Likewise, the traditionalist worries that too many

²⁷ See, e.g., Rob Walker, *Overvalued: Why Jack Welch Isn't God*, THE NEW REPUBLIC, June 18, 2001, at 22, 23-24 (arguing that the most successful CEO of General Electric was not Jack Welch but Welch's relatively unknown predecessor).

CEOs have secured compensation and perquisite packages so lavish as to be corrosive.²⁸ Middle managers vital to making the firm function well may, however hard they try, find it difficult to pursue “efficiency” or “cost-saving” initiatives wholeheartedly when the CEO is living like a Saudi prince at the firm’s expense.

The traditionalist is frustrated with the apparent inability of corporate boards to address these problems, even after the recent scandals. But the traditionalist is skeptical that government should or even could effectively write regulations governing the internal management of firms. She is also unconvinced that the way to change the behavior of particular firms is to permit institutional investors to tinker with their governance structures. What the traditionalist finds more intriguing is the idea of opening up the means to change directly the management of firms that, over time, perform poorly and act indifferently to the best interests of their stockholders. In addition, she realizes that antitrust law and large firm size impedes the M&A market from adequately disciplining certain firms. Indexed investors are likely to hold these firms’ shares indirectly, and the traditionalist is sympathetic to the notion that there should be a means to influence their direction through a change in management.

But the traditionalist, as is her trait, strives for balance. For example, the traditionalist knows that the power of independent directors in corporate governance has been expanding for several decades and was recently made even more formidable by Sarbanes-Oxley, new stock exchange rules, and evolution in the common law of corporations. The results of this strengthening of the monitoring role of independent directors over inside managers have yet to be fully realized. Obvious concerns therefore arise about the wisdom of throwing even more changes right now at corporate boards, which are expending greater time than ever attending to their duties. Moreover, the traditionalist knows that there is not an inexhaustible supply of quality independent directors and that proxy contests are distracting and expensive. The

²⁸ The explosion in CEO compensation in the United States is, one can safely venture, difficult to explain in rational terms. From 1990 to 2002, CEO pay grew 315%, the S&P 500 grew 237%, and yet American median income grew only 41.6% and worker pay grew 48%, while inflation took place at a rate of 41%. United for a Fair Economy, CEO Pay Charts, http://www.faireconomy.org/research/CEO_Pay_charts.html (last visited Mar. 11, 2006) (compiling data from Standard and Poors Corporation, U.S. Bureau of Labor Statistics, and *Business Week*); U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2004–2005, at 443 tbl.666 (2004) (providing median income data). If the minimum wage had grown at the same rate as CEO pay since 1990, it would be \$23.03 per hour. Hubert B. Herring, *Boss to Workers: A Dollar for You, and \$431 for Me*, N.Y. TIMES, Sept. 4, 2005, § 3, at 2. CEO compensation seems to be topping not only returns to labor in general but also returns to equity capital in particular — a good deal of which is now contributed indirectly by laborers who must rely on defined contribution plans as a primary retirement savings mechanism.

traditionalist's desire for greater accountability therefore is tempered by an appreciation of the need to ensure that the benefits of any reforms exceed their costs. To that end, the traditionalist would prefer a reform that enables real change at poorly performing firms over one subjecting all firms to costly exercises in stockholder voice.

Due to her knowledge of how corporate boards work, the traditionalist has little interest in initiatives that single out specific board members for defeat or embarrassment. She knows boards almost always work by consensus and it is therefore silly to hold a solitary director responsible for a company's poor performance or lack of responsiveness to shareholder interests.²⁹ As important, the traditionalist wants quality persons to serve as independent directors and fears that personalized campaigns will do little to improve firm governance but do much to discourage good director candidates from serving. When a board has failed, the traditionalist thinks the board should be removed as a whole. Although that sort of change is major, the traditionalist is reluctant to give institutional investors less potent options that would threaten to dilute the system-wide benefits achieved for diversified investors by giving centralized management a strong hand to pursue its vision of the optimal business strategy. If the Lilliputians do not trust the Gullivers at a few firms, the traditionalist is fine with them getting other Gullivers there but does not want them to tie down Gullivers everywhere. The traditionalist knows the power of a good example. Replacing a few poorly performing boards will have substantial, beneficial ripple effects on the performance of other boards.

