



Corporate Governance di Amerika

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Corporate Governance

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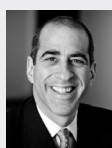
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1 Setting the Scene – Sources and Overview

1.1 What are the main corporate entities to be discussed?

This discussion focuses on publicly traded corporations incorporated under the laws of a state within the United States of America (for example, Delaware, the most common state of incorporation for U.S. companies) with securities listed on a U.S. stock exchange. Non-U.S. companies afforded “foreign private issuer” (“FPI”) status, whose securities are traded on a U.S. stock exchange, are generally subject to the laws of their home state of incorporation and modified versions of U.S. stock exchange rules; however, some U.S. laws will apply equally to FPIs and U.S. companies.

1.2 What are the main legislative, regulatory and other sources regulating corporate governance practices?

U.S. companies are governed by a variety of legal regimes relating to corporate governance matters. These consist of state law and federal statutory rules and regulations of various government agencies, including rules promulgated by the U.S. Securities and Exchange Commission (“SEC”) and self-regulatory organizations, such as stock exchanges, that impose requirements on companies whose securities are listed and traded on such exchanges.

State corporate law rules derive from the laws of the state of incorporation, and the organizational documents of each company. Each state has its own corporate code, with Delaware’s General Corporation Law (“DGCL”) being the most common for large, publicly traded corporations, as the majority of U.S. public companies are incorporated under the laws of the state of Delaware. State corporate laws generally include a mix of mandatory provisions and “default” rules that may be modified by provisions in a company’s certificate of incorporation (also referred to as a charter) or bylaws, enabling self-ordering and tailored governance features to be established on a company-by-company basis.

The primary sources of federal rules and regulations include the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”), and regulations promulgated by the SEC under those and other acts. The Securities Act regulates the offer and sale of securities, primarily through a disclosure-based approach that reaches some governance topics. The Exchange Act mandates

certain annual, quarterly, and interim reporting of financial and other material matters, in addition to proxy disclosure and other requirements concerning shareholder votes and meetings. Other relevant federal regulations imposing disclosure and compliance requirements include the Sarbanes-Oxley Act of 2002 (“SOX”) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). SOX imposed a variety of substantive requirements to enhance the integrity of financial statements and reporting. The Dodd-Frank Act requires additional disclosure in proxy statements, non-binding shareholder votes on items related to executive compensation and facilitates greater access for shareholder-proposed director nominees to the company proxy. In 2023, the SEC announced that it intended to issue new rules to address environmental, social and governance-related (“ESG”) topics, including human capital management, board diversity and climate. In 2023, the SEC also issued new rules on cybersecurity incident and governance disclosures, and, in March of 2024, the SEC issued new rules on climate-related disclosures which have subsequently stayed pending litigation.

Certain federal statutes and rulemakings provide for streamlined or reduced disclosure requirements on smaller public companies. Particular areas of corporate practice are also governed by specialized federal statutes that may have governance implications (for example, regulations promulgated by the Federal Reserve and other federal and state agencies with respect to banks and other financial institutions, and by other similar regulatory bodies in respect of communications, transportation and other regulated fields).

Stock exchange listing rules are issued by the New York Stock Exchange (“NYSE”) and the NASDAQ, the two predominant U.S. stock exchanges. Companies must comply with these rules, many of which relate to corporate governance matters, as a condition to being listed on the exchange. Exchange listing rules address a variety of corporate governance matters, including director independence, the composition of various board committees, board diversity, board evaluation, requirements to submit certain matters to a vote of shareholders beyond the requirements of state law and the company’s organizational documents, regulation of dual-class stock structures and other special voting rights, topics to be covered by corporate governance guidelines and their publication, and certain requirements related to disclosure on the corporation’s public website. These rules are enforced by the threat of public reprimand from the exchanges, temporary suspension of trading for repeat offences and permanent delisting for perennially or egregiously non-compliant companies. Other stock exchanges may have their own governance-related listing rules that go beyond, or otherwise differ from, NYSE and NASDAQ frameworks.

Non-legal sources, such as industry and third-party best practice guidelines, recommendations, shareholder proxy advisory firms (such as Institutional Shareholder Services (“ISS”) and Glass Lewis), proposals advanced by shareholders, and the evolving views and voting guidelines of the institutional investor community, provide additional sources of governance pressure and expectations. The investor community’s views have become particularly influential, as the shareholder base of most U.S. publicly traded corporations consist of an overwhelming majority of institutional shareholders, including index funds, mutual funds, hedge funds and pension funds. As a result, major institutional investors are increasingly developing their own independent views on preferred governance practices and engaging with companies on such matters.

Because of the federal system of U.S. law, different sources of law are not always harmonized and corporations are often subject to different obligations to federal and state governments, regulators at each level of government and demands of other relevant bodies, such as the applicable stock exchange. This mosaic of rules and regulations, and the mechanisms by which they are implemented and enforced, make for an environment of frequent change and evolution.

1.3 What are the current topical issues, developments, trends and challenges in corporate governance?

In the U.S., questions about the basic purpose of corporations, how to define and measure corporate success, how to balance a wider range of stakeholder interests (including employees, customers, communities, and the economy, environment and society as a whole) beyond the investor, and the role of companies in addressing negative externalities and having positive impacts, have become issues for concern and focus within corporate boardrooms and among policymakers and investors. Many of the corporate governance issues facing boards today illustrate that corporate governance is inherently complex and nuanced, and less amenable to the benchmarking and quantification that was a significant driver in the widespread adoption of corporate governance “best practices”. Prevailing views about what constitutes effective governance have morphed from a relatively binary, check-the-box mentality to tackling questions, such as how to prioritize and balance the interests of all constituencies in advancing the sustainable, long-term success of the corporation as a whole, how to craft a well-rounded board and effective board culture, how to effectively oversee the company’s management of risk (including ESG-related risks), and how to forge relationships with shareholders and stakeholders that meaningfully enhance the company’s credibility. The role of the board continues to evolve in overseeing corporate strategy and resilience, fostering reputation and trust in the corporation, and effectively partnering with management as an advisor and strategic counselor. In particular, in the U.S., the past two years have seen a surge of ongoing “anti-ESG” dynamics, which have become deeply politicized in certain camps, with certain politicians, political candidates and legislative actors at the state (and, at times, federal) level taking oppositional stances on a range of issues.

1.4 What are the current perspectives in this jurisdiction regarding the risks of short-termism and the importance of promoting sustainable value creation over the long-term?

“[H]elp[ing] the corporation build long-term, sustainable growth in value for shareholders and, by extension, other

stakeholders” has been described by the NYSE Commission on Corporate Governance as the “fundamental objective” of the board. Corporate governance is being increasingly viewed as a framework for aligning boards, management teams, investors and stakeholders towards long-term value creation and guarding against the perils of short-termism. In particular, there is increasing recognition that the value chain for alignment towards the long-term across public companies, asset managers, asset owners and ultimate beneficiaries (long-term savers and retirees) – each with their own time horizons, goals and incentives – is broken.

While some argue that short-termism is not a concern, additional academic and empirical evidence has been published that demonstrates the harm caused to GDP, national productivity and competitiveness, innovation, investor returns, wages and employment from the short-termism in U.S. public markets. Congress, the SEC, state governments, stock exchanges, academics, the Business Roundtable, and other organizations concerned with the U.S. corporate business system, are reevaluating their positions on corporate governance and its impact on the economy and society.

As mentioned above, an anti-ESG movement has also arisen, at times proposing state-level legislation that would regulate the ability of pension funds and regulated financial service firms to address certain ESG-related matters.

2 Shareholders

2.1 What rights and powers do shareholders have in the strategic direction, operation or management of the corporate entity/entities in which they are invested?

In the U.S., a unitary board of directors, elected by shareholders and subject to fiduciary duties, is charged with overseeing the corporation’s business and affairs. Accordingly, unlike some jurisdictions where shareholders directly determine key business matters, such as corporate strategy, dividend and share repurchase policy, capital raising and material acquisitions, the U.S. model gives broad authority to the board of directors to exercise their business judgment on most matters and delegate day-to-day decision-making to management. Under U.S. state law, it is generally not necessary to seek shareholder approval of management decisions, other than for fundamental changes. Under most state laws, shareholder approval is generally required to approve only relatively fundamental matters such as: (1) an amendment to the corporation’s charter; (2) a merger; or (3) the sale of all, or substantially all, of the corporation’s assets. Accordingly, in most cases, including most asset sales and spinoffs, absent a special provision in the company’s governing documents, shareholders do not have a right to vote on or ratify management’s decisions.

Under NYSE and NASDAQ exchange rules, shareholder approval may be triggered by share issuances involving: (1) 20% or more of the common stock or voting power of an issuer; (2) a change of control (often in the context of funding a large acquisition); and (3) issuances to certain related parties (subject in each case to certain limited exceptions).

While shareholder approval is not required for most business matters, shareholders will typically engage with the management teams of U.S. companies and, in certain cases, with directors to provide input and perspectives to be considered by the board and management. Shareholders participate in non-binding votes on various matters, including a vote at least every three years to approve the compensation of their Named Executive Officers or “NEOs”, and a vote at least every six years to determine the frequency of the “say on pay” votes.

If shareholders are not satisfied with the company's strategic direction, governance, operation or management, they may seek to change the composition of the board of directors (including through nominating their own candidates), register dissatisfaction through their votes, submit shareholder proposals (generally precatory) to be voted on by shareholders, inspect corporate books and records for proper purposes, pursue litigation and/or apply public and private pressure. Under Rule 14a-8 of the federal Securities Exchange Act, shareholders can propose and vote on additional non-binding resolutions, often featuring issues related to social justice or corporate responsibility. See also question 2.3 below regarding shareholder meetings.

In addition, Delaware law, as a general matter, requires shareholders to be treated equally (e.g., with respect to dividends) within share classes. As a result of this basic tenet of Delaware law, all shareholders, whether a minority or controlling shareholder, have a number of equal rights with respect to their shares, on a per share basis where applicable. However, different share classes may be accorded differential voting and economic rights.

2.2 What responsibilities, if any, do shareholders have with regard to the corporate governance of the corporate entity/entities in which they are invested?

Generally, none legally. However, robust concepts of investor stewardship and responsibility are beginning to take hold in the U.S., as concerns regarding the excesses of short-termism and shareholder power give rise to debates regarding whether shareholders should have governance-related responsibilities (even if not liability), such as through voluntary stewardship obligations and taking a long-term view with respect to governance, sustainability and business matters. In addition, shareholders may propose and vote on ESG-related shareholder proposals, vote against directors where oversight failures or other issues are identified and, in the same way, influence corporate governance. See also question 2.4 below.

For those shareholders, or groups of shareholders, acting in concert who acquire more than 5% of a company's stock, there is an obligation under Regulation 13D of the Securities Exchange Act to publicly disclose their ownership stake within the next five business days. Previously, the requirement had been 10 days; however, in 2023, the SEC amended Regulation 13D to update beneficial ownership reporting rules. This disclosure must discuss the shareholder or group's investment purpose, and include any plans or proposals related to significant transactions. Passive investors that acquire more than 5% of a company's stock, and who certify that their purpose is not to effect change or influence control of the issuer, can instead disclose ownership on a short-form version of Schedule 13D (i.e., a Form 13G). See also question 2.6 below for discussion of shareholders' disclosure obligations.

2.3 What kinds of shareholder meetings are commonly held and what rights do shareholders have with regard to such meetings?

Shareholder meetings are typically held annually, as provided by state law and the organisational documents of the company. The DGCL, for example, requires annual meetings to be held for director elections and, if a company has not held such a meeting within 13 months of the prior year's meeting, shareholders may petition the Delaware courts to order such a meeting. Meetings held in addition to the regular annual meeting are called special meetings. Annual and special meetings may be convened by the board and, to the extent provided for in the company's charter or

bylaws, shareholders satisfying certain ownership requirements (which vary across companies) may have the right to call special meetings of the shareholders or act by written consent *in lieu* of a meeting. Subject to the inclusion of any shareholder proposals or nominations that are submitted in accordance with state and federal law, the board sets the agenda of the meeting. Actions to be considered at a meeting may be binding or non-binding (precatory), and a typical annual shareholder meeting will include, at a minimum, the election of directors, ratification of the company's selection of an outside auditor (voluntary) and the non-binding "say on pay" vote. Many companies have adopted advance notice bylaws that require shareholders to provide advance notice and satisfy other procedural requirements to propose business or nominations at a meeting.

Shareholders have the right to attend meetings to vote and, more commonly, to vote by "proxy". Shareholders also have the right, subject to applicable law and satisfying disclosure and filing requirements, when applicable, to communicate with other shareholders privately or publicly regarding matters to be considered at a meeting and may support, oppose, or abstain from matters through their votes. Historically, shareholder meetings were typically held in person; however, companies largely shifted to virtual shareholder meetings conducted entirely online, and many continue this practice more often post-pandemic. Each meeting has a "record date" fixed by the board, and only persons holding shares as of such date are entitled to vote. Advance notice of the meeting must be given to shareholders by specified deadlines, and such notice must set forth the matters to be considered at the meeting. When items are subject to a shareholder vote, the company must provide shareholders with comprehensive proxy statements containing the recommendation of the board, information about the proposals to be considered, disclosure of interests of directors and officers that may differ from the general interests of shareholders and other mandatory items.

In late 2021, the SEC announced new universal proxy card rules for situations where shareholders have nominated candidates for positions on the board. The new rules hold that, after August 31, 2022, all valid director candidates must be listed on both the company proxy card and the dissident proxy card. This means that instead of choosing between a management's or dissident's entire slate, shareholders can now pick and choose among the director candidates put forward by each group.

Shareholder meetings are conducted in accordance with the company's charter and bylaws, including who chairs the meeting. Depending on the topic at issue, the specific vote requirement for shareholder action may be a majority of the outstanding shares, a majority of the shares present and entitled to vote, a majority of voted shares, or a plurality of voted shares. Depending on a company's bylaws and state law, a shareholder vote may need to occur at a meeting, or action may be taken by written consent *in lieu* of a meeting. Actions taken at a meeting will not be effective in the absence of a sufficient quorum of shares being represented at the meeting. The specific quorum requirement is generally specified in the company's bylaws.

2.4 Do shareholders owe any duties to the corporate entity/entities or to other shareholders in the corporate entity/entities and can shareholders be liable for acts or omissions of the corporate entity/entities? Are there any stewardship principles or laws regulating the conduct of shareholders with respect to the corporate entities in which they are invested?

By nature of the corporate form, shareholders are not liable for the acts or omissions of the corporation and generally do not owe any duties to other shareholders or to the corporation.

This lack of fiduciary duty on the part of shareholders to other shareholders has recently become a point of controversy; however, now shareholders wield extraordinary influence over the decisions of – and regularly exert substantial pressure on – boards of directors and management teams, including in situations where the interests and priorities of a given investor may not align with the interests of other shareholders. Concepts of stewardship – perhaps in time backed by potential liability or any other enforcement mechanism – are in the early stages of emergence to address the concern that shareholders may be exercising power without responsibility.

The principle exception to this general rule is the case of controlling stockholders, who do owe fiduciary duties to the corporation and to minority stockholders. Under prevailing Delaware law, stockholders should only be considered controlling stockholders where they either have a majority of the corporation's voting power or have a combination of potent voting power and management control, such that they have effective control of the board of directors. Courts review all self-dealing transactions that involve controlling stockholders for fairness, and the review can only be avoided if the transaction is conditioned on the fully informed and uncoerced approval of both a special committee of independent directors and a vote of the unaffiliated stockholders. Companies with a controlling shareholder (and such controlling shareholder) are also generally subject to heightened legal scrutiny and disclosure requirements, with respect to transactions between such companies and their controlling shareholders.

While specific requirements often seen in Europe and other jurisdictions related to the protection of minority shareholders, such as mandatory tender offer obligations, are generally not hardwired into the U.S. rules and regulations, certain attention must be paid to minority shareholders when there is a controlling shareholder. Stewardship concepts and principles on the part of investors are slowly emerging in the U.S. Many shareholders have done little more than tell corporations that they were in favor of sustainable long-term investment and ESG principles, and that corporations should be more transparent and keep shareholders up to date as to their strategy and operations. A few shareholders, principally the index funds such as BlackRock, State Street and Vanguard, but increasingly even some of the larger actively managed funds, are publishing commentaries and writing letters to portfolio companies to encourage companies to adopt sustainable long-term investment policies, advance diversity, equity, and inclusion matters and follow effective ESG principles, integrating sustainability considerations into corporate strategy, operations and reporting. Previously, the senior corporate governance heads of major U.S. investors came together to develop the first stewardship code for the U.S. market, and launched the Investor Stewardship Group and ISG's associated framework for U.S. Stewardship and Governance. The ISG framework would operate to hold investors, and not only public companies, to a higher standard, rejecting the scorched-earth activist pressure tactics to which public companies have often been subject, and instead requiring investors to "address and attempt to resolve differences with companies in a constructive and pragmatic manner". In addition, the ISG framework emphasizes that asset managers and owners are responsible for their ultimate long-term beneficiaries, especially the millions of individual investors whose retirement and long-term savings are held by these funds, and that proxy voting and engagement guidelines of investors should be designed to protect the interests of these long-term clients and beneficiaries. Corporations and shareholders have increasingly coalesced around acceptance of The New Paradigm as produced for the World Economic Forum, and subsequently updated and revised

(i.e., "The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment"), including the stewardship principles to be followed by asset managers and institutional investors to assure support for boards of directors that are effectively pursuing sustainable long-term strategies and ESG principles, consistent with those that a number of major asset managers and institutional investors have announced that they are supporting. The past few years have witnessed an accelerated focus and consensus around the importance of ESG, sustainability and resiliency-maximizing considerations in creating and protecting corporate value and health and the interests of society at large, along with an accompanying backlash against the ESG movement in the United States.

2.5 Can shareholders seek enforcement action against the corporate entity/entities and/or members of the management body?

Yes; state law fiduciary duties of directors and officers are predominantly enforced by private actions led by plaintiffs lawyers. These private actions generally fall into one of two categories: (1) direct suits, typically in the form of class-action suits on behalf of a particular group of the corporation's shareholders; and (2) "derivative" suits, purportedly on behalf of the corporation itself. Putative class-action suits must satisfy the criteria under the Federal Rules of Civil Procedure or analogous provisions of state law before being permitted to proceed as a class action, including the numerosity of the class members, the commonality of legal and factual issues between members of the class, the typicality of the claims or defenses of the representative parties to the class, and the fairness and adequacy of the representative parties' protection of the class interests. Derivative suits, creatures of state corporate law, provide a mechanism by which shareholder plaintiffs can, in theory, represent the corporation in suing the corporation's own board of directors or management, often after complying with a "demand" procedure in which the plaintiff must request that the corporation file suit and be rebuffed. In certain circumstances, especially when it can be shown that the board of directors is for some reason conflicted with respect to the alleged breach of duty, this "demand" requirement is excused, and the shareholder will be permitted to pursue a claim in the corporation's name without further enquiry.

Shareholders may also seek to have the SEC, or other regulatory and enforcement bodies, initiate investigatory and enforcement actions against companies and their personnel for violations of applicable law.

2.6 Are there any limitations on, or disclosures required, in relation to the interests in securities held by shareholders in the corporate entity/entities?

Certain state laws and provisions of a company's organizational documents may impose restrictions (or special approval requirements) on covered transactions between a company and significant shareholders. For example, Section 203 of the DGCL restricts the ability of a shareholder who owns 15% or more of a company's outstanding stock from engaging in certain business combination transactions with the company, unless certain requirements are met or an exception applies.

Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR Act) and relevant regulations hereunder, a shareholder's acquisition of voting securities in

excess of specified thresholds usually requires prior notice to the Federal Trade Commission and U.S. Department of Justice and observation of statutory waiting periods before closing any HSR reportable acquisition. In addition, investments and acquisitions by non-U.S. persons may also be regulated and restricted by applicable laws, such as where national security concerns are relevant through the auspices of the Committee on Foreign Investment in the United States (“CFIUS”) and implementing statutes and regulations, as well as in regulated industries where special considerations apply, such as aircraft, financial services, and communications media.

In addition, in terms of limitations on acquiring stakes in public companies, a critically important tool for enabling boards of directors to discharge their fiduciary duties, in the face of the threat of hostile takeovers and significant accumulations under current law, remains the shareholder rights plan, or “poison pill”. The shareholder rights plan entails a dividend of special “rights” to each of the corporation’s shareholders. In the event that a shareholder amasses equity ownership in excess of a predetermined threshold – often 10% to 15% – without the approval of the board of directors, the rights held by every other shareholder “trigger” and convert into the right to purchase stock of the corporation at a price substantially below the current market value. Alternatively, most rights plans provide that the board of directors may instead choose to exchange one share of common stock for each right held by shareholders, other than the hostile bidder or activist shareholder. Either way, the result of this conversion or exchange is that the ownership position of the triggering shareholder is substantially diluted. The rights plan is the only structural takeover defense that allows a board to resist a hostile takeover attempt, and it has also been deployed in numerous activism situations. While it does not provide complete immunity from a takeover, it allows the board to control the process and provides the corporation with the leverage to bargain for a higher acquisition price and the power to reject underpriced or otherwise inappropriate bids. It is also implemented exclusively by the board of directors and does not require shareholder approval, so it can be put in place in very short order. Implementing a rights plan in a given situation requires significant judgment, including taking into account investor reaction, and the potential of ISS “withhold” recommendations, if a rights plan has a term of greater than one year and is not subject to shareholder ratification. As a result, and because a rights plan can be adopted quickly, most corporations adopt a rights plan only after a threat appears – and prior to that time, the plan is kept “on the shelf”. Keeping a rights plan on the shelf offers almost all the protection of an active rights plan without any risk from an adverse ISS recommendation; however, it can leave a corporation vulnerable to “stealth acquisitions”, in which an activist shareholder purchases just under 5% of the company’s stock and then buys as much as possible on the open market within the next five business days. Since Regulation 13D under the Securities Exchange Act gives shareholders five business days, after acquiring over 5% of a company’s stock, to publicly disclose their ownership stake, this technique can result in an acquisition of a substantial portion of a company’s equity before it is ever disclosed. However, because an activist may accumulate its position in a corporation without public disclosure, the board of directors may not have any warning of the activist’s behaviour, and there is thus some risk that a company may not be able to adopt a rights plan in time to avoid a significant accumulation of stock in unfriendly and opportunistic hands.

With respect to disclosure, shareholders or groups of shareholders who own or acquire beneficial ownership of more than 5% of a corporation’s registered equity securities will

also be required to file reports with the SEC under Regulation 13D. Investors who are not “passive” and are interested in influencing the company, or are directors or officers, will be required to file a Schedule 13D within five business days of the acquisition of more than 5% in beneficial ownership of the company’s stock, disclosing such ownership and the investment purpose (e.g., control intent), as well as amendments to report subsequent changes of more than 1%. However, this five-business-day filing requirement only starts ticking once the 5% beneficial ownership threshold is reached. During the five-business-day period between crossing the 5% threshold and making the Schedule 13D filing, investors are permitted to further increase their ownership. This may involve making direct share purchases, as well as purchasing options and other derivatives. The five-business-day window allows investors the ability to increase their interest in a company, in some cases quite dramatically, before the Schedule 13D alerts the market as to their ownership, even after crossing the 5% threshold. Investors who have a “passive” interest in the company and own more than 5%, but less than 20%, of the company’s stock, or are otherwise exempt investors, will be permitted to file the shorter Schedule 13G on a delayed schedule after year-end.

Section 13F of the Exchange Act requires institutional investment managers with over \$100 million of assets under management to disclose their ownership of exchange-traded stock, shares of closed-end investment companies, shares of exchange-traded funds and certain convertible debt securities, equity options and warrants within 45 days after the end of each quarter, rather than equity positions as of the date of filing (resulting in a meaningful lag). Those with hedge funds who have transferred their equity positions into total return swaps or other derivatives prior to the end of a quarter may be able to avoid disclosing such positions under Schedule 13F, even if they still have economic exposure to the company. Confidential treatment of specific 13F positions may also be sought from the SEC while the investment manager is in the process of accumulating a position, and the SEC often grants such requests for Schedule 13F purposes, including in the context of activist or strategic accumulations. A proposal by the SEC to increase the 13F threshold several fold was withdrawn after strong opposition from many quarters, due to concerns that the proposal would reduce transparency, empower activist funds, and was not being advanced in the context of broader disclosure and ownership reforms. The SEC and Congress have been considering a range of potential updates of the Section 13F regime that would expand transparency, accelerate reporting, and address various disclosure gaps.

As noted in question 3.4 below, Section 16 filings of transactions in the company’s securities are required to be made of directors, officers and 10% shareholders, and a company’s annual proxy statement is required to specify the beneficial ownership in the company’s equity securities of the company’s directors, officers and 5% shareholders.

2.7 Are there any disclosures required with respect to the intentions, plans or proposals of shareholders with respect to the corporate entity/entities in which they are invested?

Investors who do not have a “passive” intent and cross the 5% threshold must publicly report their ownership positions and intent on a Schedule 13D. This disclosure must also address the shareholder’s identity and background (including as to members of any filing group), source of financing including a discussion of the shareholder’s plans or proposals with respect

to the company as to a wide variety of matters (including as to extraordinary transactions, acquisitions and dispositions, or changes to the company's board or management, dividend policy, corporate structure or business) and set forth various arrangements, relationships or understandings regarding the company's securities and include certain items as filed exhibits. Material changes to these disclosures must also be publicly reported. In addition, under the U.S. antitrust rules, the acquisition of equity securities in excess of specified thresholds usually requires that a filing be made with the U.S. federal antitrust authorities, and that any filing party observe certain statutory waiting periods prior to closing on the acquisition. When the proposed acquisition is not subject to a purchase agreement with the target, the acquirer must typically provide notice to the target that a filing has been made and the filing threshold that the acquirer intends to exceed, which previews to the target the shareholder's acquisitive intentions. This notice may also preview whether the acquirer intends to be passive, as the HSR Act exempts from filing passive acquisitions as long as the acquisition represents less than 10% (and, in some cases, 15%) of the target's voting securities. While such filings may be confidential as to third parties, the target will be on notice of potential activity.

2.8 What is the role of shareholder activism in this jurisdiction and is shareholder activism regulated?

Shareholder activism and engagement are increasingly viewed as fixtures in the governance of publicly traded companies in the U.S. Every proxy season sees many activist campaigns of all kinds, ranging from high-profile economic campaigns involving large public companies and "name-brand" activists, to historically lower-profile efforts by social activists, individual retail shareholders and, increasingly, larger institutions seeking to advance environmental, social, political or governance agendas (or anti-ESG agendas) using the corporate voting machinery. In discussing shareholder activism in the United States, it is helpful to separate shareholder activists into three separate categories: (1) "economic" activism by hedge funds or other "fund" activists: this category consists of professional funds investors who make sizeable (but still minority) investments in a target company, and then publicly or privately advocate for change, often characterized by a drive for short-term shareholder value; (2) 14a-8 proposal activism, by which shareholders (often pension funds or individual retail shareholders) submit proposals for a shareholder vote under Exchange Act Rule 14a-8, which requires a company to include a shareholder proposal in its proxy materials if certain requirements are met (which now feature a tiered approach for holding periods and minimum economic stake); and (3) much more recently, ESG and anti-ESG activism in which shareholders will threaten to run (or will run) a traditional proxy contest seeking to replace board members, or withhold campaigns against directors on the basis of ESG themes, such as climate change or issues related to diversity, equity and inclusion, or, conversely, encouraging resistance to the consideration of such issues. The 14a-8 proponents vary widely and include retail shareholders, social justice groups, religious organizations, labour pension funds, individuals and other coalitions. In recent years, all types of activism are on the rise. Assets under management by activist hedge funds remain at elevated levels, encouraging continued attacks, including on many large successful companies.

Proxy advisory firms have tremendous influence on the outcome of shareholder activism campaigns. The SEC, in 2020, implemented rules designed to enhance the accuracy and

transparency of proxy voting advice provided by proxy advisory firms to investors, including increasing disclosure around material conflicts of interest in proxy voting advice, providing an opportunity for a period of review and feedback through which companies and other soliciting parties would be able to identify errors in the proxy voting advice, and codifying that proxy advisor vote recommendations are considered proxy solicitations and are therefore subject to the anti-fraud provisions of Rule 14a-9, prohibiting any materially false or misleading statement. However, in 2022, the SEC subsequently adopted amendments to significantly rescind these rules as they relate to the proxy advisory firms.

Campaigns by the most well-known activist hedge funds had been surging in recent years, and more than 100 hedge funds were known for engaging in activism, and several mutual funds and other institutional investors had also begun deploying the same kinds of tactics and campaigns as the dedicated activist funds. Given the macro-economic impacts following Russia's war in Ukraine and inflation, supply chain and other pressures and related market downturns, activism continued to surge as 2023 wore on, with announcements of new high-profile campaigns by activists against a range of companies continuing, and often resolved through engagement and negotiation. The year 2024 has seen a continuation of this trend.

Legislators and regulators have largely stayed out of the fray of shareholder activism, notwithstanding some of the adverse impacts and varying views on the excesses of shareholder activism. The SEC has sought to play an even-handed role, ensuring that both sides provide full and fair disclosure and are not misleading in their proxy solicitations and has recently, as encouraged by the legislature in the Dodd-Frank Act, taken some initial action in the form of rulemaking to curb abuses by activists of the Regulation 13D early-warning disclosure system and lack of transparency in derivative accumulations by updating and expanding disclosure frameworks. Specifically, in 2023, the SEC adopted amendments to Regulation 13D-G to modernize the beneficial ownership reporting rules, including by shortening filing deadlines and expanding the securities included for assessment of beneficial ownership. These amendments represent a significant update to reporting requirements adopted in 1968. See questions 2.6 and 2.7 above.

3 Management Body and Management

3.1 Who manages the corporate entity/entities and how?

U.S. companies are managed under the direction of a single-tiered, unitary board of directors, elected by the shareholders and subject to fiduciary duties, and have full control over the company's business and affairs. Directors must be natural persons under state law but need not be shareholders (however, directors usually do have equity in the company). The board's basic responsibility is to exercise its business judgment and act in a manner reasonably believed to be in the best interests of the company and its shareholders. Boards typically delegate day-to-day management to the CEO and other senior management, all of whom serve at the pleasure of the board and focus on oversight of strategy and risk management. Outside directors are typically referred to as non-management directors and as independent directors where they qualify as such under applicable rules. Boards will also determine their own committee structures (including as to the exchange-managed committees, such as the nominating and governance committee, the compensation committee and the audit committee) and board leadership structures (for example,

with respect to the identity of the chair of the board and whether the chair is a different person than the CEO). Directors owe the corporation and its shareholders fiduciary duties, such as the duty of care and the duty of loyalty. The duty of care encompasses the obligation to act on an informed basis after due consideration and appropriate deliberation. The duty of loyalty encompasses the obligation to act in the best interests of the corporation and the shareholders, as opposed to the directors' personal interests. Corollary duties – such as duties of good faith and duties of candour and disclosure to shareholders when submitting matters for shareholder action – also often apply, and there is a legal framework for considering a director's oversight duties. The board is generally entitled to take into account long-term as well as short-term interests and set the appropriate time frame for achievement of corporate objectives. Under U.S. law, courts will typically not second-guess business decisions of the board where the “business judgment rule” applies, which involves a rebuttable presumption that directors are discharging their duties in good faith, on an informed basis and in a manner the directors reasonably believe to be in the best interests of the corporation and its shareholders. While still uncommon in the publicly traded universe, an increasing number of companies are implementing alternative for-profit corporate firms, such as the “public benefit corporation”, that would further empower (and require) boards to balance stockholder pecuniary interests with the interests of those materially impacted by corporate conduct and specified public benefits that the corporation has determined to advance.

3.2 How are members of the management body appointed and removed?

Members of the board of directors are elected by the shareholders, with the board having the right to alter the size of the board and appoint directors to fill vacancies, whether created by newly created directorships or resignations of incumbent directors. State law and the corporation's charter and bylaws will establish the extent to which directors may be removed with or without cause, whether a shareholder vote is required for removal, the voting standard that must be met and any judicial authorities to remove directors. The board of directors, and not the shareholder body, appoints and removes corporate officers.

3.3 What are the main legislative, regulatory and other sources impacting on compensation and remuneration of members of the management body?

The board of directors has the legal authority to determine compensation for directors and officers. At public companies, stock exchange rules mandate that committees of the board play a central role in compensation decisions. On account of these requirements, an independent compensation committee of the board usually determines and approves the CEO's compensation. Non-CEO executive officer compensation is also usually determined by the independent compensation committee, although stock exchange rules permit the full board to make such determinations after receiving the compensation committee's recommendation. Heightened independence rules apply to the members of compensation committees and committee advisors. Using an independent compensation committee also facilitates tax deductibility of certain compensation, although tax rules in this regard are in a period of flux.

Compensation philosophies and programs are often developed by the compensation committee with the input of its independent,

third-party compensation consultant. The appropriate mix of fixed compensation (for example, annual base salary) and variable compensation (that is, short- and long-term performance-based incentives), as well as the form of long-term incentive compensation (for example, stock options, restricted stock units or performance-based restricted stock units) vary among companies, as determined by the compensation committee in its business judgment based on the particular needs of the business. Equity-based components are common, and shareholder approval is required of equity compensation plans under stock exchange rules (including those involving grants of equity-based awards to directors and officers), subject to limited exceptions relating to corporate transactions and employment inducement awards. In addition, the non-binding shareholder advisory vote on executive compensation, commonly known as “say on pay”, provides shareholders with a means for expressing dissatisfaction with executive compensation practices. While these votes are non-binding, companies that receive support for the say on pay proposal typically engage directly with shareholders to understand the concerns and, in some cases, choose to modify their executive compensation programs accordingly, typically on a prospective basis. Although executive compensation decisions are often the subject of shareholder litigation, courts typically respect compensation decisions, so long as the directors act on an informed basis, in good faith and not in their personal self-interest. Except in the case of certain financial institutions (where special “safety and soundness” provisions apply), regulators generally cannot contest compensation decisions.

Director compensation is also within the purview of the board of directors and the company's director compensation program must be publicly disclosed. In recent years, there has been a handful of instances where outsized director compensation has been scrutinized and litigation has been pursued. Since the decisions of the board of directors on director compensation are inherently self-interested, these decisions are generally subject to a heightened standard of review.

3.4 What are the limitations on, and what disclosure is required in relation to, interests in securities held by members of the management body in the corporate entity/entities?

Directors and officers (as well as 10% shareholders) are required to file Section 16 forms that report their beneficial ownership of the company's registered securities. Such persons must file a Form 3 at the time the company registers its securities (or within 10 days after becoming subject to the provision), a Form 4 within two days of changes in beneficial ownership, and a Form 5 within 45 days after the end of the company's fiscal year to report any transactions that should have been reported earlier on a Form 4, or were eligible for deferred reporting.

Company insiders (including officers, directors and 10% shareholders) can be forced to return any profits made from the purchase and sale (or sale and repurchase) of company stock if both transactions occur within a six-month period and applicable exemptions do not apply.

To the extent a director or officer acquires or holds substantial equity positions, the limitations and disclosures that would apply generally to shareholders seeking to acquire or hold such positions, as discussed in question 2.6 above, would also generally apply to the director or officer.

Companies may also establish (and enforce) company-specific stock ownership guidelines on directors and officers, as well as restrictions on hedging or pledging of securities by such individuals.

3.5 What is the process for meetings of members of the management body?

In addition to regular meetings of the board of directors, boards may convene more frequently through special meetings of the board. The company's organizational documents and governance guidelines determines who may call a special board meeting. Notice and quorum requirements for board meetings are also set forth in the company's charter or bylaws (as is ability to waive notice requirements); the DGCL sets a majority of the total number of directors as the default quorum requirement. Board business may also be conducted through duly constituted committees, which will also meet and act as needed, and in accordance with notice and quorum requirements and committee charters. Boards may generally act by written consent *in lieu* of a meeting if such consent is unanimous.

3.6 What are the principal general legal duties and liabilities of members of the management body?

See questions 3.1, 3.8 and 5.1.

3.7 What are the main specific corporate governance responsibilities/functions of members of the management body and what are perceived to be the key, current challenges for the management body?

Effective boards typically perform dual roles: (1) advisor to and business partner of management; and (2) monitor and overseer of management. Core board responsibilities include:

- Choosing and monitoring the performance of the CEO and establishing succession plans.
- Monitoring corporate performance and providing advice to management as a strategic partner.
- Evaluating and approving the company's annual operating plan, long-term strategy and major corporate actions.
- Determining risk appetite, setting standards for managing risk and monitoring risk management matters from an oversight posture.
- Planning for and dealing with crises.
- Determining executive and director compensation.
- Handling board development and director succession matters effectively, including recruiting, interviewing and nominating director candidates and monitoring the board's performance, composition and effectiveness.
- Reviewing the company's corporate governance practices and considering changes.
- Taking centre stage in any proposed transaction involving a conflict of interest with management.
- Setting high standards for corporate social responsibility and overseeing how ESG-related matters, corporate purpose and consideration relating to stakeholders and sustainability matters are incorporated into corporate strategy, operations, risk oversight and reporting.
- Monitoring compliance and establishing an appropriate "tone at the top".
- Supporting long-term relationships with shareholders and stakeholders.
- Overseeing relations with government, community and other constituents.

See also questions 1.3 and 1.4 above.

3.8 Are indemnities, or insurance, permitted in relation to members of the management body and others?

Yes, and the available scope of indemnification and permitted insurance is broad. Under the DGCL Section 145 and comparable state laws in other states, companies have extensive power to indemnify directors, officers and others against threatened, pending and completed legal actions. The only limitations in civil suits are: first, that the indemnified person must have acted in good faith and with a reasonable belief that he or she was serving the best interests of the company; and second, in most states, a company may not indemnify a person found liable to the company itself unless a court rules otherwise. In addition to providing broad indemnification protections in corporate bylaws, U.S. companies commonly opt to protect their directors further by including in their corporate charters a provision eliminating or limiting personal liability for monetary damages for breach of fiduciary duty as a director. DGCL Section 102(b)(7), for example, permits such provisions so long as they do not eliminate or limit liability for any breach of the duty of loyalty, for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, for unlawful dividend payments or unlawful stock purchases or redemptions, or for any transaction from which the director derived an improper personal benefit. Charter provisions implemented pursuant to DGCL Section 102(b)(7) and similar state laws provide powerful protection for directors. In addition, recent amendments to Delaware law now permit companies to implement charter amendments that would provide certain limitations on liability for officers too, subject to certain exceptions. Expense advancement is also an important and customary aspect of indemnification bylaws. In most states, companies may provide advance payment of expenses to directors and officers in defending legal actions upon receipt of an undertaking to repay the advancement, if it is ultimately determined that the person is not entitled to indemnification. In some cases, companies will enter into direct indemnification agreements with directors and officers to provide additional "belts-and-suspenders" beyond the indemnification provided by statute and corporate bylaws. In addition, Directors and Officers ("D&O") insurance is also regularly provided to directors and officers at the company's expense; subject to certain standard exclusions, D&O insurance policies typically provide protection for companies that indemnify directors and officers, and for directors and officers directly in the event of non-indemnifiable claims against those individuals.

3.9 What is the role of the management body with respect to setting and changing the strategy of the corporate entity/entities?

As discussed above, a unitary board of directors, elected by shareholders and subject to fiduciary duties, is charged with overseeing the corporation's business and affairs, including setting and directing corporate strategy. Directors are fiduciaries of the corporation and its shareholders and are expected to focus on promoting and developing the long-term and sustainable success of the company. In the U.S., hostile takeovers and shareholder activism can pose significant threats to U.S. corporations and execution of long-term corporate strategies, especially where such developments result in the capture of corporate control or influence over corporate policy by short-term-oriented shareholders or bidders pursuing short-term profits, short-sighted

breakups of a company, the excess return of capital to shareholders or incurrence of inadvisable amounts of leverage. In other situations, companies are able to navigate such situations effectively, including through making prudent adjustments to the corporate strategy in a manner that is responsive to the interests of long-term shareholders and other stakeholders and aligned with the long-term success of the company. Practices are also evolving as to how ESG-related matters should be incorporated into corporate strategy and operations.

4 Other Stakeholders

4.1 May the board/management body consider the interests of stakeholders other than shareholders in making decisions? Are there any mandated disclosures or required actions in this regard?

For several decades, there has been a prevailing assumption among many CEOs, directors, scholars, investors, asset managers and others that the sole purpose of corporations is to maximize value for shareholders. This exclusive focus on shareholder wealth maximization has exacerbated pressure on corporations to take actions to maintain or boost near-term stock price. Recently, there has been increasing concern about the negative consequences of shareholder primacy and the short-termism it has facilitated, as well as the longer-term impact on broader socioeconomic and sustainability issues. In 2019, the Business Roundtable issued a statement on the purpose of a corporation, signed by 181 public company CEOs, departing from its long-standing endorsement of shareholder primacy and embracing stakeholder governance, which posits that the fiduciary duty of management and the board of directors is to promote the long-term value of the corporation for the benefit of all its constituents, not solely to maximize shareholder wealth. Several prominent institutional investors, including BlackRock, the Vanguard Group and State Street Global Advisors, subsequently issued public statements similarly endorsing stakeholder governance as part of long-term value creation and safeguarding against risks to value.

Stakeholder governance is fully consistent with well-established principles of corporate law and the existing fiduciary framework for directors. Directors have a fiduciary duty to promote the best interests of the corporation, and, in fulfilling that duty, directors exercise their business judgment in considering and reconciling the interests of various stakeholders and their impact on the business of the corporation. Indeed, the special genius of Delaware law, in particular, and one of the primary reasons why it has become the indisputably preeminent jurisdictional choice of most major U.S. public companies, is that it has been animated by a fundamental sense of pragmatism and its fiduciary duty framework has afforded corporations the breathing room they need to address evolving business challenges, as well as expectations of shareholders. Companies and investors alike have been rethinking the ways in which they engage and have been providing robust and increasingly tailored disclosures about their approaches to: strategy, purpose, and mission; board involvement, composition and practices; board oversight of strategy and risk management; the business case for long-term investments; reinvesting in the business and retraining employees; pursuing research and development, innovation, and other capital allocation priorities; sustainability, ESG and human capital matters; stakeholder and shareholder relations; corporate governance; and corporate culture. In addition, recent caselaw developments with respect to *Caremark*-related fiduciary claims against boards alleging lack of oversight have also underscored the importance of board-level

reporting and oversight systems regarding mission-critical risks, especially risks that may arise from stakeholder-related impacts and harms to the corporation and shareholders and compliance violations, and effectively using board committees and management-level structures to ensure that material risks are overseen, managed and mitigated appropriately. Particularly, in 2022, the SEC proposed rules related to climate change risk, including disclosure of board oversight and governance related to material climate impacts, greenhouse gas emissions, and transition plans reduction targets. In 2024, the SEC released the final rules, which were less burdensome and narrower in scope of disclosure requirements, as compared to the proposed rules. In 2023, the SEC also issued similar rules and regulations related to cybersecurity disclosures to require that boards report material cybersecurity incidents within four business days of determining the materiality of the incident.

4.2 What, if any, is the role of employees in corporate governance?

With respect to board composition, there are no requirements for employee or labour representation (or other mandated representation for particular constituencies) on the board of directors. In the M&A context, there are no required pre-notification or consultation provisions under U.S. law relating to employees. Some collective bargaining agreements (“CBA”) may contain provisions that provide union employees with certain benefits, or the right to re-negotiate their CBA for the second time, in the event of a change in control, but these matters are contract-specific and are, however, not legally required and do not provide a consent right on a bid. As the world has recovered from the COVID-19 pandemic and related matters, the private sector’s treatment of employees and other human capital-related matters has been even more closely scrutinized. Macroeconomic, supply chain, inflation and employment-related trends have also continued to influence thinking regarding the role of the board, with respect to employees and other workers as to corporate governance matters.

4.3 What, if any, is the role of other stakeholders in corporate governance?

Anti-ESG movement dynamics aside, the interests of non-shareholder constituencies may be considered by the board, and management for their impact on creating corporate and shareholder value, in addressing risks to the corporate enterprise, making business judgment and implementing effective shareholder and stakeholder engagement and relations programs, as well as advancing legal and regulatory compliance objectives. Many states formally permit (or require) boards to consider the interests of non-shareholder constituencies, such as employees, business partners and local communities, as well as broader constituencies, such as the economy as a whole. However, several states have also recently taken anti-ESG positions. Examples include Florida legislation enacted in 2023 to prohibit SBA fund managers from considering ESG issues when investing state money, and the Texas Permanent School Fund terminating its contract with BlackRock due to a lack of investment in fossil fuel producers.

As a practical matter, U.S. companies and large institutional investors are increasingly recognizing that the long-term success of the company and its status as a durable enterprise requires giving due regard to the interests of important stakeholders, rather than focusing solely on the desires of shareholders.

4.4 What, if any, is the law, regulation and practice concerning corporate social responsibility and similar ESG-related matters?

The COVID-19 pandemic and related matters called attention to and emphasized the health, welfare and safety of employees, customers, communities and other key constituencies. Post-pandemic, heightened attention to employee-related matters and diversity, equity and inclusion-related concerns have impacted corporate behavior and practices. Prior to the pandemic's onset, while not a matter of significant legal regulation in the U.S. beyond compliance, corporate social responsibility, including treatment of environmental, social and ethical issues, was increasingly recognized as an appropriate matter of business judgment for the board. The modern public company is expected to set and meet high standards of social responsibility. Related risks are expected to be addressed through robust risk oversight and management processes. Companies often voluntarily disclose performance and policies in this area. Specific disclosure requirements may apply in some of these areas and substantive laws may also apply, such as for anti-bribery, anti-corruption and anti-discrimination rules or environmental mandates. See question 4.1 above for a discussion of disclosure requirements related to climate-related disclosures and cybersecurity. Shareholder proposals continue to substantially involve sustainability, environmental and social issues, including: greenhouse gas emissions and renewable-energy concerns; international labour standards and human rights; and diversity, equality and non-discrimination issues, particularly with respect to sexual orientation and, recently, the concept of racial equity and civil rights audits. Where such proposals receive significant support, companies will have to determine whether and how to demonstrate responsiveness. See also question 5.3 below.

5 Transparency and Reporting

5.1 Who is responsible for disclosure and transparency and what is the role of audits and auditors in these matters?

The fundamental responsibility for a company's financial statements and disclosures rests with management and the independent auditor. Each NYSE-listed company must have an internal audit function to provide management and the audit committee with ongoing assessments of a company's risk management processes and systems of internal control. However, as part of its oversight role, the board has ultimate responsibility for overseeing management's implementation of adequate disclosure controls and procedures. Under the federal securities laws, directors can be held liable for their material misstatements or omissions of material facts in public filings. In some cases, liability is limited to circumstances where the director acted with scienter (actual knowledge or reckless disregard), and various defences, including demonstrating appropriate due diligence, may be available. Violations of the corollary fiduciary duties of candour and disclosure may also result in liability. Regulation FD generally prohibits selective disclosure of material information and requires public disclosure of information selectively disclosed to investors, subject to certain exceptions.

The federal securities laws require public companies to file annual, quarterly and periodic current reports triggered by the occurrence of specified events. The contents of such reports are prescribed by law, and false and misleading statements are generally prohibited. Annual reports contain audited financial

statements and comprehensive information about the business, performance and relevant risk factors, quarterly reports contain unaudited interim financial statements and other business information, and current reports disclose the occurrence of certain material events, such as entry into material agreements, completion of significant acquisitions or dispositions of assets, changes in officers or directors and amendments to the corporation's charter or bylaws. Public companies must have adequate internal controls over financial reporting, and publicly filed annual and quarterly reports must contain related certifications from the CEO and CFO. All public companies must have their financial statements audited annually by a registered independent accounting firm in compliance with U.S. generally accepted accounting principles and generally accepted auditing standards (U.S. GAAP and U.S. GAAS). The company's external auditor – in the case of large public companies, usually one of the major registered public accounting firms – must publicly file its signed annual report attesting to the quality of the audit and the company's internal control over financial reporting. The federal securities laws require prompt disclosure with respect to changes in the external auditor and any revision to or inability to rely on prior audited financial statements.

A public company's accounting and audit function involves an independent committee of the board (referred to as the audit committee), external independent auditors, internal auditors and senior management. Federal law and stock exchange rules require that an independent audit committee of the board (comprising financially literate members, none of whom may accept consulting or advisory fees from the company, with "comply or explain" disclosure required if no member qualifies as a financial expert) be responsible for the appointment, compensation, retention and oversight of the independent auditor, and for oversight of certain internal audit function-related matters. While not required, shareholders are typically asked to ratify such auditor's appointment. No aspect of an audit committee's role is more vital than its oversight of the audit process. An audit committee should have procedures in place to ensure that it stays abreast of evolving standards and best practices in this area. The Public Company Accounting Oversight Board ("PCAOB") has promulgated strengthened independence and ethics rules and adopted auditing standards relating to the transparency and quality of audit reports, including requirements for enhanced disclosures of certain "critical audit matters", and the effectiveness of communications between an audit committee and the independent auditor.

5.2 What corporate governance-related disclosures are required and are there some disclosures that should be published on websites?

Required governance-related disclosures include: information concerning the composition of the company's board of directors and management team; independence determinations regarding the board and director qualifications; the existence of a board diversity policy; corporate governance guidelines that address qualification standards for directors, responsibilities for directors, director access to management and independent advisers, compensation of directors, education and orientation of directors, management succession, and evaluation of board performance (as provided under NYSE rules); board committee structures and committee charters; the number of board meetings held and director attendance issues; how shareholders may communicate with the board; whether the company has a code of ethics and any waivers of such codes; the board's leadership structure and role in risk oversight; risks arising from

compensation policies that may have a material adverse effect on the company; related party transactions; and other matters.

When items are brought before the shareholders for their approval, such as for election of directors or consideration of significant transactions, such as mergers or the sale of all or substantially all corporate assets, proxy statements containing the recommendation of the board, information about the proposals to be considered, disclosure of interests of directors and officers that may differ from the general interests of shareholders and other mandatory items must be filed. Proxy statements for the annual meetings at which directors are elected contain extensive information about the board and senior management, governance practices, director and executive compensation, auditor information and other matters.

The websites of major public companies will typically include corporate governance and sustainability-related information, including the company's organizational documents (charter and bylaws), key corporate governance guidelines and policies, including as to director independence criteria, committee charters for the audit, compensation and nominating and governance board committees, business codes of conduct, proxy statements and annual reports, sustainability reports, Section 16 filings reporting trades by directors and officers and information concerning the company's board of directors and management teams. While stock exchange rules require or provide the option of posting certain governance information to the company's website, most company websites go beyond what is strictly required.

5.3 What are the expectations in this jurisdiction regarding ESG- and sustainability-related reporting and transparency?

As discussed above, in 2023 and 2024, the SEC adopted new rules that would require disclosure for material cybersecurity incidents as well as management oversight and governance issues related to material climate impacts, greenhouse gas emissions, transition plans and reduction targets. At the SEC's Investor Advisory Committee meeting in September 2023, the subcommittee approved recommendations related to human capital management and disclosures related to employee headcount, turnover metrics, compensation, demographics and diversity. In addition, California has also issued its own climate disclosure rules – AB 1305, SB 253 and SB 261. AB 1305 mandates certain disclosures by companies who do business in California and have either purchased carbon offsets or have made claims regarding significant GHG emissions reductions. SB 253 will require companies that do business in California and have annual revenues in excess of \$1 billion to disclose Scopes 1, 2 and 3 GHG emissions data. SB 261 will require companies that do business in California and have annual revenues in excess of \$500 million to provide climate-related financial risk report disclosures. AB 1305 is currently effective, while SB 253 and SB 261 are currently facing litigation. California is also yet to provide funding for the enforcement of SB 253 and SB 261. Beyond these developments, U.S. disclosures with respect to ESG and sustainability-related matters have been primarily a function of private ordering, driven in large part by engagement with major institutional investors who have demanded increased transparency and more consistent disclosures so they can assess companies with respect to ESG and sustainability-related matters. This has led to companies taking a range of approaches with respect to reporting and transparency, with

the largest U.S. companies usually incorporating, on a voluntary basis, disclosures consistent in whole or in part with one or more third-party standards such as the Global Reporting Initiative ("GRI"), the Sustainability Accounting Standards Board ("SASB"), the Task Force on Climate-related Financial Disclosures ("TCFD"), and the Stakeholder Capitalism Metrics framework recently announced by the International Business Council of the World Economic Forum ("WEF") and the four major accounting firms, while also highlighting the extent to which corporate actions are aligned with the United Nations Sustainable Development Goals ("SDGs"). On the stock exchange front, NASDAQ has implemented board diversity-related rules that would require listed companies to provide disclosure concerning the diversity of the board and have, or explain why they do not have, at least two diverse directors (as defined by the NASDAQ rules). See question 5.1 above.

5.4 What are the expectations in this jurisdiction regarding cybersecurity and technology-related reporting and transparency?

Amid the growth of generative artificial intelligence ("AI") and increasing geopolitical tensions, the risk of cybersecurity threats also increases. In 2023, the SEC adopted wide-ranging cybersecurity disclosure rules that would require companies to report all material cybersecurity incidents within four business days after the company determines that the cybersecurity incident is material. The disclosure may be delayed if the United States Attorney General determines that immediate disclosure would pose a substantial risk to national security or public safety and notifies the Commission of such determination in writing. The new rules also call for periodic reporting on company policy and procedures regarding oversight and management of cybersecurity risks, including the board's role in overseeing cybersecurity threats and identifying responsible board committees and procedures for keeping the board apprised of such risks. Additionally, the Cyber Incident Reporting for Critical Infrastructure Act of 2022 will introduce new disclosure requirements for companies operating in certain critical infrastructure sectors, including the transportation, communication, financial services, healthcare and information technology sectors regarding significant cyber incidents and ransomware payments in 2024. Certain states have also adopted data security and breach notification laws.

With AI quickly taking hold in the U.S. and globally, the Biden administration has issued a wide-ranging executive order on AI. Other U.S. regulators, including the SEC, have continued in this effort, and are working toward advancing AI regulation. In 2023, the SEC proposed a new rule that would require broker-dealers and investment advisers to take certain steps to address conflicts of interest associated with their use of predictive data analytics and similar technologies to interact with investors to prevent such firms from placing their interests ahead of investors' interests.

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Harvard Law School Forum on Corporate Governance

Thoughts for Boards: Key Issues in Corporate Governance for 2024

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on [Wednesday, January 3, 2024](#)

Tags: [AI](#), [board diversity](#), [board effectiveness](#), [Board performance](#), [Cybersecurity](#), [ESG](#), [Executive Compensation](#), [Management](#)
More from: [Martin Lipton](#), [Wachtell Lipton](#)

Editor's Note: [Martin Lipton](#) is a Partner at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell [memorandum](#) by Mr. Lipton, [Steven A. Rosenblum](#), [Karessa L. Cain](#), and [Carmen X. W. Lu](#).

Over the past year, expectations for directors have continued to evolve, bringing new challenges and responsibilities to the boardroom. The remarkable speed, volume and proliferation of channels through which information travels today continue to place more scrutiny on boards and heighten expectations regarding transparency and accountability. Director reputations that have been carefully built over decades are not immune from such pressures, particularly as activist investors hunt for underperformers and revisit former targets. The business environment has also become more complex: macroeconomic uncertainty, geopolitical tensions, regulatory unpredictability, political polarization, culture wars, cybersecurity threats, the growth of generative AI, and energy transition are among the issues that boards are now expected to navigate.

Amid this change and uncertainty, we have summarized below some practical considerations and recommendations for boards as we look ahead to 2024:

Key Principles for Board Effectiveness

As directors face mounting expectations and responsibilities, there are some fundamental principles to keep in mind to help ensure that the board operates effectively.

- **Don't Lose Sight of Priorities:** The board agenda should reflect the company's key business priorities and risks. While the number of issues that may require board oversight has expanded, time and focus should be given to those issues that will materially impact the business in the near-, medium- and long-term. Allocation of appropriate issues to board committees can help boards assign priorities and distribute responsibilities. For many agenda items, board meetings should favor depth over breadth.
- **Collaborate With Management:** The board's relationship with management is central to its effectiveness. Building a relationship of mutual trust and candor is a foundational step to ensuring that information is timely received and the board's feedback is reflected in day-to-day operations. Boards should leverage management's expertise to stay informed on emerging issues and find opportunities to share feedback and receive input both within and outside regularly scheduled board meetings.
- **Don't Overlook Soft Skills:** Skills such as leadership, diplomacy, judgment and overall business acumen are not necessarily reflected in skills matrices, but are vital to effective, engaged oversight by boards. The ability to amicably raise and discuss different perspectives, and a willingness to build consensus and collaborate with other directors, are critical to a well-functioning boardroom.
- **Balance the Near- and Long-Term:** Boards are uniquely positioned to serve as a counterweight against excessive pressures on companies to deliver near-term results. Boards are empowered to help shape the longer-term direction of the business and should guide management to see around corners, balance competing interests, anticipate risks and competitive threats and explore new opportunities.
- **Be Prepared to Innovate:** There is no one-size-fits-all approach to governance and disclosure, and boards should be prepared to develop policies and practices that are tailored to the needs of the business. While it may be advisable to take cues from peers and the market from time to time, many new and evolving issues – such as issues relating to energy transition, cybersecurity risk management and the use of generative AI – require creative approaches to unprecedented governance, disclosure and risk management challenges.

Key Pressure Points for Directors

A confluence of factors has led to increasing scrutiny of boards and directors in recent years. In 2024, we expect these pressures to continue to manifest in the following ways:

- **Individual Director Performance:** The advent of the universal proxy card has increased scrutiny of individual director qualifications and contributions to the board in the activism context, as dissidents and proxy advisors seek to identify which directors are the most vulnerable targets for board refreshment. Investors, too, are keen to better understand boardroom dynamics and have been pressing for more transparency through engagement and disclosures. In this regard, attention may turn to measuring the performance of individual directors, including through tracking the performance of the companies where they have served as a director or the outcomes of policies implemented during a director's tenure – strategies that activist shareholders have already adopted in public campaigns.
- **Director Participation in Shareholder Meetings:** Individual directors are increasingly expected to join and be active participants in meetings with investors, particularly where investors have raised concerns about a company's policies or performance. Lead independent directors and chairs of standing board committees, in particular, should be prepared to take an increasing role in investor meetings. During engagement sessions, investors expect directors to be familiar with the company's strategy, understand and substantively engage with the investors' priorities, and demonstrate independence from management. Investors regularly comment that directors who continually look to management to answer questions in investor meetings make a poor impression.
- **Engaged vs. Overstepping Board:** As shareholder expectations continue to evolve regarding the board's role in risk management, many operational issues have been morphing into governance issues. For example, the SEC's cybersecurity rules require disclosures on the board's role in overseeing cybersecurity threats, including identifying responsible board committees and describing the processes by which the board is informed about such risks. The SEC has adopted a similar approach in its proposed climate rules, which require disclosures on how the board oversees climate-related risks as part of its business strategy, risk management and financial oversight. Glass Lewis's 2024 benchmark voting policies will also assess whether companies have codified a "meaningful level" of board oversight of, and accountability for, a company's material environmental and social impacts. However, the fundamental role of the board remains one of oversight, and directors should work to raise concerns and provide [guidance](#) to management without overstepping into management's responsibilities.
- **Focus on Director Bandwidth:** As board responsibilities grow, so has the focus on director bandwidth; directors should be realistic about their bandwidth when considering new opportunities for board service. Beginning in 2024, State Street Global Advisors will require S&P 500 companies to develop their own director overboarding policies to replace the quotas that State Street has previously enforced through withhold votes. This shift reflects continued efforts by investors to develop more tailored approaches to managing director commitments. Board roles that may require additional time, such as the board chair and audit committee chair, are now being taken into account when determining whether a director is overboarded. On average, independent directors on S&P 500 boards serve on two public company boards, a number which has remained steady over the past decade. However, the percentage of independent S&P 500 directors who serve on three or more boards has declined to 29% from 33% in 2013.
- **The Stakeholder Balancing Act:** The shift away from a myopic version of shareholder primacy, in favor of a governance [paradigm](#) that balances competing stakeholder interests to forge well-rounded business decisions, has highlighted the sometimes competing priorities of stakeholders. Heading into an election year, companies may continue to find themselves caught in the domestic culture wars and pressured to take positions on divisive social and political issues. And shareholders, too, may be increasingly divided on their expectations regarding environmental and social issues, as evidenced by the continued wave of shareholder proposals in 2023, notwithstanding the declining support for such proposals among the largest institutional shareholders.

Looking Ahead to 2024

- **ESG to Evolve:** While the trendiness, and public use, of the "ESG" acronym may be fading, many of the issues for which ESG became a shorthand will continue to impact business decisions in meaningful ways. With respect to climate change, for example, the adoption of the European Union's Corporate Sustainability Reporting Directive ("CSRD"), the consolidation of voluntary global disclosures under standards promulgated by the International Sustainability Standards Board, together with ongoing regulatory efforts targeted at improving disclosures and clamping down on greenwashing, will continue to push companies to approach ESG on an issue-by-issue basis and in a manner that is grounded in actual business practices rather than aspirations.
- **Regulatory Pressure to Mount:** A flurry of new rules and regulations proposed by foreign and domestic regulators are expected to come into force over the coming months. For example, the SEC is expected to release its final rules on climate, shareholder proposals and security-based swaps and propose new rules on human capital and board diversity. The Biden Administration's executive order on artificial intelligence will require several federal agencies to release guidelines next year on the use of AI within the industries that they oversee, adding to the nascent global regulatory regime. The Federal Trade Commission is scheduled to release its updates to the Green Guides as part of ongoing regulatory efforts to combat greenwashing. Many companies will also need to prepare to comply with the CSRD. And bipartisan support for a carbon tariff continues to grow.
- **Politics and Business Continue to Collide:** Heading into an election year, it will be difficult to keep politics on the sidelines of business. The anti-ESG backlash and its opponents have continued to apply pressure on businesses in a variety of ways, ranging from congressional subpoenas and lawsuits to public letters to shareholder proposals seeking greater transparency on political activities and spending. The growing wave of labor mobilization across sectors may be among the issues that draw political interest from both sides, and may further complicate efforts to negotiate union contracts and reach consensus on other labor-related matters outside of the limelight. In addition, diversity, equity and inclusion initiatives will continue to draw political scrutiny from politicians, the media and other activists.
- **Shareholder Activism to Remain Robust:** While the past year saw activists double down on campaigns targeting strategic and operational improvements, growing macroeconomic optimism and a loosening of the credit markets may see activists once again launching campaigns centered around classic M&A theses and stock buybacks. The focus on underperformance and operational improvements, however, is unlikely to dissipate anytime soon, and activists will continue to seek management change in some campaigns. Meanwhile, some activists will continue to leverage the shareholder proposal process to engage with companies and draw attention to key governance, environmental and social issues, and companies will need to keep abreast of the evolving expectations of their shareholder base to avoid surprises at the annual meeting.
- **Cybersecurity Threats:** The rise of generative AI and ongoing geopolitical tensions will further fuel cybersecurity threats. The SEC's new cybersecurity disclosure rules may require boards and management to reassess their processes for responding to and mitigating the impacts of cyberattacks. For companies operating in certain critical infrastructure sectors, including the transportation, communication, financial services, healthcare and information technology sectors, the Cyber Incident Reporting for Critical Infrastructure Act of 2022 will introduce new disclosure requirements for significant cyber incidents and ransomware payments in 2024.

- **Demand for Board Oversight of AI to Grow**: As generative AI continues to have a transformational effect throughout the economy, demand from stakeholders for board oversight and guardrails will expand. Already regulators across the globe are exploring legislation that would curtail the use of certain types of AI. Pressure is also growing within the private sector as stakeholders, particularly employees and union groups, look to understand how companies are planning to deploy AI technology and the processes being implemented to identify and mitigate risks. The 2023 proxy season saw the first shareholder proposals calling for disclosure on the board's oversight of AI and ethical guidelines on the use of AI, and scrutiny of board oversight on AI will only grow as this technology is woven into long-term strategy and business operations.
- **Energy Transition Comes Into Focus**: The UN Climate Change Conference, COP28, recently concluded with a pledge by over 190 nations to transition "away from fossil fuels in energy systems, in a just, orderly and equitable manner." While it remains to be seen what concrete steps governments will take to facilitate a transition to green energy, the latest developments reaffirm the need for companies to reorient and revamp their operations for a global energy transition over the coming years. Already, investor focus has started to pivot from disclosure to climate transition planning. Companies that have or plan to set emissions reduction targets and initiatives to mitigate climate risk will need to credibly demonstrate the feasibility of such targets as well as strategies and interim progress.
- **Executive Compensation Remains Under Scrutiny**: New Item 402(x) of Regulation SK will come into force for companies whose fiscal year commences on January 1, 2024, and will require companies to include in their 10-K or proxy statement narrative disclosure regarding their policies and practices on timing of awards of stock options and other similar option-like instruments in relation to disclosure of material nonpublic information. Companies will also be required to include tabular disclosure of awards made in the four business days before a periodic or current report filing that discloses material nonpublic information and ending one business day after the filing or furnishing of such report.

While the expanding responsibilities and expectations of boards have created new challenges, the dynamic business environment propelling this evolution will also create new opportunities and winners. Engaged boards, working as a strategic partner to management and exercising their business judgment to identify priorities and weigh competing interests and objectives, are uniquely situated to forge new paths toward long-term value creation for all stakeholders.

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Emerging trends and challenges in corporate governance in America: A 2023 perspective

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ABSTRACT

This paper provides a comprehensive analysis of the current state and emerging trends in corporate governance within American corporations, focusing on the year 2023. It examines the evolving landscape of corporate governance in response to technological advancements, regulatory changes, and shifting societal expectations. Through a detailed review of literature and analysis of case studies, this study highlights the significant challenges and opportunities facing boards of directors, including the integration of environmental, social, and governance (ESG) criteria, the impact of digital transformation, and the evolving role of stakeholders. The findings underscore the necessity for American corporations to adapt to a rapidly changing environment, emphasizing the importance of transparency, accountability, and sustainability in corporate governance practices.

Keywords : Corporate governance, United States, ESG criteria, digital transformation, stakeholder engagement, transparency, accountability.

1. INTRODUCTION

Agency theory, a cornerstone of corporate governance, delves into the complexities inherent in relationships where one party (the principal) delegates work to another (the agent), who performs that work. In the context of corporate governance, the shareholders (principals) entrust the management (agents) with the task of running the company in their best interest (Fahlevi et al., 2022a). However, this relationship often encounters challenges due to conflicts of interest and information asymmetry, where agents may pursue personal gains over the principals' best interests. The digital era has ushered in a suite of technological innovations that reshape the operational and strategic frameworks of corporations. From blockchain and artificial intelligence to big data analytics, these advancements promise enhanced efficiency, transparency, and decision-making capabilities (Meiryani et al., 2022). However, they also introduce new dimensions to the agency problem. The asymmetric information gap can widen as the complexity of technology makes corporate operations opaquer to shareholders. Furthermore, the rapid pace of digital transformation may outstrip the ability of corporate governance structures to adapt, potentially exacerbating agency conflicts. Regulatory changes are a double-edged sword in the realm of corporate governance. On one side, they aim to mitigate the agency problem by enforcing transparency, accountability, and fairness in corporate practices. Legislation such as the Sarbanes-Oxley Act or the Dodd-Frank Act in the United States reflects

efforts to protect shareholders and strengthen the governance framework. On the other side, regulatory complexity can burden corporations with compliance costs and divert resources from core business activities, sometimes creating unintended consequences that can, paradoxically, limit shareholders' value. The challenge lies in balancing regulatory oversight to protect stakeholder interests without stifling innovation and competitiveness.

The 21st century has seen a paradigm shift in stakeholder expectations, moving towards a more inclusive model of corporate governance that considers not only shareholders but also other stakeholders, including employees, customers, society, and the environment. This shift is partly inspired by the broader adoption of environmental, social, and governance (ESG) criteria, reflecting a more holistic understanding of value creation and sustainability (Abbas et al., 2022). From an agency theory perspective, this shift complicates the governance landscape by introducing multiple principals with varying interests, further challenging the traditional agency model where the focus was primarily on shareholder value (Fahlevi et al., 2022b).

The year 2023 stands as a pivotal moment for corporate governance in America, characterized by the intersection of these technological, regulatory, and societal shifts. Effective governance practices must not only address the classic agency problem but also adapt to these evolving challenges. This adaptation might involve leveraging technology to improve transparency and stakeholder engagement, navigating the complex regulatory environment to find a balance between compliance and operational efficiency, and broadening the governance model to account for the interests of a wider set of

stakeholders (Prasetyo et al., 2022).

By placing agency theory at the heart of this analysis, the paper seeks to unravel the multifaceted challenges and opportunities presented by the current trends in corporate governance. Understanding the nuances of the principal-agent relationship in this dynamic context is essential for proposing governance strategies that can sustain corporate competitiveness and ensure long-term success in an era marked by rapid change and uncertainty (Shleifer & Vishny, 1997).

2. METHODOLOGY

The foundation of this study is a thorough literature review, which encompasses academic journals, industry reports, regulatory guidelines, and thought leadership articles on corporate governance. This step is crucial for framing the research within the current academic and practical discourse (Mushtaq et al., 2022), identifying gaps in knowledge, and understanding the evolution of governance practices over time. The literature review also helps in formulating hypotheses and guiding the empirical investigation.

Qualitative data is gathered from a variety of sources to gain insights into the nuanced aspects of corporate governance practices and their implications. This includes:

- **Regulatory Filings:** Review of documents such as 10-Ks, proxy statements, and other SEC filings to understand the formal governance structures, policies, and practices publicly traded companies are obligated to disclose. This analysis can reveal compliance trends, governance priorities, and shifts in response to regulatory changes.
- **Corporate Governance Reports:** Examination of voluntary disclosures, sustainability reports, and corporate social responsibility (CSR) reports to assess how companies communicate their governance practices and achievements beyond regulatory requirements. These documents can offer insights into the adoption of ESG principles, stakeholder engagement strategies, and ethical governance frameworks.
- **Case Studies:** In-depth case studies of governance practices in leading U.S. companies provide context-specific insights into how theoretical governance models are applied in real-world scenarios. Case studies are selected based on criteria such as industry representation, company size, governance controversies, or exemplary practices. They allow for a detailed understanding of the challenges and successes companies face in implementing effective governance practices.

Quantitative data analysis complements (Zhuang et al., 2022) the qualitative insights by providing empirical evidence of the relationship between corporate governance practices and various performance metrics. This involves:

- **Content Analysis of Governance Documents:** Quantitative content analysis is used to systematically categorize and quantify information in corporate governance documents. This can involve coding governance features (e.g., board composition, independence, diversity) and using statistical methods to identify patterns and correlations with company performance indicators.
- **Statistical Analysis of Governance Outcomes:** This includes the use of statistical tools to analyze data on company performance (financial performance, market

valuation), stakeholder satisfaction (employee engagement, customer satisfaction), and other relevant metrics (ESG scores, compliance rates). The goal is to empirically assess the impact of different governance practices on these outcomes, controlling for industry and other external factors.

By integrating these qualitative and quantitative methods, the research aims to achieve a nuanced understanding of corporate governance in America, highlighting not only the current state and trends but also the effectiveness and implications of these practices. The mixed-method approach facilitates a comprehensive analysis that can address complex research questions, offering both breadth and depth in understanding the evolving landscape of corporate governance.

3. DISCUSSION

The growing focus on Environmental, Social, and Governance (ESG) criteria signifies a paradigm shift in corporate America's approach to governance. This shift is driven by a recognition that sustainable business practices are not just ethical imperatives but also contribute to long-term profitability and risk management. The integration of ESG criteria into governance frameworks is indicative of a broader understanding of corporate accountability, extending beyond shareholders to encompass a wider array of stakeholders, including employees, communities, and the environment.

However, the implementation of ESG criteria presents challenges, particularly in measuring and reporting on these dimensions accurately and transparently. The discussion would explore how inconsistencies in ESG reporting standards and practices can impede comparability and reliability, potentially undermining stakeholder trust. Despite these challenges, the trend towards ESG integration represents a significant advancement in corporate governance, reflecting a more holistic view of a corporation's role and responsibilities within society.

Digital transformation is reshaping corporate governance by introducing both opportunities and challenges. On one hand, digital tools and platforms can enhance governance practices by facilitating more efficient board operations, improving transparency through real-time data access, and enabling more effective stakeholder engagement through digital communication channels. The adoption of technologies such as blockchain for secure voting in shareholder meetings exemplifies the potential for digital tools to strengthen governance mechanisms.

On the other hand, the digital era introduces significant risks, particularly in the realm of cybersecurity. The discussion would delve into the complexities of cybersecurity governance, emphasizing the need for boards to have robust strategies and expertise to oversee and mitigate cyber risks. Furthermore, the rapid pace of digital transformation necessitates continuous adaptation and learning within governance structures, challenging traditional governance models that may lack the agility to respond effectively to technological advancements.

The expectations of shareholders, employees, and other stakeholders are evolving, demanding greater transparency, accountability, and inclusivity from corporate governance practices. This shift reflects a broader societal movement towards stakeholder capitalism, where the interests of all stakeholders are considered in corporate decision-making processes. The discussion would examine how companies are adapting their governance structures to become more inclusive and responsive, such as through the establishment of stakeholder advisory panels or the incorporation of stakeholder feedback mechanisms into governance processes.

However, despite progress, significant gaps remain. The discussion

would highlight inconsistencies in stakeholder engagement practices across industries and companies, noting that while some corporations have made strides in enhancing inclusivity and responsiveness, others lag behind, raising questions about the universality and effectiveness of these governance adaptations.

The discussion underscores the complex interplay between advancing ESG integration, navigating the challenges of digital transformation, and meeting evolving stakeholder expectations. While American corporations are adapting and innovating in response to these trends, the discussion acknowledges the ongoing challenges and the need for continued evolution in governance practices. It calls for a balanced approach that leverages technological advancements and embraces the principles of sustainability and inclusivity, all while maintaining a steadfast commitment to governance principles that safeguard the interests of all stakeholders.

4. CONCLUSION

The research underscores a pivotal moment in corporate governance, marked by a significant realignment of priorities towards sustainability, social responsibility, and technological adaptability. The integration of ESG criteria into corporate governance has emerged as a defining trend, signaling a shift towards more sustainable and ethical business practices. This trend reflects a broader societal demand for corporations to contribute positively to environmental protection, social justice, and governance integrity (Vizano et al., 2021).

Simultaneously, the digital transformation presents both opportunities and challenges for corporate governance. Technological advancements have the potential to enhance governance efficiency (Maskuroh et al., 2022) and transparency, facilitating better decision-making and stakeholder engagement. However, they also introduce complex risks, particularly in cybersecurity, requiring robust oversight and strategic risk management (Sáenz González & García-Meca, 2014).

Moreover, the research highlights a dynamic shift in stakeholder expectations, with a growing demand for transparency, inclusivity, and accountability in corporate governance practices. Stakeholders increasingly seek a voice in corporate decisions, urging companies to adopt governance frameworks that consider a wider array of interests beyond shareholder returns (Aguilera et al., 2006).

Despite progress, the research identifies significant challenges that persist across the corporate governance landscape. Variability in ESG reporting standards, cybersecurity threats, and inconsistencies in stakeholder engagement practices exemplify the hurdles that corporations face in adapting their governance practices to the new realities of the 21st century.

However, these challenges also present opportunities for innovation and leadership in corporate governance. Companies that proactively address these issues—by standardizing ESG reporting, fortifying cybersecurity governance, and enhancing stakeholder engagement—can set new benchmarks for corporate governance excellence. These leaders can inspire broader industry shifts towards more responsible, transparent, and responsive governance practices.

Looking ahead, the future of corporate governance in America will likely be characterized by continued evolution and adaptation. As the landscape of risks and opportunities shifts, so too will the strategies and practices of corporate governance. The ongoing development of regulatory frameworks, technological innovations, and stakeholder engagement models will play a

critical role in shaping governance practices.

The research calls for a concerted effort among corporations, regulators, and stakeholders to collaboratively navigate the complexities of modern corporate governance. This includes embracing technological innovations responsibly, striving for greater transparency and consistency in ESG reporting, and fostering a governance culture that values stakeholder inclusivity and accountability.

The corporate governance landscape in America is at a crossroads, facing unprecedented challenges but also abundant opportunities for transformation and growth. As corporations navigate these turbulent waters, the principles of sustainability, responsibility, and inclusivity will be paramount. By embracing these principles, American corporations can not only enhance their governance practices but also contribute to a more sustainable, equitable, and prosperous future for all stakeholders. This research, while capturing a snapshot of the corporate governance landscape in 2023, sets the stage for ongoing inquiry and action in the evolving field of corporate governance.

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G20/OECD Principles of Corporate Governance



G20/OECD Principles of Corporate Governance 2023

The *G20/OECD Principles of Corporate Governance* are set out in the Appendix to the OECD Recommendation on Principles of Corporate Governance [[OECD/LEGAL/0413](#)] adopted by the OECD Council on 8 July 2015 and revised on 8 June 2023. The Principles were endorsed by the G20 in September 2023. For access to the official text of the Recommendation, as well as other related information, please consult the Compendium of OECD Legal Instruments at <https://legalinstruments.oecd.org>.

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Preface

The *G20/OECD Principles of Corporate Governance* provide guidance to help policy makers evaluate and improve the legal, regulatory and institutional framework for corporate governance, with a view to supporting market confidence and integrity, economic efficiency, sustainable growth and financial stability.

As the main international benchmark for good corporate governance, the *Principles* have a global reach and reflect the experiences and ambitions of a wide variety of jurisdictions with varying legal systems and at different stages of development. They are also one of the Financial Stability Board's Key Standards for Sound Financial Systems.

These revised *Principles* are the outcome of 18 months of work. They reflect a strong desire from all OECD and G20 Members to see the *Principles* offer guidance on companies' sustainability and resilience, and will help companies manage environmental and social risks, with insights on disclosure, the roles and rights of shareholders as well as stakeholders and the responsibilities of company boards.

First, they help companies improve access to finance, particularly from capital markets. By doing so, they promote investment, innovation, and productivity growth, and foster economic dynamism more broadly.

Second, they provide a framework to protect investors, which include households with invested savings. A formal structure of procedures that promotes the transparency and accountability of board members and executives to shareholders helps to build trust in markets.

Third, they support the sustainability and resilience of corporations which, in turn, contributes to the sustainability and resilience of the broader economy.

The objectives are to help improve companies' access to financial markets in an environment where investor expectations are evolving and to support investor confidence on the basis of more transparent market information and reinforced investor rights.

The *Principles* will help address the growing role of institutional investors by promoting stewardship codes, and the disclosure of conflicts of interest by advisory services, like proxy advisors and Environmental, Social and Governance index providers. They also include new recommendations which reflect the increasing importance of corporate debt and the role of bondholders in capital markets.

Policy makers, regulators, international organisations and market participants have an important role to play in putting the *Principles* to good use so that countries and corporations may continue benefitting from good corporate governance. The OECD will keep on working closely with all relevant national authorities and other partners to promote the implementation of the *Principles* globally.



Mathias Cormann,

OECD Secretary-General

Foreword

The *G20/OECD Principles of Corporate Governance* are the leading international standard for corporate governance. They aim to help policy makers and regulators evaluate and improve legal, regulatory and institutional frameworks for corporate governance, with a view to supporting market confidence and integrity, economic efficiency, and financial stability.

The *Principles* underwent a comprehensive review in 2021-2023 to update them in light of recent evolutions in corporate governance and capital markets. The revised *Principles* were adopted by the OECD Council at Ministerial Level in June 2023 (the *Principles* are embodied in the OECD Recommendation on Principles of Corporate Governance [[OECD/LEGAL/0413](#)]) and endorsed by G20 Leaders in September 2023. The *Principles* are also one of the Financial Stability Board's Key Standards for Sound Financial Systems, and form the basis for the World Bank Reports on the Observance of Standards and Codes (ROSC) in the area of corporate governance.

The review had two major objectives: to support national efforts to improve the conditions for companies' access to finance from capital markets, and to promote corporate governance policies that support the sustainability and resilience of corporations which, in turn, may contribute to the sustainability and resilience of the broader economy.

Accordingly, a major evolution in the *Principles* is the new Chapter on "Sustainability and resilience" which reflects the growing challenges corporations face in managing climate-related and other sustainability risks and opportunities. This new Chapter also incorporates Chapter IV on "The Role of Stakeholders in Corporate Governance" of the previous version of the *Principles*. A substantial number of new recommendations have also been developed and integrated within the existing chapters of the *Principles*, whose structure remains otherwise unchanged.

The review of the *Principles* was undertaken by the OECD Corporate Governance Committee, chaired by Mr Masato Kanda. OECD, G20 and FSB members participate in the Committee and contributed to the review on an equal footing. Important contributions were also received from the OECD's regional corporate governance roundtables in Asia and Latin America, and from Business at OECD (BIAC) and the Trade Union Advisory Committee (TUAC). An online public consultation and in-person stakeholder consultation were also held, and experts from relevant international organisations, notably the Financial Stability Board, the International Monetary Fund, and the World Bank Group, participated in the review.

In order to ensure the continued accuracy and relevance of the *Principles*, the review was supported and informed by extensive empirical and analytical work examining recent changes in both capital markets and corporate governance policies and practices. The reports developed informed both the Committee's choice of priority areas for consideration during the review as well as the revisions themselves.

The OECD, G20 and relevant stakeholders will now endeavour to promote and monitor the effective implementation of the revised *Principles* globally. This will include a review of the *Methodology for Assessing the Implementation of the Principles of Corporate Governance* and the regular publication of the *OECD Corporate Governance Factbook* which assesses implementation of the *Principles* in a large number of countries.

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About the Principles

The *Principles of Corporate Governance* (“the *Principles*”) are intended to help policy makers evaluate and improve the legal, regulatory, and institutional framework for corporate governance, with a view to supporting economic efficiency, sustainable growth and financial stability. This is primarily achieved by providing shareholders, board members and executives, the workforce and relevant stakeholders, as well as financial intermediaries and service providers with the right information and incentives to perform their roles and help to ensure accountability within a framework of checks and balances.

Corporate governance involves a set of relationships between a company’s management, board, shareholders and stakeholders. Corporate governance also provides the structure and systems through which the company is directed and its objectives are set, and the means of attaining those objectives and monitoring performance are determined.

The *Principles* are non-binding and do not aim to provide detailed prescriptions for national legislation. The *Principles* are not a substitute for nor should they be considered to override domestic law and regulation. Rather, they seek to identify objectives and suggest various means for achieving them, typically involving elements of legislation, regulation, listing rules, self-regulatory arrangements, contractual undertakings, voluntary commitments and business practices. A jurisdiction’s implementation of the *Principles* will depend on its national legal and regulatory context. The *Principles* aim to provide a robust but flexible reference for policy makers and market participants to develop their own frameworks for corporate governance. To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices to meet new demands and grasp new opportunities. Taking into account the costs and benefits of regulation, governments have an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function effectively and to respond to new expectations of shareholders and stakeholders. The *Principles* themselves are evolutionary in nature and are reviewed in light of significant changes in circumstances in order to maintain their role as the leading international standard to assist policy makers in the area of corporate governance.

Well-designed corporate governance policies can play an important role in contributing to the achievement of broader economic objectives and three major public policy benefits. First, they help companies to access financing, particularly from capital markets. By doing so, they promote innovation, productivity and entrepreneurship, and foster economic dynamism more broadly. For those who provide capital, either directly or indirectly, good corporate governance serves as an assurance that they can participate and share in the company’s value creation on fair and equitable terms. It therefore affects the cost at which corporations can access capital for growth.

This is of significant importance in today’s globalised capital markets. International flows of capital enable companies to access financing from a much larger pool of investors. If companies and countries are to reap the full benefits of global capital markets and attract long-term “patient” capital, corporate governance frameworks must be credible, well understood both domestically and across borders, and aligned with internationally accepted principles.

Second, well-designed corporate governance policies provide a framework to protect investors, which include households with invested savings. A formal structure of procedures that promotes the transparency and accountability of board members and executives to shareholders helps to build trust in markets, thereby supporting corporations' access to finance. A substantial part of the general public invests in public equity markets, either directly as retail investors or indirectly through pension and investment funds. Providing them with a system in which they can share in corporate value creation, knowing their rights are protected, will give households access to investment opportunities that may help them to achieve higher returns for their savings and retirement. Given that institutional investors increasingly allocate a large share of their portfolios to foreign markets, policies to protect investors should also cover cross-border investments.

Third, well-designed corporate governance policies also support the sustainability and resilience of corporations and in turn, may contribute to the sustainability and resilience of the broader economy. Investors have increasingly expanded their focus on companies' financial performance to include the financial risks and opportunities posed by broader economic, environmental and societal challenges, and companies' resilience to and management of those risks. In some jurisdictions, policy makers also focus on how companies' operations may contribute to addressing such challenges. A sound framework for corporate governance with respect to sustainability matters can help companies recognise and respond to the interests of shareholders and different stakeholders, as well as contribute to their own long term success. Such a framework should include the disclosure of material sustainability-related information that is reliable, consistent and comparable, including related to climate change. In some cases, jurisdictions may interpret concepts of sustainability-related disclosure and materiality in terms of applicable standards articulating information that a reasonable shareholder needs in order to make investment or voting decisions.

The *Principles* are intended to be concise, understandable, and accessible to all actors with a role in developing and implementing good corporate governance globally. On the basis of the *Principles*, it is the role of government, semi-government or private sector initiatives to assess the quality of the corporate governance framework and develop more detailed mandatory or voluntary provisions that can take into account country-specific economic, legal, and cultural differences.

The *Principles* focus on publicly traded companies, both financial and non-financial. To the extent they are deemed applicable, the *Principles* may also be a useful tool to improve corporate governance in companies whose shares are not publicly traded. While some of the *Principles* may be more appropriate for larger companies than for smaller ones, policy makers may wish to raise awareness of good corporate governance for all companies, including smaller and unlisted companies as well as those that issue debt securities. The *OECD Guidelines on Corporate Governance of State-Owned Enterprises* complement the *Principles*. Other factors relevant to a company's decision-making processes, such as environmental, anti-corruption or ethical concerns, are considered not only in the *Principles* but also in a number of other international standards including the *OECD Guidelines for Multinational Enterprises*, the *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, the *UN Guiding Principles on Business and Human Rights*, and the *ILO Declaration on Fundamental Principles and Rights at Work*, which are referenced in the *Principles*.

The *Principles* do not intend to prejudice or second-guess the business judgement of market participants, board members and management. What works in one or more companies or for one or more investors may not necessarily be generally applicable. Companies vary in maturity, size and complexity. There is therefore no single model of good corporate governance. However, the *Principles* follow an outcome-oriented approach, suggesting some common elements that underlie good corporate governance. The *Principles* build on these common elements and are formulated to embrace the different models that exist.

For example, they do not advocate any particular board structure and the term "board" as used in the *Principles* is intended to embrace the different national models of board structures. In the typical two-tier system, found in some jurisdictions, "board" as used in the *Principles* refers to the "supervisory board" while "key executives" refers to the "management board". In systems where the unitary board is overseen by an

internal auditor's body, the *Principles* applicable to the board are also, *mutatis mutandis*, applicable. As the definition of the term “key executive” may vary among jurisdictions and depending on context, for example concerning remuneration or related party transactions, the *Principles* leave it to individual jurisdictions to define this term in a functional manner that meets the intended outcome of the *Principles*. The terms “corporation” and “company” are used interchangeably in the text. Throughout the *Principles*, the term “stakeholders” refers to non-shareholder stakeholders and includes, among others, the workforce, creditors, customers, suppliers and affected communities.

The *Principles* are widely used as a benchmark by individual jurisdictions around the world. They are also one of the Financial Stability Board's Key Standards for Sound Financial Systems and provide the basis for assessment of the corporate governance component of the Reports on the Observance of Standards and Codes (ROSC) of the World Bank. The *Principles* are also used as a benchmark in developing sectoral corporate governance guidance by other international standard-setting bodies, including the Basel Committee on Banking Supervision. Implementation of the *Principles* is monitored and supported through the *OECD Corporate Governance Factbook*, peer reviews on thematic issues that compare practices across jurisdictions and corporate governance regional and country reviews.

The *Principles* are presented in six chapters: I) Ensuring the basis for an effective corporate governance framework; II) The rights and equitable treatment of shareholders and key ownership functions; III) Institutional investors, stock markets, and other intermediaries; IV) Disclosure and transparency; V) The responsibilities of the board; and VI) Sustainability and resilience.

Each chapter is headed by a single Principle that appears in bold italics and is followed by a number of supporting Principles and their sub-Principles in bold. The *Principles* are supplemented by annotations that contain commentary on the Principles and sub-Principles and are intended to help readers understand their rationale. The annotations may also contain descriptions of dominant or emerging trends and offer alternative implementation methods and examples that may be useful in making the *Principles* operational.

I. Ensuring the basis for an effective corporate governance framework

The corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement.

Effective corporate governance requires a sound legal, regulatory and institutional framework that market participants can rely on when establishing their private contractual relations. By promoting transparent and fair markets, this framework also plays an important role in fostering the trust in markets that is necessary to underpin the achievement of broader economic objectives. The corporate governance framework typically comprises elements of legislation, regulation, listing rules, self-regulatory arrangements, contractual undertakings, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition. The desirable mix between these elements will therefore vary from country to country.

The legislative and regulatory elements of the corporate governance framework can usefully be complemented by soft law elements such as corporate governance codes which are often based on a “comply or explain” principle in order to allow for flexibility and to address specificities of individual companies. What works well in one company, for one investor or a particular stakeholder may not necessarily be applicable to corporations, investors and stakeholders that operate in another context and under different circumstances. Thus, any particular element of a specific corporate governance framework may not be effective in addressing a particular governance issue in all situations. Rather, the methods for encouraging or requiring good corporate governance practices should aim to achieve desired outcomes by adapting approaches to fit particular circumstances. For example, the desired outcome of ensuring effective implementation of certain corporate governance practices may be achieved more efficiently in markets where institutional investors play a strong role in improving such practices in line with soft law code recommendations, while in markets where investors adopt a more passive role, the regulator may choose to require and enforce the implementation of certain corporate governance standards. As new experiences accrue and business circumstances change, the various provisions of the corporate governance framework should be reviewed and, when necessary, adjusted.

Jurisdictions seeking to implement the *Principles* should monitor their corporate governance framework with the objective of maintaining and strengthening its contribution to market integrity, access to capital markets, economic performance, and transparent and well-functioning markets. As part of this, it is important to consider the interactions and complementarity between different elements of the corporate governance framework and its overall ability to promote ethical, responsible and transparent corporate governance practices. Such analysis is an important tool in the process of developing an effective corporate governance framework. To this end, effective and timely consultation with the public is an essential element. In some jurisdictions, this may need to be complemented by initiatives to inform companies and their stakeholders about the benefits of implementing sound corporate governance practices.

Moreover, in developing a corporate governance framework, national legislators and regulators should consider the need for, and the results of, effective international dialogue and co-operation. If these conditions

are met, the corporate governance framework is more likely to avoid over-regulation, support the exercise of entrepreneurship, and limit the risks of damaging conflicts of interest in both the private sector and in public institutions.

I.A. The corporate governance framework should be developed with a view to its impact on corporate access to finance, overall economic performance and financial stability, the sustainability and resilience of corporations, market integrity, and the incentives it creates for market participants and the promotion of transparent and well functioning markets.

Capital markets play a key role in providing companies with funds that allow them to innovate and support economic growth, as well as efficiently diversify their financing sources. Equity and bond financing also support companies' resilience to overcome temporary downturns while meeting their obligations to the workforce, creditors and suppliers. Policy makers and regulators need to consider how the corporate governance framework may encourage and impact corporate access to market-based financing.

The corporate form of organisation of economic activity serves as a powerful force for growth. The regulatory and legal environment within which corporations operate is therefore of key importance to overall economic outcomes. Policy makers also have a responsibility to put in place a framework that is capable of meeting the needs of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value, and to determine the most efficient deployment of resources. Where appropriate, corporate governance frameworks should therefore allow for proportionality, in particular with respect to the size of publicly traded companies. Other factors that may call for flexibility include the company's ownership and control structure, geographical presence, sectors of activity, and the company's development stage. Policy makers should remain focused on ultimate economic outcomes, and when considering policy options they will need to undertake an analysis of the impact on key variables that affect the functioning of markets, for example in terms of incentive structures, the efficiency of self-regulatory systems, and dealing with systemic conflicts of interest. Transparent and well-functioning markets serve to discipline market participants and promote accountability.

I.B. The legal and regulatory requirements that affect corporate governance practices should be consistent with the rule of law, transparent and enforceable. Corporate governance codes may offer a complementary mechanism to support the development and evolution of companies' best practices, provided that their status is duly defined.

If new laws and regulations are needed, such as to deal with clear cases of market imperfections, they should be designed in a way that makes it possible to implement and enforce them in an efficient and even-handed manner covering all parties. Consultation by government and other regulatory authorities with corporations, their representative organisations, shareholders, and stakeholders, is an effective way of doing this. Mechanisms should also be established for parties to protect their rights. In order to avoid over-regulation, unenforceable rules, and unintended consequences that may impede or distort business dynamics, policy measures should be designed with a view to their overall costs and benefits.

Public authorities should have effective enforcement and sanctioning powers to deter dishonest behaviour and provide for sound corporate governance practices. In addition, enforcement can also be pursued through private action, and the effective balance between public and private enforcement will vary depending upon the specific features of each jurisdiction.

Corporate governance objectives are also formulated in codes and standards that do not generally have the status of law or regulation. Good practices recommended in such codes are usually encouraged through "comply or explain" disclosure mechanisms or other variations such as "apply and/or explain". While such codes can play an important role in improving corporate governance arrangements and practices, they might leave shareholders and stakeholders with uncertainty concerning their status and implementation. When codes and principles are used as a national standard or as a complement to legal

or regulatory provisions, market credibility requires that their status in terms of coverage, implementation, compliance and sanctions is clearly specified.

I.C. The division of responsibilities among different authorities and self-regulatory bodies should be clearly articulated and designed to serve the public interest.