D. The Importance of the Traditionalist Perspective

Having described the perspective of the traditionalist, I want to emphasize why that perspective is important to consider in any debate about corporate governance reform. Where corporate governance public policy is made — in state legislatures and Congress — the

²⁹ Currently, there is a major debate about moving from plurality to majority election of directors. The focus on the term "plurality" in that controversy is misleading. In an election featuring three candidates for a director position, no sensible person would object to the candidate with a plurality being elected. Even in an election with two candidates, it is possible the candidate with the most votes would still get only a plurality if a number of withhold-authority proxies are filed. At bottom, the real issue is whether an unopposed candidate who gets fewer votes than the number of withhold-authority proxies should be deemed reelected or be considered a holdover director. Related is the question of whether a candidate's failure to receive more votes than the number of withheld votes should create a vacancy for that seat, triggering a new election. Common to all the permutations of this sort of reform is the idea that it would be beneficial to stockholders to facilitate negative campaigns directed at particular director-incumbents at particular firms rather than campaigns to replace the boards that, by consensus, actually govern those firms. To the traditionalist, it is telling that the proponents of the "majority" rule are focused on unseating specific directors in this negative manner, rather than by proposing viable alternative nominees for election in the first place.

ected officials of both parties are likely to embrace some form of this perspective, thereby limiting the feasibility of any reform that does not address traditionalist concerns. They, and most individual investors, embrace this perspective in part because they do not see corporations as having solely the social purpose of benefiting investors as investors. Rather, they understand and embrace the historical reality that the corporate form was authorized as an instrumental means of enhancing the well-being of our society as a whole and not simply as a means to make investors rich and immune from liability for corporate acts. Although many traditionalist policymakers would concede that making managers more directly accountable to stockholders is a useful means to achieve the larger objective of increasing societal wealth, they do not conflate the goal of a durably wealthier society with the short-term interests of investors in higher stock prices. Indeed, they are concerned that tilting the direction of corporate policy toward short-term thinking is counterproductive, not simply for investors but for other important constituencies such as employees and communities.

Existing American corporate law bears out the popularity of these traditionalist views. Most U.S. states permit corporate directors to consider the interests of constituencies other than stockholders.³⁰ Even Delaware law has long made clear that directors have wide leeway to pursue the course of action they believe in good faith to be in the long-term best interests of stockholders, even if that means forsaking other tactics that might increase stock value in the short term.³¹

Put simply, there are two reasons the traditionalist perspective is important. One is that it advances a plausible vision about how best to use the corporate form to further society's objectives, and therefore deserves to be addressed on its merits. The other is more practical and consists in the reality that the traditionalist perspective is politically powerful.

III. THE TRADITIONALIST CRITIQUE OF BEBCHUK'S PROPOSAL

Bebchuk's proposal is unlikely to be greeted with unconflicted enthusiasm by traditionalists. Although Bebchuk has attempted to design his reform in a manner that addresses the traditionalist perspective, he falls short in several critical areas. For starters, the current American approach to corporate governance appears, on balance, to produce good results, and Bebchuk's proposal fundamentally alters it. Bebchuk's approach also appears both to put too much power in the

³⁰ See Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2525-26 (2005) (noting that as of 1999, forty-one states had adopted constituency statutes).

³¹ The most prominent decision to this effect remains *Paramount Comms., Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989).

hands of institutional investors with short-term interests and to focus largely on corporate takeovers. Finally, the capital markets have not indicated that wholesale changes in corporate governance of this kind are desirable or necessary.

I start with a central issue. A key element of Bebchuk's proposal — the ability to change the direction of the firm without electing a new board — is unattractive to the traditionalist, who values the ability of centralized management to set company policies without nitpicking by stockholders. Bebchuk's belief that diversified investors would benefit from the opportunity to set key policies directly through the charter is just that — an unproven belief. But if, as many traditionalists believe, the ingenuity of centralized management ultimately creates sustainable stockholder wealth, it is not intuitively obvious that implementing a corporate California, replete with direct stockholder democracy, is wise. Corporate law already provides stockholders with veto rights over certain transactions and the chance to elect a new board. The current balance has produced impressive results overall for our nation, and the traditionalist sees little need to fundamentally unsettle it.³²

Going further, and providing stockholders who support management's wisdom in general with the power to adopt policies at odds with management in particular areas, would necessarily dilute managerial authority. True, Bebchuk advocates that stockholders be able only to establish "rules of the game," such as procedures for governing the firm or objective criteria that spell out when stockholders must vote on an acquisition or when a dividend must be paid. He would also set a high hurdle by requiring that any stockholder-proposed rules of the game be approved by majorities at two successive annual meetings.

But traditionalists will find these assurances insufficient. Bebchuk's confidence that investors will submit only responsible, value-maximizing proposals is not shared by traditionalists. Traditionalists know the most influential "stockholders" are institutional investors —

³² In other recent work, Professor Bainbridge has aptly cited a paper by two economists to support the view that our current system of corporate governance functions well:

Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades, including the period since the scandals broke. In other words, the broad evidence . . . suggests a system that is well above average.

Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 18 (UCLA Sch. of Law, Law & Econ. Research Paper No. 05-20, 2005) (quoting Bengt R. Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 1 (European Corporate Governance Inst., Finance Working Paper No. 23/2003, 2003), available at <http://ssrn.com/abstract=441100>), available at <http://ssrn.com/abstract=796227>.

intermediaries that invest the money of others. Traditionalists are unimpressed with the discretion that institutional investors use in deciding which proposals to advance or at what companies to advance them. They perceive that the institutional investor community fixates on certain ideas of the moment and presses them at a large swath of companies. Little in the history of the precatory proposal process persuades the traditionalist that institutional investors are able to identify value-maximizing — or even more important, value-preserving and fraud-preventing — ideas for governance. Whatever their success rates, precatory resolutions of all kinds have been proposed regularly by institutional investors over recent decades. The political interests of some intermediaries are such that they will find it attractive to propose new rules of the game regardless of their likely electoral success, for reasons not necessarily connected to increasing the value of their equity in the companies to which they direct their ideas. Because Bebchuk's rules of the game would be binding parts of corporate charters, the companies facing such proposals would have to take them more seriously than precatory proposals and spend even more money addressing them. Traditionalists therefore perceive that the most certain result of Bebchuk's proposal would be increased corporate expenditures in response to stockholder-proposed charter amendments that traditionalists already find unduly costly,³³ time-consuming, and lacking in economic value.

As is often the case with corporate law scholars, Bebchuk time and again circles back to the issue of corporate takeovers. In addressing why his reform proposal is needed, Bebchuk typically refers to a particular board's resistance to either an actual takeover or the removal of defensive barriers to a future takeover. In particular, Bebchuk is convinced that classified boards, when coupled with poison pills, are bad news for investors and should be eradicated from American corporations.³⁴ But when stockholders propose and receive majority support for precatory proposals calling for the elimination of a staggered

³³ An SEC survey of corporations found that respondent companies spent an average of about \$37,000 per year determining whether proposals pursuant to 17 C.F.R. § 240.14a-8 (2005), should be included in proxy statements and that companies spent an average of \$50,000 per year on printing costs associated with actually including such proposals. Amendments to Rules on Shareholder Proposals, 63 Fed. Reg. 29,106, 29,116 (May 28, 1998) (to be codified at 17 C.F.R. pt. 240); see also Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal 10* (UCLA Law & Econ. Research Paper Series, Paper No. 03-22, 2003), available at <http://ssrn.com/abstract=470121> (noting that ISS tracked 1042 shareholder proposals in the 2003 proxy season and that if these corporations sought to exclude all proposals, given the reported average cost of \$87,000 per company, they would spend an estimated \$90,654,000 on these proposals in a given year).

³⁴ See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Anti-takeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889–93 (2002).

board, some boards do not cave.³⁵ In Bebchuk's view, there needs to be a way for stockholders to bypass this value-impairing obstinance.

Bebchuk's laser-beam focus on takeovers is consistent with that of many institutional investors whose identical fixation is reflected in the precatory proposals they advocate, most of which are designed to ease the procession of hostile takeovers. To the extent that the institutional investor community seeks to make corporate America more receptive to accepting premium-generating M&A offers, the traditionalist has an easy retort: What is the problem that demands a reform as far-reaching as Bebchuk's? Is it not the case that M&A activity, even accounting for lulls after the scandals that the institutional investor community did nothing to predict or prevent, has grown enormously during the last twenty-five years?³⁶ Have there really been too few premium-generating transactions for sell-side shareholders? Is there not evidence that the current system, which features a strong role for independent corporate boards, is working effectively to facilitate value-creating M&A transactions?³⁷

To the traditionalist, institutional investors' obsession with takeovers has illustrated their lack of alignment with their beneficiaries more than it has their wisdom. Rather than spending time carefully monitoring portfolio companies' business strategies, disclosure and accounting practices, and related party transactions to promote long-term wealth creation, activist investors fixated on defensive barriers to M&A transactions. And, so long as a company's stock price rose faster

³⁵ New data from 2005 suggest that boards are increasingly responding to shareholder precatory proposals attacking the classified board system of governance by voluntary repeal. See INST. S'HOLDER SERVS., 2005 POSTSEASON REPORT: CORPORATE GOVERNANCE AT A CROSSROADS 5 (2005) (noting that numerous boards have taken voluntary action to declassify their board structures and to moderate features of their poison pills in response to stockholder activism regarding those issues); GEORGESON S'HOLDER, 2005 ANNUAL CORPORATE GOVERNANCE REVIEW 1-2 (2005), available at http://www.georgesonshareholder.com/pdf/2005_corpgov_review.pdf (noting that thirty-two of the forty-four classification proposals voted on in 2005 were submitted by boards, and that of the thirty-two all but two recommended shareholders support the resolution); Memorandum from David A. Katz & Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, Corporate Governance Update: Director Elections and Majority Voting (Dec. 29, 2005) (on file with Harvard Law School Library) (suggesting that board declassification is a reform that "will be difficult for public companies to resist"). Thus, Bebchuk's data, which are for the period of 1997-2003, may not capture this latest shift in boards' responsiveness to stockholder sentiment. In other words, more recent experience suggests that Bebchuk's argument that boards are unresponsive to stockholder demands to reduce structural defenses has waned in strength. I thank Roberta Romano for this point.