Corporate governance requirements and practices are typically influenced by an array of legal domains, such as company law, securities regulation, accounting and auditing standards, listing rules, insolvency law, contract law, labour law, tax law, as well as potentially international law. Corporate governance practices of individual companies are also often influenced by human rights and environmental laws, and increasingly laws related to digital security, data privacy and personal data protection. Under these circumstances, there is a risk that the variety of legal influences may cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives. It is important that policy makers are aware of this risk and take measures to ensure a coherent and stable institutional and regulatory framework. Effective enforcement also requires that the allocation of responsibilities for supervision, implementation and enforcement among different authorities is clearly defined and formalised so that the competencies of complementary bodies and agencies are respected and used most effectively. Potentially conflicting objectives, for example where the same institution is charged with attracting business and sanctioning violations, should be avoided or managed through clear governance provisions. Overlapping and perhaps contradictory regulations between jurisdictions is also an issue that should be monitored to avoid regulatory arbitrage and so that no regulatory vacuum is allowed to develop (i.e. issues slipping through for which no authority has explicit responsibility) as well as to minimise the cost of compliance with multiple systems.

When regulatory responsibilities or oversight are delegated to non-public bodies, notably stock exchanges, it is desirable to explicitly assess why, and under what circumstances, such delegation is desirable. In addition, the public authority should maintain effective safeguards to ensure that the delegated authority is applied fairly, consistently, and in accordance with the law. It is also essential that the governance structure of any such delegated institution be transparent and encompass the public interest, including appropriate safeguards to address potential conflicts of interest.

I.D. Stock market regulation should support effective corporate governance.

Stock markets can play a meaningful role in enhancing corporate governance by establishing and enforcing requirements that promote effective corporate governance by their listed issuers. Also, stock markets provide facilities by which investors can express interest or disinterest in a particular issuer's governance by allowing them to buy or sell the issuer's securities, as appropriate. The quality of stock exchanges' rules for listing and for governing trading on their facilities is therefore an important element of the corporate governance framework.

What traditionally were called "stock exchanges" today come in a variety of shapes and forms. Most of the large stock exchanges are now profit maximising and themselves publicly traded joint stock companies that operate in competition with other profit maximising stock exchanges and trading venues. Regardless of the particular structure of the stock market, policy makers and regulators should assess the proper role of stock exchanges and trading venues in terms of standard setting, supervision and enforcement of corporate governance rules. This requires an analysis of how the particular business models of stock exchanges affect the incentives and ability to carry out these functions.

I.E. Supervisory, regulatory and enforcement authorities should have the authority, autonomy, integrity, resources and capacity to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

Supervisory, regulatory and enforcement responsibilities should be vested with bodies that are operationally independent and accountable in the exercise of their functions and responsibilities, have adequate powers, proper resources, and the capacity to perform their functions and exercise their powers, including with

respect to corporate governance. Many jurisdictions have addressed the issue of political independence of the securities supervisor through the creation of a formal governing body (a board, council or commission) whose members are given fixed terms of appointment. Some jurisdictions also stagger appointments and make them independent from the political calendar to further enhance independence. Some jurisdictions have sought to reduce potential conflicts of interest by introducing policies to restrict post-employment movement to industry through mandatory time gaps or cooling-off periods. Such restrictions should take into consideration the regulators' ability to attract senior staff with relevant experience. These bodies should be able to pursue their functions without conflicts of interest and their decisions should be subject to judicial or administrative review. At the same time, supervisory staff should be adequately protected against the costs related to defending their actions and/or omissions made while discharging their duties in good faith.

To guard against conflicts of interest (including the potential for political or business interference in supervisory and enforcement processes), operational independence may be reinforced by autonomy over budgetary and human resource management decisions. Such autonomy should be coupled with high ethical standards and accountability mechanisms, including timely, transparent and fully explained decisions that are open to public and judicial scrutiny. When the number of corporate events and the volume of disclosures increase, the resources of supervisory, regulatory and enforcement authorities may come under strain. As a result, they will have a significant demand for fully qualified staff to provide effective oversight and investigative capacity which will require adequate funding. Many jurisdictions impose levies on supervised entities in combination with, or as an alternative to, government funding. This may support greater financial autonomy from governments to carry out their mandates, while structuring such fees to avoid impeding supervisory independence from regulated industry participants and providing adequate transparency on the criteria adopted to set the fees. The ability to attract staff on competitive terms is also important to enhance the quality and independence of supervision and enforcement.

I.F. Digital technologies can enhance the supervision and implementation of corporate governance requirements, but supervisory and regulatory authorities should give due attention to the management of associated risks.

Many jurisdictions use digital technologies to enhance the efficiency and effectiveness of supervisory and enforcement processes related to corporate governance, with benefits, for example, for market integrity. They can also alleviate the regulatory burden on regulated entities, which can themselves use digital tools to lower compliance costs and enhance risk management capabilities. Digital technologies may also be leveraged to make regulatory compliance less onerous for companies, with a view to maintaining the rigour and scope of corporate governance regulation and corporate disclosure through improvements in the functioning of the existing framework.

Adopting digital solutions in regulatory and supervisory processes also comes with challenges and risks. Important considerations include ensuring the quality of data; ensuring that staff have proper technical competence; considering interoperability between systems in the development of reporting formats; and managing third-party dependencies and digital security risks. When artificial intelligence and algorithmic decision-making are used in supervisory processes, it is critical to maintain a human element in place to mitigate against risks of incorporating existing biases in algorithmic models and the risks from an over-reliance on models and digital technologies.

At the same time, regulators in most jurisdictions espouse the value of a technology neutral approach that does not discourage innovation and the adoption of alternative technological solutions. As technologies evolve and may serve to strengthen corporate governance practices, the regulatory framework may require review and adjustments to facilitate their use.

I.G. Cross-border co-operation should be enhanced, including through bilateral and multilateral arrangements for exchange of information.

High levels of cross-border ownership and trading require strong international co-operation among regulators, including through bilateral and multilateral arrangements for exchange of information or joint supervisory actions. International co-operation is becoming increasingly relevant for corporate governance, notably when companies or company groups are active in many jurisdictions through both listed and unlisted entities, and seek multiple stock market listings on exchanges in different jurisdictions.

I.H. Clear regulatory frameworks should ensure the effective oversight of publicly traded companies within company groups.

Well-managed company groups that operate under adequate corporate governance frameworks can help to achieve benefits based on economies of scale, synergies and other efficiencies. Nevertheless, company groups in some cases may be associated with risks of inequitable treatment of shareholders and stakeholders. The prevalence of company groups in many jurisdictions has therefore heightened the need for regulators to ensure that the corporate governance framework provides means to effectively monitor them. If not, the extensive and complex structures of company groups may pose risks to shareholders and stakeholders of publicly traded parent or subsidiary companies within group structures, including through abusive related party transactions. Some group companies may also be used to shift funds within the group as part of the group's tax planning strategies, or may use the funds for board/executive remuneration or dividend payments.

Company groups operating in different sectors and across borders call for co-operation between domestic regulators and across jurisdictions to strengthen the effectiveness and consistency of regulatory oversight. Such efforts may include information sharing on the activities of company groups for supervisory and enforcement purposes. To this end, jurisdictions are encouraged to develop a practical definition and criteria for the oversight of company groups focusing on aspects such as the controlling relationship of group companies and their parent, companies' domicile, and appropriateness of inclusion in consolidated financial reporting, among other aspects. In some jurisdictions, companies have adopted protocols and governance guidelines at group level as a tool to self-regulate group activity.

II. The rights and equitable treatment of shareholders and key ownership functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders.

All shareholders should have the opportunity to obtain effective redress for violation of their rights at a reasonable cost and without excessive delay.

Equity investors have certain property rights. For example, an equity share in a publicly traded company can be bought, sold, or transferred. An equity share also entitles the investor to participate in the profits of the corporation, with liability limited to the amount of the investment. In addition, ownership of an equity share provides a right to information about the corporation and a right to influence the corporation, primarily by participating and voting in general shareholder meetings.

As a practical matter, however, the corporation cannot be managed by shareholder referendum. The shareholding body is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the corporation's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the corporation's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations is typically placed in the hands of the board and a management team that is selected, motivated and, when necessary, replaced by the board.

Shareholders' rights to influence the corporation centre on certain fundamental issues, such as the election of board members, or other means of influencing the composition of the board, amendments to the company's organic documents, approval of extraordinary transactions, and other basic issues as specified in company law and internal company statutes. These are the most basic rights of shareholders and they are recognised by law in most jurisdictions. Additional rights have also been established in various jurisdictions, such as direct nomination of individual board members or board member slates; the ability to pledge shares; the approval of distributions of profits; shareholder ability to vote on board member and/or key executive remuneration; approval of material related party transactions; and others.

Investors' confidence that the capital they provide will be protected from misuse or misappropriation by corporate managers, board members or controlling shareholders is an important factor in the development and proper functioning of capital markets. On the contrary, an inefficient corporate governance mechanism may allow corporate boards, managers and controlling shareholders the opportunity to engage in activities that advance their own interests at the expense of non-controlling shareholders. In providing protection to investors, a distinction can usefully be made between *ex ante* and *ex post* shareholder rights. *Ex ante* rights are, for example, pre-emptive rights and qualified majorities for certain decisions. *Ex post* rights allow the seeking of redress once rights have been violated. In jurisdictions where the enforcement of the legal and regulatory framework is weak, it can be desirable to strengthen the *ex ante* rights of shareholders such as

through low share ownership thresholds for placing items on the agenda of the shareholders meeting or by requiring a supermajority of shareholders for certain important decisions. The *Principles* support equal treatment of foreign and domestic shareholders in corporate governance. They do not address government policies to regulate foreign direct investment.

One of the ways in which shareholders can enforce their rights is to be able to initiate legal and administrative proceedings against management and board members. Experience has shown that an important determinant of the degree to which shareholders' rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. Some countries have found that derivative lawsuits filed by minority shareholders on behalf of the company serve as an efficient additional tool for enforcing directors' fiduciary duties, if the distribution of litigation costs is adequately set. The provision of such enforcement mechanisms is a key responsibility of legislators and regulators, and the capacity and quality of courts also play an important role.

There is some risk that a legal system that enables any investor to challenge corporate activity in the courts can become prone to excessive litigation. Thus, many legal systems have introduced provisions to protect management and board members against litigation abuse in the form of screening mechanisms, such as a pre-trial procedure to evaluate whether the claim is non-meritorious, and safe harbours for management and board member actions (such as the business judgement rule) as well as safe harbours for the disclosure of information. In the end, a balance must be struck between allowing investors to seek remedies for infringement of ownership rights and avoiding excessive litigation.

Many jurisdictions have found that alternative adjudication procedures, such as administrative hearings or arbitration procedures organised by the securities regulators or other bodies, are an efficient method to protect shareholder rights, at least at the first instance level. Specialised court procedures can also be a practical instrument to obtain timely injunctions and to gather evidence on an alleged infringement, ultimately facilitating the effective redress for violations of shareholders' rights.

II.A. Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; 6) share in the profits of the corporation; and 7) elect, appoint or approve the external auditor.

II.B. Shareholders should be sufficiently informed about, and have the right to approve or participate in decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions, including the transfer of corporate assets that in effect result in the sale of the company.

The ability of companies to form partnerships and related companies, and to transfer operational assets, cash flow rights and other rights and obligations to them, is important for business flexibility and for delegating authority in complex organisations. It also allows a company to divest itself of operational assets and to become only a holding company. However, without appropriate checks and balances, such possibilities may also be abused.

II.C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings, and should be informed of the rules, including voting procedures, that govern general shareholder meetings.

II.C.1. Shareholders should be furnished with sufficient and timely information concerning the date, format, location and agenda of general meetings, as well as fully detailed and timely information regarding the issues to be decided at the meeting.

II.C.2. Processes, format and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

The right to participate in general shareholder meetings is a fundamental shareholder right. Management and controlling investors have at times sought to discourage non-controlling or foreign investors from trying to influence the direction of the company. Some companies have charged fees for voting. Other potential impediments include prohibitions on proxy voting, requiring personal attendance at general shareholder meetings to vote, bundling of unrelated resolutions, holding the meeting in a remote location, and allowing voting by show of hands only. Still other procedures may make it practically impossible to exercise ownership rights. Voting materials may be sent too close to the time of general shareholder meetings to allow investors adequate time for reflection and consultation. Many companies are seeking to develop better channels of communication and decision-making with shareholders. Efforts by companies to remove artificial barriers to participation in general meetings are encouraged and the corporate governance framework should facilitate the use of electronic voting in absentia, including the electronic distribution of proxy materials and reliable vote confirmation systems. In jurisdictions where private enforcement is weak, regulators should be in a position to curb unfair voting practices.

II.C.3. General shareholder meetings allowing for remote shareholder participation should be permitted by jurisdictions as a means to facilitate and reduce the costs to shareholders of participation and engagement. Such meetings should be conducted in a manner that ensures equal access to information and opportunities for participation of all shareholders.

Virtual or hybrid (where certain shareholders attend the meeting physically and others virtually) general shareholder meetings can help improve shareholder engagement by reducing their time and costs of participating. By using virtual platform providers, companies may incur additional costs but also streamline shareholders' access to agendas and related information, and provide a secure infrastructure and more efficient means for considering and addressing shareholder comments and questions. However, due care is required to ensure that remote meetings do not decrease the possibility for shareholders to engage with and ask questions to boards and management in comparison to physical meetings. Some jurisdictions have issued guidance to facilitate the conduct of remote meetings, including for handling shareholder questions, responses and their disclosure, with the objective of ensuring transparent consideration of questions by boards and management, including how questions are collected, combined, answered and disclosed. Such guidance may also address how to deal with technological disruptions that may impede virtual access to meetings.

Many companies rely on technology vendors to manage remote participation. When choosing service providers, it is important to consider that they have the appropriate professionalism as well as data handling and digital security capacity to support the conduct of fair and transparent shareholder meetings, with technical and organisational security measures in place for each of the processing operations carried out by virtue of their service, especially concerning personal data, which require stricter security measures. Such processes should allow for the verification of shareholders' identity through secured authentication of attendees and ensure equal participation as well as the confidentiality and security of votes cast prior to the meeting.

II.C.4. Shareholders should have the opportunity to ask questions to the board, including on the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.

In order to encourage shareholder participation in general meetings, many jurisdictions have improved the ability of shareholders to place items on the agenda through a simple and clear process of filing amendments and resolutions, and to submit questions in advance of the general meeting and to obtain appropriate replies from management and board members in a manner that ensures their transparency. Shareholders should also be able to ask questions relating to the external audit report. Companies are justified in assuring that

abuses of such opportunities do not occur. It is reasonable, for example, to require that in order for shareholder resolutions to be placed on the agenda, they need to be supported by shareholders holding a specified market value or percentage of shares or voting rights. This threshold should be determined taking into account the degree of ownership concentration, in order to ensure that minority shareholders are not effectively prevented from putting any items on the agenda. Shareholder resolutions that are approved and fall within the competence of the shareholder meeting should be addressed by the board.

II.C.5. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known, including through votes at shareholder meetings, on the remuneration of board members and/or key executives, as applicable. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

Electing the members of the board is a basic shareholder right. For the election process to be effective, shareholders should be able to participate in the nomination of board members and vote on individual nominees or on different lists of nominees. To this end, shareholders have access in a number of jurisdictions to the company's voting materials which are made available to shareholders, subject to conditions to prevent abuse. With respect to nomination of candidates, boards in many companies have established nomination committees to ensure proper compliance and transparency with established nomination procedures and to facilitate and co-ordinate the search for a balanced, diverse and qualified board. It is regarded as good practice for independent board members to have a key role on this committee. To further improve the selection process, the *Principles* also call for full and timely disclosure of the experience and background of candidates for the board and the nomination process, which will allow an informed assessment of the abilities and suitability of each candidate. It is required or considered good practice in some jurisdictions to also disclose information about any other board positions or committee memberships that nominees hold, and in some jurisdictions also positions that they are nominated for.

The *Principles* call for the disclosure of remuneration of board members and key executives. In particular, it is important for shareholders to know the remuneration policy, as well as the total value and structure of remuneration arrangements made pursuant to this policy. Shareholders also have an interest in how remuneration and company performance are linked when they assess the capability of the board and the qualities they should seek in nominees for the board. The different forms of say-on-pay (binding or advisory vote, *ex ante* and/or *ex post*, board members and/or key executives covered, individual and/or aggregate compensation, remuneration policy and/or actual remuneration) play an important role in conveying the strength and tone of shareholder sentiment to the board. In the case of equity-based schemes, their potential to dilute shareholders' capital and to powerfully determine managerial incentives means that they should be approved by shareholders, either for individuals or for the policy of the scheme as a whole. Shareholder approval should also be required for any material changes to existing schemes.

II.C.6. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

The objective of facilitating shareholder identification and participation suggests that jurisdictions and/or companies promote the enlarged use of information technology in voting, including secure electronic voting in all publicly traded companies for both remote and in person meetings. The *Principles* recommend that voting by proxy be generally accepted. Indeed, it is important for the promotion and protection of shareholder rights that investors can rely on directed proxy voting. The corporate governance framework should ensure that proxies are voted in accordance with the direction of the proxy holder. In those jurisdictions where companies are allowed to obtain proxies, it is important to disclose how the chair of the meeting (as the usual recipient of shareholder proxies obtained by the company) will exercise the voting rights attached to undirected proxies. Where proxies are held by the board or management for company pension funds and for employee stock ownership plans, the directions for voting should be disclosed. It is required or considered

good practice in many jurisdictions that treasury shares and shares of the company held by subsidiaries should not be allowed to vote, nor be counted for quorum purposes.

II.C.7. Impediments to cross-border voting should be eliminated.

Foreign investors often hold their shares through chains of intermediaries. Shares are typically held in accounts with securities intermediaries who in turn hold accounts with other intermediaries and central securities depositories in other jurisdictions, while the publicly traded company resides in a third jurisdiction. Such cross-border chains cause special challenges with respect to determining the entitlement of foreign investors to use their voting rights, and the process of communicating with such investors. In combination with business practices which provide only a very short notice period, shareholders are often left with only very limited time to react to a convening notice by the company and to make informed decisions concerning items for decision. This makes cross-border voting difficult. The legal and regulatory framework should clarify who is entitled to control the voting rights in cross-border situations and where necessary to simplify the depository chain. Moreover, notice periods should ensure that foreign investors in effect have the same opportunities to exercise their ownership functions as domestic investors. To further facilitate voting by foreign investors, laws, regulations and corporate practices should allow participation through electronic means in a non-discriminatory way.

II.D. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the *Principles*, subject to exceptions to prevent abuse.

It has long been recognised that in companies with dispersed ownership, individual shareholders might have too small a stake in the company to warrant the cost of taking action or for making an investment in monitoring performance. Moreover, if small shareholders did invest resources in such activities, others would also gain without having contributed (i.e. they are “free riders”). In many instances institutional investors limit their ownership stake in individual companies because it is beyond their capacity or would require investing more of their assets in one company than may be prudent or permitted. To overcome this asymmetry which favours diversification, they should be allowed, and even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda, and holding discussions directly with a company in order to improve its corporate governance, subject to shareholders’ compliance with applicable law, including, for example, beneficial ownership reporting requirements. Some major institutional investors have established initiatives to facilitate the co-ordination of their engagement, for example to address climate-related concerns. When publicly traded companies have controlling shareholders, these actions also safeguard the interests of minority shareholders while increasing their voice in company matters. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy solicitation.

It must be recognised, however, that co-operation among investors could also be used to manipulate markets and to obtain control over a company, with a view to bypass takeover or disclosure regulations which may otherwise apply. Moreover, co-operation might also be for the purpose of circumventing competition law. Safeguards may be needed to prevent anticompetitive behaviour and abusive actions, particularly in jurisdictions where institutional investors are significant owners in publicly traded companies and their co-ordinated actions could have stronger influence on companies’ decisions. Disclosure of the co-ordination policy could provide clarity to the market on the scope of such actions. However, if co-operation does not clearly involve issues of corporate control, or conflict with concerns about market efficiency and fairness, the benefits of more effective ownership may still be obtained. To provide clarity and certainty among shareholders, regulators may issue guidance on forms of co-ordination and agreements that do or do not constitute such acting in concert in the context of takeover, competition and other rules.

II.E. All shareholders of the same series of a class should be treated equally. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in economic or voting rights should be subject to approval by those classes of shares which are negatively affected.

The optimal capital structure of the company is best decided by the management and the board, subject to the approval of the shareholders. Some companies issue preferred (or preference) shares which have a preference in respect of receipt of the profits of the company but which normally have limited or no voting rights. Companies may also issue participation certificates or shares with limited or no voting rights, which would presumably trade at different prices than shares with full voting rights. All of these structures may be effective in distributing risk and reward in ways that are thought to be in the best interests of the company and to cost-efficient financing.

Within any series of a class, all shares should carry the same rights. Investors can expect to be informed regarding their voting rights before they invest. Once they have invested, their rights should not be changed unless those holding voting shares have had the opportunity to participate in the decision. Proposals to change the voting rights of different series and classes of shares should be submitted for approval at general shareholder meetings by a specified (normally higher) majority of voting shares in the affected categories.

II.F. Related party transactions should be approved and conducted in a manner that ensures proper management of conflicts of interest and protects the interests of the company and its shareholders.

II.F.1. Conflicts of interest inherent in related party transactions should be addressed.

The potential abuse of related party transactions is an important policy issue in all markets, but particularly in those where corporate ownership is concentrated and corporate groups prevail. Banning these transactions is normally not a solution as there is nothing wrong per se with entering into transactions with related parties, provided that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure. This is all the more important where significant portions of income and/or costs arise from transactions with related parties.

Jurisdictions should put in place an effective framework for clearly flagging these transactions. They should include broad but precise definitions of what is understood to be a related party. They should also include rules to disregard some of these transactions when they are not material because they do not exceed *ex ante* thresholds, can be regarded as recurrent and taking place at verifiable market terms, or take place with subsidiaries where no specific interest of a related party is present. Once the related party transactions have been identified, jurisdictions set procedures for approving them in a manner that minimises their negative potential. In many jurisdictions, great emphasis is placed on board approval supported by the audit committee review, often with a prominent role for independent members. Jurisdictions may also require the board to justify the interest of the transaction for the company and the fairness of its terms. Many jurisdictions require or recommend as good practice for interested board members to abstain from board decisions on related party transactions.

As an alternative or complement to board approval, shareholders may be given a say in approving certain transactions, which in some jurisdictions requires the approval of non-interested shareholders. This may include, in particular, large or non-routine transactions or those in which board members have an interest. Some jurisdictions also require an opinion or evaluation on the fairness of the transaction's proposed price or value by an external auditor or independent outside specialist, in some cases as a precondition for shareholder approval.

II.F.2. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

Members of the board, key executives and, in some jurisdictions, controlling shareholders have an obligation to inform the board where they have a business, family or other special relationship outside of the company that could affect their judgement with respect to a particular transaction or matter affecting the company. Such special relationships include situations where executives and board members have a relationship with the company via their association with a shareholder who is in a position to exercise control. Where a material interest has been declared, many jurisdictions require or recommend as good practice for that person not to be involved in any decision involving the transaction or matter and for the decision of the board to be specifically motivated against the presence of such interest and/or to justify the interest of the transaction for the company, notably by mentioning the terms of the transaction.

II.G. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Abusive self-dealing should be prohibited.

Many publicly traded companies have controlling shareholders. While the presence of controlling shareholders can reduce the agency problem through closer monitoring of management, weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company. Abusive self-dealing occurs when persons having close relationships to the company, including controlling shareholders, exploit those relationships to the detriment of the company and investors.

The potential for abuse is marked where the legal system allows, and the market accepts, controlling shareholders to exercise a level of control that does not correspond to the level of risk that they assume as owners by exploiting legal devices to separate ownership from control. Such abuse may be carried out in various ways, including the extraction of direct private benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic bias in business decisions and changes in the capital structure through special issuance of shares favouring the controlling shareholder. In addition to disclosure, a key mechanism for addressing such potential for abuse is the existence of a clearly articulated duty of loyalty by board members to the company and to all shareholders. Indeed, abuse of minority shareholders is most pronounced in those jurisdictions where the legal and regulatory framework is weak in this regard. A particular issue arises in some jurisdictions where groups of companies are prevalent and where the duty of loyalty of a board member might be ambiguous and even interpreted as to the group. In these cases, some jurisdictions have developed sets of rules to control negative effects, including by specifying that a transaction in favour of another group company must be offset by receiving a corresponding benefit from other companies of the group. A key underlying principle for board members who are working within the structure of a group of companies is that even though a company might be controlled by another company, the duty of loyalty of a board member is related to the company and all of its shareholders and not to the controlling company of the group.

Other common provisions to protect minority shareholders that have proven effective include pre-emptive rights in relation to share issues, qualified majorities for certain shareholder decisions and the possibility to use cumulative voting in electing members of the board. Considering that some group structures may lead to disproportionate and opaque control, and the risks this may create with respect to the rights of non controlling shareholders, some jurisdictions place limitations on certain structures of company groups such as cross-shareholdings. Under certain circumstances, some jurisdictions require or permit controlling shareholders to buy-out the remaining shareholders at a share price that is established through an independent appraisal. This is particularly important when controlling shareholders decide to de-list a company. Other means of improving minority shareholder rights include derivative and class action lawsuits. Most regulators have established mechanisms to receive and investigate complaints from shareholders, and some have the possibility to support lawsuits through disclosure of relevant information (including

whistleblowing mechanisms) and/or funding. With the common aim of improving market credibility, the choice and ultimate design of different provisions to protect minority shareholders necessarily depends on the overall regulatory framework and the national legal system.

II.H. Markets for corporate control should be allowed to function in an efficient and transparent manner.

II.H.1. The rules and procedures governing the acquisition of corporate control in capital markets, extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

II.H.2. Anti-takeover devices should not be used to shield management and the board from accountability.

In some jurisdictions, companies employ anti-takeover devices. However, both investors and stock exchanges have expressed concern over the possibility that widespread use of anti-takeover devices may be a serious impediment to the functioning of the market for corporate control. In some instances, takeover defences can simply be devices to shield the management or the board from shareholder monitoring. In implementing any anti-takeover devices and in dealing with takeover proposals, the fiduciary duty of the board to shareholders and the company must remain paramount. Some jurisdictions provide options for exit at a fair and reasonable market price to dissenting shareholders in case of major corporate restructurings including mergers and amalgamations.

III. Institutional investors, stock markets, and other intermediaries

The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.

In order to be effective, the legal and regulatory framework for corporate governance must be developed with a view to the economic reality in which it is to be implemented. In many jurisdictions, the real world of corporate governance and ownership is no longer characterised by a straight and uncompromised relationship between the performance of the company and the income of the ultimate beneficiaries of shareholdings. In reality, the investment chain is often long and complex, with numerous intermediaries that stand between the ultimate beneficiary and the company. The presence of intermediaries acting as independent decision makers influences the incentives and the ability to engage in corporate governance.

The share of investments held by institutional investors such as mutual funds, pension funds, insurance companies and hedge funds has increased significantly, and many of their assets are managed by specialised asset managers. The ability and interest of institutional investors and asset managers to engage in corporate governance vary widely. For some, engagement in corporate governance, including the exercise of voting rights, is a natural part of their business model. Others may offer their beneficiaries and clients a business model and investment strategy that does not include or motivate spending resources on active shareholder engagement. If shareholder engagement is not part of the institution's business model and investment strategy, mandatory requirements to engage, for example through voting, may or may not be effective and could potentially lead to a box-ticking approach.

The *Principles* recommend that institutional investors disclose their policies for corporate governance with respect to their investments. Voting at shareholder meetings is, however, only one channel for shareholder engagement. Direct contact and dialogue with the board and management represent other forms of shareholder engagement that are frequently used. In many jurisdictions, codes on shareholder engagement ("stewardship codes") have been introduced as a complementary governance tool with the aim of strengthening both institutional investor accountability and their role in holding company boards and management accountable. Where corporate governance codes apply on a "comply or explain" basis, the role of institutional investors as shareholders is particularly important in holding companies accountable for their explanations of departures from the provisions of those codes.

III.A. The corporate governance framework should facilitate and support institutional investors' engagement with their investee companies. Institutional investors acting in a fiduciary capacity should disclose their policies for corporate governance and voting with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights. Stewardship codes may offer a complementary mechanism to encourage such engagement.

The effectiveness and credibility of the entire corporate governance framework and company oversight could depend in part on institutional investors' willingness and ability to make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest. While this principle does not necessarily require institutional investors to vote their shares, it calls for potential

disclosure of their policies on how they exercise their shareholder rights with due consideration to cost effectiveness. For institutions acting in a fiduciary capacity, such as pension funds, collective investment schemes and some activities of insurance companies, as well as asset managers, the right to vote could be considered part of the value of the investment being undertaken on behalf of their clients. Failure to exercise the ownership rights could potentially result in a loss to the investor who should therefore be made aware of the policy to be followed by the institutional investors.

In some jurisdictions, the demand for disclosure of policies for corporate governance and voting to the market is quite detailed and includes requirements for explicit strategies regarding the circumstances in which the institution will intervene in a company, the approach it will use for such intervention, and how it will assess the effectiveness of the strategy. Disclosure of actual voting records is recognised as good practice, especially where an institution has a declared policy to vote. Disclosure is either to their clients (only with respect to the securities of each client) or, in the case of investment advisors to registered investment companies, to the market via public disclosure.

As part of an engagement policy, institutional investors can establish a continued dialogue with portfolio companies either on company-specific matters or non-diversifiable factors affecting their entire portfolio. Such a dialogue between institutional investors and companies should be encouraged, although it is incumbent on the company to treat all investors equally and not to divulge information to the institutional investors which is not at the same time made available to the market. The additional information provided by a company would normally therefore include general background information about the markets in which the company is operating and further elaboration of information already available to the market.

Stewardship codes have become a well-established practice in many jurisdictions as a complement to other disclosure requirements for institutional investors on their engagement and voting policies. Most codes on shareholder engagement leave it to institutional investors' discretion whether to apply the code or not. This voluntary and flexible approach has been conceived to allow investors to adapt the codes to their respective investment strategies. Some jurisdictions also have established an implementation mechanism for such codes to ensure compliance and to promote best practice reporting. Some jurisdictions also value carrying out periodic updates and monitoring of these codes to ensure their relevance and oversee their effective implementation.

When institutional investors have developed and disclosed corporate governance and stewardship policies, effective implementation requires that they also set aside the appropriate human and financial resources to pursue these policies in a way that their beneficiaries and portfolio companies can expect. The nature and practical implementation of active corporate governance and voting policies by such institutional investors, including staffing, should be transparent to clients who rely on institutional investors with active corporate governance and stewardship policies.

III.B. Votes should be cast by custodians or nominees in line with the directions of the beneficial owner of the shares.

Custodian institutions holding securities as nominees for customers should not be permitted to cast the votes on those securities unless they have received specific instructions to do so. In some jurisdictions, listing requirements contain broad lists of items on which custodians may not vote without instruction, while leaving this possibility open for certain routine items. Rules should require that either investment advisors or custodian institutions provide shareholders with timely information concerning their options in the exercise of their voting rights. Shareholders may elect to vote by themselves or to delegate all voting rights to custodians. Alternatively, shareholders may choose to be informed of all upcoming shareholder votes and may decide to cast some votes while delegating some voting rights to the custodian.

Holders of depository receipts should be provided with the same ultimate rights and practical opportunities to participate in corporate governance as are accorded to holders of the underlying shares. Where the direct holders of shares may use proxies, the depository, trust office or equivalent body should therefore issue

proxies on a timely basis to depository receipt holders. The depository receipt holders should be able to issue binding voting instructions with respect to the shares, which the depository or trust office holds on their behalf.

It should be noted that this principle does not apply to the exercise of voting rights by trustees or other persons acting under a special legal mandate (such as, for example, bankruptcy receivers and estate executors).

III.C. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

The incentives for intermediary owners to vote their shares and exercise key ownership functions may, under certain circumstances, differ from those of direct owners. Such differences may sometimes be commercially sound but may also arise from conflicts of interest which are particularly acute when the fiduciary institution is a subsidiary or an affiliate of another financial institution, and especially an integrated financial group. When such conflicts arise from material business relationships, for example through an agreement to manage the portfolio company's funds, they should be identified and disclosed.

At the same time, institutions should disclose what actions they are taking to minimise the potentially negative impact on their ability to exercise key shareholder rights to the extent applicable under a jurisdiction's law. Such actions may include the separation of bonuses for fund management from those related to the acquisition of new business elsewhere in the organisation. Fee structures for asset management and other intermediary services should be transparent.

III.D. The corporate governance framework should require that entities and professionals that provide analysis or advice relevant to decisions by investors, such as proxy advisors, analysts, brokers, ESG rating and data providers, credit rating agencies and index providers, where regulated, disclose and minimise conflicts of interest that might compromise the integrity of their analysis or advice. The methodologies used by ESG rating and data providers, credit rating agencies, index providers and proxy advisors should be transparent and publicly available.

The investment chain from ultimate owners to corporations involves not only multiple intermediary owners but also a wide variety of professions that offer advice and services to intermediary owners. Proxy advisors who offer recommendations to institutional investors on how to vote and sell services that help in the process of voting are among the most relevant from a direct corporate governance perspective. In some cases, proxy advisors also offer corporate governance-related consulting services to corporations. Credit rating agencies rate companies according to their ability to meet their debt obligations and ESG rating providers rate companies according to various environmental, social and governance (ESG) criteria. Analysts and brokers perform similar roles and face the same potential conflicts of interest.

Considering the importance of – and sometimes dependence on – various services in corporate governance, the corporate governance framework should promote the integrity of regulated entities and professionals that provide analysis or advice relevant to decisions by investors, such as proxy advisors, analysts, brokers, ESG rating and data providers, credit rating agencies, and index providers. These service providers, particularly ESG rating and index providers, can have significant impact on companies' governance and sustainability policies and practices given their rating methodologies and index inclusion criterion. Therefore, the methodologies used by regulated service providers that produce ratings, indices and data should be transparent and publicly available to clients and market participants. This is particularly important when they are also referenced as metrics for regulatory purposes. Exclusive reliance on ratings in regulation may raise questions, while the process for deciding which ratings are eligible for use for regulatory purposes should be transparent and could be subject to evaluation at various levels of frequency. IOSCO's November 2022 Call for Action covers good practices for ESG ratings and data providers and is addressed to voluntary

standard-setting bodies and industry associations operating in financial markets to promote good practices among their members.

At the same time, conflicts of interest may arise and affect judgement, such as when the provider of advice, rating or data is also seeking to provide other services to the company in question, when the provider or its owner have a direct material interest in the company or its competitors, or when the rating provider is at the same time an index provider who will decide on companies' inclusion in an index based on the rating they produce. Many jurisdictions have adopted regulations or voluntary codes of conduct or have encouraged the implementation of self-regulatory codes designed to mitigate such conflicts of interest or other risks related to integrity, and have provided for private and/or public monitoring arrangements.

Many jurisdictions require or recommend that proxy advisors disclose publicly and/or to investor clients the research and methodology that underpin their recommendations, and the criteria for their voting policies relevant for their clients. Some jurisdictions require that proxy advisors apply and disclose a code of conduct, and disclose information on their research, advice and voting recommendations and any conflict of interest or business relationships that may influence their research, advice or voting recommendations, and the actions they have undertaken to eliminate, mitigate or manage the actual or potential conflicts of interest. In some cases, requirements for proxy advisors include developing appropriate human and operational resources to effectively perform their functions.

III.E. Insider trading and market manipulation should be prohibited and the applicable rules enforced.

As insider trading and market manipulation undermine public confidence in and the effective functioning of capital markets, they are prohibited by securities regulations, company law and/or criminal law in most jurisdictions. These practices can be seen as constituting a breach of good corporate governance as they violate the principle of equitable treatment of shareholders. However, the effectiveness of such prohibition depends on vigorous enforcement action.

III.F. For companies who are listed in a jurisdiction other than their jurisdiction of incorporation, the applicable corporate governance laws and regulations should be clearly disclosed. In the case of cross-listings, the criteria and procedure for recognising the listing requirements of the primary listing should be transparent and documented.

It is increasingly common that companies are listed or traded at venues located in a different jurisdiction than the one where the company is incorporated. This may create uncertainty among investors about which corporate governance rules and regulations apply to that company. It may concern everything from procedures and locations for the annual shareholder meeting to minority rights. The company should therefore clearly disclose which jurisdiction's rules are applicable. When key corporate governance provisions fall under another jurisdiction than the jurisdiction of trading, the main differences should be noted.

Another important consequence of increased internationalisation and integration of stock markets is the prevalence of secondary listings of an already listed company on another stock exchange, so called cross-listings. Companies with cross-listings are often subject to the regulations and authorities of the jurisdiction where they have their primary listing. In case of a secondary listing, exceptions from local listing rules are typically granted based on the recognition of the listing requirements and corporate governance regulations of the exchange where the company has its primary listing. Stock markets should clearly disclose the rules and procedures that apply to cross listings and related exceptions from local corporate governance rules.

III.G. Stock markets should provide fair and efficient price discovery as a means to help promote effective corporate governance.

Effective corporate governance means that shareholders should be able to monitor and assess their corporate investments by comparing market-related information with the company's information about its prospects and performance. When shareholders believe it is advantageous, they can either use their voice

to influence corporate behaviour, sell their shares (or buy additional shares), or re-evaluate a company's shares in their portfolios. The quality of and access to market information including fair and efficient price discovery regarding their investments is therefore important for shareholders to exercise their rights.

All types of investors, whether they follow active or passive investment strategies, have relevant roles to play in contributing to well-functioning capital markets and efficient price discovery. In this regard, the quality of and access to market and company-specific information is key, notably for those using this information to follow active corporate governance strategies.

IV. Disclosure and transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, sustainability, ownership, and governance of the company.

In most jurisdictions a large amount of information, both mandatory and voluntary, is compiled on publicly traded and large unlisted companies, and subsequently disseminated to a broad range of users. Public disclosure is typically required, at a minimum, on an annual basis though some jurisdictions require periodic disclosure on a semi-annual or quarterly basis, or ad hoc disclosure in the case of material related party transactions and other material developments affecting the company. Companies often make voluntary disclosure that goes beyond minimum disclosure requirements in response to market demand.

The *Principles* support timely disclosure of all material developments that arise between regular reports. They also support simultaneous reporting of material or required information to all shareholders in order to ensure their equitable treatment, a fundamental principle that companies must uphold.

Disclosure requirements should not place unreasonable administrative or cost burdens on companies. Nor should companies be expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform an investor's decisions and to avoid misleading the investor. In order to determine what information should be disclosed at a minimum, many jurisdictions apply the concept of materiality. Material information can be defined as information whose omission or misstatement can reasonably be expected to influence an investor's assessment of a company's value. This would typically include the value, timing and certainty of a company's future cash flows. Material information can also be defined as information that a reasonable investor would consider important in making an investment or voting decision.

A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their shareholder rights on an informed basis. Experience shows that disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in capital markets. By contrast, weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole. Shareholders and potential investors require access to regular, timely, reliable and comparable information in sufficient detail for them to assess the performance of the company's management, and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital, and result in a poor allocation of resources.

While corporate disclosure should focus on what is material to investors' decisions and may include an assessment of a company's value, it may also help improve public understanding of the structure and activities of companies, corporate policies and performance with respect to environmental, social and governance matters.

IV.A. Disclosure should include, but not be limited to, material information on:

IV.A.1. The financial and operating results of the company.

Audited financial statements showing the financial performance and the financial situation of the company (most typically including the balance sheet, the profit and loss statement, the cash flow statement and notes to the financial statements) are the most widely used source of information on companies. They enable appropriate monitoring to take place and also help to value securities. Management's discussion and analysis of operations is typically included in annual reports. This discussion is most useful when read in conjunction with the accompanying financial statements. Investors are particularly interested in information that may shed light on the future performance of the company.

Arguably, failures of governance can often be linked to the failure to disclose the "whole picture". It is therefore important that transactions relating to an entire company group be disclosed in line with high quality internationally recognised standards and include information about contingent liabilities and off-balance sheet transactions, as well as special purpose entities.

IV.A.2. Company objectives and sustainability-related information.

In addition to their commercial objectives, companies should disclose material policies and performance metrics related to environmental and social matters, as elaborated on sustainability disclosure in Chapter VI.

IV.A.3. Capital structures, group structures and their control arrangements.

Some capital structures such as pyramid structures, cross-shareholdings and shares with limited or multiple voting rights allow shareholders to exercise a degree of control over the corporation disproportionate to their equity ownership in the company.

Company groups are often complex structures that involve several layers of subsidiaries, including across different sectors and jurisdictions. These structures may limit the ability of non-controlling shareholders of the parent and subsidiary companies to influence corporate policies and understand the risks involved, and may allow controlling shareholders to extract private benefits from group companies.

In addition to ownership relations, other devices can affect control over the corporation. Shareholder agreements are a common means for groups of shareholders, who individually may hold relatively small shares of total equity, to act in concert so as to constitute an effective majority, or at least the largest single block of shareholders. Shareholder agreements usually give those participating in the agreements preferential rights to purchase shares if other parties to the agreement wish to sell. These agreements can also contain provisions that require those accepting the agreement not to sell their shares for a specified time. Shareholder agreements can cover issues such as how the board or the chair will be selected. The agreements can also oblige those in the agreement to vote as a block. Some jurisdictions have found it necessary to closely monitor such agreements and to limit their duration.

Voting caps limit the number of votes that a shareholder may cast, regardless of the number of shares the shareholder may actually possess. Voting caps therefore redistribute control and may affect the incentives for shareholder participation in shareholder meetings.

Given the potential of these mechanisms to redistribute the influence of shareholders on company policy, and also its relevance for the enforcement of takeover regulation, the disclosure of such capital structures, group structures and their control arrangements should be required. Disclosure about such schemes also allows shareholders, debtholders and potential investors to make better informed decisions.

IV.A.4. Major share ownership, including beneficial owners, and voting rights.

One of the basic rights of investors is to be informed about the ownership structure of the company and their rights vis-à-vis the rights of other owners. The right to such information should also extend to information about the structure of a group of companies and intra-group relations. Such disclosures should make the

objectives, nature and structure of the group transparent. Disclosure of ownership data should be provided once certain thresholds of ownership are passed. In equity markets characterised by dispersed ownership structures where small shareholdings may exert significant influence over a company, these thresholds could be set lower. Such disclosure might include data on major shareholders and others that, directly or indirectly, may significantly influence or control the company through, for example, special voting rights, shareholder agreements, the ownership of controlling or large blocks of shares, the use of holding company structures involving layering of companies or significant cross-shareholding relationships and cross guarantees. It is also required or considered good practice in some jurisdictions to disclose shareholdings of directors, including non-executives, and it is good practice that such disclosure is made on an ongoing basis.

For enforcement purposes in particular, and to identify potential conflicts of interest, related party transactions, insider trading and market manipulation, information about record ownership needs to be complemented with current information about beneficial ownership. An increasing number of jurisdictions use a centralised national registry while others may require a company-level registry to facilitate access to up-to-date and accurate information on beneficial ownership. In cases where such registries are not available, information about the beneficial owners should be obtainable at least by regulatory and enforcement agencies and/or through the judicial process. In addition, guidance issued by the Financial Action Task Force and the IMF that advocates a multi-pronged approach to ensure availability of information on beneficial ownership can be useful in this regard.

IV.A.5. Information about the composition of the board and its members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

Investors require information on individual board members and key executives in order to evaluate their experience and qualifications and assess any potential conflicts of interest that might affect their judgement. Information is also important to enable investors to assess the collective experience and qualifications of the board. For board members, standardised information should include their qualifications, share ownership in the company, membership of other boards and board committees, other executive positions, and whether they are considered by the board to be an independent member. This information may also refer to directors' compliance with applicable independence criteria. It is important to disclose membership of other boards not only because it is an indication of experience and possible time pressures facing a member of the board, but also because it may reveal potential conflicts of interest and makes transparent the degree to which there are inter-locking boards.

Several jurisdictions have concluded that companies should disclose the selection process and especially whether it was open to a broad field of candidates. Such information should be provided in advance of any decision by the general shareholder's meeting or on a continuing basis if the situation has changed materially.

Many jurisdictions require or recommend disclosure of the composition of boards, including on gender diversity. Such disclosure may also extend to other criteria such as age and other demographic characteristics, in addition to professional experience and expertise. Some jurisdictions that have established such requirements or recommendations in codes also request disclosure on a "comply or explain" basis. In some cases this includes the disclosure of the composition of management boards in two-tier board systems, and of executive or other senior management positions.

IV.A.6. Remuneration of members of the board and key executives.

Information about board and executive remuneration is also of concern to shareholders, including the link between remuneration and the company's long-term performance, sustainability and resilience. Companies are generally expected to disclose timely information including material changes on the remuneration policies applied to board members and key executives, as well as remuneration levels or

amounts on a standardised and comparable basis, so that investors can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance. Disclosure on an individual basis (including termination and retirement provisions) is increasingly regarded as good practice and is now required or recommended in most jurisdictions. Some of these jurisdictions call for remuneration of a certain number of the highest paid executives to be disclosed, while in others it is confined to specified positions. The existence of directors' and corporate officers' liability insurance may also change managerial incentives, thus warranting disclosure of liability insurance policies. The use of sustainability indicators in remuneration may also warrant disclosure that allows investors to assess whether indicators are linked to material sustainability risks and opportunities and incentivise a long-term view.

IV.A.7. Related party transactions.

To ensure that the company is being run with due regard to the interests of all its investors, it is essential to fully disclose all material related party transactions and the terms of such transactions to the market individually. In many jurisdictions this is indeed already a legal requirement. In case the jurisdiction does not define materiality, companies should be required to also disclose the policy/criteria adopted for determining material related party transactions. Related parties should at least include entities that control or are under common control with the company, significant shareholders including members of their families and key management personnel. While the definition of related parties in internationally accepted accounting standards provides a useful reference, the corporate governance framework should ensure that all related parties are properly identified and that in cases where specific interests of related parties are present, material transactions with consolidated subsidiaries are also disclosed. Complicated group structures may increase the opaqueness inherent in related party transactions and the possibility of circumventing disclosure requirements. Special consideration should be given to whether the corporate governance framework properly identifies all related parties in jurisdictions with complex group structures involving publicly traded companies.

Transactions involving the major shareholders (or their close family, relations, etc.), either directly or indirectly, are potentially the most difficult type of related party transactions to monitor with a view to ensuring equal treatment of all shareholders. In some jurisdictions, shareholders above a limit as low as five per cent of shareholding are obliged to report transactions. Disclosure requirements include the nature of the relationship where control exists, and the nature, value and number of transactions with related parties, grouped as appropriate. Given the inherent opaqueness of many transactions, the obligation may need to be placed on the beneficiary to inform the board about the transaction, which in turn should disclose it to the market. This should not absolve the company from maintaining its own monitoring, which is an important task for the board.

To make disclosure more informative, many jurisdictions distinguish related party transactions according to their materiality, terms and conditions. Ongoing disclosure of material transactions is required, with a possible exception for recurrent transactions on "market terms", which can be disclosed only in periodic reports. To be effective, disclosure thresholds may need to be based mainly on quantitative criteria, but avoidance of disclosure through splitting of transactions with the same related party should not be permitted.

IV.A.8. Foreseeable risk factors.

Users of financial information and market participants need information on reasonably foreseeable material risks that may include: risks that are specific to the industry or the geographical areas in which the company operates; dependence on commodities and supply chains; financial market risks including interest rate or currency risk; risks related to derivatives and off-balance sheet transactions; business conduct risks; digital security risks; compliance risks; and sustainability risks, notably climate-related risks.

The *Principles* envision the disclosure of sufficient and comprehensive information to fully inform investors and other users of the reasonably foreseeable material risks of the company. Disclosure of risk is most

effective when it is tailored to the particular company and industry in question. Disclosure about the system for monitoring and managing risk is increasingly regarded as good practice, including the nature and effectiveness of related due diligence processes.

IV.A.9. Governance structures and policies, including the extent of compliance with national corporate governance codes or policies and the process by which they are implemented.

Companies should report their corporate governance practices and such disclosure should be mandated as part of the regular reporting. Companies should implement corporate governance principles set, or endorsed, by the regulatory or listing authority with mandatory reporting on a “comply or explain” or similar basis. In most jurisdictions, a national report reviewing adherence to the corporate governance code by publicly traded companies is published as a good practice to support effective disclosure and implementation of “comply or explain” codes.

Disclosure of the governance structures and policies of the company, including, in the case of non operating holding companies, that of significant subsidiaries, is important for the assessment of a company’s governance and should cover the division of authority between shareholders, management and board members. Companies should clearly disclose the different roles and responsibilities of the CEO and/or chair and, where a single person combines both roles, the rationale for this arrangement. It is also good practice to disclose the articles of association, board charters and, where applicable, committee structures and charters.

As a matter of transparency, procedures for shareholders meetings should ensure that votes are properly counted and recorded, and that a timely announcement of the outcome is made.

IV.A.10. Debt contracts, including the risk of non-compliance with covenants.

Under normal circumstances, shareholders and directors control the major decisions taken by a company. However, certain provisions in corporate bonds and other debt contracts may significantly limit the discretion of management and shareholders, such as covenants that restrict dividend payouts, require creditors’ approval for the divestment of major assets, or penalise debtors if financial leverage exceeds a predetermined threshold. Moreover, under financial stress but before bankruptcy, companies may choose to negotiate a waiver of compliance with a covenant, when existing creditors may require changes in the business. As a consequence, the timely disclosure of material information on debt contracts, including the impact of material risks related to a covenant breach and the likelihood of their occurrence, in accordance with applicable standards, is necessary for investors to understand a company’s business risks.

IV.B. Information should be prepared and disclosed in accordance with internationally recognised accounting and disclosure standards.

The application of high quality accounting and disclosure standards is expected to significantly improve the ability of investors to monitor the company by providing increased relevance, reliability and comparability of reporting, and improved insight into company performance and risks. Most jurisdictions mandate the use of internationally recognised standards for financial reporting, which can serve to improve transparency and the comparability of financial statements and other financial reporting between jurisdictions. Such standards should be developed through open, independent and public processes involving the private sector and other interested parties such as investors, professional associations and independent experts. High quality domestic standards can be achieved by making them consistent with one of the internationally recognised accounting standards.

IV.C. An annual external audit should be conducted by an independent, competent and qualified auditor in accordance with internationally recognised auditing, ethical and independence standards in order to provide reasonable assurance to the board and shareholders on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

The external auditor provides an opinion as to whether the financial statements present fairly, in all material respects, the financial position and financial performance of a company. The external auditor's report should also include an acknowledgement that the financial statements are the responsibility of the company's management. In some jurisdictions, the external auditors are also required to report on the company's corporate governance or internal controls over financial reporting.

The independence and ethical conduct of external auditors and their accountability to shareholders should be required and they should conduct the audit in the public interest. Moreover, the *IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence* states that "standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation". Monitoring threats to independence should be the responsibility of both the external auditor and the audited company, including its audit committee or an equivalent body.

The audit committee or an equivalent body should provide oversight of the internal audit activities and should also be charged with overseeing the overall relationship with the external auditor including the appointment, reappointment and compensation of external auditors, as well as approving and monitoring the nature of non-audit services provided by the auditor to the company. Provision of non-audit services by the external auditor to a company can impair their independence and might involve them auditing their own work or present other threats to independence. To deal with such potential threats, some jurisdictions require the disclosure of payments to external auditors for non-audit services. Examples of other provisions designed to promote external auditor independence include a ban or severe limitation on the nature of non-audit work which can be undertaken by an auditor for their audit client; periodic communications to the audit committee discussing the nature, timing and fees of the non-audit work (including the approval of such work) as well as relationships that may threaten auditor independence; mandatory rotation of auditors (either partners or in some cases the audit company); a fixed tenure for auditors; joint audits; a temporary ban on the employment of an ex-auditor by the audited company; and prohibiting auditors or their dependents from having a financial stake or management role in the companies they audit. Some jurisdictions take a more direct regulatory approach and limit the percentage of non-audit income that the auditor can receive from a particular client or limit the total percentage of auditor income that can come from one client.

Further, a system of audit oversight and audit regulation plays an important role in enhancing auditor independence and audit quality. Consistent with the Core Principles of the International Forum of Independent Audit Regulators (IFIAR), the designation of an audit regulator, independent from the profession, and who, at a minimum, conducts recurring inspections of auditors undertaking audits of public interest entities, contributes to ensuring high quality audits that serve the public interest. In addition, regulators should have at their disposal a comprehensive and effective range of regulatory tools, including disciplinary measures/sanctions, independent investigatory powers vis-à-vis auditors under their jurisdictions, and the authority to communicate disciplinary measures/sanctions to the public to address any breaches of professional or statutory duties by an external auditor in a proportionate manner.

Finally, an issue which has arisen in some jurisdictions concerns the pressing need to ensure the competence of the audit profession. A registration process for individuals to confirm their qualifications is considered good practice or required in some jurisdictions. This needs, however, to be supported by ongoing

training and monitoring of work experience to ensure appropriate levels of professional competence and scepticism.

IV.D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit in the public interest.

The practice that external auditors are recommended by an independent audit committee of the board or an equivalent body and are elected, appointed or approved either by that committee/body or by the shareholders' meeting directly can be regarded as good practice since it clarifies that the external auditor should be accountable to the shareholders. It also underlines that the external auditor owes a duty of professional care to the company rather than any individual or group of corporate managers that they may interact with for the purpose of their work. This practice, however, should not be seen as precluding other bodies such as the audit committee from making such appointments. To enhance accountability to shareholders, shareholders should have the possibility to communicate directly with the audit committee or an equivalent body regarding its oversight of the external auditor, for example by disclosures, including of the methodology for assessing the auditor's performance, or by participation of the audit committee or external auditor in shareholder meetings.

IV.E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

Channels for the dissemination of information can be as important as the content of the information itself. While the disclosure of information is often provided for by legislation, filing and access to information can be cumbersome and costly. Filing of statutory reports has been greatly enhanced in some jurisdictions by electronic filing and data retrieval systems. Jurisdictions should move to the next stage by integrating different sources of company information, including shareholder filings. Easily accessible and user friendly company websites also provide the opportunity for improving information dissemination, and most jurisdictions now require or recommend companies to have a website that provides relevant and significant information about the company itself.

Provisions for ongoing disclosure which includes periodic disclosure and continuous or current disclosure which must be provided on an ad hoc basis should be required. With respect to continuous/current disclosure, good practice is to call for "immediate" disclosure of material developments, whether this means "as soon as possible" or is defined as a prescribed maximum number of specified days. The *IOSCO Principles for Periodic Disclosure by Listed Entities* set guidance for the periodic reports of companies that have securities listed or admitted to trading on a regulated market in which retail investors participate. The *IOSCO Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities* set forth common principles of ongoing disclosure and material development reporting for listed companies.

V. The responsibilities of the board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Board structures and procedures vary both within and among jurisdictions. Some jurisdictions have two tier boards that separate the supervisory function and the management function into different bodies. Such systems typically have a “supervisory board” composed of non-executive board members, often including employee representatives, and a “management board” composed entirely of executives. Other jurisdictions have “unitary” boards, which bring together executive and non-executive board members. In some jurisdictions, there is also an additional statutory body for audit purposes. The *Principles* are intended to apply to whatever board structure is charged with the functions of governing the company and monitoring management.

Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfil their responsibilities, they must be able to exercise objective and independent judgement. Another important board responsibility is to oversee the risk management system and mechanisms designed to ensure that the corporation obeys applicable laws, including relating to tax, competition, labour, human rights, environmental, equal opportunity, digital security, data privacy and personal data protection, and health and safety. In some jurisdictions, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable.

The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take account of, and deal fairly with, stakeholder interests including those of the workforce, creditors, customers, suppliers and affected communities.

V.A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders, taking into account the interests of stakeholders.

This Principle states the two key elements of the fiduciary duty of board members: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. In some jurisdictions there is a standard of reference which is the behaviour that a reasonably prudent person would exercise in similar circumstances. Good practice takes acting on a fully informed basis to mean that board members should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board advocated by the *Principles*. In many jurisdictions, this meaning is already considered an element of the duty of care, while in others it is required by securities regulation, accounting standards, etc.

The duty of loyalty is of central importance, since it underpins the effective implementation of other principles relating to, for example, the equitable treatment of shareholders, monitoring of related party transactions and the establishment of the remuneration policy for key executives and board members. It is also a key principle for board members who are working within the structure of a group of companies: even though a company

might be controlled by another company, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group.

Board members should take account of, among other things, the interests of stakeholders, when making business decisions in the interest of the company's long-term success and performance and in the interest of its shareholders. This may help companies, for example, to attract, retain and develop more productive employees, to be supported by the communities in which they operate, and to have more loyal customers, thus creating value for their shareholders.

V.A.1. Board members should be protected against litigation if a decision was made in good faith with due diligence.

Protecting board members and management against litigation, if they made a business decision diligently, with procedural due care, on a duly informed basis and without any conflicts of interest, will better enable them to assume the risk of a decision that is expected to benefit the company but which could eventually be unsuccessful. Subject to these conditions, such a safe harbour would apply even if there are clear short-term costs and uncertain long-term negative impacts to the company, as long as managers diligently assess whether the decision could be reasonably expected to contribute to the long-term success and performance of the company.

V.B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

In carrying out its duties, the board should not be viewed, or act, as an assembly of individual representatives from various constituencies. While specific board members may indeed be nominated or elected by certain shareholders (and sometimes contested by others), it is important that board members carry out their duties in an even-handed manner with respect to all shareholders. This is particularly important in the presence of controlling shareholders who de facto may be able to select a majority of or all board members.

V.C. The board should apply high ethical standards.

The board has a key role in setting the ethical tone of a company, not only through its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long-term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations, but also with respect to longer term commitments. To make the objectives of the board clear and operational, many companies have found it useful to develop company codes of conduct based on, among others, professional standards and sometimes broader codes of behaviour, and to communicate them throughout the organisation. This may include a commitment by the company (including its subsidiaries) to comply with the *OECD Guidelines for Multinational Enterprises* and associated due diligence standards. Similarly, jurisdictions are increasingly demanding that boards oversee the lobbying, finance and tax planning strategies, thus providing authorities with timely and targeted information and discouraging practices, for example the pursuit of aggressive tax planning schemes, that do not contribute to the long-term interests of the company and its shareholders, and can cause legal and reputational risks.

Company-wide codes serve as a standard for conduct by both the board and key executives, setting the framework for the exercise of judgement in dealing with varying and often conflicting constituencies. At a minimum, the code of ethics should set clear limits on the pursuit of private interests, including dealings in the shares of the company. An overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement.

V.D. The board should fulfil certain key functions, including:

V.D.1. Reviewing and guiding corporate strategy, major plans of action, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

The board is tasked with setting the overall strategy of the company; determining the company's policies; assessing and guiding performance; and overseeing the company's financial operations. It makes important decisions as a fiduciary on behalf of the company and its shareholders. The structure and processes for carrying out these functions may vary across companies, for example with respect to size and industry or allocation of responsibilities between the supervisory and management boards in two-tier board systems. To ensure transparency on the board's duties, some jurisdictions recommend their inclusion in a board charter, the articles of association or the corporate bylaws.

V.D.2. Reviewing and assessing risk management policies and procedures.

Establishing a company's risk appetite and culture, and overseeing its risk management, including internal control, are of major importance for boards and are closely related to corporate strategy. It involves oversight of the accountabilities and responsibilities for managing risks, specifying the types and degree of risk that a company is willing to accept in pursuit of its goals, and how it will manage the risks it creates through its operations and relationships. The board's oversight thus provides crucial guidance to management in handling risks to meet the company's desired risk profile.

When fulfilling these key functions, the board should ensure that material sustainability matters are considered. With a view to increasing resilience, boards should also ensure that they have adequate processes in place within their risk management frameworks to deal with significant external company-relevant risks, such as health crises, supply chain disruptions and geopolitical tensions. These frameworks should work *ex ante* (as companies should foster their resilience in the event of a crisis) and *ex post* (as companies should be able to set up crisis management processes at the onset of a sudden negative event).

Of notable importance is the management of digital security risks, which are dynamic and can change rapidly. Risks may relate, among other matters, to data security and privacy, the handling of cloud solutions, authentication methods, and security safeguards for remote personnel working on external networks. As with other risks, these risks should be integrated more broadly within the overall cyclical company risk management framework.

Another important issue is the development of a tax risk management policy. Comprehensive risk management strategies and systems adopted by boards should include tax management and tax compliance risks, with a view to ensuring that the financial, regulatory and reputational risks associated with taxation are fully identified and evaluated.

To support the board in its oversight of risk management, some companies have established a risk committee and/or expanded the role of the audit committee, following regulatory requirements or recommendations on risk management and the evolution of the nature of risks. OECD due diligence standards on responsible business conduct are also designed to help companies in identifying and responding to environmental and social risks and impacts stemming from their operations and supply chains.

V.D.3. Monitoring the effectiveness of the company's governance practices and making changes as needed.

Monitoring of governance by the board includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organisation. Such monitoring should also include whether the company's governance framework remains appropriate in light of material changes to the company's size, complexity, business strategy, markets, and regulatory requirements. In addition to requiring the monitoring and disclosure of corporate governance practices on a regular basis, at least in summary form, many jurisdictions have moved to recommend, or indeed

mandate, assessment by boards of their performance and of the performance of their committees, individual board members, the chair and the CEO.

V.D.4. Selecting, overseeing and monitoring the performance of key executives, and, when necessary, replacing them and overseeing succession planning.

The board should oversee the performance of key executives and monitor that their actions are consistent with the strategy and policies approved by the board. The board should select the CEO and may select other key executives. In exercising this fundamental function, the board may be assisted by a nomination committee which may be tasked with defining the profiles of the CEO and board members, and making recommendations to the board on their appointment. Many jurisdictions require or recommend that all or a majority of members of the nomination committee be independent directors. The nomination committee may also help guide talent management and review policies related to the selection of key executives. In most two-tier board systems, the supervisory board is responsible for appointing the management board which normally comprises most of the key executives. The board should also be responsible for succession planning for the CEO and may also be for other key executives, with a view to ensuring business continuity. While comprising contingency mechanisms, succession planning could also be a long-term strategic tool to support talent development and diversity.

V.D.5. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

It is regarded as good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives, as well as to disclose their remuneration levels set pursuant to this policy. Such policy statements may specify, especially with respect to executives, the relationship between remuneration and performance with *ex ante* criteria linked to performance, and include measurable standards that emphasise the long-term interests of the company and the shareholders over short-term considerations. Such measurable standards among others may relate to total shareholder return and appropriate sustainability goals and metrics. Policy statements generally tend to set conditions for payments to board members for extra-board activities, such as consulting. They also often specify terms to be observed by board members and key executives about holding and trading the stock of the company, and the procedures to be followed in granting and re-pricing options. In some jurisdictions, policy statements also provide guidance on the payments to be made when hiring and/or terminating the contract of an executive. The board may also monitor the implementation of the policy statement on remuneration.

Many jurisdictions recommend or require that remuneration policy and contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors and excluding executives that serve on each other's remuneration committees, which could lead to conflicts of interest. The introduction of malus and claw-back provisions is considered good practice. They grant the company the right to withhold and recover compensation from executives in cases of managerial fraud and other circumstances, for example when the company is required to restate its financial statements due to material noncompliance with financial reporting requirements.

The design of remuneration policies and contracts for board members and key executives is critical to set incentives that are aligned with a company's business strategy, corporate governance framework and risk management. These policies, however, may not fulfil their goal if they are frequently adjusted in the absence of a significant change in the business strategy or a structural transformation of the context in which the company operates. Specifically, the likelihood of a significant economic downturn is a factor that companies reasonably should consider when designing their remuneration policies and may not necessarily justify an adjustment of these policies.

V.D.6. Ensuring a formal and transparent board nomination and election process.

The *Principles* promote an active role for shareholders in the nomination and election of board members. The board, with the support of a nomination committee if established, has an essential role to play in ensuring that the nomination and election processes are respected. First, while actual procedures for nomination may differ among jurisdictions, the board has the responsibility to make sure that established procedures are transparent and respected. Second, the board has a key role in defining the collective or individual profile of board members that the company may need at any given time, considering the appropriate knowledge, competencies and expertise to complement the existing skills of the board. Third, the board or nomination committee has the responsibility to identify potential candidates to meet desired profiles and propose them to shareholders, and/or consider those candidates advanced by shareholders. The board's engagement and dialogue with shareholders may support the effective implementation of these processes, provided that the board ensures transparency, equal treatment and that inside and business sensitive information is not disclosed. It is considered good practice to conduct open search processes extending to a broad range of backgrounds to respond to diversity objectives and evolving risks to the company.

V.D.7. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

The board should oversee the implementation and operation of policies to identify potential conflicts of interest. Where these conflicts cannot be prevented, they should be properly managed. It is an important function of the board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. This function is often assigned to the internal auditor who should maintain direct access to the board. Where other corporate officers such as the general counsel are responsible, it is important that they maintain similar reporting responsibilities as the internal auditor.

In fulfilling its control oversight responsibilities, it is important for the board to oversee the company's whistleblowing policy in order to ensure the integrity, independence and confidentiality of whistleblowing processes, and to encourage the reporting of unethical/unlawful behaviour without fear of retribution. The existence of a publicly available company code of ethics should aid this process, which should be underpinned by legal protection for the individuals concerned. A contact point for employees who wish to confidentially report concerns about unethical or illegal behaviour that might also compromise the integrity of financial statements should be offered by the audit committee or by an ethics committee or equivalent body.

V.D.8. Ensuring the integrity of the corporation's accounting and reporting systems for disclosure, including the independent external audit, and that appropriate control systems are in place, in compliance with the law and relevant standards.

The board should demonstrate a leadership role to ensure that an effective means of risk oversight is in place. Ensuring the integrity of the essential reporting and monitoring systems will require that the board sets and enforces clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is appropriate oversight by senior management.

Normally, this includes the establishment of an internal audit function. This function can play a critical role in providing ongoing support to the audit committee of the board or an equivalent body of its comprehensive oversight of the internal controls and operations of the company. The role and functions of internal audit vary across jurisdictions, but they can include assessment and evaluation of governance, risk management, and internal control processes. It is considered good practice for the internal auditors to report to an independent audit committee of the board or an equivalent body which is also responsible for managing the relationship with the external auditor, thereby allowing a co-ordinated response by the board. Both internal and external audit functions should be clearly articulated so that the board can maximise the quality of assurance it receives. It should also be regarded as good practice for the audit committee, or equivalent

body, to review and report to the board the most critical policies which are the basis for financial and other corporate reports. However, the board should retain final responsibility for oversight of the company's risk management system and for ensuring the integrity of the reporting systems. Some jurisdictions have provided for the chair of the board to report on the internal control process. Companies with large or complex risks (financial and non-financial), including company groups, should consider introducing similar reporting systems, including direct reporting to the board, with regard to group-wide risk management and oversight of controls.

Companies are also well advised to establish and ensure the effectiveness of internal controls, ethics, and compliance programmes or measures to comply with applicable laws, regulations and standards, including statutes criminalising the bribery of foreign public officials, as required under the *OECD Anti-Bribery Convention*, and other forms of bribery and corruption. Moreover, compliance must also relate to other laws and regulations such as those covering securities, taxation, competition, and work and safety conditions. Other laws that may be applicable include those relating to human rights, the environment, fraud and money laundering. Such compliance programmes will also underpin the company's code of ethics. To be effective, the incentive structure of the business needs to be aligned with its ethical and professional standards so that adherence to these values is rewarded and breaches of law are met with dissuasive consequences or penalties. Compliance programmes should also extend to subsidiaries and where possible to third parties, such as agents and other intermediaries, consultants, representatives, distributors, contractors and suppliers, consortia, and joint venture partners.

V.D.9. Overseeing the process of disclosure and communications.

The functions and responsibilities of the board and management with respect to disclosure and communication need to be clearly established by the board. In some jurisdictions, the appointment of an investor relations officer who reports directly to the board is considered good practice for publicly traded companies.

V.E. The board should be able to exercise objective independent judgement on corporate affairs.

In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the board is able to exercise objective judgement. In the first instance this will mean independence and objectivity with respect to management with important implications for the composition and structure of the board. Board independence in these circumstances usually requires that a sufficient number of board members, as well as members of key committees, will need to be independent of management.

In jurisdictions with single tier board systems, the objectivity of the board and its independence from management may be strengthened by the separation of the role of chief executive and chair. Separation of the two posts is regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision-making independent of management. The designation of a lead director who is independent of management is also regarded as a good practice alternative in some jurisdictions if that role is defined with sufficient authority to lead the board in cases where management has clear conflicts. Such mechanisms can also help to ensure high quality governance of the company and the effective functioning of the board. The chair or lead independent director may, in some jurisdictions, be supported by a company secretary.

In the case of two-tier board systems, the absence of executive directors from the supervisory board strengthens independence from management. In such systems, consideration should be given to whether corporate governance concerns might arise if there is a tradition for the head of the lower board becoming the chair of the supervisory board on retirement.

The manner in which board objectivity might be underpinned also depends on the ownership structure of the company. A controlling shareholder has considerable powers to appoint the board, and indirectly the

management. However, in this case, the board still has a fiduciary responsibility to the company and to all shareholders including minority shareholders.

The variety of board structures, ownership patterns and practices in different jurisdictions will thus require different approaches to the issue of board objectivity. In many instances objectivity requires that a sufficient number of board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members. In others, independence from controlling and substantial shareholders will need to be emphasised, in particular if the *ex ante* rights of minority shareholders are weak and opportunities to obtain redress are limited. This has led to both codes and the law in most jurisdictions to call for some board members to be independent of controlling and substantial shareholders, independence extending to not being their representative or having close business ties with them. In other cases, parties such as particular creditors can also exercise significant influence. While jurisdictions' definitions of what constitutes a substantial shareholder vary, minimum thresholds are common. Where there is a party in a special position to influence the company, there should be stringent tests to ensure the objective judgement of the board.

In defining independence for members of the board, some national codes of corporate governance or exchange listing standards have specified quite detailed presumptions for non-independence. While establishing necessary conditions, such "negative" criteria defining when an individual is not regarded as independent can usefully be complemented by "positive" examples of qualities that will increase the probability of effective independence. While national approaches to defining independence vary, a range of criteria are used, such as the absence of relationships with the company, its group and its management, the external auditor of the company and substantial shareholders, as well as the absence of remuneration, directly or indirectly, from the company or its group other than directorship fees. The board may also be required to make an affirmative finding that a director is independent of the company because they have no material relationship with the company or that the director has no relationship which would interfere with the exercise of independent judgement in carrying out the responsibilities of a director. Many jurisdictions also set a maximum tenure for directors to be considered independent.

Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisitions and the audit function. In order for them to play this key role, it is desirable that boards declare who they consider to be independent and the criterion for this judgement. Some jurisdictions also require separate meetings of independent directors on a periodic basis.

V.E.1. Boards should consider assigning a sufficient number of independent board members capable of exercising independent judgement to tasks where there is a potential for conflicts of interest. Examples of such key responsibilities are ensuring the integrity of financial and other corporate reporting, the review of related party transactions, and nomination and remuneration of board members and key executives.

While the responsibility for corporate reporting, remuneration and nomination is frequently with the board as a whole, independent board members can provide additional assurance to market participants that their interests are safeguarded. The board should consider establishing specific committees to consider questions where there is a potential for conflicts of interest. These committees should require a minimum number or be composed entirely of independent members. In some jurisdictions it is good practice that these committees be chaired by an independent non-executive member. In some jurisdictions, shareholders have direct responsibility for nominating and electing independent directors to specialised functions.

V.E.2. Boards should consider setting up specialised committees to support the full board in performing its functions, in particular the audit committee – or equivalent body – for overseeing disclosure, internal controls and audit-related matters. Other committees, such as remuneration, nomination or risk management, may provide support to the board depending upon the company’s size, structure, complexity and risk profile. Their mandate, composition and working procedures should be well defined and disclosed by the board which retains full responsibility for the decisions taken.

Where justified in terms of the size, structure, sector or level of development of the company as well as the board’s needs and the profile of its members, the use of committees may improve the work of the board and allow for a deeper focus on specific areas. In order to evaluate the merits of board committees, it is important that the market receives a full and clear picture of their mandate, scope, working procedures and composition. Such information is particularly important in the many jurisdictions where boards are required to establish independent audit committees with powers to oversee the relationship with the external auditor. Audit committees should also be able to oversee the effectiveness and integrity of the internal control system, which may include the internal audit function.

Most jurisdictions establish binding rules for the conduct and functions of an independent audit committee, and recommend nomination and remuneration committees on a “comply or explain” basis. While risk committees are commonly required for companies in the financial sector, a number of jurisdictions also regulate risk management responsibilities of non-financial companies, requiring or recommending assigning this role to either the audit committee or a dedicated risk committee. The separation of the functions of the audit and risk committees may be valuable given the greater recognition of risks beyond financial risks, to avoid audit committee overload and to allow more time for risk management issues.

The establishment of committees to advise on additional issues should remain at the discretion of the company and should be flexible and proportional according to the needs of the board. Some boards have created a sustainability committee to advise the board on social and environmental risks, opportunities, goals and strategies, including related to climate. Some boards have also established a committee to advise on the management of digital security risks as well as on the company’s digital transformation. Ad hoc or special committees can also be temporarily set up to respond to specific needs or corporate transactions. Disclosure need not extend to specific committees set up to deal with, for example, confidential commercial transactions. When established, committees should have access to the necessary information to comply with their duties, receive appropriate funding and engage outside experts or counsels.

Committees have monitoring and advisory roles, and it should be well understood that the board as a whole remains fully responsible for the decisions taken unless legally defined otherwise, and its oversight and accountability should be clear.

V.E.3. Board members should be able to commit themselves effectively to their responsibilities.

Service on too many boards or committees can interfere with the performance of board members. Some jurisdictions have limited the number of board positions that can be held. Specific limitations may be less important than ensuring that members of the board enjoy legitimacy and confidence in the eyes of shareholders. Disclosure about other board and committee memberships and chair responsibilities to shareholders is therefore a key instrument to improve board and committee nominations. Achieving legitimacy would also be facilitated by the publication of attendance records for individual board members (e.g. whether they have missed a significant number of meetings) and any other work undertaken on behalf of the board and the associated remuneration.

V.E.4. Boards should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences, including with respect to gender and other forms of diversity.

In order to improve board practices and the performance of its members, an increasing number of jurisdictions now encourage companies to engage in board and committee evaluation and training. Many corporate governance codes recommend an annual evaluation of the board, which may periodically be supported by external facilitators to increase objectivity.

Unless certain qualifications are required, such as for financial institutions, board members may need to acquire appropriate skills upon appointment through training or other means. Thereafter, such measures may also support board members to remain abreast of relevant new laws, regulations, and changing commercial and other risks.

In order to avoid groupthink and bring a diversity of thought to board discussion, evaluation mechanisms may also support boards to consider if they collectively possess the right mix of background and competences. This may be based on diversity criteria such as gender, age or other demographic characteristics, as well as on experience and expertise, for example on accounting, digitalisation, sustainability, risk management or specific sectors.

To enhance gender diversity, many jurisdictions require or recommend that publicly traded companies disclose the gender composition of boards and of senior management. Some jurisdictions have established mandatory quotas or voluntary targets for female participation on boards with tangible results. Jurisdictions and companies should also consider additional and complementary measures to strengthen the female talent pipeline throughout the company and reinforce other policy measures aimed at enhancing board and management diversity. Complementary measures may emanate from government, private and public-private initiatives and may, for example, take the form of advocacy and awareness-raising activities; networking, mentorship and training programmes; establishment of supporting bodies (women business associations); certification, awards or compliant company lists to activate peer pressure; and the review of the role of the nomination committee and of recruitment methods. Some jurisdictions have also established guidelines or requirements intended to ensure consideration of other forms of diversity, such as with respect to experience, age and other demographic characteristics.

V.F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

Board members require relevant information on a timely basis in order to support their decision-making. Non-executive board members do not typically have the same access to information as key managers within the company. The contributions of non-executive board members to the company can be enhanced by providing access to certain key managers within the company such as, for example, the company secretary, the internal auditor, and the head of risk management or chief risk officer, and granting recourse to independent external advice at the expense of the company.

In order to fulfil their responsibilities, board members should have access to and ensure that they obtain accurate, relevant and timely information. In cases when a publicly traded company is the parent of a group, the regulatory framework should also ensure board members' access to key information about the activities of its subsidiaries to manage group-wide risks and implement group-wide objectives. When board committees are established, efficient mechanisms should be put in place to ensure that the entire board has access to relevant information. At the same time, the regulatory framework should maintain safeguards to ensure that insiders will not use such information for their personal gain or that of others. Where companies rely on complex risk management models, board members should be made aware of the possible shortcomings of such models.

V.G. When employee representation on the board is mandated, mechanisms should be developed to facilitate access to information and training for employee representatives, so that this representation is exercised effectively and best contributes to the enhancement of board skills, information and independence.

When employee representation on boards is mandated by the law or collective agreements, or adopted voluntarily, it should be applied in a way that maximises its contribution to the board's independence, competence, information and diversity. Employee representatives should have the same duties and responsibilities as all other board members, and should act in the best interest of the company.

Procedures should be established to facilitate access to information, training and expertise, and ensure the independence of employee board members from the CEO and executives. These procedures should also include adequate and transparent appointment procedures, rights to report to employees on a regular basis – provided that board confidentiality requirements are duly respected – training, and clear procedures for managing conflicts of interest. A positive contribution to the board's work will also require acceptance and constructive collaboration by other members of the board as well as by management.

VI. Sustainability and resilience

The corporate governance framework should provide incentives for companies and their investors to make decisions and manage their risks, in a way that contributes to the sustainability and resilience of the corporation.

Companies play a central role in our economies by creating jobs, contributing to innovation, generating wealth, and providing essential goods and services. Countries have made commitments to transition to a sustainable, net-zero/low-carbon economy in line with the Paris Agreement and the Sustainable Development Goals, which will require companies to respond to rapidly changing regulatory and business circumstances taking into account any applicable policies and transition paths followed by different jurisdictions. In addition, many companies and investors are setting voluntary goals or otherwise taking steps to anticipate a future transition towards sustainable development. A sound corporate governance framework would allow investors and companies to consider and manage the potential risks and opportunities associated with such transition pathways, which in turn may contribute to the sustainability and resilience of the economy.

In addition, investors are increasingly considering disclosures about how companies assess, identify and manage material climate change and other sustainability risks and opportunities, including for human capital management. In response, many jurisdictions require or plan to require disclosures about companies' exposure to and management of sustainability matters. A core feature of these disclosures is to provide investors with a better understanding of the governance and management structures and processes for managing climate and other sustainability risks and identifying related opportunities. The corporate governance framework should support both the sound management of these risks and the consistent, comparable and reliable disclosure of material information in order to support investors' financial, investment and voting decisions. The combination of sound governance and clear disclosures will promote fair markets and the efficient allocation of capital, while supporting companies' long-term growth and resilience.

Several jurisdictions have oriented their capital market policies to foster a more sustainable and resilient corporate sector. In doing so, such policies should aim to also preserve access to capital markets by preventing prohibitively high costs of listing a company while still ensuring that investors have access to the information necessary to allocate capital efficiently to companies. Investors, directors and key executives must also be open to a constructive dialogue on the best strategy to support the company's sustainability and resilience. A company that takes account of stakeholder interests may be better able to attract productive workforce, support from the communities in which it operates, and more loyal customers.

In jurisdictions that allow for or require the consideration of stakeholders' interests, companies should still consider the financial interests of their shareholders. A profitable company provides jobs for its workforce and creates value for investors, many of whom are part of the general public and have invested their retirement savings.

Corporate directors are not expected to be responsible for resolving major environmental and societal challenges stemming from their duties alone. To guide corporate activities, sectoral policies that make companies internalise environmental and social externalities as well as corporate governance frameworks that set predictable boundaries within which directors have to exercise their fiduciary duties should be considered by policy makers. These policies could relate to, for instance, environmental regulation, or

directly investing in or incentivising research and development of technologies that may contribute to addressing major environmental challenges.

VI.A. Sustainability-related disclosure should be consistent, comparable and reliable, and include retrospective and forward-looking material information that a reasonable investor would consider important in making an investment or voting decision.

To ensure the efficiency of capital markets, investors must be able to compare different companies' past performance and future prospects and then decide how to allocate their capital and engage with companies. With the emergence and greater awareness of environmental and social risks, investors have been demanding better disclosure from companies on governance, strategy, risk management (e.g. overall results of risk assessments for different climate change scenarios) and sustainability-related metrics (for example related to greenhouse gas emissions and biodiversity) that are material for investors when assessing a company's business perspectives and risks.

While stakeholders may not typically be the primary users of corporate sustainability-related disclosure, disclosures may benefit such stakeholders. For instance, disclosure on collective bargaining coverage and mechanisms for workforce representation may be both material for an investor's assessment of a company's value and relevant to its workforce and other stakeholders.

At the same time, sustainability-related disclosure frameworks need to be flexible in relation to the existing capacities of companies and relevant institutions. Limiting mandatory sustainability-related disclosure to publicly traded companies might result in a disincentive for companies to go public. With these challenges in mind, policy makers may need to devise sustainability-related disclosure requirements that are flexible with respect to the size of the company and its stage of development.

Companies and their service providers, as well as regulators themselves, may face a learning curve in their understanding of sustainability matters and might need time to develop adequate processes and good practices. This may justify prioritising disclosure requirements of some of the most relevant sustainability matters, phasing in other requirements such as for independent, external assurance, or establishing some recommendations in "comply or explain" corporate governance codes.

VI.A.1. Sustainability-related information could be considered material if it can reasonably be expected to influence an investor's assessment of a company's value, investment or voting decisions.

Without prejudice to voluntary initiatives or specific environmental regulations that may contain additional disclosure requirements, corporate disclosure frameworks require at a minimum information on what is material to investors' assessment of a company's value, investment or voting decisions. This assessment typically includes the value, timing and certainty of a company's future cash flows over the short, medium and long-term.

Material sustainability-related information could include environmental and social matters that can reasonably be expected to affect a company's asset value and its ability to generate revenues and long-term growth. However, a company's own impact on society and the environment could also be considered material if it is expected to affect the company's value, such as environmental liabilities under a jurisdiction's existing laws or regulations, or greenhouse gas (GHG) emissions that may be capped or taxed in the future. Likewise, human rights and human capital policies, such as training programmes, retention policies, employee share ownership plans, and diversity strategies, can communicate important information on the competitive strengths of companies to market participants.

The determination of which information is material may vary over time, and according to the local context, company-specific circumstances, and jurisdictional requirements. The assessment of material information may also consider sustainability matters that are critical to a company's workforce and other key stakeholders. For example, sustainability risks that may not seem to be financially material in the short-

term but that are relevant to society may become financially material for a company in the long-term. In addition, some jurisdictions also consider what is material to investors to include companies' influence on non-diversifiable risks. For example, an investor may consider that the value created by a profit maximising major carbon emitting company in their portfolio would be offset by losses in the value of other investee companies affected by climate change. In this context, some jurisdictions may also require or recommend disclosing sustainability matters critical to a company's key stakeholders or a company's influence on non-diversifiable risks.

VI.A.2. Sustainability-related disclosure frameworks should be consistent with high quality, understandable, enforceable and internationally recognised standards that facilitate the comparability of sustainability-related disclosure across companies and markets.

The efficiency of capital markets is enhanced if investors are able to compare sustainability-related disclosure by companies, including those listed in different jurisdictions, helping investors decide how best to allocate their capital and engage with companies. Consistency and interoperability between regional or national sustainability-related disclosure frameworks and internationally recognised standards can still allow for flexibility of complementary local requirements, including on matters where specific geographical characteristics or jurisdictional requirements may influence materiality.

VI.A.3 Disclosure of sustainability matters, financial reporting and other corporate information should be connected.

Corporate disclosure frameworks, including financial reporting standards and regulatory filing requirements (e.g. public offering prospectuses), should have the same goal of providing information that a reasonable investor would consider important in making an investment and voting decision. It follows that information understood as material in a sustainability-related report should also be considered and assessed in the preparation and presentation of the financial statements. The same level of rigour applied to the measurement and reporting of financial information should be applied to the measurement and reporting of sustainability-related information. Ensuring such connectivity between different corporate disclosures implies the consideration of material sustainability matters in financial estimates and assumptions in the financial statements, as well as in the disclosure of risks that have had or are likely to have a material impact on a company's business.

VI.A.4. If a company publicly sets a sustainability-related goal or target, the disclosure framework should provide that reliable metrics are regularly disclosed in an easily accessible form to allow investors to assess the credibility and progress towards meeting the announced goal or target.

Sustainability-related goals, such as GHG emissions reduction targets or goals established under climate transition plans, can affect an investor's assessment of the value, timing and certainty of a company's future cash flows. These goals may also help a company to attract funding from investors to whom the relevant sustainability matters are important. Both from a market efficiency and an investor protection perspective, if a company publicly sets a sustainability-related goal or target, the disclosure framework should require sufficient disclosure of consistent, comparable and reliable metrics. This would allow investors to assess the credibility of the announced goal and management's progress towards meeting it. The disclosure may include, for instance, the definition of interim targets when a long-term goal is announced, annual consistent disclosure of relevant sustainability metrics, and possible corrective actions the company intends to take to address underperformance against a target.

VI.A.5. Phasing in of requirements should be considered for annual assurance attestations by an independent, competent and qualified attestation service provider in accordance with high quality internationally recognised assurance standards in order to provide an external and objective assessment of a company's sustainability-related disclosure.

Sustainability-related disclosures reviewed by an independent, competent and qualified attestation service provider may enhance investors' confidence in the information disclosed and the possibility to compare

sustainability-related information between companies. Wherever high quality assurance for all disclosed sustainability-related information might not be possible or is too costly, mandatory assessment for the most relevant sustainability-related metrics or disclosures, such as GHG emissions, may be considered. However, greater convergence of the level of assurance between financial statements and sustainability-related disclosures should be the long-term goal.

VI.B. Corporate governance frameworks should allow for dialogue between a company, its shareholders and stakeholders to exchange views on sustainability matters as relevant for the company's business strategy and its assessment of what matters ought to be considered material.

General shareholder meetings provide an important forum for a structured decision-making process. Dialogue between companies, shareholders, the workforce and other stakeholders may also play an essential role in informing management's decision-making process and in building trust in a long-term business strategy. While such dialogue may be useful for a range of issues, this is notably important for decisions to improve a company's sustainability and resilience, which may represent short-term cash outflows while generating long-term benefits. Such dialogue may also prove helpful for the company to assess which sustainability matters are material and, therefore, should be disclosed. When in dialogue with shareholders, the company should comply with the principle of equitable treatment of shareholders.

VI.B.1. When corporate governance frameworks allow for existing companies to adopt corporate forms that incorporate both for-profit and public benefit objectives, such frameworks should provide for due consideration of dissenting shareholder rights.

A number of jurisdictions have frameworks for the establishment of public benefit corporations or other specific corporate forms that enable companies to incorporate both for-profit and public benefit objectives, that allow them to pursue explicit objectives related to environmental and social matters. In such cases where an existing for-profit company adopts public benefit objectives, it is important to have mechanisms in place that provide for the due consideration of dissenting shareholder rights. Possible solutions to protect the interests of dissenting shareholders could include requiring the consent of minority shareholders or a supermajority shareholders' approval for a company to add public benefit goals to its articles of association, or providing the right for dissenting shareholders to sell their shares back to the company at a fair price.

VI.C. The corporate governance framework should ensure that boards adequately consider material sustainability risks and opportunities when fulfilling their key functions in reviewing, monitoring and guiding governance practices, disclosure, strategy, risk management and internal control systems, including with respect to climate-related physical and transition risks.

When fulfilling their key functions, boards are increasingly ensuring that material sustainability matters are also considered. Notably, the board has a role in ensuring that effective governance and internal controls are in place to improve the reliability and credibility of sustainability-related disclosure. For instance, boards may assess if and how sustainability matters affect companies' risk profiles. Such assessments may also relate to key executive remuneration and nomination (e.g. whether targets integrated into executives' compensation plans would be quantifiable, linked to financially material risks and incentivise a long-term view) or how sustainability is approached by the board and its committees. OECD due diligence standards on responsible business conduct can provide an important framework for embedding sustainability factors in risk management systems and processes.

VI.C.1. Boards should ensure that companies' lobbying activities are coherent with their sustainability-related goals and targets.

Boards should effectively oversee the lobbying activities management conducts and finances on behalf of the company, in order to ensure that management gives due regard to the long-term strategy for sustainability adopted by the board. For instance, lobbying against any carbon pricing policy may be expected to increase a company's short-term profits but not be in line with the company's goal to make an

orderly transition to a low carbon economy. In some jurisdictions, boards also have a role in overseeing the disclosure of political donations, including related to lobbying activities.

VI.C.2. Boards should assess whether the company's capital structure is compatible with its strategic goals and its associated risk appetite to ensure it is resilient to different scenarios.

The management and board members are best placed to decide if the capital structure of a company is compatible with the strategic goals and its associated risk appetite, within existing restrictions established by shareholders. In order to ensure the company's financial soundness, the board should monitor the capital structure and capital sufficiency with due consideration to different scenarios, including those with low probability but high impact.

VI.D. The corporate governance framework should consider the rights, roles and interests of stakeholders and encourage active co-operation between companies, shareholders and stakeholders in creating value, quality jobs, and sustainable and resilient companies.

Corporate governance aims to encourage the various stakeholders in the company to undertake economically optimal levels of investment in company-specific human and physical capital. For workers, the company they work for is not only their source of income but also where they spend a large part of their lives and the company's long-term sustainability is important to them. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, the workforce, creditors, customers, affected communities, suppliers and other stakeholders. Corporations should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and profitable businesses. It may, therefore, be in the long-term interest of corporations to foster value-creating co-operation among stakeholders.

VI.D.1. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

The rights of stakeholders are to a large extent established by law (e.g. labour, business, commercial, environmental, and insolvency laws) or by contractual relations that companies must respect. In some jurisdictions, it is mandatory for companies to carry out human rights and environmental due diligence. Nevertheless, even in areas where stakeholder interests are not legislated or established by contract, many companies make additional commitments to stakeholders, given that concern over corporate reputation and corporate performance often requires the recognition of broader interests. This may in some jurisdictions be achieved by companies using the *OECD Guidelines for Multinational Enterprises* and associated due diligence standards for risk-based due diligence to identify, prevent and mitigate actual and potential adverse impacts of their business, and account for how these impacts are addressed.

VI.D.2. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights at a reasonable cost and without excessive delay.

The legal framework and process should be transparent and not impede the ability of stakeholders to communicate and to obtain redress for the violation of rights at a reasonable cost and without excessive delay.

VI.D.3. Mechanisms for employee participation should be permitted to develop.

The degree to which employees participate in corporate governance depends on national laws and practices, and may vary from company to company as well. In the context of corporate governance, mechanisms for participation may benefit companies directly as well as indirectly through the readiness by employees to invest in firm specific skills. Examples of mechanisms for employee participation include employee representation on boards and governance processes such as works councils that consider employee viewpoints in certain key decisions. International conventions and national norms also recognise the rights of employees to information, consultation and negotiation. With respect to performance

enhancing mechanisms, employee stock ownership plans or other profit sharing mechanisms can be found in many jurisdictions. Pension commitments are also often an element of the relationship between the company and its past and present employees. Where such commitments involve establishing an independent fund, its trustees should be independent of the company's management and manage the fund in the interest of all beneficiaries.

VI.D.4. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

Where laws and practice of corporate governance frameworks provide for participation by stakeholders, it is important that stakeholders have access to information necessary to fulfil their responsibilities.

VI.D.5. Stakeholders, including individual workers and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and/or to the competent public authorities, and their rights should not be compromised for doing this.

Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be detrimental to the company in terms of reputational effects. It is therefore important for companies to establish a confidential whistleblowing policy with procedures and safe-harbours for complaints by workers, either personally or through their representative bodies, and others outside the company, concerning illegal and unethical behaviour. The board should be encouraged to protect these individuals and representative bodies and to give them confidential direct access to someone independent on the board, often a member of an audit or an ethics committee. Some companies have established an ombudsman to deal with complaints. Relevant authorities have also established confidential phone and e-mail facilities to receive complaints. While in certain jurisdictions representative workforce bodies undertake the tasks of conveying concerns to the company, individual workers should not be precluded from, or be less protected, when acting alone. In the absence of timely remedial action or in the face of reasonable risk of negative action to a complaint regarding contravention of the law, workers are encouraged to report their bona fide complaint to the competent authorities. Many jurisdictions also provide for the possibility to bring cases of alleged violations of the *OECD Guidelines for Multinational Enterprises* to the relevant National Contact Point. The company should refrain from discriminatory or disciplinary actions against such workers or bodies.

VI.D.6. The exercise of the rights of bondholders of publicly traded companies should be facilitated.

The extended and substantial rise in the use of bond financing by publicly traded companies and their subsidiaries warrants greater attention to the role and rights of bondholders in corporate governance, as well as its importance for the resilience of companies.

In bond issuances offered to a large number of investors, an independent bond trustee is typically assigned to represent them, review instances of covenant default and protect the interests of bondholders during debt restructuring. While the exact scope of a trustee's activities is generally contractually defined, policy makers may enact regulation regarding the eligibility of a trustee and its duties prior to and during a default.

The exercise of bondholder rights can also be facilitated by incentivising institutional investors to monitor and engage with companies. Institutional investors have different business models and liability structures, and therefore face distinct incentives to be more or less active as bondholders. Corporate governance frameworks can, however, spur investors to be more active as creditors, such as recommending in a stewardship code that signatories can actively exercise their rights with respect to corporate bonds. Further, market initiatives may be useful to set standards and incentivise the use of enforceable and clearly defined covenants. The use of adjustable financial metrics that leave issuers the discretion to define whether they comply with covenants may need to be avoided.

Out-of-court debt restructuring, such as a distressed debt exchange, is often more cost-effective than formal bankruptcy proceedings and its use may, therefore, be facilitated. In addition to adhering to internationally recognised benchmarks for creditor rights and insolvency frameworks, countries could benefit from facilitating bondholders' participation in publicly traded companies' out-of-court debt restructuring. For instance, clear guidance on how insider trading rules may apply during a debt restructuring or a covenant waiver negotiation could provide more comfort for bondholders to take part in such processes. Another possibility would be to make the identification of bondholders easier so that corporate debtors can quickly find them to start a debt restructuring negotiation. However, this is subject to jurisdictional legislation, such as the resolution and restructuring regime applicable to banks and credit institutions in several jurisdictions.