³⁶ For example, despite an economic slowdown in 2001 and the effects of major corporate scandals, both of which dampened M&A activity from its peak in 2000, that activity still increased from 4239 transactions with a total value of \$206 billion in 1990 to 7743 transactions with a total value of \$1.3 trillion in 2003. U.S. CENSUS BUREAU, *supra* note 28, at 499 tbl.741.

³⁷ For a balanced perspective concluding that the current M&A regime functions reasonably well, see Marcel Kahan & Edward B. Rock, *How I Learned To Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002).

than average, institutional investors were prepared to give the company's board a pass for incomprehensible disclosures and conflicts — such as with Enron. Certainly, the institutional investor community failed to propose ideas designed to prevent the accounting chicanery all too prevalent in the last decade. The traditionalist would also note that one possible causal factor for the value-destroying scandals at Enron, WorldCom, HealthSouth, Adelphia, and Tyco — the presence of a staggered board — can be ruled out definitively, as none of these companies had one.

There are other reasons traditionalists do not harbor Bebchuk's outrage about staggered boards or other structural defenses. For one thing, the steps Bebchuk proposes to eliminate a staggered board system — majority votes at two successive annual meetings — are already sufficient under a staggered board system to elect a new board majority. If investors truly believe that a board is governing poorly and hiding behind its classified status, the traditionalist, in the great spirit of American non-wimpiness, says "elect your own slate," who can then change the system. And if you don't want to take responsibility for governing, don't mess with the folks who do. Furthermore, the threat to long-term wealth creation posed by classified boards is simply too unproven to justify a system-wide alteration of a long-settled approach to corporation law. As I understand it, Bebchuk also prefers that his proposal not be permitted to be contracted away in the corporation's charter. That is, even if the initial bargain between the stockholders and managers were that the company would have a staggered board, the managers would know that the stockholders could always undo that commitment by two majority votes. Thus Bebchuk would prefer, as an across-the-board matter, to reverse the default posture of the contracting parties under Delaware law.³⁸ For the traditionalist this reallocation is a dubious step, because corporation law already provides the opportunity to shape corporate charters that, from the get-go, are free of the antitakeover provisions that Bebchuk and others find objectionable.

The traditionalist will also observe a couple of key market signals that seem to belie Bebchuk's economic argument. To begin with, it is possible in Delaware and other states to form corporations with char-

³⁸ The default posture under Delaware law requires the board to propose amendments in the first instance and stockholders to ratify. See DEL. CODE ANN. tit. 8, § 242 (2001). Bebchuk does say that the law could allow corporations to opt out of his proposal in their charters. See Bebchuk, *supra* note 1, at 874–75. But that is clearly not his preference and still does not address the traditionalist's concern about undoing the original contracting bargain. Moreover, could later stockholders opt out of the opt-out? The problem for Bebchuk with the opt-out approach is that it runs contrary to his own fundamental distrust of initial charters, which often contain provisions, such as a staggered board system, that he opposes and wants to give future stockholders the chance to modify.

ters that provide for an nonstaggered board, require stockholder votes beyond those required by statute, and limit the ability of the board to use defensive measures to block takeover bids. As confounding as it might be to Bebchuk and others, the reality is that investors often entrust their capital to new public firms with charters that mandate staggered boards, limit the ability of stockholders to act by written consent, and empower the boards to issue preferred stock and to resist takeover bids if they believe that is the right thing to do. If such measures really destroy value over the long term, then one would expect investors to demand different charters. But, it just might be, the traditionalist will think, that there is a value to investors in "precommitment strategies" that strike a balance between management's need for a strong hand to pursue long-term business plans and the investors' need to protect their capital.³⁹

If Bebchuk is correct about staggered boards, the mutual fund industry is also missing an obvious opportunity. They could sell "The Unstaggered 500" fund comprised of those members of the S&P 500 without staggered boards. With this fund, investors could achieve diversification while achieving superior returns by avoiding companies with staggered boards. The absence of a marketed fund of this kind suggests two possibilities to the traditionalist, neither of which lends support to Bebchuk's proposal. The first is that sophisticated money managers do not think metrics of this or a similar kind are proven enough to base investing strategies upon them. The second possibility is that the money manager community that runs index and pension funds has thought little about how to provide investors with the benefits of diversification in a portfolio devoid of companies with policies that are associated with poor performance over time. If the former is true, then the empirical basis for Bebchuk's proposal is thinner than he thinks.⁴⁰ If the latter is the case, Bebchuk's belief that institutional investors have not only the capacity but the incentive to identify

³⁹ See Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 522 (2003).

⁴⁰ I cannot pretend to have taken the time to delve into the empirical debate about whether board vetoes of takeovers or charters containing staggered boards can actually be said to produce poorer corporate performance in the long run. Bebchuk's proof that board rejections of bids are wealth-destroying "from a long-term perspective" is based on a definition of "long-term" that includes "thirty months." Bebchuk, *supra* note 1, at 898. That myopic definition of long-term is quintessentially nontraditionalist. As to staggered boards, Bebchuk cites evidence showing a relationship between antitakeover charter provisions and suboptimal returns over a thirteen-year period. *Id.* at 900 n.151. From a traditionalist perspective, however, this is still a sitcom-length rather than motion picture-length view. In this regard, it is interesting that Bebchuk also cites evidence that venerable firms account for a disproportionate share of the stock market's overall value. See *id.* at 866. But he claims, counterintuitively, that stockholders need to force an update of these successful companies' charters by a means other than electing a new board.

value-maximizing rules of the game emerges as more aspirational than realistic.

For these and other reasons that Professor Bainbridge outlines in his separate reply to Bebchuk,⁴¹ the traditionalist investor will prefer the status quo to the change Bebchuk advocates. Rather than dilute the clear benefits of a system that provides a strong hand for management in exchange for the certain costs and dubious benefits of providing poorly aligned and poorly incentivized institutional investors the power to make rules of the game, the traditionalist is willing to leave things where they stand even if the status quo is not ideal. Being open-minded, however, the traditionalist might embrace reform that is consistent with Bebchuk's call for greater managerial accountability but that accomplishes that end through a different means. I next sketch out what a reform along those lines might entail.

IV. A TRADITIONALIST VARIATION ON BEBCHUK'S CALL FOR INCREASED SHAREHOLDER POWER

The traditionalist, much more than Bebchuk himself, recognizes that M&A markets are not the be-all and end-all of corporate accountability. The traditionalist recognizes there are companies that are unlikely, for a variety of reasons, to be subject to takeovers. Moreover, to the extent that these companies form part of the S&P 500, poor performance by any of them drags down the returns of rationally diversified investors. In the current corporate republic, however, incumbent directors can spend the company's money to fund their campaigns and do not have to disseminate a ballot including all the candidates. These pro-incumbent features combine with the costs of running a proxy contest to produce a corporate election process that functions essentially only when a takeover bidder funds a slate to get around a poison pill. That is, the very election process that is said to give legitimacy to directors' decisions regarding takeovers typically operates in a competitive fashion only when a takeover is the issue and a bidder funds a fair contest.⁴²

To address the problem of unresponsive boards, the open-minded traditionalist might find attractive a well-tailored initiative to make the process of corporate elections more effective outside of the takeover context. But to the traditionalist, the design of the initiative is important. To be attractive to the traditionalist, any reform of the corporate election process has to balance costs and benefits and be

⁴¹ Bainbridge, *supra* note 14.

⁴² Bebchuk has documented this point. See Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45-46 (2003).

measured against the ultimate goal of creating, over the long term, the most societal wealth from the corporate form.

For example, the SEC's apparently now moribund proposal dealing with access to public company proxies⁴³ is the kind of initiative that traditionalists find unattractive. In simple terms, the SEC Proxy Access Proposal would have provided an annual opportunity, under certain conditions, for stockholders to nominate a "short slate" of director candidates whose names would have had to be included in the company's proxy statement. In other words, the proposal would have facilitated only contests targeting particular directors on an ad hominem basis and not elections to replace entire boards. This narrower approach overlooks the reality that boards almost always act by consensus and threatens to diminish the pool of qualified candidates for independent director positions. The SEC's proposed strengthening of the election process was not accompanied by any reform of the precatory proposal process; instead, increased proxy access was simply to be heaped on top of that costly process. Moreover, to the traditionalist the proposal was troubling simply because the SEC proposed it. Without entering the narrow but heated debate about whether the SEC could squeeze its Proxy Access Proposal into its legal authority, one can safely say that the corporate election process is a central element of substantive corporate law, within the province of state law until Congress determines otherwise.⁴⁴ Whether corporations have to hold elections, how elections are funded, who is eligible to be a director, and how often elections occur are core state law questions.⁴⁵

Proponents of the SEC Proxy Access Proposal often lost sight of the fact that corporate elections are not the same as elections in actual politics. In the context of political elections, the ability to express oneself freely at the ballot box has more than instrumental value. The

⁴³ Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

⁴⁴ See, e.g., *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) ("So long as each State regulates voting rights only in the corporations it has created, each corporation will be subject to the law of only one State. No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.").

⁴⁵ Having no real legal or political mandate to reform the corporate election process in a systematic and comprehensive manner, the SEC chose to proceed cautiously and incrementally at the margins, leaving the central issues for another time. Nonetheless, the SEC still managed to ignite a debate, albeit an ill-tempered one, about marginal issues rather than a clash of ideas about fundamental issues. The SEC Proxy Access Proposal promised at best some modest improvements in accountability while adding to the mounting tally of administrative costs attributable to scandal-fueled corporate governance reform. For the traditionalist, the SEC Proxy Access Proposal simply did not move toward a more coherent, efficient, fair, and value-maximizing system of corporate elections.

chance to have a say, to speak one's mind, and to have a fair chance to persuade others to one's point of view about how to govern the community is a legitimate end in itself. But the traditionalist knows there is nothing sacred about the governance of corporate entities. The right to elect directors is an important tool for stockholders, allowing them to hold centralized management accountable and thereby contributing to the creation of stockholder wealth by checking agency costs. But the director election process is only one of the many methods by which accountability to stockholder interests is assured, and its structure must be designed with efficiency in mind, lest it destroy more value than it protects.