VI.D.7. The corporate governance framework should be complemented by an effective and efficient insolvency framework and by effective enforcement of creditor rights.

Creditors are key stakeholders and the terms, volume and type of credit extended to companies will depend importantly on their rights and on their enforceability. Companies with a good corporate governance record are generally able to borrow larger sums on more favourable terms than those with poor records or which operate in less transparent markets. The framework for corporate insolvency varies widely across countries. In some countries, when companies are nearing insolvency, the legislative framework imposes a duty on directors to act in the interests of creditors, who might therefore play a prominent role in the governance of the company.

Creditor rights also vary, ranging from secured bondholders to unsecured creditors. Insolvency procedures usually require efficient mechanisms for reconciling the interests of different classes of creditors. In many jurisdictions provision is made for special rights such as through "debtor in possession" financing which provides incentives/protection for new funds made available to the company in bankruptcy.

G20/OECD Principles of Corporate Governance

The *G20/OECD Principles of Corporate Governance* help policy makers evaluate and improve the legal, regulatory and institutional framework for corporate governance. They identify the key building blocks for a sound corporate governance framework and offer practical guidance for implementation at the national level. The Principles also provide guidance for stock exchanges, investors, corporations and others that have a role in developing good corporate governance.



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The impact of corporate governance on financial performance: a cross-sector study

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Abstract

Corporate governance remains the focus of current research and a concept that continues to evolve to meet the needs of business managers. Faced with the need for companies to cope with a world characterized by perpetual change and successive economic crises (Prowse in *Revue d'économie financière* 31:119–158, 1994), the identification of the results of the implementation of good governance mechanisms in the structure of the management of companies on financial performance remains a necessity that helps managers and researchers specialized in management sciences and financial accounting to have a better visibility on the importance of corporate governance. It should be mentioned that the economic environment and the characteristics of the sectors of activity of the companies remain a relevant criterion in the study of the relation between the governance of the companies and their financial performance. In this sense, we have tried through this research work to study the impact of the implementation of effective corporate governance on the financial performance of 160 companies in the UK between 2005 and 2018 while taking into account the specificity of the business sectors. Through our study, we used multivariate regressions based on FGLS models while dividing our sample to several clusters. As a result, we found that the implementation of good corporate governance leads to the improvement of the financial performance of companies measured by the return on equity. As a motivation, it must be said that this study can be of major importance for future studies that want to make comparisons on the sectoral and temporal level. Indeed, this study gives the possibility for future research work to make comparative studies based on comparisons for different sectors of activity in the UK before and after the Brexit and also after the COVID 19 period.

Keywords Corporate governance · Financial performance · Cross-sector study · FGLS analysis

Introduction

There has been much research on the relationship between corporate governance and financial performance. Referring to the literature on the role of corporate governance, we can cite the work of Shleifer and Vishny (1997) who consider corporate governance as the set of mechanisms by which capital providers guarantee shareholder profitability. Denis and McConnell (2003) have emphasized the importance of

distinguishing between the notion of internal and external mechanisms of governance and their importance for the providers of funds on all points of value creation.

The study of the relationship between governance expressed by the corporate governance score and the improvement of the performance of the latter remains a vast field of study and research that has inspired researchers in the field of accounting, finance, and taxation (Louizi 2007).

The existence of such a relationship has led us to wonder about the factors that can impact this relationship in a direct or indirect way. Considering this fact, we note that managers who behave in a discretionary manner will exert a major influence on the fate of the accounting and tax manipulation of companies and will try to increase their discretionary power.

Within this framework, agency theory has explained this behavior by focusing on the interests of the funders

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and decision makers in a way that reflects the interest of each party (Jensen and Meckling 1976).

From an accounting perspective, the manager often has the power to manipulate earnings while using the accounting estimates and manipulation techniques available to him (Ahadiat and Hefzi 2013).

The practices of corporate governance have not stopped evolving. This is presented via the succession of guides to good governance practices that seek to counter the failures detected over time and which manifest themselves at the level of financial scandals, sometimes inducing a harmful imbalance for the global economic fabric. Based on the "FTSE 350 corporate governance review (2013), for the UK, the evolution of good governance guidelines as well as institutions in the field of corporate governance has developed to respond to the panoply of problems that may be directly related to corporate governance.

In the same context, it is important to emphasize that the study of corporate governance must take into account the specificity of each sector of activity since each sector has its own regulations, key success factors, and compliance rules. In our research paper, as our focus is on UK companies, we have chosen to use the 2 digit ICB industry code, which is relevant to the context of our study. In addition, it should be noted that previous research has studied the relationship between corporate governance and financial performance while focusing only on a particular governance mechanism or a particular specificity related to the strengthening of these mechanisms. Again, it must be emphasized that the majority of research studies have examined the relationship between corporate governance and financial performance without giving much importance to the sectoral specificity of the companies studied.

To give a clearer idea of the orientation of our research work and based on previous developments, we can form the following research question:

What relationship can exist between the governance score and financial performance, taking into account the characteristics of the different business sectors in the United Kingdom economy?

It follows that the objective of the research is to examine the relationship between governance score and financial performance while taking into account the characteristics of the business sectors.

This research paper contributes to the existing literature on several levels. Indeed, it consolidates previous research that tried to show the importance of corporate governance in improving financial performance. Moreover, it focuses on the effect of changes in the business sectors of UK firms so that we can identify the effect of the quality of corporate governance on the performance of firms related to a particular business sector.

This research paper allows us to study the impact of corporate governance on the financial performance sought by shareholders while basing ourselves on the FGLS method, which allowed us to eliminate the various sources of bias identified when using different regressors, namely the generalized least squares method, the regression with the consideration of the presence of the fixed effect as well as the persistence of the autocorrelation problem.

We will try through this research work to emphasize the possible relations between corporate governance and financial performance which is mainly based on the agency theory. It should also be added that the study of the previous relationship by taking into consideration the sectoral characteristics will lead us to turn to the foundations of the institutional theory. The latter theory emphasizes that an institution is constrained by its social, political, economic, legal and technological environment, which it conforms to in order to guarantee its legitimacy and durability.

In order to achieve our research objective, we will not use a simple governance mechanism to reflect the importance of corporate governance on financial performance, but we will opt for a governance score that better reflects all managerial, strategic and CSR characteristics. To achieve the objective of this research work, the remainder of the paper is arranged as follows. First, in "[Review and development of hypotheses](#)" section, we briefly discuss previous literature and the development of hypotheses. In "[Research methodology](#)" section, the research design and methodology are discussed including data, variables description. "[Empirical approach to the analysis of the relationship between corporate governance and financial performance](#)" section summarizes the empirical results, the discussions of the findings and their implications, including the focus on the difference in industry specifications using different regressors. Finally, in the last section, we conclude the study and provide the implications of our findings and the recommendations for future research.

Review and development of hypotheses

Agency theory and corporate governance

Corporate governance has always played a fundamental role in monitoring and controlling the proper functioning of business processes transparently. By referring to the various research works, we can see that the agency theory is at the heart of the studies on corporate governance. The work of Ross (1973) and subsequently Jensen and Meckling (1976) has indicated that the agency theory is the most appropriate sphere to study corporate governance.

This theory can lead us to reflect on the way in which managers can behave. We can cite the case of companies



that offer their managers variable remuneration depending on the growth of turnover. In the same sense, it must be said that internal control efficiency and internal audit within companies can play an important role in strengthening the governance structure of companies. It represents one of the guarantors of the proper functioning of business processes in a controlled environment to ensure the improvement of financial performance (Nyakundi et al. 2014).

To further develop the role of agency theory in the governance-performance relationship, we can say that agency theory is an analytical framework for understanding the relationships between a firm's stakeholders, including shareholders and management. According to this theory, shareholders have different objectives from those of managers, which can lead to conflicts of interest. Managers seek to maximize their own wealth and power, while shareholders seek to maximize the value of their shares. To align the interests of stakeholders and improve the financial performance of the firm, agency theory advocates the establishment of an effective governance system. Good corporate governance involves putting in place control and oversight mechanisms to ensure that management acts in the best interests of shareholders. This can include the appointment of an independent board of directors, executive compensation linked to company performance, financial transparency and disclosure of relevant information to shareholders. By establishing appropriate incentives and controls, corporate governance can help reduce conflicts of interest and improve the company's financial performance by increasing the value of the company and the return on investment for shareholders. The importance of corporate governance mechanism and its impact on the financial performance was studied by Yermack (1996), en plus Shleifer and Vishny (1997) reviewed the state of corporate governance research using a review of the existing literature. The authors concluded that agency theory is an important framework for understanding the relationship between corporate governance and financial performance, and that it can be used to develop effective governance mechanisms for firms.

Consider a publicly traded company whose shareholders are concerned with maximizing the value of their shares. The company's managers, on the other hand, may have different objectives, such as maximizing their own compensation or maintaining their power within the company. This divergence of interests can lead to strategic decisions that are not optimal for the company or its shareholders. In this case, agency theory suggests that strong corporate governance can help align stakeholder interests and improve the firm's financial performance. For example, the appointment of an independent and competent board of directors can help monitor the activities of executives and make strategic decisions in the interests of shareholders. Similarly, compensating

executives based on company performance can provide an incentive to work hard to increase the value of the company.

In summary, agency theory shows that corporate governance is essential for aligning stakeholder interests and improving the financial performance of the firm. By putting in place appropriate control and oversight mechanisms, corporate governance can help reduce conflicts of interest and improve shareholder value.

Effect of governance score on performance

In studies that have introduced corporate governance as a main variable, two main areas have been examined. The first seeks to address governance from a shareholder and capital structure perspective, the second seeks to address the composition of boards of directors and the improvement of the quality of governance mechanisms to improve financial performance. Among the research that has emphasized the importance of capital structure, we can cite McConnell and Servaes (1990), Nesbitt (1994), Smith (1996), Del Guercio and Hawkins (1999), and Hartzell and Starks (2003), who found that the presence of institutional shareholders positively affects management behavior. Regarding the research that has dealt with the functioning of boards of directors, we can cite Brickley et al. (1994), Lee et al. (1999) who have emphasized the importance of independent or outside directors in improving the level of governance quality. In addition, Jensen (1993) has shown that dual directorships increase the discretion of the director so that the director can influence the financial outcome. For Dechow and Sloan (1991), the introduction of the CEO's age as a variable makes it possible to reflect the difference between executives and their behaviors throughout their career and especially in the last year of service. During the last two decades, institutional theory has contributed greatly to the understanding of the behavioral aspect and the explanation of the reaction of the different stakeholders toward corporate governance (Aguilera and Jackson 2003; Judge et al. 2008). It must be said that this theory has contributed enormously to the study of the interaction between the governance mechanism and the institutional framework in which any firm operates. Several studies tried to examine closely the main characteristics of corporate governance to show if there is a possible explanation of the relationship between corporate governance and fiscal management in a perspective of improving financial performance. While Armstrong et al. (2015) and Seidman and Stomberg (2017) found a significant relationship between the latter two variables, Blaylock (2016) did not find any relationship between these two concepts. Before proposing the research hypothesis of the first chapter, it was necessary to first list the results found by researchers who studied the relationship between corporate governance and



financial performance based on the governance index or score.

Indeed, La Porta et al. (2000) have shown that the value of firms is positively associated with minority shareholders' rights. In their research, they emphasized the role of compliance with good governance practices while focusing on the impact of external governance mechanisms such as the level of control of firms in the market.

Indeed, other research works, such as those of Guney et al. (2019), have shown that the quality of corporate governance measured by Data Stream's ESG ASSET 4 governance score presents a negative and significant association with financial performance for panel data for a sample of 10171 US companies between 2002 and 2014 classified into 10 industries. Indeed, these authors indicated that there are several studies that have given importance to the relationship between corporate governance and its financial performance and whose results of impact or association are mixed while taking into consideration the sectoral characteristics. Other research works have emphasized the importance of internal governance mechanisms while studying factors related to other aspects such as board structure, board function, executive properties of management, and the effect of compensation (Bhagat et al. 2008; Guney et al. (2019); Walsh and Seward 1990). In addition and while referring to the work of Guney Guney et al. (2019), we can say that several research works have tried to investigate the relationship between governance and the performance of companies that seeks to be consistent with the principles of good governance codes. They have used a governance index in particular; the G-INDEX of Gompers et al. (2003) which focused on the structure and characteristics within American companies to find in conclusion a positive and significant association between their governance index and the value of the companies, their level of profits, their growth in sales and their reduction in capital expenditure.

We also distinguish the E-INDEX index used by Bebchuk et al. (2006, 2002). According to Bebchuk et al. (2006), the E-INDEX derives from an index that consists of 6 attributes related to the IRRC provisions in the USA and that can allow academics to find meaningful results. In fact, these authors divided the Gompers et al. (2003) index into two indices: the E-INDEX, which is made up of six governance factors, and the O-INDEX, which is made up of the rest of the provisions or attributes used by Gompers et al. (2003). It should be remembered that this E-INDEX index includes six provisions, which are: the board of directors, limits on changes in shareholder regulations, poison pills, golden parachutes, the requirement of an absolute majority for mergers, and changes in the charter. As a result, they found that increases in the index level are monotonically associated with economically significant reductions in firm valuation and large negative abnormal returns over the period

1990–2003. Regarding the other 18 Investor Responsibility Research Center (IRRC) requirements that formed the O-INDEX, they do not correlate with reductions in firm valuation or with abnormal market returns. Ribando and Bonne (2010) tried to analyze the relationship between the ASSET4 ESG index of Data Stream and the performance of the company. Indeed, they used the information coefficient (IC) while trying to find possible relationships between ESG characteristics of firms between 2003 and 2009 and future returns. For these characteristics, they found positive and significant associations with all scores except for the corporate governance component. Jun Xie et al. (2019) found that board independence has a positive and significant association with financial performance as measured by (ROA). On the other hand, there is a negative and significant association between executive compensation, duality, number of audit committee meetings on the one hand, and financial performance on the other hand. Concerning the presence of women on boards of directors, it does not show a significant relationship with ROA. Finally, the control variable, which is research and development expenses, shows a positive and significant association with financial performance. We can notice that the literature on the subject has not ceased to emphasize the relationship between corporate governance and financial performance while missing the importance of the deconstruction of the relationship by taking into account the sectoral characteristics of the firms under study. For this reason, we can say that our work will present an added value to the previous literature because it gives a lot of importance to the sectoral characteristics. As we have seen, the literature on the relationship between corporate governance and financial performance can present mixed results. This leads us to propose the first research hypothesis, which is as follows:

H1 Corporate governance score has a positive and significant association with financial performance.

In our study, we will try to investigate this relationship taking into account the sectoral characteristics of the firms in the UK economy (ICB Code). In the same sense, it is important to underline the importance of taking into account the contribution of institutional theory which has been the basis of several research works on the relationship between corporate governance and financial performance. For example, we can cite the research work of Rachmawati et al. (2018) who examined the relationship between corporate governance and financial performance in different economic sectors in Indonesia, using institutional theory as a theoretical framework. The authors found that corporate governance had a positive impact on financial performance in all sectors studied, but that the impact was greater in more regulated sectors. In addition, Boubakri et al. (2019) examined the relationship between corporate governance, institutional



environment and financial performance of Russian firms. The authors found that corporate governance had a positive impact on financial performance. Qin et al. (2019) studied the relationship between corporate governance and financial performance of technology firms in the United States and China. These authors found that corporate governance had a positive impact on financial performance, but that the impact was greater in firms operating in stronger institutional environments. In addition, Muda et al. (2018) examined the relationship between corporate governance and firm financial performance in different economic sectors in Malaysia, using institutional theory as a theoretical framework. The authors found that corporate governance had a positive impact on financial performance in all the sectors studied, but the impact was greater in the more regulated sectors.

Research methodology

When studying the relationship between corporate governance and financial performance, we must always refer to certain theories that can guide us in establishing our research methodology in order to test our conceptual model. Referring to the governance literature, we can indicate that there is no single pioneering theoretical framework that can be considered as a foundation for governance research. Nevertheless, we can face a particular set of research currents gathered in a paradigm to explain the logic of the relationships in corporate governance. Thus, we can distinguish the research stream focusing on the contractual aspect of the relationship between agents, principals, and creditors. A such relationship can be detailed in the following part of this research paper.

Sample selection

As mentioned at the beginning of this paper, the targeted context is the United Kingdom. Given that we seek to identify the nature of the relationship between corporate governance and financial performance, we first selected all UK-listed companies for which governance characteristics are available from the ASSET4 database, a Thomson Reuters domain, which provides environmental, social, and governance (ESG) information. This initial selection attempts to capture an initial sample of panel data that corresponds to 349 companies that will remain active, between the period of 1998 and 2019, and we will limit ourselves to the period of 2005–2018, i.e., 14 years. This choice is justified by two reasons. The first is the choice of 2005 as the reference year, which corresponds to the year of adoption and application

Table 1 First step of the sample selection

Initial sample (ASSET4)	349
The banks	(10)
Companies specializing in financial services	(26)
Life insurance	(6)
Non-life insurance	(6)
Basic sample	301

Table 2 Second stage of sample selection

Basic sample	301
Company with a currency different from the £	(15)
Company not listed on the London Stock Exchange	(2)
Financial sector company according to ICB code	(2)
Final sample	282

of IFRS by the United Kingdom. The second is the elimination of the year 2019 which does not present complete information when we collected data. In order to obtain a homogeneous sample that allows us to achieve a consistent interpretation, we have eliminated banks and companies that provide financial services, as well as life and non-life insurance (Table 1).

This first elimination reduces our sample to 301 companies, obtained as follows:

When processing the panel data that make up our sample, we were obliged to eliminate observations relating to firms whose functional currency does not correspond to the currency of the context of the study, i.e., the pound sterling. These companies number is about 15. In preparing our data, we were obliged to remove the English companies that are not listed on the London Stock Exchange. The number of these companies is 2. We also eliminated 2 other companies that belong to sectors of activity that could cause outliers in our analysis (Financial services according to the ICB classification). This data processing allowed us to obtain a final sample of 282 companies that served as a basis for the study of the relationship between corporate governance and the financial performance of UK companies (Table 2). These steps are summarized in the following data processing table:

For a more in-depth study that aims to analyze the impact of governance on financial profitability, we also eliminated firms with missing observations and with a missing value or a very high age of establishment. They are 21 firms. This reduced the number of firms in the sample to 261 firms. We also eliminated 101 firms with outliers in the dependent variable so that the value varies between -100% and $+200\%$, which leads us to a final sample of 160 firms with better



Table 3 Third stage of sample selection

Final sample	282
Companies with missing observations and high age	(21)
Companies with abnormally low or high ROE	(101)
Final sample	160

homogeneity in the dependent variable (ROE). In fact, there is no hard and fast rule for determining an appropriate range for ROE. However, a range of -100% to $+200\%$ for ROE can be considered as less extreme for our study because we identified more extremum values. We can add that we have tried to refer to other previous works that have tried to present a homogeneous value of financial profitability ROE cite Masood and Ahmad (2012) who studied the determinants of capital structure of firms in the manufacturing sector in Pakistan. The authors used regression analysis to study the effect of various factors on the capital structure of firms. The authors also used a homogeneous value of ROE by eliminating ROE outliers to reduce the effect of extreme values on the results of the analysis. The results showed that firm size, tax rate, firm growth, and liquidity have a significant influence on the capital structure of firms in the manufacturing sector in Pakistan. We also refer to Almazari and Abuzayed (2016), who studied the relationship between corporate governance and capital structure in the Gulf Cooperation Council (GCC) countries. The authors used regression analysis to study the effect of corporate governance on firms' capital structure. The authors also used a homogeneous ROE value by eliminating ROE outliers to reduce the effect of extreme values on the results of the analysis (Table 3). The results showed that corporate governance has a significant effect on the capital structure of firms in the GCC countries.

In the processing of the data obtained at the level of the variables of the research model, we found some missing observations that could influence the results. To solve this problem, we have resorted to the literature to know how to treat them. In this framework and by reference to Florou and Galarniotis (2007), missing values (i.e., not disclosed) are treated as an absence of the variable at the study level and thus, the firms constituting the study sample are penalized in the evaluation of the variable studied. Indeed, the missing values were excluded from the analysis. We can add that in the field of corporate governance research, the variables do not present a remarkable change between the following years. For this reason, we preferred to replace the missing values by the weighted average of the existing variables in order not to reduce our sample of panel data further, which

remained cylindrical. This choice was made with reference to Rahman et al. (2016) and White et al. (2011).

Measures of variables

The study of the relationship between corporate governance and financial performance requires particular attention in the choice of variables of the model to be used. Indeed, we can refer to the work of Alodat et al. (2022a), who assessed the effect of the board of directors and the audit committee attributes and ownership structure on firm performance. They stated that better governance leads to better financial performance. Mansour et al. (2022) investigated the relationship between corporate governance quality, capital structure and firm performance for Jordanian non-financial firms listed on the Amman Stock Exchange from 2014 to 2019. The results show that good corporate governance practices have a positive impact on firm performance, and that capital structure can strengthen this relationship. The variables reported that summarizes our model are in the form of dependent variables reflecting the financial performance of firms and independent explanatory variables reflecting the quality of corporate governance as well as other control variables relating to the characteristics of UK firms and reflecting size, debt, and age. Our choice of variables was the result of several investigations of the prior research literature on the relationship between corporate governance and financial performance. Alodat et al. (2022a, 2022b) studied ESG disclosure in Jordanian industrial firms. ESG disclosure is low but improving due to stakeholder pressure. Board size and meetings have an impact on ESG performance, but other corporate governance mechanisms do not. The study provides recent evidence from the literature on disclosure in emerging markets. Other research has attempted to study the mediating role of sustainability disclosure in the relationship between corporate governance and firm performance (Alodat et al. 2022a, 2022b).

In this sense, we will try to detail the measures of the variables used in our research work starting with the dependent variable, the independent variable and then control variables.

Dependent variable

Previous studies used variables reflecting the financial performance while taking into account the effect of governance (Cornett et al. 2008). The latter used EBIT (earnings before interest and taxes) divided by total asset value to measure financial performance. Indeed, the use of EBIT or operating profits divided by total asset value has been used by a range of research studies (Eberhart et al. 2004; Denis and Denis 1995; Hotchkiss 1995; Huson et al. 2004; Cohen et al. 2005). Also, Cornett et al. (2008) provide another measure of performance



which is profitability, not subject to result management. This is the financial profitability with neutralization of the effect of discretionary accruals which is detailed as follows:

$$\text{Financial profitability with neutralization of discretionary accruals} = \frac{\text{Income before taxes}}{\text{total assets}} - \% \text{discretionary accruals}$$

While referring to the research on corporate finance, we can see that several researchers have adopted accounting and non-accounting evaluations to arrive at the quantification of this variable. In our study, we will measure the financial performance as follow (measure proposed by data stream):

$$\text{ROE} = \frac{(\text{net income} - \text{preferred dividend effect})}{\text{average of the value of ordinary shares for the last year and the current year}}$$

It reflects the variation of ROE that adjusts for the effect of preferred dividends. We have opted for the ROE because our objective is to measure the company's performance in terms of shareholder return, ROE measures the return on shareholder investment by comparing the company's net income to the value of its equity. It measures the company's ability to generate profits from the funds invested by shareholders. We will thus consider that this measure of the dependent variable is the most adequate for our analysis which remains adaptable.

Independent variable

Corporate governance practices have not stopped evolving. This is presented through the succession of good governance practice guides that seek to counter the failures detected over time and which manifest themselves in financial scandals, sometimes inducing a harmful imbalance in the global economic fabric. Based on the "FTSE 350 corporate governance review (2013)" elaborated by Grant Thornton (auditing and consulting firm), especially for the UK, the evolution of good governance guides, as well as institutions in the field of corporate governance, have developed to respond to the panoply of problems that may be directly related to corporate governance.

Zahra and Pearce (1989) have identified several studies that have attempted to investigate the effect of corporate governance characteristics on financial performance. We cite the research work of Zahra and Stanton (1988) who studied the relationship between the size of the board of directors and the financial performance of companies by measuring it based on the variable (ROE), the gross sales margin, the ratio of revenues net of capital, the earnings per share (EPS), and the log of revenues. Based on a sample of 100 Fortune, 500 companies in the USA between 1980 and 1983 found that board size and the ratio reflecting the proportion of

outsiders on boards are not associated with financial performance. Schmidt (1977), taking into account the US context, focused on the external affiliation of outsiders while measur-

ing financial performance by ROE in 156 industrial firms. Schmidt found no relationship between these two variables. Kesner (1987) studied the effect of the proportion of insiders at the board level and the percentage of equity held by board members while aiming to explain their effects on gross mar-

gin, (ROE), (ROA), earnings per share (EPS), stock price and (ROI). Based on a sample of 250 Fortune 500 companies across 27 industries, he found a positive association between the percentage of board members' ownership and the cited financial performance. In addition, Baysinger and Bulter (1985) studied the impact of outsiders on the financial profitability (ROE) of 266 companies between 1970 and 1980 and found that the presence of a significant number of outsiders on the board of directors improved their financial performance. Pearce (1983) studied the effect of directors' skills and attitudes on the financial performance of firms measured by several variables including (ROE). He found, based on the responses of 137 respondents in 8 banks, that there is a strong association between the attitude of directors and the financial performance of their company. Referring to the above, we can say that previous studies have tried to examine the relationship between the different governance mechanisms and financial performance while quantifying the latter by using different variables and financial ratios. Among these variables, it is important for us to focus on the financial profitability of shareholders, namely the ROE, which will be used as the dependent variable for our research. Regarding the variables that measure governance mechanisms, we can distinguish variables that were proposed by Cornett et al. (2008).

After having exposed these research works, we can see that previous research has used particular measures of governance mechanisms to reflect the quality of corporate governance we allow ourselves to indicate that in our research work we are going to use the governance score (CGVS: Corporate Governance Score) which encompasses a significant number of governance mechanisms, and this one manifests itself as the governance score that we have obtained from the database (Data Stream) for the companies that make a disclosure according to ASSET 4. The latter measures a company's governance systems and processes, ensuring that



its board members and executives act in the best interests of shareholders over the long term. It reflects a company's ability, through its use of best management practices, to direct and control its rights and responsibilities through the creation of incentives and control mechanisms to generate long-term value for shareholders. Its value is presented as a percentage so that it can be used to detect the effectiveness of companies in terms of governance. Based on the Thomson Reuters ESG Scores calculation guide (February 2019), we can see that the governance score we will use as an independent variable in our analysis plays an important role in determining the governance component of the ESG score.

Control variables

Control variables refer to the characteristics of UK firms and reflect size, leverage and age. The selection of variables is based on a review of some of the previous research literature on the relationship between corporate governance and financial performance.

- LNTA: It is the total assets of the company; in our research work, we will use as recommended in the literature the Log of TA as a control variable for our research model.
- leverage = ((short-term debt and a current portion of long-term debt + long-term debt) / (total assets)).
- AGE: the age of the company

Empirical approach to the analysis of the relationship between corporate governance and financial performance

For the study of the relationship between corporate governance and financial performance, we have tried to respect the scientific approach that ensures a quality analysis of the data that have been initially collected. It is a matter of following a positivist epistemological posture according to a hypothetical-deductive approach. Indeed, when analyzing panel data, there is a very specific approach to follow and a set of econometric tests that will allow us to obtain the research model that leads us to the realization of the necessary predictions. First, when we use cylindrical panel data, we must verify the necessary conditions that give us the assurance of the reliability of the database studied. The verification of such conditions allows us to have the best unbiased predictor that ensures an efficient interpretation of the associations that may exist between the variables. Then, we must analyze the influence of the fixed effect and the random effect of the observations,

which will guide us toward the path of analysis to follow. It should be added that the results of the preliminary tests will give us a better idea of which regressor to use so that we can ensure that all sources of bias in the results are eliminated. Among these preliminary tests, we can mention the homoscedasticity test, the autocorrelation test, the multicollinearity test. In our research approach, we made sure to verify these preliminary tests in order to be able to move on to the analysis of associations via the execution of adequate regression models.

At this level, it should be noted that the estimation of panel data can be carried out through 3 possible estimators depending on the behavior of the data. In this respect, we mention 3 methods, which are the Pooled OLS regression (pooled OLS) which can lead us to the use of the GLS method which eliminates estimation bias problems. As an illustration, it is relevant to mention that the GLS method allows us to overcome the heteroscedasticity problem and the first-order autocorrelation problem. The second method is the fixed effect model (or within model): This model is characterized by the existence of a particular characteristic or behavior for a well-defined set of individuals or the firms in the sample. In our analysis, we are going to move directly toward an approach that targets the verification of the fixed effect while taking into consideration the specific characteristics related to each sector of activity (ICB industry code).

Finally, the third method is the random effect model. In this last case, the individuals understudy can also be influenced by both factors at the same time (*i* and *t*).

In the context of the analysis of the association that may exist between the governance score and the financial performance of the company and while taking into account a significance level of 5% for the interpretation of the results, we will run the model based on the sample of UK companies that we have specified. This will allow us to verify the strength of the link between the endogenous and exogenous variable which is manifested through an approach that can test the existence of the fixed and random effects. The execution of the model via the command "xtreg" on STATA, which implements the method of generalized least squares (GLS: generalized least square), remains effective for the study of panel type databases. For a more refined analysis and in order to use a more accurate estimator, we will show

Table 4 Descriptive statistics of the 282 companies

Variable	Obs	Mean	Std. Dev	Min	Max
ROE	3948	-0.1643323	11.54527	-563.3157	72.0645
CGVS	3948	0.6703196	0.2345235	0.024	0.9801
LNTA	3948	14.03506	1.60258	5.308268	19.20148
Leverage	3948	0.2513059	0.2044684	0	1.9732
Age	3948	64.11018	62.88838	0	502



the results found by the execution of the GLS command which allows finding a better estimate allowing to reduce the bias effect caused by the presence of heteroscedasticity and the first-order autocorrelation. This is the Feasible GLS (FGLS) method. (Feasible Generalized Least Squares).

In our research work, we will first try to have a global vision of our research sample, which consists of 282 companies listed on the London Stock Exchange and which make disclosures according to ASSET 4 as already mentioned (Table 4). For this reason, we will expose the descriptive statistics that are manifested as follows:

These descriptive statistics tell us that the sample of 282 firms obtained displays numerous observations, namely 3948 observations.

Regarding the dependent variable, we note that the (ROE) shows a mean of -0.16 which reflects in a global but not precise way that all the companies studied operate in an unstable environment that can be considered unfavorable given the circumstances through which the United Kingdom is passing such as the effect of the repercussions of the global financial crisis of 2008 and the BREXIT. The dependent variable shows a maximum value of 72.06 which is considered an extremely high value in relation to the measure of financial profitability (ROE). The same remark can be made regarding the minimum value of the dependent variable, which is equal to 563.32. It should be noted that these outliers led us to reduce our sample. Concerning the independent variable (CGVS) which is the governance score proposed by Data Stream. This shows an average of 0.67, which indicates that all the companies in our sample give importance to governance and its mechanisms for creating value and improving financial profitability. This governance score has a maximum value of 0.98 and a minimum value of 0.02. These values indicate that there are two types of companies, those that give importance to governance and its mechanisms and those that do not. Moving on to the control variables, we can see that the variable (LNTA), which reflects the size of the company according to the current literature, has an average of 14.03. For the variable (LVERAGE), we have an average of 0.25, which indicates the level of indebtedness of the companies in the sample. Regarding the last control variable, which is the (AGE), it indicates that the average age of the companies studied is equal to

64 years. After presenting the descriptive statistics of our sample which is composed of 282 companies, we will try to start the study of the relationship between their governance score and their financial performance in order to know if we are able to confirm the hypothesis providing the existence of a positive and significant relationship between these variables.

For this reason, we will present our correlation matrix for the sample of 282 companies (Table 5).

This correlation matrix clearly shows that (CGVS) has a positive and significant correlation at the 5% level with (ROE). This supports the hypothesis of the existence of a relationship. Indeed, the analysis of the correlation remains insufficient to decide on such a relationship. For this reason, we will proceed to the analysis of the regressions necessary to provide a precise vision of the association between these two variables.

It should be noted that the outliers identified in the descriptive statistics forced us to reduce our sample to avoid problems of discordance and observations with outliers as explained in the approach to the selection of our final sample, which reflects the shift from the sample of 282 companies to the sample of 160 companies. In the rest of our analysis, we will limit ourselves to this sample of 160 firms to avoid being influenced by the high values of financial profitability. During our analysis, we will even try to perform robust regression to validate our results.

It must be said that in our analysis we have based ourselves on the book by William Greene (2011). Our research approach will be based on the identification of biases that can affect the quality and the level of convergence of the estimator to be used. Indeed, we will check the effect of the individuals studied which merit the use of an approach that takes into account the individual effect of each sector of activity for the analysis of the results. For the random effect and while basing ourselves on William Greene (2011), we can say that the most adequate estimator is the generalized least square as well as the quasi-generalized least square estimator (feasible) which presents a better level of correction of possible sources of bias (Table 6). Indeed, we will start by exposing the descriptive statistics of the 160 companies as follows:

Table 5 Correlation matrix of the 282 companies

	ROE	CGVS	LNTA	Lverage	Age
ROE	1.0000				
CGVS	0.0508*	1.0000			
LNTA	0.0270	0.4367*	1.0000		
Lverage	-0.0630*	-0.0540*	0.2549*	1.0000	
Age	0.0415*	0.2675*	0.2666*	-0.0112	1.0000

* significant at the 5% level



Table 6 Descriptive statistics of 160 companies for the study of governance and performance

Variable	Obs	Mean	Std. Dev	Min	Max
Roe	2240	0.1699846	0.2303871	-0.9244	1.9716
Cgvs	2240	0.6856706	0.219321	0.0247	0.9801
Lnta	2240	14.15234	1.559384	8.770128	19.20148
Lverage	2240	0.245043	0.1862903	0	1.0756
Age	2240	68.8875	61.83613	1	294

Table 7 List of study sectors by “ICB industry code”

ICB IND CODE	ICB name
10	Technology
15	Telecommunications
20	Health care
30	Financials
35	Real estate
40	Consumer discretionary
45	Consumer staples
50	Industrials
55	Basic materials
60	Energy
65	Utilities

Table 8 Correlation matrix of 160 companies for the study of the relationship between corporate governance and financial performance

	ROE	CGVS	LNTA	Leverage	Age
ROE	1.0000				
CGVS	0.0316 0.1349	1.0000			
LNTA	-0.0819* 0.0001	0.4318* 0.0000	1.0000		
Leverage	-0.0931* 0.0000	-0.0264 0.2119	0.3171* 0.0000	1.0000	
Age	0.0282 0.1814	0.1930* 0.0000	0.2520* 0.0000	-0.0024 0.9097	1.0000

* significant at the 5% level

The descriptive statistics mentioned above indicate that the value of the dependent variable which is financial profitability measured by (ROE) has an average of 16.9%, which could lead to an increase in results management. In the same framework, the governance score indicates that it varies between 2 and 98%, with an average of 68.5%. In fact, for

Table 10 : Heteroscedasticity test of 160 firms to study the relationship between corporate governance and financial performance

Breusch–Pagan/Cook–Weisberg test for heteroskedasticity

Ho: Constant variance
Variables: residu
chi2(1) = 1353.22
Prob > chi2 = 0.0000

companies with a low governance score, we can say that the security of shareholders can be negatively affected. Regarding the control variables, we find that (LNTA) displays an average of 14.152. For the level of debt that is presented through (LEVERAGE), it shows that the companies in our sample display leverage equivalent to 24.5%, and the average age of the companies studied is equal to 68 (Table 7). In fact, we did not limit ourselves to the presentation of descriptive statistics according to the companies which are the object of our global sample only but also we used descriptive statistics by sector according to the criterion ICB industry which is summarized as follows:

Moving forward in our analysis of the results, we present the correlation matrix for our sample of 160 listed companies that are characterized by the disclosure of governance characteristics according to ASSET4 (Table 8).

This correlation matrix indicates the absence of correlation at the 5% level between (ROE) and (CGVS). However, we can estimate that there is a correlation at the 15% level, which means that in 85% of the situations we distinguish a positive and significant correlation between the financial performance and the governance score. Despite a weak correlation, there is a possible link between the dependent and independent variables. Moreover, and concerning the control variables, we can notice the existence of a negative and significant correlation at the 5% level between (LEVERAGE) and (ROE) which reflects the negative effect of debt on English companies. Similarly, LNTA shows a negative and significant correlation with the financial

Table 9 OLS regression of 160 firms to study the association between corporate governance and financial performance

ROE	Coef	Std. Err	t	P> t	[95% Conf	Interval]
CGVS	0.0695751	0.0249628	2.79	0.005	.0206223	0.1185279
LNTA	-0.0150945	0.0037674	-4.01	0.000	-.0224825	-0.0077066
Leverage	-.0727749	0.0279328	-2.61	0.009	-.1275517	-0.017998
Age	0.000153	0.0000813	1.88	0.060	-6.47e-06	0.0003125
_cons	0.3431934	0.0456238	7.52	0.000	0.2537239	0.4326628
Source	SS	Df	MS		Number of obs	2240
Model	2.03173353	4	0.507933382		F(4, 2235)	9.72
Residual	116.810431	2235	0.052264175		Prob > F	0.0000
Total	118.842165	2239	0.053078234		R-squared	0.0171
					Adj R-squared	0.0153
					Root MSE	0.22861



Table 11 Autocorrelation test of 160 firms to study the relationship between corporate governance and financial performance

Wooldridge test for autocorrelation in panel data	
H0: no first-order autocorrelation	
$F(1, 159)$	17.261
Prob > F	0.0001

Table 12 Multicollinearity test for 160 companies to study the relationship between corporate governance and financial performance

Variable	VIF	1/VIF
LNTA	1.48	0.676340
CGVS	1.28	0.778756
Leverage	1.16	0.862068
Age	1.08	0.922828
Mean VIF	1.25	

performance of firms, which is explained by an unfavorable effect of the growth of the political visibility of firms in the UK. In order to unravel and further analyze such a relationship, it is necessary to conduct a correlation analysis by sector to identify those that may imply a correlation. Indeed, the present research work will be based essentially on the study of the relationship between governance and financial performance which has been widely studied by most researchers. Thus, OLS regression will allow us to approach this analysis as presented in Table 9:

Indeed, it remains clear that the OLS regression presents a positive and a significant association at the 5% level between the governance of firms and their financial performance, measured on the basis of the ROE. But at this level, we cannot admit such results for the analysis of the mentioned relationship due to the fact that the data we are analyzing is panel data that require the absence of heteroscedasticity and autocorrelation problems (Table 10). Thus, we can present the preliminary tests in question. We start with heteroscedasticity, which presents a remarkable problem in the data. This manifests itself through the Breusch–Pagan test, which is displayed as follows:

Table 13 GLS regression for the 160 firms to study the relationship between corporate governance and financial performance

ROE	Coef	Std. Err	z	$P > z $	[95% Conf	Interval]
CGVS	0.1326331	0.0297175	4.46	0.000	0.0743878	0.1908785
LNTA	-0.0327726	0.0062284	-5.26	0.000	-0.0449801	-0.0205652
Leverage	-0.1253454	0.0389433	-3.22	0.001	-0.2016729	-0.0490178
Age	0.0001128	0.0001921	0.59	0.557	-0.0002637	0.0004893
_cons	0.5657964	0.0820295	6.90	0.000	0.4050215	0.7265714
R -sq: within	0.0324	Wald chi2(4)	55.62			
Between	0.0160	Prob > chi2	0.0000			
Overall	0.0161					

This test is based on a null hypothesis predicting the equality of the variance of the residuals. However, as indicated, it follows that we will reject this hypothesis and accept the alternative hypothesis which reflects the existence of a heteroscedasticity problem (Table 11).

Still, within the framework of the reliability of the data quality, we used the Woodridge autocorrelation test which shows the following results:

This test includes a null hypothesis that considers the absence of an autocorrelation problem. However, we find that such a hypothesis can only be rejected. This indicates the presence of a first-order autocorrelation problem, which will be corrected.

We also tested the multicollinearity problem by computing the VIF (Table 12). We found that such a problem does not taint the processed data. The multicollinearity test is displayed as follows:

After checking the quality of the data, we proceed to the use of a second estimator namely, the GLS, which is an efficient and unbiased estimator of the parameters of the model with a lower variance. The use of such an estimator presents the following results:

Table 13 shows a P value < 5%. This means that the model is significant in its entirety. Furthermore, it remains clear that the governance score has a positive and significant relationship at the 5% level with financial profitability.

Regarding the control variables, we find that they also show a significant association with the dependent variable. For example, the debt ratio has a negative and significant association at the 5% level with financial performance. This is due to the fact that excessive debt can damage the financial performance of the firm. Regarding age, we find that it does not show a significant association with the dependent variable. These results can only reinforce the confirmation of the basic hypothesis predicting the existence of the positive and significant association between governance and financial performance.

An analysis of the GLS regression by sector for the study of the relationship between corporate governance and financial performance remains essential (Table 14). This



Table 14 Summary table of the GLS regression by sector for the study of the relationship between corporate governance and financial performance

ICB IND CODE	ICB name	Coef	P value	Association by GLS	Globally significant model
10	Technology	0.2155342	0.044	+ & sig	Yes
15	Telecommunications	0.3602275	0.062	+	Yes
20	Health Care	0.10679	0.264	+	No
30	Financials	NA	NA	NA	NA
35	Real Estate	0.0647609	0.235	+	Yes
40	Consumer Discretionary	0.229015	0.000	+ & sig	Yes
45	Consumer Staples	0.059291	0.260	+	No
50	Industrials	0.1653197	0.007	+ & sig	Yes
55	Basic Materials	−0.026218	0.815	−	No
60	Energy	0.1512735	0.473	+	No
65	Utilities	0.160153	0.331	+	No

Table 15 Hausmann test to decide whether there is a fixed or random effect

	Coefficients		$(b - B)$ Difference	sqrt(diag($V_b - V_B$)) S.E
	(b)	(B)		
	fe	re		
CGVS	0.1878204	0.1326331	0.0551873	0.0164667
LNTA	−0.0399176	−0.0327726	−0.0071449	0.0086222
Leverage	−0.2136421	−0.1253454	−0.0882967	0.0254169
Age	−0.0036303	0.0001128	−0.0037431	0.001307

b = consistent under H_0 and H_a ; obtained from xtreg

B = inconsistent under H_a , efficient under H_0 ; obtained from xtreg

Test: H_0 : difference in coefficients not systematic

$\chi^2(4) = (b - B)'[(V_b - V_B)^{-1}](b - B) = 29.09$

Prob > $\chi^2 = 0.0000$

Table 16 Regression of the data with the inclusion of the fixed effect to study the relationship between corporate governance and financial performance

ROE	Coef	Std. Err	T	P> t	[95% Conf	Interval]
CGVS	0.1878204	0.0339747	5.53	0.000	0.1211923	0.2544486
LNTA	−0.0399176	0.0106365	−3.75	0.000	−0.0607768	−0.0190583
Leverage	−0.2136421	0.0465038	−4.59	0.000	−0.304841	−0.1224431
Age	−0.0036303	0.001321	−2.75	0.006	−0.006221	−0.0010396
_cons	0.9085602	0.1187743	7.65	0.000	0.6756311	1.141489
R-sq: within	0.0379		F(4, 2076)	20.47		
between	0.0001		Prob > F	0.0000		
overall	0.0002					

regression will be presented in this synthetic table, which is displayed as follows:

This table indicates that with the use of GLSs we obtain a positive and significant association at the 5% level between (ROE) and (CGVS) this is in line with the confirmation of our research hypothesis at the level of ICB10, 40, and 50 namely the technology sector, the sector of non-essential discretionary consumption and industrial (Table 15). To

determine whether the fixed or random effect is the effect that influences the research data, we referred to the Hausman test which indicates a P value = 0.0000 < 0.05, this leads us to reject the null hypothesis predicting the existence of the random effect. The last test is as follows:

To refine the quality of the analysis, we will, in the following, analyze the presence of the fixed effect which will allow us to reinforce the expected result (Table 16).



Indeed, the regression of the data taking into account the existence of a fixed effect is as follows:

It remains clear that taking the fixed effect into consideration can only confirm the previous results regarding the association between the governance score and financial performance at the 5% level.

In order to analyze this association by sector, we performed the sectoral GLS regression, taking into account the presence of the fixed effect. In fact, based on the results obtained we can say that we found a positive and significant relationship at the 5% level between corporate governance and financial performance in the ICB 15 40 50 and 60 sectors. However, it should be noted that the association found

Table 17 Summary table of the sectoral GLs regression with the fixed effect taken into account

ICB IND CODE	ICB name	Coef	P value	Association with FE	Globally significant model
10	Technology	0.1812102	0.112	+	Yes
15	Telecommunications	0.4559933	0.040	+ & sig	No
20	Health Care	0.0477244	0.675	+	No
30	Financials	NA	NA	NA	NA
35	Real Estate	0.1729416	0.101	+	Yes
40	Consumer Discretionary	0.2294146	0.000	+ & sig	Yes
45	Consumer Staples	0.0889826	0.120	+	No
50	Industrials	0.2031276	0.004	+ & sig	Yes
55	Basic Materials	0.148905	0.230	+	Yes
60	Energy	0.4660237	0.022	+ & sig	Yes
65	Utilities	0.1073196	0.518	+	No

Table 18 Regression of 160 firms with the presence of the fixed effect, with correction for autocorrelation to study the relationship between governance and financial performance

ROE	Coef	Std. Err	t	P> t	[95% Conf Interval]
CGVS	0.1916551	0.03714	5.16	0.000	0.1188161 0.2644941
LNTA	-0.0136638	0.0130739	-1.05	0.296	-0.0393044 0.0119767
Leverage	-0.3043237	0.051028	-5.96	0.000	-0.4044001 -0.2042474
Age	-0.0056333	0.0016334	-3.45	0.001	-0.0088367 -0.0024299
_cons	0.694147	0.1183525	5.87	0.000	0.4620338 0.9262602
R-sq: Within=0.0370			F(4,1916)=18.40		
Between=0.0012			Prob>F=0.0000		
Overall=0.0001					

Table 19 Summary table of sectoral regressions with the presence of the fixed effect, with correction for autocorrelation for the study of the relationship between governance and financial performance

ICB IND CODE	ICB name	Coef	P value	Association with FE AR1	Globally significant model
10	Technology	0.1331525	0.093	+	Yes
15	Telecommunications	0.6871515	0.016	+ & sig	No
20	Health Care	0.1678458	0.121	+	No
30	Financials	NA	NA	NA	NA
35	Real Estate	0.3241455	0.010	+ & sig	Yes
40	Consumer Discretionary	0.1743539	0.007	+ & sig	Yes
45	Consumer Staples	0.1021243	0.159	+	No
50	Industrials	0.1918444	0.011	+ & sig	Yes
55	Basic Materials	0.1871969	0.113	+	Yes
60	Energy	0.4356504	0.135	+	Yes
65	Utilities	0.1448372	0.404	+	No



in ICB 15 will not be taken into account because the model is not significant in its entirety for the companies in this last sector (Table 17). To summarize our results, we can present the table of results found, by sector according to the regressor that takes into account the fixed effect which is presented as follows:

In the following, we will try to take into account the autocorrelation problem identified by the fact that the fixed effect estimator is consistent (Table 18). Indeed, the regression in the presence of a fixed-effect by correcting the effect of autocorrelation can be presented as follows:

Taking into account the correction of the first-order, autocorrelation leads us to the same finding, which predicts the existence of a positive and significant association at the 5% level between governance and financial performance. An analysis by sector based on the sectoral regression with the presence of the fixed effect, with correction of the autocorrelation for the study of the relationship between governance and the financial performance of the company remains adequate to detail our results. This regression is presented in Table 19. This analysis by sector, with the correction of the autocorrelation problem of order 1, indicates that we have a positive and significant

association at the 5% level between the two main variables studied at the level of ICB35, 40, and 50. It is true that we had found a significant relationship at the level of ICB 15, but such an association will not be taken into account because Fisher test for this sector indicates that there is no overall significance of the model.

To summarize these results, we present the following table, which presents the fixed effect regression correcting for the effect of the first-order autoregressive autocorrelation.

Still, in the context of supporting the confirmation of our initial hypothesis, we will, in the following, try to develop our analysis by seeking the resolution of the problem of heteroscedasticity and autocorrelation that have been detected. It must be said that the econometric tools of "STATA" have made it possible to find solutions to such problems by using the Feasible Generalized Least Squares (FGLS) method which can make the GLS estimation feasible by correcting the autocorrelation and heteroscedasticity problem (Table 20). The use of such a regressor gives us the following results:

Table 20 FGLS regression of the entire sample to study the relationship between governance and financial performance

ROE	Coef	Std. Err	z	P > z	[95% Conf	Interval]
CGVS	0.2966842	0.1049067	2.83	0.005	0.091071	0.5022975
LNTA	-0.0234933	0.021399	-1.10	0.272	-0.0654345	0.0184479
Leverage	-0.1087691	0.0950651	-1.14	0.253	-0.2950933	0.0775551
Age	-0.0008685	0.0009103	-0.95	0.340	-0.0026527	0.0009158
_cons	0.3634439	0.2833834	1.28	0.200	-0.1919773	0.918865
Estimated covariances = 12,880			Wald chi2(4) = 14.24			
Estimated autocorrelations = 1			Prob > chi2 = 0.0066			
Estimated coefficients = 5						

Table 21 Summary table of the FGLS regression by sector for the study of the relationship between corporate governance and financial performance

ICB IND CODE	ICB name	Coef	P value	Association with FGLS	Globally significant model
10	Technology	0.1499412	0.000	+ & sig	Yes
15	Telecommunications	0.1274849	0.334	+	Yes
20	Health Care	0.2372147	0.000	+ & sig	Yes
30	Financials	NA	NA	NA	NA
35	Real Estate	0.0301446	0.200	+	Yes
40	Consumer Discretionary	0.180493	0.000	+ & sig	Yes
45	Consumer Staples	0.075521	0.000	+ & sig	Yes
50	Industrials	0.1297632	0.005	+ & sig	Yes
55	Basic Materials	0.1112845	0.000	+ & sig	Yes
60	Energy	0.2777256	0.060	+	No
65	Utilities	0.0837993	0.381	+	No



$$ROE_{it} = \alpha_0 + \alpha_1 CGVS_{it} + \alpha_2 LNTA_{it} + \alpha_3 LEVERAGE_{it} + \alpha_4 AGE_{it} + \varepsilon_{it}$$

By analyzing this FGLS regression, we can see that this model is generally significant in its entirety because the P value $< 5\%$. Thus, there is at least one explanatory variable that can analyze the variable to be explained.

The results found indicate that we have a positive and significant association at the 5% level for the 160 firms in our study. In addition, to identify the effect of sectors of activity, we propose the FGLS regression by sector for the study of the relationship between corporate governance and financial performance which is presented in Table 21. The results obtained can be summarized as follow:

These results indicate that when correcting for the statistical problems identified, we were able to obtain in almost all the sectors of activity studied a positive and significant association at the 5% level between the governance index and financial performance in fact for ICB 10,20,40,45,50 and 55, we were able to obtain a very significant association at the 5% level. It must be said that with the correction of inconsistencies, we can confirm our H1 hypothesis in almost all sectors of activity. This leads us to emphasize

the importance of governance in improving the financial performance of firms.

To further summarize our results, we can present the following summary table that analyzes, by sector and by regressor used, the type of association between governance and financial performance (Table 22).

As part of the validation of our results, we used robust regression to ensure that our results remained free of bias.

Indeed, we performed robustness checks on the overall sample of 160 companies as well as by sector of activity studied (Table 23).

For the overall sample we found these results:

The results obtained after the verification of the robustness of our model validate the results obtained previously indicating the fact that corporate governance presents a positive and significant association with financial performance which further confirms our research hypothesis (Table 24).

In addition, we performed robustness checks on the detailed results by sector and obtained the following results:

The results of the robustness checks lead us to validate the previous results obtained mainly in the ICB40 (Consumer Discretionary) and ICB50 (Industrials) sectors.

Table 22 Summary table of the different regressors in the sector study of the relationship between corporate governance and financial performance

ICB IND CODE	ICB name	Association avec MCG	Association avec effect fixe FE	Association avec effect fixe FE AR1	Association avec FGLS
10	Technology	+ & sig	+	+	+ & sig
15	Telecommunications	+	+ & sig	+ & sig	+
20	Health Care	+	+	+	+ & sig
30	Financials	NA	NA	NA	NA
35	Real Estate	+	+	+ & sig	+
40	Consumer Discretionary	+ & sig	+ & sig	+ & sig	+ & sig
45	Consumer Staples	+	+	+	+ & sig
50	Industrials	+ & sig	+ & sig	+ & sig	+ & sig
55	Basic Materials	–	+	+	+ & sig
60	Energy	+	+ & sig	+	+
65	Utilities	+	+	+	+

Table 23 Robust regression for the global sample of 160 companies

ROE	Coef	Std. Err	Z	$P > z $	[95% Conf Interval]
CGVS	0.1326331	0.0347034	3.82	0.000	0.0646156 0.2006507
LNTA	–0.0327726	0.0101727	–3.22	0.001	–0.0527108 –0.0128344
Leverage	–0.1253454	0.0748006	–1.68	0.094	–0.2719518 0.021261
Age	0.0001128	0.0001761	0.64	0.522	–0.0002324 0.000458
_cons	0.5657964	0.1339279	4.22	0.000	0.3033026 0.8282902
R -sq: within = 0.0324					Number of obs = 2240
Between = 0.0160					Number of groups = 160
Overall = 0.0161					Obs per group: min = 14
Wald chi2(4) = 21.75					avg = 14.0
Prob > chi2 = 0.0002					max = 14



Table 24 Robust regression by sector

ROE	Coef	Std.Err	z	P> z	[95%	Conf.Interval]
icbcode = 10						
Cgvs	0.2155342	0.1152058	1.87	0.061	−0.0102651	0.4413334
Lnta	−0.1334019	0.1180915	−1.13	0.259	−0.364857	0.0980532
Leverage	−0.0608078	0.1196745	−0.51	0.611	−0.2953656	0.1737499
Age	0.006701	0.0043164	1.55	0.121	−0.0017589	0.015161
_cons	1.573155	1.380659	1.14	0.255	−1.132886	4.279197
R-sq: within = 0.1393				Number of obs = 126		
between = 0.3438				Number of groups = 9		
overall = 0.2873				Obs per group: min = 14		
Wald chi2(4) = 18.91				avg = 14.0		
corr(<i>u_i</i> , X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 9 clusters in id)				Prob > chi2 = 0.0008		
icbcode = 15						
Cgvs	0.3602275	0.3051295	1.18	0.238	−0.2378153	0.9582703
Lnta	−0.0970114	0.0548379	−1.77	0.077	−0.2044917	0.0104688
Leverage	−0.2208968	0.1446089	−1.53	0.127	−0.504325	0.0625314
Age	0.0067016	0.0009817	6.83	0.000	0.0047775	0.0086258
_cons	1.241752	0.5433501	2.29	0.022	0.1768058	2.306699
R-sq: within = 0.1143				Number of obs = 42		
between = 0.9986				Number of groups = 3		
overall = 0.3730				Obs per group: min = 14		
Wald chi2(2) =				avg = 14.0		
corr(<i>u_i</i> , X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 3 clusters in id)				Prob > chi2 =		
icbcode = 20						
Cgvs	0.10679	0.1267952	0.84	0.400	−0.1417241	0.3553041
Lnta	0.0172711	0.0304159	0.57	0.570	−0.042343	0.0768852
Leverage	−0.1800574	0.0635073	−2.84	0.005	−0.3045294	−0.0555855
Age	−0.0016286	0.002467	−0.66	0.509	−0.0064639	0.0032067
_cons	−0.1435951	0.4930002	−0.29	0.771	−10.109858	0.8226675
R-sq: within = 0.0225				Number of obs = 98		
between = 0.3329				Number of groups = 7		
overall = 0.1773				Obs per group: min = 14		
Wald chi2(4) = 9.38				avg = 14.0		
corr(<i>u_i</i> , X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 7 clusters in id)				Prob > chi2 = 0.0523		
icbcode = 35						
Cgvs	0.0647609	0.0627724	1.03	0.302	−0.0582708	0.1877925
Lnta	−0.0273047	0.0105899	−2.58	0.010	−0.0480605	−0.006549
Leverage	−0.4433999	0.1035733	−4.28	0.000	−0.6463999	−0.2403999
Age	−0.000246	0.0002757	−0.89	0.372	−0.0007863	0.0002944
_cons	0.6212522	0.1561536	3.98	0.000	0.3151968	0.9273076
R-sq: within = 0.1823				Number of obs = 252		
between = 0.2997				Number of groups = 18		
overall = 0.1026				Obs per group: min = 14		
Wald chi2(4) = 36.56				avg = 14.0		
corr(<i>u_i</i> , X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 18 clusters in id)				Prob > chi2 = 0.0000		
icbcode = 40						
Cgvs	0.229015	0.0793339	2.89	0.004	0.0735234	0.3845066



Table 24 (continued)

ROE	Coef	Std.Err	z	P> z	[95%	Conf.Interval]
Lnta	−0.0678924	0.0197171	−3.44	0.001	−0.1065372	−0.0292475
Leverage	0.0938975	0.1801093	0.52	0.602	−0.2591103	0.4469053
Age	−0.0001365	0.0002709	−0.50	0.614	−0.0006675	0.0003946
_cons	1.012461	0.2613969	3.87	0.000	0.5001322	1.524789
R-sq: within = 0.0445				Number of obs = 644		
between = 0.1944				Number of groups = 46		
overall = 0.1150				Obs per group: min = 14		
Wald chi2(4) = 14.46				avg = 14.0		
corr(u_i, X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 46 clusters in id)				Prob > chi2 = 0.0060		
icbcode=45						
Cgvs	0.059291	0.0312548	1.90	0.058	−0.0019672	0.1205493
Lnta	0.0084168	0.0247957	0.34	0.734	−0.0401818	0.0570155
Leverage	0.023369	0.1021535	0.23	0.819	−0.1768481	0.2235862
Age	0.0007849	0.0003413	2.30	0.021	0.0001158	0.0014539
_cons	−0.0668126	0.3385501	−0.20	0.844	−0.7303587	0.5967334
R-sq: within = 0.0058				Number of obs = 210		
between = 0.3771				Number of groups = 15		
overall = 0.2609				Obs per group: min = 14		
Wald chi2(4) = 14.11				avg = 14.0		
corr(u_i, X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 15 clusters in id)				Prob > chi2 = 0.0070		
icbcode = 50						
Cgvs	0.1653197	0.0589975	2.80	0.005	0.0496867	0.2809526
Lnta	−0.0282074	0.0173994	−1.62	0.105	−0.0623096	0.0058947
Leverage	−0.0944772	0.1328019	−0.71	0.477	−0.3547643	0.1658098
Age	0.0000712	0.000191	0.37	0.710	−0.0003033	0.0004456
_cons	0.4693504	0.2152309	2.18	0.029	0.0475057	0.8911952
R-sq: within = 0.0408				Number of obs = 462		
between = 0.0006				Number of groups = 33		
overall = 0.0058				Obs per group: min = 14		
Wald chi2(4) = 13.32				avg = 14.0		
corr(u_i, X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 33 clusters in id)				Prob > chi2 = 0.0098		
icbcode = 55						
Cgvs	−0.026218	0.0781638	−0.34	0.737	−0.1794162	0.1269803
Lnta	−0.0258369	0.0263307	−0.98	0.326	−0.0774441	0.0257704
Leverage	−0.2029159	0.2827652	−0.72	0.473	−0.7571254	0.3512936
Age	−0.0000581	0.0004994	−0.12	0.907	−0.0010368	0.0009207
_cons	0.6043553	0.3481115	1.74	0.083	−0.0779306	1.286641
R-sq: within = 0.0603				Number of obs = 238		
between = 0.0002				Number of groups = 17		
overall = 0.0042				Obs per group: min = 14		
Wald chi2(4) = 8.11				avg = 14.0		
corr(u_i, X) = 0 (assumed)				max = 14		
(Std. Err. adjusted for 17 clusters in id)				Prob > chi2 = 0.0875		
icbcode = 60						
Cgvs	0.1512735	0.0929068	1.63	0.103	−0.0308205	0.3333676
Lnta	−0.0366555	0.0408417	−0.90	0.369	−0.1167037	0.0433927
Leverage	0.4668216	0.190425	2.45	0.014	0.0935954	0.8400477



Table 24 (continued)

ROE	Coef	Std.Err	z	P> z	[95%	Conf.Interval]
Age	0.0015661	0.0019363	0.81	0.419	−0.002229	0.0053612
_cons	0.3830048	0.4450229	0.86	0.389	−0.489224	1.255234
R-sq: within=0.0024				Number of obs = 112		
between=0.5100				Number of groups = 8		
overall=0.0479				Obs per group: min = 14		
Wald chi2(4)=9.92				avg = 14.0		
corr(<i>u_i</i> , X)=0 (assumed)				max = 14		
(Std. Err. adjusted for 8 clusters in id)				Prob> chi2=0.0419		
icbcode = 65						
cgvs	0.160153	0.1495931	1.07	0.284	−0.1330441	0.4533501
lnta	0.0104272	0.031076	0.34	0.737	−0.0504807	0.0713351
leverage	−0.4012913	0.2673566	−1.50	0.133	−0.9253007	0.1227181
age	0.0034901	0.0020891	1.67	0.095	−0.0006044	0.0075847
_cons	0.0187172	0.5712578	0.03	0.974	−1.100928	1.138362
R-sq: within=0.0093				Number of obs = 56		
Between=0.9757				Number of groups = 4		
Overall=0.1063				Obs per group: min = 14		
Wald chi2(3)=				avg = 14.0		
corr(<i>u_i</i> , X)=0 (assumed)				max = 14		
(Std. Err. adjusted for 4 clusters in id)				Prob> chi2 =		

Table 25 summary of Robust regression by sector

ICB IND CODE	ICB name	Association robust
10	Technology	+ significant
15	Telecommunications	Non significant model
20	Health Care	Non significant model
30	Financials	NA
35	Real Estate	+
40	Consumer Discretionary	+ significant
45	Consumer Staples	+
50	Industrials	+ significant
55	Basic Materials	Non significant model
60	Energy	+
65	Utilities	Non significant model

Comparing the validation results with the previous results, we can see that for the sector ICB 10 (Technology), ICB 35 (Real Estate), ICB 45 (Consumer Staples) and ICB 60 (Energy) we could visualize a positive association between ROE and CGVS (Table 25).

These results can be summarized in the following table:

Benefits and contributions

These results indicate that when correcting for the identified statistical problems, we were able to obtain in almost all the sectors of activity studied a positive and significant association at the 5% level between the governance index and financial performance in fact for ICB 10,20,40,45,50 and 55, we were able to obtain a very significant association at the 5% level. It must be said that with the correction of inconsistencies, we can confirm our H1 hypothesis in almost all sectors of activity. This leads us to emphasize the importance of governance in improving the financial performance of firms active in industries, which gives specific importance to the role of governance. It should be noted that our in-depth investigations and the use of robust regression have shown that the significant association between corporate governance and financial performance is still mainly valid for the ICB10 and ICB40 sectors.

Interpretation of results

At this level, we can see that the results that were found by reference to the different regression methods used, lead us to confirm our first hypothesis H1 predicting the existence of a positive and significant association between the governance score and financial performance. Indeed, in order to have better visibility of the effect of the improvement of



the results via the correction of the identified econometric problems and to reflect the approach that led us to adopt the FGLS regressor, we propose the following summary table that shows the corrections of the estimates of the strength of the relationship between corporate governance and financial performance when taking into account the sectoral influences and the correction of the various sources of bias.

In our present research, we have tried to focus on the impact of corporate governance on the financial performance of firms in the United Kingdom. The 160 companies studied between 2005 and 2018 are listed on the London Stock Exchange and are characterized by the achievement of corporate social responsibility disclosures according to ASSET4.

In this chapter, we have tried to clarify the important concepts that are directly related to our study on the relationship between corporate governance score (CGVS) and corporate financial performance (ROE). In this chapter, we have also tried to demonstrate how the adoption of good governance measures can be associated with better firm performance. In this sense, we conducted a sectoral analysis according to the ICB code, which allowed us to identify a positive and significant association in the companies of 6 sectors of activity, which are ICB 10 (Technology), 20 (Health), 40 (Secondary consumption), 45 (Basic consumption), 50 (Industrial) and 55 (Basic material or raw materials). These results led us to observe that companies that are characterized by best practices in governance, as well as those with a favorable structure of their board of directors that are well organized and disciplined, can have better financial profitability through the enhancement of their corporate organizational architecture. It should also be added that the establishment of controls and compensation committees reinforces the role of governance in achieving better financial performance. In addition, the protection of shareholders' interests and the consideration of social and environmental factors at the decision-making level can only improve the financial performance of companies. We must add that the robustness checks we have performed confirm and validate the results obtained mainly in the ICB 40 and 50 sectors, i.e., the Consumer Discretionary sector and the Industrial sector.

Conclusion

Through our study, we have corroborated the findings drawn by a significant number of research works. Nevertheless, the originality of ours, which we consider innovative, consists in focusing attention on the different sectors of activity in the UK (United Kingdom). We have followed an approach advocating achieving a cross-sector benchmark which allows to reflect the ideas proposed by the institutional

theory. This paper evinces that despite the variation in the sectors of activity, the corporate governance plays a key role in improving the financial performance of English corporations. This result is consistent with the foundations of agency theory. We also emphasize the prominence of using the clustering technique with a view to targeting the analysis of the relationship between the corporate governance and financial performance. The analytical approach we have used has inspired several previous authors, including Lo and Shekhar (2018) who examined the impact of corporate governance on the financial performance of companies in Germany. They identified a positive association between strong corporate governance and financial performance in all industries studied. In addition, and for the economy of the UK, we can cite the research of O'Sullivan and Carroll (2021) which studied the impact of corporate governance on the financial performance of firms in the United Kingdom using a cluster approach to distinguish firms according to their industry. The results found suggest that corporate governance is positively associated with financial performance, but that this relationship varies across industries. This confirms the role of our research in consolidating the results of previous research and highlighting the importance of the use of cluster analysis in the dissection of the phenomena studied.

Moreover, identifying the positive and significant association between the corporate governance in most sectors studied makes us confirm our research hypothesis, which remains well founded by a rich literature (Alodat et al. 2022a, 2022b; Jia et al. 2021; Khan and Hanafi 2021; Agyei-Mensah and Gyimah 2020; Abdulsalam and Oyewo 2019). Previous research has identified mixed results owing to the differences in the measures used to assess the corporate governance quality or to measure the financial performance level.

Through this research work, we have also been able to validate that corporate governance plays a key role in improving the performance of English companies, mainly in the consumer discretionary sector and in the industrial sector. These results reflect the level of detail of our analyses which give a lot of importance to the sectoral characteristics of the firms.

Like any research study, we have found difficulties in the data collection process. Yet, our strength and originality consist in a new empirical approach making us dismantle a particular phenomenon. This latter has been widely studied in the different sectors of activity through analyzing the corporate governance research. This remains substantial from a managerial point of view, and extremely beneficial for advisors and decision-makers at a scale characterized by a more remarkable degree of precision. What is more, it is worth noting that our work has some limitations related to the study period dealing only with the period before Brexit



(the withdrawal of the United Kingdom from the European Union). The process of preparing the database has also led us to eliminate several companies, but this is necessary to avoid any source of econometric bias.

To put this into perspective, we suggest carrying out a comparative study of the UK corporations before and after the Brexit period. This period has been characterized by a political and regulatory flow, especially at the European and international levels. Furthermore, the studies on corporate governance mechanisms in times of health crises, such as the COVID-19 pandemic period, are significantly important. In this sense, we have only introduced in our study the health sector, but this may necessitate more detailed investigations in future works.

Declarations

Conflict of interest On behalf of all authors, the corresponding author states that there is no conflict of interest.

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GOVERNANCE AND CORPORATE CONTROL IN THE UNITED STATES

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Abstract

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This paper provides an overview of business entities in the United States. We analyze current trends in the ownership structures of U.S. firms, diversity and inclusion, mergers and acquisitions, minority shareholder rights protections, and review the literature related to corporate ownership and financial performance. With the shift in the U.S. from defined benefit pension plans to defined contribution plans and a desire for increased corporate governance, we observe a significant increase in the financial assets under management by large institutional investors. It is believed these large institutional investors can have a significant impact on the governance, decision-making, and performance of the U.S. publicly traded firms. We observe an increasing trend in foreign indirect investment in the U.S. from countries in Europe, Asia and the Pacific Rim, North and South America, the Middle East, and Africa. Additionally, increased compensation of publicly traded firms' top executives is shown, which has resulted in an increased disparity between the compensation of top management teams and the firms' hourly employees. Lastly, we expect the suggested bias against women and other minorities, as evidenced here, will be lessened in the future and should result in improved financial performance for firms.

Keywords: Ownership Structures, Mergers and Acquisitions, Shareholder Rights, Financial Performance, Diversity

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1. INTRODUCTION

As recent as the 1970s in the United States, workers could look forward to working an entire career at one company. In fact, defined benefit retirement plans, also known as pensions, where the employer pays employees after retirement based on a number of factors including the length of service and salary, were the norm. Historically, these types of plans, because of their design, penalized job changes for workers thus tying them to the firm for life.

Starting in the mid-1980s, defined benefit plans began to be phased out and replaced with defined contribution plans. These defined contribution plans required the employee to put in some or all of the money while working. As a result, their actual retirement fund is tied to the securities that they are invested in as part of their own portfolio in

the capital markets. At the same time in the 1980s, the U.S. corporations saw a huge takeover wave with a movement towards a performance-based executive compensation for management. This new performance-based compensation helped make managers more focused on the value of the corporation's stock, which by default has had repercussions on the value of the worker's portfolios. By the 1990s, according to Dobbin and Zorn (2005), managers aligned themselves increasingly with the interests of shareholders through new forms of executive pay and adopting the ideology of shareholder value. Shareholder value, the primary goal for the firm, is defined as the increase in the value of the shareholder's wealth, either via the distribution of dividends or the increased value of the firm's stock. Interestingly enough, this movement towards the shareholder

value, coupled with the increased use of defined contribution plans, has caused a reduction in individual or retail ownership of stocks toward a movement to more institutional ownership.

According to Gelter (2016), by the 2000's we see a reconcentration of share ownership with a higher proportion of shares being held by institutional investors with retail investors progressively leaving the market. Gelter (2016) argues that while the U.S. remains to a large extent manager-centric, managerial incentives are more aligned with shareholder interest. He argues that because of the defined contribution plans, which now constitute the majority of retirement plans held by employees in the U.S., the role of labor has changed fundamentally and employees have effectively become shareholders.

As ownership and executive pay changes shifted in the U.S. so did the need for more corporate oversight and accountability. The corporate scandals of the 1990s, such as Enron, Tyco, WorldCom, etc., lead to an increased emphasis on effective corporate governance and increased regulations at both the state and federal levels including the passage of the Sarbanes-Oxley Act (SOX) of 2002. The SOX is a measure to improve transparency in financial accounting and to prevent fraud. The global financial crash of 2008 led to among other things the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which increased capital requirements for financial institutions to limit the risk by enforcing transparency and accountability.

The result is that much of the current debate that centers on corporate governance in the U.S. focuses on the issues that surround ownership structure. Are corporations owned by a wide variety of disempowered shareholders, thus rendering the management team of the corporation free reign? Alternatively, are corporations governed by a closely held and controlling shareholder or a coalition of shareholders (family, hedge fund, institutional investor, etc.) that closely monitor management and have a larger say in the path of the corporation's day-to-day operations? Owners of businesses in the U.S. derive their rights from the charter and bylaws of the company, the laws of the state, in which the company is incorporated or organized, and the U.S. federal securities laws and regulations. Shareholders of firms with shares trading on listed stock exchanges may also have additional rights emanating from the rules of the exchange.

In this paper, we provide an overview of business entities in the U.S. in Section 2. We analyze trends in ownership structures of U.S. firms in Section 3, analyze trends in mergers and acquisitions in Section 4, discuss minority shareholder rights protections in Section 5, and review the literature related to corporate ownership and financial performance in Section 6. In Section 7, we conclude.

2. A LEGAL OVERVIEW OF BUSINESSES IN THE U.S.

2.1. Types of business entities in the U.S.

According to the United States Internal Revenue Service, there are five different types of businesses in the U.S. as shown in Table 1.

Table 1. Types of business entities in the U.S.

No.	Types
1.	Sole proprietor
2.	Partnership
3.	Corporations
4.	S corporations
5.	LLC (limited liability company)

Sole proprietorship: The sole proprietorship is the simplest form of a business operation. The sole proprietor is the person who owns the business. The business is not a legal entity. Many sole proprietors use their own name as the company name or a trade name such as Grace's Beauty Salon. The person who is the sole proprietor is the person who is legally responsible for the debts and liabilities of the business. They own the business by themselves and are not in business with someone else.

The sole proprietorship is a very popular form of business in the U.S. because it is easy to set up and costs very little in the way of legal red tape. There is no need to observe such things as annual board meetings, voting rights, etc., as with other businesses since there is no one else connected to the business. Companies that are sole proprietorships will only do one set of taxes and all profits and losses go through the personal taxes of the individual who owns the company. Such an arrangement with reference to taxes is called a "pass-through".

Sole proprietorships cannot raise funds by selling shares in the company as there are no shares to sell. Additionally, if a sole proprietor runs into financial trouble with the business the sole proprietor is the only person responsible for all the business's debts and liabilities. Creditors can bring lawsuits against the proprietorship and the owner of the sole proprietorship will be responsible for paying all the debts, etc., with their own money. Many businesses start as a sole proprietorship and progress from there to become other forms of more complicated businesses as they grow.

General partnerships, a limited partner, and limited liability partnerships: A partnership is where two or more individuals choose to carry on a trade or a business operation together to share in its profits and losses. Each of the members of the partnership brings something to the table of interest to the other party, i.e., labor, skill, and money. There are three types of partnerships: a general partnership, a limited partnership, and a limited liability partnership.

General partnerships are more complicated than sole proprietors since they are owned by more than one person. As such, they need to file annual paperwork with the government that details income, profit/losses, deductions, expenses, etc. associated with the business. This report informs the government of its financial history over the course of the year. However, the firm does not pay taxes via the partnership. Instead, the owners of the partnership allocate the partnership's income or losses to each other based on the percentages of their ownership. The income or losses are "passed through" to their own personal income taxes and each pays according to what they owe. The ease of the "pass-through" with partnership profits and losses makes owning a partnership relatively inexpensive. General partners share in the liabilities of the firms and are responsible for liabilities that other partners incur related to the firm. This risk of liability can be too much for some partners to incur. As a result, some companies have limited partners or can be set up as limited liability partnerships.

Limited partners are those who do not take on any risk liability of the actions of the management/owners and cannot participate in the management of the company. They are usually just investors in the company and can share in the profits of the company. In this partnership form, management can govern the business as they wish without the limited partners getting involved in the running of the business. Taxes are handled as they are in a general partnership by passing the profits and losses to the individual's personal taxes.

A limited liability partnership (LLP) allows limited liability for all the parties associated with the business. Limited liability partnerships do allow partners to participate in management decisions and each partner is not responsible for the liabilities of the other partners. The partner in the LLP is responsible for their own negligence and is responsible for the negligence of anyone working directly under their supervision, but is not responsible for the negligence of the other partners. This type of partnership is only available to a few types of professionals such as doctors or lawyers.

Corporations: A corporation is a legal entity, which is guided by a group of individual officers known as the board of directors. The corporation's owners are its shareholders. Shareholders exchange funds for ownership in the business. The ownership is in the form of the company's capital stock. The company will pay taxes at the corporate level on any profits the firm earns. When these profits are distributed, as dividends, the individual owners will be taxed on those dividends as well. As a result, the operating profits of corporations in the U.S. may be double taxed, first at the corporation level and secondly at the shareholder level.

A corporation files legal paperwork to be incorporated in a particular state and then must file paperwork with any state which they wish to do business in. The owners of the firm (its shareholders) have elections each year to elect the board of directors. The board of directors meets regularly to discuss and monitor the health and direction of the company. The board of directors also, in turn, elects officers to run the company such as a President (CEO), a Chief Financial Officer (CFO),

a Secretary, etc. These officers run the day-to-day operations of the company.

Shareholders of the corporation have limited liability in the company. They do not take on any legal responsibility for any damage the corporation may do. The most that they stand to lose is their financial investment in the company. None of their personal assets is at risk if the company fails. They do get to share in the profits of the company through dividends and price appreciation but do not get involved in the day-to-day operation of the company.

S corporations: An S corporation is a special type of corporation that allows the profits and losses to be passed directly through the shareholders so they can pay taxes at the individual level. This type of corporation eliminates the disadvantage of double taxation, while at the same time, keeping the limited liability of the shareholders. The result is that the S corporation is more appealing to small firms that want to incorporate. However, the cost of administrative paperwork associated with filing at the corporate level makes it a more expensive option than the partnership. According to the Internal Revenue Service, S corporations must be domestic corporations, with only certain types of shareholders. They can have no more than 100 shareholders. S corporations need to follow all the paperwork of regular corporations and must also follow the same structure of directors and shareholder meetings each year. While traditional or general corporations are allowed to issue multiple types of stock, S corporations are only allowed to issue common stock. This stipulation can make it more difficult for S corporations to find investors and limits growth opportunities.

Limited liability corporations (LLCs): A limited liability corporation (LLC) is a special type of corporation that has the advantages of the limited liability of the owners to the debts and liabilities of the company. LLCs also have the advantage, similar to that of an S corporation, of the pass-through tax entity, which allows the profits and losses of the company to pass through to the individual owners' personal taxes thus eliminating the double taxation standard.

Table 2. Comparison of the typical business ownership and the requirements

Type of business structure	Ease of formation	Amount of liability	Operational requirements	Management considerations	Federal tax consequences
Sole proprietorship	Easy	Sole proprietor has unlimited liability	Relatively few	Sole proprietor has 100% control of management	Profit and loss are taxed at personal level
General partnership	Low/Moderate	Each partner is liable for themselves and the other partners	Moderate some requirements but less than corporations	Each general partner has a say in the management of the firm	Each partner is taxed at the personal level based on their ownership
Limited partner	Low/Moderate	No liability really just an investor	Moderate some requirements but less than corporations	Limited partners are not allowed to be involved in management	Each partner is taxed at the personal level based on their ownership
Limited liability partnership (LLP)	Low/Moderate	Each partner is liable for themselves and those under their direction	Moderate some requirements but less than corporations	Each partner has a say in the management of the company	Each partner is taxed at the personal level based on their ownership
Corporation	High	Shareholders are not responsible for firm liabilities	Board and shareholders' meetings and files	Board of directors responsible for management	A separate entity is required to pay taxes. Taxed again at the dividend level to shareholders
S corporation	Med/High	Shareholders are not responsible for firm liabilities	Board and shareholders' meetings and files	Board of directors responsible for management	Profits and losses are passed through to the personal level
Limited liability corporation (LLC)	Medium	Shareholders are not responsible for firms' liabilities	Some requirements but less than corporation	Management responsibilities are outlined by owner agreement	Profits and losses are passed through to the personal level

However, unlike the S corporation, the LLC can have more than 100 shareholders. An LLC is also allowed to have non-U.S. citizens as shareholders. LLCs are also more flexible in distributing profits to their owners and are not bound by the level of ownership to do so. The LLC can issue more than just common stock, but unlike an S corporation, more than one person is necessary to form an LLC and its ownership is not perpetual. Owners of the LLC will have to seek approval from other owners in the LLC to transfer their interest to another party. Table 2 shows a summary comparison of the typical business ownership structures available in the U.S.

2.2. Share structure in U.S. corporations

Many companies have two different types of shares: common and preferred. Common shares are the most prevalent. Usually, common shares carry a voting right per share and a claim on the potential dividends the company will pay. The voting rights allow the investors to vote for the board members that will be responsible for managing the company. Sometimes the common shares are delineated into different types. For example, Class A shares may have more voting rights per share and lower dividends while class B shares have less voting rights but higher dividends. This concentrates the decision-making power of the firm into a major block of owners such as a family or institutional investors.

The second form of shares is called preferred shares. Preferred shares are similar in valuation to a perpetual bond. The preferred shares usually do not come with any voting rights for the firm and usually have a fixed dividend payment. Preferred shares have a higher claim on the assets than do the owners of the common shares. As such, dividends on preferred shares are required to be paid before any payout to common shareholders.

3. OWNERSHIP STRUCTURES IN THE U.S.

Many businesses start as a single entity or family-run company and grow to include a wider base of owners. The concentration of ownership can vary depending on the individual characteristics of the firm. Below are some types of ownership that companies in the U.S. may have.

3.1. Family ownership

Family ownership can run the gamut of types of firms from sole proprietor through the public

corporation. Usually, when associated with a family connection, it means that the family has a controlling ownership stake in the firm by holding a majority of the firm's shares of stock. Family members may serve as CEOs, top managers, chairpersons, or directors of the firms.

3.2. Institutional ownership

One of the problems of having many individual owners of a corporation's stock is that each owner carries such a small weight in the voting rights that agency problems could arise due to the inability of any individual investor to make a difference as to the management of the firm. As the result of many individual investors moving their assets into institutional funds for defined contribution plans, the corporate governing functions of institutional owners can reduce agency problems and improve firm performance (Shleifer & Vishny, 1986). In a corporation with many small owners, it may not pay any one of them to monitor the performance of the management. Shleifer and Vishny (1986) explore a model in which the presence of a large minority shareholder such as an institutional owner can provide a partial solution to this agency problem.

Institutional investors are by definition not an individual person. They are intermediaries who can be described as managers and investors of other people's money. Institutional ownership refers to the amount of a company's stock, which is owned by pension funds, mutual funds, insurance companies, hedge funds, venture capital firms, investment funds, endowments, and private foundations. According to Borochin and Yang (2016), by the 1980s institutional investors held approximately 20–30% of the average publicly traded firm with the remaining 70–80% made up by individual retail investors. However, according to Blume and Keim (2017), by the 2010s as markets changed and more individuals moved their investments into investment funds, insurance companies, and mutual funds, etc., over 65% of the average publicly traded firm is now owned by institutional investors.

Table 3 shows the financial assets in the U.S. in billions of dollars under management by various institutional investors. Investment funds have increased financial assets managed between 2009 and 2016 by 8%; while insurance companies and pension funds have seen a 5% and 6% increase respectively.

Table 3. Financial assets under management in billions of U.S. dollars

	2009	2010	2011	2012	2013	2014	2015	2016
Investment funds*	12,335	13,366	13,356	15,252	17,867	18,864	18,672	19,798
Insurance companies	6,448	6,941	7,284	7,667	7,935	8,365	8,294	8,672
Pension funds	13,181	14,554	14,927	15,765	16,976	17,598	17,931	18,734

Notes: * Investment funds = Non-money market funds + money market funds.

Source: OECD (2017).

Large investors can have a significant impact on the governance, decision-making, and performance of publicly traded firms. When an individual or group of investors acquire ownership of more than 5% of a voting class of a firm's equity securities registered under Section 12 of the Securities Exchange Act of 1934, they are

required to file a Schedule 13D (or possibly the abbreviated Schedule 13G) with the Securities and Exchange Commission (SEC) within 10 days of the purchase. This information is provided to the firm and each exchange where the security is traded and is available for most publicly traded firms in the SEC's EDGAR database.

Table 4 provides trends of institutional block ownerships of greater than 5% from 1997 to 2016. Institutional block owners can provide an external monitoring role of the firm's top management thereby mitigating potential agency issues. The number of institutional block owners increased each year from 2003 to a peak of 13,167 in 2007 followed by a downward trend after the market crash of 2008. By 2016, the number of block institutional owners with greater than 5% of the outstanding common shares was 8,567 fewer than the 8,808 owners in 1997 reflecting a persistent preference for diversification by large institutional investors since the market crash 2008.

In 1975, Congress passed Section 13(f) of the Securities Exchange Act of 1934 to increase the public availability of information regarding the securities holdings of institutional investment managers. According to the SEC, institutional investment managers are those entities that either invest in, buy or sell, securities for their own accounts, including banks; insurance companies; brokers/dealers; corporations and pension funds

that manage their own investment portfolios; investment advisors who manage private accounts, mutual fund assets, pension plan assets including municipal pension funds; and trust departments of banks who exercise investment discretion over \$100 million or more in Section 13(f) securities. The Official List of Section 13(f) securities primarily includes the U.S. exchange-traded stocks, shares of closed-end investment companies, and share of exchange-traded funds (ETFs), as well as certain convertible debt securities, equity options, and warrants and are available on the SEC website. According to data compiled from the Thomson Reuters 13-F holdings database, the average number of 13-F institutional owners for firms providing data increased each year from 36 in 1997 to 91 in 2016, an increase of 153% over the twenty years. The results of Table 4 suggest a growing trend in the U.S. financial markets in the average number of large institutional owners each year over the 1997 to 2016 period, yet the number of institutional owners with a greater than 5% interest in a particular firm has generally decreased since the market crash of 2008.

Table 4. Trends of institutional block ownership of greater than 5% from 1997 to 2006

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Number > 5%	8,808	10,087	9,297	9,213	8,862	8,780	8,486	9,847	11,093	11,968
Avg. 13-F	36	38	41	43	45	47	56	60	59	63
Number	10,413	12,044	12,119	12,113	10,825	10,609	9,997	10,045	10,722	11,027
Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number > 5%	13,167	12,871	11,249	11,551	10,967	10,988	9,363	9,816	9,417	8,567
Avg. 13-F	66	61	66	67	69	77	81	82	87	91
Number	10,971	10,831	10,356	10,599	10,183	9,022	9,582	9,585	8,576	8,007

Notes: Number > 5% is the number of institutional block owners with greater than 5% of the outstanding shares, Avg. 13-F is the average number of 13-F institutional owners, and number is the number of firms providing data (information is gathered from U.S. Securities and Exchange Commission website, <https://www.sec.gov/>).

Source: Data is compiled from Thomson Reuters 13-F Holdings and Standard and Poor's databases.

3.3. Foreign investment in the U.S.

The Bureau of Economic Analysis (BEA) follows foreign stakeholders of the U.S. firms and the U.S. affiliates. The BEA compiles statistical reports on companies for the analysis of multinational enterprises. According to the BEA, direct foreign investment in the U.S. is defined as a foreign investor owning at least 10% or more of voting securities of an incorporated U.S. business enterprise or an equivalent interest of an unincorporated U.S. business enterprise. The entity that is purchasing the investment is known as a foreign parent, and the foreign-owned U.S. entity is known

as a U.S. affiliate. The BEA also collects data on foreign direct investment in the U.S. (FDIUS) classified by country of the entity that ultimately owns or controls the U.S. affiliate (UBO).

Table 5 shows the total assets data of foreign direct investment in the U.S. by country from 2007 to 2015. The total foreign direct investment in the U.S. was \$12,224 trillion in 2009, the year after the market crash, and peaked at \$15,018 trillion in 2014. The largest foreign direct investment in the U.S. is by far from Europe and the European Union, followed by Asia and the Pacific Rim, and Canada.

Table 5. Foreign direct investment in the U.S.

	Total assets in millions of dollars								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
All countries	12,955,017	12,940,379	12,224,926	12,477,805	13,458,569	13,848,988	14,641,199	15,018,614	14,449,471
Canada	1,108,494	1,227,428	1,355,937	1,412,515	1,563,611	1,816,414	1,733,092	1,918,221	1,913,131
Europe	9,768,958	9,194,813	8,631,428	8,792,337	8,727,006	8,664,753	8,882,046	8,777,480	7,983,437
Latin America and other Western Hemisphere	450,672	433,324	368,029	314,369	349,834	346,174	401,838	426,000	(D)
Africa	(D)	(D)	(D)	(D)	(D)	5,878	5,529	7,031	11,298
Middle East	131,579	151,552	152,603	151,066	183,564	187,220	193,348	198,504	194,512
Asia and Pacific	1,321,184	1,743,844	1,531,866	1,650,025	2,452,444	2,622,733	3,145,948	(D)	3,495,266
European Union	7,706,033	7,492,121	7,256,911	7,347,922	7,142,144	7,154,016	7,444,730	7,344,348	6,644,945
OPEC	92,839	98,867	100,005	104,801	119,112	119,969	126,081	129,337	124,682

Notes: D suppressed to avoid disclosure of data of individual companies. OPEC is the Organization of Petroleum Exporting Countries. Source: Bureau of Economic Analysis (BAE), Department of Commerce (n.d., https://www.bea.gov/iTable/index_MNC.cfm).

4. THE U.S. MARKET FOR CORPORATE CONTROL

4.1. Remuneration and diversity

Table 6 provides information concerning the diversity of top management of publicly traded firms and compensation data of top management and other workers. The degree of corporate governance and control can be manifested in the firm's increase in the percentage of females in top management positions from only 4.2% in 1997 to a still troubling 8.1% in 2014. More troubling was the decrease of women in top management to only 6.9% in 2015 and 6% in 2016. It is unclear whether the results of 2015 and 2016 are just statistical noise in the data or the start of a new trend of fewer

women in top management positions. Reasons for the low participation of women in top management positions may include lower labor market participation rates, gender differences in career goals and negotiations, and, of course, gender biases. However, in discussions with human resources managers across multiple industries, the authors observe a clear preference among the U.S. publicly traded firms for diverse candidates for entry-level and middle management positions. The expectation is that biases against women and other minorities will be lessened in the future, but the process will take many years before it is fully recognized and understood that any bias is a shareholder wealth reducing strategy.

Table 6. Diversity and compensation of top management

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
% Female	0.042	0.046	0.052	0.057	0.062	0.065	0.067	0.069	0.069	0.073
Avg. salary % Δ	28.50	27.09	32.53	32.48	31.41	36.62	34.29	38.97	31.09	22.30
Avg. hourly % Δ	3.90	4.00	3.69	3.93	3.71	2.96	2.67	2.08	2.74	3.91
Number	12,063	12,656	12,214	11,542	11,384	11,559	11,817	10,904	9,388	10,971
Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
% Female	0.074	0.077	0.077	0.080	0.079	0.082	0.082	0.081	0.069	0.060
Avg. salary % Δ	26.06	29.14	19.40	18.14	18.47	16.27	19.81	18.39	16.35	15.82
Avg. hourly % Δ	4.00	3.67	3.05	2.36	2.05	1.54	1.98	2.38	2.04	2.43
Avg. SEC Comp.	2,530	2,390	2,315	2,738	2,903	2,983	2,972	3,553	3,315	3,513
Number	12,848	12,321	11,755	11,413	11,202	11,004	10,819	10,587	10,132	9,273

Notes: % female is equal to the percent of females who belong to the top 5 executives; Avg. salary % Δ is the average salary percent change year-to-year (%) of top 5 executives; Avg. hourly % Δ is average hourly wages in private non-farm sector of economy percent change year-to-year (%); Avg. SEC Comp. is the average total compensation of top 5 executives as reported in SEC filings (in thousands); Number is the number of firms providing data.

Source: Data is compiled from S&P Compustat Executive Compensation database and U.S. Bureau of Labor Statistics.

Table 6 also provides information concerning the compensation of publicly traded firms' top 5 executives relative to hourly workers in the non-farm sector of the U.S. economy. The results demonstrate a growing disparity between the compensation of top management and hourly workers each year from 1997 to 2016. While the growth in hourly wages is comparable to changes in the Consumer Price Index (CPI) over the period, the compensation of the top executives has increased significantly in real terms. We also observe that the average total compensation of top management as reported in SEC filings has increased from \$2,530,000 in 2007 to \$3,513,000 in 2016. By comparison, the average hourly wages in the non-farm sector of the U.S. economy were \$17.42 (or \$32,234 annually) in 2007 and \$21.54 (or \$44,803) in 2016.

4.2. Mergers and acquisitions (M&A)

Corporate growth can be achieved through the acquisition of new assets (direct investment) or by the acquisition of existing assets via mergers and acquisitions (indirect investment). Both sources of growth are positively correlated and related to expectations concerning the overall economy. Table 7 provides information from Mergerstat Review concerning the number of net merger and acquisition announcements from 1997 to 2016. The number of M&As ranged from a low of 6,796 in 2009, the year after the market crash, to a high of 12,012 in 2015. For years of increases in the number of M&As exceeding 23% (1997, 2004, 2010, 2014), we observe significant increases in the S&P 500 the year before.

Table 7. Trends in mergers and acquisitions (M&A)

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Number	7,800	7,809	9,278	9,566	8,290	7,303	7,983	9,783	10,332	10,660
% Δ	33%	0%	19%	3%	-13%	-12%	9%	23%	6%	3%
S&P 500 % Δ	33.36	28.58	21.04	-9.10	-11.89	-22.10	28.68	10.88	4.91	15.79
Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number	10,559	7,807	6,796	9,116	9,519	9,610	8,777	11,240	12,012	11,657
% Δ	-1%	-26%	-13%	34%	5%	1%	-8%	28%	7%	-8%
S&P 500 % Δ	5.49	-37.00	26.46	15.06	2.11	16.00	32.39	13.69	1.38	11.96

Notes: Number is the number of net M&A announcements; % Δ is the year to year percentage change in net M&A announcements; S&P 500 % Δ is the percentage change in S&P 500 total return.

Source: Data is taken from FactSet Mergerstat (2017) and S&P databases.

Mergerstat attributes the growth in M&A activity in the late 1990s to deregulation and consolidation in the banking, utilities, office supply, and healthcare industries. Decreased M&A activity in 2001 and 2002, was related to the internet bubble, recession, corporate scandals, terrorist attacks, and conflicts with Iraq. With lower interest rates, merger activity increased in 2004 through 2006 when it reached an all-time high of 10,660 deals. Mergerstat identifies the transformational deal-making of private equity groups as an important source of the number of M&As in 2006 and 2007. The Great Recession combined with the collapse of the U.S. banking system had a profound effect on the significant reduction of deals in 2008 and 2009. The period of 2014 to 2016, saw an increase in M&A activity with the record number of and total deal volume in 2014 and 2015 followed by near-record highs in 2016 (FactSet Mergerstat, 2017). Table 8 provides information from Mergerstat Review that decomposes the number of net M&A announcements by characteristics of the sellers for the period 2007

to 2016. By far, the largest group of sellers involved privately-owned businesses ranging from 51% of M&A announcements recorded in 2009 to 59% in 2015 and 2016. It is noted that the actual relative amount of deals involving privately held sellers are most likely understated since many transactions involving privately held sellers and buyers can go unreported. We observe the highest percentage of divestitures occurred in 2009 after the market crash of 2008. Also of interest is that the percentage of foreign sellers remained relatively stable each year ranging from a high of 12% in 2008 to a low of 9% in 2009. Although average transaction values were much higher, publicly traded sellers made up only 3–5% of the number of deals during the 2006 to 2016 period. This causes some trepidation in interpreting academic research on M&A activity since most samples use only publicly available information included in financial databases and ignore the majority of deals involving privately held sellers.