Therefore, if reform attractive to the traditionalist is to come, it must emanate from state policymakers who can implement a reform that coheres with an overall approach to corporate law.⁴⁶ State law determinations about corporate elections are not made in a vacuum but as part of an overall consideration of how to shape a working system of corporate law that promotes responsible wealth creation. In that deliberative process, policymakers have to balance the social utility of empowering centralized management against the need for protective mechanisms that ensure managers' fidelity to the entities they govern. That balance informs the policy debate about what transactions stockholders should have the right to veto, how easy it should be to bring a derivative suit, when a board should be able to block a takeover, and most every important question of corporate law. In positing a traditionalist-style reform, I therefore give the central role to state policymakers. Being realistic, however, I also recognize the important role of the federal government and point out means by which the federal government could help better balance the costs and benefits of stockholder activism at the ballot box.

For the remainder of this essay, I outline an example of the form that a coherent and more traditionalist reform might entail. It would involve action by both state governments and the SEC, but the bulk of the policy reform would be at the state level. I do not outline this potential reform program as one that I endorse but as a type of initiative that would address the real issues that inspire Bebchuk's and others' calls for reform while responsibly taking into account the concerns of traditionalists. Fundamental to this conceptual model is the traditionalist's strong bias toward the republican model of democracy, which affords a great deal of authority to elected decisionmakers but holds them accountable through periodic fair elections.

⁴⁶ For a recent scholarly argument to this effect, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *YALE L.J.* 1521, 1597-99 (2005).

Let us start with the state law changes.⁴⁷ The contours of a traditionalist-influenced statute of that kind might go like this: Suppose that every three years, all public companies⁴⁸ without staggered boards had to

* Distribute a proxy card that includes the name of any qualified director candidate⁴⁹ who has been timely nominated by a qualified stockholder or stockholders owning at least 5% of the company's voting stock.⁵⁰

* Reimburse the reasonable solicitation costs⁵¹ of any qualified director candidate — nominated by a qualified stockholder or stockholders owning at least 5% of the company's voting stock — who has received at least 35% of the votes cast in an election governed by the reformed process. That is, this would not be an annual requirement but a system of reimbursement that operates triennially.⁵²

State law might also limit public companies' ability to adopt nomination deadlines that exceed a certain period in advance of annual meetings so that stockholders are able to take advantage of the increased access the new reforms would permit.

To avoid the subsidizing of hostile bidders, the definition of qualified stockholder could exclude any stockholder who, individually or in

⁴⁷ The traditionalist might view it as more fitting that stockholders choose to opt into any new reformed system of elections, on a corporation-by-corporation basis. Therefore, one could imagine a statute that permitted stockholders, by a majority vote at two successive meetings à la Bebhuk, to subject their corporations to an enhanced statutory election process. See Bebhuk, *supra* note 1, at 872–73. Arguably stockholders can already achieve this through the bylaw process, but that is debatable and is complicated by the reality that directors often have the right to amend the bylaws too. A coherent and more certain reform could be achieved by a mandatory statutory approach. There is real value to a systemic reform that is easily understood if that reform is well designed.

⁴⁸ To be defined in accordance with SEC standards.

⁴⁹ A “qualified director candidate” is a candidate eligible to serve on the board in the precise position she seeks in accordance with state, federal, and stock exchange rule requirements.

⁵⁰ There are subsidiary issues that would come with having a real ballot containing more than one candidate for each position, but these can be addressed practicably and efficiently if there is the will to do so. This essay is not designed to get “granular,” as a Silicon Valley CEO might say, about such issues.

⁵¹ Costs could be deemed presumptively reasonable if they do not exceed a certain percentage of the costs incurred by the company in support of the management slate. In that regard, if proponents chose to run a short slate, their reimbursement should be prorated to account for the smaller number of candidates for which they are soliciting.

⁵² This reimbursement system obviously draws on not only analogies to our national political process but also elements of an important proposal by a quintessential traditionalist, Martin Lipton. See Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 225–52 (1991). The proposal here is less managerialist and cumbersome than Lipton's, as its more open election system operates with greater frequency and with fewer strings attached. The proposed system also builds on my own previous musings with Professor Allen and Justice Jacobs. See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002).

concert with others, is seeking to acquire within the twelve or twenty-four months following the meeting date either more than 20% of the company's voting stock or a sizeable portion of its assets. Alternatively, use of this access could subject the users to the strictures of Delaware's antitakeover statute.⁵³ To gain access to the company's proxy card, the qualified stockholders would be required to represent to the company that they qualify under this definition and agree to comply with the prohibition on takeover behavior.⁵⁴

Now, companies with staggered boards would have to be treated differently. For public companies with staggered boards, this system would operate annually with the same ownership thresholds and the same prohibition against access to the proxy card and reimbursement to present or potential bidders. In this way, every seat on a board, staggered or not, would periodically be subject to the competitive system outlined above. Taken together, these reforms might be called a "State-Authorized Ballot Access Statute."

SEC action could complement these State-Authorized Ballot Access Statutes. For starters, it would be useful for the SEC to relax Section 13(d)⁵⁵ requirements for qualified stockholders availing themselves of a Statute's provisions, so long as those provisions exclude stockholders who are current or potential bidders. Dispersed institutional investors who wish in the short term to change a company's management via the ballot box but not to wield cohesive voting control do not pose the same risks as classic bidders for control and should not be treated the same way. Concomitantly, the SEC could issue new rules or relax existing rules to facilitate inexpensive Internet proxy solicitations in order to improve electoral debate.

To address the traditionalist's concerns about the costs of expanded ballot access, the SEC could allow exclusion of precatory resolutions at annual meetings, at least in years when companies without staggered boards must permit qualified director candidates nominated by qualified stockholders access to the company's proxy card. For reasons I will touch upon momentarily, it would be even better for the SEC to allow exclusion of such precatory proposals at annual meetings every year for all companies covered by a State-Authorized Ballot Access Statute.

What are the advantages of a system like this to Bebchuk and to traditionalists? For traditionalists concerned with federalism, this type of reform envisions a more appropriate allocation of responsibility for

⁵³ See DEL. CODE. ANN. tit. 8, § 203 (2001).

⁵⁴ Traditionalists might also favor a condition requiring stockholders to have held shares in the company for some substantial period, for example a year or two, before being eligible to use this system.

⁵⁵ Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m (2000 & Supp. II 2004).

corporate lawmaking. States are the primary source of substantive corporate law and elections are a core aspect of substantive corporate law. Congress has not broadly authorized the SEC to make corporate election policy. More importantly, by having much of the reform occur at the correct level, a more rational and effective reform can be implemented. Because the change would be to substantive corporate law, rather than under the guise of measures to improve the fairness of the SEC proxy rules, increased ballot access could be implemented periodically as a systematic reform.

The periodic nature of this system has important benefits. First, it is far less costly and distracting for the enhanced electoral process to operate only every three years. Second, a periodic approach more realistically fits with institutional investors' capacity to focus and to propose candidates. With appropriate design, approximately one-third of the companies with nonstaggered boards would be subject to State-Authorized Ballot Access elections every year, allowing for institutions to focus on a more manageable set of companies each year. Third, this would also mean that nonstaggered boards would face more competitive election pressures only every three years, giving them breathing space to concentrate on implementing their business strategies. Relatedly, a triennial system of election fits with the reality that contested elections usually follow a period of prior unsuccessful efforts by stockholders to effect change by other means. The periodic operation of the system gives stockholders and boards time to assess how managerial strategies have panned out and to engage in productive discussion, but with the understanding that every three years an effective proxy fight can be mounted by a slate with sufficiently broad appeal. In other words, the periodic nature of the system will tend to create a more durably appropriate investment focus by both shareholder activists and corporate managers.

The periodic operation of the system also recognizes that corporate elections are not ends in themselves and that contested corporate elections should not occur more frequently than political elections. In this regard, it is important that nothing in this system would preclude stockholder-financed or bidder-financed proxy fights in any year. That is, the periodic nature of the proposal need not reduce present opportunities to conduct proxy fights but could provide a triennial enhancement for companies with nonstaggered boards and an annual enhancement for companies with staggered boards. And, because staggered boards would be subject to the enhanced ballot access process every year, this would create an incentive to "de-stagger."

Another advantage to the proposal is that it allows "long slates," thus enhancing stockholder clout, but also expecting more from stockholders in terms of responsibility. Short slates are oddments to the traditionalist. Boards make decisions collectively, almost invariably by consensus; individual directors do not make business decisions. Tradi-

tionalists find contests that involve competing slates more meaningful and productive than contests that single out particular directors for responsibility for decisions that an entire board made. If the goal is to implement a rational system of elections, then stockholders ought to have the opportunity to present a full slate proposing an alternative platform. And when they do not choose to run a full slate, the incumbents ought to be able to point out as an election argument that the insurgents are not willing to propose a full governing board but are simply presenting a few dissenters for the boardroom.⁵⁶

If elections are to be contests about important policy disagreements over corporate strategy and direction, as traditionalists hope, and not about personal vendettas against particular director candidates, then there is no obvious reason to forbid stockholders from proposing a full slate if they so choose, at least so long as bidders for voting control are excluded and cannot run a quasi-takeover fight “on the cheap.” After less aggressive attempts at persuasion have failed, stockholders may feel the need to change the board majority in order to obtain desired company policy changes. This strategy could be thought more necessary at a very large-cap company that is not as subject to discipline through the takeover market and at which long-term holders (for example, index funds) feel a new board majority is needed to improve performance.