Table 8. M&A seller's characteristics 2007 to 2016

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Divest	30%	30%	36%	34%	31%	31%	32%	29%	27%	27%
Public	5%	4%	4%	4%	3%	4%	4%	3%	3%	4%
Private	55%	54%	51%	52%	55%	55%	54%	57%	59%	59%
Foreign	11%	12%	9%	11%	11%	10%	11%	11%	10%	10%
Number	10,559	7,807	6,796	9,116	9,519	9,610	8,777	11,240	12,012	11,657

Notes: Divestitures is the sale of subsidiaries, minority interests, or divisions; Public is the publically traded sellers; Private is the privately-owned sellers; Foreign is the foreign sellers; Number is the number of net M&A announcements.

Source: Data is taken from FactSet Mergerstat (2017).

Table 9 provides information from Mergerstat Review concerning the method of payment for the period 1997 to 2016 when the information is reported. Cash transactions are the preferred method of compensation for the sellers each year

while deals resulting in sellers receiving debt securities are rarely observed (maximum of 2% of deals in any given year). Transactions, where cash was the method of payment, ranged from a low of 40% in 1997 to a high of 76% in 2016.

Table 9. Method of payment

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Cash	40%	44%	46%	49%	45%	56%	59%	57%	54%	59%
Stock	33%	30%	30%	32%	27%	22%	18%	18%	19%	17%
Comb	27%	26%	24%	18%	27%	21%	22%	24%	25%	23%
Debt	0%	0%	0%	0%	0%	0%	0%	0%	2%	1%
Number	3,153	3,440	4,048	3,602	3,080	2,702	2,870	3,113	3,143	2,896
Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Cash	58%	57%	51%	60%	64%	71%	71%	72%	72%	76%
Stock	16%	20%	29%	21%	17%	13%	12%	12%	10%	9%
Comb	24%	22%	19%	18%	19%	16%	16%	16%	18%	14%
Debt	2%	2%	1%	1%	1%	1%	0%	0%	0%	0%
Number	2,928	1,977	1,614	2,573	2,458	2,455	2,836	3,886	4,013	3,819

Notes: Cash is used to pay the target shareholders; Stock is an exchange of stock between acquiring and target shareholders; Comb is a combination of cash and stock and other securities used to pay target shareholders; Debt is debt and other securities used to pay target shareholders; and Number is the number of transactions disclosing a method of payment.

Source: Data is taken from FactSet Mergerstat (2017).

Stock deals ranged from a high of 33% of all deals reported in 1997 to a low of 9% in 2016. Deals involving a combination of securities ranged from a high of 27% in 1997 and 2001 to a low of 14% in 2016. Deals involving a combination of securities became more important relative to stock-only transactions beginning in 2003 and continuing each year to 2016.

5. MINORITY SHAREHOLDER RIGHTS PROTECTIONS IN THE U.S.

State statutes and court decisions are the primary sources of law regarding the protection of minority shareholders. Most corporations are incorporated in the state of Delaware and many states follow Delaware corporate law with regard to the relative powers, rights, and responsibilities of boards of directors, officers, and shareholders.

The U.S. federal securities laws and regulations govern the issuance, sales, and purchase of

securities by issuers and investors, disclosure, and governance requirements for firms listed on an exchange. Overall, shareholders have little direct influence over the operations of the firm but can influence decisions only indirectly by shaping the composition of the board.

One of the main issues confronting minority shareholders is preemptive rights to protect against dilution. A majority of the U.S. states, including Delaware and New York, have adopted “opt-in” statutes where absent an express provision in the firm’s charter establishing preemptive rights shareholders do not have them. Since preemptive rights can impede the capital allocation process, or make it more costly, less than 20 companies in the S&P 500 have preemptive rights. Minority shareholders are not given any special rights to appoint boards of directors other than having the right to vote on nominees at the annual shareholders’ meetings. Shareholders do not have the right to interfere with the board of directors imposing antitakeover measures unless specified in its certificate of incorporation. Fair price status and minority shareholder appraisal rights in mergers and acquisitions are governed by state laws. Shareholders have the right to inspect corporate books and records while investigating corporate mismanagement (see Cheffins, Bank, and Wells, 2016, for a detailed discussion of the minority shareholder rights in the United States).

6. THE U.S. CORPORATE OWNERSHIP AND FIRM PERFORMANCE

6.1. Corporate social responsibility (CSR) and performance

Over the past decade, academic finance and management literature has focused on the potential benefits and costs associated with a company’s corporate social responsibility (CSR). CSR is used to define and evaluate a company’s involvement in its corporate community. Other terms synonymous with the concept of CSR would be stakeholder theory as defined by Freeman (1984), corporate social performance (CSP) as defined by Waddock and Graves (1997a, 1997b), corporate community involvement (CCI) as defined by Burke (1999), corporate philanthropy as defined by Godfrey (2005), and the general term social responsibility (SR). Depending on your point of view, either CSR can be an important component of the company’s strategy or it can be a waste of shareholders’ funds. Godfrey (2005) looks at the relationship between corporate philanthropy and shareholder wealth. Godfrey (2005) argues that overall rational managers should engage in corporate philanthropy because such activity benefits shareholders. Gan (2006) analyzes a sample of 40 Fortune 500 companies over seven years. Gan (2006) finds support for Godfrey (2005) by looking at the relationship between corporate philanthropy and shareholder wealth using the philanthropic behavior of 40 Fortune 500 companies over seven years. He argues that the data shows that philanthropy could provide insurance-like protection for relational wealth. Gan (2006) continues to argue that companies appear to do good to do well. The reputational benefits from making the donation in hard times

may be better appreciated and applauded than if made in good times. Patten (2008) investigates the market reaction to corporate press releases announcing donations to the relief effort following the December 2004 tsunami in Southeast Asia using a sample of 79 U.S. companies. Overall, Patten’s results also support Godfrey (2005) who claims that philanthropic giving needs to be interpreted as being a genuine manifestation of the firm’s underlying social responsiveness in order to increase firm value.

Hogan, Olson, and Sharma (2015) expand on Godfrey’s (2005) work to assess the relationship between a firm’s community spending and the scores it receives from organizations that rate firms’ CSR and whether community spending and these scores are related to shareholder return. They find differences in the relationship between corporate philanthropy and a firm’s scores on various measures of CSR. They also report that firms with a lower probability of bankruptcy, more women on the board, and larger boards tend to give more money to the community. They ultimately find that excess returns are positively related to a firm’s governance disclosure score, but negatively related to its social disclosure score. Their data does not support the contention that, on average, community spending as a percent of EBITDA has any effect on the value to the firm.

Dimson, Karakas, and Li (2015) analyze an extensive proprietary database of corporate social responsibility engagements with the U.S. public companies from 1999–2009. Engagements address environmental, social, and governance concerns. Successful (unsuccessful) engagements are followed by positive (zero) abnormal returns. Companies with inferior governance and socially conscious institutional investors are more likely to be engaged. Success in engagements is more probable if the engaged firm has reputational concerns and a higher capacity to implement changes. Collaboration among activists is instrumental in increasing the success rate of environmental/social engagements. After successful engagements, particularly on environmental/social issues, companies experience improved accounting performance and governance and increased institutional ownership.

Corporate social responsibility has also been credited for attracting and retaining employees. According to Rochlin and Christoffer (2000), there is a “war for talent.” They argue that the relationship between CSR and customer recruitment has been around for some time. Many industries use the relationships established from business involvement in civic affairs to spill over into new client and customer development.

6.2. Corporate governance and performance

In the U.S., most public companies have what is considered a two-tier system for corporate governance. The first tier is the board of directors sometimes also called the board of governors. The shareholders (owners of the corporation) elect this first tier. The board of directors has both inside directors (those chosen from within the company such as the CEO, CFO, etc.) and outside directors, which are individuals that are external to the company. The board also has a Chairman

of the board who is in charge of the board itself. The overall role of the board of directors is to represent the shareholders to make sure the firm is being run properly and with the shareholders' best interests in mind.

The second tier is the managers of the corporation who do the day-to-day running of the company. The board of directors hires this second tier. Within the second tier, you would have the management team that runs the company. Individuals such as the CEO, COO, and CFO are considered firm management. Management can also be considered insiders on the board of directors. For example, the CEO may also be called the company President and thus is a board insider. Usually, the Chairman of the board is not the company CEO so that the lines of authority are not blurred while trying to carry out the wishes of the board with the will of the managers.

The board of directors also has many standing committees to take advantage of the talents of their board members. According to Chen and Wu (2016), a study of publicly traded firms from 2001 to 2013 evaluated common standing or "operating" committees as part of most board of directors. The authors find the four most common operating committees in U.S. public companies and the percentage of firms who had them were:

- Audit Committee (99.9%) which is responsible for financial oversight of the firm.
- The Remuneration (compensation) Committee (98.1%) which decides on high-level manager's compensation structure.
- The nominating or Governance Committee (84.8%) which evaluates future board members.
- The Executive Committee (21.2%) which has the executive power to speak for the board as a whole.

Bolton (2014) finds a positive relationship between audit committee stock ownership and firm performance in large US firms from 1998 to 2008. According to Bolton, the results persist throughout the sample period, do not weaken after Sarbanes-Oxley, and are robust to controlling for endogeneity between ownership and performance. The research shows no support for a relationship between audit committee independence and firm performance. The author suggests that audit committee stock ownership is an important corporate governance mechanism and potentially a more relevant variable than audit committee independence from a policy perspective.

Von Lilienfeld-Toal and Ruenzi (2014) examine the relationship between CEO ownership and stock market performance. A strategy based on public information about managerial ownership delivers annual abnormal returns of 4% to 10%. The effect is strongest among firms with weak external governance, weak product market competition, and large managerial discretion, suggesting that CEO ownership can reverse the negative impact of weak governance. The authors argue that owner-CEOs are increasing as they reduce empire building and run their firms more efficiently.

Much of the argument around agency theory and executive compensation centers on the short-term mindset of some managers when it comes to firm performance and compensation. Quinn (2018) investigates whether adoptions of executive stock

ownership plans coincide with decreased incentives to meet or just beat analysts' near-term EPS forecasts. Firms often assert that ownership plans focus executives on long-term performance. The results suggest that firms use binding ownership plans to shift executives' focus from near-term earnings benchmarks to long-term value creation.

Sur, Lvina, and Magnan (2013) examine how the ownership structure of a firm, specifically the aggregation of the different ownership types within each firm, relates to the composition of its board. Using archival data from a sample comprising 1,487 U.S. firms, the researchers find that the composition of the individual profiles of directors on corporate boards (i.e., independent, affiliated, or insider) match a firm's aggregated ownership configuration (institutional, corporate parent, family-entrepreneur control) even after parsing out the impact of CEO characteristics, firm size, and performance. Each type of ownership has differing imperatives and may prefer different types of directors to fulfill their governance needs. This study shows that ownership and board composition are not substitutable governance mechanisms as commonly understood, but might be complementary mechanisms.

Weiss and Hilger (2012), analyze the relationship between ownership concentration and firm performance. Using a sample of 1,079 firms from 8 countries they find evidence for a curvilinear effect of ownership concentration on firm performance, which becomes insignificant after controlling for ownership structure, differences in governance systems, and the use of alternative performance measures.

Jermias and Gani (2004) investigate a sample of the U.S. companies listed in the Compustat S&P 500 database, to determine the effects of board capital (directors' educational level, directors' industry-specific experience, and interlocking directorate ties) on the relationship between CEO duality, board dependence, managerial share ownership, and performance. The authors argue that highly qualified board members who possess more board capital will be better at monitoring management and as a result add more value to the firm. The authors find that when the CEO also holds the position of the chairman of the board, the performance is negatively affected and that board capital mitigates the negative effects. They also find that managerial share ownership positively affects performance and that board capital strengthens this positive relationship. The results are consistent with the view that firms benefit from board capital in terms of outside directors' ability to monitor managers and provide advice and counsel to managers.

Zhang and Gimeno (2016) argue that CEOs who are forced to have a longer view of performance due to incentives that have not yet vested will behave more in line with long-term strategic goals for the firm. This behavior is in contrast to CEOs who focus on short-term goals where they have no vesting requirements on their stock-based incentives. The study looked at decisions made by U.S. airlines under quarterly earnings pressure and examined the effect of earnings pressure on competitive behavior under different ownership structures and CEO incentives. The evidence

supports the view that the pursuit of short-term earnings, because of earnings pressure, may be detrimental to long-term competitiveness.

Fahlenbrach (2009a) analyzes the role of executive compensation in governance using proxies for corporate governance of board size, board independence, CEO-chair duality, institutional ownership concentration, CEO tenure, and an index of shareholder rights. The author's results from a broad cross-section of large U.S. public corporations are inconsistent with recent claims that entrenched managers design their own compensation contracts. If a corporation has generally weaker governance, the compensation contract helps better align the interests of shareholders and the CEO.

Fahlenbrach (2009b) evaluated the difference between founder CEO firms and successor CEO firms for equal-weighted investments between 1993 and 2002. Founder CEO firms were shown to invest more in research and development, have higher capital expenditures, and make more focused mergers and acquisitions. The abnormal return of nearly 5% for founder CEO firms persisted even after adjusting for various firm characteristics.

Cheng, Cummins, and Lin (2017) investigate the role of organizational form and ownership structure in corporate governance by examining CEO turnover for U.S. property-casualty insurers. Their sample looked at both public and non-public closely held firms. Family and nonfamily CEOs were also separated to determine the effects, if any, on firm performance. The authors find that the probability of unexpected turnover in control has a significant negative relationship with firm performance. Firms that were governed by a CEO in the family had the lowest turnover rate of any ownership type. Their results support the evidence that organizational structure matters if the goal is to control potential agency costs.

Kryzanowski and Mohebshahedin (2016) use a panel database of the U.S. closed-end funds (CEFs) during 1994–2013 and examine relations between board effectiveness and board structure. CEF boards with higher percentages of independent directors are associated with lower expense ratios and different CEF benchmark-adjusted returns, but not with CEF premiums. The authors find that independent directors are more effective in monitoring and influencing fund performance measures that are less complex and more directly controllable. These results are consistent with theoretical and empirical findings in the literature that interested directors can better monitor and control companies with high degrees of information asymmetry, uncertainty, and require specialized knowledge to operate. Their results suggest that CEFs with higher board ownerships are better aligned with shareholders' interests.

Memili and Misra (2015) examine the moderation effects of corporate governance provisions on the link between family involvement (i.e., family ownership and family management) in publicly traded firms and firm performance. Their data consists of 386 S&P 500 firms. The paper finds support for the hypotheses suggesting the moderation effects of the use of provisions such as protecting controlling owners in terms of their sustainability of controlling status and protecting

management legally on the inverted U-shaped relationship between family ownership and firm performance.

Baek, Cho, and Fazio (2016) examine how family firm ownership and management control affect corporate capital structure strategy. They evaluated 200 U.S. public firms in the S&P Small-Cap 600 index from 1999 to 2007. Their results support the argument that, although family ownership has a positive effect on a firm's leverage, family control through the CEO position and equity performance moderate its impact. This paper separates ownership and management control factors to explain why family firms use more or less leverage. This study, thus, reconciles the mixed results of prior studies, which do not differentiate between these two governance factors.

According to Gillan and Starks (2003), institutional investors can also affect the management activities directly as owners of firms or indirectly through trading in securities of such firms. As a result, institutional investors can play a key role in monitoring the management of firms, and their investments or disinvestments in firms can act as an important source of information to other shareholders.

Connelly, Hoskisson, Tihanyi, and Certo (2010) synthesize research from multiple disciplines on different types of owners and offer a unifying framework of governance through ownership. The authors describe the motivations of various types of owners, the tactics owners use to affect firms in which they are invested, and the dominant firm outcomes these owners seek to influence. The authors discuss how increased managerial awareness of diverse owner interests increases owner influence on firm-level outcomes. Their study draws attention to emerging forms of ownership, such as hedge funds and sovereign wealth funds.

7. CONCLUSION

It was written thousands of years ago that the want of money is the root of all evil. Sadly, we observe across time, across cultures, and across socioeconomic groups that some people will steal, lie, and cheat for money. As a result, it is imperative that individuals enter into financial exchanges with caution and a goal of reducing the risk inherent in these transactions.

In the United States, we observe an attempt to thwart the potential agency theory behavior of top management by increased oversight of boards of directors and increased regulations at the state and federal levels of government. A response to the corporate scandals of the 1990s and 2000s has been increased corporate governance by boards of directors and regulators to protect shareholders from the actions of unethical managers. As a result of the shift in the U.S. from defined benefit pension plans to defined contribution plans and a desire for increased corporate governance, we observe a significant increase in the financial assets under management by large institutional investors. It is believed these large institutional investors can have a significant impact on the governance, decision-making, and performance of the U.S. publicly traded firms.

Perhaps reflecting the increased corporate governance associated with large institutional investors and state and federal laws, as well as regulations requiring more financial disclosure and transparency, we observe an increasing trend in foreign indirect investment in the U.S. from countries in Europe, Asia, and the Pacific Rim, North and South America, the Middle East, and Africa.

In an attempt to better align the interests of the shareholders and management in the U.S., we observe a trend of increased compensation of publicly traded firms' top executives. This has resulted in an increased disparity between the compensation of top management teams and the firms' hourly employees.

Mergers and acquisitions can be viewed as a transfer of ownership based on expectations of future performance and current market values. In the U.S., we observe the number of net mergers and acquisitions announcements are positively related to stock market indices and forecasts of

future economic activity with cash being the preferred method of payment. One area of future research is to develop a better understanding of M&A transactions involving privately held firms. Although most academic research on mergers and acquisitions centers on publicly traded sellers, they made up only 4% of all M&A announcements in 2016. However, very little is known about the transactions involving privately held firms which made up 59% of all M&A announcements in 2016.

Another area for future research is to assess whether the diversity characteristics of a firm's top management team and board of directors have an impact on the financial performance of the firm. In the U.S., we observe a low but increasing trend in female top executives at publicly traded firms peaking at 8.1% in 2014. We expect biases against women and other minorities will be lessened in the future which should result in improved financial performance as long as one set of biases is not replaced with another.

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BUREAUCRACY IN THE UNITED STATES OF AMERICA: A Review of Corporate Policies in the Period of Governance Donald Trump

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ABSTRACT

One of the policies for corporations that reap the pros and cons of Donald Trump's administration is the Tax Reform Act, known as the Tax Cuts and Jobs Act (TCJA) 2018. Important points of the Act are: 1) changing the Corporate Income Tax rates from 35% to 21% and a drastic reduction that gives tax discounts of up to 60%. 2) change from worldwide to a territorial system. The tax reform was carried out because Trump saw the US tax system was no longer competitive. After all, it had a high corporate income tax rate of 35% and adopted a worldwide tax system. Pros and cons in discussing this law are that the outcome of the political process contained in the Act is not the same as the initial points put forward by Trump. Using literature studies from various libraries, this paper reviews the characteristics of the bureaucracy in the United States, by looking at the phenomenon of policies issued to corporations during Donald Trump's administration. This paper concludes that the characteristics of bureaucracy in the US tend to dominate institutions; the level of importance is different for each stage. Bureaucracy is seen as an instrument of power for the elite in running the government.

Keywords: bureaucracy, government's policy, united states of America

ABSTRAK

Salah satu kebijakan untuk korporasi yang menuai pro dan kontra pada masa Pemerintahan Donald Trump adalah UU Reformasi Pajak atau yang dikenal dengan *Tax Cuts and Jobs Act* (TCJA), yang berlaku efektif sejak 2018. Point penting UU tersebut adalah: 1) mengubah tarif PPh Badan dari 35% ke 21% dan penurunan drastis yang memberi diskon pajak hingga 60%. 2) perubahan dari sistem *worldwide ke territorial*. Reformasi pajak dilakukan karena Trump melihat sistem pajak AS sudah tidak kompetitif karena memiliki tarif PPh Badan yang termasuk tinggi yaitu 35% dan menganut *worldwide tax system*. Pro kontra dalam pembahasan UU ini adalah bahwa hasil akhir proses politik yang ada dalam UU tersebut tidak sama dengan pokok-pokok awal yang diajukan Trump. Dengan menggunakan studi literatur dari berbagai pustaka, tulisan ini mengulas karakteristik birokrasi yang ada di Amerika Serikat, dengan melihat pada fenomena kebijakan yang dikeluarkan untuk korporasi di masa pemerintahan Donald Trump. Kesimpulan dari tulisan ini adalah bahwa karakteristik birokrasi di AS cenderung pada dominasi institusi, yang tingkat kepentingannya berbeda untuk masing-masing tahap. Birokrasi dilihat sebagai alat kekuasaan bagi elit dalam menjalankan pemerintahan.

Kata Kunci: birokrasi, kebijakan pemerintah, amerika serikat

BACKGROUND

By quoting Weber's explanation that bureaucracy is an unavoidable process (Albrow, 2005), it makes bureaucratic

discussions in each country interesting because it has superior characteristics. For example, based on Ripley and Franklin's observations made on the bureaucracy in

the United States, there are six characteristics of bureaucracy found; 1) wherever the bureaucracy is located, it is chosen as a social instrument aimed at dealing with problems defined as public affairs. 2) the bureaucracy is the dominant institution in implementing policy programs, which have different levels of importance for each stage. 3) the bureaucracy has some different goals. 4) the function of the bureaucracy is in a broad and complex environment. 5) bureaucracy rarely dies; the survival instinct is unquestionable. 6) the bureaucracy is not something neutral in their policy choices. (Winarno, 2008)

The handling of a problem that can be resolved through the bureaucracy did not escape Max Weber's view. He believed that administration, in general, and the modern state could exert as many influences as the economy is running. Unlike Karl Marx, who explained that society's activities are fundamentally based on the mode of production and economic institutions, Weber believes that authority or domination is the centre of modern society. He also believes that society is indeed alienated, but it is more from an administrative side than material production. (Orum, 2001)

In Weber's view, the state is the highest authority because it has power and power. In a sense, Weber asserts that the modern world occupies an equally important and central place, as the church did in the medieval world. Hence, Weber wrote two criticisms on the organizational dimension of the state. First; the state bureaucracy itself. Based on his observations, that the bureaucracy is central

to state organization and administration. He saw that although the parliament, the congress is parts representing officially elected people, the state bureaucracy also presents state servants (PNS). He pointed out that in 19th century Germany, in fact, the state bureaucracy was more powerful than the elected officials. Second; is the power dimension possessed by certain groups of officials who have privileges over others. An example is a lawyer who understands the law, representing a strong social alliance as society develops more modernly. (Orum, 2001)

Although a democratic state allows for an efficient and transparent bureaucracy because it has aspects of freedom, equality, justice, and fulfilment of citizens' rights, the fact is not the case. Quoting Millib's explanation and when in 1962 he compiled the book "The State in a Capitalist Society", he challenged the hegemony of pluralist political theory. This theory explains that power in Western society is competitive, fragmented and diffuse. Milliband also challenged Key Asian post-war economic theory which states that public policy is autonomous from capitalist interests. Miliband also explains that "the most important fact about advanced capitalist society ... is the continuation of the existence of private and more concentrated economic forces in it." (Milliband, 1973) Thus, he wanted to state that the bureaucracy cannot be neutral. The bureaucracy can become a ruler because it has its own interests, as found in the US bureaucracy's characteristics discussed at the beginning of the paper.

One of the bureaucratic portraits that can be seen in the United States as a

superpower that carries liberalism is corporations' existence. Corporations were born as the US economy grew and impacted significant changes in the business world. A corporation is a form of business organization in the form of a legal entity. The corporation may own its property, sue or be sued in court, and make contracts. Because they are legal entities, the corporations are also taxed by the government. Corporate make the sale and purchase of the property, signed a contract with, and lends money or capital. Corporations first appeared in the railroad industry and later appeared in other endeavours. Some of the corporate types are most commonly used in the US is a *holding company*. (Armiyati, 2019)

These corporations have an influence on the Wall Street stock index in the United States. For example, index *Dow Jones Industrial Average* (DJIA), which rose 5.27 becomes 17781.01. The increase in Covidien shares which rose 20 per cent as the world's leading health product, was triggered by plans from a drug technology company in the United States. (Gideon, 2014) Apart from corporations, other things such as government policies on war, domestic policies related to economy and politics, socio-culture, also influence *Wall Street*.

The name *Wall Street* is familiar to the financial world around the world. The name *Wall Street* itself is a street name on the outskirts of Manhattan, New York, starting from the east, namely Broadway down the valley towards South Street on the East River, and passing through the American financial district's historical centre, Manhattan. However, this line is not

an ordinary route because a *Wall Street* building is the first permanent building of the *New York Stock Exchange* (NYSE). There are many stock exchanges and other trades headquartered on Wall Street and the financial district including the NYSE, NASDAQ, AMEX, NYMEX and NYBOT.

Hence, *Wall Street* is a place where financial transactions worth billions of US dollars take place every day. For this reason, *Wall Street* is called the world's financial centre. Based on available information, *Wall Street* largely determines humans' fate and hundreds of large companies in the world. In fact, US economic indicators can be read on *Wall Street*. If the stock index on *Wall Street* falls, it means that something is wrong in the US economy. Conversely, if the index rises, then the US economy is triumphant. Not only that, *Wall Street* itself has an influence on regional exchanges and developing countries such as the Indonesian Economic Exchange (IDX). (Wdi, 2011)

METHOD

This paper tries to review the characteristics of the United States bureaucracy by looking at the phenomenon of policies issued to corporations during the Donald Trump administration. To answer this review's focus, this research was conducted through thought-provoking literature research/literature studies related to the bureaucracy in the United States, which focuses on corporate policy studies. The research using secondary data types or data obtained from the literature. Thus, the data collection method is carried out by

searching for relevant literature, both from books, journals, websites and other supporting documents.

In future research relevant to this theme, the author's method will be complemented and refined by conducting interviews with several elements that are part/representatives of the US government in Indonesia such as the Embassy, to inquire about the corporate policies.

RESULT AND DISCUSSION

Portrait of Policy towards Corporations in the AS

The modern bureaucracy of the United States has not escaped debates about the nature, authenticity, and significance of the constitution. Much of administrative history marked the 1880s as the decade when an administrative state was born. In particular, many of the two-credit decisions were: the passing of the Pendleton Act in 1883 and the Interstate Trade Act's passage in 1887. The former established a system of competitive vetting rather than patronage appointments to fill federal offices. The latter created the first federal regulatory commission, the Interstate Trade Commission. In the first step, though hesitant, the scientific story unfolds, America sets itself on the path to an administrative state. (Postell, 2017) Significantly, the original law provisions, which limited the President's power to remove administrative officials, were violated from the last law after constitutional objections were raised. (Postell, 2017)

Bureaucracy, as public administration, as stated by Albrow, is an administrative system, which allocates

goods and services in a government, through state policies, and the bureaucracy as the implementer. In this case, the US's policies towards corporations in the US are part of the bureaucratic portrait. The portrait of economic policies that occurred during the Trump administration can be seen from many events. One of them is the trade war between the US and China. Trump responded to the trade war by making a protection policy from imported Chinese goods, which costs up to the US \$ 50 billion. The US economic sector's protection policy has actually been seen when Trump conducted a presidential candidate campaign. The large import tariffs addressed to Chinese products entering the US improve the domestic economy and reduce the trade balance deficit between the two countries. Apart from imposing import tariffs, the US also plans to limit investment and take action for China in the *World Trade Organization* (WTO) because it considers China unfair in bilateral trade.

This policy direction led to a polemic that occurred in the US itself. However, it can be said that the original intention of this policy was to protect the US economy. Some politicians and industrial circles worry about the possibility of retaliation from China and then affect the life of US agriculture, which has so far depended on exports to China. They are also worried that China will boycott US products that are sent to the ginseng country. The negative reactions from market players eventually affected the US stock market, which experienced a decline. As written by Adirini, Trump's policy is a blow to the "Made in China 2025" policy.

This is the Chinese government's policy to direct the Chinese industry towards innovative industries based on science and technology. (DPR, 2018).

The policy towards corporations in the US regarding taxation issued by Trump also reflects the bureaucracy's portrait as a power exercised by officials, as in one of the points put forward by Albrow. Changes in the US taxation scheme are said to increase the excitement of Uncle Sam's country's business life. However, for many international companies, Donald Trump's policy changes can actually cost companies billions of rupiah in losses. Banks such as Barclays, Credit Suisse and the oil company Shell said that the new taxation was doing them a disservice.

According to them, the losses experienced could reach the US \$ 3 billion or Rp. 40.5 trillion. Previously, Trump passed the Tax Reform Act in December 2017 and is the largest tax reform since the 1980s. (DPR, 2018) Trump explained in his statement that the tax reform law was intended so that the US middle class and small entrepreneurs could *exist*. The US government also almost doubled the amount of taxes on US citizens. The US government under Donald Trump's leadership has also cut taxes on businesses from 35 per cent to 21 per cent, and with that, Trump hopes US companies can compete in the world. (Setiawan, 2018)

Tax reform policy cannot be separated from Trump's main agenda during the last Presidential Candidate campaign. By carrying the motto "Make America Great Again", Trump can attract many people in the US. Indeed, the US condition at that time was experiencing a

very worrying economic situation. In addition to the relatively high number of unemployed people, the trade balance deficit and government debt are getting bigger. The tax reform was carried out because Trump saw that the US tax system was no longer competitive. After all, it had a high corporate income tax rate of 35% and adhered to the *worldwide tax system*. (Kristiaji, nd)¹

Finally, on 22 December 2017, a new law called the *Tax Cuts and Jobs Act* (TCJA) was passed, effectively enforced in 2018. The media informed that the final results of the political process contained in TCJA were not the same as the initial points stated. Proposed by Trump. However, it can be said that most of Trump's and Republican parties' big ideas have been accommodated in the Act. Some important points from the law are; changed the corporate income tax rate from 35% to 21% and is a drastic reduction that provides a tax discount of up to 60%.

Next is the change from the *worldwide to a territorial* system. The definition of a territorial is to provide an exemption from dividend payments originating from abroad. In this case, the

¹ What is meant by *Worldwide Tax System* is that a country will impose taxes on all income received or obtained by domestic taxpayers (WPDN) in that country, regardless of whether the income originates from within the country or abroad. In other words, if an entity is a WPDN from a country that adheres to a worldwide tax system, that entity will be taxed regardless of the source of revenue generated by the agency. In addition to imposing taxes on all income received by WPDN, countries that adhere to the worldwide tax system also impose taxes on income received by foreign taxpayers (WPLN) originating from their country.

US followed the steps of Japan and the UK, which had previously changed to the *territorial tax system*. Corporate Income Tax, but the Law also revises the structure of Personal Income Tax (OP), primarily by lowering the highest rates and increasing the value of the income cap in the highest income groups. The revision is considered more profitable for the people in the top 20% income group and is a characteristic of Republicans leaning towards the wealthy population group. (Kristiaji, nd)

In the form of presidential like the US, they have a presidential veto power mechanism. The veto right in question is that the President clearly has a veto in the process of passing laws. The President can also use this right to reject laws that have been passed by parliament. However, the parliament can also annul the veto with the majority of the congress (*senate* and *house representative*), about two-thirds of the parliament's vote. (Hanta Yuda, 2010) Although full of pros and cons, the tax reform law was approved by a senate filled with representatives from the Republican party. The Senate approved and provided notes of minor revisions to the then US tax bill. After a poll process, the ratification was made that resulted in 51 votes in favour and 48 votes against in 2017. The Democrat party's inputs were 1) a more detailed explanation of the new tax provision dubbed TCJA, 2) the abolition of a provision that allows parents to use 529 education savings to cover their children's school fees and 3) tax exemption from private universities. The reduction in tax rates from 35% to 21% is said to make the US compete with other industrialized countries in terms of imposing corporate

tax rates. This is because the industrialized country averages a corporate tax rate of 22.5%. (Andri, nd)

The portrait of the proposal, discussion and approval of the Tax Reform Law above shows some of the US bureaucracy's characteristics, namely that the bureaucracy is the dominant institution in implementing policy programs, with different levels of importance, for each stage. The bureaucracy is also not something neutral in policy choices. The author sees that the senate members, which is filled by the majority of representatives of the Republican party, will certainly agree with Trump's policies for rational reasons because they are seen as increasing the excitement of the US economy.

However, for many corporations in the US, this policy is certainly not a profitable thing. Taxes mechanism in some states in the US, causing more than 70 financial services company moved to Palm Beach County, Florida, in three years. The companies that moved the majority came from three main areas: New York, Boston and Connecticut. The three locations were affected by the imposition of state and local tax limits of US \$ 10,000 or approximately Rp. 142.8 million which can be deducted in federal tax returns.

The Florida area corporate tax rate is 5.5%, and there is no corporate income tax on limited partnerships. Also, there is no individual tax (PPh) in Florida. US census bureau data show that Florida has received more movements than any other state in the past year. Moving from New York to Florida could save more than the estimated US \$ 69,700 (approx. 995.7 million) in taxes per year. Palm Beach is

also not the only Florida state that gets migrations from high-tax states, with Miami, Texas, Nevada as other states that are frequent destinations for migrations. (News, nd)

In the US, Trump's policies also impact the economies of other countries, including Indonesia. Bloomberg Economics in its report in March 2018 projected that the world economy would grow 0.5% lower in 2020 than if Trump's policies were not made. The impact is in Indonesia, existing exports may experience contraction, as a component of economic growth. The Central Bureau of Statistics (BPS) wrote that exports contributed 20.37% of the gross domestic product (GDP) structure last year (2017) with a growth of up to 9.09%.

Corporations in the US have a long history, and after the mid-18th century, corporations grew and developed rapidly. By the 1920s, the company had grown and expanded so much that, in fact, scholars began to focus again on the separation of ownership and control that had been a concern for Adam Smith. They were not worried that the corporation would fail, but that the company's managers would not do the right thing by shareholders. The stock market fever spread to the masses during that giddy decade, owners of large corporations became increasingly scattered and ineffective as voices in directing management - and their managers and lawyers became increasingly adept at finding ways to keep cranky outside investors out of sight. post threats. (Fox, 2009) The market euphoria of the late 1920s and the ensuing devastation had

undermined Berle from the previous idea that investment bankers or large investors might force corporate managers to do the right thing.

The corporation became so large and powerful that Berle and Means believed that competitive forces alone could not control them. They concluded that the only solution is to control the big companies to "develop into technocracy pure neutral, balancing a variety of claims by various groups in society and place each portion of the revenue stream based on public policy, instead of c updates private". (Fox, 2009)

Renowned journalist and columnist, Fox introduced a new wave of economists and scholars who no longer teaches that investors are rational or that the market is always right. Many of them now agree with Yale professor Robert Shiller that the theory of efficient markets "represents one of the most extraordinary errors in the history of economic thought." Today these theories have provided the way for opposing hypotheses about human behaviour, psychological models of decision making, and market irrationality. Investors overreact, underreact, and make irrational decisions based on imperfect data. (Fox, 2009)

The discussion of the Tax Reform Act in the US in 2017 brings a positive indication when viewed from the increase in the stock market on *Wall Street*. As we know, US economic indicators can be read on *Wall Street* and indicate how the superpower's economy is stretching. When discussing the law, *Wall Street* rose with three main indexes, fueled by the belief that the US tax cut policy would get enough

support from lawmakers to pass. The Dow Jones, Nasdaq and others are reported to have strengthened, including the technology and health indices, although the energy sector is in the red and is declining. Meanwhile, the financial index rose because the Bank was seen as one of the biggest tax reform beneficiaries. (Nurmayanti, nd).

Although it brings positive indications for the rise in the stock market on *Wall Street*, the tax reform policy promoted by Trump and affecting existing corporations have drawn pros and cons in the US. With the Tax Reform Law's presence, it could help the US attract more companies to invest, both from within and outside the country. However, the Ernst & Young agency said these benefits could be erased by President Donald Trump administration's trade policies. As it is known that Trump imposes high tariffs on the entry of goods from China, leading to the US-China trade war. The U.S. withdrawal from the Trans-Pacific Partnership and the South Korea-America Bilateral Free trade agreement (KORUS) occurred during the Trump administration. In the context of trade issues, Mark Weinberger as Global Director and CEO of Ernst & Young stated that many depend on NAFTA and KORUS. The trade agreement affects existing corporate investments. According to him, withdrawing from the various trade agreements and issuing strict requirements, can reduce the incentives for companies to invest in the US, and this is of course reversed with the spirit of the Tax Reform Law. The output of tax reform benefits can

only be felt when the US opens up to the world's large economies. (Natalia, nd).

The US administration's agenda that regulates the economy and corporations can also be found during the Obama administration. In 2014, Obama invited many large international companies to boost investment. At that time, he gathered executives from many international corporations, including Ford Motor Co. and Deutsche Lufthansa AG. The program initiated by the White House is called SelectUSA and has a target of attracting more than the US \$ 18 million in business investment in 17 federal states and territories. The program initiated will take advantage of the localization cycle, growth, and hiring businesses in the US. (Kusumawardhani, nd) The role of a President in recommendations and policymaking in the US is large, showing the character of the bureaucracy that reflects the power exercised by officials.

IN HIS BOOK, James Q Wilson explains that many recommendations of the President's Committee on administrative management have been adopted, but fundamental tensions remain. Formally, all the bureaus cleared their budgets and their legislative proposals with the White House; informally, the congress had no difficulty understanding which bureau chiefs were distinguished from the president in this respect. Formally, all agencies in the executive branch are under the President; informally, congress, by its powers to authorize, match and investigate, has little difficulty influencing at least the more visible activities and shaping these institutions' more operational objectives. (Wilson, 1989).

The policy on corporate life, which Trump initiated by presenting the tax reform law, wanted to protect the US economy and help small and medium entrepreneurs in the US. However, the policies that emerged after the enactment of the Tax Reform Law are seen as policies that are not in line with the tax reform's breath. Instead of attracting foreign investors and companies to the US, Trump started a trade war with China in an economic context.

This contradictory policy shows the conception of the bureaucracy, which is said to be the official elite's power. Trump issued this policy in line with his view that China is increasingly controlling the pace of the world's economy. To that end, with the President's right of veto in making policies, Trump tried many measures to dispel the dominance of China and officially in 2017 the US pull out of trade agreements Trans-Pacific Partnership (TPP). This step is said to be moving the US away from its allies in Asia in line with China's influence in the region.

Post-Policy Trump Electability

Many policies issued by Trump have also had political implications or consequences for him. As the US President who is often said to be "quirky" and controversial, Trump is indeed full of surprises. In his book "The Making of Donald Trump" David Clay says that Donald Trump never knew his grandfather, Friedrich, who died when Donald's father Fred was only twelve years old. However, as a rogue entrepreneur, Friedrich overshadowed the Trump family for a century with his passion for money. He

despised the good of law - such as erecting buildings on land he did not own.

Friedrich Trump grew up in the southwestern German winemaking region of the city of Kallstadt. His father had died when Friedrich was only a few years old. In 1885, at the age of sixteen and facing conscription, Friedrich left a note to his mother and did what millions of other Europeans with little prospect of at home did: flee Germany to the United States. Enduring the North Atlantic's arduous crossing in an overcrowded steamship, Friedrich finally landed in New York, where he lived with an older sister, Katherine and her husband, who had both immigrated previously. The Friedrich Trump family tradition did start in America. However, they are a prosperous family but want more. Friedrich sold his restaurant and set up a new business about thirty miles north. (Johnston, 2016)

Fred Trump, Donald's father, was known not to establish a quality building or be a good landlord. He bought the cheapest materials to build more than 27,000 subsidized apartments and flats, many of his family continuing to collect rent decades later. As a child of Fred Trump, Donald Trump, born in 1946, is the heir to his father's business. Since 1971 he has led The Trump Organization, the main holding company for all of his property and other business interests. He has two mottoes of success, "always hit back" and "hit back harder than you hit", which came into play shortly after his father died in 1999 at the age of ninety-three. (Johnston, 2016).

Since becoming the 45th US President inaugurated in 2017, many policies issued by Trump have drawn pros

and cons. A survey agency released data on the level of US public satisfaction with Donald Trump ahead of a year after he took office. The Gallup Survey Institute stated that the level of public satisfaction with Trump throughout 2017 only reached 39 per cent. The data makes Trump the President with the lowest level of public satisfaction in US history. This figure comes after Trump's policies which were later criticized by the public. US public doubts also occurred after the publication of a book entitled *Fire and Fury: Inside the Trump White House* in 2018. The book tells the audience about Trump's figure, who is impatient, unable to focus, and always babbles. However, the Gallup survey found that Trump still has a place in his Republican supporters' hearts. It was noted that 83 per cent of Republican supporters were satisfied with Trump's performance in the first year. In fact, another survey agency named Quinnipiac said that 37 per cent of US citizens expressed satisfaction with Trump for helping restore the economy. (Utomo, 2018).

Not only surveys at home but also abroad, the survey results on Trump are interesting to examine. An example is a survey conducted by YouGov, a UK-based agency with operations in Europe, North America, the Middle East and the Asia Pacific. The survey in Germany was conducted by interviewing more than 2000 people as a sample. The survey results stated that US President Donald Trump is considered a dangerous figure for the world for German citizens. In fact, he is more dangerous than other famous leaders such as Vladimir Putin and Kim Jong-un.

Respondents also saw Trump as a more dangerous figure than Iran's supreme leader, Ayatollah Ali Khamenei and Chinese President Xi Jinping. 41 per cent of respondents said Trump was the biggest threat to global peace. The institute's survey was conducted in December 2019 and involved 2,024 German citizens. (Online, 2019).

However, some people think that Donald Trump will be re-elected as President even though there are many pros and cons in his policies. This opinion poll/poll can be seen from CNN conducted by the SSRS research institute. The majority of US citizens think Donald Trump will win the 2020 presidential election again, even though he is bombarded with issues that the US economy will move negatively. 54 per cent of respondents thought Trump would win again, and 41 per cent thought he would lose.

CNN's poll results are also inversely proportional to a similar poll in December 2018, where 51 per cent of Americans expected Trump not to be re-elected. The reasons for respondents who disagreed with Trump's re-election were that Trump was full of lies, racism, incompetence and did not act as president. Meanwhile, those who agree with Trump's re-election argue that they like how Trump handles his job as President, which focuses on achieving issues. A quarter of respondents voted for economic reasons, and 12 per cent for keeping promises and five per cent related to border policies. (Indonesia, 2019) On average, respondents like Trump's performance in the economic sector and migration issues are higher than

foreign trade policy. This poll conducted by CNN was conducted in May 2018 and used a random sample of 1,006 respondents contacted by telephone or cellphone and interviewed directly.

The US community's political electability towards Trump was increasingly seen when Joe Biden won the US Presidential Election in 2020. Based on the BBC's information, Democratic candidate Joe Biden won the US presidential election by obtaining 306 *electoral college votes* compared to Trump, who was a Republican candidate with 232 votes. According to the US constitution, the *electoral college* vote threshold for winning the presidential election competition is 270, and Biden is way beyond that number.

The results of a survey of Trump, both from respondents who expressed their love or hatred, showed that as a leader, Trump is indeed loved and hated. Some policies he issued on the grounds of making America great again, both in the economic, trade, foreign, defence, immigration and other sectors show that the bureaucracy in a democratic system can also be seen as a "tool of power foremost for those who control the apparatus. bureaucracy". (Blau & Meyer, 1987) It is further said that under normal conditions, the power of a developed bureaucracy is always tremendous. A "political leader will feel himself in the" weak "position as opposed to an" expert ", and face trained officials who are in the middle of government management.

CONCLUSION

The bureaucracy can be seen as a means of power for the elite in running the government. One of the phenomena seen in this bureaucratic frame is the policy towards corporations during the Donald Trump administration. Through the Tax Reform Act or known as the *Tax Cut Job Action* (TCJA), Trump tries to lower the tax rate which is then expected to impact the entry of investments in the US and help entrepreneurs from the middle to lower classes do business.

However, even though the congress approved this tax reform policy, the pros and cons continued to roll. Politically and economically, Trump's tax reform policy has resulted in the US-China trade war, which economists say contradicts the tax reform policy. It will make it difficult for the US to improve the economy.

Trump's economic sector policies, one of which is tax reform, have practically influenced Trump's electability. Many surveys show that respondents do not like the policies made by Trump and the Trump administration. However, some other Trump supporters also said that they liked Trump's fast performance and occupied his first campaign promise. The clear evidence of the political impact of Trump's policies during his tenure is the defeat of Trump by Joe Biden in the US Presidential election in November 2020. The US people certainly see what Trump programs have produced regarding welfare, security, migration and foreign policy politics.

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Democracy in America at Work: The History of Labor's Vote in Corporate Governance

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ABSTRACT

Can there be democracy in America at work? The historical division between democracy in politics and hierarchy in the economy is under strain. Hierarchical interests in the economy are shifting their model of power into politics, and yet a commitment to revive the law is resurgent. Central examples are the proposed Accountable Capitalism Act, Reward Work Act, Workplace Democracy Acts, and Employees' Pension Security Acts. They would create a right for employees to elect 40% of directors on \$1 billion company boards, a right for employees to elect one-third of directors on other listed company boards and require one-half employee representation on single-employer pension plans. All challenge long held myths: that labor's involvement in corporate governance is foreign to American tradition, that when codified in law, labor voice is economically inefficient; that the legitimate way to have voice in the economy is by buying stocks; or that labor voice faces insurmountable legal obstacles. This Article shows these myths are mistaken, by exploring the history and evidence from 1861. The United States has one of the world's strongest traditions of democracy at work. Economic democracy has not been more widespread primarily because it was suppressed by law. Americans favor voice at work, while asset managers who monopolize shareholder votes with "other people's money" enjoy no legitimacy at all. This Article concludes that, even without the federal government, and by recreating themselves as laboratories of democracy and enterprise, states can adapt the current proposals and rebuild a living law.

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INTRODUCTION

In 1921 the author of America's modern economic constitution, Adolf A. Berle, wrote that "labor could control," and this "dream" could be realized if workers and unions controlled their enterprises, by having stock "tied to the job."¹ Over his career Berle changed his mind.² He advocated tax to encourage diversified investments (not concentrated risk) in a "wider distribution of stocks" through pensions or mutual funds (not tied to the job). When everyone had a stake in the future, stockholding enabled "rationalized wealth distribution . . . serving the American ideal of a just civilization." With labor rights to limit the "power of corporate managements with respect to wages and labor relations,"³ democracy in the economy would follow the "corporate revolution," just as democracy in politics followed the industrial revolution.⁴ In the Great Society's twilight, the goal of modern corporate law was to work in the interests of the ultimate investor, as labor law's goal was the interests of the worker. In the end, they were the same: the people of a democracy in America at work.⁵

Today, as economic crisis has lurched toward political rupture, commitment to the kind of economic constitution that Berle once dreamt of is resurgent. Four proposed laws provide central examples. First, the Accountable Capitalism Act of 2018 would require that 40% of boards in \$1 billion companies be elected by employees.⁶ Second, the Reward Work Act of 2018 would ensure one-third of listed company board seats are

1. Adolf A. Berle, Jr., *How Labor Could Control*, NEW REPUBLIC, Sept. 7, 1921, at 37, 38.

2. Cf. ADOLF A. BERLE, JR., POWER WITHOUT PROPERTY 52–55 (1959) (warning against asset managers using other people's money emerging as "a permanently concentrated group of officials building a paramount and virtually unchallenged power position over the American industrial economy."); ADOLF A. BERLE, JR., STUDIES IN THE LAW OF CORPORATE FINANCE 39 (1928) (suggesting that if "trust companies were in the habit of accepting, on 'custodian account,' deposits of stocks from small shareholders, thereby gathering many small holdings into an institution commanding a block so large that protection was worthwhile, and that they also provided themselves with power to represent the depositors of stock. Such institutions could easily keep themselves informed as to the affairs of the corporation . . . and, as representing their clients, could take the action necessary to prevent or rectify violations of property rights.").

3. Adolf A. Berle, Jr., *Property, Production and Revolution*, 65 COLUM. L. REV. 1, 10 (1965).

4. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 67 (Macmillan 1933) (1932) ("With the corporate revolution, this quality has been lost to the property owner much as it has been lost to the worker through the industrial revolution.").

5. Cf. Franklin D. Roosevelt, Campaign Address on Progressive Government at the Commonwealth Club in San Francisco, California (Sept. 23, 1932) ("Democracy . . . is a quest, a never-ending seeking for better things.").

6. Accountable Capitalism Act, S. 3348, 115th Cong. § 6 (2018). This would also require federal charters for \$1 billion companies (not a necessity for the operation of other provisions) and require political donations to have approval of 75% of the board and shareholders.

elected by employees.⁷ These are unprecedented proposals in federal law: the United States would join the majority of countries in the Organization for Economic Co-operation and Development (OECD) with laws for voice at work.⁸ Third, the Workplace Democracy Acts, whose provisions have been reintroduced in Congress in varying forms, including the Employees' Pension Security Act of 2009,⁹ would require one-half representation of employees on the boards of every single-employer pension plan.¹⁰ Fourth, the latest version of the Workplace Democracy Act of 2018 would also restore the capacity for sectoral collective bargaining, ban discrimination against union members, and prevent employers from misrepresenting their staff as independent contractors to avoid tax and labor rights.¹¹

These proposals to revive corporate governance meet direct challenges: historical, economic, political, and legal. First, a story has been told, notably by labor law scholar Clyde Summers, that votes at work are foreign and the United States had "no experience with employee representation on corporate boards."¹² Second, it is assumed that laws to protect workers' votes in the economy damage efficiency because, according to business scholars Michael Jensen and Bill Meckling, such laws are "less efficient than the alternatives which grow up and survive in a competitive environment."¹³ Third, it has been argued as a matter of political principle, by figures like Louis Kelso, that the only legitimate way

7. Reward Work Act, S. 2605, 115th Cong. § 3(c)(2) (2018); H.R. 6096, 115th Cong. § 3(c)(2) (2018).

8. The majority of OECD countries (currently 19 out of 36) have some form of law requiring worker representation on company boards. See the map in Ewan McGaughey, *Votes at Work in Britain: Shareholder Monopolisation and the 'Single Channel'*, 47 INDUS. L.J. 76, 81 (2018). The United Kingdom's Conservative government reformed most recently, requiring from January 2019 that listed companies comply or explain with employee involvement, including having at least one worker representative on boards. FIN. REPORTING COUNCIL, U.K. CORPORATE GOVERNANCE CODE 5 (July 2018), <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.PDF> [<https://perma.cc/WF8L-U68T>].

9. Employees' Pension Security Act of 2009, H.R. 4281, 111th Cong. (2009); *see also* Employees' Pension Security Act of 2008, H.R. 5754, 110th Cong. (2008); Employees' Pension Security Act of 2005, H.R. 4055, 109th Cong. (2005).

10. Workplace Democracy Act of 1999, H.R. 1277, 106th Cong. (1999); *see also* Workplace Democracy Act of 1997, H.R. 2012, 105th Cong. (1997); Workplace Democracy Act of 1995, H.R. 1355, 104th Cong. (1995); Workplace Democracy Act of 1992, H.R. 5126, 103d Cong. (1994); Workplace Democracy Act of 1992, H.R. 6041, 102d Cong. (1992).

11. Workplace Democracy Act, H.R. 5728, 115th Cong. (2018); Workplace Democracy Act, S. 2142, 114th Cong. (2015) (reintroduced 2018).

12. Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. SEC. REG. 155, 155 (1982) ("The United States has had no experience with employee representation on corporate boards, apart from the small number of employee-owned enterprises.").

13. Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469, 473 (1979).

to have voice in corporate governance is by buying stocks.¹⁴ And fourth, the case has frequently been made that, even if legislators wanted, legal obstacles from federal preemption to antitrust make a more democratic economy unlawful.¹⁵ The purpose of this Article is to show that these challenges—and all challenges like them—are misplaced: democratic voice in the economy is embedded in American tradition; efficient, legitimate (and even without federal) law reform could be written into states today.

Part I uncovers the remarkable history of democracy in America at work: in corporate board rooms, pension governance, and work councils, which the labor movement drove. It concentrates on four historical periods, from 1861 to 1916, to 1946, to 1980, and to today. As a matter of history, far from there being “no experience” with workers on boards, since 1919 the United States has had (however forgotten) the world’s oldest law continually in force for worker participation in corporate governance.¹⁶ Against all obstacles, unions have had unparalleled success in getting collective agreements that put workers in boardrooms. The United States has one of the world’s most sophisticated systems of pension board governance.¹⁷ As a matter of economics, the concentration of voting power in the hands of the asset managers who control votes on shares, far from growing up “in a competitive environment,” has only been possible by law suppressing collective bargaining and the voice in labor’s capital. The law exacerbates labor’s inherent inequality of bargaining power, which starts with inequality in the distribution of property.¹⁸ Corporate

14. *E.g.*, LOUIS O. KELSO & MORTIMER J. ADLER, *THE CAPITALIST MANIFESTO* 153, 167 (1958). (“government should surround the economic status of the capitalist as stockholder with legal protections and privileges analogous to those it has conferred on the political status of the citizen, and for an analogous reason; namely, in order to make the capitalist, like the citizen, a man who can exert legal power in the control of his own affairs”); *cf.* 9 COMM. ON INDUS. RELATIONS, FINAL REPORT AND TESTIMONY 8294 (1916).

15. Summers, *supra* note 12, at 157.

16. To compare Germany and the United Kingdom, see Ewan McGaughey, *The Codetermination Bargains: The History of German Corporate and Labor Law*, 23 COLUM. J. EUR. L. 135 (2016); McGaughey, *supra* note 8. The United Kingdom does have an older set of codetermination laws, for instance the Oxford University Act 1854, requiring staff voice in university governance, although universities do not (most of the time) have shareholders.

17. *See generally* DAVID WEBBER, *THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR’S LAST BEST WEAPON* (2018).

18. ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* § 12 (1776) (enabling the wealthier party to “hold out” longer in any negotiation). A second cause is inequality in the ability to take collective action. JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY* §§ 8–12 (1848). A third cause is inequality in information. WILLIAM STANLEY JEVONS, *THE THEORY OF POLITICAL ECONOMY* § 74 (3d ed. 1888). Unequal bargaining power is both a distributional and an efficiency problem (a fact that Ronald Coase and much “law and economics” theory attempts to deny), because unfair distribution affects the motivation to work. BERLE & MEANS, *supra* note 4, at 122 (“In the operation of the corporation the controlling group even if they own a large

governance today has become monopolized not even by shareholders, but by asset managers or banks, and all with “other people’s money.”¹⁹ The evidence suggests this has deeply damaged efficiency and productivity and is uncompetitive.

Part II addresses the political arguments. As a matter of principle, there is no defensible theory, of “shareholder primacy” or otherwise, that justifies asset managers and banks monopolizing votes in the economy with other people’s labor or “other people’s money.”²⁰ Part III addresses the law. States could enact legislation that mirrors the current federal proposals. Neither the preemption doctrine, nor antitrust law, prevent states democratizing the economy through corporate law reform, not least because state and federal laws do it already. Until the Presidency and Congress regain their capacity to function and legislate,²¹ state governments can lead. They can revive as laboratories of enterprise,²² and recreate a living law that will restore democracy in America: a project still at work. It can be done again because it was before. The next part turns to how.

I. THE HISTORY OF LABOR’S VOTE IN CORPORATE GOVERNANCE

The principle of democracy at work was always part of the movement towards democracy in politics: an inseparable need to hold people in power accountable in every social institution.²³ When Alexis de Tocqueville came to America, he wrote about a “strong and independent”

block of stock, can serve their own pockets better by profiting at the expense of the company than by making profits for it.”); Alain Cohn, Ernst Fehr, Benedikt Herrmann & Frédéric Schneider, *Social Comparison in the Workplace: Evidence from a Field Experiment*, 12 J. EUR. ECON. ASS’N 877 (2014); see also Ewan McGaughey, *Behavioural Economics and Labour Law* 7–9 (LSE Legal Studies, Working Paper No. 20/2014, 2014).

19. Cf. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* (1914); SMITH, *supra* note 18, § 107.

20. Theories of shareholder primacy assume shareholders bear residual risk in insolvency, when in fact the beneficiaries of pensions or mutual funds do: asset managers control votes on other people’s money. See discussion *infra* Part II.

21. See TIMOTHY SNYDER, *THE ROAD TO UNFREEDOM: RUSSIA, EUROPE, AMERICA* (2018); Martin Gilens & Benjamin I. Page, *Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens*, 12 PERSP. POL. 564 (2014) (Law reflecting people’s preferences have been impossible at least since 1981.); Ewan McGaughey, *Fascism-Lite in America (or the Social Ideal of Donald Trump)*, BRITISH J. AM. LEGAL STUD. (forthcoming 2018) (The decline of the democratic process wrought by the Supreme Court since *Buckley v. Valeo*, 424 U.S. 1 (1976)).

22. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (A “[s]tate may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”).

23. Cf. THUCYDIDES, *HISTORY OF THE PELOPONNESIAN WAR* 2 (Henry Dale ed., Harper and Bros. 1891) (ca 411 BC) (Pericles said, “Our government does not copy our neighbors, but is an example to them. It is true that we are called a democracy, for the administration is in the hands of the many and not of the few.”).

community, where the American citizen had “an interest in it because he shares in its management.”²⁴ In 1834, even though democracy was a privilege and freedom violently suppressed, Americans were still wedded to a kind of equality: they were relatively wary about a one-share, one-vote norm that departed too far from democracy in capital²⁵ and were attached to cumulative voting to represent multiple interest groups on corporate boards.²⁶ Stockholders in this time of pre-democratic politics were the rich. They monopolized the votes in the economy.²⁷ This did not mean the dominance of capital over labor went unchallenged.

A. Towards Industrial Democracy? 1861 to 1916

Abraham Lincoln challenged the old system. His call for a “government of the people by the people for the people”²⁸ was shaped by

24. See ALEXIS DE TOCQUEVILLE, *DE LA DÉMOCRATIE EN AMÉRIQUE* ch. 5 (1835).

25. See Alexander Hamilton, Final Version of the Second Report on the Further Provision Necessary for Establishing Public Credit (Report on National Bank) (Dec. 13, 1790) reprinted in 7 THE PAPERS OF ALEXANDER HAMILTON 305, 334–39 (Harold C. Syrett & Jacob E. Cooke eds., 1963) (“A vote for each share renders a combination, between a few principal [s]tockholders, to monopolise the power and benefits of the Bank too easy. An equal vote to each [s]tockholder, however great or small his interest in the institution, allows not that degree of weight to large stockholders, which it is reasonable they should have, and which perhaps their security and that of the bank require. A prudent mean is to be preferred.”). After this, one-share, one-vote was dominant, but often with limits. JOSEPH G. BLANDI, MARYLAND BUSINESS CORPORATIONS 1783–1852, at 65–69 (1934) (40% of charters issued between 1849 and 1852 instituting voting ceilings.); JOHN W. CADMAN, JR., THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS 1791–1875, at 309 (1949) (finding in New Jersey, 15% of companies between 1796 and 1867 deviated from a one-ordinary-share, one-vote standard); Edwin Merrick Dodd, *American Business Corporations Until 1860*, 60 AM. HIST. REV. 620 (1954) (finding a general standard of a ten vote limit prevailed in most kinds of company); Alex Dreier, Shareholder Voting Rules in 19th Century American Corporations: Law, Economics and Ideology (Apr. 24, 1995) (unpublished manuscript) (on file with Yale Law School) (finding in Connecticut that 85% of charters between 1789 and 1856 adhered to a one-ordinary-share, one-vote norm); see also Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347, 1361–65 (2006) (One-share, one-vote represented entrenchment of plutocratic power.); Henry Hansmann & Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption* (EGCI Law, Working Paper No 219/2013, 2013).

26. *E.g.*, *People ex rel. Stevenson v. Higgins*, 15 Ill. 110 (1853) (concerning trustees of a hospital). Abraham Lincoln acted for Higgins. He lost on the point of who, precisely, was empowered by common law to exercise the right of removal. Lincoln argued that it should only be the legislature, the governor, or the Supreme Court, but not the hospital’s trustees, but the court felt the trustees too could exercise the power of a motion.

27. See VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 251 (2d ed. 1886) (“It is frequently in the power of the corporation, through a majority vote of the shareholders, to remove the directors or managing agents who have failed in their duty.”). It is noteworthy that stockholder control appeared firmly dominant also over director compensation. *Id.* § 508 (noting that it “would be contrary to established principles to allow the directors or other agents of a corporation to fix their own compensation.”).

28. Abraham Lincoln, Gettysburg Address (Nov. 19, 1863), reprinted in THE PORTABLE ABRAHAM LINCOLN 295 (Andrew Delbanco ed., 1992).

how Lincoln envisaged economic power in his first annual message as President in 1861. In a land torn by civil war, he warned against the “approach of returning despotism.”²⁹ This came from “the effort to place capital on an equal footing with, if not above, labor in the structure of government” and the assumption that “a hired laborer is fixed in that condition for life.” “Labor,” said Lincoln, “is prior to and independent of capital. Capital is only the fruit of labor and could never have existed if labor had not first existed.”³⁰

In the *Emancipation Proclamation* of 1863, Lincoln made the momentous step towards freedom of association, declaring all people who were enslaved to not only be free but also to have the right to work for “reasonable wages” and a guarantee of a job for “persons of suitable condition . . . into the armed service.”³¹ Lincoln created the first public pensions in 1862, for disabled army personnel,³² and in 1865 it seemed he intended to go beyond, for all veterans.³³ Over the trauma of the Civil War and assassination, this was the basis of a constitution, a house less divided,³⁴ “which opens the way to all, gives hope to all, and consequent energy and progress and improvement of condition to all.”³⁵

Between the end of the Civil War and the start of the First World War, three ideals that Lincoln embodied slowly took shape: (1) meaningful freedom of association, (2) growing prosperity in pay and pensions, and (3) growing commitment to an industrial democracy. All faced staunch opposition. In 1842, *Commonwealth v. Hunt* had already approved the

29. Abraham Lincoln, First Annual Message (Dec. 3, 1861), <https://www.presidency.ucsb.edu/ws?pid=29502> [<https://perma.cc/QR66-SMWH>].

30. *Id.*

31. Abraham Lincoln, Emancipation Proclamation (Jan. 1, 1863) (“I do order and declare that all persons held as slaves within said designated States and parts of States are and henceforward shall be free . . . I hereby enjoin upon the people so declared to be free to abstain from all violence, unless in necessary self-defense; and I recommend to them that in all cases when allowed they labor faithfully for reasonable . . . such persons of suitable condition will be received into the armed service of the United States.”).

32. An Act to Grant Pensions, ch. 166, § 1, 12 Stat. 566 (1862) (Army personnel who had since March 4, 1861 been “disabled by reason of any wound received or disease contracted while in the service of the United States” were entitled.).

33. Abraham Lincoln, Second Inaugural Address (Mar. 4, 1865) in THE LITERARY WORKS OF ABRAHAM LINCOLN 273 (1942) (appearing to envisage an extension but was assassinated just a month later). He called “to bind up the nation’s wounds, to care for him who shall have borne the battle and for his widow and his orphan, to do all which may achieve and cherish a just and lasting peace among ourselves and with all nations.” *Id.*

34. *Cf.* Abraham Lincoln, Speech in Acceptance of Nomination as United States Senator at the Illinois Republican State Convention, Springfield, Illinois (June 16, 1858) reprinted in THE ABRAHAM LINCOLN ENCYCLOPEDIA (Mark E. Neely Jr. ed., Da Capo Press, Inc. 1982) (“A house divided against itself cannot stand. I believe this government cannot endure, permanently half *slave* and half *free*. I do not expect the Union to be *dissolved*—I do not expect the house to *fall*—but I do expect it will cease to be divided. It will become *all* one thing, or *all* the other.”); *Matthew* 12:25.

35. Lincoln, *supra* note 29.

right of labor unions to take collective action,³⁶ abandoning English common law conspiracy theory in Massachusetts.³⁷ But nationwide there were still three cases from 1842 to 1863 where unions on strike were held to be conspiracies. From 1863 to 1880 there were at least fifteen.³⁸ In 1869, the Knights of Labor organized the first major union federation, but though it committed to race and gender equality, it disavowed strikes. Also in 1869, the Supreme Court tacitly ensured corporations engaged in interstate commerce had the right to freely establish and had mutual recognition.³⁹ In 1875, American Express, then engaged in rail and post, started the first occupational pension, but without any worker voice.⁴⁰ It aimed to compel worker loyalty. It asserted pensions were a gift that was made, not a right that was earned nor a fund that labor could control.⁴¹

The paucity of voice at work and in capital was not surprising; it was only in 1886 that the American Federation of Labor (AFL), which did assert the right to strike, was formed.⁴² The situation before then was captured by the U.S. Senate, Education and Labor Committee, led by Henry W. Blair from 1883–1885. It issued no final Report but gathered over 4000 pages of testimony from workers, unions, employers, journalists and activists.⁴³ Southern workers were riven by deprivation following

36. *Commonwealth v. Hunt*, 45 Mass. (1 Met.) 111 (1842). The Boston Journeymen Bootmakers' Society was charged with a common law conspiracy, argued to have been received from English common law, for going on strike against employers who hired non-union workers that were receiving less pay. Chief Justice Shaw said there was no liability at common law because people "are free to work for whom they please, or not to work, if they so prefer [W]e cannot perceive, that it is criminal for men to agree together to exercise their own acknowledged rights, in such a manner as best to subserve their own interests." *Id.* at 130. Note that a common law right to strike is further dependent on the invalidity of contracts excluding the right or requiring imbalanced notice periods before collective action can be taken. There would, of course, be little justification for a court to enforce such an agreement, since consent and true agreement would be absent, unless perhaps the workforce had negotiated a no-strike agreement through independent representatives.

37. *See People v. Fisher*, 14 Wend. 9 (N.Y. Sup. Ct. 1835) (holding it was an unlawful conspiracy to strike for higher wages); *see also R v. Journeymen-Tailors of Cambridge* (1721) 88 Eng. Rep. 9. The year after *Fisher*, Judge Edwards convicted a tailors' union for conspiracy on this precedent. The response was a meeting of 27,000 workers which burned effigies of them both. Outrage spread in the press. Edwin E. Witte, *Early American Labor Cases*, 35 YALE L.J. 825, 826–27 (1926).

38. Witte, *supra* note 37, at 82.

39. *See* U.S. Const. art I, § 8, cl. 3 (the Commerce Clause); *Paul v. Virginia*, 75 U.S. 168 (1869) (holding that states were not allowed to attach special conditions to corporations doing interstate business but could regulate insurance contracts). *See generally* Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33 (2006).

40. WILLIAM C. GREENOUGH & FRANCIS P. KING, PENSION PLANS AND PUBLIC POLICY 27 (1976).

41. STEVEN A. SASS, THE PROMISE OF PRIVATE PENSIONS: THE FIRST HUNDRED YEARS 22–24 (1997).

42. SELIG PERLMAN, A HISTORY OF TRADE UNIONISM IN THE UNITED STATES 118–24 (1922).

43. GORDON B. MCKINNEY, HENRY W. BLAIR'S CAMPAIGN TO REFORM AMERICA: FROM THE CIVIL WAR TO THE U.S. SENATE 110–11, 132–40 (2012) (giving an excellent summary of Blair's engagement over the years).

emancipation without any meaningful property reform.⁴⁴ This fact was entrenched by the Supreme Court in the *Civil Rights Cases* of 1883, deciding that desegregation of public services was “unconstitutional.”⁴⁵ The timeless dissent of Justice John Marshall Harlan urged that this left people’s civil rights “practically at the mercy of corporations and individuals wielding power under the States.”⁴⁶ Northern workers were struggling to secure basic wages, reduce their working hours, and have the freedom to take collective action.⁴⁷ Pensions were barely mentioned, except for one witness who, though lucky enough to have a pension, said that he laughed when people asked him if it was enough to support a family.⁴⁸

There were flickers of the future.⁴⁹ A witness before the Committee named George Storm, of cigar manufacturer Straiton & Storm, explained how from 1879 he introduced an arbitration board—with four employee and four management representatives, and one “neutral” representative—to ensure wages or work conditions were “settled upon a fair basis.”⁵⁰ His employees belonged to unions, but he testified there were no strikes since the board of arbitration began. He was adamant that it should never be a replacement for unions and called employers who imagined it could be “tricksters.”⁵¹ This was not equal representation on a board of directors, but it was still remarkable. If we take Storm at his word, it was a microcosm of joint industrial councils operating with collective bargaining.⁵²

The Senate Labor Commissioners’ proposed reforms were limited: they began from an almost blank slate. Blair pushed to extend federal

44. *Id.* at 111.

45. *See generally* The Civil Rights Cases, 109 U.S. 3 (1883) (Harlan, J., dissenting).

46. *Id.* at 55.

47. MCKINNEY, *supra* note 43, at 133–34.

48. 3 COMM. ON EDUC. & LABOR, 48TH CONG., REPORT OF THE COMMITTEE OF THE SENATE UPON THE RELATIONS BETWEEN LABOR AND CAPITAL AND TESTIMONY TAKEN BY THE COMMITTEE 395 (Comm. Print 1885) [hereinafter REPORT ON LABOR AND CAPITAL] (testimony of Edward L. Davenport).

49. STUART D. BRANDES, AMERICAN WELFARE CAPITALISM: 1880–1940, at 121 (1976) (noting that shop committees existed in 1833 but not where).

50. REPORT ON LABOR AND CAPITAL, *supra* note 48, at 803–19 (testimony of George Storm).

51. *Id.* at 806. (George Storm: “I have had employers come to me to inquire about this method of arbitration, and how it worked, and, after taking all the trouble to explain it to them, they would say in a sly manner, ‘Well, I suppose you have it all your own way, don’t you?’ These people are unfit to have arbitration—they are tricksters. In speaking of arbitration, we must, therefore, leave all such people out of account.”).

52. RAYMOND L. HOGLER & GUILLERMO J. GRENIER, EMPLOYEE PARTICIPATION AND LABOR LAW IN THE AMERICAN WORKPLACE 15 (1992) (recording that from 1898 a Boston retail clothing store called William Filene’s Sons, run by Edward A. and A. Lincoln Filene, delegated responsibility for welfare, lunchroom and entertainment, and then from 1901 gave seats on an arbitration board. They say, however, this was mainly as a mechanism to preempt collective bargaining with the union.).

spending in education, particularly in the south, and for labor unions to have legal personality. The education measures stalled amidst the campaigns for Senate reelection in 1884.⁵³ An Act did pass for unions to incorporate, but they showed no interest.⁵⁴ The most lasting reform was the Bureau of Labor Statistics Act of 1884.⁵⁵ But another fight soon opened up: the Sherman Act of 1890 was meant to stop business combinations acting in restraint of trade; instead, its first use was against labor unions. In 1894, Chicago railroad workers struck against the Pullman Palace Car Co.'s emaciating wage cuts, ostensibly to cope with the drop in orders from economic depression.⁵⁶ For instance, the monthly wage of a painter, Mr. Rhodie, was cut from \$65.28 in May 1893 to \$12.52 by Christmas. None of the managers' salaries were reduced.⁵⁷ If this was not enough, many Pullman staff were housed by the Pullman Co., thus paying it rent. Wage cuts with rent hikes meant employees got into debt, and so were chained to the company. For all practical purposes, they were indentured labor.

The American Railway Union opposed the Pullman management because its principles stated "employees are entitled to a voice in fixing wages and in determining the conditions of employment."⁵⁸ For exercising the right to strike, the ARU leader and future socialist presidential candidate, Eugene Debs, was imprisoned by an Illinois court, supposedly enforcing a Sherman Act injunction.⁵⁹ The decision was later upheld by the United States Supreme Court in *In re Debs* on even broader grounds.⁶⁰

53. MCKINNEY, *supra* note 43, at 139–40.

54. An Act to Legalize the Incorporation of National Trades Unions, 29 U.S.C. §§ 21–25 (1886) (repealed 1926); U.S. STRIKE COMM'N, REPORT ON THE CHICAGO STRIKE OF JUNE–JULY, 1894, S. EXEC. DOC. No. 7, at liii (1895).

55. An Act to establish a Bureau of Labor, ch. 127, 23 Stat. 60 (1884).

56. U.S. STRIKE COMM'N, *supra* note 54, at xxxiv ("The testimony of the Pullman company . . . has left its claim . . . in such loose and indefinite shape as to compel the conclusion that the reduction in the repair department was not made with reference to these depression results, but was part of a plan designed to reduce wages in every department to the lowest point possible to be reached in the department most seriously affected by the depression. Some reduction of wages in all departments was of course proper . . . but a uniform reduction as between departments so differently situated in reference to revenue as the car-building and repair departments was not relatively just and fair toward the repair-shop employees.").

57. *Id.*

58. U.S. STRIKE COMM'N, *supra* note 54, at 148 (Eugene Debs quoting the American Railway Union's "declaration of principles").

59. *United States v. Debs*, 64 F. 436 (C.C.N.D. Ill. 1894) (imposing an injunction on the striking workers of the Pullman Company).

60. *In re Debs*, 158 U.S. 564 (1895) (holding that the federal government could enforce the injunction as part of its right to regulate interstate commerce, without considering the Sherman Act of 1890). *But see* *Loewe v. Lawlor*, 208 U.S. 274 (1908) (endorsing the imposition of damages on unions). From a competition law perspective, see generally Herbert Hovenkamp, *Labor Conspiracies in American Law, 1880–1930*, 66 TEX. L. REV. 919 (1988).

Troops were sent into Chicago and shot thirty people. The subsequent inquiry by the United States Strike Commission concluded that, instead of trying to resolve disputes, the courts were still “poring over the laws of antiquity in order to construe conspiracy out of labor unions.” In his evidence, Debs argued that “Government ownership of the railroads is decidedly better for the people than railroad ownership of [the] Government.”⁶¹ Ultimately he favored, not state socialism, but “a cooperative commonwealth as a substitute for the wage system.”⁶² The Strike Commission recommended, more modestly, a government panel to resolve disputes and wages, analogous to the Interstate Commerce Commission.⁶³ But the courts continued imposing liability on unions,⁶⁴ and did little (until 1911) to stop capital combinations. Spurred by the Sherman Act, the largest merger wave in United States history was unfolding.⁶⁵ Another Industrial Commission appointed by Congress reported on labor relations in 1902 and finally recommended that state laws begin to enact labor rights, particularly by reducing working time.⁶⁶ The Supreme Court’s answer in 1905 was *Lochner v. New York*, ensuring most economic and social experiment was “unconstitutional.”⁶⁷

With labor rights suppressed, few employees had surplus savings for pensions. But as the problems of old-age poverty spread, so did experiments.⁶⁸ Only one witness to the 1895 Strike Commission advocated pensions for all rail workers.⁶⁹ Some employers acted: by 1901, the Chicago and Northwestern Railway Company had five officials running a \$200,000 fund, but all were employer-appointed.⁷⁰ Courts asserted that employers were “voluntarily” setting aside “a portion of its profits

61. U.S. STRIKE COMM’N, *supra* note 54, at 163.

62. *Id.* at 170.

63. *Id.* at Lii (recommending a three-member strike commission, plus a union representative, to settle “disputes between railroads and their employees similar to those vested in the Interstate Commerce Commission as to rates, etc.”).

64. *E.g.*, *Vegeahn v. Guntner*, 167 Mass. 92 (1896) (Finding a union picket to be tortious intimidation. In dissent, Justice Holmes said, “Combination on the one side is patent and powerful. Combination on the other is the necessary and desirable counterpart, if the battle is to be carried on in a fair and equal way.”).

65. *See generally* HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW, 1836–1937* ch. 20 (1991).

66. 19 U.S. INDUS. COMM’N, *FINAL REPORT OF THE INDUSTRIAL COMMISSION* 948 (1902).

67. *See Lochner v. New York*, 198 U.S. 45 (1905) (playing out the consequences of *Allgeyer v. Louisiana*, 165 U.S. 578 (1897)).

68. F. Spencer Baldwin, *The Work of the Massachusetts Commission on Old Age Pensions*, 85 PUBLICATIONS AM. STAT. ASS’N 417 (1909) (remarking that there were no official statistics on the extent of deprivation).

69. US STRIKE COMM’N, *supra* note 54, at 678.

70. *E.g.*, George G. Tunell, *The Pension System of the Chicago and Northwestern Railway Company*, 9 J. POL. ECON. 271 (1901).

belonging to shareholders,”⁷¹ not giving employees pay for their work.⁷² In 1904 President Theodore Roosevelt extended a state pension to all army veterans who reached age 65,⁷³ but for retirement security almost everyone else had to turn to private markets. One option was life insurance. In 1905, this became the focus of the Armstrong Commission, with Charles Evans Hughes as chief counsel. Equitable Life had hosted an opulent party for a policyholder that caught media attention. The Commission uncovered patterns of bribes, mismanagement, and self-dealing. The New York legislative response was merely to limit insurers’ rights to own shares, control banks, or invest in securities, but not to create a public system of social security.⁷⁴ In 1909, Louis Brandeis tried to launch a different initiative in Massachusetts.⁷⁵ Insurance, he said, had become “legalized robbery.”⁷⁶ He promoted a voluntary “social alternative.” But though he consulted three hundred unions, the scheme attracted few subscribers.⁷⁷

On the other hand, a growing number of states—partly inspired by a Massachusetts commission⁷⁸ and the United Kingdom’s Old Age Pension Act 1908—started pensions for public sector workers, particularly teachers.⁷⁹ Yet the courts were ready to strike down reform. In 1914, Arizona had a popular initiative and a referendum for a new pension scheme to cover everyone.⁸⁰ In *State Board of Control v. Buckstegge*, the

71. *McNevin v. Solvay Process Co.*, 32 A.D. 610 (N.Y. App. Div. 1898) *endorsed in* *Menke v. Thompson*, 140 F.2d 786 (8th Cir. 1944). This view expired by the time of ERISA in 1974. *See* *Howell v. United States*, 775 F.2d 887 (7th Cir. 1985).

72. *Cf. McNevin v. Solvay Process Co.*, 32 A.D. 610 (N.Y. App. Div. 1898) (Green, J., dissenting) (“A promise, founded upon a valuable consideration inuring to the benefit of a promisor, to pay a sum of money upon specified contingencies, is not a promise to make a gift, even though the parties call it so . . . it constitutes a contract founded upon a valuable consideration.”).

73. Executive Order No. 78 extended the Disability Pension Act 1890 which had recast the previous 1862 law. *See* Peter Blanck, *Civil War Pensions and Disability*, 62 OHIO ST. L.J. 109, 124–27 (2001).

74. Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639, 656–57 (1993).

75. For an interesting biographical comparison, see Paul Brickner, *Different Styles and Similar Values: The Reformer Roles of Charles Evans Hughes and Louis Dembitz Brandeis in Gas, Electric, and Insurance Regulation*, 33 IND. L. REV. 893 (2000).

76. LOUIS D. BRANDEIS, *LIFE INSURANCE: THE ABUSES AND THE REMEDIES: AN ADDRESS DELIVERED BEFORE THE COMMERCIAL CLUB OF BOSTON* (1905).

77. Louis D. Brandeis, *Massachusetts Savings-Bank Insurance and Pension System*, 11 PUBLICATIONS AM. STAT. ASS’N. 409 (1909) (optimistically arguing this “social alternative” avoided the “compulsory” nature of the German pension, and unlike National Insurance in the UK, the need to buy insurance individually would both make “workingmen independent,” and avoid “burdening general taxation”).

78. REPORT OF THE MASSACHUSETTS COMMISSION ON OLD AGE PENSIONS, ANNUITIES AND INSURANCE (1910).

79. *See* W. CARSON RYAN, JR. & ROBERTA KING, DEP’T OF THE INTERIOR, BUREAU OF EDUC., *STATE PENSION SYSTEMS FOR PUBLIC-SCHOOL TEACHERS* 5–8 (1916).

80. An Act Providing for an Old Age and Mothers’ Pension and Making Appropriation Therefor, 1914 Leg., Reg. Sess. (Ariz. 1914) (winning a massive 67.57% of the vote).

Arizona Supreme Court declared it “unconstitutional” because there was no means testing. Chief Justice Henry D. Ross argued that apparently a “taxpayer ought not to be made . . . to help pay pensions to those who have enough” because he could “think of no principle of law or justice that could be invoked . . . that required him to do so.”⁸¹

Although courts’ aggression to labor grew in *Debs*, *Lochner*, and *Buckstegge*, Congress began to act. It established a Commission on Industrial Relations in 1912, after two renegade union members dynamited the Los Angeles Times building.⁸² The Commission led directly to the Clayton Act of 1914 § 6, proclaiming the “labor of a human being is not a commodity or article of commerce,” and removing labor from antitrust liability.⁸³ Samuel Gompers, the American Federation of Labor President, said it was “the Magna Carta of America’s workers.”⁸⁴ But just as fast, *Coppage v. Kansas* held over powerful dissent that state laws, which prohibited employers demanding that workers forgo the right to a union, were “unconstitutional.”⁸⁵ “No union or no job” was the choice that the Supreme Court gave American workers until the Wall Street Crash.

The Commission’s later hearings gave valuable insight into three fundamentally different views over the future of economic governance, represented by three key witnesses: JD Rockefeller, Andrew Carnegie, and Louis Brandeis. First, Rockefeller, the oligarch of Standard Oil, which was broken up in 1911,⁸⁶ was brought to the Commission because of a strike at his Colorado Fuel & Iron Co. In April 1914, company guards machine-gunned twenty-five people, including eleven children, camped in tents. He displayed contrition and hired William MacKenzie King, the ex-Canadian Minister of Labor and Canadian Prime Minister from 1921 to 1930 and 1935 to 1948, to consult on resolving the unrest. Rockefeller promised to introduce a board of workers and managers where “questions affecting conditions of employment can be discussed and grievances examined.”⁸⁷ Rockefeller’s own directors opposed even this.⁸⁸ So did the United Mine

81. *State Bd. of Control v. Buckstegge*, 158 P. 837, 842 (Ariz. 1916).

82. The United States labor movement, including Gompers and Debs, initially believed the two accused McNamara brothers were innocent, until they finally pleaded guilty in the trial. See Eugene V. Debs, *The McNamara Case and the Labor Movement*, 12 INT’L SOCIALIST REV. 397 (1912); see also Herbert Shapiro, *The McNamara Case: A Crisis of the Progressive Era*, 59 S. CAL. L.Q. 271 (1977).

83. 15 U.S.C. § 17 (2012).

84. Samuel Gompers, *Labor and the War: The Movement for Universal Peace Must Assume the Aggressive*, 21 AM. FEDERATIONIST 849, 860 (1914).

85. *Coppage v. Kansas*, 236 U.S. 1 (1915).

86. *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911).

87. 8 COMM. ON INDUS. RELATIONS, FINAL REPORT AND TESTIMONY 7766 (1916).

88. RAYMOND L. HOGLER & GUILLERMO J. GRENIER, EMPLOYEE PARTICIPATION AND LABOR LAW IN THE AMERICAN WORKPLACE 21–25 (1992).

Workers of America because it was “not a union and can never be recognized as such by the American labor movement . . . an organization so created and so controlled.”⁸⁹ Indeed, Rockefeller had no intention of working with unions. He wanted to replace them and privatize freedom of association. The plan’s constitution explicitly said, “officials of the company may decide any question without consulting committees or employees’ representatives.”⁹⁰

Second, as a more enlightened and thoughtful representative of business, Andrew Carnegie gave evidence. The popular Scottish rail and steel magnate had often said the “man who dies thus rich dies disgraced” and that “the millionaire will be but a trustee of the poor.”⁹¹ He was a trustee of Cornell University from 1890 but was equally tarnished by labor conflict from the Homestead Strike of 1892, where twelve people were killed and twenty-three had been injured. Carnegie defended himself by saying, “I drew the line at contract breaking,” that it “was the first time I had found labor, . . . ready to break a contract,” (dictated by the employer) “and it was the last.”⁹² Yet it was clear that, while Carnegie charmed the Commission and the audience⁹³ and reminisced about the supposedly “great times” he had doing collective bargaining,⁹⁴ he was committed to reform. Initially, Carnegie spoke of workers becoming shareholders so

89. *Id.* at 26 (quoting the *Denver Post* (Sept. 26, 1915)).

90. *Id.* at 28 (quoting BEN M. SELEKMAN & MARY VAN KLEEK, EMPLOYEES’ REPRESENTATION IN COAL MINES: A STUDY OF THE INDUSTRIAL REPRESENTATION PLAN OF COLORADO FUEL AND IRON COMPANY 291 (1924)).

91. Andrew Carnegie, *Wealth*, 148 N. AM. REV. 653, 653–64 (1889).

92. 9 COMM. INDUS. RELATIONS, FINAL REPORT AND TESTIMONY 8289 (1916).

93. *Id.* at 8294 shows a typical exchange:

Mr. Carnegie: Undoubtedly. I knew them by name, I delighted and you see behind my back they always call me Andy. I like that, and I would rather have it than “Andrew” or “Mr. Carnegie.” There is no sympathy about that. But you have your men calling you “Andy” and you can get along with them. [Laughter.]

Chairman Walsh: I have had no difficulty in restraining the expression of the audience until you came.

Mr. Carnegie: [Laughter.] That is all right.

Chairman Walsh: We must observe order.

Mr. Carnegie: Mr. Chairman, I congratulate you upon having such an audience and to see how many ladies are here. Do you know, one of the greatest triumphs in this age? It is the elevation of woman. [Laughter.]

Chairman Walsh: Ladies and gentlemen, if you will please keep quiet a few minutes I will ask Mr. Carnegie to repeat that sentence, as some of you may not have heard it. If you will keep quiet, I will ask him what it was. What was it that you said, Mr. Carnegie?

Mr. Carnegie: I want to tell you something, that I never can forget. I was traveling in China . . .

94. *Id.* (Carnegie said he “was only too glad when the workmen came. I felt pretty sure that if they came to consult with me that we would part all right.” This appears difficult to square with his later observation that if someone was “a director in the corporation he naturally would not hear of the trouble at the works and would not feel the responsibility.”).

that “workmen and capitalists” were “pulling and owning the same boat.”⁹⁵ But after the Commission, the practical steps he took were to improve pensions and, critically, to give staff a voice in them.⁹⁶ In 1915, Carnegie asked Dr. Henry Pritchett, president of the Carnegie Foundation for the Advancement of Teaching, to create a new plan for universities, one that involved “some form of oversight” by the policyholders.⁹⁷ Carnegie donated the startup capital for a new Teachers Insurance and Annuity Association (TIAA). Members elected a quarter of the twenty person board, albeit from nominees screened by a committee.⁹⁸ TIAA’s first board was appointed by the Carnegie Foundation, but then member representation was implemented with one trustee a year from 1921 to 1926.

Third, there was Louis Brandeis, the “people’s lawyer.” He argued that the “one cause” that was “fundamental” to industrial unrest was “the contrast between our political liberty and our industrial absolutism.” “The individual employee,” said Brandeis, “has no effective voice or vote.” Large corporations made industrial absolutism inevitable, and instead the law should reform to follow what unions would achieve in collective agreements, if the playing field were fair.⁹⁹ If there was one goal, it was “the attainment of rule by the people, and that involved industrial democracy as well as political democracy.”¹⁰⁰ Brandeis set out general principles, rather than specifics. In the end, the Commission’s leading Report recommended reforms following the United Kingdom Trade Disputes Act 1906;¹⁰¹ its model of industrial democracy was synonymous with collective bargaining, not writing rights to votes at work into law. Other Commissioners only recommended improvements to industrial arbitration.¹⁰² These options—votes at work, collective bargaining, and arbitration—set the essential frame of the debate on how labor law

95. *Id.* at 8288 (“When workmen were made shareholders they were sold shares in the company upon a very liberal basis and guarded against loss. I consider this the greatest of all steps forward yet taken for making workmen and capitalists fellow workmen indeed, pulling and owning the same boat. This can not fail to prove highly profitable to both.”); cf. Andrew Carnegie, *The Future of Labor*, 33 ANNALS AM. ACAD. POL. SOC. SCI. 15, 17 (1909) (calling for workers as “part owners having a right to vote with their fellow-proprietors, and sharing in the profits”).

96. See Richard L. Hannah, *The Control of Pensions: A Brief History and Possibilities for the Future*, 40 MGMT. DECISION 938, 939 (2000) (noting that Carnegie pre-funded his steel worker pensions, thus placing him at the progressive end).

97. WILLIAM C. GREENOUGH, IT’S MY RETIREMENT MONEY TAKE GOOD CARE OF IT: THE TIAA-CREF STORY 35 (1990).

98. *Id.*

99. COMM. INDUS. RELATIONS, *supra* note 87, at 7659–7700.

100. *Id.*

101. 1 COMM. INDUS. RELATIONS, FINAL REPORT AND TESTIMONY 137 (1916) (using the U.K. Trade Disputes Act 1906 as a model for U.S. law).

102. *Id.*

developed in the next thirty years. Brandeis wrote after the hearings, that to create a “living law,” the ideal had been “[a] government of the people, by the people and for the people.” Now it was “[d]emocracy and social justice.”¹⁰³

B. The Slow Deal: 1916 to 1946

From the First World War to the end of the Second, America clearly became a more social democracy, but it was a slow deal. Three main shifts were that (1) workers’ savings flooded the stock market, separating ownership and control of companies more than ever, and these new worker-shareholders had to fight against disenfranchisement; (2) the first worker representatives were placed on boards of directors, and this practice was even reflected in a Massachusetts Law of 1919; but (3) business tried to hijack the language of “industrial democracy” with sham work councils that shielded management authority. Labor fought back with collective bargaining, culminating in Roosevelt’s New Deal.

The changes of labor’s fortunes were fundamental causes of the Wall Street Crash and the Great Depression because the stock market was built on labor’s capital. Even with the Clayton Act’s minimal freedoms, prosperity grew, and people wanted to save for old age. While *Lochner* and *Buckstegge* suppressed statewide social security, the Tariff Act of 1913 reintroduced a progressive income tax¹⁰⁴ and enabled employers to deduct pension payments and deferred annuity premiums as a business expense.¹⁰⁵ The Civil Service Retirement Act of 1920 set up a model that many state governments, as employers, followed, while a trickle of private employers set up workplace pensions. The Revenue Act of 1921 exempted any profit sharing or stock bonus trust used “for the exclusive benefit of some or all . . . employees.”¹⁰⁶ By 1926, the Internal Revenue Service also exempted pension funds.¹⁰⁷ When companies built up pension savings, they paid no tax until employees received and spent the money. Despite

103. Louis D. Brandeis, *The Living Law*, 10 ILL. L. REV. 461 (1916).

104. *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429 (1895) (striking down the progressive income tax; however, in 1913 the Sixteenth Amendment was passed, discussed in *Brushaber v. Union Pacific Railroad*, 240 U.S. 1 (1916)).

105. This meant that smaller sums of profit were taxable. The Revenue Act of 1918 said that employers who separately constituted funds could claim deductions. SASS, *supra* note 41, at 102–03.

106. Revenue Act of 1921, Pub. L. No. 67-98, § 219(f), 42 Stat. 227, 247. The Act was primarily a tax cut initiative led by Andrew Mellon. Mellon had inherited his father’s bank, diversified it into industry, acquired the position of Secretary of the Treasury, and became the third highest American taxpayer by the mid-1920s.

107. See Revenue Act of 1928, Pub. L. No. 70-562, § 165, 45 Stat. 792, 839 (updated in 1932, 1934 and 1936; it also allowed deductions for past accumulations, but the deduction had to be spread over ten years); Revenue Act of 1926, Pub. L. No. 69-20, § 219(f), 44 Stat. 9, 33–34; Revenue Act of 1924, Pub. L. No. 68-176, § 219(f), 43 Stat. 253, 276–77.

the tax reforms, most workers did not have the option of a workplace pension.¹⁰⁸

For labor, workplace pensions were problematic. The law still framed pensions as a “gift.” Employers threatened to withdraw workplace pensions if workers joined unions. This is why AFL President Samuel Gompers insisted that labor should control pensions alone until the government established an old age pension.¹⁰⁹ But Arizona’s public pension plan in 1916 was not the only one to be struck down. In 1923, a Nevada law was passed, but it was amended in 1925 so that counties could opt out.¹¹⁰ In 1925, the Pennsylvania Supreme Court struck down its fledgling state pension because apparently redistributing money for “benevolent” purposes was “unconstitutional.”¹¹¹ By 1929, only Montana’s old age pension remained. Just 3.7 million U.S. workers had workplace pensions, around 10% of the non-agricultural labor force. Pensions that unions controlled were small and many failed during the Depression.¹¹² In railways, where unionization was high, around 85% of people had pensions. But again, a substantial number were unilaterally reduced or closed when Wall Street crashed.¹¹³

Denied social security by their courts and denied workplace pensions by their employers, Americans had to save for old age somewhere else: the stock market. This drove the great separation of ownership and control

108. JOHN R. COMMONS & JOHN B. ANDREWS, *PRINCIPLES OF LABOR LEGISLATION* 398–403 (1936).

109. See LUTHER CONANT JR., *A CRITICAL ANALYSIS OF INDUSTRIAL PENSION SYSTEMS* 22 (1922) (Quoting Samuel Gompers, “Paternalism either in government or in industry is abhorrent. It takes away the initiative of the workers who should themselves prepare for old age Until the Government itself establishes an old age pension system, labor will insist that pension systems shall be controlled by the workers themselves, without any connection whatever with the employers.”).

110. See Abraham Epstein, *The American State Old Age Pension System in Operation*, 170 *ANNALS AM. ACAD. POL. & SOC. SCI.* 107, 107 (1933).

111. *Busser v. Snyder*, 128 A. 80, 83 (Pa. 1925); see also Ira Jewell Williams, *The Attack Upon the Supreme Court*, 7 *CONST. REV.* 143, 239 (1923); Gifford Pinchot, *Old Age Assistance in Pennsylvania: Righting the Neglects of Yesterday*, 14 *AM. LAB. LEGIS. REV.* 288 (1924).

112. MURRAY WEBB LATIMER, *TRADE UNION PENSION SYSTEMS: AND OTHER SUPERANNUATION AND PERMANENT AND TOTAL DISABILITY BENEFITS IN THE UNITED STATES AND CANADA* 8–9 (1932); SASS, *supra* note 41, at 125–27.

113. D. Shapiro, *Employee Pensions in Collective Bargaining*, 59 *YALE L.J.* 678, 680 (1950). Mellon’s response to the crash in November 1929, according to Herbert Hoover, was to “liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.” EDWARD GALE AGRAN, *HERBERT HOOVER AND THE COMMODIFICATION OF MIDDLE-CLASS AMERICA* 161 (2016).

from 1916 to 1919, later described by Gardiner Means.¹¹⁴ Workers saving for retirement flooded the stock market, which rocketed from 1916.¹¹⁵

Consistent data on stock market growth and pension savings in the early twentieth century are hard to find over time.¹¹⁶ However, we know that when public pension spending is higher (because the state replaces a proportion of income in retirement), people save less for retirement themselves. When the public pension is smaller (fixed at a minimum, safety-net level), people save more in occupational pensions, life insurance, mutual funds, and private savings. This money floods stock markets and creates a diversified shareholder base. This is why in OECD countries, as public pension spending rises, dispersion of shareholding falls. As the Figure 1 shows, countries like Germany or France with income-linked state pensions have many block shareholders.¹¹⁷ Countries like the United Kingdom or the United States with minimum state-pensions have a massive dispersion of shareholders, as the blockholders are flooded out.

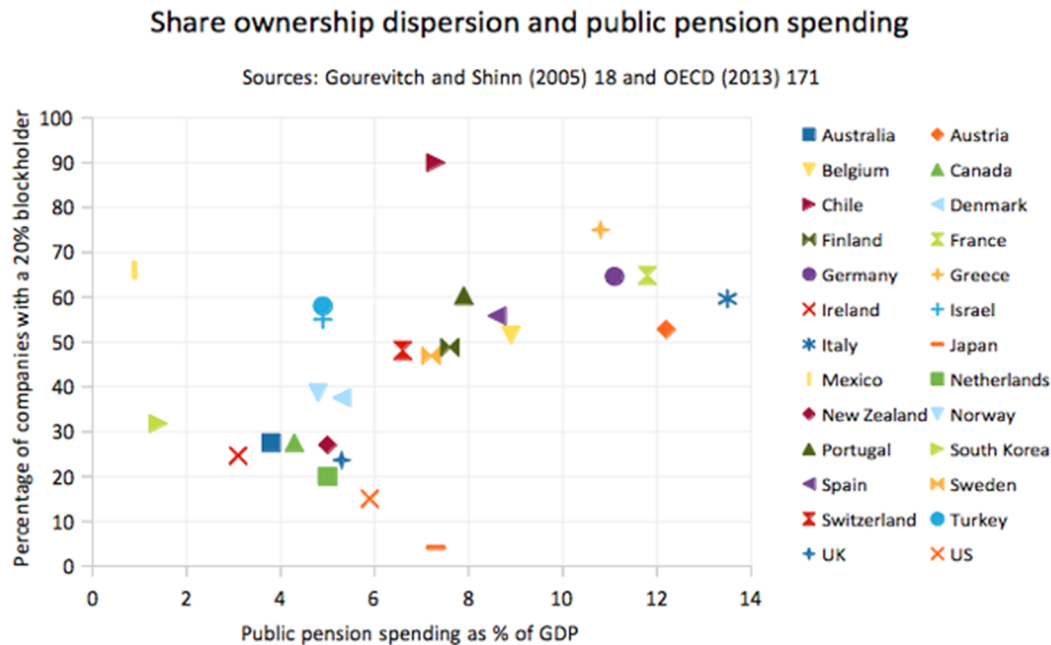
114. Gardiner C. Means, *The Diffusion of Stock Ownership in the United States*, 44, Q. J. ECON. 561, 562 (1930); see also 3 KARL MARX, CAPITAL: THE PROCESS OF CAPITALIST PRODUCTION AS A WHOLE 316 (Friedrich Engels ed., 1894) ("In stock companies the function [of appropriating labor] is divorced from capital ownership, hence also labour is entirely divorced from ownership of means of production and surplus-labour. This result of the ultimate development of capitalist production is a necessary transitional phase towards the reconversion of capital into the property of producers, although no longer as the private property of the individual producers, but rather as the property of associated producers, as outright social property."); Gardiner C. Means, *The Separation of Ownership and Control in American Industry*, 46 Q.J. ECON. 68 (1931).

115. See Marco Becht & J. Bradford DeLong, *Why Has There Been so Little Block Holding in America?*, in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 640 (Randall K. Morck ed., 2005) (charting data on the number of shareholders at AT&T, Pennsylvania Railroad and U.S. Steel, taking off from 1916).

116. Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5, 15 tbl.3, 46 app. (2003) (Showing the "[e]volution of stock market capitalization over GDP." This shows, in snapshots of 1913, 1929, 1938, and so on, the dramatic growth in U.S. stock market capitalization, as well as the U.K., Germany and 22 other countries. Its use is difficult because GDP fluctuates. Ideally, stock market capitalization figures over time could be correlated with public pension spending over time.).

117. The data in Figure 1 comes from JAMES SHINN & PETER GOUREVITCH, POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE (2005).

Figure 1



Before the Wall Street Crash, extraordinary investment growth meant a mass base of small investors. They lacked organization or bargaining power. By 1925, a growing number of companies had begun issuing nonvoting shares.¹¹⁸ Then, the Dodge Motor company was taken over by an investment bank, Dillon Read & Co.,¹¹⁹ and made a huge \$160 million share issue. Every share was nonvoting, and all of the shares were bought. Economist William Ripley led an outcry,¹²⁰ saying nonvoting shares “strike at the very tap-root of our capitalistic system” because “power and responsibility must ever be yoked together,” to stop the “absolute control by intermediaries—most commonly bankers.”¹²¹ Many

118. W.H.S. Stevens, *Stockholders' Voting Rights and the Centralization of Voting Control*, 40 Q.J. ECON. 353, 355, 361 (1926) (Showing 16 issues of nonvoting shares in 225 companies, sometimes with no votes, sometimes with limited votes. In 1898, International Silver Co. issued stock with no votes until 1902 and restricted after.).

119. The Dodge brothers, from the notorious *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919), had just died.

120. William Z. Ripley (1867–1941) was a complicated figure, which probably accounts for him being less well known, despite the resonance of his work today. He was an overt xenophobe, viewing both black people and women as less than competent to exercise political rights. After the Wall Street Crash, which many people credited him with predicting, Ripley suffered a series of nervous breakdowns and retired in 1933.

121. William Z. Ripley, *Two Changes in the Nature and Conduct of Corporations*, 11 PROC. ACAD. POL. SCI. N.Y. 143, 143–46. (1926) reprinted in 67 CONG. REC. 7719.

argued dispersed shareholders were unwilling or unworthy. Ripley replied that at least they “might always be stimulated to assert themselves,”¹²² and a rising corporate lawyer, Adolf A. Berle, added that at least with votes “there is always a latent power which can be exercised whenever the majority chooses to act.”¹²³

The campaign was successful enough for Ripley to be invited by President Calvin Coolidge to the White House.¹²⁴ On January 27, 1926, the New York Stock Exchange (NYSE) responded to the disenfranchisement outcry with a policy statement, that they would “give careful thought to the matter of voting control.” This was eventually hardened into a rule after the New Deal.¹²⁵ Even more, the new Securities and Exchange Commission (SEC) would eventually pressure the NYSE to issue Rule 452,¹²⁶ preventing brokers from voting on their depositors’ shares without instructions, either on mergers or when it might “affect substantially the rights or privileges of such.”¹²⁷ However, the SEC continued to allow voting upon “routine” matters, including an uncontested election for the board of directors.¹²⁸

122. Stevens, *supra* note 117, at 383 (objecting that while bondholders claims to interest would be enforceable, the voteless shareholder has no enforceable right).

123. Adolf A. Berle, Jr., *Non-Voting Stock and “Bankers’ Control,”* 39 HARV. L. REV. 673, 675 (1926); *see also* Adolf A. Berle, Jr., *Participating Preferred Stock*, 26 COLUM. L. REV. 303, 306 (1926).

124. *See* WILLIAM Z. RIPLEY, *MAIN STREET AND WALL STREET* (1927) (introduced by Woodrow Wilson).

125. *See* Securities and Exchange Act of 1934, Pub. L. No. 73-291, § 19, 48 Stat. 881, 898–99 (enabling the SEC to oversee and veto NYSE rules). On May 7, 1940, a “Statement of Listing Requirements as to Preferred Stock Voting Rights” confidently proclaimed, “Since 1926, The New York Stock Exchange has refused to list non-voting common stock.” Similarly, the Investment Company Act of 1940, Pub. L. No. 76-768, § 18, 54 Stat. 789, 817–21, required the capital structure in investment companies to be one-share, one-vote for common stock. *Contra* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 698 (1986).

126. Securities and Exchange Act of 1934 § 14(b) regulates proxy voting.

127. Richard Maidman, *Voting Rights of After-Record-Date Shareholders: A Skeleton in a Wall Street Closet*, 71 YALE L.J. 1205, 1215 (1962); *see also* Aktiengesetz [AkGt] [German Stock Corporation Act] Law of Jan. 30, 1937, RGBL I (Ger.) (describing voting instructions); Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1936, 1975, 1977 (1993) (arguing that “populist” reasons existed for U.S. banks becoming smaller, but does not explore this element of the law; the German experience with bank voting on deposited shares presents a stark contrast); Detlev F. Vagts, *Reforming the “Modern” Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 57 (1966) (noting comparisons with the Aktiengesetz 1965 § 135).

128. 15 U.S.C. § 78n(b) (Supp. 1965) gave authority for further rule making by the SEC, but nothing was done immediately. Broker voting typically supported management. *See* JAMES E. HEARD & HOWARD D. SHERMAN, *CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM* 22 (1987); Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1443 (1964). On the other, general aspects of Manne’s work and its contemporary reception, *see* Adolf A. Berle, *Modern Functions of the Corporate System*, 62 COLUM. L. REV. 433–49 (1962).

Although they were not completely disenfranchised, small shareholders still lacked information. The law did not guarantee that adequate information was disclosed about the securities they bought. After the fact, the dominant economic literature has theorized the Wall Street Crash was caused by a classic speculative bubble,¹²⁹ or by the Federal Reserve's policy on money supply.¹³⁰ At the time, the institutional cause of the speculative bubble, rather than human irrationality, was recognized to be the absence of disclosure regulation. The Securities Act of 1933—directly inspired by Berle and Means's Book III—resolved this.¹³¹ The larger question was that, if that regulation had always been lacking before, why were the bubble and bust so tremendous this time? The answer is the historically unprecedented volume of American workers saving for retirement: Wall Street crashed labor's capital.

How did labor rights evolve from the War to the crash? In 1918, Eugene V. Debs had been sentenced to prison again, this time for opposing the war,¹³² and he ran on the Socialist ticket for President in 1920 from prison. "No job or no union" employment contracts remained common from *Coppage v. Kansas* until the Norris-La Guardia Act of 1932. Further, in 1921, *Duplex Printing Press Co. v. Deering* held the right to strike in solidarity with workers of other employers had no immunity under the Clayton Act.¹³³

On the other hand, one year after entering World War One, on April 8, 1918, a National War Labor Board was established by the Department of Labor.¹³⁴ To smooth war production and avoid strikes,¹³⁵ it promoted work councils, collective bargaining, and arbitration, not as alternatives to one another but as complements. The Board had five representatives nominated by the National Conference Board, five by the American Federation of Labor, and two "public" representatives agreed to by each.¹³⁶ It heard labor dispute appeals and had an inspectorate office to enforce agreed standards. It urged employers to set up work councils on the same

129. See generally JOHN KENNETH GALBRAITH, *THE GREAT CRASH* ch. 10 (1954); JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* 149 (1936).

130. See generally MILTON FRIEDMAN & ANNA J. SCHWARZ, *A MONETARY HISTORY OF THE UNITED STATES, 1867–1960* (1963) (arguing that the Great Depression's cause was that the government allowed the monetary supply to shrink, and it should have kept all banks going as the lender of last resort).

131. See generally BERLE & MEANS, *supra* note 4, at 289–331.

132. *Debs v. United States*, 249 U.S. 211 (1919).

133. *Duplex Printing Press Co. v. Deering*, 254 U.S. 443 (1921) (holding that secondary strike action was unlawful because the Clayton Act of 1914 § 20 referred to immunity for trade disputes between an "employer and employees").

134. This was established as a separate entity in 1913 on the last day of the Taft presidency.

135. See generally Richard B. Gregg, *National War Labor Board*, 33 HARV. L. REV. 39 (1919).

136. *Id.* at 40.

model to settle disputes.¹³⁷ To attain its goals, the Board had no express enforcement power, but was backed by the ability to withdraw government contracts and had emergency powers to commandeer factory production.¹³⁸ From the Clayton Act of 1914 to the creation of the Board in 1918, union membership was growing and inequality shrinking. But at the end of the War, with Republicans winning the Senate election in November 1918, employers flouted its orders. On August 12, 1919, the Board was ended.¹³⁹

Before the Board shut down, a remarkable law was passed putting workers on company boards. In April 1919, the newly elected Governor of Massachusetts, Calvin Coolidge, signed an Act that a “manufacturing corporation may provide by by-law for the nomination and election by its employees of one or more of them as members of its board of directors.”¹⁴⁰ This is still on the books today, in § 23 of the Massachusetts Laws chapter on business corporations,¹⁴¹ and is therefore the world’s oldest codetermination law continuously in force. The option was adopted in part by the Dennison Manufacturing Co. at Framingham,¹⁴² but in reality the law codified what had already become a growing social practice. By 1922, a Boston clothing store, William Filene’s Sons, enabled employees to effectively choose four of the eleven members of the board of directors, a practice that emerged from growing employee involvement since 1898.¹⁴³

137. See NAT’L INDUS. CONFERENCE BD., REPORT NO. 21, WORKS COUNCILS IN THE UNITED STATES 8 (1919).

138. Gregg, *supra* note 135, at 45.

139. Louis L. Jaffe, *Post-War Labor Relations: The Contributions of the War Labor Board*, 29 IOWA L. REV. 276 (1944) (“Not more than three years later the Steel Industry had smashed the Unions and underwritten the Open Shop Era of the Twenties. It is, of course, true that the Board worked out in considerable detail the meaning of the right to collective bargaining: it forbade individual contracts, discharge for union activity, etc. It thus gave concreteness to an idea which only a decade later bore fruit. It insisted on the ‘living’ or ‘minimum’ wage and one observer believed (in 1919) that it had established the principle as an ‘actuality’; yet as we know it failed to educate the Supreme Court in this respect and certainly much of Industry remained unconverted.”).

140. An Act to Enable Manufacturing Corporations to Provide for the Representation of Their Employees on the Board of Directors, 1919 Mass. Acts 45.

141. MASS. GEN. LAWS ch. 156, § 23 (2018); *see also* N.J. REV. STAT. § 14.9:1-3 (1957) (repealed).

142. Calvert C. Magruder, *Labor Copartnership in Industry*, 35 HARV. L. REV. 910, 915–19 (1921) (describing how the Dennison Manufacturing Company at Framingham, Massachusetts, with over 3000 staff, gave voting power to 368 managerial employees, while non-managers had voice in a consultative works committee).

143. RAYMOND L. HOGLER & GUILLERMO J. GREINER, EMPLOYEE PARTICIPATION AND LABOR LAW IN THE AMERICAN WORKPLACE 15 (1992) (In 1898, William Filene’s Sons had delegated responsibility to workers for welfare, running the canteen and entertainment, and from 1901 had allocated employee seats on an arbitration board. This would, however, be seen today as an illegal sham company union.); EARL J. MILLER, WORKMEN’S REPRESENTATION IN INDUSTRIAL GOVERNMENT 39–40 (1922) (“All employees, including salaried officials, by virtue of being employed in the store, are members of the Filene cooperative association There are eleven

In other states, by 1919 there were at least two plans: at Procter and Gamble and at the General Ice Delivery Company of Detroit.¹⁴⁴ A more complex arrangement, yet adopted by at least twenty companies by 1919, was developed by John Leitch: workers elected a “House of Representatives,” foremen a “Senate,” top management a “Cabinet,” and for a proposal to become “law,” it had to pass all three. This was first employed at the Packard Piano Company in 1913, although its fate is unclear.¹⁴⁵ Many of these systems tied employees to buy stocks, but not always.¹⁴⁶ For example, in New York, the Dutchess Bleachery at Wappingers Falls had a five member board of directors, one appointed by a subsidiary board representing employees.¹⁴⁷ Jett Lauck recorded that in 1926 there were at least eight companies with employee representation on a board of directors, five through voluntary action, and three through stock purchase.¹⁴⁸ On these grounds alone, it is clear that Clyde Summers’ opinion that the United States had “no experience with employee representation on corporate boards” went too far.¹⁴⁹

Work councils were another form of representation, but after the War Labor Board was gone employers pushed to retool them as replacements for unions, not complements. In 1919, the National Industry Conference Board (NICB), the major American employer organization,¹⁵⁰ found in a survey of 225 work council plans that 120 had been created under Federal government auspices and 105 on the employers’ initiative.¹⁵¹ The NICB argued councils could quell labor unrest and improve productivity, but its

members on the Board of Directors. The employees nominate six members for this board, and the stock-holders of the company choose four from this panel of six. These four employee members have the same powers as the ones representing the employers.”).

144. NEIL M. CLARK, *COMMON SENSE IN LABOR MANAGEMENT* 28–29 (1919) (The Proctor & Gamble plan was not yet instituted.).

145. Milton Derber, *The Idea of Industrial Democracy in America: 1915–1935*, 8 LAB. HIST. 3 (1967).

146. WILLIAM O. DOUGLAS & CARROL M. SHANKS, *CASES AND MATERIALS ON THE LAW OF MANAGEMENT OF BUSINESS UNITS* 130–31 (1931) (Employee representation in management is not always associated with employee stock ownership.).

147. *Id.* at 130.

148. See JETT W. LAUCK, *POLITICAL AND INDUSTRIAL DEMOCRACY 1776–1926*, chs. 3, 6 (1926); Paul F. Gemmill, *The Literature of Employee Representation*, 42 Q.J. ECON. 479, 492 (1928) (describing the five “torchbearers of industrial democracy” that “stand out above all others as indicating a sincerity of purpose and as offering a basis for future constructive action” as (1) William Filene’s Sons, (2) the Dutchess Bleachery, (3) the Dennison Manufacturing Co., (4) the A. Nash Co., and (5) Philadelphia Rapid Transit Co.).

149. Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. SEC. REG. 155, 155 (1982) (“The United States has had no experience with employee representation on corporate boards, apart from the small number of employee-owned enterprises.”).

150. This is now The Conference Board. It was established in 1916. The two other main lobby groups for employers are the Business Roundtable and the US Chamber of Commerce.

151. See generally NAT’L INDUS. CONFERENCE BD., *supra* note 137.

enthusiasm seemed conditional on an employer's supposedly unalienable "right to employ and discharge, the direction of the working forces . . . the management of the business . . . reserved exclusively to the company."¹⁵² Workers and unions were not interested in this kind of work council, because without binding legal rights it was a sham: a dishonest alternative to collective bargaining. By 1925, 1,177,037 employees were covered by such work councils. This relatively low level suggests the initiatives were far more about staving off trade unions than managements implementing an obvious efficiency measure.¹⁵³ Nevertheless, the NICB was intent on spreading the idea that its plans still embodied the true definition of "industrial democracy."¹⁵⁴

After the Wall Street Crash, labor and capital reform also became a question of equality. President Roosevelt's Federal Reserve Chair from 1934, Marriner Stoddard Eccles, later wrote that the crash became a Depression because "hoarded funds" meant the "distribution of wealth" was not enough "to provide [people] with buying power equal to the amount of goods and services offered."¹⁵⁵ To change this, government support for unions became critical. The National Industrial Relations Act of 1933 guaranteed a charter of labor rights and would have promoted sectoral collective bargaining. It was struck down as "unconstitutional."¹⁵⁶ Instead, the reframed National Labor Relations Act of 1935 proclaimed its goal to remedy "inequality of bargaining power" between employees "and employers who are organized in the corporate or other forms." Although the new National Labor Relations Board (NLRB) focused only on building enterprise bargaining among local unions, the Act gave private sector workers federal rights to unionize, collectively bargain, and take-strike action.¹⁵⁷ As the Act's sponsor, Senator Robert Wagner said, "democracy in industry must be based upon the same principles as democracy in government."¹⁵⁸

152. See generally NAT'L INDUS. CONFERENCE BD., REPORT NO. 21, WORKS COUNCIL MANUAL SUPPLEMENTAL RESEARCH (1920) (noting that union members should not be discriminated against).

153. NAT'L INDUS. CONFERENCE BD., REPORT NO. 32, THE GROWTH OF WORKS COUNCILS IN THE UNITED STATES: A STATISTICAL SUMMARY 5 (1925).

154. See generally NAT'L INDUS. CONFERENCE BD., REPORT NO. 50, EXPERIENCE WITH WORKS COUNCILS IN THE UNITED STATES (1922).

155. MARRINER S. ECCLES, BECKONING FRONTIERS: PUBLIC AND PERSONAL RECOLLECTIONS 75–77 (1951) ("[W]hile savings that are invested in new enterprises are beneficial not only to savers but also to the entire economy, savings that find no outlet and accumulate as idle or hoarded funds interrupt the flow of national income and result in a depression. *As mass production has to be accompanied by mass consumption, mass consumption, in turn, implies a distribution of wealth—not of existing wealth, but of wealth as it is currently produced—to provide men with buying power equal to the amount of goods and services offered by the nation's economic machinery.*").

156. *Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

157. National Labor Relations Act of 1935 §§ 7–8, 29 U.S.C. §§ 157–158 (2012).

158. 79 Cong. Rec. 7571 (1935); see also N.Y. TIMES, Apr. 13, 2018, at 1.

And now that people had something to organize for, they did. Even without widespread sectoral bargaining, union membership soared. So did employers' enthusiasm for company "unions." By 1935, 3,100 companies with 2.6 million workers had company "unions," and over two-thirds of them had arisen since 1933.¹⁵⁹ In March 1934, Wagner had urged publicly that sham unions should be suppressed because otherwise employers would sit "on both sides of the table" or pull "the strings behind the spokesmen."¹⁶⁰ The NLRA of 1935 § 8(a)(2) made it unlawful to interfere with, or support, any labor organization. Under § 2(5), a labor organization meant anything where employees participated to deal with disputes or terms and conditions at work.¹⁶¹ In the first major case in 1939, *NLRB v. Newport News Shipbuilding Co.*,¹⁶² the NLRB ordered disestablishment of a company "work council" at the Eastern Seaboard's largest docks, operating since 1927, so that an independent union could replace it. It resolved disputes and balloted employees, but the Supreme Court held it was unlawful because, like the NICB model, no decision of this "work council" could be implemented and the plan could not be amended without management approval.¹⁶³ The law strictly outlawed sham participation, but § 8(a)(2) also lacked a positive model of work councils that unions could pursue.

How did the New Deal change social security? Reform followed a similar pattern of social action, court repression, and federal legislation.

159. Johanna Oreskovic, *Capturing Volition Itself: Employee Involvement and the TEAM Act*, 19 BERKELEY J. EMP. & LAB. L. 229, 241 (2014) (citing *Hearings on S. 1958: Before the Committee on Education and Labor*, 74th Cong. 40 (1935) (statement of Sen. Wagner, Chairman, Comm. Pub. Lands and Surveys), reprinted in 1 LEGISLATIVE HISTORY OF THE NATIONAL LABOR RELATIONS ACT, 1935, at 1416 (1985)).

160. *Hearings on H.R. 6228 Before the H. Comm. on Labor*, 74th Cong. 15 (1935); see also Robert F. Wagner, *Company Unions: A Vast Industrial Issue*, N.Y. TIMES, Mar. 11, 1934, at 1. Wagner, born in Germany, was acutely aware that in May 1933, Hitler's Nazi regime had violently seized the union movement, setting up the state controlled Deutsche Arbeitsfront. It was "probable that his own origins made Wagner particularly sensitive to the barbarities perpetrated by those who had assumed power in the land of his birth." J. JOSEPH HUTHMACHER, SENATOR ROBERT F. WAGNER AND THE RISE OF URBAN LIBERALISM 268 (1968); see also Letter from Robert F. Wagner to J.B. Mayer (Jan. 16, 1934). Wagner was among the first to condemn Hitler's regime. Robert F. Wagner Papers, Wagner Speech File, Mar. 27, 1933; Robert F. Wagner Papers, International Affairs File, 1933–1939.

161. National Labor Relations Act of 1935, 29 U.S.C. §§ 152(5), 158(a)(2) (2012) (Section 152(5) states that it is an unfair labor practice "to dominate or interfere with the formation or administration of any labor organization or contribute financial or other support to it." Section 152(5) states that "a labor organization means any . . . employee representation committee or plan, in which employees participate and which exists for the purpose, in whole or in part, of dealing with concerning grievances, labor disputes, wages, rates of pay, hours of employment, or conditions of work.").

162. *NLRB v. Newport News Shipbuilding & Dry Dock Co.* 308 U.S. 241 (1939).

163. *Id.* at 250 (disestablishment of the plan was the "only effective way of wiping the slate clean and affording the employees an opportunity to start afresh in organizing for the adjustment of their relations with the employer.").

First, California, Wyoming, New York, and Massachusetts had introduced pensions by 1930, and almost half the states followed by 1933.¹⁶⁴ Second, the Roosevelt administration passed the Railroad Retirement Act of 1934, with a compulsory contributory scheme for railway workers, vested in the U.S. Treasury and managed by a government board. The Supreme Court in *Railroad Retirement Board v. Alton Railroad Co.* struck it down.¹⁶⁵ Echoing the reasoning in *Buckstegge*, Justice Owen Roberts, writing for the majority of the Court, stated that employers subsidizing employees of other companies was “an unnecessarily harsh and arbitrary imposition if the plan is to be what on its face it imports—a joint adventure with mutuality of obligation and benefit.”¹⁶⁶

But third, the 1934 Act was only a prelude to the Social Security Act of 1935. The Supreme Court continued to strike down New Deal laws until on November 3, 1936, Roosevelt won reelection with 60.8% of the vote, carrying every state except Maine and Vermont. With Democrats prepared to pack the Court with new judges,¹⁶⁷ Justice Roberts switched to support the New Deal.¹⁶⁸ In *Helvering v. Davis*, a shareholder of Edison Electric Illuminating Co. brought a derivative claim to injunct the company from paying contributions under the Social Security Act, saying it exceeded the Federal government’s power.¹⁶⁹ Justice Benjamin Cardozo, now with a majority, explained that it was lawful for Congress to spend money for “general welfare,” and Congress had broad discretion to determine what that meant.

Beyond the minimum provision of social security, how did workers get fair pensions? With more collective bargaining, more employers introduced workplace pensions, but many limited pensions to top officials while claiming the payments were tax deductible because it was for “some

164. Epstein, *supra* note 110, at 107–11; cf. DORA L. COSTA, THE EVOLUTION OF RETIREMENT: AN AMERICAN ECONOMIC HISTORY, 1800–1990, at 107–11 (1998). To paraphrase Justice Brandeis, it turned out that during the economic crisis many a “courageous state” were keen to “serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.” *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

165. *Railroad Retirement Bd. v. Alton R.R. Co.*, 295 U.S. 330 (1935).

166. *Id.* at 357 (The government argued that it fulfilled the requirements of due process because pensions promoted efficiency due to their ability to improve morale and create loyalty to the company. The reply was apparently that the removal of the voluntary character of pensions necessarily “will eliminate all sense of loyalty and gratitude to the employer.”).

167. President Roosevelt’s Bill to Reorganize the Judicial Branch of the Government was known as the “court packing plan.” S. 1392, 75th Cong. (1937); H.R. 4417, 75th Cong. (1937).

168. This succeeded first with the approval of Washington’s minimum wage legislation in *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937). The NLRA of 1935 was approved in *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1 (1937).

169. See generally *Helvering v. Davis*, 301 U.S. 619 (1937).

or all employees.”¹⁷⁰ From the Stabilization Act of 1942 and Revenue Act of 1942, tax exemptions could only be given if 70% of permanent employees were covered by a plan. During the war, wage restraints had been imposed, but pensions were exempt.¹⁷¹ Unions asked for pension contributions, instead of wage rises, through collective agreements.¹⁷² In *Helvering*, Justice Cardozo recorded that 75% people over 65 had been wholly or partly dependent on others in old age.¹⁷³ Social security ended extreme dependence. Collective bargaining meant private sector pension coverage rose from 15% in 1940 to over 40% by 1960.¹⁷⁴ And initially, unions bargained for plans where they controlled the contributions completely.

As World War Two drew to a close, American society had been transformed: it now had a modern system of social security, and meaningful labor rights were building a thriving middle class. People had enough money to save for retirement, and unions sought to manage workers’ capital. Income inequality was decreasing as never before.

170. See Randolph E. Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41, 77 (1937); George T. Altman, *Pension Trusts for Key Men*, TAX MAG., June 1937, at 324.

171. See Stabilization Act of 1942, Pub. L. No. 77-729, § 10, 56 Stat. 765, 768 (repealed 1956); Revenue Act of 1942, Pub. L. No. 77-753, § 165(a), 56 Stat. 798, 862–63 (codified as amended at 26 U.S.C. § 401(a)) (allowing exclusion for temporary, seasonal or under-five-year workers, and prohibiting discrimination in favor of executives, except insofar as benefits could be proportional to pay); Arthur H. Kent, *The Revenue Act of 1942*, 43 COLUM. L. REV. 1 (1943); Leon L. Rice Jr., *Employee Trusts under the Revenue Act of 1942*, TAX MAG., Dec. 1942, at 721.

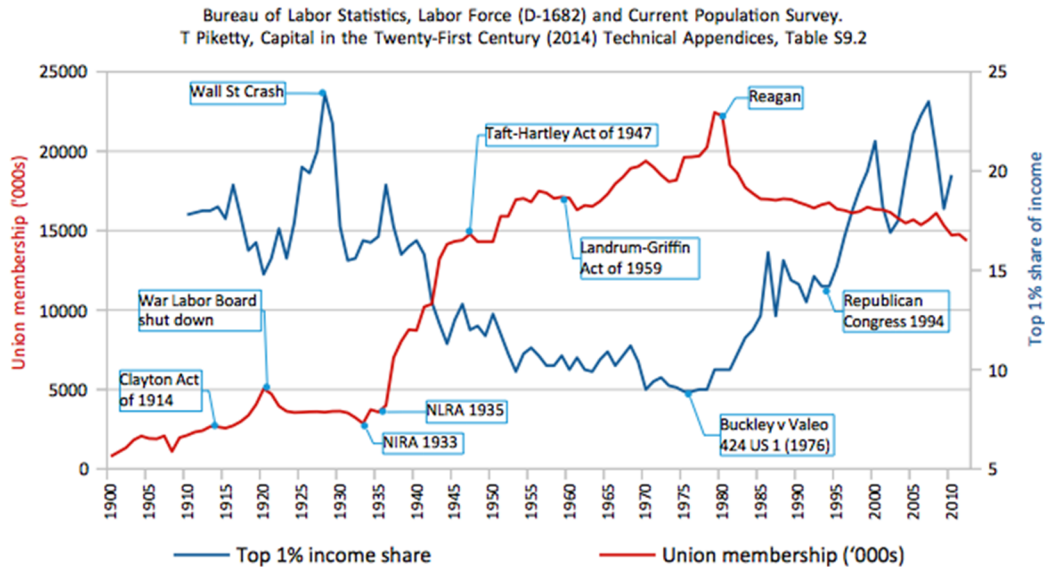
172. See generally Editor, *Legal Status of Private Industrial Plans*, 53 HARV. L. REV. 1375 (1940).

173. MARJORIE SHEARON ET AL., ECONOMIC INSECURITY IN OLD AGE: SOCIAL AND ECONOMIC FACTORS CONTRIBUTING TO OLD-AGE DEPENDENCY 15 (1937).

174. ALICIA H. MUNNELL & STEVEN A. SASS, SOCIAL SECURITY AND THE STOCK MARKET: HOW THE PURSUIT OF MARKET MAGIC SHAPES THE SYSTEM 32 (2006) (depicting a graph showing a high of 47% in 1982 and declining to an unsteady level around 43% by 2004).

Figure 2

US union membership and income inequality, 1900-2012



Labor rights and social security were central to what Roosevelt called in 1944 a “Second Bill of Rights,” designed to achieve “new goals of human happiness and well-being.”¹⁷⁵ But there was one notable absence: there was no settled view yet on the constitution of economic relations. Collective bargaining strength was growing, but who appointed the company boards unions bargained with? Pensions funds were building, but who would control the assets? Sham company unions were banned, but what could a legitimate work council look like? Ironically, in 1946 in occupied Germany, the United States Military Government passed Control Council Law No. 22, which set out a model work council that unions could bargain for.¹⁷⁶ German workers and unions had the right to establish work councils with rights to enforce collective agreements, investigate grievances, participate in setting up social insurance and social welfare, and collectively agree on any further functions for work councils, reserved from management prerogative.¹⁷⁷ The United States helped win the war for peace, democracy, and social justice abroad, but it was not yet there at home.

175. See G.A. Res. 217 (III) A, arts. 20–26, Universal Declaration of Human Rights (Dec. 10, 1948).

176. Control Council Law No. 22 Works Councils, Apr. 10, 1946, OFFICIAL GAZETTE OF THE CONTROL COUNCIL FOR GERMANY 1945–1946, at 133–36 (1946), LSE Archives 43 (R498).

177. *Id.* arts. IV–V.

C. Democracy in America, Almost: 1946 to 1980

Labor's position after World War Two was one of unprecedented strength, yet it was vulnerable. In the period up to 1980, labor became increasingly aware of, and organized to use, its power in pension savings to democratize corporate governance. This culminated in an astonishing, concerted effort to win representation on company boards of directors. At the same time, the interests behind corporate boardrooms and Wall Street consolidated their opposition and used every instrument of the state—the legislature, executive, and courts—to halt labor's advance.

By 1946, union density had climbed to 35.5% of non-agricultural workers, and labor was determined to secure an increase in wages. Unions went on strike: one of the largest waves in American history.¹⁷⁸ Employers accused unions of having an “unfair” advantage by using pensions to pay strikers. They argued employers should have no duty to bargain over pensions at all,¹⁷⁹ and shareholders brought derivative actions arguing any payments to union pensions were ultra vires.¹⁸⁰ In Congress, Senator Robert Taft proposed a prohibition on employees' involvement in pensions.¹⁸¹ This mirrored the position of the U.S. Chamber of Commerce that “the primary responsibility for . . . old age must rest with the individual.”¹⁸² He singled out the United Mine Workers pension fund,¹⁸³ where the union leader, John Lewis, demanded a solely union administered fund from the government.¹⁸⁴ The miners' dispute itself was resolved by the federal government getting an agreement to jointly administer the fund.

178. See JACK METZGAR, *The 1945–1946 Strike Wave*, in THE ENCYCLOPEDIA OF STRIKES IN AMERICAN HISTORY 216–25 (A. Brenner et al. eds., 2009) (explaining the standard demand became an 18.5% pay raise).

179. *Inland Steel Co. v. Nat'l Labor Relations Bd.*, 170 F.2d 247 (7th Cir. 1948) (holding that pensions were a mandatory subject of collective bargaining), *cert. denied*, 336 U.S. 960 (1949).

180. F. Hodge O'Neal, *Stockholder Attacks on Corporate Pension Systems*, 2 VAND. L. REV. 351 (1949).

181. 93 CONG. REC. 4892 (1947); see also H.R. REP. NO. 80-245, at 29–30 (1947), reprinted in 1 NLRB, LEGISLATIVE HISTORY OF THE LABOR MANAGEMENT RELATIONS ACT OF 1947, at 309 (1948); *House Set to Compromise on Labor Bill in Order to Obtain Measure on Which Veto Could Be Beaten*, WALL ST. J., May 10, 1947, at 3.

182. Conference on Emp. Pension Plans, Conference Minutes (July 9–10, 1947) (unpublished minutes) (on file with USCOC Collection, Series 3, Box 6, Employee Pension Plans folder).

183. R. Blodgett, *Union Pension Fund Asset Management*, in ABUSE ON WALL STREET 320, 321 (1980).

184. Louis Stark, *New Strike Looms, Coal Official Says*, N.Y. TIMES, Feb. 12, 1947, at 5 (Quoting the hostile view of Forney Johnston of the National Coal Association, that the Union of Mine Worker proposed funds “are now on the agenda of every central union in a program of sweeping encroachment on the earnings and on the functions of ownership and management, with no limitation whatever except the conscience of the union dynasty.”); see also *United States v. United Mine Workers of Am.*, 330 U.S. 258 (1947).

In the November 1946 election, Republicans won a majority in Congress and the new Taft-Hartley Labor Management Relations Act 1947 was passed to reduce labor power. It created an express right for employers to proselytize against a union, created unfair labor practices for unions, reinstated the prohibition on secondary action, and prohibited the closed shop: unions could charge non-members fees for their services, unless state laws stopped it.¹⁸⁵ For pensions, its central change was § 302(c)(5)(B). While it did not affect union pension funds that were already established,¹⁸⁶ employers could pay no money into a new union fund unless the board was managed jointly, with a neutral umpire or a court determining disputes in case of deadlock.¹⁸⁷ While Carnegie's TIAA was designed with rights to minimum labor voice in pensions, Taft-Hartley guaranteed a minimum voice for corporate boardrooms. President Harry Truman vetoed the Act, but enough Democrats supported it that it became law.

While the Taft-Hartley Act suppressed union governance of workers' capital, more and more plans were collectively agreed to under the joint-management model, ironically named Taft-Hartley plans.¹⁸⁸ By 1960, in addition to single-employer pensions, Taft-Hartley multi-employer plans covered 3.3 million workers,¹⁸⁹ rising to 9.7 million workers in 1988.¹⁹⁰ As Taft had known well,¹⁹¹ this money could be invested in shares. Employers were keen to preempt union control if they could. In 1950, in the so-called "Treaty of Detroit,"¹⁹² which was flaunted as a victory for both sides, General Motors initiated a sole-employer pension as part of a five year collective agreement.¹⁹³ Managers were instructed to be inactive in corporate governance, and the treaty confined investment to a maximum

185. Labor Management Relations Act of 1947 § 302(c)(5)(B), 29 U.S.C. § 186 (2012).

186. Gerald P. Cunningham, *The Employee Retirement Income Security Act of 1974 and Union Influence in Pension Fund Investment Decisions*, 12 FORDHAM URB. L.J. 151, 153 (1983).

187. Labor Management Relations Act of 1947 § 302(c)(5)(B), 29 U.S.C. § 186 (2012).

188. Robert Cook, *The Case for Joint Trusteeship of Pension Plans*, 6 J. LAB. & SOC'Y 26 (2002).

189. H. ROBERT BARTELL & ELIZABETH T. SIMPSON, PENSION FUNDS OF MULTIEMPLOYER INDUSTRIAL GROUPS, UNIONS, AND NONPROFIT ORGANIZATIONS 105 (1968).

190. 135 CONG. REC. 5984-6005, 6233 (1989) (citing a study by the ME Segal consulting firm).

191. JEREMY RIFKIN & RANDY BARBER, THE NORTH WILL RISE AGAIN: PENSIONS, POLITICS AND POWER IN THE 1980S, at 101 (1978) ("Senator Claude Pepper of Florida . . . suggest[ed] that Taft and his business friends, when they fretted over possible union abuses of the funds, were really fretting over the possibility that they might lose control of the potential pool of capital that pension funds represented. Pepper was right, but despite the fact, or probably because of it, the vote went against labor.").

192. Daniel Bell, *The Treaty of Detroit*, FORTUNE, July 1950, at 53.

193. Fredrick H. Harbison, *The General Motors-United Auto Workers Agreement of 1950*, 58 J. POL. ECON. 397 (1950).

of 0.75% in any company's stock.¹⁹⁴ By contrast, in 1952 the AFL-CIO released a ten-point bargaining agenda that included joint-investment boards.¹⁹⁵ The Teachers Insurance and Annuity Association was also extended to buy into shares, with the College Retirement Equity Fund: this made TIAA-CREF.¹⁹⁶ These steps were still rare: only in 1967 was California's Public Employee Retirement Scheme, CalPERS, first able to invest 25% of its assets in shares. Only in 1984 was the limit removed.¹⁹⁷

The spirit of the 1950s was unfavorable to labor. Along with Senator McCarthy's "investigations" aiming to conflate unions with Soviet dictatorship, a fund manager named Louis Kelso was popularizing stock ownership, especially among employees, as the only way to have voice in the economy.¹⁹⁸ His motivation, which caught Republican attention, was to ward off socialism by making all workers small capitalists without any toleration of collective voice.¹⁹⁹ This was not Carnegie's pre-TIAA worker-shareholder vision, nor was there any goal to ensure worker voice. Kelso believed in the right to manage. Even on the Democratic side of politics, Robert F. Kennedy's search for the so-called "Enemy Within" culminated in an ever-growing set of burdens on union governance in the Landrum-Griffin Act of 1959.²⁰⁰ With states limiting unions under Taft-Hartley, even more than raw membership,²⁰¹ union density faltered.

194. PETER F. DRUCKER, *THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA* 7 (1976); PAUL HARBRECHT, *PENSION FUNDS AND ECONOMIC POWER* 8 (1959).

195. TERESA GHILARDUCCI, *LABOR'S CAPITAL: THE ECONOMICS AND POLITICS OF PRIVATE PENSIONS* 116 (1992).

196. GREENOUGH, *supra* note 97, at 360–62. In 1988, to register a new money market fund with the SEC, TIAA-CREF risked losing charitable status, although it was previously exempt under 26 U.S.C. § 501(c)(3). Instead, CREF trustees were wholly elected by policyholders, according with the Investment Company Act 1940 § 16, 15 U.S.C. § 80a–16 (2012).

197. *See generally* CHRISTOPHER J. CASTANEDA, *DEDICATION, VISION, HEART: THE CALPERS STORY* (2007).

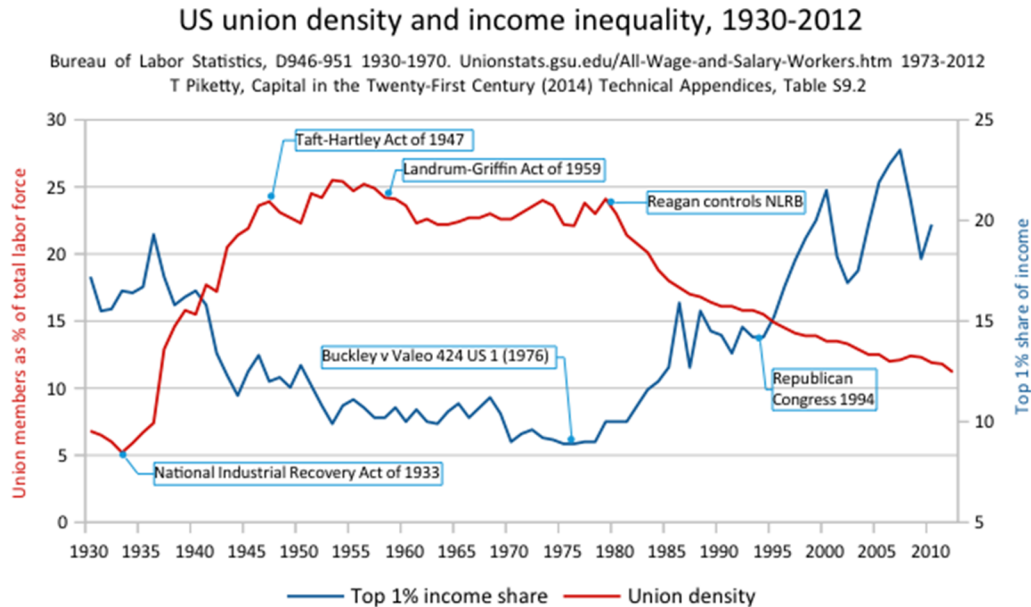
198. KELSO & ADLER, *supra* note 14, at 202–04 ("Equity-sharing plans should not be built around the concept of retirement . . . [It should enable] the worker gradually to shift, over the period of his employment, from absolute dependence on toil as the source of his income to dependence, in a substantial degree, on his ownership of a capital interest.").

199. LOUIS KELSO & PATRICA HETTER, *HOW TO TURN EIGHTY MILLION WORKERS INTO CAPITALISTS ON BORROWED MONEY* (1967).

200. Labor Management Reporting and Disclosure Act of 1959, 29 U.S.C. § 401 (2012); *see* Ewan McGaughey, *Democracy or Oligarchy? Models of Union Governance in the UK, Germany and US* 36–38 (King's Coll. London Law Sch., Research Paper No. 2017-35, 2017).

201. N.B. The United States is unique compared to other countries in that it is experiencing sustained, rapid population growth. There were 76 million people in 1900, 123 million by 1930, 151 million by 1950, 203 million by 1970, 248 million by 1990, and over 328 million today.

Figure 3



Nevertheless, by the 1960s labor rights were strong enough to create “a rising tide” that “lifts all boats.”²⁰² In 1965, A.A. Berle believed a peaceful “revolution” was still in motion, as the old forces of private property were infused with a constitution of economic and social rights. Workers saving for pensions, encouraged by tax reform, meant a growing stake for everyone in economic growth.²⁰³ In 1968, Paul Blumberg went further, arguing in *Industrial Democracy: the Sociology of Participation* for the economic and scientific case to expand voice at work.²⁰⁴ He argued that in the leading management case study, the Hawthorne experiments of Elton Mayo, the data showed productivity rose when workers were given genuine control over their working patterns, were no longer subjected to authoritarian managers, and were treated with dignity.²⁰⁵ This became known as the “participation hypothesis,” meaning that “significant changes in human behavior can be brought about rapidly only if the

202. TED SORENSON, COUNSELOR: A LIFE AT THE EDGE OF HISTORY 227 (2008) (John F. Kennedy’s speechwriter attributes the phrase to the regional chamber of commerce, the New England Council.).

203. Adolf A. Berle, *Property, Production and Revolution*, 65 COLUM. L. REV. 1 (1965).

204. PAUL BLUMBERG, *INDUSTRIAL DEMOCRACY: THE SOCIOLOGY OF PARTICIPATION* chs. 2–3 (1968).

205. Compare *id.* at 25, with ELTON MAYO, *TEAMWORK AND LABOR TURNOVER IN THE AIRCRAFT INDUSTRY OF SOUTHERN CALIFORNIA* (1944).

persons who are expected to change participate in deciding what the change shall be and how it shall be made.”²⁰⁶

The benefits of labor participation were not completely ignored in government. While sham company unions were unlawful, there had been real success with “Scanlon plans” developed in 1938 by Ohio union leader Joseph Scanlon: workers made suggestions for production and administration in return for guaranteed bonuses if suggestions worked.²⁰⁷ The President’s National Commission on Productivity and Work Quality in 1972 sought to promote productivity, including drawing on joint union–management committees.²⁰⁸ Some unions were wary of participation either with or in management,²⁰⁹ a view that some managerial interests appeared keen to encourage. But many workers and unions were not shy because they could see the right to select directors operating effectively in other countries.²¹⁰

The early 1970s unlocked a wave of experiments for workers on boards, both through collective bargaining and voice in shares. In 1971, the first proxy proposal was made at the General Motors annual meeting for employee representation, followed by similar proposals the following year at Ford, and the Illinois retailer Jewel.²¹¹ Also in 1972, the pilots of United Airlines used the shares they held collectively to propose board representation at the 1972 stockholder meeting. They won 5% of the vote.²¹² At AT&T, shareholders proposed employees be included on the board to “provide a continuing flow of information to management” and “avoid periodic labor disruptions which place financial hardships on

206. H.A. Simon, *Recent Advances in Organization Theory*, in RESEARCH FRONTIERS IN POLITICS AND GOVERNMENT 23, 28–29 (1955).

207. ROBERT J. KÜHNE, CO-DETERMINATION IN BUSINESS: WORKERS’ REPRESENTATIVES IN THE BOARDROOM 113–14 (1980) (By 1945, around 3,200 companies had joint production committees, but in 1948 most had ended. Interest revived haphazardly afterward.). See generally Gilbert K. Krullee, *The Scanlon Plan: Co-Operation Through Participation*, 28 J. BUS. 100 (1955).

208. E.g., NAT’L COMM’N ON PRODUCTIVITY, ANNUAL REPORT NO. 1, at 17 (1972) (United Steelworkers of America AFL-CIO, in its 1971 collective agreement, required “joint union-industry committees on productivity at the plant level.”); see also NAT’L COMM’N ON PRODUCTIVITY, ANNUAL REPORT NO. 4, at 21 (1975) (making clear these “committees are not a substitute for nor an alternative to collective bargaining”).

209. Robert Dahl, *Power to the Workers?*, N.Y. REV. OF BOOKS, Nov. 19, 1970, at 9 (“[M]any employees of a particular firm might not wish to participate in governing . . . workers and trade unions may be the greatest barriers at present to any profound reconstruction of economic enterprise in this country Along with the officialdom of the trade union movement, workers are deeply ingrained with the old private property view of economic enterprise . . . affluent workers . . . tend to be consumption-oriented, acquisitive, privatistic, and family-centered.”).

210. E.g., McGaughey, *supra* note 16.

211. Phillip I. Blumberg et al., *Corporate Social Responsibility Panel: The Constituencies of the Corporation and the Role of the Institutional Investors*, 28 BUS. LAW. 177, 179 (1973).

212. Brian Hamer, *Serving Two Masters: Union Representation on Corporate Boards of Directors*, 81 COLUM. L. REV. 639, 640 (1981).

employees and impose losses on the company and shareowners.”²¹³ In 1973, workers at the small Providence and Worcester Railroad succeeded in getting representation by collective bargaining, which the *Wall Street Journal* described as a “precedent shattering labor agreement.”²¹⁴ The United Rubber Workers also proposed to the General Tire and Rubber Company that a union member be appointed to the board, but they were turned down.²¹⁵

These developments in worker representation plainly troubled the Nixon administration. In 1974, the Securities and Exchange Commission, using its power to regulate shareholders soliciting support for proposals,²¹⁶ issued a letter to AT&T that management could exclude proposals for worker directors to be placed on boards.²¹⁷ This was ostensibly because New York law, where AT&T was incorporated, gave the right to elect directors to shareholders. It ignored that a simple bylaw amendment could create classes of shareholders, or shareholders could agree to use their votes to guarantee worker representatives. It was far from clear that agreement upon shutting down experiment was widespread: the Republican Senator for New York, Jacob K. Javits, said that “an effort to open up corporate board room opportunities to workers would improve workers’ understanding of management as well as exposing management to workers’ ideas.”²¹⁸ Unions persisted. In 1976, the Teamsters union proposed that two union representatives be appointed to the board of the brewing giant, Anheuser-Busch.²¹⁹ Similarly, the International Federation of Professional and Technical Engineers proposed at AT&T’s annual meeting that a union representative be put on the board, but the proposal won just 3.3% of votes cast.

The SEC and management opposition played into uncertainty within the labor movement. While many unions themselves were strongly in favor of board representation, the AFL-CIO, at a time of considerable pressure, was not. Thomas Donahue (who became Secretary-Treasurer

213. Jerry W. Markham, *Restrictions on Shared Decision-Making Authority in American Business*, 11 CAL. W. L. REV. 217, 245–46 (1975).

214. Davison Douglas, *Labor Unions in the Boardroom: An Antitrust Dilemma*, 92 YALE L.J. 106, 106 n.1 (1982).

215. Union Asks Seat on Board, N.Y. TIMES, Mar. 27, 1973, at 31.

216. Securities and Exchange Act of 1934 § 14(a), 15 U.S.C. § 78l (1964); 17 C.F.R. § 240.14-8(c)(1) (1970) (A company can omit to consider a proposal if “the proposal as submitted is, under the law of the issuer’s domicile, not a proper subject for action by security holders.”).

217. American Telephone & Telegraph Company, Fed. Sec. L. Rep. (CCH) ¶ 79,658 (1974). In 1974, there were 363 work days lost per 1,000 workers to strikes in the United States, but only 3 per 1,000 workers in Germany. Bennet Abramowitz, *Broadening the Board: Labor Participation in Corporate Governance*, 34 SW. L.J. 963, 984 (1980).

218. KÜHNE, *supra* note 207, at 105.

219. Lassus, *What the Teamsters Really Wanted*, BEVERAGE WORLD, June 1976, at 34 (cited by Douglas, *supra* note 213, at 106 n.1).

from 1979 to 1995, and briefly President) said in 1976 that because “American unions have won equality at the bargaining table, we have not sought it in corporate boardrooms.” He did not want to be “the junior partner in success and the senior partner in failure” or “blur the distinction between management and labor.”²²⁰

But unions that bargained directly with management pressed on. In 1976, the United Auto Workers (UAW) declared that they sought representation on the board of Chrysler. The proposal was rejected,²²¹ but then in 1979, as Chrysler drifted into severe financial problems, the board conceded, and a worker director stepped on board.²²² Chrysler denied “that it intended to establish any principle of labor representation.” But Douglas Fraser, UAW President and the new director, said this was “nonsense” and just “to protect their flanks.”²²³ As Fraser declared before his election by shareholders, arranged by the board, “it isn’t enough for a union to argue about plant closings or layoffs after the decision has been made.”²²⁴

How did corporate boardrooms and Wall Street react to labor’s growing assertiveness? First, in 1971, Lewis Powell wrote a memo for the U.S. Chamber of Commerce urging concerted action in public education, journalism, and for the courts to stop the “[a]ttack on [the] American Free Enterprise System.”²²⁵ He urged business to “press vigorously in all political arenas for support of the enterprise system,” learning lessons “from organized labor in this respect” because the “American business executive,” Powell lamented, “is truly the ‘forgotten man.’” It was true that in 1969 the Delaware General Corporation Law § 141(h) was amended, virtually unnoticed, to enable directors to set their own pay.²²⁶ Before this, the standard rule was that pay was set in bylaws or by shareholder vote. This triggered an exponential curve in the chart below, Figure 4. But far more profound and damaging in the long-term was Nixon’s placement of Powell on the Supreme Court. In the first case after Justice William O. Douglas left the bench, *Buckley v. Valeo*, it was

220. Eileen Appelbaum & Larry W. Hunter, *Union Participation in Strategic Decisions of Corporations* 267 (Nat’l Bureau of Econ. Research, Working Paper No. 9,590, 2003).

221. Craig R. Whitney, *Auto Union Seeks Directors’ Seats*, N.Y. TIMES, May 13, 1976, at 51; cf. JOHN FURLONG, *LABOR IN THE BOARDROOM* (1977).

222. John D. Blackburn, *Worker Participation on Corporate Directorates: Is America Ready for Industrial Democracy?*, 18 HOUS. L. REV. 349, 352 (1981).

223. *UAW’s Fraser to Speak Out for Labor, Public, in Role as Director of Chrysler*, WALL ST. J., Oct. 29, 1979, at 6.

224. WALL ST. J., May 14, 1980, at 6.

225. Memorandum from Lewis F. Powell Jr. to Eugene B. Syndor Jr., Chairman of the Educ. Comm. of the U.S. Chamber of Commerce, *Attack on American Free Enterprise System* (Aug. 23, 1971).

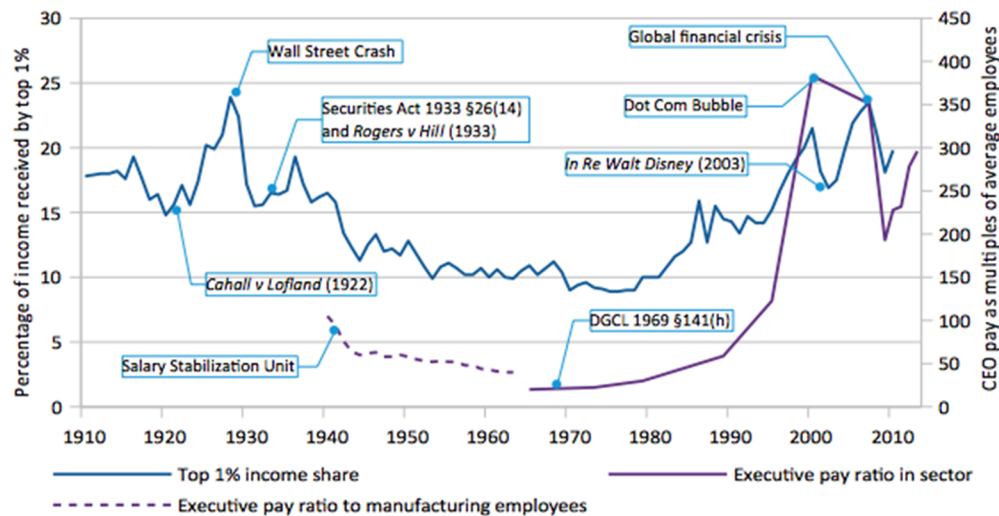
226. S. Samuel Arsht & William K. Stapleton, *Delaware General Corporation Law: 1969*, 25 BUS. LAW. 287 (1969).

decided, over powerful dissent, that candidates for political office could spend unlimited amounts of money in election campaigns: it was “unconstitutional” under the First Amendment to try and stop them.²²⁷ This was soon followed by *First National Bank of Boston v. Bellotti*, where Justice Powell held that state legislation could not restrict expenditure by corporations during a ballot.²²⁸ This must be seen as the start of an exponential rise in inequality, as the American social and political system was ground to a halt by money.

Figure 4

US inequality and executive pay ratios

Sources: Piketty (2014), Davis and Mishel (2014), Lewellen (1968)



227. *Buckley v. Valeo*, 424 U.S. 1 (1976). In this case, the Supreme Court struck down parts of the Federal Election Campaign Act of 1971. In his dissent, Justice White explained,

Congress was plainly of the view that these expenditures also have corruptive potential; but the Court strikes down the provision, strangely enough claiming more insight as to what may improperly influence candidates than is possessed by the majority of Congress that passed this bill and the President who signed it. . . . Without limits on total expenditures, campaign costs will inevitably and endlessly escalate By limiting the importance of personal wealth, [§] 608(a) helps to assure that only individuals with a modicum of support from others will be viable candidates. This in turn would tend to discourage any notion that the outcome of elections is primarily a function of money.

Id. at 261–66 (White, J., concurring in part and dissenting in part).

228. *First Nat'l Bank Bos. v. Bellotti*, 435 U.S. 765 (1978). Justice White wrote, Corporations are artificial entities created by law for the purpose of furthering certain economic goals . . . the special status of corporations has placed them in a position to control vast amounts of economic power which may, if not regulated, dominate not only the economy but also the very heart of our democracy, the electoral process.

Id. at 809 (White, Brennan, and Marshall, JJ., dissenting); see also J. Skelly Wright, *Money and the Pollution of Politics: Is the First Amendment an Obstacle to Political Equality?*, 82 COLUM. L. REV. 609 (1982).

Second, the structure of capital was gradually changed. In 1965, a Committee on Corporate Pension Funds had recommended federal rights against pensions being withdrawn by employers, so that they “vested,” and standards for funding.²²⁹ In 1972, the NBC documentary *Pensions: The Broken Promise* publicized the extent of the problems.²³⁰ If workers moved jobs, they had no right to take their pensions with them. Employers might also promise a pension but set aside no money. This led to the Employee Retirement Income Security Act (ERISA) of 1974, requiring that money vested after one year’s work, and that defined benefit (DB) schemes had minimum funding, guaranteed by the Pension Benefit Guaranty Corporation.²³¹

Positive though ERISA was, it also influenced governance choices. A plan had to be in a written instrument, and assets had to be held by trustees which could include a company’s own officers or employees, despite the possible conflicts of interest.²³² Moreover, ERISA § 402(d)(1) created immunity for trustees in negligence cases (including duties to diversify) if they outsourced or “delegated” to an external manager, and § 404(c)(1) created immunity for the employer (the plan “sponsor”) if beneficiaries exercised any minimal control over the plan’s assets. At the time, only a handful of public pensions—for California,²³³ Connecticut, and Nebraska state employees, as well as Ohio teachers—enabled pension

229. President’s Comm. on Corporate Pension Funds and Other Private Ret. and Welfare Programs, *Public Policy and Private Pension Programs* (1965); see Arthur C. O’Meara, *Public Policy and Private Pension Programs*, 21 BUS. LAW. 971 (1966); cf. HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, REPORT OF THE SEC ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (2d Sess. 1966).

230. PENSIONS: THE BROKEN PROMISE (NBC News 1972). The documentary won a Peabody Award and sufficiently outraged the Richard Nixon government and lead the Nixon administration to bring an action, through the Federal Communications Commission, for breaching the then “fairness doctrine” that programming had to be duly impartial. After the Nixon-controlled FCC found that NBC was in breach, the Federal Court of Appeals overturned the ruling to find no breach in *Nat’l Broad. Co. v. FCC*, 516 F.2d 1101 (D.C. Cir. 1974). The fairness doctrine was later abolished by the Reagan administration, so that broadcasting does not need to give any semblance of fairness, due impartiality, or accuracy. Equivalent laws persist for all television in the United Kingdom under the Communications Act, 2003, c.21, § 319 (Eng.), and in Germany, see Rundfunkstaatsvertrag [RSTV] [Interstate Broadcasting Agreement], July 31, 1991, § 11. Internet regulation has not yet caught up.

231. 29 U.S.C. §§ 1081–1102 (1980).

232. Employee Retirement Income Security Act of 1974 §§ 402(a), 403(a), 408(c)(3), 29 U.S.C. §§ 1102(a), 1103(a), 1108(c)(3) (2012) [hereinafter ERISA]; see Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. Rev. 75, 91 (1993) (“[C]onflicts that benefit managers are tolerated.”).

233. See Castaneda, *supra* note 197 (Section 20100-3 of the California Government Code (1991), now found in § 20090 (2011), requires seven members appointed by the employer (i.e., the government), but six elected by beneficiaries, from 2010.).

beneficiaries to elect their trustees.²³⁴ ERISA did nothing to empower the ultimate investors of capital: it encouraged the reverse.

The incentives for pension trustees and employers to outsource pension management enabled asset managers to take shareholder voting rights on other people's money. Tax incentives drove this further. First, the Self-Employed Individuals Tax Retirement Act of 1962 originally allowed self-employed workers to establish tax deferred saving accounts, called Keogh plans. Second, ERISA extended this right to defer tax to a maximum of \$2,000 a year in Individual Retirement Accounts (IRAs) to everyone, including workers who already had employer, union, government or Keogh pensions plans. IRAs were often held by banks. Tax exemptions were created for employers who put worker retirement money or savings into stock ownership schemes.²³⁵ Third, people still wanted to put more funds in tax-deferred accounts, so the Internal Revenue Code of 1978 § 401(k) was introduced. Employers found these "401(k)" plans convenient. They could send off their staff details and fund "choices" to be organized by an investment manager.²³⁶ If the fund's management was outsourced, trustees had no liability. If beneficiaries had some choice of plan, employers had no liability.

This series of changes (the incentives to outsource investment management and the easy option of IRAs) laid the groundwork for an assault on workers' pensions in the 1980s. In 1976, the management theorist Peter Drucker argued that because workers' pensions made up 25% of equity capital, and "by 1985 (probably sooner), they will own at least 50—if not 60 per cent—of equity capital."²³⁷ But the stark reality was that workers lacked any meaningful voice over their money. As Rifkin and Barber argued in 1978, banks and asset managers exercised "direct control" and "have sole voting rights for the stock they purchase with pension-fund assets."²³⁸ For example, Chase Manhattan managed a \$423 million pension for the tire company Firestone while at the same time the bank trust held 950,000 shares in Firestone.²³⁹ Also, the former Chase president sat on Firestone's board. Rifkin and Barber hoped that an upcoming case, *Daniel v. Teamsters*, might see the Supreme Court

234. Louis M. Kohlmeier, *State and Local Pension Fund Asset Management*, in ABUSE ON WALL STREET, *supra* note 182, at 278 (1980). Ohio's system of representation began in 1973. The Wisconsin State Teachers Retirement System, unusually, had a wholly employee elected board, although a separate State of Wisconsin Investment Board managed investments, and were appointed.

235. ERISA § 407(d)(6); 26 U.S.C. § 4975(e)(7).

236. Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 876 (2009).

237. PETER F. DRUCKER, THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA 1 (1976).

238. RIFKIN & BARBER, *supra* note 191, at 114.

239. *Id.* at 116.

approve the view that every beneficiary had “the right to exercise control over some \$400 billion in pension assets.”²⁴⁰ Perhaps not surprisingly, the Supreme Court did not oblige.²⁴¹

Third, it was clear that a number of business leaders, however irrationally, viewed workers on boards “with horror.”²⁴² In 1976, Michael Jensen and Bill Meckling gave that horror a theoretical framework by arguing that efficient enterprise came about through the reduction of “agency costs” in the “nexus of contracts” that made up a corporation.²⁴³ The idea that a corporation was a bundle of contracts was not new.²⁴⁴ Emboldened by its absence of empirical foundation, the theory’s critical feature was a total rejection of bargaining power as a relevant factor in explaining who got voice in corporate governance. In 1979, Jensen and Meckling warned that if workers entered board rooms, or legislation was introduced like in West Germany, the economy would grind to a halt as it had in Marshall Tito’s Yugoslavia.²⁴⁵ This echoed the Business Roundtable’s view: workers on boards were “inconsistent with U.S. traditions and style of management-labor relationships at arm’s length.” The notion that workers might have any vote in corporate governance was rejected.²⁴⁶

D. Ownership Society, Enron Economy: 1980 to 2018

In many ways, the evolution of labor’s voice in corporate governance since 1980 played out the consequences of *Buckley v. Valeo*: labor law “ossified” and asset managers, not the real investors of capital, took over votes in the economy because the capacity for progressive legislation was

240. *Id.* at 135.

241. *Daniel v. Int’l Bhd. Of Teamsters*, 561 F.2d 1223, 1241–42 (7th Cir. 1977) (“Because employee pension plans are now the major, if not sole, form of investment for most American workers to provide for their old age and because of the now crucial role that such plans play in today’s capital markets, they are just the sort of investment vehicle that the securities acts were passed to regulate.”), *rev’d*, 439 U.S. 551 (1979).

242. Richard M. Steuer, *Employee Representation on the Board: Industrial Democracy or Interlocking Directorate*, 16 COLUM. J. TRANSNAT’L L. 255, 255 (1977).

243. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).

244. Friedrich Kessler, *Wirtschaftsführertum und Vertragsethik im Neuen Aktienrecht*, 83 U. PA. L. REV. 393 (1935) (reviewing Johannes Zahn’s book *the German Aktiengesetz 1937*); see Ewan McGaughey, *Ideals of the Corporation and the Nexus of Contracts*, 78 MOD. L. REV. 1057 (2015).

245. Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 468, 469–506 (1979).

246. Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2107 (1978). The term “arms length” is probably a reference to the U.S. Supreme Court decision in *Pepper v. Litton*, 308 U.S. 295, 306–07 (1939), which defined a director’s fiduciary duties as requiring arm’s length negotiation.

shut down by money.²⁴⁷ Upon his victory as President, one of Ronald Reagan's first acts was to dismiss members of the Professional Air Traffic Controllers Organization who were attempting to bargain for a three-day weekend.²⁴⁸ After this, the National Labor Relations Board was restaffed by people opposed to collective bargaining, while Supreme Court jurisprudence ground the remainder of union rights down further.²⁴⁹

Nevertheless, labor's vote in corporate governance persisted. Douglas Fraser of the UAW served on the board of Chrysler from 1980 to 1984, treading a fine line between rescuing the company and recusing himself from negotiating collective agreements.²⁵⁰ In 1981, the UAW also proposed a labor representative on the American Motors Corporation board. The employers accepted UAW's proposal contingent on the government's approval. The Federal Trade Commission viewed this proposal as lawful. But the Department of Justice argued the Clayton Act of 1914 § 8, which prohibits interlocking directorates, was engaged if unions appointed board members to competing companies. It failed to provide credible evidence that there were any anti-competitive effects under similar European systems²⁵¹ or that there was any way to recognize that local union appointees or direct elections by employees would present any problem.²⁵² While the UAW did not press the issue, in 1982 Pan

247. Martin Gilens & Benjamin I. Page, *Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens*, 12 PERSP. POL. 564 (2014) (finding that legislation bears virtually no relation to people's preferences since 1981).

248. John M. Keynes, *Economic Possibilities of Our Grandchildren* (1930), in *ESSAYS IN PERSUASION* 358, 358–73 (1932).

249. *Janus v. Am. Fed'n of State, Cty., & Mun. Emps., Council 31*, 138 S. Ct. 2448 (2018) (held 5 to 4 that unions could not collect fees from non-member workers who benefit from collective agreements); *14 Penn Plaza LLC v. Pyett*, 556 U.S. 247 (2009) (held 5 to 4 that an employer can bind workers to submit to arbitration, with "arbitrators" chosen by employers to "decide" even statutory rights); *Hoffman Plastic Compounds v. NLRB*, 535 U.S. 137 (2002) (held 5 to 4 that NLRA of 1935 removed protection for undocumented workers to the fundamental right to organize a union); *Mertens v. Hewitt Assocs.*, 508 U.S. 248 (1993) (held 5 to 4 that ERISA enabled employees to be denied the right to claim medical malpractice, when employers were the direct purchaser of a health care plan); *Brown v. Hotel & Rest. Emps. & Bartenders Int'l Union Local 54*, 468 U.S. 491 (1984) (held 5 to 4 on the NLRA of 1935 allowed states to ban union representatives who were not of "good moral character"); *O'Connor v. Ortega*, 480 U.S. 709 (1987) (held 5 to 4 that the Fourth Amendment allowed employees to be searched at work like criminal suspects); see, e.g., *NLRB v. Yeshiva Univ.*, 444 U.S. 672 (1980) (held 5 to 4 that professors with nominal "management" input were deprived of the fundamental human right to collective bargaining).

250. See Douglas A. Fraser, *Worker Participation in Corporate Government: The U.A.W.—Chrysler Experience*, 58 CHI.-KENT L. REV. 949 (1982); cf. Ronald M. Sharp, *Codetermination: A Postmortem*, 40 LAB. L.J. 323, 331–32 (1989).

251. For examples today, the Swedish Board Representation (Private Sector Employees) Act 1987 (SFS 1987:1245) § 6 empowers unions to appoint board members. The German Codetermination Act 1976 §§ 9 and 18 enable unions to cast votes by default in companies with over 8,000 workers, but workers always have the right to opt out.

252. Cf. Davidson Douglas, *Labor Unions in the Boardroom: An Antitrust Dilemma*, 92 YALE L.J. 106, 117–25, (1982) (presenting a two-fold exemption test that (1) a representative should not be

American Airways elected a union member to serve on its board.²⁵³ In 1984, the new UAW President, Owen Bieber, took up Fraser's board seat at Chrysler.²⁵⁴ The Pan American arrangement was ended by the board in 1991, but then revived in 1998 when the next UAW President, Stephen Yokich, joined²⁵⁵ during the merger with German corporation Daimler-Benz.²⁵⁶ In 1993, the United Steel Workers agreed to representation on five company boards for six years,²⁵⁷ and the USW leader, Lynn Williams, pushed for more whenever the opportunity arose.²⁵⁸ Compared to other OECD countries, these experiments alone mean the United States achieved one of the strongest traditions of codetermination. It was a remarkable feat in the face of the full force of the administrative state and the hostility of a Supreme Court, Department of Labor, Securities and Exchange Commission, and Department of Justice dominated by business interests.

Many board representation plans were entangled with share schemes, were without meaningful voice,²⁵⁹ and came with unacceptable risk. In a sample from 1998, Larry Hunter found that among 25 firms, all linked to share schemes, there was no majority of workers on a board.²⁶⁰ In 1999, Robert McKersie recorded there were around 35 major representation plans in total.²⁶¹ Critically, share schemes were exempted from ERISA's

a national union appointee, or (2) a full time official). It is notable that, unlike the serious issues with mutual funds discussed below, evidence of anti-competitive effects in European countries with codetermination laws and union appointees does not appear to exist.

253. WALL ST. J., May 13, 1982, at 22.

254. Doron P. Levin, *Chrysler to Cut Board; U.A.W. Chief Is Out*, N.Y. TIMES, Mar. 14, 1991, at 1.

255. JOHN W. BUDD & JAMES G. SCOVILLE, THE ETHICS OF HUMAN RESOURCES AND INDUSTRIAL RELATIONS 270 (2005).

256. The corporation became Chrysler LLC in 2007, after being sold to Cerberus Capital Management. It went bankrupt in 2009: workers got board seats again, but it became a Fiat SpA subsidiary in 2014, now Fiat Chrysler Automobiles NV.

257. *The Unions Step on Board*, FIN. TIMES, Oct. 27, 1993.

258. Bruce E. Kaufman, *An Interview with Steelworkers' President Lynn Williams*, 22 J. LAB. RES. 145, 164-45 (2001).

259. Cf. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/PEMD-87-8, EMPLOYEE STOCK OWNERSHIP PLANS: BENEFITS AND COSTS OF ESOP TAX INCENTIVES FOR BROADENING STOCK OWNERSHIP 41-43 (1986) (In a survey of 3,000 ESOPs, around 15% carried an employee involvement in decision-making.).

260. Larry W. Hunter, *Can Strategic Participation be Institutionalized? Union Representation on American Corporate Boards*, 51 INDUS. & LAB. REL. REV. 557, 557-78 (1998); see also Elieen Appelbaum & Larry W. Hunter, *Union Participation in Strategic Decisions of Corporations*, in EMERGING LABOR MARKET INSTITUTIONS FOR THE TWENTY-FIRST CENTURY 265, 282 tbl.8.1 (Richard B. Freeman et al. eds., 2005) (showing a list of companies with union-nominated directors).

261. Robert B. McKersie, *Union Nominated Directors: A New Voice in Corporate Governance*, in NEGOTIATIONS AND CHANGE: FROM THE WORKPLACE TO SOCIETY 223 (Thomas A. Kochan & David B. Lipsky eds., 2003).

requirements for prudent investment and diversification.²⁶² These consequences were on display when the energy company, Enron, collapsed in December 2001. Enron's 20,000 employees had been encouraged,²⁶³ and partly required,²⁶⁴ to invest an average of 62.5% of their retirement savings in 401(k) plans in Enron itself. For this, the workforce had no board representation. Enron workers were not alone. One study found that employees invested an average of 29.6% of their pension savings in their employer. Procter & Gamble's employees had 94.7% invested, Coca-Cola's employees had 81.5%, and General Electric's employees had 77.4%.²⁶⁵ Again, employees had no representation and were "horrifically underdiversified."²⁶⁶ The Enron economy, which sold ownership without power, was given an even bigger name by President George W. Bush in 2005: the "ownership society."²⁶⁷ The Enron economy, the ownership society, meant boardrooms, asset managers, and banks held onto economic privilege with other people's labor and other people's money.

It was easy to be cynical about labor's voice in corporate governance. In 1987, President Carter's former Labor Secretary, John Dunlop, said it was "damned insignificant and won't spread[,] . . . codetermination is not about to sweep industrial relations in this country."²⁶⁸ Dunlop was also not planning to help. When President Clinton was elected, he appointed Dunlop to head a Commission on the Future of Worker-Management Relations.²⁶⁹ It recommended a unified definition of an "employee" to receive labor rights, as well as minor reforms to collective bargaining. It said nothing about board participation, though it did stoke debate about work councils. In 1992, the National Labor Relations Board decided that

262. ERISA § 404(a)(1)(C), 29 U.S.C. § 110469(a)(1)(C), requires diversification, but under (a)(2) this "is not violated by acquisition or holding qualifying employer securities" as defined under §407(d).

263. David Millon, *Worker Ownership through 401(k) Retirement Plans: Enron's Cautionary Tale*, 76 ST. JOHN'S L. REV. 835, 840 (2002) ("[I]n August 2001, CEO Ken Lay told employees, 'Now is the time to buy Enron shares' and, in September, he reiterated that the stock was a great bargain Lay himself sold shares worth twenty million dollars during the same period.").

264. ENRON CORP. SAVINGS PLAN AS AMENDED AND RESTATED EFFECTIVE JULY 1, 1999, § III.1, 4, V.16(a).

265. PATRICK J. PURCELL, CONG. RESEARCH SERV., RS21115, THE ENRON BANKRUPTCY AND EMPLOYER STOCK IN RETIREMENT PLANS 4 (2002).

266. JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 640-41 (4th ed. 2006).

267. President George W. Bush, Second Inaugural Address (Jan. 20, 2005) ("To give every American a stake in the promise and future of our country, we will . . . build an ownership society. We will widen the ownership of homes and businesses, retirement savings and health insurance—preparing our people for the challenges of life in a free society.").

268. *Bureau of National Affairs*, DAILY LAB. REP., Nov. 30, 1987.

269. U.S. COMM'N ON THE FUTURE OF WORKER-MGMT. REL., DUNLOP COMMISSION ON THE FUTURE OF WORKER-MANAGEMENT RELATIONS: FINAL REPORT (1994).

“action committees” at Electromation Inc. violated NLRA of 1935 § 8(a)(2).²⁷⁰ The committees heard complaints about pay or bonuses and had a majority of employee representatives, but the employer structured their proposals and paid the members.²⁷¹ Dunlop said § 8(a)(2) should be “clarified” by Congress, but did not say how or why with any clarity.²⁷² After the 1994 Congressional elections, Republicans proposed the Teamwork for Employees and Managers Act of 1995, which proposed to allow committees on any issue of “mutual interest” so long as they did not claim to become exclusive bargaining representatives.²⁷³ This was essentially a way, once more, to privatize labor voice, and reincarnate company unions. In 1996, President Clinton was forced to veto the Bill, though calls for § 8(a)(2) to be repealed or amended have persisted.²⁷⁴ The same issue resurfaced in 2014 at the Chattanooga, Tennessee plant of Volkswagen. At first, management suggested it wanted a “work council,” though not clearly with autonomous rights that would ordinarily be found abroad. This led to an unprecedented campaign by Republican lobbyists and politicians to stop anything. Eventually, the UAW simply held a recognition ballot, where 626 workers voted in favor but 712 voted against. Instead, the UAW held and succeeded in a ballot for a segment of the plant. Management refused to bargain.²⁷⁵

Without meaningful voice on boards and in work councils, and with unions fighting hard, who held the votes in the American economy? In 1980, predictions were still widespread that labor’s capital would grow, pensions or other collective funds could become democratic, and so would economic governance. This was not to be. A broad variety of corporate, trust, and contract pensions could be organized, either by collective agreement or the employer.²⁷⁶ But increasingly, people’s savings were pressed into individual accounts, dominated by mutual firms. In 1982, one

270. *Electromation Inc.*, 309 N.L.R.B. No. 163, 142 L.R.R.M. 1001 (1993).

271. *EI du Pont de Nemours & Co.*, 311 N.L.R.B. No. 88, 143 L.R.R.M. 1121 (1993) (deciding safety and health committees, because they were subject to a management veto, were an unlawful usurpation of labor organization functions); see Dennis M. Devaney, *Electromation and du Pont: The Next Generation*, 4 CORNELL J. L. & PUB. POL’Y 3, 14 (1994).

272. See U.S. COMM’N ON THE FUTURE OF WORKER-MGMT. REL., *supra* note 268, at 22, 27, 30–31. See, therefore, the dissenting view of Douglas A. Fraser, *id.* at 32.

273. Teamwork for Employees and Managers Act of 1995, H.R. 743, 104th Cong. § 3 (1996).

274. See, e.g., Samuel Estreicher, *The Dunlop Report and the Future of Labor Law Reform*, 12 LAB. LAW. 117 (1996).

275. See Stephen J. Silvia, *The United Auto Workers’ Attempts to Unionize Volkswagen Chattanooga*, 71 INDUS. L. REV. 600 (2018) (But note that the assessment at 605–06, suggesting it is unlawful under § 8(a)(2) to establish a work council, cannot be regarded as entirely accurate if, as in Germany, workers, not employers, take the initiative to set up work councils.).

276. See the excellent summary by Gerald P. Cunningham, *The Employee Retirement Income Security Act of 1974 and Union Influence in Pension Fund Investment Decisions*, 12 FORDHAM URB. L.J. 151 (1984).

account of an election for four board vacancies at Prudential found the only four candidates were nominated by the board:

Eligible to vote were 18.4 million policyholders. Of these, 323 did—virtually all of them employees of Prudential. Later in the same year, policyholders of the Equitable were called upon to choose among a field of 11 nominees to fill 11 board seats. An estimated 3,250,000 policyholders were eligible to vote but were not informed of the election; 6,400, mostly Equitable employees, voted by mail.²⁷⁷

Investment companies like Prudential or Equitable, increasingly running 401(k) plans, would be set up by firms under the Investment Advisers Act of 1940 without any real governance standards. The Investment Company Act of 1940 § 16 required policyholders to vote for the investment company board. But in practice, advisers selected the investment company's first board of directors and delegated the investment work back to the advisers.²⁷⁸

This was the model the Reagan administration aggressively sought to promote for labor's capital. In 1983, the Internal Revenue Service ruled that "surplus assets," which could be taken by a company when it closed down a pension scheme, meant anything in excess of current liabilities.²⁷⁹ In 1984, the Department of Labor and the Pension Benefit Guaranty Corporation issued termination guidelines for pension trusts.²⁸⁰ The closure of defined benefit pension funds was colossal, peaking in 1985. The Tax Reform Act of 1986 placed a cap on tax deferment in IRAs, encouraging the shift to mutual funds.²⁸¹ The Single-Employer Pension Plan Amendments Act of 1986 enabled easy terminations. "Between 1980 and 1989, firms terminated more than 2,000 pension plans and used \$20 billion in 'excess' funds for their own purposes, leaving 1.6 million individuals . . . 50 percent of what they would have received had their plans remained intact."²⁸² Those who did not lose their pensions got risky 401(k) plans. In 1979, 401(k) assets were 2% of U.S. household assets,

277. ANDREW TOBIAS, *INVISIBLE BANKERS: EVERYTHING THE INSURANCE INDUSTRY NEVER WANTED YOU TO KNOW* 35–36 (1982) ("Seven showed up at the election to vote in person.").

278. Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 849 (2009).

279. Internal Revenue Code § 1.401(b) permits "the employer to recover at the termination of the trust . . . any balance which is due to erroneous actuarial computations during the life of the trust." Rev. Rul. 83-52, 1983-1 C.B. 87.

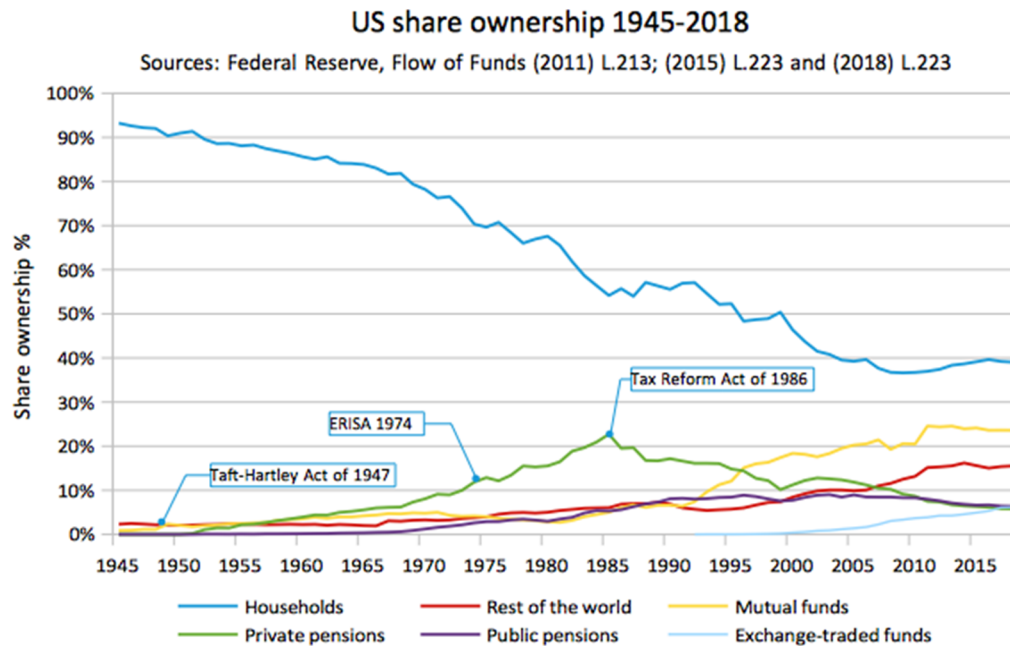
280. TERESA GHILARDUCCI, *LABOR'S CAPITAL: THE ECONOMICS AND POLITICS OF PRIVATE PENSIONS* 90–91 (1992).

281. *Mutual Funds, Brokers Taking A Bigger Slice of the IRA Pie*, AM. BANKER, Mar. 10, 1986.

282. GHILARDUCCI, *supra* note 280, at 97.

3% in 1987, but rose to 21% by 2009.²⁸³ Share ownership was transformed.²⁸⁴

Figure 5



The turning point was 1985: private pensions (in green) went into decline, to be replaced in part by mutual fund firms (in yellow) selling individual 401(k)s. The largest termination in 1986 was made by Exxon: it took advantage of a tax-credit that was about to expire, seizing \$1.6 billion of its workers' pension money without paying corporate tax.²⁸⁵ The major asset management firms, especially Vanguard, State Street, and the new BlackRock, were on track to monopolize the priorities of corporate governance, and all with "other people's money."

283. INVESTMENT COMPANY INSTITUTE, *INVESTMENT COMPANY FACTBOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY* (50th ed. 2010).

284. The sources for the charts are BD. OF GOVERNORS OF FED. RESERVE SYS., *FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 2005–2010*, at 85 tbl.L.223 (2011), and the updates in (2015) and (2018). *Id.* at 23 tbl.F.118, and 25 tbl.F.121 explain the concepts used at 85 tbl.L.213. The "private pension" figures included both defined benefit and defined contribution plans when they invested in shares, but only if it was managed independently or through a custodial bank. If money was placed into an open-ended investment company—run by an asset manager—it would show up under the mutual fund figures. The author has calculated percentages of total assets from the raw data and merged the federal, state and local pensions as "public." Various smaller categories are excluded.

285. GHILARDUCCI, *supra* note 280, at 87.

Employers were taking the votes on labor's capital as well. In 1989, a House of Representatives subcommittee on leveraged buyouts heard that trustees of single-employer pension plans were investing in junk bonds and terminating plans prematurely to make takeovers more attractive.²⁸⁶ Company directors used votes on employee pension money to defend against takeovers of friendly colleagues on other boards²⁸⁷ or simply to pursue pro-management policies.²⁸⁸ In 1989, Representative Peter Visclosky proposed a new § 403(a)(2) in ERISA, so that for single-employer plans elected labor representatives and unions would have half the seats on pension boards.²⁸⁹ It was rejected. With similar provisions, the Workplace Democracy Act of 1992, sponsored by Bernie Sanders, was rejected, and so were its reintroductions up to 1999.²⁹⁰ A further bill, sponsored again by Peter Visclosky entitled the Employees' Pension Security Act of 2005, repeated to 2009, met the same fate.²⁹¹

Where labor was represented, pensions were increasingly organized and active.²⁹² In 1993, 45 of 50 state public pension funds had beneficiary representatives, although most were still appointed rather than elected.²⁹³ The reputation of appointed members had been tarnished, as employers used pensions to plug budget deficits by directing them to buy sub-prime government bonds.²⁹⁴ This led to a concerted move to ensure actual elections.²⁹⁵ By 1998, out of 2,670 public retirement systems, there was an

286. *Oversight Hearings on the Role of Pension Funds in Corporate Takeovers Before the Subcomm. on Labor-Mgmt. Relations of the H. Comm. on Educ. & Labor*, 101st Cong. (1989).

287. WILLIAM M. O'BARR & JOHN M. CONLEY, *FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING* 182 (1992).

288. Roe, *supra* note 231, at 91-94.

289. Joint Trusteeship Act of 1989, H.R. 2664, 101st Cong. (1989).

290. Workplace Democracy Act of 1999, H.R. 1277, 106th Cong. (1999); *see also* H.R. 2012, 105th Cong. (1997); H.R. 1355, 104th Cong. (1995); H.R. 5126, 103d Cong. (1994); H.R. 6041, 102d Cong. (1992).

291. Employees' Pension Security Act of 2009, H.R. 4281, 111th Cong. (2009); *see also* H.R. 5754, 110th Cong. (2008); H.R. 4055, 109th Cong. (2005).

292. Marleen O'Connor, *Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Capitalism*, 31 U. RICH. L. REV. 1345 (1997); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998). N.B. The SEC and courts ended social responsibility amendments under Rule 14a-8.

293. CYNTHIA L. MOORE, *PUBLIC PENSION PLANS: THE STATE REGULATORY FRAMEWORK* (2d ed. 1993).

294. *See generally* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993), where the proposed solution was apparently to give employees "more" control by transforming public pensions into defined contribution plans with guaranteed insurance contracts to mimic defined benefit outcomes. It is difficult, however, to detect how this alone would not simply place control in the hands of fund management families.

295. One aspect was the model Uniform Management of Public Employee Retirement Systems Act of 1997 § 17(c)(3) suggesting pension plans disclose how its trustees were selected. *See* Steven L.

average of 36% elected trustees, 15% *ex officio* trustees, and 44% appointed trustees.²⁹⁶ Adverse opinion still lingered, with some arguing that “public pension fund trustees lack significant financial incentives to maximize fund performance.”²⁹⁷ But the better view was that the increasingly “high activism of public pension funds” reflected “the way owners would tend to act. They lack the managerial command structure that private pensions have.”²⁹⁸ With size and motivation, public pensions drove better governance standards.²⁹⁹ This made them political targets. In 2005, Governor Arnold Schwarzenegger attempted to terminate the Californian plans and resurrect them as a form of 401(k) operation, until the plan was defeated by protests.³⁰⁰ He was simply following the successful strategy of individualizing and outsourcing private pensions.

Although public or union pensions could be active, even acting together they would still invariably be a minority among registered stockholders in a company meeting: the others would typically be asset managers and, before 2010, banks acting as brokers. For example, in 2006, pensions campaigned against the reelection of Disney’s Michael Eisner after he approved a \$100 million golden parachute for the ex-CEO Michael Ovitz. The motion to remove Eisner from office was, however, defeated by broker banks, who cast votes for their retail shareholders: votes on other people’s money.³⁰¹ This led to calls for the NYSE to tighten Rule 452, and it made a request to the SEC in 2006.³⁰² The SEC finally condoned the

Willborn, *Public Pensions and the Uniform Management of Public Employee Retirement Systems Act*, 51 RUTGERS L. REV. 141, 145 (1998).

296. David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187, 196 (2005).

297. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 UNIV. PA. L. REV. 1021 (2007). This referred to an old, slightly hostile article by Roberta Romano, *supra* note 293.

298. Roe, *supra* note 231, at 91–92 (“The high activism of public pension plans—pensions run for state employees—contrasts sharply with the relative passivity of private pensions. Public pensions persistently propose charter amendments, prod managers, and establish lobbying groups. Some of their actions may be political posturing, but I believe many are not. They are acting, roughly and imprecisely, the way owners would tend to act. They lack the managerial command structure that private pensions have.”).

299. Cal. Pub. Emps.’ Ret. Sys., *Global Principles of Accountable Corporate Governance* (2010) (requiring, for instance, under B6.1, removal of directors without cause and under A4, one share one vote).

300. Jim Wasserman, *CA: Governor Ousts CalSTRS Appointees Who Oppose His Pension Plan*, FREE REPUBLIC (Feb. 11, 2005), <http://www.freerepublic.com/focus/f-news/1340769/posts> [<https://perma.cc/7LNM-PKCH>].

301. REPORT AND RECOMMENDATIONS OF THE PROXY WORKING GROUP TO THE NEW YORK STOCK EXCHANGE 9 (June 5, 2006), <http://www.shareholdercoalition.com/sites/default/files/NYSE%20Proxy%20Working%20Grp%20Rpt%206-5-2006.pdf> [<https://perma.cc/M6E8-E34C>].

302. The background is summarized briefly by Elisse B. Walter, *Regulating Broker–Dealers and Investment Advisers: Demarcation or Harmonization?*, 35 J. CORP. L. 1 (2009).

change in 2009,³⁰³ prohibiting brokers from voting on any election for directors, whether contested or not, unless they were registered as advisers under the Investment Company Act.³⁰⁴ The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 957 then introduced a new Securities Exchange Act of 1934 § 6(b)(10). This prohibited brokers from using other people's shares to vote on anything that the Commission determined to be "significant" without express instruction from their customers,³⁰⁵ including director elections and executive pay.

Brokers could no longer vote, but asset managers still could, and the concentration of power has been spectacular. Invariably asset managers outsourced the actual casting of votes to proxy advisers,³⁰⁶ but they still controlled voting policy. By 2017, the three largest mutual firms, BlackRock, Vanguard, and State Street, if they combined the shares they held, would constitute the largest shareholder in 438 of the top 500 firms, and the largest in 40% of all companies.³⁰⁷ The largest five shareholders (mostly mutuals) owned an average 20.8% in the top-twenty corporations.³⁰⁸ It has been found that mutual firms have already caused rising consumer prices.³⁰⁹ This has been described as "the major new antitrust challenge of our time."³¹⁰

Even more than damage to competition, it is clear that conflicts of interest—by selling pension products to the firms in which they exercise voting rights—have become systemic. In a dataset from 2003 to 2011, a study found that the "presence of a fund with business ties can destroy up to 41% of the value enhancement" that comes from shareholder proposals.³¹¹ To maintain influence, mutual fund families significantly overweight the stocks of companies where the family provides 401(k)

303. Eliminate Broker Discretionary Voting, Exchange Act Release No. 34-60215, 74 Fed. Reg. 33293, 3329395 (July 1, 2009).

304. Giving Proxies by Member Organization, New York Stock Exch., r. 452.11(19) (2018).

305. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 957, 124 Stat. 1376, 1906-07 (2010) (codified as amended at 15 U.S.C. § 78f(b) (2018)).

306. See generally Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869 (2010); Michael C. Schouten, *Do Institutional Investors Follow Proxy Advice Blindly* (Jan. 4, 2012) (unpublished Ph.D. dissertation, University of Amsterdam).

307. Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 1, 2 (2017).

308. Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 92 tbl.1 (2017).