Next, the use of substantial nomination and reimbursement thresholds and sound definitions of qualified stockholders and qualified director candidates as the sole triggers is efficient, which is important to the traditionalist. Stockholders with a substantial amount of “skin in the game” — and not the government — should determine when an election contest is in order. The reimbursement provision helps alleviate the real barrier to electoral challenges — the cost concerns of institutional investors. Meanwhile, a high threshold — no lower than thirty-five percent — encourages the nomination of candidates with broad appeal rather than appeal only to narrow interests.⁵⁷ Thus, this proposal balances concerns of managers and directors about “special interest” directors while providing a vehicle for reasonable cost reimbursement to institutional investors legitimately worried about the high costs of proxy fights.

⁵⁶ There is a strong traditionalist case to be made that reimbursement of expenses ought only be available to those who run a full slate.

⁵⁷ Traditionalists might actually favor eliminating the feature allowing access to the company proxy altogether. Under this reasoning, so long as the insurgents’ cost of preparing their own proxy card is subject to ultimate reimbursement, it is both more efficient and fair to rely solely on the reimbursement feature. By this means, insurgents would concentrate on nominating a slate that has genuinely broad strength rather than one with sufficient attractiveness simply to get on the company ballot.

Lastly, this sort of system reflects a coherent approach to corporate democracy that tends to shift voters' attention to the most important issues affecting their corporations. To begin with, by reforming the incumbent-biased election process, the system gives greater legitimacy to corporate directors and strengthens their argument that they ought to have a free hand to shape corporate strategy between elections, even by blocking a takeover bid. Second, by making the election process competitive outside of the takeover context, this system diminishes any continued need for the SEC to allow frustrated stockholders to propose costly and meaningless precatory proposals at stockholder meetings. If stockholders have a fair shot to elect boards periodically, the traditionalist believes they ought to express their ideas about issues in the old-fashioned way and run candidates espousing their views. The indulgence of a form of direct democracy redolent of some of the more inefficient state government systems is viewed as costly by traditionalists now; in a reformed system like the one articulated, it would be perceived as unjustifiable. Instead of a pretend polity, stockholders would be expected to act on matters that had binding impact, like the election of directors, the approval of transactions that require their approval, and votes on bylaws — things that actually matter. As a result, while the reform would strengthen the ability of stockholders to replace boards by winning support from a majority of the electorate, it would also weaken the ability of stockholders obsessed with special issues to waste corporate money and time on their isolated concerns.

* * * *

One suspects that Bebchuk would find this type of reform appetizing but not mouthwatering.⁵⁸ He may fear that stockholders as a class lack the capacity to use an enhanced election process in a vigorous and effective manner and may therefore still prefer to let them influence policy through a corporate referendum process.

But the lack of appeal of a real republican form of democracy to Bebchuk might also suggest that his reform agenda is incomplete and not well targeted. Granted, there remains a sound basis to argue for a variety of economic, tax, trade, corporate disclosure, and other regula-

⁵⁸ Bebchuk has long favored reforming the election process to ease its use by disaggregated investors. See, e.g., Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1134–35 (1990); see also LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 207–13 (2004). What is uncertain is how maximalist Bebchuk wishes to be; whether he would support a move toward a real republic in which the election process, and stockholder votes on board-initiated measures and bylaws, are the primary, nonlitigation corporate law accountability measures; and if so, whether he agrees that any reform to make proxy fights outside the takeover context more affordable should operate periodically for nonstaggered boards.

tory changes to better align the incentives of managers of American corporations with the national goal of creating durable wealth for our citizens. But within the corporate law itself, a continued preoccupation solely with management's flaws ignores the reality that the growing influence of institutional investors during the last quarter century has not been an unadulterated good. Rather than continue to focus exclusively on the fiduciary duties of managers of operating companies, reform advocates like Bebchuk might be well advised to look hard at those fiduciaries who directly hold the capital of most Americans — the fiduciaries who run mutual and pension funds. If these fiduciaries — particularly those who run index funds — do not act as effective and informed citizens of a corporate republic, how should they be held accountable? What are their duties? And as a polity, what can be done to better align the incentives of institutional investors with the interests of individual investors who are concerned with sustainable, long-term wealth creation?

The traditionalist is likely dubious that these financial intermediaries can be incentivized into, and held accountable for, taking a more far-sighted view of their fiduciary responsibilities. But until they are, stockholder advocates like Bebchuk can expect resistance to the idea that these intermediaries be given more clout. Or as the historically minded traditionalist might quip, "A true republic, if you can prove you deserve it."