309. Jose Azar, Martin C. Schmalz & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

310. Posner, Morton & Weyl, *supra* note 306, at 2. The authors' proposal, despite the prescient antitrust analysis, of limiting shareholdings to 1% would be highly damaging and disproportionate to the problem. This essentially mirrors the General Motors "Treaty of Detroit" plan, *supra* at Part I.C.

311. Dragana Cvijanovic, Amil Dasgupta & Konstantinos Zachariadis, *Ties that Bind: How Business Connections Affect Mutual Fund Activism*, 76 J. FIN. 2933 (2016).

plans.³¹² For over four decades,³¹³ mutual funds have been empowered to engage in mass self-dealing, using shareholder votes to close collective DB schemes, open 401(k) plans, and so inflate the fees they earn by giving everyone an individual account: “smashing and scattering” pensions wherever they go.³¹⁴

Mutual firms do not only use their votes for mass self-dealing: they crush proposals that do not match the political preferences of fund managers. In 2009, Jennifer Taub found that “the greater the dependency of the Adviser upon the [defined contribution] channel for asset management business, the less likely the fund family will be to support shareholder-sponsored governance resolutions.”³¹⁵ Indeed, Vanguard, BlackRock, and State Street have almost identical voting guidelines.³¹⁶ Through sheer inertia they routinely opposed all attempts to restrain spiraling executive pay, advance employment rights, control corporate political donations, or stop climate damage.³¹⁷ Mutual funds support management 90% of the time, and spend almost nothing to do it: Vanguard employed just fifteen people for engagement and voting in 13,000 companies, BlackRock twenty people for 14,000 companies, and State Street under ten people for 9,000 companies.³¹⁸ Less than fifty people dominate and abuse the U.S. economy, all unelected.

II. THE MYTH OF SHAREHOLDER LEGITIMACY

The concentration of power in the modern economy has followed no coherent historical or economic logic. Instead of arising through fair competition, voting was shaped by legal suppression of labor’s voice, compounded upon capital’s unequal bargaining power. Though the history is clear, are there political justifications for asset managers monopolizing the votes in the economy today?

312. Lauren Cohen & Breno Schmidt, *Attracting Flows by Attracting Big Clients: Conflicts of Interest and Mutual Fund Portfolio Choice* (Harvard Bus. School, Working Paper No. 08-054, 2007).

313. Recall RIFKIN & BARBER, *supra* note 190, at 116 on Firestone and Chase, *supra* at Part I.C.

314. David Webber, *The Real Reason the Investor Class Hates Pensions*, N.Y. TIMES (Mar. 5, 2018), <https://www.nytimes.com/2018/03/05/opinion/investor-class-pensions.html> (full story told in WEBBER, *supra* note 17, chs. 1, 7, 8).

315. Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders’ Rights*, 34 J. CORP. L. 843, 847 (2009).

316. Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 101, 124 (2018).

317. Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 224–27 (2018) (showing tables of resolutions and the voting record of support on political spending disclosure and carbon emission disclosure).

318. Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016), <https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101>.

Like Louis Kelso's view that holding shares is the passport to corporate citizenship,³¹⁹ conventional wisdom in corporate governance, at least in the United States,³²⁰ is dominated by an idea of legitimacy for "shareholder primacy" because it is said shareholders bear the greatest risks in bankruptcy. In 1979, Jensen and Meckling argued that because a shareholder is (supposedly) "the residual claimant on the firm's cash flows"—or the party to be paid last upon a corporation's bankruptcy—the shareholder is the best monitor of the corporation. The "monitoring of management will be far less efficiently performed" by workers because they, said Jensen and Meckling, are not the "residual claimant."³²¹ In 1983, Easterbrook and Fischel argued that shareholders monopolize votes because "[v]oting flows with the residual interest in the firm" and, if laws do anything else, "there will be a needless agency cost of management."³²² In 1984, Oliver Williamson suggested that shareholders make the only "asset-specific" investments in corporations that cannot be protected without monopolizing votes for the board of directors. While workers' interests could apparently be protected through job security, the "capital is always at hazard."³²³

These theories have become major canons of corporate governance for at least three decades, but rest on a premise that is evidently wrong: shareholders usually bear no risk and make no firm-specific investments. Asset managers control shareholder voting rights with other people's money.³²⁴ This is why theories of shareholder primacy were rejected by Berle and Means, and from the New Deal to the 1970s.³²⁵ Sometimes, a

319. KELSO & ADLER, *supra* note 14, at 167.

320. Cf. Simon Deakin, *The Corporation as Commons: Rethinking Property Rights, Governance and Sustainability in the Business Enterprise*, 37 QUEEN'S L.J. 339 (2012); Thomas Raiser, *The Theory of Enterprise Law in the Federal Republic of Germany*, 36 AM. J. COMP. L. 111 (1988). But also in the United States, see Lynn A. Stout, *The Corporation as Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form*, 38 SEATTLE U. L. REV. 685 (2015), which holds up Oxford University—whose governance is dominated by its employees—as a central example for good long-term governance.

321. Jensen & Meckling, *supra* note 244, at 485–86.

322. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. ECON. 395, 409 (1983). The authors also suggest that this is the reason that a one-share, one-vote norm prevails. Basic historical understanding shows such a norm does not prevail in absence of regulation. See EWAN MCGAUGHEY, PARTICIPATION IN CORPORATE GOVERNANCE ch. 5 (2014).

323. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 29 (1985); Oliver E. Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984).

324. Cf. JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY ch. 15, § 1 (1848), (making the point that capital bears risk, but believed, at Book IV, ch. 7, § 4, "the relation of masters and work-people will be gradually superseded by partnership, in one of two forms: in some cases, association of the labourers with the capitalist; in others, and perhaps finally in all, association of labourers among themselves").

325. E.g., BERLE & MEANS, *supra* note 4, at 353–56 (arguing that corporations must serve, not a self-enriching group of directors or shareholders, but "the paramount interests of the community").

claim is added that multiple interest groups on boards will quarrel with one another, leading to inefficient management.³²⁶ Shareholders, it is said, should monopolize governance because they have a homogenous interest in maximizing profits, while workers (ostensibly) have more heterogeneous views.³²⁷ Even if interest-heterogeneity could be measured,³²⁸ or the claim that multiple interest groups lead to inefficiency were backed by empirical evidence,³²⁹ asset manager interests are diametrically opposed to those of the true investors. With ownership separated from control,³³⁰ asset managers profit from their office, charging fees in markets they vote to rig, not from doing good work.³³¹ Even if one accepts the evidence-free theory that asset managers do bear risk, or share interests with other shareholders, most people know the risk of losing a job is more serious than the risk of losing money on one insolvent company in a diversified share portfolio.³³² Job-risk weighs more in people's lives than capital-risk. The monopolization of shareholder votes by asset managers is not a system that emerged in a competitive environment,³³³ but one backed by the coercive power of federal law and the unequal bargaining power of captured capital.

But would shareholder monopolization be more legitimate if the true investors of capital, not asset managers, alone held all voting rights? This

326. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 111–12 (1996) (“[T]he board is not used for making the particular types of decisions where workers and shareholders have the most strongly conflicting interests, and where the workers have the most strongly conflicting interests among themselves.”); accord JOHANNES C. D. ZAHN, *WIRTSCHAFTSFÜHRERTUM UND VERTRAGSETHIK IM NEUEN AKTIENRECHT* 15 (1934) (“Sie haben dabei richtig erkannt, daß es im gewerblichen Leben entscheidend auf die führende Einzelpersonlichkeit ankommt und daß man mit der Zersplitterung der Leitung den Keim der Schwäche in ein Unternehmen hineinlegt.” Referring to American business, “They have rightly recognised that in business life, that the personality of the leader is decisive and that any division of the leadership carries the seed of corporate weakness.”); Vagts, *supra* note 126, at 52–53.

327. HANSMANN, *supra* note 325, at 62–63, 97.

328. *Id.* at 97 says it is a social construct.

329. Cf. Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 J. FIN. ECON. 673, 678–81 (2006); Tom Schuller & Jeff Hyman, *Trust Law and Trustees: Employee Representation in Pension Schemes*, 12 INDUS. L.J. 84, 91–93 (1983) (on codetermined pension boards); 403 Parl Deb HL (6th ser.) (1979) cols. 1158–66 (U.K.) (the U.K. Post Office).

330. Cf. Ronald J. Gilson & Jeffrey N. Gordon, *The agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Leo Strine, *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 6 (2007).

331. BERLE & MEANS, *supra* note 4, at 122.

332. This situation obviously changes in a company like Enron.

333. HANSMANN, *supra* note 325, at 111, like Jensen & Meckling, *supra* note 244, also claims that “codetermination has been imposed upon German firms by force of law; no similar system seems to have been adopted by any significant number of firms either inside or outside of Germany in the absence of compulsion.” This is mistaken because German codetermination came from collective agreements, which were later codified in law. See McGaughey, *supra* note 16.

is doubtful, precisely because the true investors of capital are usually workers saving for retirement, and people want voice at work as well as in their savings. In 2018, in a survey of 3,330 likely voters, 53% supported having the right to vote for representatives on the boards of large companies, while just 22% were opposed, and 25% did not know.³³⁴ In addition, survey data in 1995 suggested thirty to 40 million American workers wanted union representation, and 80 million wanted independent collective voice in their workplace.³³⁵ The trend, despite the declining density of membership, has been towards more support for unions.³³⁶ In 2017, a survey of 3,915 people found 48% of interviewees would join a union if they could.³³⁷ This strongly suggests that the extreme position of shareholders monopolizing the votes in corporate governance, let alone asset managers, is deeply illegitimate in the United States today.

III. RECREATING THE LABORATORIES OF ENTERPRISE

Articulated support for labor's voice in corporate governance has grown so much³³⁸ that it is necessary to ask, are there any barriers to law reform? At first glance the barriers may seem tremendous, because it is commonplace that labor law has "ossified" at a federal level,³³⁹ for at least four reasons. First, money buys almost all sides of the political spectrum,³⁴⁰ and the rich and corporate boards oppose labor rights. Second, federal legislation must pass the House, Senate, and President that, due to different election times, are often politically divided. Third, the Senate filibuster and cloture rules mean sixty of one hundred votes are needed to make law. Since 1980, Democrats had a legislative majority in just four years. Fourth, even if a law passes, the Supreme Court has

334. Dylan Matthews, *Workers Don't Have Much Say in Corporations. Why Not Give Them Seats on the Board?*, VOX (Apr. 6, 2018), <https://www.vox.com/2018/4/6/17086720/poll-corporate-board-democracy-worker-council-codetermination-union-labor> [perma.cc/WFC5-KE7L].

335. Joel Rogers & Wolfgang Streeck, *Workplace Representation Overseas: The Works Councils Story*, in WORKING UNDER DIFFERENT RULES 97, 97–98 (Richard B. Freeman ed., 1995).

336. Alex Bryson & Richard B. Freeman, *Workers Needs and Voice in the US and UK* (Nat'l Bureau Econ. Research, Working Paper No. 12310, 2006) (citing a 2005 Zogby poll that reported 35% would vote for union, while a 2004 Zogby poll found 45% would support a union).

337. Thomas A. Kochan et al., *Voice Gaps at Work, Options for Closing Them, and Challenges for Future Actions and Research* (Int'l Labour Review, Working Paper, 2018).

338. E.g., ELIZABETH ANDERSON, LIBERTY, EQUALITY, AND PRIVATE GOVERNMENT (2015) (referring to codetermination as "highly successful"); Stephen F. Befort, *A New Voice for the Workplace: A Proposal for an American Works Councils Act*, 69 MO. L. REV. 607 (2004); Charles B. Craver, *Mandatory Worker Participation is Required in a Declining Union Environment to Provide Employees with Meaningful Industrial Democracy*, 66 GEO. WASH. L. REV. 135 (1997); Kenneth G. Dau-Schmidt, *Promoting Employee Voice in the American Economy: A Call for Comprehensive Reform*, 94 MARQ. L. REV. 765 (2011).

339. Cynthia L. Estlund, *The Ossification of American Labor Law*, 102 COLUM. L. REV. 1527 (2002).

340. See *Buckley v. Valeo*, 424 U.S. 1 (1976); McGaughey, *supra* note 21.

assumed an ostensible right (based on theories of “unconstitutionality” that its members invent)³⁴¹ to strike down legislation. Judges tend not to be from working-class backgrounds and have used their self-endowed power to suppress labor voice.

All this said, the same conditions do not prevail among the states, where the political balance is very different than in Washington D.C. Before the federal government recovers its capacity to act, could the states recreate themselves as laboratories of enterprise? In 1982, Clyde Summers argued that the federal government would have to legislate for codetermination because, otherwise, corporations would move to avoid state law, and any such laws could conflict with federal labor and antitrust law.³⁴² Of course, states could be interested not only (1) in workers on boards, but also (2) in advancing labor’s voice in capital, and (3) in work councils. So, do legal barriers exist for democracy in America at work?

First, states can in fact enact codetermination laws without any real barrier. There is no reason in constitutional or federal law to prevent it, and this is especially true since Massachusetts has had a codetermination law, however voluntary, since 1919. The dominant view is that the National Labor Relations Act of 1935 § 8(a)(2) also presents no barrier to corporate board participation.³⁴³ Worker representation on corporate boards is one of the most important achievements of collective bargaining, which the NLRA promotes. But would corporations move to other states to avoid a codetermination law? The empirical evidence from the European Union, which has similar incorporation freedom, suggests such predictions are exaggerated,³⁴⁴ and codetermination has steadily spread. Firms have very good reasons to maintain the trust, confidence and participation of their workforces because it is clear that worker participation raises productivity, and therefore the potential for profit for

341. Recent examples include *District of Columbia v. Heller*, 554 U.S. 570 (2008), striking down a 30-year ban on handguns in Washington D.C., and *Citizens United v. Federal Election Committee*, 558 U.S. 310 (2010), striking down limits on corporations spending money to influence elections. The source of the U.S. Supreme Court’s authority to strike down legislation is the U.S. Supreme Court case *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803), implying the Court’s power into Article 3, Section 2 of the U.S. Constitution, to strike down laws by adopting, in substance, the reasoning of *Dr. Bonham’s Case*, (1610) 77 Eng. Rep. 646; 8 Co. Rep. 113b.

342. Clyde Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. SEC. REG. 155, 157 (1982).

343. E.g., J. Bautz Bonanno, *Employee Codetermination: Origins in Germany, Present Practice in Europe and Applicability to the United States*, 14 HARV. J. LEGIS. 947 (1976); Brian Hamer, *Serving Two Masters: Union Representation on Corporate Boards of Directors*, 81 COLUM. L. REV. 639 (1981); Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 UNIV. CHI. L. REV. 73, 126–38 (1988); Erik B. Wulff, *The West German Model of Codetermination Under Section 8(a)(2) of the NLRA*, 51 IND. L.J. 795 (1976).

344. Simon Deakin, *Legal Diversity and Regulatory Competition: Which Model for Europe?*, 12 EUROPEAN L.J. 440 (2006).

everyone. Capital moves faster than labor, but ideas move faster still. Ideas also stick. The states that make up nearly two-thirds of all incorporations are Delaware, California, and New York.³⁴⁵ These states lean towards Democratic majorities. If they or others chose, they could require that a percentage of board seats are reserved for employees, adapting the models in the Reward Work Act or the Accountable Capitalism Act. Alternatively, state laws could require that employees as well as shareholders have a percentage of votes at each annual general meeting, or they could do both.³⁴⁶

Second, could states ensure that the votes bought by labor's capital are cast only in accordance with the preferences of elected representatives of workers and beneficiaries? While the Employee Retirement Income Security Act of 1974 has broad preemption provisions,³⁴⁷ its absence of governance rules means it cannot preempt state law that requires governance rights for labor: this logically remains the domain of state trust or corporate law. Many trusts and mutual fund corporations are established in Massachusetts and Delaware.³⁴⁸ If states chose, first, they could follow the model of the Workplace Democracy Acts or the Employees' Pension Security Acts to require one-half representation of beneficiaries in any single-employer or other form of pension plan. A federal model to do so is readily available in the Taft-Hartley Act of 1947 § 302(c)(5)(B).³⁴⁹ In addition, states could require that corporate governance departments of

345. Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1809–10 (2002) (Showing Delaware 57.75%, California 4.33%, New York 3.46%, Nevada 3.32%, Minnesota 2.73%, Florida 2.53%, Texas 2.25%, Colorado 2.02%, Pennsylvania 1.9%, Maryland 1.81%, and Ohio 1.72%. By contrast, the real seats of corporations are California 19.2%, Texas 8.97%, New York 8.82%, Maryland 5.51%, Florida 5.02%, New Jersey 4.76%, Pennsylvania 3.8%, Illinois 3.69%, Minnesota 3.25%, and Colorado 3.08%).

346. State corporation law typically suggests that shareholders exercise appointment or removal rights over the board. *See, e.g.*, DEL. CODE. tit. 8, § 141(k) (2016) (removal “by the holders of a majority of the shares”); CAL. CORP. CODE § 301 (2016) (directors elected “at each annual meeting of shareholders.”); CAL. CORP. CODE § 303 (directors may be removed “if the removal is approved by the outstanding shares” subject to various rules); CAL. CORP. CODE § 304 (10% of shareholders can apply for removal by court for fraud or gross abuse); N.Y. BUS. CORP. LAW § 703 (2016) (“At each annual meeting of shareholders, directors shall be elected.”); N.Y. BUS. CORP. LAW § 706 (removal “for cause by a vote of shareholders”); *see also* MODEL BUS. CORP. ACT (AM. BAR ASS'N 2016) (The Model Act is mirrored in many states. It suggests in § 8.03(c), “Directors are elected at the first annual shareholders’ meeting,” in § 8.08(a), “[S]hareholders may remove one or more directors with or without cause,” and in § 8.08 (b), “If a director is elected by a voting group of shareholders, only the shareholders of that voting group may participate in the vote to remove that director.”). These Acts can be amended to say “shareholders or employees” have these powers, with the percentage of votes in annual meetings, or board seats, to be allocated to employees by a company’s bylaws.

347. 29 U.S.C. § 1144(a) (1974) (noting that ERISA “supersede[s] any and all State laws insofar as they may now or hereafter relate to any employee benefit plan”).

348. Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 222 (2018).

349. *Cf. Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85 (1983) (holding that a New York law was preempted only insofar as it prohibited practices that were lawful under federal law).

mutual funds are wholly elected by the holders of 401(k) accounts. Most importantly, states have the right to enforce fiduciary laws to stop any possibility of a conflict of interest between a mutual firm's voting and its sale of pension products to companies.³⁵⁰ States could require that no asset manager casts votes on other people's money without express instructions or without following the wishes of elected representatives of beneficiaries. A model that can be adapted is the Dodd-Frank Act § 957, which restricts brokers voting without instructions.

Third, could states require that employees within their territory have a right to elect work councils with binding rights, for instance, in working time, social funds, or dismissals?³⁵¹ Fundamentally, there appears to be no reason why a truly independent work council, which is not dominated or funded by the employer, cannot be established by collective agreement or law.³⁵² The NLRA of 1935 § 8(a)(2) prohibits a body where there is "actual domination" by an employer, so bona fide cooperative efforts are not hindered,³⁵³ nor are genuine initiatives for "a meaningful avenue for the expression of employee wishes."³⁵⁴ If there is not merely an expression of wishes, but binding rights resulting from elected work council decisions, it is inconceivable that this touches the mischief that Senator Wagner and Congress intended to resolve. The episode at the Volkswagen plant in Chattanooga, Tennessee from 2014 to 2016 underlines the point. The only credible argument that a work council would be preempted was if the policy ensured that management could veto whatever the "work council" decided.³⁵⁵ Management vetoes would make the work council a sham under a genuine work council law. If states simply adopted the model that the U.S. government helped write for Germany in 1946,³⁵⁶ they would meaningfully advance voice at work.

350. See *Halebian v. Berv*, 931 N.E.2d 986 (Mass. 2010); *Saminsky v. Abbott*, 185 A.2d 766 (Del. Ch. 1961).

351. For an indicative list, see the *Betriebsverfassungsgesetz (BetrVG)* [German Works Constitution Act], Jan. 15, 1972, BGBl. I at 2518, §§ 87, 111 (Ger.) (as amended) (listing thirteen issues plus arrangements for dismissal decisions to go to arbitration or a court if the employee-elected work council objects).

352. The funding of work councils appears to be the only difference between the system that emerged in Germany following Control Council Law No. 22, as the employer must provide financing for work council activities: this is not viewed as compromising the work council's independence.

353. *Modern Plastics Corp. v. NLRB*, 379 F.2d 201 (6th Cir. 1967).

354. *Hertzka and Knowles v. NLRB*, 503 F.2d 625, 631 (9th Cir. 1974).

355. Cf. Benjamin Sachs, *A New Way Forward for VW-Tennessee*, ONLABOR, May 20, 2014, <https://onlabor.org/a-new-way-forward-for-vw-tennessee/> [perma.cc/3QWH-LEHD].

356. Control Council Law No. 22 Works Councils, Apr. 10, 1946, OFFICIAL GAZETTE OF THE CONTROL COUNCIL FOR GERMANY 1945–1946, at 133–36 (1946), LSE Archives 43 (R498).

CONCLUSION

Can there be democracy in America at work? The answer must be yes. The United States has the world's oldest codetermination law continually in force. Workers have been on the boards of manufacturing, retail, automobile, aeroplane, steel, and food companies. Had labor not been continually suppressed by hostile courts and governments, unions would have pressed for workers on boards in telecommunications, supermarkets, beverage production and more. The use of labor's capital by union and public pension funds for positive social policies counts among the most sophisticated and organized in the world.³⁵⁷ In the broad sweep of history, over half of the Amendments to the Constitution, nine out of seventeen since the Declaration of Independence, have directly concerned the right to vote.³⁵⁸ The right to vote, not just in politics but also at work, in retirement, and in the economy holds no less constitutional significance. In this like so much else, America is still a land of opportunity.

As the empirical case grows, and as labor law becomes central to twenty-first century corporate governance,³⁵⁹ it is likely that the opposition to labor's voice in the economy will become increasingly based on emotional appeal. This Article has made the case that the claims of labor voice being foreign, inefficient, unpopular, or unlawful are evidence-free. But if history or reality will not comply, an opponent's best alternative is to build contempt for reason.³⁶⁰ This is the tragic state of political debate today. At its core, a more democratic economy is essential to preserve democracy in politics. Escalating economic inequality means a house more divided, and the laws which underpin corporate governance are probably the most important pre-tax causes of escalating inequality today.³⁶¹ Democracy ensures that governance is in the hands of the many, not the few, and that informed, democratic deliberation, with reasoned

357. See generally WEBBER, *supra* note 17.

358. Those Amendments include the Twelfth (presidential election procedure), Thirteenth (abolishing slavery), Fourteenth (defining citizenship), Fifteenth (vote regardless of race), Seventeenth (direct Senator elections), Nineteenth (vote regardless of gender), Twenty-Third (enfranchising D.C. voters), Twenty-Fourth (prohibiting poll taxes), and Twenty-Sixth (enfranchising people over eighteen years old).

359. Cf. ROBERT CHARLES CLARK, *CORPORATE LAW* 32 (1986) ("[E]ven if your aim is not to understand all of law's effects on corporate activities but only to grasp the basic legal 'constitution' or make-up of the modern corporation, you must, at the very least, also gain a working knowledge of labor law.").

360. See TIMOTHY SNYDER, *THE ROAD TO UNFREEDOM: RUSSIA, EUROPE, AMERICA* 244–49 (2018) (on web: "robots who told [American voters] what they wanted to hear").

361. Cf. Elizabeth Warren, *Companies Shouldn't Be Accountable Only to Shareholders*, WALL ST. J. (Aug. 14, 2018), <https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687> (noting "the wealthiest 10% of U.S. households own 84% of American-held shares").

social debate, provides the basis for freedom, personal autonomy, and liberty because this is what the overwhelming majority of people want for themselves. “We may have democracy,” Louis Brandeis once said, “or we may have wealth concentrated in the hands of a few, but we can’t have both.”³⁶² The truth is, the corporation has already socialized property,³⁶³ ensuring that individuals can freely invest their savings, and invest their labor, as one. Through the strength of their common endeavor, people can achieve social and economic progress, and better together than they would alone. But if property is social, it is sorely unequal because it is not yet democratic. The problem is no longer merely the socialization of ownership, but the democratization of power. Democracy in America needs to work.

362. RAYMOND LONERGAN, MR. JUSTICE BRANDEIS, GREAT AMERICAN 42 (1941).

363. ADOLF A. BERLE, ECONOMIC POWER IN A FREE SOCIETY (1957).

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REFORMING CORPORATE GOVERNANCE VIA LEGISLATION IN THE UNITED STATES – THE CASE OF THE SARBANES-OXLEY ACT**

Summary: *The scope of this paper is to evaluate the Sarbanes-Oxley Act from a legislative theoretical point of view with the aid of showing some theories on legislation, a field which came to the forefront of jurisprudence in relatively recent times in Anglo-American jurisprudence. The intention is to show that Sarbanes-Oxley Act was a piece of suboptimal legislation, by comparing and contrasting it to some normative theories.*

Keywords: *Sarbanes-Oxley Act, optimal-legislation, law-making, efficiency of law, efficacy of law*

INTRODUCTION

The aim of the paper is to analyse legislation as an instrument for reforming corporate governance. Owing to its importance, the Sarbanes-Oxley Act was chosen as the subject for the analysis. Despite its bi-partisan support in the Congress, the opinions on the Act have never been unanimous, for different reasons. The Republicans claim the Act was highly restrictive towards smaller businesses, punishing them unfairly for the transgressions of the major corporations involved in the large-scale scandals of 2002. Meanwhile, the Democrats criticised the Act for being too lenient, as it did not contain too many novelties. This division can also be observed in the evaluation of the Act by the academia.

To find out the justification of the differing opinions, it is important to give a legislative-minded analysis of the Act. Therefore, the paper firstly wishes to briefly introduce the historical background. For that, it is important to recall some of the major events of the era. Secondly, the legislative process itself is reviewed. It is important to overview what happened in both houses of the Congress, as it gives us the relevant understanding of the political climate. The third part of the paper wishes to analyse the Act and its genesis with the help of some theories

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LITIGATION DISCOVERY AND CORPORATE GOVERNANCE: THE MISSING STORY ABOUT THE “GENIUS OF AMERICAN CORPORATE LAW”

Érica Gorga*

Michael Halberstam**

ABSTRACT

Strikingly absent from the entire corporate governance and corporate litigation debate is a unique feature of American civil procedure that deserves special attention: the modern civil discovery regime. This Article attempts to fill this gap. We argue that modern discovery—first established by the Federal Rules of Civil Procedure in 1938—has had a profound impact on the evolution of shareholder litigation, corporate governance, and the culture of corporate disclosure in the United States.

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This Article shows that (1) litigation discovery, and its threat, have driven and structured the process of corporate shareholder litigation; (2) the information generated by discovery has stimulated the development of case law defining shareholder rights and managerial duties; (3) the episodic legal demands for detailed corporate internal information (and the threat of discovery) have induced incremental improvements in corporate governance practices, including more exacting decision procedures, internal monitoring, recordkeeping, and disclosure; (4) highly developed, continuously evolving discovery practices have established templates for independent corporate internal investigations by boards and regulators; and (5) discovery has given regulators steady insight into changing corporate internal practices and patterns of wrongdoing to which regulators have responded with broad legal and regulatory changes. This Article concludes that litigation discovery serves, inter alia, as a form of ex post disclosure, which complements and enforces ex ante disclosure under the federal securities laws.

These observations have important normative implications for legal transplants and the enforcement debate. Among other things, this Article cautions against legal transplants of U.S.-style securities disclosure, aggregate litigation mechanisms, and other enforcement mechanisms without considering appropriate tools for investigating corporate internal wrongdoing ex post, and points to problems in the empirical literature on U.S. shareholder litigation outcomes. It also questions current proposed reforms to the federal discovery rules.

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“As stated by the Supreme Court in Hickman v. Taylor, ‘Mutual knowledge of all the relevant facts gathered by both parties is essential to proper litigation.’ Such, however, is not the basis of procedural policy in any other country in the world.”

—Geoffrey C. Hazard, Jr.¹

INTRODUCTION

Professor Romano’s seminal work, *The Genius of American Corporate Law*, inspired an international debate on corporate governance and influenced the research agendas of law, economics, and finance scholars for over two decades. Romano’s book offered an explanation for the curious American exceptionalism in financial markets development based on the counterintuitive theory that the competition among states for incorporations generated a “race to the top” in state legal regimes governing corporate internal affairs.² She famously argued that the creation of a market for legal rules allowed firms to select corporation codes with better corporate governance devices to mitigate agency costs.³ The genius of American corporate law, according to Professor Romano, relied on the consequences of federalism for the evolution of American corporate and securities laws while much less successful institutional frameworks were implemented in other countries.⁴

Ever since Romano first articulated her theory of the genius of American corporate law, researchers have attempted to analyze, identify, and compare across national legal regimes and economies precisely what legal variables have been responsible for resolving (or failing to resolve, as it were) the agency-cost problems between shareholders and managers inherent in the structure of large public firms. This comparative enterprise has been highly consequential in that the legal variables so identified have, in turn, been deemed “preconditions” to the highly developed capital markets in the United

¹ Geoffrey C. Hazard, Jr., *From Whom No Secrets Are Hid*, 76 TEX. L. REV. 1665, 1665 (1998) (footnotes omitted) (quoting *Hickman v. Taylor*, 329 U.S. 495, 507 (1947)).

² ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 14–15, 118 (1993). The dominant view was, and in many areas of law still is, that regulatory competition among jurisdictions creates a “race to the bottom” in regulatory standards. The “race to the bottom” thesis in corporate law was advanced by Adolph A. Berle, Jr. and Gardiner C. Means in *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932), and was adopted by Justice Louis Brandeis in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 557–60 (1933) (Brandeis, J., dissenting).

³ ROMANO, *supra* note 2, at 1–2.

⁴ *Id.*

States that other nations across Europe, Asia, and Latin America ought to emulate.⁵

By now the corporate governance debate has, with mixed success, explained national differences as depending variously on corporate ownership structures,⁶ minority shareholder protections,⁷ stock exchange rules,⁸ mandatory disclosure regimes, and liability standards,⁹ as well as much broader explanations, including differences in social and cultural norms,¹⁰ political histories,¹¹ historic legal origins of national legal systems,¹² and, more recently, varying levels of “intensity” in the enforcement of corporate and securities laws.¹³

⁵ See CURTIS J. MILHAUPT & KATHARINA PISTOR, *LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD* 17–20 (2008); Bernard Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 J. CORP. L. 537, 539–40 (2001) (noting Asian recognition of the contribution of corporate law to economic prosperity); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1234 (2002) (arguing that “the core beliefs and practices that have underpinned the academic analysis of corporate law and governance . . . amount to an interlocking set of institutions that constitute ‘shareholder capitalism,’ American-style that [U.S. academics] have been aggressively promoting throughout the world”).

⁶ See Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 471–73, 511 (1999).

⁷ See Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 4 (2000) (“[T]he protection of shareholders and creditors by the legal system is central to understanding the patterns of corporate finance in different countries.”).

⁸ See John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 8–9, 76 (2001).

⁹ See Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 2, 27–28 (2006).

¹⁰ See John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2151–52, 2171–75 (2001); Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law?*, 69 U. CHI. L. REV. 1251, 1262–64 (2002).

¹¹ See MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT* 1–5, 49–51, 201–04 (2003); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 542–43 (2000).

¹² See Edward L. Glaeser & Andrei Shleifer, *Legal Origins*, 117 Q.J. ECON. 1193, 1194 (2002); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1116 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1131–33, 1149 (1997). *Contra* Holger Spamann, *The “Antidirector Rights Index” Revisited*, 23 REV. FIN. STUD. 467, 467–68, 477 (2010); Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.’s ‘Antidirector Rights Index’ Under Consistent Coding* 69–71 (European Corporate Governance Inst., Law Working Paper No. 67, 2006), available at <http://ssrn.com/abstract=894301>.

¹³ See, e.g., John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 232–33 (2007); Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207, 208–10, 230–33 (2009); La Porta et al., *supra* note 9, at 2–3; see also John Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687, 688–90 (2009); Mathias M. Siems, *Private Enforcement of Directors’ Duties: Derivative Actions as a Global Phenomenon*, in *COLLECTIVE ACTIONS:*

The enforcement literature has studied differences in levels of public and private enforcement.¹⁴ It has also revisited various aspects of derivative and class action litigation from a more comparative perspective with the express intent of paying closer attention to procedure. Professor Bernard Black and coauthors, for example, surveyed procedural rules that affect the adjudication of directorial and managerial liability claims in the United States, Russia, France, Germany, Austria, Korea, and the United Kingdom.¹⁵ But Black and coauthors mostly confine their survey to analyzing who can file a claim, what the available filing mechanisms are, and how attorneys' fees and litigation costs are allocated among the litigants.¹⁶ In a separate study on private enforcement, Professor Coffee argues that U.S. aggregate litigation rules establish a "unique" system of "entrepreneurial litigation."¹⁷ In particular, the "intensity" of such enforcement by "private attorneys general" is generally considered to be a distinctive feature of the U.S. system.¹⁸ But Coffee, like the rest of the literature, confines his analysis to a relatively narrow discussion of class action rules and the incentives created in the class action context by the American rules on fee shifting and contingency fees.¹⁹

Similarly, academic and jurisprudential debates in the corporate law literature about exporting U.S.-style aggregate litigation to European and other countries have concentrated on such rules as shareholder standing requirements, fee shifting, contingency fees, and class action rules. But the

ENHANCING ACCESS TO JUSTICE AND RECONCILING MULTILAYER INTERESTS? 93, 93–96 (Stefan Wrzka et al. eds., 2012).

¹⁴ See Coffee, *supra* note 13, at 266–67 (explaining that "private enforcement" refers to the enforcement of corporate and securities statutes and laws by plaintiffs who are private parties); Jackson & Roe, *supra* note 13, at 237; La Porta et al., *supra* note 9, at 20–21, 27–28. A civil action commenced against an officer of a corporation by the Securities and Exchange Commission is an example of public enforcement. See La Porta et al., *supra* note 9, at 2–3.

¹⁵ Bernard Black et al., *Legal Liability of Directors and Company Officials Part 2: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability (Report to the Russian Securities Agency)*, 2008 COLUM. BUS. L. REV. 1, 2–4; see also Armour et al., *supra* note 13, at 689 (providing a quantitative comparison of private enforcement lawsuit outcomes in the United States and United Kingdom).

¹⁶ See Black et al., *supra* note 15, at 1–13.

¹⁷ John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 291–92 (2010) (internal quotation marks omitted).

¹⁸ *Id.* at 344–45.

¹⁹ See *id.* at 292–93. Professor Merritt Fox attributes the limited development toward class action litigation in Korea, Sweden, France, Spain, Germany, Norway, and the other countries to "some mix of the absence of contingent fees for plaintiffs lawyers, the existence of a 'loser pays' rule concerning the victor's legal fees, an 'opt in' rather than an 'opt out' structure of class action, and the lack of explicit reference to securities fraud as being among the claims that can be brought collectively." Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 251 (2009).

enforcement debate has ignored how private litigants might obtain information about corporate internal wrongdoing in civil law systems in Europe, Asia, or Latin America.²⁰

The extensive (twenty-year) debate about what legal variables are conducive to private and public enforcement, and therefore to corporate governance and capital markets development, has ignored the distinctive features of U.S. fact investigation—even where civil procedure has been a focus.²¹ Strikingly absent from this entire literature is any analysis of a truly exceptional feature of the U.S. legal landscape: The United States is unique in how it structures the process of litigation and, in particular, the process of information and evidence acquisition by parties in private shareholder litigation.²²

There is no equivalent to U.S. discovery in civil law jurisdictions,²³ and common law jurisdictions also differ dramatically from the U.S. model.²⁴ The

²⁰ See, e.g., THE LAW AND ECONOMICS OF CLASS ACTIONS IN EUROPE: LESSONS FROM AMERICA (Jürgen G. Backhaus, Alberto Cassone & Giovanni B. Ramello eds., 2012) (referencing discovery sporadically, but never discussing or comparing civil law judicial fact investigation with party-on-party discovery in the United States nor noting the complete absence of U.S.-style discovery in all other jurisdictions); Coffee, *supra* note 13, at 288 (noting that “the contemporary debate in Europe centers on whether certain elements of the U.S. model—namely, opt-out class actions, contingent fees, and the ‘American rule’ on fee shifting—must be adopted in order to assure access to justice,” and offering “an alternative ‘nonentrepreneurial model’ for aggregate litigation that is consistent with European traditions”).

²¹ See Simeon Djankov et al., *Courts*, 118 Q.J. ECON. 453, 454–55 (2003). *But see* Holger Spamann, *Legal Origin, Civil Procedure, and the Quality of Contract Enforcement*, 166 J. INSTITUTIONAL & THEORETICAL ECON. 149, 149–50, 162 (2010) (examining the claim that civil procedure is less efficient in civil law countries than in common law countries and shedding doubt on the claim). One notable exception is the inclusion of a variable measuring rights of “access to evidence” in the “anti-self-dealing index” by financial economists Simeon Djankov et al. in *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 434 (2008). Their index considers whether plaintiffs can request the court to appoint an inspector to examine a company’s affairs, whether plaintiffs must identify specific documents before receiving any discovery, whether they can question defendants and nonparties in court, and to what extent they can do so without prior court approval. *Id.* at 434, 437. Surprisingly, however, the legal literature has failed to pick up on and analyze these variables.

²² Stephen N. Subrin, *Discovery in Global Perspective: Are We Nuts?* 52 DEPAUL L. REV. 299, 301–03 (2002); see Geoffrey C. Hazard, Jr., *Discovery and the Role of the Judge in Civil Law Jurisdictions*, 73 NOTRE DAME L. REV. 1017, 1017 (1998) [hereinafter Hazard, *Discovery and the Role of the Judge*]; Geoffrey C. Hazard, Jr., *Discovery Vices and Trans-substantive Virtues in the Federal Rules of Civil Procedure*, 137 U. PA. L. REV. 2237, 2237–39 (1989) (discussing the broad access to documents provided by the Federal Rules of Civil Procedure).

²³ See generally, R.R. VERKERK, *FACT-FINDING IN CIVIL LITIGATION: A COMPARATIVE PERSPECTIVE* 142 (2010) (providing an in-depth treatment of the historical evolution of principles and practices of fact investigation in different legal systems); Oscar G. Chase, *American “Exceptionalism” and Comparative Procedure*, 50 AM. J. COMP. L. 277, 292–96 (2002); John H. Langbein, *The German Advantage in Civil Procedure*, 52 U. CHI. L. REV. 823, 824 (1985) (explaining that “by assigning judges rather than lawyers to

lasting influence of such fundamental principles as *nemo tenetur edere contra se*, the *principle of immediacy*, the *principle of party presentation*, and the code provisions governing evidence acquisition and presentation in civil law countries, bar direct party-on-party discovery entirely.²⁵ And the “inquisitorial” design of civil law proceedings centralizes all fact gathering and review in the hands of the judge, who has neither the authority nor the resources to conduct the kind of factual investigation that is standard in U.S. litigation.²⁶

This oversight in the corporate law literature is remarkable in that this literature has paid so much attention to the disclosure regime established by the 1933 Securities Act and the 1934 Securities Exchange Act, even as it has neglected the modern discovery rules that armed litigants with vastly expanded investigatory powers for obtaining information about corporate internal mismanagement, for the same reasons at roughly the same time. The U.S. rules of civil procedure and litigation discovery, in particular, are intricately related (both historically and functionally) to the basic principles that inform the U.S. style of regulation.

investigate the facts, the Germans avoid the most troublesome aspects of [American] practice”); Richard L. Marcus, *Putting American Procedural Exceptionalism into a Globalized Context*, 53 AM. J. COMP. L. 709, 732 (2005) (book review); Subrin, *supra* note 22, at 301–02 (explaining that “two of the biggest differences between civil law countries and the United States with respect to pretrial discovery are the centrality of the judge in civilian civil litigation and the continuity of the proceedings”); Yasukei Taniguchi, *The 1996 Code of Civil Procedure of Japan—A Procedure for the Coming Century?*, 45 AM. J. COMP. L. 767, 772–76 (1997) (describing very limited changes to fact investigation in Japan’s new civil code). See generally OSCAR G. CHASE ET AL., CIVIL LITIGATION IN COMPARATIVE CONTEXT 207–40 (2007) (comparing the discovery mechanisms in England, the United States, Germany, and Japan).

²⁴ See NEIL ANDREWS, ENGLISH CIVIL PROCEDURE: FUNDAMENTALS OF THE NEW CIVIL JUSTICE SYSTEM 595, 613–21 (2003) (discussing limited situations in which judges are likely to grant pre-action disclosure orders); KUO-CHANG HUANG, INTRODUCING DISCOVERY INTO CIVIL LAW 231 (2003) (“Unlike discovery under the FRCP, there is no general scope of discovery uniformly applicable to all discovery devices under the English system.”); *id.* at 235; PAUL MATTHEWS & HODGE M. MALEK, DISCLOSURE 27–29 (4th ed. 2012) (discussing the British system); MICHAEL ZANDER, CASES AND MATERIALS ON THE ENGLISH LEGAL SYSTEM 86–88 (10th ed. 2007). See generally ADRIAN A.S. ZUCKERMAN, CIVIL PROCEDURE (2003) (treating the English system).

²⁵ See HUANG, *supra* note 24, at 21–27; PETER L. MURRAY & ROLF STÜRNER, GERMAN CIVIL JUSTICE 275–78 (2004); VERKERK, *supra* note 23, at 16, 30, 248, 264–65.

²⁶ The term “inquisitorial” is here used as a short-hand for the American reader. Civil law proceduralists do not view their adjudication system as “inquisitorial” but as “adversarial,” and the neutrality of the judge is a fundamental principle of modern civil law. See VERKERK, *supra* note 23, at 280–81. Like translations of legal vocabulary more generally, the word “adversarial” also has different meanings in different legal systems and must be understood in connection with the other principles that inflect it, and in the context of the practices that inform and are informed by the concept. Note that, in civil law systems, appeals court judges make their own evidentiary findings and may seek additional evidence. See, e.g., MURRAY & STÜRNER, *supra* note 25, at 16. But this does not markedly increase judicial resources available for fact-finding, if at all.

Modern discovery rules refashioned civil procedure, creating a long phase of adversarial, direct party-on-party fact investigation that has become the focus of U.S. litigation.²⁷ During litigation discovery, parties waded through millions of documents, take dozens (and, in large cases, even hundreds) of witness depositions, subpoena third parties for information and testimony, hire experts and produce expert reports—and do all of this before trial with almost no involvement by a judge.²⁸

The “discovery revolution” in private litigation was part of a much broader transformation of economic governance during the 1930s.²⁹ This transformation was animated by a “scientific approach” that deployed information-pushing regimes in contexts as diverse as financial markets regulation and private litigation for the purpose of obtaining the data that government officials, markets, and private parties needed to make rational, fact-based decisions.³⁰ Just as securities disclosure by issuers would generate information for markets and regulators, modern litigation discovery would generate information for litigants and courts. In both cases, increased efficiencies were a major goal.

But the corporate-law scholarship has largely failed to recognize litigation discovery as a distinctive factor shaping the evolution of U.S. corporate and securities law, even as scholars in other legal fields have long understood that substantive “developments in areas such as products liability, employment discrimination, and consumer protection have been the result at least partly of broad-ranging discovery provisions.”³¹

²⁷ See FED. R. CIV. P. 26–37 & advisory committee’s notes (describing these developments).

²⁸ See *infra* notes 460–62 and accompanying text, for a discussion of the theory that the federal rules have turned trial judges into “managerial judges.”

²⁹ See, e.g., GOVERNANCE OF THE AMERICAN ECONOMY 3–5 (John L. Campbell, J. Rogers Hollingsworth & Leon N. Lindberg eds., 1991) (explaining how and why transformations in governance occurred in different industries).

³⁰ For a discussion of legal realism’s influence on securities regulation and civil procedure during the New Deal, see *infra* notes 105–19 and accompanying text.

³¹ Jack H. Friedenthal, *A Divided Supreme Court Adopts Discovery Amendments to the Federal Rules of Civil Procedure*, 69 CALIF. L. REV. 806, 818 (1981); see also GEOFFREY C. HAZARD, JR., CONFERENCE ON THE FEDERAL RULES OF CIVIL PROCEDURE: REPORT 3 (1995) (reporting on the proceedings of the Conference on the Federal Rules of Civil Procedure, convened in Dallas, Texas, on March 30–31, 1995); Richard L. Marcus, *Discovery Containment Redux*, 39 B.C. L. REV. 747, 749 (1998) (“[B]road discovery put pressure on the substantive law to expand . . .”).

The discovery revolution has been a *bête noire* for the business community ever since.³² A 2010 white paper on discovery by the American Chamber of Commerce, for example, observed that “discovery has become the focus of litigation, rather than a mere step in the adjudication process . . . [and that] the effort and expense associated with electronic discovery are so excessive that settlement is often the most fiscally prudent course—regardless of the merits of the case.”³³ On this basis, business leaders and especially corporate defendants have, for decades, complained that the costs and burdens of discovery are too high.³⁴

The costs and abuses of discovery were also a key focus of the debates concerning the Private Securities Litigation Reform Act of 1995 (PSLRA).³⁵ Congress enacted the PSLRA in response to industry complaints (especially from Silicon Valley)³⁶ that class actions under the SEC’s Rule 10b-5 antifraud regulation³⁷ led to countless “strike suits” that extracted settlements from defendant corporations regardless of the merits of such claims by threatening them with costly discovery and potentially ruinous damages.³⁸ Discovery was

³² See, e.g., FRANKLIN S. WOOD, CHAMBER OF COMMERCE OF THE STATE OF N.Y., SURVEY AND REPORT REGARDING STOCKHOLDERS’ DERIVATIVE SUITS 61–66 (1944) (discussing the cost and nuisance of discovery).

³³ JOHN H. BEISNER, U.S. CHAMBER INST. FOR LEGAL REFORM, THE CENTRE CANNOT HOLD: THE NEED FOR EFFECTIVE REFORM OF THE U.S. CIVIL DISCOVERY PROCESS 2 (May 2010), available at http://ilr.iwssites.com/uploads/sites/1/ilr_discovery_2010_0.pdf.

³⁴ See, e.g., Paul D. Carrington, *Politics and Civil Procedure Rulemaking: Reflections on Experience*, 60 DUKE L.J. 597, 606–09 (2010) (detailing the efforts of business leaders to effect reform); Danya Shocair Reda, *The Cost-and-Delay Narrative in Civil Justice Reform: Its Fallacies and Functions*, 90 OR. L. REV. 1085, 1123–24 (2012) (“[P]ro-business and insurance organizations helped to underwrite surveys that were then relied upon by . . . the CJRA [Civil Justice Reform Act of 1990] legislation . . . [i]t is no secret that the anti-discovery pressure [in the 1998 proposed discovery rules] has come from defendants, especially defendants in product liability, securities, and antitrust cases.” (quoting Elizabeth G. Thornburg, *Giving the “Haves” a Little More: Considering the 1998 Discovery Proposals*, 52 SMU L. REV. 229, 243 (1999))).

³⁵ Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

³⁶ See, e.g., Timothy K. Roake & Gordon K. Davidson, *The Private Securities Litigation Reform Act of 1995*, CORP. & SEC. L. UPDATE (Fenwick & West LLP, Mountain View, Cal.), Jan. 1996, at 1, available at http://www.fenwick.com/fenwickdocuments/corp_sec_01-00-96.pdf (“Abusive securities litigation has been an unfortunate fact of life in the Silicon Valley for years, and the high tech community lobbied long, hard and well for [this] reform. . . . against ‘strike suits.’”).

³⁷ 17 C.F.R. § 240.10b-5 (2012) (prohibiting “any untrue statement of a material fact . . . in connection with the purchase or sale of any security”).

³⁸ See Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ‘33 and ‘34 Act Claims*, 76 WASH. U. L.Q. 537, 552–53 (1998) (reviewing the arguments behind the reform). In *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000), the Second Circuit stated that “[l]egislators were apparently motivated in large part by a perceived need to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to exact large settlement recoveries,” *id.* at 306. This view was also endorsed by the academic literature. See generally Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV.

exclusively treated as an expense or burden that had to be contained.³⁹ The view prevailed, leading Congress to heighten pleading requirements for securities class actions under 10b-5 and to impose a discovery stay during the pendency of any motions to dismiss.⁴⁰ Both measures made it more difficult for plaintiffs to obtain discovery.⁴¹

Legislators, practitioners, and scholars have for the most part accepted the narrative of disproportionately high discovery costs and focused on diminishing discovery costs.⁴² They have largely neglected careful analysis of discovery's information production and scrutiny mechanism for the governance of corporations and securities markets, which is the topic of this Article. Even if we grant that discovery costs are high, especially in large corporate cases, such costs must be assessed in relative terms, not only with regard to the stakes at issue in a particular lawsuit but with regard to discovery's benefits to the efficiency of the capital markets system. This Article therefore focuses on the aggregate benefits of the discovery cost–benefit equation. It analyzes the positive externalities of discovery.

Along the way, this Article also speaks to important debates in the corporate law literature. For example, the literature has questioned the continued significance of shareholder derivative suits and fiduciary duty

497, 499–500 (1991) (describing how the structural characteristics of securities class actions, rather than substantive merits, determine the amount of settlements).

³⁹ See H.R. REP. NO. 104-369, at 31, 37 (1995) (Conf. Rep.). See generally Craig C. Martin & Matthew H. Metcalf, *The Fiduciary Duties of Institutional Investors in Securities Litigation*, 56 BUS. LAW. 1381, 1382–83 (2001) (outlining the PSLRA's stated purposes and extensive legislative history).

⁴⁰ See Securities Act of 1933, 15 U.S.C. § 77z-1(b)(1) (2012); Securities Exchange Act of 1934, *id.* § 78u-4(b)(3)(A)–(B).

⁴¹ See, e.g., Stephen J. Choi, *Do the Merits Matter Less after the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598, 599 (2007) (“Without the ability to engage in discovery, plaintiffs’ attorneys face a higher cost in determining the presence of specific misleading statements and omissions and the materiality of such misstatements and omissions.”); Sale, *supra* note 38, at 538.

⁴² See, e.g., Jason M. Rosenthal, *Staying Discovery in Federal Securities Lawsuits*, PRAC. LITIGATOR, Nov. 2002, at 7 (admitting the high cost of discovery). See generally John H. Beisner, *Discovering a Better Way: The Need for Effective Civil Litigation Reform*, 60 DUKE L.J. 547, 571–75 (2010) (pointing out flaws in arguments by scholars attempting to refute the assertion that discovery is expensive and prone to abuse); Earl C. Dudley, Jr., *Discovery Abuse Revisited: Some Specific Proposals to Amend the Federal Rules of Civil Procedure*, 26 U.S.F. L. REV. 189, 190 (1992) (arguing that the “managerial approach” to discovery is not cost-effective); Frank H. Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 636 (1989) (noting how the high costs of discovery shape litigants’ decisions). But see Sale, *supra* note 38, at 538, 540 (arguing that the PSLRA reform was “overinclusive” in that meritorious claims would be dismissed and proposing a solution based on judicially managed discovery); Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 713–15 (1996) (discussing potential underdeterrence problems).

litigation in the United States.⁴³ The current view—in spite of some holdouts—is that shareholder derivative suits no longer discipline directors and officers, as evidenced by the fact that such suits almost never impose liability on outside directors,⁴⁴ most cases settle (thus protecting directors at the expense of shareholders),⁴⁵ and the twin hurdles of the demand requirement and the business judgment rule mean that most cases do not even go to discovery in the first place.⁴⁶ This literature has, perhaps understandably, focused primarily on liability and litigation outcomes in its assessment of the usefulness of shareholder litigation. However, in doing so, it never considers to what extent salutary internal investigations are triggered by shareholder complaints of corporate internal wrongdoing, by the threat of litigation discovery, and by defensive discovery—regardless of the litigation outcome. Moreover, it misses the very connection between discovery and corporate internal investigations, which have become critical features of U.S.-style corporate governance.⁴⁷ Such investigations make use of the tools, and track the practices of litigation discovery.⁴⁸

In this Article we show, *inter alia*, that private enforcement in the United States depends on the power that *litigation discovery* affords private attorneys general⁴⁹ to investigate, uncover, and reconstruct the facts and circumstances

⁴³ See generally, ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS 734 (10th ed. 2007) (suggesting that “virtually all derivative litigation filed today is without merit”); Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 388 (2008); Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 135 (2004).

⁴⁴ See Bernard Black, Brian Cheffins & Michael Klausner, *Liability Risk for Outside Directors: A Cross-Border Analysis*, 11 EUR. FIN. MGMT. 153, 155 (2005) [hereinafter Black et al., *Liability Risk for Outside Directors*]; Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059 (2006) [hereinafter Black et al., *Outside Director Liability*]; Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1387 (2006).

⁴⁵ See Armour et al., *supra* note 13, at 703 (2009).

⁴⁶ See Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1331 (2005) (discussing the analytical link between demand requirements and business judgment considerations); Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1759 (2004) (“Even if a suit survives the demand hurdle, the board of directors can still form a special independent litigation committee that can dismiss the case.”). But see Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1311 (2009) (finding that special litigation committees do not always dismiss derivative litigation).

⁴⁷ See *infra* Part III.A.5.

⁴⁸ See *infra* Part III.A.4–5.

⁴⁹ The term “private attorney general” was coined by Judge Frank in *Associated Industries of New York State, Inc. v. Ickes*, 134 F.2d 694, 704 (2d Cir. 1943), and refers to a private party who brings a lawsuit

of corporate mismanagement in great detail. We argue that the process of discovery itself disciplines management.⁵⁰

The thesis of this Article is that civil procedure, and in particular the investigation of corporate internal wrongdoing by outsiders authorized and encouraged by the federal discovery rules, has had a substantial influence on the evolution of corporate governance in the United States. In this Article, we argue that *litigation discovery is a critical legal variable in the development of U.S. corporate and securities laws, and, more broadly, of the U.S. culture of corporate disclosure.*

Litigation discovery, and the threat of litigation discovery, has driven and structured the process of corporate shareholder litigation.⁵¹ The results of litigation discovery have led to the development of the case law defining shareholder rights and managerial duties. The threat of discovery and the episodic legal demands for detailed corporate internal information have induced incremental improvements in corporate governance practices, including more exacting decision procedures, internal monitoring, recordkeeping, and securities disclosure. Defensive discovery exposes decision-making by individual managers or directors to the scrutiny of the entire board and outside litigation counsel, all of whom have either fiduciary duties or professional obligations to the company.⁵² Moreover, the highly developed, continuously evolving litigation discovery practices have established templates for independent corporate internal investigations by boards and regulators.⁵³

considered to be in the public interest. See David Shub, Note, *Private Attorneys General, Prevailing Parties, and Public Benefit: Attorney's Fees Awards for Civil Rights Plaintiffs*, 42 DUKE L.J. 706, 708 (1992).

⁵⁰ See *infra* Part III.A.4–5.

⁵¹ In this Article, “shareholder litigation” includes all types of shareholder litigation at the state and federal level, including shareholder direct actions (such as breach of duty in the merger context, or requests under title 8, section 220 of the Delaware Code), shareholder derivative actions, and shareholder securities class actions. We focus primarily on shareholder derivative actions under state law and shareholder securities class actions under federal law as examples. While shareholder derivative actions may, of course, be brought in federal courts, the Securities Litigation Uniform Standards Act of 1998 (SLUSA) precludes federal securities class actions from being litigated in state courts. See Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections of 15 U.S.C.).

⁵² See *infra* Part III.A.4.

⁵³ See Paul Lomas & Daniel Kramer, *Introduction to CORPORATE INTERNAL INVESTIGATIONS: AN INTERNATIONAL GUIDE* 1, 3 (Paul Lomas & Daniel J. Kramer eds., 2008) (“The US has been in the forefront of the trends that have led corporations to conduct internal investigations and to cooperate with governmental inquiries, but the procedures in the US are constantly evolving themselves.”).

Discovery has also given regulators steady insight into changing corporate governance practices to which they have responded with regulatory changes. The information revealed through discovery of corporate internal wrongdoing in response to scandals, such as Enron and WorldCom, stock options backdating, executive pay, and subprime mortgage lending, has driven broad legal, statutory, and regulatory reforms.⁵⁴

This Article concludes that litigation discovery serves as a form of *ex post* disclosure that complements and enforces *ex ante* disclosure under the federal securities laws. Securities disclosure proceeds *ex ante*, is standardized, and is necessarily limited and summary in nature.⁵⁵ In contrast, discovery occurs *ex post* and generates additional, extensive, specific disclosures not mandated by the regulator *ex ante*. Consequently, litigation discovery promotes and influences the U.S. culture of public company disclosure.

This Article is structured as follows. Part I presents the basic insight of the paper. It argues that discovery is the “elephant in the boardroom.” By treating the *Disney* shareholder litigation as an example, it illustrates how discovery disciplines corporate management.

Part II describes the U.S. information-pushing regime implemented by the modern discovery rules. It recalls the New Deal origins of modern discovery, describes the unprecedented scope of the rules, and considers the significance of devolving judicial authority for fact gathering onto private parties.

Part III, the core of the Article, examines a range of institutional consequences that flow from the rules and practices of discovery: It describes how discovery (a) generates information and disciplines management at every stage of shareholder litigation (even prior to the motion to dismiss); (b) has established templates for independent corporate internal investigations; (c) induces incremental improvements in corporate governance practices, including more exacting decision procedures, internal monitoring, recordkeeping, and controls; (d) stimulates and shapes the development of case law and judicial precedent; (e) reveals information of corporate internal wrongdoing that drives substantive corporate law, securities laws, and regulatory reforms; and (f) concludes that discovery serves as a form of *ex post*

⁵⁴ See *infra* note 233 and accompanying text.

⁵⁵ See Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 363–64 (2006) (discussing the virtues of mandatory disclosures).

disclosure, which complements and enforces *ex ante* disclosure under the federal securities laws.

Part IV then addresses specific objections to our thesis that corporate and civil procedure scholars have advanced.

Part V offers several normative conclusions concerning policy proposals regarding legal transplants, criticisms of the empirical literature on shareholder actions, and reforms of the current discovery regime. This Part cautions against legal transplants of U.S.-style securities disclosure, aggregate litigation mechanisms, or other aspects of enforcement without considering appropriate tools for investigating corporate internal wrongdoing *ex post*. Here we also return to the enforcement debate and offer some suggestions on disaggregating data on litigation outcomes by focusing instead on what fact investigations have taken place at what phase in the adjudication process. Finally, we consider the implications of our thesis for the current proposed changes to the federal discovery rules.

I. THE ROLE OF DISCOVERY IN U.S. CORPORATE GOVERNANCE

A. *The Elephant in the Board Room*

All companies guard their knowledge resources, including information about their internal operations, business practices, and decision procedures.⁵⁶ Public companies only disclose what they must.⁵⁷

Yet in the United States, the CEO of a company must be prepared to allow an army of litigation attorneys to subject every aspect of her company's operations to intense scrutiny. Every document, electronic record, and communication among employees, managers, executives, and board members

⁵⁶ See generally Érica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions, and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 NW. U. L. REV. 1123, 1127 (2007) (arguing that firms must produce knowledge, disperse it within the firm, but also "prevent its transfer outside the firm").

⁵⁷ See Tom C.W. Lin, *Undressing the CEO: Disclosing Private, Material Matters of Public Company Executives*, 11 U. PA. J. BUS. L. 383, 385, 394–95 (2009) (discussing the growing prominence and wealth of corporate CEOs and the need for a corresponding increase in disclosure); Michael R. Siebecker, *Trust & Transparency: Promoting Efficient Corporate Disclosure Through Fiduciary-Based Discourse*, 87 WASH. U. L. REV. 115, 117 (2009) ("[D]espite a host of federal and state statutes mandating disclosure of various corporate practices, corporations seem reluctant to disclose fully what consumers and investors want to know . . .").

may have to be revealed during litigation discovery—on short notice.⁵⁸ The scope of such investigations into the corporation's internal affairs can be extensive, covering several years of operations and including the interrogation of employees who have long since left the company.⁵⁹ A CEO can never be sure that even highly confidential conversations with her most trusted advisors will be safe from forced disclosure. Discovery reaches personal e-mail accounts, home computers, and PDA devices.⁶⁰ And even if the production of confidential information is forestalled by achieving a settlement at an early stage in the litigation, the collection and review of relevant information by a corporate defendant's outside litigation counsel for the purpose of preparing for settlement will generally expose a manager's communications and conduct to the corporation's general counsel and other gatekeepers, whose legal duties and loyalties all run to the corporation.⁶¹

Once underway, the discovery process threatens to expose to public scrutiny⁶² anything from minor lapses in judgment to serious wrongdoing that could lead to separate litigation or criminal charges unconnected with the pending litigation.⁶³ Discrepancies between public statements and corporate internal information publicized by discovery will raise the specter of securities law and corporate fiduciary duty violations. And even if the threat of personal

⁵⁸ See John S. Beckerman, *Confronting Civil Discovery's Fatal Flaws*, 84 MINN. L. REV. 505, 525 (2000) ("Proficient advocates maximize strategic advantage during the investigation and discovery phase of pretrial litigation by obtaining as much relevant and useful information, admissions and impeachment material as possible from and about the adversary, for potential use at trial . . .").

⁵⁹ See William W. Schwarzer, *Mistakes Lawyers Make in Discovery*, LITIGATION, Winter 1981, at 31, 31 ("Deposition notices drop like autumn leaves."); see also, e.g., *Sperano v. Invacare Corp.*, No. 03-CV-6157, 2006 WL 3524483, at *1–2 (W.D.N.Y. Dec. 6, 2006) (allowing deposition of the defendant's former employee, even though she suffered from a rare brain disease).

⁶⁰ *Hopson v. Mayor of Balt.*, 232 F.R.D. 228, 245 (D. Md. 2005) (describing the scope of electronic records as including "e-mail, voice mail, archived data, back-up or disaster recovery data, laptops, personal computers, PDA's, deleted data").

⁶¹ See *infra* notes 296–308 and accompanying text.

⁶² Exposure need not be to the general public in order to effectively discipline. As we discuss below, defensive discovery alone, or even a prediscovery corporate internal investigation by a special litigation committee, both of which operate in the shadow of the discovery rules, can lead to employment actions, improve compliance monitoring, and deter aggressive reporting practices.

⁶³ See, e.g., Press Release, U.S. Dep't of Justice, *Former Computer Associates Executives Indicted on Securities Fraud, Obstruction Charges* (Sept. 22, 2004), http://www.justice.gov/opa/pr/2004/September/04_crm_642.htm (stating that the financial restatement and the realization of the magnitude of the fraud by Computer Associates executives resulted from corporate internal investigation).

liability is remote,⁶⁴ the reputational consequences of embarrassing revelations could be severe.⁶⁵

Discovery materials are deemed public by default.⁶⁶ Of course, most information disclosed during discovery will not become public. Discovery often produces millions of documents, which are not published, and dozens of deposition transcripts, which may become available only in part. But, there are many examples of the publication of discovery materials, including very large datasets,⁶⁷ and of plaintiffs in different litigations sharing discovery materials.⁶⁸ Moreover, private parties have incentives to select the most troubling documents and the most relevant information and use them to make their cases. In important cases, the public may obtain information if any party

⁶⁴ See Black et al., *Outside Director Liability*, *supra* note 44, at 1099.

⁶⁵ See Eliezer M. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, 86 J. FIN. ECON. 306, 335 (2007) (showing that “fraud allegations have significant reputational consequences for outside directors”); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1489 (2007) (concluding that “in light of the Delaware courts’ reluctance to impose monetary liability on directors, the most significant independence-enhancing effect of litigation is probably through improving the operation of the reputation market rather than through the threat of monetary sanctions”); Bruce Haslem, Aimee Hoffmann Smith & Irena Hutton, *How Much Do Corporate Defendants Really Lose? A New Verdict on the Reputation Loss Induced by Corporate Litigation* 7 (July 8, 2013) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290821.

⁶⁶ Unless there is a confidentiality agreement between the parties, or a protective order is obtained by the court, a party is generally free to pass on documents or deposition transcripts to third parties who are not involved in the litigation. Because discovery materials are not filed with the court, *see* FED. R. CIV. P. 5, it is not always recognized that they are not protected from publication, even at an early stage in the litigation process. Some academics who have attended to the issue have deplored the “public by default” standard. But in so doing, their focus is on the rights and burdens of the parties and other narrow procedural issues without considering the broader impact that publication and its threat have on the regulation of securities markets and corporate governance more generally. *See, e.g.*, Richard L. Marcus, *A Modest Proposal: Recognizing (At Last) That the Federal Rules Do Not Declare That Discovery Is Presumptively Public*, 81 CHI.-KENT L. REV. 331, 331 (2006) (“[T]he real problem is that the overbroad notion that all information turned over in discovery (no matter what it contains, or what the court or even the parties, know about the material involved) is presumptively open to the public, even if no party wants to permit public access to the information.”).

⁶⁷ One need only search YouTube to locate hundreds of excerpts of videotaped depositions that may embarrass defendant corporate managers. *See, e.g.*, CenterJD, *Enron Banks—Will President Bush Support Them?*, YOUTUBE (Jul. 30, 2007), <http://www.youtube.com/watch?v=9zxAJO7owy8> (showing deposition of Enron’s Chief Financial Officer, Andrew Fastow); *see also infra* note 226.

⁶⁸ *See* *Citizens First Nat’l Bank of Princeton v. Cincinnati Ins. Co.*, 178 F.3d 943, 946 (7th Cir. 1999) (observing that “[m]ost cases endorse a presumption of public access to discovery materials” and citing numerous such cases); *Okla. Hosp. Ass’n v. Okla. Publ’g Co.*, 748 F.2d 1421, 1424 (10th Cir. 1984) (“[P]arties to litigation have a constitutionally protected right to disseminate information obtained by them through the discovery process absent a valid protective order . . .”); *see also* MANUAL FOR COMPLEX LITIGATION (FOURTH) § 11.432, at 67–68 (2004) (endorsing the sharing of information obtained from discovery for litigation purposes).

leaks it to the specialized media. The media will be eager to generate news. And parties have incentives to reveal information in egregious cases when the generation of public outrage supports their case.

Transparency generated by discovery is not measured by the quantity of information that is published, but by its quality. The most important content, by a *qualitative* standard, will generally inform the litigation process and therefore become available, if not to the public, at least to lawyers, gatekeepers, judicial authorities, and regulators.

Confidentiality agreements among the parties offer limited protection against disclosure of discovery materials.⁶⁹ Even where parties sign a confidentiality agreement, these discovery materials may nonetheless become available to lawyers, legal experts, gatekeepers,⁷⁰ or regulators,⁷¹ and thereby inform legal proceedings indirectly. The publication of discovery documents depends on the stage the suit reaches. The further the litigation goes, the more information is likely to become available. Close to trial, more information is revealed. But that does not mean information obtained during discovery will not be revealed at earlier stages. Cases dismissed, settled, or resolved at earlier stages tend to generate less information as compared with cases that are resolved at trial. However, as we show in Part III, the U.S. discovery system generates information flows at every stage of the litigation process.

The main point is that the U.S. civil procedure system, through litigation discovery, generates more high-quality information about corporate wrongdoing than any other legal system in the world. In this way, the U.S. civil procedure system is exceptional.

Litigation discovery, and its threat, disciplines the entire corporate hierarchy. Not personal liability, as has often been assumed, but discovery

⁶⁹ Note that the deposition transcript of Neil Cotty, Bank of America's Chief Accounting Officer, was marked "confidential" but was nonetheless filed with the court and testimony was cited in the press. See Continued Videotaped Deposition of Neil Andrew Cotty, *In re Bank of Am. Corp., Sec., Derivative, & ERISA Litig.*, 757 F. Supp. 2d 260 (S.D.N.Y. 2010) (No. 09 MD 2058 (PKC)), ECF No. 694-6. Even where sealed documents are obtained and leaked, as in the *Zyprexa* case, judges craft their injunctions narrowly and have not issued general injunctions on republication of already leaked documents. See, e.g., *In re Zyprexa Injunction*, 474 F. Supp. 2d 385, 395, 397 (E.D.N.Y. 2007).

⁷⁰ See JOHN C. COFFEE JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 2 (2006) ("[G]atekeeper . . . [means] an agent who acts as a reputational intermediary to assure investors as to the quality of the 'signal' sent by the corporate issuer."). Examples of gatekeepers include auditors, investment bankers, securities analysts, and attorneys. *Id.* at 2, 192.

⁷¹ See *infra* Part III.A.5 (discussing information sharing by special litigation committees with the SEC).

itself encourages truth telling, constrains officers and directors from breaching their fiduciary duties, and mandates great care in the dutiful management of corporate internal affairs. Litigation discovery is the proverbial “elephant in the room.”

Case law shows how consequential information obtained through discovery can be.

B. The Example of the Disney Company Shareholder Derivative Litigation

The shareholder derivative litigation against the board of the Walt Disney Company serves as a prime example of how litigation discovery exposes corporate governance failures, disciplines management, and focuses public attention on corporate governance issues—in this case, on the excesses of executive pay—regardless as to whether directors face personal liability for mismanagement or misconduct.

The basic facts are well known. Disney’s board awarded Michael Ovitz, its departing president, a severance package of approximately \$140 million after just fourteen months in office, in accordance with an early termination provision in Ovitz’s employment contract.⁷² In this derivative action based on waste, complaining shareholders challenged not merely the board’s initial approval of the excessive downside protection in the original employment contract, but also the board’s approval of Disney Chairman Michael Eisner’s decision to terminate Ovitz without cause.⁷³

The litigation lasted more than eight years and resulted in five decisions, three by the Delaware Court of Chancery and two by the Delaware Supreme Court.⁷⁴ After initially dismissing the case for failure to satisfy the demand requirement,⁷⁵ the Delaware Chancery ultimately ordered defendants to answer the complaint and granted the plaintiffs discovery.⁷⁶ We note that Delaware

⁷² See *Brehm v. Eisner*, 746 A.2d 244, 249, 252–53 (Del. 2000).

⁷³ *In re Walt Disney Co. Derivative Litig. (Disney I)*, 731 A.2d 342, 353 (Del. Ch. 1998), *aff’d in part, rev’d in part sub nom.* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

⁷⁴ *In re Walt Disney Co. Derivative Litig. (Disney IV)*, 906 A.2d 27 (Del. 2006); *Brehm*, 746 A.2d 244; *In re Walt Disney Co. Derivative Litig. (Disney III)*, 907 A.2d 693 (Del. Ch. 2005), *aff’d*, 906 A.2d 27 (Del. 2006); *In re Walt Disney Co. Derivative Litig. (Disney II)*, 825 A.2d 275 (Del. Ch. 2003); *Disney I*, 731 A.2d 342.

⁷⁵ *Disney I*, 731 A.2d at 380.

⁷⁶ *Disney II*, 825 A.2d at 291.

rules of discovery track the discovery rules of the Federal Rules of Civil Procedure (FRCP).⁷⁷

After extensive discovery, the case went to trial. The trial lasted 37 days (from October 20, 2004, to January 19, 2005), included 24 witness examinations, and generated 9,360 pages of transcripts.⁷⁸ Ultimately, the Delaware Supreme Court found in favor of the directors, which some have described as a “complete victory.”⁷⁹ But the court explicitly found that their conduct “fell significantly short of the best practices of ideal corporate governance,” that Eisner “enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom,” and that he “stacked his . . . board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes.”⁸⁰ Michael Eisner resigned as Disney’s CEO the following month and from Disney’s board shortly thereafter.⁸¹

For attorneys trained in civil law jurisdictions, the extraordinary detail of the factual recitations and the extent to which they render transparent highly sensitive, confidential internal decision-making by the company’s officers and directors are bewildering. “The Court . . . reviewed thousands of pages of deposition transcripts and 1,033 trial exhibits that filled more than twenty-two 3½-inch binders.”⁸² In an eighty-two-page opinion on its decision after trial, the Chancery spent nearly forty-seven pages reciting the facts of the case, another twenty-one pages analyzing the facts in light of the applicable law, and only eleven pages reciting the law.⁸³

⁷⁷ See *infra* Part II.D.

⁷⁸ *Disney III*, 907 A.2d at 697.

⁷⁹ See, e.g., Jonathan Macey, *Delaware: Home of the World’s Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1131 (2005).

⁸⁰ *Disney III*, 907 A.2d at 697, 760, 763. For public reaction, see, for example, Steven Taub, *Disney Wins Shareholder Lawsuit*, CFO (Aug. 10, 2005), <http://ww2.cfo.com/risk-compliance/2005/08/disney-wins-shareholder-lawsuit/> (reporting that the court “did not exonerate Eisner and the Disney board outright”).

⁸¹ See Bloomberg News, *Eisner Makes Clean Break, Resigns from Board of Directors*, CHI. TRIB. (Oct. 7, 2005), http://articles.chicagotribune.com/2005-10-07/business/0510070136_1_robert-iger-michael-eisner-disney (reporting that Eisner resigned as Disney’s CEO on September 30, 2005).

⁸² *Disney III*, 907 A.2d at 697.

⁸³ See *id.* at 696–97. One reason for trial courts to include such lengthy recitations of fact is, of course, to avoid getting overturned on appeal, as the standard of review for facts is clear error, but a *de novo* standard applies to judicial review of matters of law. See FED. R. CIV. P. 52(a)(6); *United States v. U.S. Gypsum Co.*, 333 U.S. 364, 399 (1948); see also Steven Alan Childress, *Standards of Review Primer: Federal Civil Appeals*, 229 F.R.D. 267, 270 (2005).

In European civil law systems, opinions are shorter and include significantly less recitations of facts. See, e.g., MITCHEL DE S.-O.-L’E. LASSER, *JUDICIAL DELIBERATIONS: A COMPARATIVE ANALYSIS OF JUDICIAL*

The Court's factual recitations were, of course, entirely dependent on the extensive discovery that plaintiffs had conducted during the pretrial period over many years.⁸⁴ Moreover, they reflect only the tip of the iceberg. The opinion discusses only the most relevant evidence, that was *admissible* and which the attorneys culled from mountains of discovery for presentation at trial.⁸⁵ The *Disney* case illustrates how discovery by plaintiffs in U.S. shareholder derivative actions succeeds in reconstructing the "who, what, when, where, and why" of corporate internal decision-making.⁸⁶

We note here in particular the kinds of facts to which plaintiffs gained access as a result of discovery. Plaintiffs' discovery substantially covered Ovitz's business arrangements since the founding of Creative Artist Agency in the 1970s.⁸⁷ Plaintiffs dissected Ovitz's career, business partnerships, leadership positions, and opportunity costs, including confidential internal personnel and management issues of the partnership that he founded, and the details and structure of a completely separate failed deal to install him as CEO of the Music Corporation of America (formerly MCA, now Universal Studios) just prior to his appointment as president of the Walt Disney Company.⁸⁸ Extensive pretrial collection, review, analysis, and synthesis of evidence from testimony, business records, correspondence, public records, and news accounts, from the parties as well as entirely uninvolved third parties, allowed plaintiffs to offer the fact-finder a blow-by-blow account of the process of

TRANSPARENCY AND LEGITIMACY 104–112 (2004) (discussing the brevity of European Court of Justice opinions); Gillian K. Hadfield, *The Quality of Law: Judicial Incentives, Legal Human Capital and the Evolution of Law* 28 (Univ. S. Cal. Ctr. in Law, Econ. & Org., Research Paper No. C07-3, 2007), available at <http://ssrn.com/abstract=967494> ("Common law regimes, for example, tend to produce extensive, publicly available judicial opinions laying out factual findings and legal reasoning; civil code regimes tend to produce detailed academic commentary, published alongside short, relatively opaque, legal opinions with extensive judicial analysis sometimes confined to documents distributed only within the judiciary." (citing LASSER, *supra*)); Annette Marfording & Ann Eyland, *Civil Litigation in New South Wales: Empirical and Analytical Comparisons with Germany*, 500–01 (Univ. of N.S.W. Faculty of Law Research Series, Paper No. 28, 2010), available at <http://ssrn.com/abstract=1641554> (comparing page length of decisions in New South Wales and Germany); see also, ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE] § 313(2) (Ger.) (providing that, in the reasons for judgment, the plaintiff's claim and the parties' respective factual allegations are to be presented only as far as essential, and otherwise the court is to simply refer to the parties' pleadings and the transcript).

⁸⁴ U.S. judges do not collect facts, identify witnesses, or control the preparation of evidence for trial. See *infra* notes 148–53 and accompanying text.

⁸⁵ The scope of discovery extends to "relevant" information and other information "reasonably calculated to lead to the discovery of admissible evidence." FED. R. CIV. P. 26(b)(1).

⁸⁶ See *infra* note 254 and accompanying text.

⁸⁷ *Disney III*, 907 A.2d at 700.

⁸⁸ *Id.* at 700–02.

hiring and firing Ovitz.⁸⁹ The investigation uncovered what each and every board member knew, when they knew it, and what they did or did not do to inform themselves.⁹⁰ The Court recited in detail what information was kept from the board entirely, what private and business relationships Eisner maintained with Ovitz and with every board member, the express or implied motivations of Eisner's conduct at each stage of the process to hire and fire Ovitz, and much more.⁹¹

Discovery revealed that Eisner and Irwin Russell largely controlled the hiring process. Russell, who was the head of the compensation committee, and also Eisner's personal counsel, was thus determined to be a nonindependent director.⁹² Discovery revealed that the "first instance where a board member other than Russell or Eisner was brought into the Ovitz negotiation process" was when the financial terms of Ovitz's employment agreement had already been worked out.⁹³ Discovery revealed that the analysis of Ovitz's proposed compensation agreement by the executive compensation consultant, Graef Crystal, was "never circulated to any board member other than Eisner."⁹⁴ The analysis—now available to the entire world—voiced serious concerns the board should have seen before it approved Ovitz's contract. In it, Crystal emphasized that he "was philosophically opposed to a pay package that would give Ovitz the best of both worlds—*i.e.*, low risk and high return."⁹⁵ It also took the discovery process for the board to learn that it had not been properly informed of the opposition to Ovitz's hiring by two of the most important Disney executives, Sanford Litvack (Disney's General Counsel) and Stephen Bollenbach (Disney's CFO).⁹⁶ Again, it was discovery that turned up all this information, not the court, and not the press.

The Court used the wealth of information about Disney's executive pay practices to castigate Eisner, announce stricter fiduciary duty standards on

⁸⁹ *Id.* at 699–740.

⁹⁰ *See, e.g., id.* at 724–40.

⁹¹ *See id.* at 702–40.

⁹² *Disney I*, 731 A.2d 342, 360 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

⁹³ *Disney III*, 907 A.2d at 704 & n.40.

⁹⁴ *Id.* at 705–06.

⁹⁵ *Id.* at 705.

⁹⁶ The record states, "In executive session, the board was informed of the reporting structure that Eisner and Ovitz agreed to, but no discussion of the discontent Litvack or Bollenbach expressed at Eisner's home was recounted." *Id.* at 710.

board decision-making, and identify best practices that corporate management should adopt to shield themselves from similar claims going forward:

Eisner's actions in connection with Ovitz's hiring should not serve as a model for fellow executives and fiduciaries to follow. His lapses were many. He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement. He prematurely issued a press release that placed significant pressure on the board to accept Ovitz and approve his compensation package in accordance with the press release. To my mind, these actions fall far short of what shareholders expect and demand from those entrusted with a fiduciary position. Eisner's failure to better involve the board in the process of Ovitz's hiring, usurping that role for himself, although not in violation of law, does not comport with how fiduciaries of Delaware corporations are expected to act.⁹⁷

What was remarkable about the litigation for U.S. observers, as Professor Macey and others have noted, is that the outcome of the case—no liability for any defendant—was widely predicted, but the Delaware Courts nonetheless permitted the litigation to proceed for so long, at considerable cost to the company and its shareholders.⁹⁸ Explanations proffered in the corporate law literature included the Delaware Chancery's attempt to maintain its relevancy in light of the increasing federalization of corporate and securities laws, and in particular Congress's passage of the Sarbanes-Oxley legislation in 2002; the signaling function of the opinion; the capture of Delaware's legislature and judiciary by the interests of the corporate bar; and the reputational sanction the court imposed on the Disney Board and its CEO as a result.⁹⁹ But the critical importance of the discovery regime for the court's ability to accurately describe the facts in such granular detail, to deliver the reputational sanction to Eisner, and to signal to market participants that they could be exposed to the same kind of scrutiny, was never considered. The reason for this oversight is that we have come to take this kind of discovery for granted.

Litigation discovery, and the threat of litigation discovery, defines corporate shareholder litigation in the United States. As we show in Parts III and IV, the impact of shareholder litigation is intimately bound up with how modern discovery (1) affords litigants unprecedented tools to investigate

⁹⁷ *Id.* at 762–63 (footnote omitted).

⁹⁸ *See* Macey, *supra* note 79, at 1132–33.

⁹⁹ *See id.* at 1132, 1134–36.

corporate internal wrongdoing, (2) significantly decentralizes and leverages judicial investigative powers, (3) empowers parties with the greatest incentives to uncover wrongdoing, and (4) structures the litigation process more generally.

In agency-cost terms, the availability of litigation discovery by shareholders addresses an information asymmetry problem.¹⁰⁰ Shareholders can use litigation discovery to get information about the details of corporate self-dealing transactions or suspicious deals, which would otherwise be inaccessible to them.¹⁰¹ Knowing that this opportunity is available, and that shareholders can use the information once they obtain it,¹⁰² makes managers more likely to avoid such conduct. By allowing monitoring, *ex post* discovery reduces the private benefits of control associated with running public corporations. The impact of discovery goes far beyond the litigation process in that it promotes an overall culture of transparency in U.S. corporate governance.

II. THE U.S. INFORMATION-FORCING REGIME

While most scholars and practitioners are generally aware of the atypical character of U.S. discovery, few fully appreciate the profound disparities between pretrial fact investigation in the U.S. courts and fact investigation in virtually every other court system.¹⁰³ Simply stated, the U.S. “system of pretrial discovery is unique”; no other country has anything like it.¹⁰⁴

A. *New Deal Origins of Modern Discovery*

The significance of modern civil discovery for corporate governance is not an unintended consequence of the rules. The modern rules originated with the same legal-realist philosophy that informed FDR’s New Deal legislation and

¹⁰⁰ See generally George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489 (1970) (explaining the information asymmetry problem in the context of used cars).

¹⁰¹ See Lucian Arye Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404, 413 (1984) (“[T]he discovery requirement will likely reduce the informational asymmetry between the parties . . .”).

¹⁰² Third-generation transparency work suggests that transparency and disclosure are effective if interested parties can act on the information. See ARCHON FUNG ET AL., *FULL DISCLOSURE: THE PERILS AND PROMISE OF TRANSPARENCY* 173–74 (2007).

¹⁰³ See Marcus, *supra* note 23, at 709. (“American proceduralists have not been comparativists.”) American proceduralists instead believe “it is best and sufficient to attend only to American topics.” *Id.* at 710.

¹⁰⁴ Hazard, *Discovery and the Role of the Judge*, *supra* note 22, at 1018.

helped revolutionize the governance of U.S. markets in the 1930s.¹⁰⁵ The goal of legal realists was nothing short of a modern revolution in governance. They sought to place governance on a scientific footing, turn over the details of public administration to experts, and thereby create a modern state that would promote social welfare.¹⁰⁶ Unfettered competition would be tempered by social cooperation. Scientific decision-making by experts based on objective data would replace haphazard judgments by lay politicians and judges.¹⁰⁷ Centralization would overcome the unsurveyable thicket of state and local governance regimes and ensure uniform, rational policies based on empirical evidence.

The Rules Enabling Act, which authorized the judiciary to develop and promulgate new rules of civil procedure for Article III courts, was passed in 1934¹⁰⁸ along with the second wave of New Deal legislation that included the Securities Act of 1933¹⁰⁹ and the Securities Exchange Act of 1934.¹¹⁰ The rules were adopted in 1937 and became effective in 1938.¹¹¹ Charles Clark, then Dean of Yale Law School, the hotbed of legal realist thinking at the time, became the Reporter to the Judicial Conference's Advisory Committee on Civil Rules ("Committee" or "Advisory Committee") responsible for drafting the new rules.¹¹² At the same time, another Yale Professor, William Douglas (later appointed to the Supreme Court) brought the same legal realist agenda to

¹⁰⁵ See generally David Marcus, *The Federal Rules of Civil Procedure and Legal Realism as a Jurisprudence of Law Reform*, 44 GA. L. REV. 433, 438 (2010) (showing how the positive potential of legal realism translated into reform); Stephen N. Subrin, *How Equity Conquered Common Law: The Federal Rules of Civil Procedure in Historical Perspective*, 135 U. PA. L. REV. 909, 944–48 (1987) (documenting the Federal Rules' heavy reliance on equity procedures, which mirrored New Deal principles). See also Judith Resnik, *Failing Faith: Adjudicatory Procedure in Decline*, 53 U. CHI. L. REV. 494, 502–05 (1986).

¹⁰⁶ See Marcus, *supra* note 105, at 468–69.

¹⁰⁷ See *id.*

¹⁰⁸ Pub. L. No. 73-415, 48 Stat. 1064 (1934) (codified as amended at 28 U.S.C. § 2072 (2012)). The Rules Enabling Act gave the Supreme Court the power to make rules of procedure for federal courts as long as they did not "abridge, enlarge, or modify any substantive right." 28 U.S.C. § 2072(b).

¹⁰⁹ Pub. L. No. 73-22, tit. I, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

¹¹⁰ Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78pp).

¹¹¹ See generally Stephen N. Subrin, *Fishing Expeditions Allowed: The Historical Background of the 1938 Federal Discovery Rules*, 39 B.C. L. REV. 691, 729 (1998) (providing a historical survey of discovery reforms and their driving rationale).

¹¹² See generally, AMERICAN BAR ASSOCIATION, RULES OF CIVIL PROCEDURE FOR THE DISTRICT COURTS OF THE UNITED STATES WITH NOTES AND PROCEEDINGS OF THE INSTITUTE ON FEDERAL RULES (William W. Dawson ed., 1938) [hereinafter IFR PROCEEDINGS] (providing a transcript of the proceedings of the ABA Institute on Federal Rules in Cleveland, Ohio, on July 21–23, 1938, at which Dean Clark was a lecturer).

implementing the new securities disclosure regime at the Securities Exchange Commission, which was created by the 1934 Securities Exchange Act.¹¹³

The Rules Enabling Act authorized the promulgation of new uniform federal rules of procedure,¹¹⁴ whereas, previously, federal district courts followed the procedural rules of the state in which the district was located.¹¹⁵ The arcane and esoteric nineteenth century writ system was abolished.¹¹⁶ The outcome of litigation would no longer depend principally upon the skill of adversaries to manipulate the complicated pleading rules and other technicalities.¹¹⁷

The new rules created a single cause of action, permitted the pleader to state multiple, alternative, and even mutually inconsistent claims, and joined bills in equity with actions at law. Pleading became a simple affair that, in simple negligence cases, barely required the assistance of counsel.¹¹⁸ All that was needed was an ordinary-language complaint (no magic words required) that gave the defendant notice of the claims and stated the grounds for relief.¹¹⁹ The goal was the resolution of disputes on their merits and in the interests of justice. The rule-makers explicitly rejected dismissals based on technical defects in the pleadings before the plaintiff was given the chance to develop facts in support of his claims.¹²⁰

Instead of deciding cases at the pleading stage or at trial, the new rules placed great emphasis on broad fact investigation by the parties themselves during an extended discovery period that would unveil the facts and circumstances of the dispute to both parties.¹²¹ Extensive discovery was to afford all the parties to a case access to all the facts on either side before trial, thus allowing them to rationally assess the value of their case and encouraging settlements.¹²²

¹¹³ See C. Paul Rogers III, *The Antitrust Legacy of Justice William O. Douglas*, 56 CLEV. ST. L. REV. 895, 897, 899–903 (2008).

¹¹⁴ Pub. L. No. 73–415, 48 Stat. 1064 (1934) (codified at 28 U.S.C. § 2072 (2012)).

¹¹⁵ See Subrin, *supra* note 111, at 693–729.

¹¹⁶ See Marcus, *supra* note 105, at 476 (describing the writ system).

¹¹⁷ See *Conley v. Gibson*, 355 U.S. 41, 48 (1957) (“The Federal Rules reject the approach that pleading is a game of skill in which one misstep by counsel may be decisive to the outcome . . .”), *abrogated on other grounds by Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).

¹¹⁸ See, e.g., FED. R. CIV. P. 8; FED. R. CIV. P. Form 20.

¹¹⁹ FED. R. CIV. P. 8(a)(2); *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 508 (2002).

¹²⁰ See *supra* note 117; cf. Subrin, *supra* note 111, at 693.

¹²¹ See Subrin, *supra* note 111, at 703.

¹²² See *id.* at 716.

B. *The New Tools of Modern Discovery*

The new discovery rules gave private litigants an entirely new panoply of tools to obtain information, expanding considerably on discovery mechanisms that first emerged in courts of equity and were gradually introduced in different forms in cases at common law in about half of the states during the late nineteenth and early twentieth centuries.¹²³ Combining the most liberal discovery rules to be found within the several states (and in common law jurisdictions abroad) and reshaping them systematically, the reformers changed the nature of civil adjudication.¹²⁴

The reformers recognized the unprecedented and experimental character of the new rules. Their approach “complemented the legal realist movement[’s]” emphasis on “the importance of amassing all of the facts before deciding social policy or a case.”¹²⁵ The proposed modern discovery tools were analogized to the latest scientific tools of observation. According to George Ragland, one of the main proponents of modern discovery, a “lawyer who does not use discovery procedure” is like “a physician who treats a serious case without first using the X-ray.”¹²⁶ Discovery would place civil adjudication on a more rational, scientific foundation. Edson Sunderland, who was responsible for drafting the modern discovery rules, described the central role of discovery as follows:

It is probable that no procedural process offers greater opportunities for increasing the efficiency of the administration of justice than that of discovery before trial. Much of the delay in the preparation of a case, most of the lost effort in the course of the trial, and a large part of the uncertainty in the outcome, result from the want of information on the part of litigants and their counsel as to the real nature of the respective claims and the facts upon which they rest.¹²⁷

According to Professor Hazard, the new rules of civil procedure led to a new role for civil claims as “an integral part of law enforcement in this

¹²³ See GEORGE RAGLAND, JR., *DISCOVERY BEFORE TRIAL* 19–24 (1932) (surveying state discovery practices); Subrin, *supra* note 105, at 922–25.

¹²⁴ See Subrin, *supra* note 111, at 718–19. Although the earlier Federal Equity Rules had contained some related provisions for depositions and the *subpoena duces tecum* that authorized the procurement of documents from third parties, these tools were essentially limited to situations in which witnesses were unavailable for examination in open court and required a showing of good cause. See *id.* at 699.

¹²⁵ *Id.* at 739–40.

¹²⁶ RAGLAND, *supra* note 123, at 251 (internal quotation mark omitted).

¹²⁷ Edson R. Sunderland, *Foreword* to RAGLAND, *supra* note 123, at iii.

country.”¹²⁸ “[T]he scope of discovery,” he concluded, has “determine[d] the scope of effective law enforcement in many fields regulated by law.”¹²⁹

The most striking new tool was the deposition.¹³⁰ Prior to the implementation of the FRCP, many states, including Delaware, did not permit the taking of oral depositions of witnesses before trial.¹³¹ Even states that allowed oral depositions generally permitted the practice only for the purpose of preserving evidence.¹³² In courts at equity, depositions were traditionally permitted only as written questions.¹³³ Interrogatories as written questions, however, were widely understood to be a “very ineffective” method of inquiry.¹³⁴ As Sunderland explained,

To draw up a series of questions and present them all at once to be answered, is certainly far less searching than to present questions one at a time, framing each successive question on the basis of prior answers given. Answers usually suggest lines of further inquiry which often lead to the most important disclosures. This is, of course, the chief reason for the effectiveness of the oral cross-examination. By submitting a complete set of interrogatories prepared in advance, the parties seeking discovery entirely lose this enormous advantage in eliciting the truth.¹³⁵

The Delaware Court of Chancery’s 1868 rules of practice did allow “taking the testimony of witnesses on behalf of such party within the State . . . upon oral examination and subject to cross-examination and re-examination by the parties or their solicitors, before an examiner or examiners, to be appointed by the Chancellor.”¹³⁶ But depositions were permitted only of supporting witnesses. Witnesses to be called by the opponent could not be deposed before trial, and party opponents were not required to provide testimony detrimental to their own case.¹³⁷ The principal purpose of depositions had been to preserve

¹²⁸ HAZARD, *supra* note 31, at 3.

¹²⁹ *Id.*

¹³⁰ See FED. R. CIV. P. 26.

¹³¹ See DEL. REV. STAT. ch. 121, § 49 (1915) (“The deposition must be taken in writing . . . [N]either party shall be present at the taking the [sic] deposition, and no question shall be put but those sent by the justice.”); see RAGLAND, *supra* note 123, at 283–84.

¹³² See RAGLAND, *supra* note 123, at 22–23.

¹³³ See Subrin, *supra* note 105, at 918–19.

¹³⁴ See, e.g., IFR PROCEEDINGS, *supra* note 112, at 285.

¹³⁵ *Id.* at 279–80.

¹³⁶ DEL. CH. CT. R. 40 (1868).

¹³⁷ *Supra* note 131. For the European perspective, compare VERKERK, *supra* note 23, at 246 (“[A] common restriction [of the scope of party interrogation in European systems] is that the law recognizes

evidence.¹³⁸ By the 1920s, a few states tolerated the use of depositions as tools of discovery.¹³⁹ But the oral deposition of parties before trial for the purpose of developing evidence remained highly contentious.¹⁴⁰

In a radical departure from prior practice, the FRCP incorporated deposition rules of the broadest scope.¹⁴¹ Neither leave of court nor the presence of a judge or commissioner was required.¹⁴² Both supporting and hostile witnesses could now be deposed, including party opponents and their employees.¹⁴³ Parties were required to appear on simple notice.¹⁴⁴ Third parties could be subpoenaed directly without leave of court.¹⁴⁵ Attorneys could directly examine the witnesses.¹⁴⁶

Under the current rules, examination proceeds as at trial.¹⁴⁷ But unlike at trial, cross-examination during deposition is not limited to matters raised on direct. Both parties can cross-examine a witness. And examiners can ask questions going far beyond what can be asked at trial. Witnesses must answer any question “relevant to the subject matter [now “claims and defenses”] involved in the action,” including questions seeking inadmissible evidence, such as hearsay.¹⁴⁸ The deposition is recorded verbatim, allowing the examiner to pin down the witness.¹⁴⁹ The testimony can be used as evidence at summary

privileges that grant parties the right to withhold information.”). Such privileges go far beyond attorney client privileges but include the right to refuse to bear witness against oneself.

¹³⁸ See RAGLAND, *supra* note 123, at 19–24.

¹³⁹ See, e.g., CAL. CIV. PROC. CODE § 2021 (1921); RAGLAND, *supra* note 123, at 279.

¹⁴⁰ See RAGLAND, *supra* note 123, at 126.

¹⁴¹ See IFR PROCEEDINGS, *supra* note 112, at 278–80. In the 1938 Rules, Rule 26 on depositions was the most important discovery rule, and the discovery section was entitled “Depositions and Discovery.” See *id.* at 57.

¹⁴² FED. R. CIV. P. 26(a) (1938). Contrast this with civil law rules that require both. VERKERK, *supra* note 23, at 193 (“A personal appearance of the parties is a court hearing . . .”). “[O]n the continent the party seeking discovery has to convince the court that there is a good reason to order the discovery.” *Id.* at 247.

¹⁴³ FED. R. CIV. P. 26 (1938).

¹⁴⁴ *Id.*

¹⁴⁵ FED. R. CIV. P. 30(a) (1938).

¹⁴⁶ FED. R. CIV. P. 26(b) (1938). Contrast this with civil law rules making the judge the principal examiner. VERKERK, *supra* note 23, at 247–48; see also Langbein, *supra* note 23, at 826–30.

¹⁴⁷ FED. R. CIV. P. 30(c).

¹⁴⁸ FED. R. CIV. P. 26(b), 30(c).

¹⁴⁹ See 2 JAMES WM. MOORE & JOSEPH FRIEDMAN, MOORE’S FEDERAL PRACTICE UNDER THE NEW FEDERAL RULES § 26.01, at 2443 (1938) (“A party or witness whose deposition has been taken at an early stage in the litigation cannot, at a later date, readily manufacture testimony in contradiction to his deposition.”).

judgment, at any hearing, or at trial.¹⁵⁰ Testimony can be taken from witnesses who are not called at trial.¹⁵¹ Examinations can last several days.

The rules specifically contemplate the need to obtain information from large organizations without knowing who in the organization has the information sought.¹⁵² A special provision requires “a public or private corporation” to “designate one or more officers, directors, or managing agents, or designate other persons who consent to testify on its behalf” to “testify about information known or reasonably available to the organization” on topics designated by the requesting party.¹⁵³

The significance of this discovery tool cannot be overstated. The power to force a party opponent to sit for deposition under oath, answer virtually every question put to him by opposing counsel, confront him with documentary evidence, and have his testimony recorded verbatim, was unprecedented. It shocked at least one member of the original Advisory Committee, as the following transcript shows:

[Sen. George Wharton Pepper]. . . . [T]his sort of power given to a plaintiff is simply going to be used as a means of ruining the reputation of responsible people. You bring a suit against a man, without any ground whatever—the president of some important company, the president of a utilities company or a bank or something. You take his deposition, have the reporters present, and grill him in the most unfair way, intimating that he is a burglar or murderer, or this, that, and the other. He has no redress, and the next morning the papers have a whole lot of front-page stuff. . . .

¹⁵⁰ FED. R. CIV. P. 32(a). Other deposition testimony is also admissible, so long as it is otherwise admissible under the Federal Rules of Evidence. *See, e.g.,* *Fiber Sys. Int’l, Inc. v. Roehrs*, 470 F.3d 1150, 1160 (5th Cir. 2006).

¹⁵¹ *See* FED. R. CIV. P. 27(a)(4) (“[A] deposition to perpetuate testimony may be used . . . in any later-filed district-court action involving the same subject matter . . .”). In civil law jurisdictions, such as Germany, employees have a contractual duty to answer questions from an employer, e.g., in connection with a company internal investigation, but former employees or third parties have no obligation to answer questions outside of court. *See* Hanna Blanz et al., *Investigations in Germany*, in *CORPORATE INTERNAL INVESTIGATIONS: AN INTERNATIONAL GUIDE*, *supra* note 53, at 287, paras. 6.168–170, at 332, paras. 6.180–186, at 335–36.

¹⁵² *See* FED. R. CIV. P. 30(b)(1). A party can issue a deposition notice to a witness whose “name is unknown” by “provid[ing] a general description sufficient to identify the person or the particular class or group to which the person belongs.” *Id.* This is not possible under civil law rules, because taking the examination of a witness under oath is a judicial prerogative. Moreover, there is no obligation to answer questions by an attorney absent a specific contractual relationship, such as that between employer and employee. *See, e.g.,* Blanz et al., *supra* note 151, paras. 6.180–186, at 335–36.

¹⁵³ FED. R. CIV. P. 30(b)(6).

[Chairman Mitchell]. It is too much like some of these Senate committees you used to sit on. (Laughter)

[Sen. Pepper]. Exactly; and that is where I got a taste of the kind of lawlessness that ruins people's reputations without the opportunity ever to redress the harm that is done.¹⁵⁴

The Committee thus recognized that the new deposition rules would give plaintiffs much the same authority as a congressional committee. It had taken precisely this type of authority to investigate and uncover allegedly coercive, deceptive, and collusive practices among corporate and financial elites in the period before the rise of private enforcement through civil litigation.¹⁵⁵

Document discovery was, until 1946, subject to a narrow scope permitting discovery of documents “which constitute or contain *evidence material* to any matter involved in the action,”¹⁵⁶ and, until 1970, available only on motion based on a showing of “good cause.”¹⁵⁷ Both limitations were removed in 1970, dramatically expanding document discovery; the current rules allow unlimited document requests covering any “nonprivileged matter that is

¹⁵⁴ Subrin, *supra* note 111, at 721 (quoting Proceedings of the Meeting of the Advisory Committee on Rules for Civil Procedure of the Supreme Court of the United States (Feb. 22, 1936), in RECORDS OF THE U.S. JUDICIAL CONFERENCE: COMMITTEES ON RULES OF PRACTICE AND PROCEDURES, 1935–1988, at CI-209-59 to CI-209-60).

¹⁵⁵ In 1913, the Congressional Pujo Committee investigated the money trusts, concluding that in almost “all great corporations with numerous and widely scattered stockholders[,] . . . management is virtually self-perpetuating and is able through the power of patronage, the indifference of stockholders[,] and other influences to control a majority of the stock.” H.R. REP. NO. 62-1593, at 147 (1913). See generally LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT 2–3 (1914) (relying heavily on the Pujo Committee’s findings). These and other confrontations in the 1920s informed the debate about corporate governance problems arising from the separation of ownership and control. See, e.g., ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 86–88, 124 (1932). But see Harwell Wells, *The Birth of Corporate Governance*, 33 SEATTLE U. L. REV. 1247, 1248 (2010) (suggesting that Berle and Means’s work “was not a radical break from earlier thought but the end product of several decades in which [scholars] tried to understand both the governance problems of the new modern corporations and what impact those corporate governance problems had on the nation’s public”). There has been some debate as to whether the findings of the Pujo Committee and of subsequent attacks on the money “trusts” by the Committee on Banking and Currency (1932–1934), also known as the Pecora Hearings, were misguided. See Guolin Jiang, Paul G. Mahoney & Jianping Mei, *Market Manipulation: A Comprehensive Study of Stock Pools*, 77 J. FIN. ECON. 147, 153–54 (2005) (finding informed trading and no manipulation in an empirical analysis of stock pools in the 1920s).

¹⁵⁶ Compare FED. R. CIV. P. 34 (1938) (amended 1946) (emphasis added), with *id.* (1946) (amended 1970) (permitting discovery of documents “which constitute or contain *evidence relating* to any of the matters within the scope” (emphasis added)).

¹⁵⁷ Compare FED. R. CIV. P. 34 (1946) (amended 1970), with *id.* (1970) (amended 1980) (removing the requirement of a showing of good cause and allowing that “[a]ny party may serve any other party a request . . . within the scope of [the rules]”).

relevant to any party's claim or defense."¹⁵⁸ Relevance—as opposed to some property or other specific right to a document, as under European civil law¹⁵⁹—now defines the scope of discovery.¹⁶⁰ Significantly, “relevance” is defined very broadly as “any matter that bears on, or that reasonably could lead to other matter that could bear on, any issue that is or may be in the case.”¹⁶¹

This broad conception of relevance extends to all of discovery, including party-on-party interrogatories, document requests, witness examinations, requests for admissions, expert discovery, and third-party subpoenas. The combination of these tools, which can, for the most part, be used in any order, enable U.S. attorneys to design extremely effective fact investigations.¹⁶² Of special significance, perhaps not entirely recognized by the original 1938 rules, is that the extraordinary authority to force the other party to produce all of its relevant documents makes depositions much more effective. It is by confronting a witness with her own documents on the record, under oath, and with the help of cross-examination that an examiner can extract important admissions. Moreover, the use of interrogatories and the opportunity to depose record-keepers early during discovery provide all-important information about the existence and location of documents.¹⁶³

The Federal Rules of Civil Procedure's broad scope of discovery has had an especially far-reaching impact on document discovery in the age of e-mail

¹⁵⁸ FED. R. CIV. P. 26(b); *see also* FED. R. CIV. P. 34 (allowing document discovery within the scope of FED. R. CIV. P. 26(b)); *Thompson v. Dept. of Hous. & Urban Dev.*, 199 F.R.D. 168, 172 (D. Md. 2001) (explaining that while the scope of discovery became narrower after “subject matter” in Rule 26(b) was changed to “claims and defenses,” debating the difference between the two is “equivalent to debating the number of angels that can dance on the head of a pin”). *See generally* 6 JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE § 26.43 (3d ed. 2013) (discussing the scope of discovery after the 2010 amendments).

¹⁵⁹ MURRAY & STÜRNER *supra* note 25, at 277 (“[Prior to the recent 2001 reforms of the German code of civil procedure,] there was no right to production if the request was based solely on the document's relevance to a decisive issue in the case. . . . If a party had a substantive right to possession of a document in the hands of a third party, that party could request that the proceeding be stayed to permit him to exercise his right to possession”); VERKERK, *supra* note 23, at 31 (discussing “common document” principle).

¹⁶⁰ 8 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 2008 (3d ed. 2010).

¹⁶¹ *Hager v. Graham*, 267 F.R.D. 486, 491 (N.D. W. Va. 2010) (quoting *Hickman v. Taylor*, 329 U.S. 495, 501 (1947)) (internal quotation marks omitted); *cf.* *Oil, Chem. & Atomic Workers Local Union No. 6-418 v. NLRB*, 711 F.2d 348, 359–60 (D.C. Cir. 1983).

¹⁶² These tools are not available in this form in civil law adjudication. *See infra* notes 524–37.

¹⁶³ In civil law countries, parties have no such means to identify discoverable information. *See infra* notes 537–39 and accompanying text.

and electronically stored information (ESI), beginning in the late 1980s.¹⁶⁴ The 2013 rules do not place any specific limits on the kind or quantity of information that may be obtained via document requests.¹⁶⁵ In practice, this means that blanket requests for “all documents”—including all electronic records—will be propounded, and that a responding party may, for example, need to produce all electronic records and communications that reference the names of certain employees within relevant time periods. As is well known to U.S. observers, this routinely leads to the disclosure of millions of documents and e-mails by corporate defendants in large cases. While this statistic is vaguely appreciated outside the United States, the full extent and logistical requirements of litigation discovery in a U.S. securities class action or shareholder derivative action are still mind-numbing for attorneys trained in a civil law jurisdiction.¹⁶⁶

C. *The Devolution of Judicial Authority onto Private Parties*

A critical feature of the modern rules as they eventually evolved by the 1970s is the “self-executing” nature of discovery, dramatically reducing the court’s involvement in fact investigation.¹⁶⁷ The FRCP allow parties to engage in the exchange of information with very little supervision by the judge.¹⁶⁸ In a departure from prior practice, and contrary to civil law jurisdictions,¹⁶⁹ the burden of showing relevance is on the party resisting discovery, thus avoiding

¹⁶⁴ See JAMES N. DERTOUZOS ET AL., *THE LEGAL AND ECONOMIC IMPLICATIONS OF ELECTRONIC DISCOVERY: OPTIONS FOR FUTURE RESEARCH 1* (2008) (describing the vast amount of discoverable data available in an electronic world).

¹⁶⁵ See FED. R. CIV. P. 34.

¹⁶⁶ Subrin, *supra* note 22, at 307, 311.

¹⁶⁷ See Hazard, *Discovery and the Role of the Judge*, *supra* note 22, at 1018. Discovery is said to be “self-executing,” and experienced litigators know not to bother the judge with motions to compel or protective orders, under FED. R. CIV. P. 26(b)(2)(B) and 26(c), respectively, unless necessary. *But see infra* notes 460–66 and accompanying text (discussing the thesis that “case management” rules have produced “managerial judges”).

¹⁶⁸ See, e.g., FED. R. CIV. P. 26(a)(1) (requiring parties to provide preliminary information before discovery requests); FED. R. CIV. P. 26(b) (allowing discovery without court interference for relevant matters); FED. R. CIV. P. 30(a) (allowing parties to orally depose any person without leave of court); FED. R. CIV. P. 31 (allowing parties to depose any person through written depositions without leave of court).

¹⁶⁹ In civil law jurisdictions, parties must petition the court for an order to obtain evidence. See, e.g., MURRAY & STÜRNER, *supra* note 25, at 242 (explaining that the court may order production but is required to “assess the relevance of any such document under the standards applicable to proof in general when issuing such orders”); see also HUANG, *supra* note 24, at 39–42.

the involvement of the judge altogether until a dispute arises.¹⁷⁰ The party resisting discovery must challenge the request by specific objection, which, in the first instance, is returned to the requesting party in the form of a “response.”¹⁷¹ Before seeking an order to compel or a protective order from a judge, the parties must first attempt to resolve their dispute.¹⁷²

Discovery practice is principally a sustained negotiation between the parties. When one party loses an unreasonable discovery motion, that party must pay the costs of the opposing party, which further discourages involving judges.¹⁷³ Objections based on lack of relevance are disfavored. Orders of protection in document discovery are granted sparingly.¹⁷⁴ The results of discovery—interrogatory responses, documents, deposition transcripts, and other information—are not filed with the court, unless provided as evidence on a substantive motion; nor does the court review a majority of the testimony or documents produced during discovery. This shows how decentralized the process of fact investigation is.

The structure of the U.S. litigation process as a whole thus gives litigants control over exploring, collecting, organizing, and presenting information in civil litigation that is peculiar when viewed from the European civil law perspective. The authority to conduct lengthy and probing investigations, and the extrajudicial resources that private parties bring to bear on this process, gives the term “private attorney general”—a term frequently used, but not defined, in the enforcement debate—its full meaning.¹⁷⁵

U.S. discovery devolves judicial and prosecutorial authority to investigate wrongdoing onto the private parties.¹⁷⁶ This means that the parties need not rely on the initiative or the presence of a judge; they control and perform this time-intensive phase of adjudication on their own.¹⁷⁷ This reduces the burden

¹⁷⁰ See FED. R. CIV. P. 26(b)(2)(B), (c); see also, Marcus, *supra* note 31, at 748 (explaining that prior to the 1970 amendments, Rule 34 document discovery was available only on a motion based on a showing of “good cause”).

¹⁷¹ FED. R. CIV. P. 34(b)(2).

¹⁷² FED. R. CIV. P. 26(c), 37.

¹⁷³ FED. R. CIV. P. 37(a)(5)(A).

¹⁷⁴ Hazard, *Discovery and the Role of the Judge*, *supra* note 22, at 1018.

¹⁷⁵ See John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 215–16 (1983).

¹⁷⁶ See *id.* at 218.

¹⁷⁷ See Marcus, *supra* note 66, at 334 (“Nowhere in this country, nor anywhere in the world, had there previously been such a broad or unconfining opportunity for private litigants to use the power of the state to compel disclosure of information by others.”).

on judges and prosecutors, whose resource constraints are most acutely felt in discovery; expedites the process; and enables more in-depth investigation by parties with the interests, expertise, and resources suited to pursue them. In this way, the U.S. system transfers the investigative authority of the state, and the costs of investigation, to private parties.

As we discuss in the next section, federal rules of discovery influenced practice in state courts, like the Delaware Court of Chancery, which are important venues for corporate litigation.

D. The Influence of Federal Rules of Discovery on State Civil Procedure: The Case of Delaware

The Supreme Court's decision in *Erie Railroad Co. v. Tompkins* held that federal courts apply state and federal substantive law, but *federal procedural rules*.¹⁷⁸ State courts, where most shareholder derivative actions are litigated, apply *state procedural rules*. Do state procedural rules afford the same kind of probing discovery as the federal rules? The short answer is yes.

While there are differences between federal and state court rules, which can easily trip up attorneys not familiar with local practices, as of 1986, most U.S. jurisdictions had adopted the principles, if not the precise wording, of the liberal federal discovery rules.¹⁷⁹ The FRCP were adopted *in toto* with some minor differences in at least thirty-five states, including Delaware.¹⁸⁰ But most jurisdictions, including the ones that follow their own rules, like California, New Jersey, and New York, do not significantly differ from the federal rules with regard to the scope of discovery or the available tools and procedures.¹⁸¹

¹⁷⁸ 304 U.S. 64, 78 (1938).

¹⁷⁹ John B. Oakley & Arthur F. Coon, *The Federal Rules in State Courts: A Survey of State Court Systems of Civil Procedure*, 61 WASH. L. REV. 1367, 1377–78 (1986). In their 1986 study, comparing state and federal rules, Oakley and Coon found that twenty-two states, plus the District of Columbia, could be classified as having procedural systems that were true replicas of the FRCP. These are Alabama, Alaska, Arizona, Colorado, District of Columbia, Hawaii, Indiana, Kentucky, Maine, Massachusetts, Minnesota, Montana, New Mexico, North Dakota, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, and Wyoming. *Id.* at 1377. Further, ten states, including Arkansas, Delaware, Georgia, Idaho, Kansas, Mississippi, Nevada, North Carolina, Oklahoma, and South Carolina largely replicated the federal rules, except for slight variations or codifications that had nothing to do with the nature or conduct of discovery. *Id.* at 1378. Oakley and Coon concluded that in a majority of states there was “‘but one procedure for state and federal courts.’” *Id.* at 1427 (quoting 1 W. BARRON & A. HOLTZOFF, FEDERAL PRACTICE AND PROCEDURE § 9, at 44–45 (Wright ed. 1960)).

¹⁸⁰ *See id.* at 1378.

¹⁸¹ *See* John B. Oakley, *A Fresh Look at the Federal Rules in State Courts*, 3 NEV. L.J. 354, 355 (2002/2003) (finding that states failed to keep up with the federal rules changes). Oakley concludes that

While there are fewer “exact replica” states today, this is because states have not felt the need to keep up with the many rule changes that the federal rules have undergone in 1993, 2000, 2006, 2007, 2010, and 2013.¹⁸² These rule changes, however, did not expand discovery; if anything, they attempted to expedite discovery and limit discovery excesses by, *inter alia*, requiring parties to agree on a discovery plan early in the case,¹⁸³ insisting on judicial involvement in approving such a plan,¹⁸⁴ ever so slightly limiting the definition of relevancy in the text of the rules,¹⁸⁵ and adding rules to address the special issues of e-discovery.¹⁸⁶ But the basic version of the FRCP prevails in all states.¹⁸⁷

This is true of Delaware. Delaware’s discovery rules track those in the FRCP by number and in content.¹⁸⁸ But they are, in certain respects, more permissive than the ones presently in effect in federal court. Thus, for example, Delaware Chancery Court Rule 26 is almost identical to the version of Federal Rule 26 from the 1970s, when the philosophy of liberal discovery was at its apex.¹⁸⁹ And Delaware Chancery Court Rule 26(b) still retains the broader “subject matter discovery” language that was excised from the Federal Rules in

“significant” amendments were frequently rejected, *id.* at 359, 383, but a careful examination of the differences he describes between state and federal rules shows that these differences, while important to recognize and apply with precision for attorneys litigating in these courts, are minor when compared to the fundamental differences between the U.S. system and civil law jurisdictions. *See infra* notes 528–39 and accompanying text.

¹⁸² *See* Oakley, *supra* note 180, at 355, 383 (“Even among states that fifteen years ago could be counted as substantially conforming to the federal model of procedure, recent significant amendments have been more frequently rejected or ignored than adopted.”); *see also* FED. R. CIV. P. historical note at xi–xii.

¹⁸³ FED. R. CIV. P. 26(f).

¹⁸⁴ FED. R. CIV. P. 26(f)(2).

¹⁸⁵ *Supra* note 158; *see also* Sanyo Laser Prods., Inc. v. Arista Records, Inc., 214 F.R.D. 496, 500 (S.D. Ind. 2003).

¹⁸⁶ FED. R. CIV. P. 26(b)(2)(B).

¹⁸⁷ THOMAS D. ROWE, JR., SUZANNA SHERRY & JAY TIDMARSH, CIVIL PROCEDURE 18 (3d ed. 2012).

¹⁸⁸ Oakley, *supra* note 179, at 379–81 (“Delaware has separate but substantially identical rules of civil procedure for each of its three principal systems of courts: the Court of Chancery, the Superior Court, and the inferior civil court of non-equitable jurisdiction, the Court of Common Pleas.”). *Compare, e.g.*, DEL. CH. CT. R. 11 (sanctions), DEL. CH. CT. R. 12 (motion to dismiss), DEL. CH. CT. R. 26 (discovery generally, scope, privileges, expert witnesses, timing, limitations), DEL. CH. CT. R. 30 (oral depositions), DEL. CH. CT. R. 31 (written depositions), DEL. CH. CT. R. 32 (use of deposition testimony), DEL. CH. CT. R. 33 (interrogatories), DEL. CH. CT. R. 34 (production of documents and things), DEL. CH. CT. R. 35 (physical and mental examinations of persons), DEL. CH. CT. R. 36 (requests for admissions), DEL. CH. CT. R. 37 (discovery disputes and sanctions), and DEL. CH. CT. R. 45 (subpoena power), with FED. R. CIV. P. 11, 12, 26, 30–37, 45.

¹⁸⁹ Oakley, *supra* note 179, at 380 (“Delaware Court of Chancery Rule 26 is a virtually exact copy of the 1970 version of Federal Rule 26, and does not incorporate any part of later amendments.”). The same is true for other jurisdictions. *Id.* at 362, 365–66, 369–70, 375.

2010 to slightly limit discovery to “the claims and defenses” of the parties, unless the judge finds there is good cause for obtaining additional subject matter discovery.¹⁹⁰ Similarly, the chancery rules have no presumptive limits on the number of depositions or the number of interrogatories, as the Federal Rules now do.¹⁹¹ But the Delaware Chancery amended its electronic discovery rules in 2013 to bring them in line with similar amendments to the FRCP.¹⁹²

In short, the nature and scope of discovery in civil litigation is very similar in federal and state courts. The tools of discovery deployed in federal courts (including interrogatories, depositions, the authority of attorneys to issue subpoenas, and the right to obtain all nonprivileged information, including ESI) are also available in state courts. Discovery is broad in scope, conducted by the parties themselves in accordance with the rules, and performed with minimal involvement by a judge. As Delaware shows, this does not mean that state rules are exact replicas of the federal rules, but that they operate in substantially the same way and produce substantially the same results. And, if anything, discovery in federal courts can sometimes be less permissive than in state courts.

III. CONSEQUENCES OF DISCOVERY FOR U.S. CORPORATE GOVERNANCE INSTITUTIONS

This Part describes in detail how litigation discovery has shaped U.S. corporate governance institutions.

Section A shows how the practices of offensive and defensive discovery generate and disseminate company internal information relevant to the determination of management misconduct at every stage of shareholder litigation, even prior to the beginning of formal discovery. It argues that the

¹⁹⁰ Compare DEL. CH. CT. R. 26(b)(1) (“Parties may obtain discovery regarding any matter, not privileged, *which is relevant to the subject matter involved in the pending action*, whether it relates to the claim or defense of the party seeking discovery or to the claim or defense of any other party, including the existence, description, nature, custody, condition and location of any documents, electronically stored information, or tangible things and the identity and location of persons having knowledge of any discoverable matter. It is not ground for objection that the information sought will be inadmissible at the trial if the information sought appears reasonably calculated to lead to the discovery of admissible evidence.” (emphasis added)), with FED. R. CIV. P. 26(b)(1) (allowing for discovery of any nonprivileged matter relevant to a party’s claim or defense but disposing of the “subject matter” language).

¹⁹¹ Compare DEL. CH. CT. R. 30(a), 33(a), with FED. R. CIV. P. 30(a)(2)(A)(i), 33(a)(1).

¹⁹² Leo E. Strine, Jr., *Delaware Court of Chancery Announces Rule Changes and New Discovery Guidelines*, METROPOLITAN CORP. COUNS., May 2013, at 35, 35, available at <http://www.metrocorpcounsel.com/pdf/2013/May/35.pdf>.

process of discovery generates positive information externalities and disciplines management *ex post* and *ex ante*.

Section B briefly discusses how the rules and practices of discovery have shaped mechanisms of *internal* corporate governance that protect against mismanagement and wrongdoing.

Section C describes changes in substantive law that have been influenced by discovery. We first examine developments of fiduciary duty doctrine, such as the “proceduralization” of the boardroom in the wake of *Smith v. Van Gorkom*.¹⁹³ Second, we describe the gradual transformation of shareholder information rights into vehicles for prelitigation discovery. Third, we consider the impact of information obtained through litigation discovery on changes in securities regulation.

Section D concludes that litigation discovery complements federal securities disclosure and serves as a form of *ex post* disclosure.

This Part shows that, even if one concedes that discovery is not cost-effective in every individual case (and abusive in some), discovery’s systemic benefits are more significant than heretofore understood.

A. Shareholder Litigation

Corporate law scholars have acknowledged the role of procedural rules in mitigating the risk of false positives (Type I Errors) and false negatives (Type II Errors) in the enforcement of corporate and securities laws.¹⁹⁴ Commenting on the burdens imposed on securities class action plaintiffs by the Private Securities Litigation Reform Act of 1995, Lynn A. Stout writes that “an example of a . . . false positive would be a judicial finding that a defendant had fraudulently misrepresented something, when in fact no fraud occurred.”¹⁹⁵ In contrast, a “false negative occurs when a court trying to decide whether the

¹⁹³ 488 A.2d 858 (Del. 1985), *overruled in part on other grounds by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

¹⁹⁴ Stout, *supra* note 42, at 711–12; *see also* Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1500 (2006) (discussing “empirical findings on the merits of post-PSLRA claims”); Sherrie R. Savett, *The Merits Matter Most and Observations on a Changing Landscape Under the Private Securities Litigation Reform Act of 1995*, 39 ARIZ. L. REV. 525, 531 (1997) (observing that the PSLRA “produces great delay in getting the case moving to the merits”); Thompson & Thomas, *supra* note 46, at 1758 (2004) (describing efforts to deter “strike” or “nuisance” suits).

¹⁹⁵ Stout, *supra* note 42, at 711.

defendant has committed fraud mistakenly finds there has been no fraud, even though fraud actually occurred.”¹⁹⁶ False positives lead to overdeterrence, whereas false negatives lead to underdeterrence. The risk of false positives could be affected by legislation that heightened or lowered burdens of proof, demanded or forgave heightened pleading standards for enforcers, required that bond be posted by plaintiffs for costs incurred as a result of litigation, adopted “loser pays” fee-shifting rules, or employed sanctions to deter marginal lawsuits.¹⁹⁷ On the other hand, Type II errors would increase where “meritorious suits [are] thrown out of court because plaintiffs, without discovery, cannot offer sufficient evidence of fraud.”¹⁹⁸

But neither Stout nor others¹⁹⁹ have appreciated that the availability of discovery per se in the United States (as compared to its absence in other countries) attacks the problem of false positives and false negatives at its core, because discovery reveals company internal information that bears directly on the merits of the parties’ claims and defenses.²⁰⁰ Broad discovery reduces both false positives and false negatives by increasing accuracy, because it affords access to critical information. The better the information, the greater the accuracy, and the less likely a judge is to conclude from a single rotten apple that every apple in the barrel has worms.

In re Caremark International Inc. Derivative Litigation,²⁰¹ which we discuss below, provides a good example of how discovery avoids Type I errors. In *Caremark*, the board was exonerated in a settlement that took place after discovery established that the board had not engaged in systematic oversight failures, in spite of \$250 million in fines and payments the corporation had to pay to public and private parties because employees of the company criminally violated federal and state health care laws. Chancellor Allen could make these findings in the civil case only because of extensive

¹⁹⁶ *Id.*

¹⁹⁷ See Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2192 (2010). The PSLRA used all of these methods to deter strike suits, or, in Stout’s terminology, avoid Type I errors. See Stout, *supra* note 42, at 711.

¹⁹⁸ Stout, *supra* note 42, at 712.

¹⁹⁹ See, e.g., Rose, *supra* note 197, at 2192.

²⁰⁰ Indeed, the elimination of Type I and Type II errors was foremost in the minds of the drafters of the Federal Rules. In an extended discussion of New York practice, for example, George Ragland notes “the ineffectiveness of restrictions upon the scope of the discovery as an aid in arriving at the truth.” RAGLAND, *supra* note 123, at 130. In particular, he cites the New York limitation that “the defendant can have no discovery except on his affirmative defenses.” *Id.* at 132.

²⁰¹ 698 A.2d 959 (Del. Ch. 1996).

civil discovery into what the board knew and what systems of monitoring and reporting the company had in place.²⁰²

Litigation discovery is integral to private enforcement and defines shareholder litigation in concrete and specific ways. Shareholder derivative actions are subject to different rules that intricately calibrate under what circumstances shareholders will be given the opportunity to obtain discovery against directors or officers of a corporate defendant. Specialized judicial doctrines and procedural rules have emerged in this context. The business judgment rule,²⁰³ the demand requirement,²⁰⁴ and the rule of *Auerbach v. Bennett*²⁰⁵—authorizing dismissal based on a corporate defendant’s nonadversarial self-investigation by a special litigation committee (SLC) of the board²⁰⁶—all considerably raise the threshold for obtaining discovery against a corporate defendant.

The hurdles to obtaining discovery that plaintiffs face have developed over time, mostly in response to a new wave of shareholder derivative actions during the 1970s.²⁰⁷ Perhaps not incidentally, the 1970s amendments to the FRCP represented the highpoint of liberal discovery, generating backlash by the business community.²⁰⁸

²⁰² *Id.* at 960–61, 971 (“Concerning the possibility that the Caremark directors knew of violations of law, none of the documents submitted for review, nor any of the deposition transcripts appear to provide evidence of it.”).

²⁰³ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (explaining that the business judgment rule “is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company” (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)) (internal quotation marks omitted)), *overruled in part on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944). Absent fraud, illegality, or self-dealing, the business judgment rule ordinarily bars courts from reviewing the decisions of corporate management for breach of fiduciary duty. *Van Gorkom*, 488 A.2d at 872–73.

²⁰⁴ See *Aronson*, 473 A.2d 805, 811–12; see also FED. R. CIV. P. 23.1 (setting pleading requirements for shareholder derivative actions). The demand requirement forces a potential plaintiff to first make a demand on the company’s board of directors to remedy the alleged misconduct, or to allege why such demand would be futile. See CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 369 (5th ed. 2006).

²⁰⁵ 393 N.E.2d 994, 999–1000 (N.Y. 1979). Delaware followed a substantially similar rule in *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981).

²⁰⁶ See ROBERT CHARLES CLARK, CORPORATE LAW § 15.2.3, at 646–47 (1986).

²⁰⁷ See Choi & Thompson, *supra* note 194, at 1492–93.

²⁰⁸ Marcus, *supra* note 31, at 748.

Subsequent developments in securities litigation resulted in the passage of the Private Securities Litigation Reform Act of 1995.²⁰⁹ The PSLRA raised the pleading requirements for securities fraud actions and instituted other measures, such as a mandatory stay of discovery during the pendency of any motions to dismiss, in response to a wave of securities class actions during the late 1980s and early 1990s.²¹⁰ When plaintiff-side attorneys responded by filing actions in state court, Congress passed the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which preempted most state securities litigation.²¹¹ SLUSA required that all federal securities actions be litigated in federal courts, to reinforce the PSLRA's restrictions on discovery.²¹² State cases filed in the aftermath of the PSLRA often had nearly identical claims to those brought by the same law firm in federal court.²¹³ SEC Chairman Arthur Levitt pointed out that "[i]t is reasonable to assume that these cases were filed primarily to get discovery for use in the Federal action."²¹⁴ The passage of SLUSA prevented plaintiffs from avoiding the discovery stay in federal court (because state courts would apply their own procedural rules).

Significantly for this Article's thesis, the political battles over securities class actions in the 1990s were about whether plaintiffs would get past the pleading stage and obtain discovery. While the corporate defense lobby successfully argued that the high discovery costs effectively allowed plaintiff-side firms to blackmail defendants into settling cases without merit, this is only one side of the story. As the plaintiff-side lobby argued in the debate about the PSLRA and SLUSA, discovery is what allows plaintiffs to expose management misconduct and mismanagement.

In sum, the special hurdles to obtaining discovery have evolved in response to the special threat of discovery for corporate defendants in probes of corporate internal wrongdoing.

²⁰⁹ Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

²¹⁰ H.R. REP. NO. 104-369, at 31-32 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 731. See generally Eugene Zelensky, Recent Legislation, *New Bully on the Class Action Block—Analysis of Restrictions on Securities Class Actions Imposed by the Private Securities Litigation Reform Act of 1995*, 73 NOTRE DAME L. REV. 1135, 1135-37 & n.19 (1998) (discussing legislative history).

²¹¹ Pub. L. No. 105-353, §§ 2(2), (5), 112 Stat. 3227, 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.).

²¹² *Id.* § 101(a), 112 Stat. at 3227-33.

²¹³ See H.R. REP. NO. 105-803, at 14 (1998) (Conf. Rep.).

²¹⁴ *Securities Litigation Abuses: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs*, 105th Cong. 49 (1997) (statement of Arthur Levitt, Chairman, SEC); see also Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions*, 77 B.U. L. REV. 69, 71 (1997).

The threat of discovery emanates from multiple factors. Discovery is a costly procedural mechanism per se.²¹⁵ Moreover, unlike civil law jurisdictions where the loser pays, U.S. procedure requires the parties to pay their own costs.²¹⁶ Thus, even if a defendant corporation succeeds on the merits in a shareholder action, it is saddled with its own litigation costs—which largely flow from discovery. In most shareholder actions, the corporate defendant's discovery costs will be higher than the plaintiff's discovery costs, because the corporation is the party being investigated. It is the defendant corporation that must search for, review, and produce almost all of the documents and witnesses.

But the threat of discovery is not limited to the high litigation costs incurred by corporate defendants. Quite apart from the costs, discovery increases chances that management will face liability for wrongdoing—whether related or unrelated to the claims set forth in any given complaint. Even if the threat of personal liability is remote,²¹⁷ discovery may uncover mistakes and misjudgments, some of which may have to be publicly acknowledged and corrected.²¹⁸ Such mistakes may result in direct and indirect financial penalties. Executives may be forced to forgo expected compensation.²¹⁹ And because executives often hold significant quantities of stock options they are also vulnerable to any decline in their company's stock price that may result from revelations of mismanagement. Discovery, moreover, threatens management with reputational costs, diminishing the value

²¹⁵ First, the parties must complete all discovery before trial. Therefore, they gather as much information as possible. See generally FED. R. CIV. P. 26 (a)(3)(B) (timing); FED. R. CIV. P. 26(b)(1) (scope of discovery). See *supra* note 42 on the costs of discovery.

²¹⁶ *Hensley v. Eckerhart*, 461 U.S. 424, 429 (1983) (affirming the “American Rule”).

²¹⁷ See Black et al., *Outside Director Liability*, *supra* note 44, at 1059; Cheffins & Black, *supra* note 44, at 1465.

²¹⁸ M. Todd Henderson, *Impact of the Rakoff Ruling: Was the Judge's Scuttling of the SEC/BofA Settlement Legally Pointless or Incredibly Important—or Both?*, WALL ST. LAW., Nov. 2009, at 1, 6 (“[A] suit generates not only legal costs but also negative publicity and the potential that even more damning information will be revealed during discovery or the trial.”).

²¹⁹ *Id.* at 6 (noting that Bank of America's CEO, Kenneth Lewis, was forced to “leav[e] the bank, after reportedly being forced to give up many millions of dollars in compensation as a result of the suit and the handling of the merger with Merrill”). Note that this was nearly a year before the court ruled partially against defendants' motion to dismiss in the plaintiff shareholders' action. See *In re Bank of Am. Corp. Sec., Derivative, & ERISA Litig.*, 757 F. Supp. 2d 260, 269–70 (S.D.N.Y. 2010); Tami Luhby, *Bank of America CEO Ken Lewis to Retire*, CNNMONEY (Sept. 30, 2009, 6:53 PM), http://money.cnn.com/2009/09/30/news/companies/bank_of_america_ken_lewis_resigns/index.htm.

of an executive's most important asset.²²⁰ Finally, management also faces opportunity costs as a result of discovery.

The rules governing shareholder litigation are thus structured by determinations about when to allow, and when to deny, access to discovery. Special features that characterize contemporary shareholder litigation in the United States—and that are generally taken for granted by U.S. scholars—emerged and developed because of the unique role that discovery plays in U.S. civil procedure. These characteristics do not exist in other countries, because discovery does not exist.

Some have objected to our thesis on the central importance of discovery by arguing that discovery materials, like corporate internal documents, e-mails, and witness testimony, generally do not become available to nonlitigants. Where discovery materials are subject to confidentiality agreements, only the litigating parties have access to these materials. And the public only gains access to information obtained through discovery where such information is disclosed during hearings in open court—principally at trial. But cases are almost always settled before trial. Therefore, discovery cannot generate the kind of information externalities or disciplinary results that we suggest.

These issues are addressed in subsections 1 through 5 below.

In response, we first note that some shareholder derivative actions, like *Disney*²²¹ and *Van Gorkom*,²²² do go to trial, as do some securities class actions, like the Apollo Group Securities litigation,²²³—although this is admittedly rare.²²⁴ We address such cases in subsection 1.

²²⁰ See Chelsea C. Liu, Corporate Litigation, Corporate Governance Restructuring, and Executive Compensation 221–81 (Jan. 2013) (unpublished Ph.D. dissertation, University of Adelaide), <http://digital.library.adelaide.edu.au/dspace/bitstream/2440/81971/3/02whole.pdf> (reviewing literature on executive reputational damages resulting from litigation and providing empirical evidence).

²²¹ *Disney II*, 825 A.2d 275 (Del. Ch. 2003).

²²² *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), *overruled in part by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

²²³ See *In re Apollo Grp. Inc. Sec. Litig.*, No. CV-04-2147-PHX-JAT, 2008 WL 410625, at *1 (D. Ariz. Feb. 13, 2008).

²²⁴ See Kevin LaCroix, *Plaintiffs Prevail in Mixed Jury Verdict in Household International Securities Fraud Trial*, D&O DIARY (May 7, 2009), <http://www.dandodiary.com/2009/05/articles/securities-litigation/plaintiffs-prevail-in-mixed-jury-verdict-in-household-international-securities-fraud-trial/> (“According to data compiled by the Securities Litigation Watch, [as of 2009] only 21 cases have gone to trial since the PSLRA was enacted in 1995.” (citation omitted)).

Discovery, however, is presumptively public before and after trial.²²⁵ Plaintiffs are not required to enter confidentiality agreements that cover documents and testimony produced during discovery. Moreover, confidentiality agreements have their limitations. There are many examples of discovery materials becoming public before trial, including materials that are marked “confidential.”²²⁶ Two situations in which this occurs are on summary judgment, where all materials that are relied upon as evidence must be disclosed,²²⁷ and during settlement of derivative litigation and class actions, which require supporting discovery. We discuss these scenarios in subsections 2 and 3.

Finally, even if discovery materials are not filed with the court, explored during settlement hearings, or otherwise made available to the general public, discovery nonetheless generates detailed information about potential corporate internal wrongdoing during defensive discovery and during prediscovery internal investigations. In both cases, such information is shared with gatekeepers, and typically with regulators and parties to any settlement. We discuss these scenarios in subsections 4 and 5.

1. *Cases That Go to Trial*

Critics of shareholder litigation have focused on discovery costs,²²⁸ especially where, as in the Disney shareholder derivative action, directors avoid personal liability.²²⁹ Recent empirical studies show that managers of

²²⁵ *Supra* notes 67–68.

²²⁶ See, e.g., Karen Gullo, *Goldman, Merrill E-Mails Show Naked Shorting, Filing Says*, BLOOMBERG (May 16, 2012, 5:34 PM), <http://www.bloomberg.com/news/2012-05-15/goldman-merrill-e-mails-show-naked-shorting-filing-says.html>. See also, for example, *Legacy Tobacco Documents Library*, U.C.S.F., <http://legacy.library.ucsf.edu> (last visited May 28, 2014), which contains “more than 14 million documents (80+ million pages) created by major tobacco companies related to their advertising, manufacturing, marketing, sales, and scientific research activities.” A simple search turns up more than two million documents, which (based on spot checks) are Bates-stamped, and some of which are marked “Confidential: Tobacco Litigation.”

²²⁷ For example, in the Bank of America case, Neil Cotty’s deposition transcript was marked “confidential,” but was nonetheless filed, and available online, as an exhibit to the plaintiffs’ motion for summary judgment. See Continued Videotaped Deposition of Neil Andrew Cotty, *supra* note 69.

²²⁸ See sources *supra* note 42.

²²⁹ STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 8.5, at 403–04 (2002) (“In almost all cases, the legal fees collected by plaintiff counsel exceeded the monetary payment to shareholders. . . . A radical solution would be elimination of derivative litigation.”). But see Thompson & Thomas, *supra* note 46, at 1172–73.

public companies are rarely subject to personal liability, and liability for outside directors is almost nonexistent.²³⁰

But our discussion of the *Disney* litigation shows that, independent of any remedy, shareholder actions reveal and publicize substantial information about corporate internal practices, controls, judgments, and failures, including information about culpable wrongdoing and wrongdoing that falls just short of liability. The knowledge and information produced by discovery about what really happened and how executives run their companies is an informational public good that private enforcement generates for markets, institutional investors, regulators, courts, gatekeepers, self-regulatory organizations, and the general public.²³¹

The public good of information generated by shareholder litigation is illustrated by the *Disney* example. The *Disney* court articulated new standards of fiduciary duty in board decision-making, relying on the facts revealed by discovery, which became part of a much broader corporate governance discussion about executive pay practices.²³² Discovery in this case, and many other cases, such as *Enron*, *Worldcom*, and *Tyco*, informed the broader executive pay discussion, which ultimately led the SEC to require that public companies include a compensation, disclosure, and analysis (CDA) section in their periodic disclosures.²³³ As Thompson and Thomas have stated,

Public company suits continue to be filed and to make new law. The impact of decisions in derivative cases like *Caremark*, *Disney*, and *Oracle* goes well beyond the outcome of the cases themselves. These decisions changed the rules for future legal practice by allowing well-motivated legal counselors to get their clients to accept better conduct and procedures.²³⁴

²³⁰ See Black et al., *Liability Risk for Outside Directors*, *supra* note 44; Black et al., *Outside Director Liability*, *supra* note 44; Cheffins & Black, *supra* note 44.

²³¹ See Gorga & Halberstam, *supra* note 56, at 1168–69 (discussing the public goods characteristics of knowledge).

²³² *Supra* Part I.B.

²³³ See Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54302A, Investment Company Act Release No. 27444A, 71 Fed. Reg. 53,158 (Sept. 8, 2006); see also Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L. 675, 692 (2005) (affirming that "[t]he Disney litigation, revived in the post-Enron environment, has become, regardless of outcome, an extended morality tale on the board's responsibility to monitor executive compensation" (footnote omitted)).

²³⁴ Thompson & Thomas, *supra* note 46, at 1749 (footnotes omitted). For an example of such advice on best practices after *Disney*, see Kevin M. LaCroix, *Board Decision-Making Practices After the Disney Decision*, OAKBRIDGE INSIGHTS (OakBridge Ins. Servs., Bloomfield, Conn.), Apr. 2006, available at

Just as securities regulation is influenced by litigation discovery, shareholder litigation is also frequently driven by the actions of the securities regulator. Administrative agencies play a crucial role in investigating and requiring information about alleged corporate wrongdoing. This role results in an important interaction between shareholder private litigation and SEC investigations. Plaintiffs' firms will often file shareholder actions against public companies after the SEC announces an investigation.²³⁵ In this respect, discovery is not the only mechanism available for *ex post* information gathering and may be induced by other regulatory actions.

But investigations and enforcement actions by the SEC have serious shortcomings with regard to information production. SEC investigations are generally confidential, and those confronted with an SEC enforcement action will provide the SEC with information, including documents and testimony, subject to a confidential treatment request. Also, unlike a civil complaint, an SEC notice of formal investigation is confidential.²³⁶ Discovery, by contrast, promotes an important informational flow to the judiciary, to the administrative regulatory authorities, and to the public.

Moreover, the SEC cannot pursue all cases that it should. There are many reasons why this is so. The SEC does not have nearly enough staff or budgetary resources to investigate every allegation of wrongdoing.²³⁷

<http://www.rtspecialty.com/rtproexec/insights/Issue1DisneyArticle.pdf>. Oakbridge is a leading directors and officers liability (D&O) insurer.

²³⁵ Kevin LaCroix, *First the Regulatory Investigation, Then the Securities Suit*, D&O DIARY (Dec. 9, 2013), <http://www.dandodiary.com/2013/12/articles/securities-litigation/first-the-regulatory-investigation-then-the-securities-suit/>.

²³⁶ See Ralph C. Ferrara & Philip S. Khinda, *SEC Enforcement Proceedings: Strategic Considerations for When the Agency Comes Calling*, 51 ADMIN. L. REV. 1143, 1151 (1999); see also DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, *SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS* 668 (3d ed. 2012); cf. Ferrara & Khinda, *supra*, at 1149 (“[C]ounsel should request that [during the course of an informal inquiry a witness examination] be done via an interview rather than through testimony, *i.e.*, not under oath and without the use of a court reporter. Interviews are generally preferable whenever parallel proceedings or litigation exists or is likely, as such discussions with the staff will not generate witness transcripts (as would be the case with formal testimony) that may be discoverable . . .”).

²³⁷ See, e.g., U.S. GEN. ACCOUNTING OFFICE, GAO-09-358, *SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN ENFORCEMENT DIVISION 24* (2009) (finding that “resource challenges . . . [have delayed cases], reduc[ed] the number of cases that can be brought, and potentially undermin[ed] the quality of cases”); U.S. GEN. ACCOUNTING OFFICE, GAO-02-302, *SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES* 11–19 (2002) (finding that workload growth and limited resources have forced the SEC to be selective in its enforcement, have delayed investigations and case closings, and raise general concerns about SEC's enforcement; the SEC cannot pursue every case that it should); Joshua Gallu, *SEC Enforcement Story Doesn't Add Up for 2011*, BLOOMBERG (March 2, 2012, 12:00 AM), <http://www.bloomberg.com/news/2012-03->

Furthermore, according to the theory of regulatory capture put forward by George Stigler, the SEC may not have the right incentives to do so.²³⁸ The SEC staff may suffer from selection or cognitive biases, or make mistakes in evaluating cases, which may interfere with efficient oversight.²³⁹ For example, the SEC may under-monitor smaller firms or foreign issuers,²⁴⁰ or choose to focus on cases with greater repercussions on Wall Street. The SEC may focus on certain types of claims, in which wrongdoing is easier to observe. Finally, the SEC may simply not have the authority to take action in cases in which there are regulatory gaps, when the supposed wrongdoing falls under the overlapping authority of state law or a foreign jurisdiction.

All of these administrative issues, biases, and hindsight may prevent the regulator from making the best or most efficient decisions from a market perspective. In situations where the regulator has failed to pursue enforcement actions, the system must rely on the work of private attorneys general to oversee market participants and investigate misconduct. As the *Disney* litigation and many other cases show, often a complaint by shareholders is first brought by private plaintiffs.²⁴¹

As described in our discussion of the *Disney* litigation, the very process of discovery disciplines management, aside from the generation of informational public goods. Becoming the object of the kind of intense adversarial scrutiny that the *Disney* management endured is burdensome and disciplinary per se. Discovery forces managers to answer questions they do not want to answer; it challenges their power and authority in a public setting; it requires them to reveal their business secrets; and they face contempt and possible criminal charges if they engage in misrepresentations. The process can result in

02/sec-accounting-of-record-enforcement-year-in-2011-doesn-t-add-up.html (claiming that SEC filed fewer enforcement actions in 2011 than in 2009). One response is to dramatically increase the resources of the SEC. See Rose, *supra* note 197, at 2209–10. But the SEC's congressional appropriations have already tripled since 2002. And there are political limits to further increases. NAGY ET AL., *supra* note 236, at 665.

²³⁸ See generally George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (discussing a theory for regulatory capture according to a supply and demand model for regulation).

²³⁹ See generally Christine Jolls, *Behavioral Law and Economics* 11–18 (Nat'l Bureau of Econ. Research, Working Paper No. 12879, 2007), available at <http://www.nber.org/papers/w12879> (discussing biases and judgment errors by rational actors).

²⁴⁰ See Natalya Shnitser, Note, *A Free Pass for Foreign Firms? An Assessment of SEC and Private Enforcement Against Foreign Issuers*, 119 YALE L.J. 1638, 1645–46 (2010); see also Érica Gorga, Is the U.S. Law Enforcement Stronger? The Case of Securities Fraud by Brazilian Corporations and Lessons for the Private and Public Enforcement 34 (Feb. 5, 2014) (unpublished manuscript) (on file with authors).

²⁴¹ See *supra* Part I.B.

employment and reputational consequences.²⁴² Discovery may trigger a duty to file a Form 8-K with the SEC or restate earnings (as was typical in the stock options backdating cases), because once obtained, whether routinely or through litigation discovery, material information must be disclosed. Such probes also raise the specter of criminal liability and other sanctions by regulators.²⁴³ Finally, there are opportunity costs associated with the process for all executives affected by discovery.

The threat of discovery creates positive externalities, because it not only affects parties involved in the particular litigation, but signals to management's peers at other corporations that they are likely to be subject to similar scrutiny²⁴⁴ at some point during their tenure. Thus, they must exercise extreme care in the discharge of their disclosure and oversight responsibilities to make sure they are not personally damaged in this event.

Cases informed by extensive fact investigation through discovery that go to trial result in a decision on the merits. This will shape case law development and legal change, as we discuss in section C below. But what about cases that do not go to trial? These include most shareholder litigation. Critics contend these cases do not have the benefit of exposing information to the public because discovery is not revealed at trial.

In response, we describe how cases on summary judgment also publicize information, as do cases settled prior to summary judgment. Even cases settled prior to the motion to dismiss, as we will show, often generate substantial information on corporate internal practices and wrongdoing. An important point that has been overlooked is that defensive discovery produces at least as much information as adversarial discovery produces, and that information is shared with gatekeepers and regulators even prior to the motion to dismiss. The same is true for corporate internal investigations.

Below we examine what information is revealed at each stage in the litigation process.

²⁴² See Rose, *supra* note 197, at 2191.

²⁴³ See Paul J. Cohen et al., *Investigations in the United States*, in CORPORATE INTERNAL INVESTIGATIONS: AN INTERNATIONAL GUIDE, *supra* note 53, at 53, paras. 3.13–20, at 59–62, paras. 3.134–.142, at 112–15.

²⁴⁴ Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339, 340 (2000) (“[L]aw changes behavior by signaling the underlying attitudes of a community or society. . . . [T]he information signaled by legislation and other law affects [people’s] behavior.”).

2. Cases Resolved at Summary Judgment

Cases that go through discovery and are resolved upon the filing of a motion for summary judgment will typically produce a substantial portion of the information that the parties would have presented at trial. Motions for summary judgment are decided based on evidence submitted to the court by the parties.²⁴⁵ Motion papers include statements of fact that identify and explain why, based on all the evidence presented to the court on the motion, there is no need to go to trial.²⁴⁶ Admissible evidence is attached to the motion in the form of exhibits.²⁴⁷ In shareholder actions, plaintiffs may present the court with thousands of pages of compromising documents, excerpts from deposition transcripts, responses to interrogatories and requests for admission, and other admissible evidence. This information is public, because it can be obtained from the court's clerk. For more than a decade now, the federal trial courts have required electronic filing on PACER, making this information readily available online, and increasingly entire dockets are becoming available on Bloomberg and other legal information services.²⁴⁸

The 2012 settlement of the Bank of America (BoFA) securities class action litigation concerning BoFA's 2008 acquisition of Merrill Lynch illustrates how extensive the information is at this stage.²⁴⁹ Plaintiffs claimed, *inter alia*, that BoFA had failed to disclose more than \$15 billion in late-2008 Merrill Lynch losses, as well as billions of dollars set aside to pay bonuses to Merrill Lynch executives, in the proxy statements to the merger agreement.²⁵⁰ Shortly before the parties reached a settlement on June 20, 2012, plaintiffs and defendants

²⁴⁵ FED. R. CIV. P. 56.

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ PACER stands for "Public Access to Court Electronic Records," which is "an electronic public access service that allows users to obtain case and docket information from federal appellate, district and bankruptcy courts, and the PACER Case Locator via the Internet. PACER is provided by the federal Judiciary in keeping with its commitment to providing public access to court information via a centralized service." PACER, <http://www.pacer.gov> (last visited May 28, 2014). Attorneys who practice in federal court, legal academics, law students, librarians, and journalists working for a major news organization have full access to documents filed with the federal courts in every case across the country. Proprietary databases, such as Bloomberg Law, will also include content provided by PACER.

²⁴⁹ See *In re Bank of Am. Corp., Sec., Derivative, & ERISA Litig.*, 757 F. Supp. 2d 260, 274–84 (S.D.N.Y. 2010). This case consolidated securities fraud, derivative, and ERISA claims against Bank of America for misstatements and omissions during the acquisition of Merrill Lynch following the 2008 financial meltdown. The full docket, including all pleadings, motions, court decisions, and exhibits filed with the court, are readily available, for a per-page fee, on PACER.

²⁵⁰ *Id.* at 278–79.

each moved for summary judgment.²⁵¹ In the month of June alone, the parties attached at least 600 exhibits—including thousands of pages of deposition transcripts, documents, e-mails, confidential memos, and other information, to support their motions.²⁵² Again, all of these exhibits, and thousands of others, are readily available online to anyone with a PACER account.

The exhibits paint a picture of top executives at BofA pointing fingers at one another and their attorneys as to who was responsible for negotiating, overseeing, and monitoring key terms of the merger and for disclosing relevant material information in their SEC filings.²⁵³ Collectively, the exhibits allow the same kind of step-by-step reconstruction of the entire negotiation and decision-making process of BofA's acquisition of Merrill Lynch, including the part that individual managers and their inside and outside advisors played in the events as they unfolded. In an article reviewing the plaintiffs' filings, including deposition testimony by top executives at BofA, the *New York Times* wrote the following:

What Bank of America's top executives, including its chief executive then, Kenneth D. Lewis, knew about Merrill's vast mortgage losses and when they knew it emerged in court documents filed Sunday evening in a shareholder lawsuit being heard in Federal District Court in Manhattan.

. . . .

The filing in the shareholder suit included sworn testimony from Mr. Lewis in which he concedes that before Bank of America stockholders voted to approve the deal he had received loss estimates relating to the Merrill deal that were far greater than reflected in the figures that had appeared in the proxy documents filed with regulators.²⁵⁴

The settlement was negotiated even as the compromising discovery materials were being filed with the court. The \$2.43 billion settlement, in

²⁵¹ Motion for Summary Judgment, *In re Bank of Am. Corp.*, 757 F. Supp. 2d 260 (No. 09-MD-2058-PKC); Order, *In re Bank of Am. Corp.*, 757 F. Supp. 2d 260 (No. 09-MD-2058-PKC), ECF No. 620 (giving notice that the court had been advised of an executed settlement agreement on June 20, 2012).

²⁵² See Docket Items 577–659, Civil Docket, *In re Bank of Am. Corp.*, 757 F. Supp. 2d 260 (No. 09 MD 2058 (PKC)).

²⁵³ See, e.g., Continued Videotaped Deposition of Neil Andrew Cotty, *supra* note 69, at 14 (claiming he did not understand that Merrill Lynch was selling substantial assets to cut their balance sheet days before the deal was approved by the shareholders by stating, “My only comment earlier . . . that it would have come from either Joe or [BofA CEO] Ken [Lewis], but I don’t recall a discussion on the balance sheet at December 3rd”).

²⁵⁴ Gretchen Morgenson, *Merrill Losses Were Withheld Before Merger*, N.Y. TIMES, June 4, 2012, at A1.

which BofA admitted to no wrongdoing, was finalized within weeks of the summary judgment filings.²⁵⁵

The *Bank of America* case illustrates how settlement prior to trial does not necessarily affect the publication of information revealed by discovery. Top management did not escape scrutiny in extensive depositions. Encroaching on BofA's attorney-client privilege, the court even permitted the deposition of BofA's longtime outside counsel at Wachtell Lipton, one of the most powerful corporate law firms in the United States.²⁵⁶

This case also illustrates how the very information produced by discovery influences the parties' choices about going to trial. Settlement rates are likely to increase where parties have full access to the facts and information before trial, as intended by the rule-makers.²⁵⁷ Alison Frankel, for example, wrote for *Thompson Reuters* that the "settlement reflects the nuanced understanding of Bank of America's failure to disclose billions of dollars in escalating Merrill Lynch losses that shareholders' counsel gained through dozens of depositions and millions of pages of discovery."²⁵⁸

Settlements before trial thus introduce a selection bias into the empirical debate about outcomes in shareholder litigation because the very cases that

²⁵⁵ Jessica Silver-Greenberg & Susanne Craig, *Bank of America Settles Suit Over Merrill for \$2.43 Billion*, DEALBOOK (Sept. 28, 2012, 9:19 PM), http://dealbook.nytimes.com/2012/09/28/bank-of-america-to-pay-2-43-billion-to-settle-class-action-over-merrill-deal/?_php=true&_type=blogs&r=0.

²⁵⁶ While depositions of attorneys are disfavored, defendants who claim to have relied on advice of counsel may waive their attorney-client privileges in this regard, thus opening the door to testimony by their counsel. See, e.g., *Arthur Andersen LLP v. United States*, 544 U.S. 696, 699 (2005); *Rhone-Poulenc Rorer Inc. v. Home Indem. Co.*, 32 F.3d 851, 863 (3d Cir. 1994); *Joy v. North*, 692 F.2d 880, 893 (2d Cir. 1982); *In re Bank of Am. Corp.*, 757 F. Supp. 2d at 279; *In re ML-Lee Acquisition Fund II, L.P.*, 859 F. Supp. 765, 766 (D. Del. 1994).

²⁵⁷ In an economic model of litigation and settlement decisions under imperfect information, Bebchuk argues that discovery requirements "increase the probability of settlement." Bebchuk, *supra* note 101, at 413. In a model with one-sided discovery, Sobel shows that mandatory discovery rules reduce the probability of trials. Joel Sobel, *An Analysis of Discovery Rules*, LAW & CONTEMP. PROBS., Winter 1989, at 133, 133; see also Robert D. Cooter & Daniel L. Rubinfeld, *An Economic Model of Legal Discovery*, 23 J. LEGAL STUD. 435, 436 (1994) ("[D]iscovery increases settlements and decreases trials by organizing the voluntary exchange of information."). In civil law jurisdictions, which do not allow broad discovery, settlement rates are lower. Huang reports an interesting development after the introduction of civil discovery in Taiwan in a 2000 legal reform. Kuo-Chang Huang, *Does Discovery Promote Settlement? An Empirical Answer*, 6 J. EMPIRICAL LEGAL STUD. 241 (2009). He shows that settlement rates for civil cases consistently increased over time in all district courts following the adoption of the discovery regime. *Id.* at 257–59.

²⁵⁸ Alison Frankel, *How BofA Was Forced to Settle \$2.43 Bln Merrill Class Action*, REUTERS (Oct. 1, 2012), <http://blogs.reuters.com/alison-frankel/2012/10/01/how-bofa-was-forced-to-settle-2-43-bln-merrill-class-action/>.

could lead to liability are likely to be settled; in other words, the same cases in which discovery has turned up evidence that would encourage the defendants to settle.

All class action and derivative settlements must be approved by the court. As the *Bank of America* case showed, judges will sometimes insist on additional discovery before approving a settlement.²⁵⁹ The more damning the information revealed by discovery (or internal investigations, discussed below), the more likely a case is to settle before trial. Defendants have the incentive to settle because of the risk of an adverse litigation outcome, the publicity that a trial brings, and because the directors' and officers' liability insurance will cover settlement costs. The lack of liability, including personal liability, thus does not necessarily show that shareholder litigation fails to discipline corporate wrongdoing—as most of the literature concludes. Information about alleged wrongdoing is revealed and will be assessed by market participants, with the potential for generating serious reputation damages. And settlement values will also reflect the seriousness of the alleged wrongdoing.

We show in the next subsection how cases resolved during discovery also reveal substantial information about mismanagement or management misconduct.

3. *Cases Settled Prior to Summary Judgment*

In cases settled prior to summary judgment, discovery materials are not usually filed with the court unless required to support a motion.²⁶⁰ But discovery materials are nonetheless available under various circumstances. In federal securities class actions, the parties may file discovery materials with the court in connection with the motion for class certification.²⁶¹ In shareholder derivative actions, plaintiffs may support their complaint with evidence

²⁵⁹ See, e.g., Peter J. Henning, *Behind Rakoff's Rejection of Citigroup Settlement*, DEALBOOK (Nov. 28, 2011, 5:14 PM), <http://dealbook.nytimes.com/2011/11/28/behind-judge-rakoffs-rejection-of-s-e-c-citigroup-settlement/>.

²⁶⁰ FED. R. CIV. P. 5(d)(1) (“[D]isclosures under Rule 26(a)(1) or (2) and the following discovery requests and responses must not be filed until they are used in the proceeding or the court orders filing . . .”).

²⁶¹ Until the Supreme Court held that plaintiffs were not required to prove materiality (an essential element in securities fraud claims) on a motion for class certification, plaintiffs conducted discovery and filed relevant admissible evidence with the court on this issue. See *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1191, 1202 (2013).

obtained by means of a shareholder information request.²⁶² And judges must approve settlements in shareholder actions, which requires a hearing and a “finding that it is fair, reasonable, and adequate.”²⁶³ In so doing, courts may request the full settlement agreement from the parties and review what discovery revealed. This occurred in the *Caremark* case, Delaware’s most important oversight case.²⁶⁴ The court may also require additional discovery before approving a settlement.

Chancellor Allen’s opinion in *Caremark* was issued on a motion to approve a settlement in a consolidated derivative action that was negotiated prior to summary judgment.²⁶⁵ Nonetheless, the court engaged in a lengthy examination of the factual record.²⁶⁶ In *Caremark*, plaintiffs alleged that Caremark’s directors had breached their fiduciary duty of care, for failure to oversee employees who violated federal and state laws governing health care providers, resulting in a criminal indictment of the company and a \$250 million fine.²⁶⁷ In reviewing the standard for approving settlements in shareholder derivative actions, Chancellor Allen held that

[a] motion of this type requires the court to assess the strengths and weaknesses of the claims asserted *in light of the discovery record* and to evaluate the fairness and adequacy of the consideration offered to the corporation in exchange for the release of all claims made or arising from the facts alleged. . . . In this effort the court does not determine contested facts, but evaluates the claims and defenses *on the discovery record* to achieve a sense of the relative strengths of the parties’ positions.²⁶⁸

Allen proceeded to review the facts that emerged in discovery, concluding that

²⁶² See DEL. CODE ANN. tit. 8, § 220 (West Supp. 2014).

²⁶³ FED. R. CIV. P. 23(e)(2). The Advisory Committee Notes to the 2003 Amendments state that “[t]he court must make findings that support the conclusion that the settlement is fair, reasonable, and adequate. The findings must be set out in sufficient detail to explain to class members and the appellate court the factors that bear on applying the standard.” FED. R. CIV. P. 23 advisory committee’s note (2003 Amendments); see also FED. R. CIV. P. 23.1 (governing derivative actions); Donald F. Parsons, Jr. & Jason S. Tyler, *Docket Dividends: Growth in Shareholder Litigation Leads to Refinements in Chancery Procedures*, 70 WASH. & LEE L. REV. 473, 497 (2013) (citing *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1283 (Del. 1989)) (“[T]he Court of Chancery vigilantly examines the merits of every settlement of a representative action, whether objected to or not, to determine whether, in the exercise of the reviewing court’s independent business judgment, the settlement is in the shareholders’ interest.”).

²⁶⁴ *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 961 (Del. Ch. 1996).

²⁶⁵ *Id.* at 960.

²⁶⁶ See *id.* at 961–66.

²⁶⁷ *Id.* at 960–61.

²⁶⁸ *Id.* at 961 (emphasis added).

in light of the discovery record, . . . there is a very low probability that it would be determined that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise. Indeed the record tends to show an active consideration by Caremark management and its Board of the Caremark structures and programs that ultimately led to the company's indictment and to the large financial losses incurred in the settlement of those claims. It does not tend to show knowing or intentional violation of law.²⁶⁹

Discovery revealed detailed information about the day-to-day operations of the firm, Caremark's management structure, fees paid to physicians for services to Medicare and Medicaid, efforts made to ensure compliance with company policies and contracts, legal advice by inside and outside counsel, uncertainty about relevant legal interpretations, the scope of ongoing government investigations, an internal audit plan, policies governing management supervision, and employee training to ensure legal compliance and adherence to company ethics rules.²⁷⁰ Adversarial discovery and factual development were key to Chancellor Allen's decision that "[t]he Board appears to have been informed about [these] and other efforts to assure compliance with the law."²⁷¹

The *Caremark* settlement included several corporate governance improvements, including (a) changes in compensation structure, commissions, and fees paid variously to employees, agents, physicians and health care providers; (b) mandatory review of material changes in government health care regulations and their implications for Caremark on a semi-annual basis by the full Board; (c) written disclosure of the financial relationship between Caremark and health care providers to patients; (d) the establishment of a four-member board committee on compliance and ethics (with at least two independent directors) to meet at least four times a year to carry out these policies, monitor compliance, and report back to the full board; and (e) direct reporting by corporate officers to the committee, which was charged with reviewing and approving contracts and new contract forms with the assistance of outside counsel.²⁷²

²⁶⁹ *Id.*

²⁷⁰ *Id.* at 962–63.

²⁷¹ *Id.* at 963.

²⁷² *Id.* at 966.

In sum, although the case settled before summary judgment, *Caremark* did publicize facts obtained through discovery.²⁷³ More generally, the *Caremark* decision represented an important development in corporate case law. While the pronouncements of the court were technically mere dicta, the court identified a new legal standard that only “sustained or systematic failure . . . to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists [sic]—will establish the lack of good faith that is a necessary condition to liability.”²⁷⁴ This “*Caremark* standard” was subsequently applied in board oversight cases.²⁷⁵

One standard criticism of settlements in shareholder derivative and class actions is that they do not accurately reflect the merits of the case.²⁷⁶ A judge may approve a settlement that awards attorneys’ fees to plaintiff’s counsel only if the parties can show a benefit to the corporation.²⁷⁷ This benefit need not be pecuniary, but may consist in corporate governance improvements.²⁷⁸

But the critics maintain that such corporate governance improvements are typically devised by the defendant corporation’s counsel after a settlement has been reached and are designed to minimize structural changes to the defendant corporation’s management routines.²⁷⁹ To the extent that such changes are meaningful, they would have been undertaken anyway, but instead they are attributed to the litigation so that the plaintiffs’ attorneys can get their fees.²⁸⁰

²⁷³ *Id.* at 961–66. Chancellor Allen acknowledged that “none of the documents submitted for review, nor any of the deposition transcripts appear to provide evidence of [the possibility that the *Caremark* directors knew of violations of law].” *Id.* at 971.

²⁷⁴ *Id.* at 971.

²⁷⁵ See Thompson & Thomas, *supra* note 46, at 1749 (pointing out the importance of *Caremark* beyond the outcome of the case).

²⁷⁶ Alexander, *supra* note 38, at 499; Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 55–56 (1991); see, e.g., Kevin M. LaCroix, *More Options Backdating Settlements and Other Web Notes*, D&O DIARY (Sept. 8, 2007, 3:44 PM), <http://dandodiary.blogspot.com/2007/09/more-options-backdating-settlements-and.html> (“[F]or the cases that are settling, companies are agreeing to adopt some mild corporate therapeutics, and paying some negotiated amount supposedly corresponding to the amount of the plaintiffs’ attorneys’ fees. The sole benefit to the shareholders on whose behalf the plaintiffs . . . ostensibly proceeded is the ostensible benefit of the corporate therapeutics. I am sure there are skilled advocates who have persuaded themselves, at least, that this process represents something more than a highly stylized form of larceny.”).

²⁷⁷ See Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 2 (1999) (discussing the “substantial benefit” rule).

²⁷⁸ See *id.* at 1–3.

²⁷⁹ See LaCroix, *supra* note 276.

²⁸⁰ See, e.g., Daniel Fisher, *Lawyer Fights \$10 Million Fee for “Cosmetic” Johnson and Johnson Settlement*, FORBES (Sept. 4, 2012, 6:40 PM), <http://www.forbes.com/sites/danielfisher/2012/09/04/lawyer-fights-10-million-fee-for-cosmetic-johnson-johnson-settlement/>.

Such “corporate therapeutics” are thus largely seen as window dressing, which adds no value, but merely serves to ensure judicial acceptance of the settlement.²⁸¹ On this view, lawyers maximize their returns and the whole settlement effort constitutes nothing more than a rent-seeking device. Settlement negotiations are not affected by discovery, and the judge merely rubber-stamps the settlement. According to this rationale, parties and the litigation itself do not benefit from discovery, because litigation results have been somehow fixed *ex ante*.

There are many examples one could cite to make this point. A general observer might find the \$2.75 million fee award that Barnes & Noble paid plaintiff’s counsel (in connection with the settlement of a shareholder derivative action for stock options backdating) hard to justify as a fair price for relatively minor changes in internal controls (considering that, in addition, the company spent millions of dollars on its own litigations costs).²⁸² However, Barnes & Noble’s 2006 annual report shows that more was accomplished. It includes extensive findings of management, oversight, and accounting failures and reports the repayment of \$2 million to the company and further repricing, saving another \$2.64 million.²⁸³ If one reviews Barnes & Noble’s own press release of the findings of the special litigation committee, it is clear that more was accomplished than the adoption of superficial “corporate therapeutics” and that the SLC’s report was hardly a whitewash.²⁸⁴

Stock option awards can end up costing a company like Barnes & Noble tens or even hundreds of millions of dollars. And an empirical study shows significant reputational penalties for compensation committee members of firms involved in backdating.²⁸⁵ The negative view of “corporate therapeutics” thus exaggerates and oversimplifies. It neglects that important information

²⁸¹ See sources cited *supra* note 276.

²⁸² See Barnes & Noble, Inc., Annual Report (Form 10-K), 20 (Apr. 2, 2008).

²⁸³ Barnes & Noble, Inc., Annual Report (Form 10-K), exhibit 13.1, at F-6 to F-7 (Apr. 4, 2007).

²⁸⁴ See Press Release, Barnes & Noble, Inc., Barnes & Noble, Inc. Announces Findings of Special Committee Review of the Company’s Stock Options Practices and Adoption of Remedial Recommendations (Apr. 4, 2007), available at http://www.barnesandnobleinc.com/press_releases/2007_april_4_stock_options_practices.html (detailing wrongdoing that internal corporate investigation uncovered with regard to stock options backdating). Note that these findings constitute only a summary of the SLC’s full report, which was never published or filed with the court.

²⁸⁵ See Yonca Ertimur, Fabrizio Ferri & David A. Maber, *Reputation Penalties for Poor Monitoring of Executive Pay: Evidence from Option Backdating*, 104 J. FIN. ECON. 118, 120 (2012).

concerning the diagnosis of the misconduct may have been revealed by the discovery process.²⁸⁶

Assessing the quality of structural settlements is an empirical issue we do not pursue here, but we note that these agreements may include important changes in executive compensation, changes in board composition, and restrictions on self-dealing transactions.²⁸⁷ Moreover, the nature and content of the changes themselves respond to information obtained during discovery. While attorneys' fees can explain the efforts to include corporate governance changes in settlements, they do not explain the nature of these changes. Settlement of representative litigation is conditioned on confirmatory discovery.²⁸⁸ In *Caremark*, for example, the board agreed to some very concrete changes that addressed the failure of the board to become aware of the compliance problems within the company.²⁸⁹ Moreover, Chancellor Allen also reduced the fees to be awarded to the plaintiffs' attorneys.²⁹⁰ All this leads us to conclude that judicial approval of settlements is not as meaningless as is often suggested.

Recent studies refute the view that, in settling class actions, the merits do not matter.²⁹¹ But even assuming that the information revealed by discovery is deficient in certain cases, or lawyers fail to propose useful corporate governance improvements, the general thesis that discovery promotes corporate governance can still be sustained in a Kaldor–Hicks framework.

²⁸⁶ Cf., e.g., Affidavit of Jeffrey N. Gordon in Support of Plaintiffs' Motion for Preliminary Approval of Derivative Action Settlement at 1, *In re Pfizer Inc. S'holder Derivative Litig.*, 722 F. Supp. 2d 453 (S.D.N.Y. 2010) (No. 09-CV-7822), 2010 WL 5068906 ("[T]he Reforms embodied in the Proposed Settlement will significantly strengthen Board oversight of Pfizer's compliance with the FDA's drug marketing regime and related compliance mandates and will produce other improvements to internal compliance and accountability.").

²⁸⁷ Romano, *supra* note 276, at 63 (commenting that some corporate governance changes resulting from settlements did reflect important reforms, such as changing the board's majority).

²⁸⁸ See Parsons & Tyler, *supra* note 263, at 504 ("[I]f [the plaintiff] discovered evidence before the final settlement hearing that suggested its claims were stronger than [it] had realized, it could rescind the settlement and litigate post-closing damages."); see also *In re Celera Corp. S'holder Litig.*, No. 6304-VCP, 2012 WL 1020471, at *8 (Del. Ch. Mar. 23, 2012) (detailing the various steps the court must take in the approval process), *aff'd in part, rev'd in part*, 59 A.3d 418 (Del. 2012).

²⁸⁹ *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 966 (Del. Ch. 1996).

²⁹⁰ *Id.* at 972. In a recent case, the Delaware Court of Chancery examined the therapeutic benefit achieved in light of the numerous cases evaluating supplemental disclosures and reduced the attorneys' fees from the \$500,000 requested to \$300,000. See Order, *In re Inspire Pharm. Inc. S'holders Litig.*, No. 6378-VCP, (Del. Ch. Jan. 30, 2012), 2012 WL 275115; Parsons & Tyler, *supra* note 263, at 496.

²⁹¹ James D. Cox, Randall S. Thomas & Lynn Bai, *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 384–85 (2008).

Discovery may generate significant positive externalities in a few cases, or small positive externalities in a large number of cases, which may compensate for these flaws. In other words, instead of looking only at the aggregate costs of discovery, even imperfect outcomes may produce positive effects that result in compound aggregate benefits to corporate governance, whether at the firm level or systemwide.

To be sure, we do not deny that parties are driven by economic incentives and self-interest in prosecuting a civil law suit. Rent-seeking will certainly drive outcomes in some cases.²⁹² We do not attempt to provide a comprehensive solution to this problem here. One normative prescription that follows, however, is that judges should take the social utility of discovery into account when approving settlements and awarding attorneys' fees. Judges should monitor settlements to maximize the value of the information revealed by discovery.²⁹³

4. Cases That Go Through "Some" Discovery

Some cases do not go through the entire process of discovery. But even if discovery is not completed, its disciplining function is much more extensive than often recognized. The disciplining function of discovery is typically associated with the ability of a plaintiff to obtain information from a defendant corporation, that is, with *offensive discovery*.²⁹⁴ But the disciplining function of *defensive discovery* is rarely, if ever, considered.

Party-on-party discovery involves both offensive and defensive discovery. Every party to a lawsuit may serve and must respond to discovery requests during the discovery period approved by the court. The task of serving discovery requests is called "offensive discovery." It entails obtaining information from the other side by, *inter alia*, serving document requests and taking depositions. In a typical shareholder derivative action, the plaintiffs are

²⁹² Exemplary of this are the cases of William Lerach and Melvin Weiss, top plaintiffs lawyers involved in egregious securities class actions scandals. See Jonathan D. Glater, *Class-Action Lawyer Given a 30-Month Prison Term for Hiding Kickbacks*, N.Y. TIMES, June 3, 2008, at C3; Michael Parrish, *Leading Class-Action Lawyer Is Sentenced to Two Years in Kickback Scheme*, N.Y. TIMES, Feb. 12, 2008, at C3.

²⁹³ See generally Hillary A. Sale, *Judges Who Settle*, 89 WASH. U. L. REV. 377 (2011) (analyzing the role of judges as gatekeepers and monitors of settlements).

²⁹⁴ See Bebchuk, *supra* note 101, at 413; cf. Cooter & Rubinfeld, *supra* note 257 (providing an economic analysis of discovery).

the ones who will conduct most of the offensive discovery, because their interest is to investigate the company.²⁹⁵

The task of responding to discovery requests is called “defensive discovery.” This involves providing information to the other side by producing documents or witnesses. Defensive discovery is a task that all parties to the litigation must complete. It typically begins with the collection of information from the client even before discovery begins. There is a disciplining effect to having litigation counsel perform the internal investigation necessary to prepare the case and conduct defensive discovery.

Consider concretely what occurs when a large public corporation defends itself and its executives against a shareholder action. A good faith discovery effort (and standard practice) requires that litigation counsel to a corporate defendant must collect, restore, sort, and review a much larger quantity of electronic information and documents than are eventually disclosed.²⁹⁶ This includes highly confidential documents subject to attorney–client privilege, many marginally relevant documents, as well as documents that will eventually not be produced.²⁹⁷ This process often begins before discovery and means that no one in the corporate hierarchy—including the company’s executives and directors—can expect that their communications or documents will be sequestered from the litigation discovery machinery and kept private.

Public companies typically hire outside litigation counsel for shareholder litigation—especially in cases alleging management misconduct or securities fraud. The technology and complexity of ESI discovery make it very hard, if not impossible, for the executive suite to manage or limit what information is turned over to outside counsel once an investigation gets underway.²⁹⁸ Review by outside counsel will necessarily occur before any discovery is disclosed to parties in litigation or the SEC. And it will need to be done, even if discovery

²⁹⁵ Corporate defendants will conduct some offensive discovery on jurisdictional requirements and issues like standing to sue under FED. R. CIV. P. 23.1. Defendants in securities class actions will seek discovery in connection with a plaintiff’s motion for class certification and to assess damages.

²⁹⁶ See, e.g., Kathleen B. Havener, *Defensive Strategies in Discovery: A Refresher*, A.B.A. (Aug. 30, 2012), <http://apps.americanbar.org/litigation/committees/pretrial/email/summer2012/summer2012-0812-defensive-strategies-discovery-refresher.html> (“Ask your client to send you copies of everything remotely related to your claims or defenses and to your opponent’s document requests. After you have reviewed those documents, select those that are responsive, note documents that are not clearly responsive but that may have some significance to your claims or defenses, and remove and log any privileged documents. Then follow up with your client to confirm that nothing has been missed.”).

²⁹⁷ See *id.*

²⁹⁸ See Cohen et al., *supra* note 243, para. 3.132, at 112 (describing extensive e-discovery).

is ultimately avoided altogether because the case is settled or the regulator decides not to proceed with an investigation. Corporate internal practices and operations will therefore be subject to intense, granular review by sophisticated outside professionals who have independent professional and reputational concerns.²⁹⁹

As already noted, these professionals include gatekeepers—such as outside litigation counsel, accountants, auditors, and financial institutions with independent legal or fiduciary obligations—as well as other outside professionals, such as financial experts, consultants, and expert witnesses. All these professionals are thus exposed to detailed information and learn from their experience, improving their expertise and organizational knowledge, which they can later apply in their practice for other clients.³⁰⁰ Gatekeepers, in particular, play an important role in counseling management.³⁰¹ Their exposure to this information therefore has consequences for management not only in present, but also future, litigation. Here again, we note that the discovery regime—and how it works in practice—generates positive informational externalities for corporate governance.

Outside counsel represents the company, not the individuals within the company.³⁰² Covering up management misconduct violates an attorney's duty to his or her client³⁰³—and can lead to a wide range of sanctions, including ethics charges brought against an entire firm, fines, civil malpractice claims, and criminal charges. The Sarbanes-Oxley legislation (Sarbox) provides for sanctions on gatekeepers who participate in a cover-up. Sarbox requires attorneys and accountants to report “evidence of a material violation” of the securities laws up the “ladder” to management, and if necessary to the board of directors, when counsel becomes aware of such evidence—even before, and regardless as to whether, the company is required to disclose such information during litigation discovery.³⁰⁴ The regulators are, of course, well aware of the practices of defensive discovery and corporate internal investigations. Just as New York Mayor Edward Koch's parking signage warned drivers “Don't Even

²⁹⁹ See generally *id.*

³⁰⁰ See generally Gorga & Halberstam, *supra* note 56 (discussing the process of generating organizational knowledge and individual knowledge).

³⁰¹ See John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1405 (2002) (“[G]atekeepers are reputational intermediaries who provide verification and certification services to investors.”).

³⁰² See *Upjohn Co. v. United States*, 449 U.S. 383, 389–90 (1981).

³⁰³ See, e.g., *Cohen v. Telsey*, No. 09-2033 (DRD), 2009 WL 3747059, at *17 (D.N.J. Nov. 2, 2009).

³⁰⁴ Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C. § 7245 (2012); 17 C.F.R. § 205.3(b) (2013).

Think of Parking Here,”³⁰⁵ Sarbox signals to outside counsel and audit firms how seriously regulators will take it if a law firm conspires with management to conceal evidence of corporate internal wrongdoing from the board or from the regulator.³⁰⁶ Independently of Sarbox, the institutions, techniques, professional rules, and relationships that have emerged in connection with the practice of modern litigation discovery have made it very hard to hide corporate internal wrongdoing.³⁰⁷

Even if none of the documents, e-mail, testimony, or other information obtained through discovery are published or turned over to regulators or adversaries in litigation, any serious response to allegations of wrongdoing, whether by regulators, plaintiffs’ attorneys, or, increasingly, originating internally with a company’s employees, means that a company will at the very least be subject to such internal review.³⁰⁸ Such cases include derivative actions settled by special litigation committees, which we cover in the next subsection. Defensive discovery necessarily anticipates and responds to offensive discovery, and is thus shaped by discovery’s evolving rules and

³⁰⁵ Sewell Chan, *At the Sign-Making Shop, No Standing, No Idling*, N.Y. TIMES, Aug. 14, 2005, at 30.

³⁰⁶ See, e.g., Stephen M. Cutler, Dir., Div. of Enforcement, SEC, *The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program*, Address at the UCLA School of Law (Sept. 20, 2004), text available at <http://www.sec.gov/news/speech/spch092004smc.htm>; see also Paul B. Murphy & Lucian E. Dervan, *Watching Your Step: Avoiding the Pitfalls and Perils of Corporate Internal Investigations*, ALAS LOSS PREVENTION J., Summer 2005, at 2, 6.

³⁰⁷ For a historical account of the developments of internal investigations, see Arthur F. Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655 (1984); and Jim Hubbell, Note, *Discovery of Internal Corporate Investigations*, 32 STAN. L. REV. 1163 (1980).

³⁰⁸ See, e.g., Robert Trigaux, *Backdating Inquiry Ends, SEC Tells Jabil Circuit*, TAMPA BAY TIMES (Nov. 26, 2008, 9:27 AM), <http://www.tampabay.com/blogs/venturebiz/content/backdating-inquiry-ends-sec-tells-jabil-circuit/2093484>. Jabil’s Form 10-K for the fiscal year ending August 31, 2008, reads as follows:

In response to shareholder derivative actions that also were filed in connection with these certain grants, an independent Special Committee of our Board of Directors (the “Special Committee”) was appointed to review the allegations in such actions. . . . The Special Committee concluded that the evidence does not support a finding of intentional manipulation of stock option grant pricing by any member of management. In addition, the Special Committee concluded that it was not in our best interests to pursue the derivative actions. The Special Committee identified certain factors related to our controls surrounding the process of accounting for option grants that contributed to the accounting errors that led to the restatement of our consolidated operations for certain of our previous fiscal years (as further described in the Explanatory Note immediately preceding Part I of our Annual Report on Form 10-K for the fiscal year ended August 31, 2006 and discussed below). Pursuant to the state court’s approval on April 7, 2008, and the federal court’s approval on April 25, 2008, of our proposed settlement of the derivative actions, these actions are no longer pending.

Jabil Circuit, Inc., Annual Report (Form 10-K), 14–15 (Oct. 29, 2008), available at <http://www.sec.gov/Archives/edgar/data/898293/000119312508219096/d10k.htm>.

practices. When companies face adversarial discovery under the federal rules, they must necessarily investigate themselves, not merely comply with discovery requests. In anticipation of discovery, and even prior to any motion to dismiss, a defendant company must thoroughly investigate the factual basis of the charges. To proceed with a proper defense, and also to avoid future claims of securities disclosure violations, the litigation defense must develop a theory of the case and establish facts to support its own defenses in the litigation.

Defensive discovery practices contribute to compliance and the development of corporate governance standards, producing positive externalities, even if adversarial discovery is ultimately not fully pursued. The disciplinary function of defensive discovery helps us understand why corporate internal investigations play such an important role in U.S. contemporary corporate governance. We develop the role of internal investigations in the next subsection.

5. *Cases That Are Dismissed or Settled Prior to the Motion to Dismiss Based on a Corporate Internal Investigation by a Special Litigation Committee*

Since the mid-1970s, corporate internal investigations by special committees have become a powerful procedural mechanism that defendant corporations have at their disposal to respond to shareholder derivative actions, securities violations, and other charges, including charges of criminal wrongdoing.³⁰⁹

SLCs originated in the 1970s in connection with the questionable political payment cases.³¹⁰ In response to revelations by the Watergate special prosecutor that many companies had made undisclosed illegal campaign contributions and funneled money to foreign politicians to secure contracts, the SEC brought enforcement actions against several companies and their executives.³¹¹ Because so many companies were implicated in these probes—ultimately almost 400 companies³¹²—the SEC could not investigate every

³⁰⁹ See Davis, *supra* note 43, at 390–405. See generally CORPORATE INTERNAL INVESTIGATIONS: AN INTERNATIONAL GUIDE, *supra* note 53 (giving a comprehensive account of corporate internal investigations in major jurisdictions, including the United States).

³¹⁰ See Davis, *supra* note 43, at 390.

³¹¹ *Id.* at 393.

³¹² *Id.* at 395.

instance.³¹³ The SEC thus applied a new form of ancillary relief in these cases. The companies were required to “create a special review committee composed exclusively of independent directors. Typically using independent counsel and accountants, the committee was to investigate the irregularities alleged in the SEC’s complaint and submit a public report to the board of directors, which was responsible for reviewing and implementing the committee’s recommendations.”³¹⁴ *Gall v. Exxon Corp.*³¹⁵ was the first case in which a federal court implemented the same remedy in a civil case.³¹⁶

The SLC procedure in derivative litigation thus implemented the same type of equitable remedy that courts allowed the SEC to fashion in its civil enforcement actions and administrative negotiations with issuers. But this does not mean that modern litigation discovery was irrelevant to this type of enforcement, or that the SEC has been the sole or primary force behind the U.S. corporate governance culture of transparency.

First, it is not coincidental that self-investigations by special board committees became an enforcement tool in the 1970s, precisely at the time that the federal discovery regime had reached its apex. SLCs were a response to the liberal grant of discovery in shareholder derivative actions and served, at least in part, to limit the costs and burdens of litigation discovery for corporate defendants.³¹⁷ Second, the SEC’s use of self-investigation was a response to its limited resources as the regulator. Moreover, the “reasonableness” of corporate internal investigations has been measured by the standard of full disclosure that animates the federal rules and the tools of discovery that have been developed in private litigation. Corporate internal investigations thus have continued to evolve together with the tools of offensive and defensive discovery. With the advent of e-discovery, for example, the methods, software, and standards of ESI collection have become standard in corporate internal investigations.³¹⁸

³¹³ *Id.* at 395–96. (“Unable to pursue each instance of questionable payments on its own, the SEC had leveraged its resources by pressuring corporations to investigate themselves.”).

³¹⁴ *Id.* at 395.

³¹⁵ 418 F. Supp. 508 (S.D.N.Y. 1976).

³¹⁶ See Davis, *supra* note 43, at 395–98.

³¹⁷ See *id.* at 400.

³¹⁸ See Brad Mixner, *Reducing Discovery Challenges Through Innovative Use of Technology in Cross-Border Litigation*, INSIDE COUNS. (March 6, 2014), <http://www.insidecounsel.com/2014/03/06/reducing-discovery-challenges-through-innovative-u> (“Since its initial beginnings, e-discovery has been transformed drastically, now having an exciting array of technology options for managing data which is exponentially different in variety, scale, source and complexity. This is further complicated by today’s trend toward the globalization of many industries, the proliferation of multi-national companies and the complexities of cross

Put differently, without private litigants devoting enormous resources to the process and demanding to collect ESI in accordance with the discovery rules, e-discovery would not have developed into the full-fledged assault on corporate internal secrecy that it has.

In response to a shareholder derivative action, a board of directors may appoint a special litigation committee composed of independent directors to investigate the allegations in the complaint. The investigation is performed prior to any decision on a motion to dismiss and prior to any discovery.³¹⁹ Upon application, a judge will grant a stay of discovery until the SLC has completed its internal investigation and produced a report (this usually takes eight or ten months).³²⁰ The SLC can then move to dismiss the complaint, if it concludes that the pursuit of litigation against any fiduciaries is not in the “best interests of the corporation.”³²¹ If the judge is satisfied that the SLC’s members are disinterested and independent, and that the SLC’s investigation was “reasonable” under the circumstances and carried out in “good faith,”³²² New York law requires that judges apply the business judgment rule to the SLC’s recommendation.³²³ Delaware’s approach is somewhat less deferential, affording a judge discretion to weigh the evidence and substitute his or her business judgment for the business judgment of the SLC.³²⁴ The dismissal has preclusive effect.

Doctrinally, two arguments are advanced to justify judicial deference to an SLC’s recommendation, even in cases where the SLC investigation has uncovered corporate internal wrongdoing: (1) the decision whether to pursue

border litigation.”). For countless new e-discovery platforms and technologies, see, for example, EDISCOVERYTIMES, <http://ediscoveytimes.com> (last visited May 29, 2014).

³¹⁹ Myers, *supra* note 46, at 1313. This includes a motion to dismiss for failure to make a demand. SLCs therefore allow defendants to avoid the risk of losing on the issue of demand futility.

³²⁰ See Douglas M. Branson, *The Rule That Isn’t a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 648 (2002) (describing the formation and nature of the SLC).

³²¹ See Richard C. Brown, *Shareholder Derivative Litigation and the Special Litigation Committee*, 43 U. PITT. L. REV. 601, 620–21 (1982). Shareholders may theoretically also sue third parties on behalf of the corporation, but we are not interested in such cases here.

³²² Plaintiffs may seek “limited discovery” solely on whether the SLC’s members are independent and the investigation was reasonable.

³²³ See, e.g., *Auerbach v. Bennett*, 408 N.Y.S.2d 83 (App. Div. 1978), *aff’d as modified*, 393 N.E.2d 994 (N.Y. 1979). The Supreme Court accepted this type of approach in *Burks v. Lasker*, 441 U.S. 471 (1979), reversing *Lasker v. Burks*, 567 F.2d 1208 (2d Cir. 1978). Some states have codified the SLC procedure. See, e.g., WIS. STAT. § 180.0744 (2012); *Einhorn v. Culea*, 2000 WI 65, 235 Wis. 2d 646, 612 N.W.2d 78; see also Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts’ Response to Recent Corporate Scandals*, 60 FLA. L. REV. 589, 596–99 (2008).

³²⁴ See *infra* note 325.

litigation in the name of the company is a matter that lies within the business judgment of the board,³²⁵ and (2) shareholders should exhaust corporate internal remedies before a judge steps in.³²⁶

Special committees have, for the most part, been viewed negatively by academics and corporate governance proponents.³²⁷ The prevailing view is that SLCs invariably recommend dismissal,³²⁸ which courts grant “in the vast majority of cases.”³²⁹ The SLC mechanism has been thought of as yet another procedural hurdle to shield directors from exposure and liability for misconduct.³³⁰

A recent empirical study by Professor Minor Myers, however, shows that (1) SLCs decide to pursue or settle claims much more frequently than

³²⁵ See *Auerbach*, 393 N.E.2d 994, 1000–03 (explaining that the plaintiff bears the burden of rebutting the business judgment rule presumption with respect to the SLC’s decision, and the judicial inquiry is limited to the disinterestedness and independence of the SLC). Delaware’s less deferential approach in *Zapata Corp. v. Maldonado* is as follows:

First the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries.

The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.

430 A.2d 779, 788 (Del. 1981) (footnote omitted). The Court may then, in its discretion, apply “its own independent business judgment, [in determining] whether the motion should be granted.” *Id.* at 789. In other words, step two permits a consideration of the substance of the report.

³²⁶ See Davis, *supra* note 43, at 398.

³²⁷ See, e.g., Davis, *supra* note 46, at 1306 (citing literature).

³²⁸ FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.3.4, at 434 (2d ed. 2010) (“Special litigation committees usually have concluded that derivative suits which the committees looked into were not in the corporation’s best interest.”); see also 9 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION § 11(C)(4)(b) n.340, at 420 (4th ed. 2013); JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 65–66 (2008); George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 109 & n.70 (1980) (surveying SLC dismissals). But see Myers, *supra* note 46, at 1311.

³²⁹ Scarlett, *supra* note 323, at 598–99 (quoting Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 409 (2005)) (internal quotation marks omitted).

³³⁰ See Myers, *supra* note 46, at 1314–16; see also Brown, *supra* note 321, at 620–21 (collecting reported cases in support of the conclusion that “[s]pecial litigation committees, after completing their investigations, have so far always determined that the derivative action was not in the best interests of the corporation and have voted to terminate the suit”); Davis, *supra* note 46, at 1357 (“[J]udicial deference to the dismissal recommendations of SLCs is the product of a broader recognition of the diminished role of the derivative suit within the portfolio of devices available to hold directors and officers to account.”); Dent, *supra* note 328, at 109 & n.70 (collecting reported cases on demand in support of the conclusion that in the SLC context “almost invariably, the directors charged with the decision decide to oppose the suit”).

heretofore recognized,³³¹ and (2) most shareholder claims subject to SLC review end up settling and are not dismissed.³³² Myers also observed that “SLC decisions to settle . . . were usually made longer after the filing of claims than either decisions to pursue [the litigation] or dismiss.”³³³ He speculates that this might be attributable to the time needed to negotiate the settlement.³³⁴ Once the SLC decided to settle, however, the cases were resolved quickly.³³⁵

Myers’s empirical findings are consistent with the view that SLCs spend significant time conducting corporate internal investigations before they return to the negotiating table and negotiate a settlement with plaintiffs’ counsel. This makes sense, because an SLC’s leverage in settlement discussions depends on actually conducting an adequate internal investigation into the specific allegations in the complaint. Only a thorough investigation can present a credible threat of dismissal and generate the information that helps the parties come to a better assessment of the value of the case. In other words, the SLC investigation produces information not otherwise available to the decision-makers and provides a basis for deciding whether to pursue or settle a claim.

SLC investigations push fact investigation, which usually takes place during discovery, into the pre-discovery phase. In so doing, an SLC incorporates all of the disciplining practices of defensive discovery.

The investigation is conducted by independent board members who are not to take direction from the company or its management. The board members must hire an outside law firm, which, preferably, has had no prior dealings with the company.³³⁶ The reputation of the law firm itself is important, given that the decision to dismiss considers the quality of the internal investigation. The outside law firm’s client is the SLC. Communications between the SLC and the law firm are thus privileged. Anything that the SLC shares with the board is potentially discoverable by plaintiffs.³³⁷ Sharing information with the

³³¹ Myers, *supra* note 46, at 1320.

³³² *Id.* at 1327 tbl.6.

³³³ *Id.* at 1331. The time to settlement has also been lengthened in securities class actions after the PSLRA. Choi & Thompson, *supra* note 194, at 1498.

³³⁴ Myers, *supra* note 46, at 1331.

³³⁵ *Id.* (“[O]nce the SLC decided to settle, the cases were resolved almost immediately.”).

³³⁶ The SEC guidelines state the same criteria regarding cooperation for crediting the results of a corporate internal investigation as in the derivative context. Exchange Act Release No. 44,969, 76 SEC Docket 220 (Oct. 23, 2001) (asking whether an outside counsel or auditor had “done other work for the company” and whether “management previously engaged such counsel” in considering whether “the company commit[ted] to learn the truth, fully and expeditiously”).

³³⁷ See, e.g., Ryan v. Gifford, No. 2213-CC, 2007 WL 4259557, at *2–3 (Del. Ch. Nov. 30, 2007).

board before the conclusion of the investigation may compromise the independence of the investigation in the eyes of the court.

In assessing an SLC's conclusion that maintaining the suit is not in the best interests of the company, a court will conduct two separate inquiries. The first focuses on the independence of the SLC's members.³³⁸ The second focuses on the thoroughness of the investigation. The SLC has the burden of proving that it engaged in a "reasonable investigation" that was "independent" and conducted in "good faith."³³⁹

At this stage, plaintiffs may seek "limited discovery" . . . to facilitate the inquiries of the trial court into the independence and good faith of the Committee and the reasonableness of its investigation and conclusions."³⁴⁰ A court should not dismiss if either "the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee."³⁴¹

A credible internal investigation must "explore all relevant facts and sources of information that bear on the central allegations in the complaint."³⁴² The scope of the investigation must encompass "all theories of recovery asserted in the plaintiffs' complaint."³⁴³ Courts will thus closely examine the SLC's investigative procedures and methods.³⁴⁴ The SLC must convince a judge, or the plaintiffs during settlement negotiations, that discovery is unlikely to produce important additional information about the nature or extent of corporate internal wrongdoing. In ruling on the motion, a judge will want to be assured that the plaintiffs are unlikely to come up with anything substantial

³³⁸ This requires an inquiry into the relationship of the SLC members to the company and its management, as well as an inquiry into any relationship between the company and the professionals the SLC has hired to conduct the investigation. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788–79 (Del. 1981).

³³⁹ *Id.* at 788.

³⁴⁰ *Kaplan v. Wyatt*, 484 A.2d 501, 510 (Del. Ch. 1984); see also *Kindt v. Lund*, No. Civ.A. 17751, 2001 WL 1671438, at *1 (Del. Ch. Dec. 14, 2001).

³⁴¹ *Zapata Corp.*, 430 A.2d at 789.

³⁴² *London v. Tyrrell*, No. 3321-CC, 2010 WL 877528, at *17 (Del. Ch. Mar. 11, 2010) ("If the SLC fails to investigate facts or sources of information that cut at the heart of plaintiffs' complaint this will usually give rise to a material question about the reasonableness and good faith of the SLC's investigation.").

³⁴³ *Id.* ("To conduct a good faith investigation of reasonable scope, the SLC must investigate all theories of recovery asserted in the plaintiffs' complaint."). An SLC may be required to go beyond the allegations in the complaint.

³⁴⁴ See generally *Zapata Corp.*, 430 A.2d 779 (holding that the board's delegation of its managerial authority over litigation to a special committee was effectual).

that is not already in the SLC report, if the case went to adversarial discovery.³⁴⁵

In practice, this means that an SLC will use the same methods of investigation that the defendant corporation's outside litigation counsel would have used, if the case went to discovery. The law firm conducting the investigation must engage in credible electronic discovery, including the restoration of backup tapes, and the collection and review of all relevant documents and e-mail communications of the parties involved in the alleged wrongdoing.³⁴⁶ Outside counsel is expected to interview all relevant witnesses, including senior management,³⁴⁷ and question the witnesses about potentially compromising documents as necessary.³⁴⁸ Depending on the nature of the case, outside counsel may be required to hire an independent forensic accounting team to pursue an in-depth investigation of accounting procedures.

The SLC process thus mimics the procedures of defensive discovery. It pushes witness interrogation, document discovery, expert testimony, and the exchange of facts between the parties into the prediscovery period, the same way that the modern discovery rules pushed trial testimony and the exchange of facts at trial into the pretrial period. Instead of preparing a case for trial, however, an SLC produces a report detailing its findings. Reports are lengthy and attach witness accounts, documentary proof, and any expert findings on the basis of which a judge will render an opinion.³⁴⁹ If the SLC report is filed with the court, it is served on the plaintiffs and becomes the basis for the defendant's motion to dismiss.

³⁴⁵ See *id.* at 788–89.

³⁴⁶ See Cohen et al., *supra* note 243, para. 3.177, at 124 (“For the investigative counsel—and the company on whose behalf the investigation is undertaken—the ability to say, at the conclusion of the investigation, that all known relevant documents have been collected and reviewed is critical to the credibility of the investigation.”).

³⁴⁷ Alice A. Seebach, *Special Litigation Committees: A Practitioner's Guide*, 24 LOY. L.A. L. REV. 1, 28–30 (1990) (“A broad investigation appears thorough. Courts accepting special committees’ recommendations to dismiss often comment on the number of witnesses interviewed. For example, one special committee that considered claims that a CEO misused a corporation interviewed 140 witnesses ‘throughout the world.’” (quoting *Kaplan v. Wyatt*, 484 A.2d 501, 511 (Del. Ch. 1984), *aff’d* 499 A.2d 1184 (Del. 1985))); see also Cohen et al., *supra* note 243, paras. 3.166–211, at 121–35.

³⁴⁸ See, e.g., *London*, 2010 WL 877528, at *21 (finding SLC investigation not reasonable, because, *inter alia*, “Tyrrell’s own emails suggest that he believed these higher internal forecasts were [sic] achievable, in direct contradiction to the testimony he provided the SLC, but the SLC does not appear to have questioned him thoroughly about these emails”).

³⁴⁹ See Seebach, *supra* note 347, at 25 & n.171.

The overly cynical view of SLCs that is characteristic of much of the literature thus overlooks the significant informational and disciplinary functions performed by SLC investigations.³⁵⁰

It is often attractive for the parties to settle without the SLC actually having to file a motion to dismiss with the court.³⁵¹ Instead of filing a motion to dismiss, an SLC can share its final report with the plaintiffs subject to a confidentiality agreement. The advantage for plaintiffs is to obtain a settlement without additional investment in discovery, or the risk of an adverse ruling by the court. The advantage for the board is to avoid filing, and thereby publicizing, the SLC report, which typically will include at least some unpleasant information about internal practices.³⁵²

What the SLC procedure accomplishes, even if the parties decide to settle prior to the motion to dismiss, and the SLC report remains confidential, is that the corporation thoroughly investigates itself. Outside counsel knows that, “[a]t a minimum, the [SLC] investigation should address the actual allegations of wrongdoing” as well as “*other possible violations that are uncovered during the course of the investigation.*”³⁵³ What this means is that once the investigation is initiated, the SLC essentially takes on the responsibility of a regulator and conducts the fact investigation that a regulator would otherwise conduct.³⁵⁴ It is not enough for an SLC to narrowly consider whether the factual allegations in the complaint are accurate, or whether plaintiffs can support their claims. The SLC is charged with broadly investigating the allegations in the complaint, but then pursuing other “possible violations” that are uncovered incidentally during the course of the investigation, regardless as to whether such violations are related to the claims in the complaint. A failure to acknowledge “red flags” during an SLC investigation could result in

³⁵⁰ As Myers’s empirical study finds, the “claim about SLC behavior—that, even if they do not dismiss claims, they may nevertheless take it easy on defendants by failing to pursue claims diligently or by settling claims for nothing— . . . finds no support in the data.” Myers, *supra* note 46, at 1311.

³⁵¹ See Dent, *supra* note 236, 99 n.17 (“The purpose of requiring a demand on the board has been stated variously as . . . giving the board the opportunity to settle the dispute without litigation, thus promoting judicial economy . . .” (citing *Winter v. Farmers Educ. & Coop. Union*, 107 N.W.2d 226, 233 (Minn. 1961))).

³⁵² Apart from the reputational damage, facts discovered in the internal investigation can be used as a basis for additional litigation, including criminal indictments. See Cohen et al., *supra* note 243, para. 3.173, at 123.

³⁵³ *Id.* para. 3.168, at 121–22 (emphasis added).

³⁵⁴ See Davis, *supra* note 43, at 392–95 (describing how “specific credit for developing the SLC itself goes to the Securities and Exchange Commission’s . . . Enforcement Division,” which originated the process to deal with a wave of disclosure violations in the 1970s by affording issuers more flexible relief and conserving its own resources).

securities disclosure violations by the company and ethics charges against the law firm. The decision to undertake such an investigation is therefore a consequential decision.

As for remediation, the settlement or dismissal of a case after an internal investigation does not necessarily mean that there are no consequences for officers and directors.³⁵⁵ A proper internal investigation should be broad enough to include consideration of appropriate remedial actions.³⁵⁶ While SLC investigations may not result in judicial sanction,³⁵⁷ they often enough result in financial recoveries by the company, employment actions, changes in leadership, and specific corporate governance improvements.³⁵⁸ If any material misstatements in the financial disclosures of the company are discovered that lead to earnings restatements—not an uncommon situation—then a Form 8-K must be filed with the SEC, and shareholders and market watchers will expect the company to explain what went wrong and what oversight mechanisms will be improved to avoid such problems in the future.³⁵⁹ In the Barnes & Noble stock options backdating case, and other backdating cases, executive stock options were repriced,³⁶⁰ and often earnings had to be restated. This information becomes available to markets and regulators.³⁶¹

Again, dismissal or settlement does not mean that internal wrongdoing is covered up. If unconvincing in scope, the findings of the internal investigation run the risk of being discounted, regardless as to whether the audience for the final report is a judge, the SEC, or plaintiffs' counsel.

Derivative actions filed in state court are often filed parallel to securities class actions in federal courts.³⁶² Defendants seek a stay of the proceedings in federal court, while they proceed with their SLC investigation in a state

³⁵⁵ Cohen et al., *supra* note 243, para. 3.171, at 122.

³⁵⁶ As did the Barnes & Noble SLC. See Press Release, Barnes & Noble, *supra* note 284; see also Cohen et al., *supra* note 243, para. 3.169, at 122.

³⁵⁷ See Myers, *supra* note 46, at 1332 (“[T]he SLC appears to function as a form of alternative dispute resolution.”).

³⁵⁸ See *id.*

³⁵⁹ See, e.g., Press Release, Barnes & Noble, *supra* note 284.

³⁶⁰ *Id.*

³⁶¹ Indeed, even if an SLC report is not filed with the court, remains confidential, and is only shared with plaintiffs' counsel subject to a confidentiality agreement, it is often shared with the SEC in an effort to negotiate and assuage the regulator—subject to a “confidential treatment request.” See Ferrara & Khinda, *supra* note 236, at 1165–67.

³⁶² See Parsons & Tyler, *supra* note 263, at 517 (“[A]s has become common today, multiple plaintiffs file multiple complaints in multiple jurisdictions”); Thomas & Martin, *supra* note 214, at 72.

derivative action. The cases are typically subject to a joint settlement, or are consolidated, as in the Bank of America case.³⁶³ SLC investigations were, for example, common in the stock options backdating cases, in which a corporation might face inquiries by the SEC, one or more state court derivative actions, and one or more federal securities fraud actions.³⁶⁴ In such cases, the final SLC report would sometimes be shared with the SEC and the plaintiffs at the same time to achieve a simultaneous resolution in all three forums.

Corporate internal investigations have increasingly become a standard tool of corporate governance. Corporations may launch internal investigations in response to any type of lawsuit or inquiry by the government,³⁶⁵ but also in connection with problems that are brought to management's attention internally by a company's own employees or auditors.³⁶⁶ As a result of the obligations imposed on public corporations by the Sarbanes-Oxley Act of 2002, such "internally-sparked investigations have increased dramatically in the post-Enron business climate, so much so that 'internal investigation attorneys are becoming a dreaded necessity for a growing number of public companies.'"³⁶⁷ The literature has underestimated the increasing importance of corporate internal investigations for the development of U.S. and global corporate governance,³⁶⁸ in large part, because it has not appreciated the impact of defensive discovery.

B. Discovery Has Shaped Internal Corporate Governance

The rules and practices of litigation discovery have had an important influence on the development of new internal corporate governance procedures and compliance systems. The requirement to produce information during discovery forces corporations to maintain, store, and monitor their in-house communications and business documentation *ex ante*. Corporations must develop records management policies that make the timely search and

³⁶³ See *supra* Part III.A.2. Cases dismissed because the plaintiffs failed to satisfy the heightened pleading requirements under the PSLRA, or the demand requirement in derivative actions, may raise concerns about underdeterrence, but we do not discuss these cases here.

³⁶⁴ See, for example, *Roth v. Reyes*, No. C 06-02786 CRB, 2007 WL 2470122, (N.D. Cal. Aug. 27, 2007), for derivative litigation; and *Smajlaj v. Brocade Communications Systems, Inc.*, No. C 05-02042 CRB, 2007 WL 2457534 (N.D. Cal. Aug. 27, 2007) for securities class action.

³⁶⁵ See Murphy & Dervan, *supra* note 306, at 2.

³⁶⁶ *Id.*

³⁶⁷ *Id.* (quoting Leigh Jones, *Call for Internal Probes Growing*, NAT'L L.J., Nov. 22, 2004, at 1).

³⁶⁸ Lomas & Kramer, *supra* note 53, at 1–2.

collection of documents feasible.³⁶⁹ They must develop contingency plans to suspend auto-delete functions and to prevent the recycling of backup tapes in response to litigation holds.³⁷⁰ The failure to implement firm-wide information governance can be costly.

An entire industry of consultants and service providers has sprung up to assess and improve the litigation preparedness of large corporations. Consultants who advise on improving electronic data management for litigation preparedness are often the same ones who have developed sophisticated software for ESI discovery during litigation.³⁷¹ The routines and practices of ESI discovery are thus setting standards for information governance and transparency in everyday operations.

These responses to the demands of litigation discovery contribute to the effectiveness of internal monitoring. In the age of ESI, corporations must engage in “proactive” information governance to become litigation ready.³⁷² This includes the ability to implement adequate litigation holds, the ability to produce requested documents within a reasonable timeframe, and the ability to do so efficiently and cost-effectively.³⁷³ Corporations may be subject to a range of sanctions if they fail to implement litigation holds.³⁷⁴

Not only is information about organizational flows systematized in this way, but organizational knowledge may thereby also be assessed by professionals and improved.³⁷⁵

³⁶⁹ See, e.g., *Litigation Preparedness*, E-DISCOVERY BASICS (Gibson, Dunn & Crutcher LLP, L.A., Cal.), May 31, 2011, <http://www.gibsondunn.com/publications/Documents/E-DiscoveryBasics3-LitigationPreparedness.pdf>.

³⁷⁰ *Id.*

³⁷¹ See, e.g., D4 EDISCOVERY, <http://www.d4discovery.com/services-solutions/> (last visited May 29, 2014) (offering comprehensive discovery management across platforms, including discovery best practices and solutions for social media); *Managed Services*, XEROX LITIG. SERVS., <http://www.xerox-xls.com/ediscovery/managed-services.html?PHPSESSID=4804a414c2ed6c54cf38202f8619841e> (last visited May 29, 2014) (offering “expertise in all phases of discovery” to law firms and corporations); see also *Top Discovery Software Products*, CAPTERRA, <http://www.capterra.com/electronic-discovery-software> (last visited May 29, 2014).

³⁷² See PETER PEPITON II, BECOMING LITIGATION READY THROUGH PROACTIVE INFORMATION GOVERNANCE 1 (2008).

³⁷³ See *id.* at 5. See Sheri Qualters, *30% of Companies Still Lack Policies for Preserving Evidence for Discovery*, NAT’L L.J., Dec. 9, 2008 (“[H]aving no legal hold policy is a significant risk factor for companies.” (emphasis removed) (internal quotation mark removed)).

³⁷⁴ See, e.g., *Sekisui Am. Corp. v. Hart*, 945 F. Supp. 2d 494, 509 (S.D.N.Y. 2013) (sanctioning the plaintiff for failing to preserve electronic information on its servers).

³⁷⁵ See Gorga & Halberstam, *supra* note 56, at 1127.

C. How Discovery Informs Legal Change

Corporate law scholars have never identified discovery as a key driver of legal change, even as scholars in other legal fields have recognized that substantive developments in other law areas have been driven by “broad-ranging discovery provisions.”³⁷⁶ Nonetheless, the discovery regime has influenced case law on fiduciary duties and the substantive development of corporate law in many areas. In this section, we look at just two examples.

1. The Development of Fiduciary Duty Doctrines

As already observed in our discussions of *Disney* and *Caremark*, critical developments in the judicial interpretation of fiduciary duties have depended on information that would not have become available to courts but for probing discovery. Moreover, the fiduciary duty standards that they have articulated assume and depend upon the availability of discovery for their meaningful enforcement. The seminal case of *Van Gorkom* can also be read this way.³⁷⁷

In *Van Gorkom*, shareholders sued the directors of Trans Union, Inc., for breach of their fiduciary duty of care in connection with the sale of the company to the Chicago investor Jay Pritzker.³⁷⁸ The Court found that the defendants acted “reckless[ly]”—and awarded substantial damages—because of their failure to adequately inform themselves and ask the right questions, and for approving the sale too quickly.³⁷⁹ The court held that the business judgment rule barred a review of the *substance* of such board decisions, but not of the adequacy of the *decision-making process*.³⁸⁰ *Van Gorkom* thus resulted in what some have called the “proceduralization” of the boardroom.³⁸¹

³⁷⁶ Marcus, *supra* note 31, at 749 (quoting Jack H. Friedenthal, *A Divided Supreme Court Adopts Discovery Amendments to the Federal Rules of Civil Procedure*, 69 CALIF. L. REV. 806, 818 (1981)); see also Geraldine Szott Moohr, *The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement*, 46 AM. CRIM. L. REV. 1459, 1472 (2009).

³⁷⁷ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), *overruled in part on other grounds by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

³⁷⁸ *Id.* at 863–64.

³⁷⁹ *Id.* at 871.

³⁸⁰ *Id.* at 872.

³⁸¹ See, e.g., Charles M. Elson & Robert B. Thompson, *Van Gorkom’s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 584 (2002) (arguing that *Van Gorkom*’s legacy is the “rise of elaborate decision-making procedures involving lengthy meetings [and] voluminous documentation . . . that today accompany board decisions”); Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 676–77 (2002) (defending the business judgment rule’s emphasis on process after *Van Gorkom*).

The vast literature on *Van Gorkom* has never considered how critical discovery was for arriving at this result.³⁸² As in the *Disney* and *Caremark* cases, the decision in *Van Gorkom* depended on the court's ability to reconstruct the events leading up to the merger in rich detail.³⁸³ The reconstruction included information about the understandings, opinions, and conclusions of all those involved in the deal as the deal evolved, and enabled the ability to identify who knew what, when they knew it, who communicated with whom, what they said, what information they did or did not obtain, and how assessments of the deal varied considerably as between the various actors involved.³⁸⁴

The record revealed that Van Gorkom did not consult with the board or his top executives during his negotiation with Pritzker, but only with Trans Union's controller.³⁸⁵ He proposed the price of \$55 per share to Pritzker at a social event without seeking a bid or negotiating the price.³⁸⁶ Depositions revealed that Van Gorkom chose this price based on an earlier determination by Trans Union's CFO, Romans, that a management-sponsored leveraged buyout could be financed at between \$50 to \$60 per share, instead of an assessment of the value of the company.³⁸⁷ But Van Gorkom never even saw the actual report prepared by Romans, nor did he ask Romans to discuss his valuation of the company (at up to \$65 per share) or his concerns about the "lock-up" agreement (that interfered with a true market test) with the board.³⁸⁸ And the board never heard about internal dissent to the terms of the sale among senior management that discovery revealed.

The evidence showed that "the Board accepted without scrutiny Van Gorkom's representation as to the fairness of the \$55 price per share for sale of the Company—a subject that the Board had never previously considered,"³⁸⁹

³⁸² See generally BAINBRIDGE, *supra* note 229, at 393–405 (discussing the fate of shareholder derivative suits).

³⁸³ To be precise, the proceedings before the Delaware Chancery generated the extensive factual record that the Delaware Supreme Court ultimately relied on in issuing its opinion. See *Van Gorkom*, 488 A.2d at 864–70.

³⁸⁴ See *id.*

³⁸⁵ *Id.* at 866.

³⁸⁶ *Id.*

³⁸⁷ *Id.* at 865, 867 ("According to Romans: They did not 'come up' with a price for the Company. They merely 'ran the numbers' at \$50 a share and at \$60 a share with the 'rough form' of their cash figures at the time. Their 'figures indicated that \$50 would be very easy to do but \$60 would be very difficult to do under those figures.'"). This evidence emerged during Romans's depositions.

³⁸⁸ *Id.* at 867.

³⁸⁹ *Id.* at 877.

and failed to inform itself “as to the intrinsic value of the Company.”³⁹⁰ Neither Van Gorkom nor any other director read the agreement prior to its signing.³⁹¹ The proposed merger agreement was approved at a board meeting that lasted two hours.³⁹²

Just as in the *Disney* litigation, the evidence in the record—although presented at trial—was generated during extensive and probing discovery.³⁹³ Only party-driven depositions, supported by document discovery, could have elicited the kinds of admissions and conflicting accounts and impressions on the part of the various actors involved in the deal.

To appreciate this point, it is critical to recognize that this type of information could not have been obtained in a civil suit by shareholders in a civil law jurisdiction because of the lack of a discovery process. In Germany, for example, the only case that engages in the close examination of a board’s decision-making process in the sale of a company is the *Mannesmann* case.³⁹⁴ In that case, management was charged with paying Mannesmann’s CEO an improper £10 million bonus for the successful sale of the company.³⁹⁵ But *Mannesmann*, which was hailed as the first fiduciary duty case in Germany, was, in fact, a criminal prosecution that relied on the investigative powers of a criminal prosecutor.³⁹⁶

In contrast, the U.S. system incentivizes parties and trial courts to focus on the facts.³⁹⁷ Not only did the *Van Gorkom* court explicitly acknowledge its heavy dependence on the factual record produced by discovery, it emphasized the importance of entire record review in such fiduciary duty cases going forward.³⁹⁸ This result means that the “proceduralization” of the boardroom and the Court’s interpretation of the business judgment rule in *Van Gorkom*

³⁹⁰ *Id.* at 874; *see also id.* at 866 (“Apart from the Company’s historic stock market price, and Van Gorkom’s long association with Trans Union, the record is devoid of any competent evidence that \$55 represented the per share intrinsic value of the Company.” (footnote omitted)).

³⁹¹ *Id.* at 869.

³⁹² *Id.*

³⁹³ *See, e.g., id.* at 864 n.1 (“[F]ollowing extensive discovery, the Trial Court denied the plaintiff’s motion for preliminary injunction . . .”).

³⁹⁴ Bundesgerichtshof [BGH] [Federal Court of Justice] Dec. 21, 2005, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 522, 2006 (Ger.); *see also*, Franklin A. Gevurtz, *Disney in a Comparative Light*, 55 AM. J. COMP. L. 453, 459–62 (2007) (discussing the case in English).

³⁹⁵ Gevurtz, *supra* note 394, at 461.

³⁹⁶ *Id.* at 455.

³⁹⁷ In order to avoid de novo review of the law on appeal, trial courts have an incentive to heavily emphasize the facts, which are subject to a “clear error” standard on appeal.

³⁹⁸ *Van Gorkom*, 488 A.2d at 871.

only make sense if private litigants are in a position to discover what procedures were actually followed.

In this way, litigation discovery has repeatedly underwritten substantive corporate fiduciary duty law. One can reread the seminal Delaware fiduciary duty cases, including the previously discussed *Van Gorkom*, *Caremark*, and *Disney* cases, as well as *Stone v. Ritter*,³⁹⁹ *In re Citigroup Inc. Shareholder Derivative Litigation*,⁴⁰⁰ and others in this light, focusing on how judicial standards have been shaped by the practice and results of litigation discovery over time.⁴⁰¹

2. *The Development of DGCL Section 220 Case Law*

Another good example of how discovery has shaped substantive law and shareholder rights is the changing standards governing shareholder information requests under section 220 of the Delaware General Corporation Law (DGCL).⁴⁰² While originally different in scope from discovery itself, recent case law shows how shareholder information requests have changed substantially from very limited, pinpointed inquiries to much broader, discovery-like requests for the production of entire categories of documents, including ESI, and that courts are enforcing such requests.⁴⁰³ In part, broader shareholder information requests can be seen as a response to the increasing difficulty of overcoming the business judgment rule in shareholder litigation. In part, this development might be seen as a correction of the increasing difficulty of obtaining discovery in securities class actions after the PSLRA. In a 1997 article in the *Boston University Law Review*, Professors Randall Thomas and Kenneth Martin thus argued for the use of state inspection statutes to obtain discovery in federal securities fraud actions.⁴⁰⁴

In *Rales v. Blasband*⁴⁰⁵ and *Grimes v. Donald*,⁴⁰⁶ the Delaware Supreme Court noted that, “[s]urprisingly, little use has been made of section 220 as an

³⁹⁹ 911 A.2d 362 (Del. 2006).

⁴⁰⁰ 964 A.2d 106 (Del. Ch. 2009).

⁴⁰¹ See Parsons & Tyler, *supra* note 263, at 479 (discussing the “importance of the Delaware Court of Chancery’s procedural rules to Delaware’s substantive law of corporations,” in the most recent spate of shareholder challenges to mergers and acquisitions). Parsons and Tyler discuss the use of motions to expedite discovery to sort out meritorious from unmeritorious cases. *Id.* at 499–500.

⁴⁰² DEL. CODE ANN. tit. 8, § 220 (West Supp. 2014).

⁴⁰³ Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands—Reprise*, 28 CARDOZO L. REV. 1287, 1412 (2006).

⁴⁰⁴ Thomas & Martin, *supra* note 214, at 70.

⁴⁰⁵ 634 A.2d 927 (Del. 1993).

information-gathering tool in the derivative context,” to engage in a prefiling investigation of corporate mismanagement.⁴⁰⁷ In *Security First Corp. v. U.S. Die Casting & Development Co.*⁴⁰⁸ and the subsequent case law,

The court emphasized that books and records inspections permitted under Section 220 and discovery permitted in the context of a shareholder derivative action are “not the same and should not be confused.” Section 220 books and records requests, the court stated, must be “circumscribed with rifled precision,” while discovery in other contexts “may often be broader” in scope.⁴⁰⁹

But in *Brehm v. Eisner*, for example, the Delaware Court dismissed a shareholder action against the Disney Corporation for waste in the hiring and firing of Ovitz, but ordered the Chancery to allow plaintiffs leave to amend after they made use of the “tools at hand”—that is, a valid shareholder information request under DGCL section 220—“to develop the necessary facts for pleading purposes.”⁴¹⁰

Delaware books and records demands under section 220 also play an increasing role in compensation and corporate governance disputes outside the derivative litigation context.⁴¹¹ Litigators have identified a “new frontier in Section 220 . . . as a means of gathering information for other purposes,” specifically in matters surrounding executive compensation and proxy contests.⁴¹²

The court has persisted in drawing a distinction between the “full panoply of discovery rights”⁴¹³ and the “rifled precision” of section 220 demands.⁴¹⁴ However, while the scope of a section 220 request is limited to a “proper purpose,” and the Delaware Supreme Court has insisted that the requesting shareholder must “make specific and discrete identification, with rifled

⁴⁰⁶ 673 A.2d 1207 (Del. 1996).

⁴⁰⁷ *Id.* at 1216 n.11 (quoting *Rales*, 634 A.2d at 934–35 n.10).

⁴⁰⁸ 687 A.2d 563 (Del. 1997).

⁴⁰⁹ Radin, *supra* note 403, at 1294–95 (footnote omitted) (quoting *Sec. First Corp.*, 687 A.2d at 570).

⁴¹⁰ 746 A.2d 244, 266–67 (Del. 2000) (internal quotation marks omitted).

⁴¹¹ See John F. Grossbauer & Charles T. Williams, III, *The Increasing Role of Delaware Books and Records Demands in Compensation and Governance Disputes*, POTTER ANDERSON CORROON LLP (Nov. 1, 2004), <http://www.potteranderson.com/publication/the-increasing-role-of-delaware-books-and-records-demands-in-compensation-and-governance-disputes> (describing the use of section 220 in the context of executive compensation and proxy contests).

⁴¹² *Id.*

⁴¹³ Radin, *supra* note 403, at 1339.

⁴¹⁴ *Brehm*, 746 A.2d at 266.

precision, of the documents sought,”⁴¹⁵ we note that section 220 requests increasingly include broad categories of documents, corporate internal communications, and ESI.

The Delaware Supreme Court’s ruling in the *Saito v. McKesson HBOC, Inc.* derivative action contributed to this development.⁴¹⁶ In *McKesson*, the Court of Chancery granted McKesson’s motion to dismiss a shareholder lawsuit challenging a stock-for-stock merger between McKesson Corporation and HBO & Company after the revelation of certain accounting irregularities.⁴¹⁷ Saito, the only plaintiff, filed suit to enforce his demand for inspection when the corporation rejected his information request.⁴¹⁸ The Delaware Chancery held that, while Saito stated a “proper purpose” for his demand, the scope of inspection “only extended to potential wrongdoing after the date on which Saito acquired his McKesson stock.”⁴¹⁹ The Delaware Supreme Court reversed, substantially expanding the scope of inspection to time frames well before Saito acquired his shares, ruling that section 327 of the DGCL did not “defin[e] the temporal scope of a stockholder’s inspection rights under § 220.”⁴²⁰ The court also reasoned that shareholders could make use of information gathered via section 220 request for purposes other than filing shareholder actions.⁴²¹

The court thus expanded the scope of documents a corporation is required to make available in response to a books and records demand in two respects. Interpreting DGCL section 220 broadly, following the civil procedure principle that the scope of litigation discovery should be interpreted broadly, the court appears to have made “relevance” the touchstone of its analysis, instead of the temporal limitations under DGCL section 327, which it arguably could have relied upon to justify a much narrower scope for the shareholder information request. Furthermore, the limitation of the scope of inspection to a qualifying “proper purpose” was in practice considerably expanded beyond what the “rifle shot precision” doctrine would allow.⁴²²

⁴¹⁵ *Id.*

⁴¹⁶ 806 A.2d 113 (Del. 2002).

⁴¹⁷ *Id.* at 115.

⁴¹⁸ *Id.*

⁴¹⁹ *Id.* at 116.

⁴²⁰ *Id.* at 117.

⁴²¹ *See id.* at 116.

⁴²² *See Radin, supra* note 403, at 1292 n.33.

The language of the information requests that the Delaware Chancery Court allowed on remand in *McKesson* shows precisely how broad and discovery-like such section 220 requests have become.⁴²³ (See the appendix for the *McKesson* information request.)

Scholars have now proposed that Delaware courts explicitly include access to ESI. Their reasoning is that in interpreting section 220, the Chancery should look to the discovery provisions in the Federal Rules of Civil Procedure.⁴²⁴

We understand these developments to be a response to the retreat from discovery in shareholder derivative actions and in securities fraud class actions. Because information gained through shareholder inspection can be used to develop facts to support both types of claims, the court appears to be giving back with one hand what the Court and Congress took away with the other. It is worth asking whether expanding the tools and the scope of section 220 requests is preferable to allowing discovery proper in the first place. One might favor expanded section 220 requests over full discovery because they allow judges control in shaping a plaintiff's investigatory demands, while nonetheless still leaving the initial formulation of the request and the collection, processing, and review of the information obtained to the parties themselves. This approach appears to strike a balance between U.S. decentralized fact investigation and the European concentration of fact investigation in the hands of the judge.

3. *Regulatory Changes and Federal Law Reform*

Similarly, discovery influences changes in administrative and federal regulation. The new rules for gatekeepers, adopted by the Sarbanes-Oxley legislation in light of corporate scandals, are intricately calibrated to take advantage of private enforcement and, very specifically, of the access that gatekeepers have to company internal information through corporate internal investigations and through defensive discovery.

New regulations, such as the “Compensation Disclosure and Analysis” section in public filings of company financial statements and “say on pay”

⁴²³ See *McKesson Corp. v. Saito*, 818 A.2d 970 (Del. Ch. 2003) (citing *Saito*, 806 A.2d 113).

⁴²⁴ Francis G.X. Pileggi, Kevin F. Brady & Jill Agro, *Inspecting Corporate “Books and Records” in a Digital World: The Role of Electronically Stored Information*, 37 DEL. J. CORP. L. 163, 171–72 (2012) (arguing for a “readily accessible” standard for the restoration of back-up tapes in response to a “books and records” request, instead of the more demanding “reasonably accessible” standard under FED. R. CIV. P. 26 (citing *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 218 (S.D.N.Y. 2003))).

provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act, have been influenced, at least in part, by public outrage about executive compensation practices disclosed as a result of shareholder litigation involving such companies as Tyco, Enron, WorldCom, Global Crossing, and Disney,⁴²⁵ as well as the hundreds of stock options cases that went forward in 2006 and 2007.⁴²⁶

Many of the stock options cases were settled, but enough went to discovery to generate considerable public outrage.⁴²⁷ Even corporations whose cases were settled or dismissed were often subject to a corporate internal investigation that generated sufficient public information, either by disclosing the SLC report or by including details of an SLC's findings in the notice of settlement, and the settlement agreement to shareholders, to document widespread negligence or malfeasance on the part of compensation committees, CEOs, and CFOs of public companies.⁴²⁸

*D. Litigation Discovery Complements and Enforces Securities Disclosure—
Discovery as Ex Post Disclosure*

Our previous discussion about the role of offensive discovery, defensive discovery, and discovery-related practices for generating information about corporate wrongdoing leads us to conclude that discovery is a form of *ex post* disclosure. This type of *ex post* disclosure is unique to the U.S. system and virtually nonexistent in every other country. This view of discovery as supplementing disclosure has not been previously explored.

⁴²⁵ See, e.g., ALAN PALMITER & FRANK PARTNOY, CORPORATIONS: A CONTEMPORARY APPROACH 681–85 (2010); Coffee, *supra* note 301, at 1404 n.6; Gordon, *supra* note 233, at 686 (“Part of what fuels the sense that the executive compensation-setting process is seriously flawed are the high-profile cases of exceptionally large payouts or mega-stock option grants, particularly where the firm’s subsequent performance is subpar, if not disastrous.”).

⁴²⁶ See David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 563 (2007).

⁴²⁷ See, e.g., M.P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 U. MICH. L. REV. 1597, 1599, 1638 (2007); Eric Dash, *Report Estimates the Costs of a Stock Options Scandal*, N.Y. TIMES, Sept. 6, 2006, at C4; Mark Maremont & Charles Forelle, *Bosses’ Pay: How Stock Options Became Part of the Problem*, WALL ST. J. (Dec. 27, 2006, 12:01 AM), <http://online.wsj.com/news/articles/SB116718927302760228>.

⁴²⁸ See *Perfect Payday: Options Scorecard*, WALL ST. J. (Sept. 4, 2007), <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html> (documenting the 2006–2007 stock options backdating probes, revelations, and outcomes on a company for company basis).

Litigation discovery complements and enforces the securities disclosure regime. It constitutes an *ex post* form of particularized disclosure that enforces and complements the standardized *ex ante* disclosures required by the SEC pursuant to SEC regulations, the 1933 Securities Act, and the 1934 Securities Exchange Act. The first obvious thing to recognize is that litigation discovery allows private actors to explore and generate information about corporate internal wrongdoing that is not already known to the markets (or other public and private actors), via a mechanism entirely distinct from regulatory disclosure.

Disclosure under the securities laws proceeds *ex ante* in accordance with disclosure requirements that have been regulated *ex ante* in a standardized form applicable to all companies.⁴²⁹ *Ex ante* disclosure is necessarily limited and summary in nature: it is made at regular time intervals known in advance by the issuer, or generated by known events, and the issuer determines how to interpret the underlying facts. Once the formal disclosures requirements have been met, they are generally not challenged *ex ante* by the regulator.

In contrast, litigation discovery occurs *ex post* and generates additional disclosures that were not required at the time a company completed its standardized *ex ante* regulatory disclosure. It is particularized and extensive. And it enables the exploration of information that goes far beyond the disclosure of “material information” that issuers must make. Private parties may obtain additional disclosure in situations that were not specifically contemplated by the regulator, including specific transactions that a company was not required to disclose, but which security holders now want to scrutinize. This can supplement information to back up more general disclosures in an issuer’s regulatory filings (like the original records of stock options grants to document the timing and market value of certain stock options awards), or concerning particular individuals and related parties involved in particular transactions (as countless cases from *Van Gorkom* to *Disney* show).⁴³⁰

Litigation discovery thus fills gaps and loopholes in periodic, mandatory public company disclosure. Moreover, it allows plaintiffs to challenge an

⁴²⁹ See generally Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 17.

⁴³⁰ See *supra* Part III.A.

issuer's interpretation of particular facts or developments, including the issuer's interpretation of "materiality."⁴³¹

While regulators and prosecutors also have the ability to engage in such probes, the fact that private litigants also do—and with some frequency—changes the rules of the game.⁴³² Regulators in the United States do not have the resources to provide the current level of verification and enforcement of securities disclosure without the substantial resources dedicated by private parties.⁴³³ Shareholders and the plaintiffs' bar are widely recognized to have very different motivations from regulators and prosecutors for filing shareholder actions.⁴³⁴ Moreover, materials and information obtained through discovery are public by default.⁴³⁵ A plaintiff may thus share information that he or she has obtained with others, including the press and regulators. Management cannot expect the same kind of "confidential treatment" from private plaintiffs that it often enjoys when dealing with the regulator.⁴³⁶

Modern discovery is what enables private attorneys general to pursue securities violations or fraud claims. For example, the ability of private plaintiffs to enforce strict liability for failure to disclose "material information" in a registration statement would be meaningless without the ability to engage in broad discovery—even if all fee arrangements, aggregate litigation rules, and standing requirements stayed the same. Similarly, the private right of action for securities fraud claims under section 10(b) of the Securities Exchange Act would mean little if plaintiffs did not have the ability to obtain detailed information from issuers. Such information is critical for testing not

⁴³¹ See *supra* note 41.

⁴³² See Coffee, *supra* note 13, at 245 ("In the United States, public enforcement of law is supplemented by a vigorous, arguably even hyperactive, system of private enforcement. Relying on class actions and an entrepreneurial plaintiffs' bar motivated by contingent fees, the U.S. system of private 'enforcement by bounty hunter' appears in fact to exact greater annual aggregate sanctions than do its public enforcers. This system has no true functional analogue anywhere else in the world.").

⁴³³ See, e.g., Jason Krause, *Government Agencies Look Within to Solve E-Discovery Woes*, LAW TECH. NEWS, Aug. 1, 2011, at 56 ("[T]here is a misperception that government agencies have unlimited resources to shoulder the burden of electronic data discovery costs in big cases like [the antitrust investigation of Google] Government litigators often manage EDD without proper software."); Melanie Rodier, *Lack of SEC Resources Could Be Biggest Hurdle for Volcker Rule*, WALL ST. & TECH. (Jan. 21, 2011), <http://wallstreetandtech.com/articles/229100012/>.

⁴³⁴ See, for example, the dramatic difference between the SEC's \$150 million settlement with Bank of America regarding its acquisition of Merrill Lynch, compared with the \$2.43 billion settlement shareholders ultimately achieved. Silver-Greenberg & Craig, *supra* note 255.

⁴³⁵ See *supra* note 65 and accompanying text.

⁴³⁶ See SEC ENFORCEMENT MANUAL § 4.3.1 (2013), available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf> (describing confidential treatment requests).

just whether particular developments or events were disclosed, but when they were disclosed, what the underlying facts were, how management interpreted these facts when it became aware of the information, and ultimately whether there was an intent to defraud. To reconstruct the kind of detailed factual accounts and timelines about who knew what, when they knew it, what they did about it, and why, requires substantial factual investigation. The very least one can say on behalf of the private exploration of facts concerning corporate internal wrongdoing is that it has the potential to generate additional information that may affect the price of a firm's securities and its market valuation.⁴³⁷

Discovery interacts with the securities disclosure regime in other ways. The additional information about corporate internal practices that comes to light by way of corporate internal investigations and litigation discovery becomes available to the regulator. Discovery thus serves as an additional source of intelligence for the regulator about constantly evolving internal corporate governance practices and strategies that might be used to avoid full compliance with the regulatory regime. The SEC relies on corporate internal investigations and private securities litigation, because it cannot investigate every case.

IV. OBJECTIONS AND REPLIES

Numerous objections have been raised to our thesis that litigation discovery plays an integral role in the U.S. corporate governance regime.

Discovery, it is argued, is increasingly more difficult to obtain, particularly in shareholder suits. Moreover, even if discovery is available, the rules and practices of discovery have created perverse incentives that may well undermine truth seeking more than they promote it.

First, it has been argued that federal and state laws have increasingly curtailed the ability of plaintiffs to obtain litigation discovery in all types of shareholder suits.⁴³⁸ Critics point to the heightened pleading requirements under the PSLRA, that have considerably raised the threshold for obtaining

⁴³⁷ There is empirical evidence on the effect of filings on share prices. See Gregg A. Jarrell & Annette B. Poulsen, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?*, 2 J.L. ECON. & ORG. 225, 228–29 (1989); Gregg A. Jarrell, James A. Brickley & Jeffrey M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, J. ECON. PERSP., Winter 1988, at 49, 52.

⁴³⁸ See Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 93–94 (2008) (recognizing that federal laws have dramatically affected plaintiffs' access to information in securities litigation, limiting many to only self-obtained information).

discovery in securities class actions, and the discovery stay pending decision on a motion to dismiss.⁴³⁹ Further there is an extensive literature on shareholder derivative actions that strongly suggests their disciplining function is limited. Such actions face significant procedural hurdles, rarely lead to success on the merits, and are frequently either dismissed or settled before a case gets to discovery.⁴⁴⁰

Civil procedure scholars have also objected to our thesis. They have insisted that the modern discovery regime did not live up to the expectations of the drafters in that adversarial discovery offers litigants both motive and substantial opportunity to conceal damaging information during discovery.⁴⁴¹ The most frequently heard complaint about discovery is that witnesses are so extensively prepped before depositions that their testimony often becomes worthless.⁴⁴² Civil procedure scholars have also noted that the litigation process has been reformed in a way that calls into question the account we have given of the judge in the U.S. litigation process.⁴⁴³ These critics claim that the “case management revolution” of the 1990s significantly expanded the role and authority of judges in the discovery process.⁴⁴⁴ Moreover, cumulative developments in civil procedure over the past several decades, such as the imposition of sanctions regimes in the 1980s (FRCP Rules 11 and 37) and the heightening of pleading requirements in such cases as *Bell Atlantic v. Twombly* and *Ashcroft v. Iqbal* during the past decade, have arguably all sought to curb the original drafters’ enthusiasm for discovery, and have reduced the likelihood that plaintiffs will obtain discovery as well as the scope and breadth of that discovery.

Finally, it has been argued that the threat of litigation discovery may well have made it more difficult to obtain evidence of corporate internal

⁴³⁹ 15 U.S.C. § 78u-4(b)(1)–(3) (2012) (including scienter and other specific pleading requirements). Choi and Thompson argued that heightened pleading and other elements of the PSLRA “all work to increase the costs for plaintiffs’ attorneys seeking to bring a class action” and have proven to be a difficult hurdle without access to witnesses or documents. See Choi & Thompson, *supra* note 194, at 1529; see also 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B) (providing a mandatory discovery stay during the pendency of motion to dismiss).

⁴⁴⁰ See *supra* notes 206–14 and accompanying text.

⁴⁴¹ See, e.g., Wayne D. Brazil, *The Adversary Character of Civil Discovery: A Critique and Proposals for Change*, 31 VAND. L. REV. 1295, 1330 (1978).

⁴⁴² See *id.* at 1330–31.

⁴⁴³ See Steven S. Gensler, *Judicial Case Management: Caught in the Crossfire*, 60 DUKE L.J. 669, 705 (2010) (recognizing that any reform that would give judges “more case-management power” must be designed so as to respond to critics); see also Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374, 378 (1982).

⁴⁴⁴ Steven S. Gensler & Lee H. Rosenthal, *Managing Summary Judgment*, 43 LOY. U. CHI. L.J. 517, 520 (2012); see also Gensler, *supra* note 443, at 680–81.

wrongdoing because firms have responded strategically to its threat. For example, firms have put elaborate document management and “retention” policies in place that destroy sensitive documents, e-mails, and other information on a regular basis.⁴⁴⁵ On this view, the threat of exposure has resulted in perverse incentives to eliminate important records, to avoid creating them in the first place, and may result in forcing decision-making underground. “Most executives are smart enough not to say incriminating stuff in emails these days,” as a columnist for *The American Lawyer* states in an article reviewing a jury’s decision to acquit former Citigroup employee Brian Stoker of negligence in a suit brought by the SEC.⁴⁴⁶

In light of these criticisms, how can it be maintained that litigation discovery is so important for corporate governance? In the following sections, we discuss and address each of these objections.

A. *The Special Hurdles to Discovery in Shareholder Actions*

In answering objections based on the hurdles of discovery in shareholder actions, it is important to recognize that legal regimes are neither static nor do they typically reflect the neutral implementation of an ideal policy blueprint. Legal rules are constantly evolving and their development is a political process that reflects the pressures that dominant interests bring to bear on the policymaking process at various junctures.⁴⁴⁷ Given the necessarily political process of negotiating legal rules for investor protection, it is therefore not surprising that the balance between robust litigation discovery and its burdens on corporate defendants and their officers and directors have been contested for decades.⁴⁴⁸ As Professors Stephen Choi and Robert Thompson note, “The

⁴⁴⁵ See DAVID FERRIS, SETTING RETENTION POLICY FOR ELECTRONIC INFORMATION 2 (2011), available at <http://www.ironmountain.com/Knowledge-Center/Reference-Library/View-by-Document-Type/White-Papers-Briefs/S/Setting-Retention-Policy-for-Electronic-Information.aspx> (“Producing information in response to an eDiscovery request can be extremely time-consuming and costly. If the material has been deleted, the costs of production are obviously reduced. Following a clear, communicated retention policy adds defensibility to the deletion of electronic information.”).

⁴⁴⁶ Susan Beck, *Susan Beck’s Summary Judgment: Stoker Jury Foreman Explains How Verdict Didn’t Absolve Citi*, AM. LAW. LITIG. DAILY (Aug. 1, 2012, 12:00 AM), <http://www.litigationdaily.com/id=1202565746363/Susan-Beck’s-Summary-Judgment:-Stoker-Jury-Foreman-Explains-How-Verdict-Didn’t-Absolve-Citi?slreturn=20140105010532>.

⁴⁴⁷ MILHAUPT & PISTOR, *supra* note 5, at 40.

⁴⁴⁸ Most academics agree there are problems but defend securities class actions as a necessary mechanism for shareholder monitoring and general deterrence. See, e.g., Coffee, *supra* note 13, at 245; Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 345–48; Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297,

PSLRA was not the first time policymakers had sought to curb the abuses of representative litigation brought to police management behavior within corporations.”⁴⁴⁹

The empirical literature on the impact of the PSLRA reforms has been voluminous but hardly conclusive. Important for our purposes is whether the PSLRA significantly compromised the integral role of litigation discovery in policing corporate management. Summarizing the empirical evidence available in 2006, ten years after passage of the PSLRA, Choi and Thompson reported that the number of pre-PSLRA filings and post-PSLRA filings remained stable.⁴⁵⁰ Higher value claims were more likely to be filed after the PSLRA.⁴⁵¹ And empirical studies reported an increase in the time between filing and settlement in post-PSLRA cases.⁴⁵² Almost all securities class actions are either settled or dismissed.⁴⁵³ However, there is evidence that a greater percentage of cases are now dismissed or settled prior to the motion to dismiss, raising concerns about underdeterrence.⁴⁵⁴ In light of the mandatory discovery stay, this development suggests plaintiffs have less opportunity to obtain discovery.⁴⁵⁵ Most securities fraud complaints are now dismissed before the plaintiffs get any discovery. Our account of the discovery process therefore suggests that the PSLRA was problematic.

This development does not mean that discovery is no longer important to “outcomes.” For our purposes, “outcomes” does not refer to whether plaintiffs

310–18; Lawrence E. Mitchell, *The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 243. These academics are largely responding to new criticism that today’s securities class actions yield little compensation or deterrence. See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1534 (2006).

⁴⁴⁹ Choi & Thompson, *supra* note 194, at 1491.

⁴⁵⁰ *Id.* at 1496.

⁴⁵¹ *Id.* at 1497–98.

⁴⁵² *Id.* at 1498.

⁴⁵³ Stephen J. Choi, Karen K. Nelson & A.C. Pritchard, *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. EMPIRICAL L. STUD. 35, 35–36 (2009) (“Trials . . . are almost unheard of in this area . . .”).

⁴⁵⁴ *Id.* at 35 (“There is evidence . . . that pre-PSLRA nonnuisance claims would be less likely to be filed under the PSLRA regime. The latter result, which we refer to as the screening effect, is particularly pronounced for claims lacking hard evidence of securities fraud or abnormal insider trading.”). This raises concerns about the balance that has been struck by the PSLRA.

⁴⁵⁵ See *id.* at 38. Actions claiming fraud must generally satisfy the heightened pleading requirements under FED. R. CIV. P. 8(a), requiring plaintiffs to plead the circumstances surrounding the fraud with specificity—but not intent. The PSLRA additionally requires that plaintiffs allege facts that support a “strong inference” of scienter. 15 U.S.C. § 78u-4(b)(2) (2012).

win or lose, or how and at what stage a case is ultimately disposed of. Rather, “outcomes” refers to the information production, disciplining effects, and positive externalities that flow from strategic behavior within an enforcement scheme structured by litigation discovery. Only by engaging in more fine-grained analyses of how the contest between plaintiffs seeking discovery in shareholder litigation, and defendants seeking to avoid it, plays out, and how the law in practice intricately configures this contest, can we understand the implications of the discovery system. This is what we have done in Part III. Whereas discovery in securities class actions is very hard to obtain, such actions are often filed together with parallel state court actions that allege fiduciary duty violations based on the same facts and circumstances.⁴⁵⁶ Settlements in federal securities class actions may thus be informed by discovery in state actions, or by information produced by special litigation committee investigations on the part of defendants in a state derivative action, with all the positive consequences of such SLC investigations.

Nonetheless, judges have the flexibility to allow securities fraud actions to go forward, as the wave of stock options backdating cases showed in 2006 and 2007.⁴⁵⁷ The threat of discovery is therefore ever present even in securities litigation. As the *Wall Street Journal*’s Options Scorecard shows, and as already discussed in Part III, internal investigations also generated earnings restatements, information for the SEC (which would typically obtain any SLC report subject to a confidential treatment agreement), corporate governance improvements, and other information for markets, even when they were subject to confidentiality and never filed with the court.⁴⁵⁸ Some cases went to discovery, and in some cases, the Justice Department and state authorities launched criminal investigations.⁴⁵⁹

In response to the objection that shareholder derivative actions are frequently dismissed or settled prior to discovery, we again refer to our discussion in Part III on the information-producing impact and disciplining effects of internal investigations in such cases.

⁴⁵⁶ “[T]he intertwining of 10b-5 violations and breaches of fiduciary duty . . . pervades most derivative actions against directors where a transfer of securities is involved . . .” Kurt M. Swenson, *Remedies for Private Parties Under Rule 10b-5*, 10 B.C. INDUS. & COM. L. REV. 337, 355–56 (1969) (discussing *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967)). This is also why SLUSA was passed in the wake of the PSLRA. Plaintiffs, however, have been able to adjust by bringing claims in the form of shareholder derivative actions in state court.

⁴⁵⁷ See, e.g., *Perfect Payday: Options Scorecard*, *supra* note 428.

⁴⁵⁸ *Id.*

⁴⁵⁹ *Id.*

B. *The FRCP's Retreat from Liberal Discovery Since the 1970s*

In spite of the “case management revolution” of the 1990s and other developments, the judicial role in discovery remains very limited when compared to civil law adjudication. To be sure, “case management” requirements and authority under FRCP 16 and 37 have increased since the 1980s, generating an entire literature on “managerial judges.”⁴⁶⁰ Although the new rules give judges significant authority to set deadlines and timetables for discovery, case management rules have not changed the basic structure of litigation. Parties conduct discovery adversarially. The tools remain the same, and the scope of discovery is still very broad. Although judges are now required to issue a scheduling order, there is no evidence that this interferes with thorough discovery.⁴⁶¹ These changes represent little more than the proverbial fly on the elephant’s back. Comparatists who take this literature as somehow reflecting a dramatic change in U.S. discovery rules and practices have mistaken superficial similarities in separate discourses as functional equivalents.⁴⁶²

The case *Acuna v. Brown & Root Inc.* illustrates how far a judge might go under the case management rules to restructure the ordinary course of pretrial litigation and deny plaintiffs discovery.⁴⁶³ In *Acuna*, the court required plaintiffs to submit expert affidavits to establish with particularity the illnesses complained of by 600 plaintiffs, who had allegedly suffered from defendants’ uranium mining and processing operations, before allowing plaintiffs any discovery at all.⁴⁶⁴ When the plaintiffs’ attorneys failed to comply with the scheduling order for the expert reports, the judge dismissed the claims.⁴⁶⁵ But *Acuna* is a controversial case that illustrates the limits of judicial case management in a situation where the class action mechanism was pushed to its

⁴⁶⁰ Resnik, *supra* note 443, at 378; see also, Richard L. Marcus, *Reining in the American Litigator: The New Role of American Judges*, 27 HASTINGS INT’L & COMP. L. REV. 3, 17–20 (2003); Resnik, *supra* note 105, at 497–98.

⁴⁶¹ Moreover, deadlines are not infrequently extended.

⁴⁶² See *infra* notes 524–39 and accompanying text. Civil law countries are introducing small changes in light of their increasing contact with the U.S. system. See HUANG, *supra* note 24, at 160 (arguing for conversion of procedural rules). But see, e.g., VERKERK, *supra* note 23, at 370 (“A remarkable conclusion is that the differences between the fact-finding arrangements in Continental and American jurisdiction are larger today than they were a century ago.”).

⁴⁶³ See 200 F.3d 335, 340–41 (5th Cir. 2000).

⁴⁶⁴ *Id.* at 337–38.

⁴⁶⁵ *Id.* at 338.

limits.⁴⁶⁶ To be sure, in large mass-tort actions, case management has become more specialized. But these changes do not alter the fundamental structure of shareholder litigation.

Twombly and *Iqbal* have been influential and reflect the Supreme Court's concern that discovery imposes substantial burdens on defendants that are not always justified. A WestlawNext database search in the thirty months after *Iqbal* was decided shows that federal courts issued 27,500 reported opinions citing both *Twombly* and *Iqbal*. "*Twombly* and *Iqbal* now rank among the Court's most-cited decisions,"⁴⁶⁷ and the academic commentary on this line of cases is voluminous. But a study by the Federal Judicial Center on reported and unreported cases in twenty-three federal districts from 2006 to 2010 showed that, while the rate of filing motions to dismiss for failure to state a claim increased over this period, the rate at which such motions were granted without leave to amend did not show a statistically significant increase in any area other than cases challenging mortgage loans.⁴⁶⁸ And this was likely the result of a tripling of such cases from 2006 to 2010.⁴⁶⁹ The empirical evidence therefore fails to show that discovery has been restricted by these cases in shareholder litigation.

Moreover, even if there has been a retreat in discovery as a result of *Twombly* and *Iqbal*, the retreat is marginal compared to the fundamental difference between the U.S. discovery regime and the lack thereof in civil law and other common law jurisdictions. To the extent that judges exert more control over whether a case goes to discovery, this does not detract from our more general claim that discovery serves as an *ex post* mechanism for disclosure. If judges are able to weed out meritless cases prior to discovery, that only benefits shareholders.

⁴⁶⁶ See *id.* The litigation involved a large plaintiff class, with each plaintiff suffering from different symptoms, occurring during different time frames, in different places, purportedly caused in different ways by one or more of a large class of diverse defendant companies engaged in a variety of different activities at different times, and in different places. *Id.* at 340.

⁴⁶⁷ ROWE, SHERRY & TIDMARSH, *supra* note 187, at 64.

⁴⁶⁸ *Id.*

⁴⁶⁹ See JOE S. CECIL ET AL., FED. JUDICIAL CTR., MOTIONS TO DISMISS FOR FAILURE TO STATE A CLAIM AFTER *IQBAL*: REPORT TO THE JUDICIAL CONFERENCE ADVISORY COMMITTEE ON CIVIL RULES, at vii, 12 (2011).

C. *Dysfunctions of Discovery*

There is considerable disagreement about the value and efficiency of discovery. Critics have claimed that the adversarial system has distorted the drafters' original intent and turned discovery into a game of hide and seek. At the same time, discovery has been severely criticized for being far too costly, intrusive, and wasteful.⁴⁷⁰

In response, it should first be noted that no serious observer maintains the general claim that discovery fails to afford litigants the information they need to prosecute their cases. Even the most ardent critics of discovery do not claim that discovery is ineffective. To the contrary, their claims are that discovery is used too frequently and extensively, burdens litigants with costly discovery requests, and encourages "open-ended fishing expeditions" that cause excessive delays in the disposition of cases, clogging the judicial system and overwhelming the judiciary.⁴⁷¹ Worse, discovery, they argue, is frequently abused and coerces litigants into unjust settlements simply to avoid its tremendous costs, which have skyrocketed since the advent of e-discovery.⁴⁷² While e-discovery certainly poses many new challenges for litigants, these claims are controversial and do not seem to be borne out by the empirical evidence.⁴⁷³ Moreover, such claims are not new and predate the advent of e-discovery.⁴⁷⁴

Critics have argued that the rules and practices of discovery have created perverse incentives that undermine truth-seeking more than they promote it. Civil procedure scholars have pointed out that the modern discovery regime did not live up to the expectations of the drafters in that adversarial discovery

⁴⁷⁰ See *supra* note 42.

⁴⁷¹ See BEISNER, *supra* note 33, at 1–2 (internal quotation marks omitted).

⁴⁷² *Id.*; see also FINAL REPORT ON THE JOINT PROJECT OF THE AMERICAN COLLEGE OF TRIAL LAWYERS TASK FORCE ON DISCOVERY AND THE INSTITUTE FOR THE ADVANCEMENT OF THE AMERICAN LEGAL SYSTEM 9 (2009), available at <http://www.actl.com/AM/Template.cfm?Section=Home&template=/CM/ContentDisplay.cfm&ContentID=4053>; Henry S. Noyes, *Good Cause Is Bad Medicine for the New E-Discovery Rules*, 21 HARV. J.L. & TECH. 49, 67–68 (2007) ("[E]-discovery is more time-consuming, more burdensome, and more costly than conventional discovery."); Martin H. Redish, *Electronic Discovery and the Litigation Matrix*, 51 DUKE L.J. 561, 592 (2001).

⁴⁷³ See *infra* notes 491–95.

⁴⁷⁴ See, e.g., William H. Erickson, *The Pound Conference Recommendations: A Blueprint for the Justice System in the Twenty-First Century*, 76 F.R.D. 277, 288 (1978) (observing that "[w]ild fishing expeditions . . . seem to be the norm," and lamenting the "[u]nnecessary intrusions into the privacy of the individual, high costs to the litigants, and correspondingly unfair use of the discovery process as a lever toward settlement" that had come to characterize the American legal system).

offers litigants both motive and substantial opportunity to conceal damaging information during discovery.⁴⁷⁵ A frequently heard complaint is that witnesses are so extensively coached before depositions that their testimony often becomes worthless.⁴⁷⁶

With regard to witness preparations, it is useful to recall that the authority under the modern discovery rules to cross-examine a witness under oath during deposition is undoubtedly the most powerful tool in an attorney's investigative arsenal—in spite of the frequent criticism that deponents are all too well prepared for testimony by opposing counsel. Critics rarely consider that the *thorough preparation of the examiner* is a very important distinguishing feature of U.S. witness examination. The discovery rules allow the parties to determine the order in which they use the discovery tools and notice depositions. A common strategy is to document and lock in as many facts as possible via interrogatories, document discovery, and depositions of other knowledgeable but less important witnesses, so that the examiner has a thorough understanding of the case before taking the final depositions of key witnesses.⁴⁷⁷ A plaintiff's attorney in a shareholder action is likely to save depositions of the most important witnesses—typically executives and other named defendants—for last.⁴⁷⁸

During a deposition, the examiner may ask open and leading questions, confront the witness with his or her own prior statements, and refresh a witness's memory with the help of copious documents and e-mails previously disclosed during document discovery—which the examiner reviews, organizes, and strategically deploys during questioning. ESI is particularly devastating in that e-mails are produced in strings of correspondence—permitting the reconstruction of who said what to whom, who was in the loop, who was later apprised of a conversation on what date and at which time, and who was excluded from subsequent conversations. ESI documents may have to be produced with metadata, containing information on whose hard drive they

⁴⁷⁵ Subrin, *supra* note 111, at 706–07, 728.

⁴⁷⁶ See, e.g., Ronald J. Allen, *Idealization and Caricature in Comparative Scholarship*, 82 NW. U. L. REV. 785, 786 (1988) (discussing Langbein's criticism of depositions and citing contrary evidence).

⁴⁷⁷ Another strategy is to take a first deposition of key witnesses early in the case to lock them into positions before defensive discovery allows them to assess how far they can bend the truth without their testimony being later challenged and contradicted by documents and other witness testimony, but to reserve the right to reexamine the witness again at a later date.

⁴⁷⁸ By contrast, in civil law systems, witness examinations occur issue by issue in an order entirely determined by the judge. A judge likely would take the most important witnesses first, given that the judge is always looking for dispositive issues. See Langbein, *supra* note 23, at 830, 846.

came from, when they were created and revised, and supplying all drafts and revisions with time-stamps and author identification together with the original document—making it very hard for a witness to credibly deny knowledge of specific transactions, communications, routines, and practices that obviously bear the witness’s electronic signature.⁴⁷⁹

If an examiner is well prepared, depositions tend to be very productive. The only relatively safe strategy for resisting is to state “I do not recall” to every question. While this does occur—as it did, for example, in the deposition of Arthur Andersen witnesses in the Enron cases—it is extremely embarrassing to the witness. Although this strategy may be open to witnesses who have no professional reputation left to preserve and whose primary concern is to avoid incriminating themselves, it tends not to be available to executives for reputational, psychological, and institutional reasons. In any case, it is the rare witness who can sustain this type of testimony during the hours of humiliation that such behavior will inevitably draw from an examiner intent on obtaining information from an important witness.⁴⁸⁰ And it may prompt the examiner to call the judge to threaten the witness with contempt, if the witness is worth the trouble. While an examiner may not get the precise admission she wants from a well-coached party-opponent, who might thereby be able to avoid liability, depositions are generally productive and extraordinarily uncomfortable for anyone who has something to hide.⁴⁸¹

Sophisticated document retention policies that regularly purge ESI also do not concern us. While theoretically the threat of discovery could incentivize the destruction of evidence, this is not plausible for several reasons. First, firm internal decisions and decision-making processes must be documented at every level of the firm hierarchy for business reasons and for purposes of regulatory compliance. Gaps in such documentation can severely compromise a firm’s business, its position in negotiations with regulators, and its ability to mount a

⁴⁷⁹ See generally Philip J. Favro, *A New Frontier in Electronic Discovery: Preserving and Obtaining Metadata*, 13 B.U. J. SCI. & TECH. L. 1 (2007) (discussing the hazards of metadata and recent developments in the case law requiring production of metadata).

⁴⁸⁰ See, for example, the deposition of Timothy J. Mayopoulos, BofA’s associate general counsel in the Merrill Lynch case. See *supra* note 249 and accompanying text.

⁴⁸¹ See Marcus, *supra* note 31, at 750 (“One of the striking things about American discovery is that parties often do reveal damaging information, and the importance of that discovered material in litigation cannot be overstated.”); see also H. Christopher Boehning & Daniel J. Toal, *More Than a Security Risk: Director E-mails in Discovery*, N.Y.L.J., Apr. 3, 2012 (discussing the vulnerability to discovery of electronic communications among directors).

defense in civil litigation.⁴⁸² If management expects to enjoy the protection of the business judgment rule, it must keep detailed records, as *Van Gorkom*'s "proceduralization of the boardroom" dictates in fiduciary duty cases.⁴⁸³ Decision-makers cannot anticipate *ex ante* which documents to destroy or to retain in the face of potential future legal challenges. Therefore, a point can be made that they are more likely to retain documents than destroy them.

Another reason document retention policies are not a concern is that the e-discovery regimes and practices strongly discourage routine destruction or mishandling of documents. The demands of e-discovery make meticulous document management protocols, including the firm-wide standardization of file types, software platforms, and IT systems critical.⁴⁸⁴ The cost of defending even a handful of depositions can become astronomical if a firm has failed to properly maintain the data. And judges will not necessarily protect firms from the consequences of such mismanagement where such problems could have been readily foreseen. Courts are proposing the use of counsel with expertise in computer systems and internal experts to assist with the challenges presented by e-discovery.⁴⁸⁵ Of course, it is always possible for management to go out of its way to destroy records for certain transactions. But, if anything, such activities have become far more difficult in an era of e-discovery, where metadata that trace all sorts of user activity in multiple ways are routinely subject to discovery.⁴⁸⁶ Finally, failure to produce evidence and document

⁴⁸² See generally Lee H. Rosenthal, *A Few Thoughts on Electronic Discovery After December 1, 2006*, 116 YALE L.J. POCKET PART 167 (2006), <http://www.thepocketpart.org/images/pdfs/82.pdf> (discussing issues likely to arise under new discovery laws and potential challenges for lawyers, litigants, and judges).

⁴⁸³ See *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000) ("[I]n making business decisions, directors must consider all material information reasonably available, and . . . the directors' process is actionable only if grossly negligent.").

⁴⁸⁴ See generally Richard L. Marcus, *Confronting the Future: Coping with Discovery of Electronic Material*, LAW & CONTEMP. PROBS., Spring/Summer 2001, at 253; Richard Marcus, *Only Yesterday: Reflections on Rulemaking Responses to E-Discovery*, 73 FORDHAM L. REV. 1 (2004).

⁴⁸⁵ See, e.g., THE CHIEF JUDGE'S TASK FORCE ON COMMERCIAL LITIG. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS TO THE CHIEF JUDGE OF THE STATE OF NEW YORK 19 (2012), available at <http://www.nycourts.gov/courts/comdiv/PDFs/ChiefJudgesTaskForceOnCommercialLitigationInThe21stpdf.pdf>.

⁴⁸⁶ See James H.A. Pooley & David M. Shaw, *Finding Out What's There: Technical and Legal Aspects of Discovery*, 4 TEX. INTELL. PROP. L.J. 57, 64 (1995) ("There are sophisticated computer programs that can retrieve e-mail messages and computer files from the guts of the computer system long after those messages and files were thought to have been forever deleted. . . . [T]he mere fact that files were destroyed, perhaps systematically, could prove to be more valuable information than the actual files retrieved, especially if such fact is used to prove a cover-up, for example.").

destruction can lead to civil and criminal sanctions.⁴⁸⁷ As a result, corporations are spending more money on recordkeeping systems. This is what legal counsel and, most recently, the Dodd-Frank Act require—to keep detailed records of all transactions.⁴⁸⁸

D. The Costs of Discovery

The usual approach to discovery in the business community and academic scholarship is to point out the excesses and costs imposed by discovery.⁴⁸⁹ A report by the U.S. Chamber of Commerce notes that up to 90% of litigation-related costs are incurred during discovery.⁴⁹⁰

However, empirical literature suggests that discovery abuse, and impositional discovery in particular, is not as significant a problem as is generally assumed.⁴⁹¹ Surveying the recent literature, Professor Danya Shocair Reda concludes that “[e]mpirical studies have repeatedly failed to document

⁴⁸⁷ See, e.g., *Sekisui Am. Corp. v. Hart*, 945 F. Supp. 2d 494, 509–10 (S.D.N.Y. 2013) (imposing sanctions in the form of monetary damages and an adverse inference jury instruction where a party destroyed electronic documents); *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, 685 F. Supp. 2d 456, 469–72 (S.D.N.Y. 2010) (discussing cases involving sanctions for nonproduction of evidence), *abrogated by* *Chin v. Port Auth. of N.Y. & N.J.*, 685 F.3d 135 (2d Cir. 2012).

⁴⁸⁸ See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 and 15 U.S.C.).

⁴⁸⁹ See *supra* note 42.

⁴⁹⁰ BEISNER, *supra* note 33, at 2 & n.7 (citing THOMAS E. WILLGING ET AL., FED. JUDICIAL CTR., DISCOVERY AND DISCLOSURE PRACTICE, PROBLEMS, AND PROPOSALS FOR CHANGE: A CASE-BASED NATIONAL SURVEY OF COUNSEL IN CLOSED FEDERAL CIVIL CASES 15 tbl. 4 (1997), available at <https://bulk.resource.org/courts.gov/fjc/discovery.pdf>; see also H.R. REP. NO. 104-369, at 37 (1995) (Conf. Rep.) (“[D]iscovery costs account for roughly 80% of total litigation costs in securities fraud cases” (quoting the general counsel of an investment bank)); *Judicial Conference Adopts Rules Changes, Confronts Projected Budget Shortfalls*, THIRD BRANCH (Admin. Office U.S. Cts., D.C.), Oct. 1999, at 2–3 (“Discovery represents 50 percent of the litigation costs in the average case and up to 90 percent of the litigation costs in cases in which it is actively used.”), available at http://www.uscourts.gov/News/TheThirdBranch/99-10-01/Judicial_Conference_Adopts_Rules_Changes_Confronts_Projected_Budget_Shortfalls.aspx). But note that the 90% number is highly misleading. The report cited in the Chamber of Commerce report stated that, in about 15% of cases, there was no discovery, that discovery costs on average constituted 3% of the value of a dispute, and that in a small number of large cases, 90% of litigation-related costs are incurred during discovery. WILLGING ET AL., *supra*, at 15 tbl. 4, 17 tbl. 6. That 90%, however, notably does not consider the value of the claim or dispute. Thus, even if discovery costs constituted 90% of the litigation costs, these costs quite likely reflect a very small percentage (i.e., in the single digits) of the value of the dispute.

⁴⁹¹ Separate empirical studies by the Federal Judicial Center in 1996 and the RAND Corporation in 1993 found that only a small minority of cases presented significant discovery problems, but that, among other findings, 54% of attorneys thought that the expense of discovery was about right in relation to the stakes of the case, 15% thought the expenses too high, 20% thought them too low, and the rest had no opinion. ROWE, SHERRY & TIDMARSH, *supra* note 187, at 118 (reviewing empirical literature).

exorbitant costs or widespread discovery abuse; they have generally found the volume of discovery, the costs of discovery, and the total costs of litigation to be less than expected.”⁴⁹² The robust finding of every independent empirical study on litigation costs is that the amount at stake in the litigation is “the greatest determinant of cost in civil litigation.”⁴⁹³ A 2009 Federal Judicial Center study reported that for defendants the median ratio of discovery costs to stakes was 3.3%,⁴⁹⁴ a finding consistent with prior studies.⁴⁹⁵ Therefore, discovery costs should not be discussed in abstract and generic formulations based on absolute and aggregate numbers, but should be assessed relative to the stakes at issue in judicial cases, in a way that specifies and disaggregates the costs in relation to litigation outcomes.

The corporate law literature considers the costs of discovery in shareholder actions primarily from the perspective of the outcome that shareholders obtain from a particular lawsuit, but the benefits of discovery are not considered in the balance.⁴⁹⁶ The literature has focused on the negative externalities of discovery in encouraging and rewarding meritless strike suits. It has also focused on the misallocation of costs, in that ultimately the shareholders bear the costs of management wrongdoing in successful lawsuits. In other words, it has considered the negative externalities of discovery, but not its positive externalities. Moreover, it has focused on the micro level—and done so inadequately⁴⁹⁷—but ignored the macro level.

The only argument in the corporate law literature we are aware of that considers the private costs of discovery at the micro level in relation to its social benefits at the macro level is by Professor Lynn Stout. Stout provided a cost–benefit analysis of the additional burdens the PSLRA imposes on

⁴⁹² Reda, *supra* note 34, at 1111; *see also* Lawyers for Civil Justice et al., *Litigation Cost Survey of Major Companies*, Presentation at the Duke Law School 2010 Conference on Civil Litigation 2 (May 10, 2010), <http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/Duke%20Materials/Library/Litigation%20Cost%20Survey%20of%20Major%20Companies.pdf> (“[F]ew empirical studies document the costs and utility of discovery.”).

⁴⁹³ Reda, *supra* note 34, at 1104.

⁴⁹⁴ EMERY G. LEE III & THOMAS E. WILLGING, FED. JUDICIAL CTR., *PRELIMINARY REPORT TO THE JUDICIAL CONFERENCE ADVISORY COMMITTEE ON CIVIL RULES 42* (2009), *available at* [http://www.fjc.gov/public/pdf.nsf/lookup/dissurv1.pdf/\\$file/dissurv1.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/dissurv1.pdf/$file/dissurv1.pdf).

⁴⁹⁵ WILLGING ET AL., *supra* note 490, at 17 tbl. 6 (1997); *see also* Linda S. Mullenix, *The Pervasive Myth of Pervasive Discovery Abuse: The Sequel*, 39 B.C. L. REV. 683, 684 (1998) (“[D]iscovery data have remained surprisingly constant over time.”).

⁴⁹⁶ *See supra* notes 44–46 and accompanying text. Indeed, this is also the law governing the judicial approval of settlements.

⁴⁹⁷ *See supra* Part III.A.

plaintiffs.⁴⁹⁸ She compared the losses from defending against meritless strike suits with the potential effects of discouraging legitimate suits.⁴⁹⁹ By raising pleading requirements and preventing plaintiffs from obtaining discovery, investors are also discouraged from pursuing legitimate fraud claims.⁵⁰⁰ In other words, she concludes that the social costs of (perceived) underdeterrence far outweigh the private costs that the PSLRA was intended to avoid.⁵⁰¹

But even Stout's argument considers only one of the positive externalities of discovery—the impact on the securities markets in connection with Type II errors. This Article has set forth a host of concrete positive externalities at the micro and macro level.

First, at the micro level, considering the private costs and benefits of every individual lawsuit separately, the literature generally does not properly value the benefits of corporate governance improvements in cases that are settled—and it entirely misses the disciplining (and sometimes remedial) benefits of defensive discovery that occur after the motion to dismiss, as well as the benefits of corporate internal investigations that occur prior to any motion to dismiss. These positive externalities are all direct results of evolving discovery rules and practices.

Still at the micro level, the literature generally does not take into account the positive externalities of discovery at the firm level after a particular shareholder action: deterrence of misconduct based on the experience of probing internal investigations by outside gatekeepers, improved internal controls and monitoring systems, corporate governance enhancements at the board level, and improved data management and litigation-hold protocols developed in connection with litigation preparedness.

These private benefits, of course, are not cost free. It can be argued, for example, that corporations face significant private costs because of the threat of discovery in that they must implement these changes, establish litigation preparedness procedures, bear the costs of litigation discovery, establish more

⁴⁹⁸ Stout, *supra* note 42, at 712–13.

⁴⁹⁹ *Id.* at 713–14.

⁵⁰⁰ Stout notes that corporate losses from defending against meritless strike suits were described at the time as being in the hundreds of millions of dollars annually. But if one considers the possibility of a mere 1% discount applied by investors to shares of public companies, based on investor concern of underdeterrence (or Type II errors), the combined losses to the securities markets could surmount \$100 billion. *Id.* See also *supra* notes 194–202 and accompanying text for a discussion of Type I and Type II errors.

⁵⁰¹ Stout, *supra* note 42, at 713–14.

sophisticated document management systems, etc. But even if these private costs are large, they must be considered in connection with the social benefits at the macro level.

At the macro level, the positive externalities include continuous information production for markets, regulators, and courts about constantly evolving corporate internal practices; the resulting developments of substantive law (both case law and statutory law); efficiency gains by courts and regulators, which heavily rely on private actors to generate the information critical for enforcement; deterrence based on the threat of discovery; the development of best practices of internal and external corporate governance; lower costs of capital (if Stout is right); and a general corporate governance culture of transparency.

Here, and in our discussion in Part III, we have identified concrete variables that should affect any calculus of the private/social costs and benefits of discovery. The efficiency of discovery must therefore be assessed in a Kaldor–Hicks framework, which evaluates whether discovery’s aggregate social benefits surpass the private costs associated with it.⁵⁰²

V. POLICY IMPLICATIONS FOR COMPARATIVE CORPORATE GOVERNANCE

The account of litigation discovery’s integral role in U.S. corporate governance generates important normative prescriptions. We briefly discuss them here and set up a research agenda for future study.

A. *The Enforcement Debate*

A substantial literature has emerged on the importance of private enforcement of corporate and securities laws. In particular, the *level of private enforcement* has been identified as a significant aspect of American exceptionalism. The enforcement debate, however, is neither homogenous nor precise about what is meant by enforcement or how it is measured. Different studies use different concepts and proxies for studying levels of enforcement, including funds expended,⁵⁰³ director and officer liability,⁵⁰⁴ incentives such as

⁵⁰² *Supra* note 291 and accompanying text.

⁵⁰³ *See, e.g.*, Jackson & Roe, *supra* note 13.

⁵⁰⁴ *See supra* Part III.A; *see also supra* note 44.

fee structures,⁵⁰⁵ number of filings, the availability of certain causes of action and case outcomes.⁵⁰⁶

Surprisingly, no studies so far have paid attention to the broad role that American fact investigation exerts on private enforcement. The detailed account of the impact of discovery at each stage of the litigation process enables us to complement the analysis that some empirical studies on private enforcement make, and to propose to further disaggregate the variables used in such studies.

In a comparison of private enforcement in the United Kingdom and the United States, Professor John Armour and coauthors concluded that private enforcement is much more intensive in the United States than in the United Kingdom, where private enforcement is virtually nonexistent.⁵⁰⁷ But their empirical data lead them to conclude that “private enforcement of corporate law is less central to strong securities markets than might be anticipated.”⁵⁰⁸

Armour and coauthors base their conclusions on both an analysis of available causes of action and empirical research on filings and outcomes of lawsuits.⁵⁰⁹ They report that lawsuits against directors of public companies alleging breach of duty are nearly nonexistent in the United Kingdom, where, “absent exceptional circumstances, direct suits are not available, and derivative suits have also been extremely hard to sustain.”⁵¹⁰ Their empirical results show that the United Kingdom has almost no formal private enforcement of corporate substantive law against directors of publicly traded companies.⁵¹¹ They attribute the absence of formal private enforcement to procedural rules.⁵¹² Like other scholars, they focus on “rules governing class actions, contingency fees, and who pays the winner’s legal expenses.”⁵¹³

⁵⁰⁵ See, e.g., Coffee, *supra* note 17, at 292.

⁵⁰⁶ See Armour et al., *supra* note 13, at 688–89.

⁵⁰⁷ *Id.* at 690.

⁵⁰⁸ *Id.* at 687.

⁵⁰⁹ *Id.* at 689.

⁵¹⁰ *Id.* at 695.

⁵¹¹ *Id.* at 690.

⁵¹² *Id.* at 721.

⁵¹³ *Id.*

In contrast, shareholders in the United States are able to commence and sustain litigation (both direct and derivative) in many circumstances where directors may have breached their duties.⁵¹⁴ While directors are much more likely to be sued under U.S. corporate law than their British counterparts, the authors remark that out-of-pocket liability is rare.⁵¹⁵ They present their main results in the following table.⁵¹⁶

Table 6: Outcomes for Reported Decisions in Damages Cases

<i>Case Outcome</i>	<i>Insiders Only</i>	<i>Outsiders Only</i>	<i>Insiders & Outsiders</i>	<i>Total</i>
No relief				
Defendants' motion to dismiss or for summary judgment granted	11	0	173	184
Trial verdict for defendants	0	0	5	5
Relief				
Trial verdict for plaintiffs	2	0	8	10
Settlement	2	1	45	48
Outcome unknown; last-known result is				
Defendants' motion to dismiss or for summary judgment denied or partly denied	8	1	54	63
Settlement denied	0	0	6	6
Stay granted or denied	0	0	12	12
Other	1	0	26	27
Total	25	2	328	355

NOTE: Principal outcome for 355 corporate law cases with damages claims that resulted in one or more decisions over 2000–2007, in Delaware state court, other state courts, or federal court. Outcome is based on reported decisions and, where these do not indicate the outcome, a search for settlements (see text for search details).

As Armour and coauthors' Table 6 shows, their empirical study of U.S. private enforcement focuses on cases filed and outcomes.⁵¹⁷ Their analysis shows that "[t]he most common outcome was for the defense to succeed on a motion to dismiss or for summary judgment."⁵¹⁸ They report that 52% (184 out of 355) of damages cases were resolved on pretrial motions (in favor of defendants).⁵¹⁹ The problem with their approach is that they aggregate the results of dismissals before discovery with dispositions of summary judgment, which in most cases occurs after discovery in a case has been completed. In so

⁵¹⁴ *Id.* at 695.

⁵¹⁵ *Id.* at 722.

⁵¹⁶ *Id.* at 708 tbl. 6.

⁵¹⁷ *See id.*; *see also id.* at 707 ("[O]ur primary concern is with director liability.").

⁵¹⁸ *Id.* at 708.

⁵¹⁹ *Id.*

doing, the authors overlook the substantial threat that discovery represents for individual defendants. Discovery in these cases is not merely expensive; it subjects the actions of the directors and officers, as well as the behavior of all company employees, to a level of scrutiny that is virtually nonexistent in any other country.

The authors do not specify what percentage of the remaining 48% (171) of the cases that were not disposed of on pretrial motion received discovery.⁵²⁰ Looking at their Table 6, one can infer that all but 48 cases, that is, the 14% that were settled, received some discovery.⁵²¹ But the authors do not disaggregate settlements before and after discovery, which means that this number may include cases that went through discovery. Even if a disproportionate number of the settled cases in Armour and coauthors' data set are settled prior to discovery, this does not necessarily mean there was no extensive fact investigation into the challenged practices, as our discussion on the special litigation committees showed.

The failure to disaggregate the data and to consider what consequence the procedural posture has for the "intensity of private enforcement" variable to which the study ultimately intended to speak, may have led Armour and coauthors to underestimate the importance of private litigation. Private litigation might significantly discipline management, because of the effectiveness of discovery to render corporate internal practices transparent, thereby influencing settlement rates. As noted in Part III, the cases in which discovery turns up evidence that are likely to lead to a defendant's liability are also the ones that are most likely to settle. This introduces a selection bias. It is therefore important to distinguish between cases resolved with and without discovery, even if plaintiffs lose on the merits of the claim.

In this and other ways, the empirical literature on private enforcement needs to be revisited in light of our observations.

B. Exporting U.S. Corporate Governance and Securities Laws

The comparative corporate governance debate has been highly consequential by encouraging other nations across Europe, Asia, and Latin America to emulate the U.S. corporate and securities laws.⁵²² But the role of

⁵²⁰ *Id.* at 709.

⁵²¹ *See id.* at 708 tbl. 6.

⁵²² *See supra* notes 2–13 and accompanying text.

the discovery regime in fashioning the laws, institutions, and practices of corporate governance, compared with the significant barriers to private fact investigation in other countries, has broad implications for legal transplants.⁵²³

Civil law systems have no pretrial discovery.⁵²⁴ In part, this is a function of the very different roles of civil law judges and attorneys, reflecting substantial differences in the design of the litigation process.

The U.S. pretrial period presupposes a distinction between at least two stages of litigation: a concentrated trial at which evidence is presented, in many cases to a jury, and a period before the trial during which the advocates prepare for trial and conduct their fact investigation. By contrast, civil law adjudication “proceeds according to an entirely different logic.”⁵²⁵ It follows an inquisitorial model, in which the judge drives the entire process, and there is no distinction between trial and pretrial proceedings.⁵²⁶ Adjudication is akin to a series of business meetings at which the judge investigates and considers only the evidence relevant to the one or two issues that she believes might decide the case. The judge only seeks additional evidence if the case cannot be disposed of on the issues presently before the court.⁵²⁷ It is the judge who explores, sifts through, and controls the investigation and presentation of evidence, all of which must take place during a hearing.⁵²⁸ The judge decides what evidence parties may present at what time, how the evidence is to be interpreted, and whether any issue warrants further investigation.⁵²⁹

⁵²³ See, e.g., Scott Dodson & James M. Klebba, *Global Civil Procedure Trends in the Twenty-First Century*, 34 B.C. INT’L & COMP. L. REV. 1, 1–2 (2011) (“In a number of areas, civil procedure practices in the United States differ significantly from the rest of the world, particularly the civil law world. Notable differences include the use of civil juries, the prevalence of partisan experts paid for directly by the litigants, the existence and extent of party-controlled pre-trial discovery, standards for second instance (or appellate) review, notions of finality in litigation (*res judicata*), the use of class actions and other forms of aggregate litigation, pleading requirements, and the role and status of the judge. Together, these individual attributes have given rise to a holistic assessment that U.S. civil procedure is highly exceptionalist when compared to the civil law systems in the rest of the world.” (footnotes omitted)).

⁵²⁴ See Hazard, *Discovery and the Role of the Judge*, *supra* note 22, at 1022; Langbein, *supra* note 23, at 824.

⁵²⁵ Hazard, *Discovery and the Role of the Judge*, *supra* note 22, at 1021.

⁵²⁶ *Id.* at 1022; see also Langbein, *supra* note 23, at 826.

⁵²⁷ See Langbein, *supra* note 23, at 830.

⁵²⁸ Hazard, *Discovery and the Role of the Judge*, *supra* note 22, at 1022; Langbein, *supra* note 23, at 829 (“The process merges the investigatory function of our pretrial discovery and the evidence-presenting function of our trial.”).

⁵²⁹ See Langbein, *supra* note 23, at 831.

Solely for practical reasons, this concentration of fact-finding in the hands of the judge makes it impossible to replicate U.S.-style discovery. A civil law judge (and his handful of clerks) cannot equal the work of teams of privately financed U.S. attorneys, deposing dozens of witnesses and reviewing millions of documents in a complex corporate case. Moreover, they do not have the same pecuniary incentives to engage in the type of fact exploration that is routine in U.S. complex litigation.⁵³⁰

But more fundamental civil law principles of due process and litigants' rights preclude U.S.-style discovery independently. Judges lack the authority and the tools to conduct U.S.-style fact investigation.

Civil law jurisdictions have traditionally exempted party defendants from producing information that can be used against them. This right against "self-incrimination" in *civil cases* is a due process principle (the *nemo tenetur edere contra se* principle) deeply embedded in the civil law legal culture.⁵³¹ Although procedural codes in civil law systems have rejected the *nemo tenetur* principle in its rigid nineteenth-century form, and civil codes now generally allow parties to seek some evidence from their opponents—albeit always via a specific request to the judge⁵³²—the basic privilege of a party not to disclose evidence against its own interest or to open itself up to searching discovery, remains in place in Germany⁵³³ and other countries,⁵³⁴ and its influence still significantly limits the scope of judicial fact investigation in other jurisdictions. Thus, direct party-on-party discovery is not available in any civil law country, parties cannot be called as witnesses in many civil law countries, and courts are constrained in what information a court can demand from parties.⁵³⁵

In many civil law systems, a plaintiff is required to identify each document she seeks from a party-opponent with specificity in the complaint at the

⁵³⁰ HUANG, *supra* note 24, at 40 ("One important cause of incomplete information for fact-finding [in civil law systems] is the misalignment of authority, burden, and incentives."). Commentators have responded to the incentives argument by pointing to the quality of a country's judiciary. *See, e.g.,* Langbein, *supra* note 23, at 848. But Langbein explicitly excluded "Big Case[s]" from his analysis, and Germany's system may be hard to replicate. *Id.* at 858.

⁵³¹ *See* VERKERK *supra* note 23, at 16.

⁵³² *See id.* at 66–73.

⁵³³ *Id.* at 68.

⁵³⁴ *See, e.g.,* Lei No. 5.869, de 11 de Janeiro de 1973, CÓDIGO DE PROCESSO CIVIL [C.P.C.]: art. 363 de 11.1.1973 (Braz.).

⁵³⁵ *See, e.g., id.; see also* HUANG, *supra* note 24, at 40.

beginning of the litigation and justify on what basis she is entitled to it.⁵³⁶ The German *Gerichtstordnung*, for example, requires the requesting party to “identify the document requested with reasonable specificity, describe its relevance to some fact in issue, and set forth the basis for the belief that it is in the possession or control of the opponent.”⁵³⁷ Under the Italian-influenced Brazilian Code, the party must specify with particularity “*the document or the thing*” that is being sought, explain how “*the document*” is relevant to the demands of proof in the case, and state the circumstances based on which the party believes that the requested “*document*” exists.⁵³⁸ The emphasis on “document” in the singular in Brazil’s code reflects expectations about the scope of discovery. Civil law attorneys look at a standard U.S.-style discovery request that includes words like “all” or “any” and find them not merely curious, but laughable.⁵³⁹

In the following section, we consider two problems that arise from the lack of pretrial discovery in civil law countries in relation to transplants of U.S.-style regulatory disclosure and litigation procedures. As we discuss, these transplants will not be effective unless a transplant of the underlying discovery regime that supports them is also implemented.

1. *How Well Does Disclosure Work Without Litigation Discovery?*

In his article, *The Legal and Institutional Preconditions for Strong Securities Markets*, Professor Bernard Black identifies information asymmetry between issuers and investors as the key problem that countries face in reproducing the kinds of institutional networks that support strong securities markets in the United States.⁵⁴⁰ In the quest to develop their financial markets, many countries have, accordingly, looked to the U.S. mandatory disclosure regime and its implementation by the SEC as a model for addressing the

⁵³⁶ “Relevance” has only recently appeared as a factor, and some “legal right” to the document that can override the privacy and property interests of the owner must be shown. Compare the discarded doctrine of *Boyd v. United States*, 116 U.S. 616, 622 (1886) (holding that “a search and seizure [was] equivalent [to] a compulsory production of a man’s private papers” and that the search was “an ‘unreasonable search and seizure’ within the meaning of the Fourth Amendment”).

⁵³⁷ MURRAY & STÜRNER, *supra* note 25, at 277 (translating ZIVILPROZESSORDNUNG [ZPO] §§ 421 ff., 427).

⁵³⁸ Lei No. 5.869, de 11 de Janeiro de 1973, CÓDIGO DE PROCESSO CIVIL [C.P.C.]: art. 356 de 11.1.1973 (Braz.) (emphasis added).

⁵³⁹ Conversation with a government attorney in the Office of General Counsel for the Mayor of the City of São Paulo, in São Paulo, Braz. (Jan. 20, 2012).

⁵⁴⁰ Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 786 (2001).

information asymmetry problem.⁵⁴¹ But, as Black emphasizes, “[d]elivering information to investors is easy, but delivering *credible* information is hard. Insiders have an incentive to exaggerate the issuer’s performance and prospects, and investors can’t directly verify the information that the issuer provides.”⁵⁴²

Brazil serves as an example where the credibility of disclosure has suffered from lack of verification. While Brazil’s Securities Exchange Commission has disclosure requirements for related-party transactions, executive remuneration, and shareholders’ agreements,⁵⁴³ evidence suggests that the information companies actually disclose is incomplete and does not reflect reality.⁵⁴⁴ The simple explanation for this is that there is no effective mechanism for verifying the accuracy of disclosures *ex post*.

Lacking litigation discovery, private parties in Brazil have restricted means of verifying company disclosures.⁵⁴⁵ Because Brazil lacks adversarial discovery, the kind of detailed information about such transactions necessary to successfully prosecute such cases is never revealed, even though shareholders are entitled to mount legal challenges to related-party transactions in the courts. The absence of the kind of “discovery culture” that informs U.S. private and regulatory enforcement means that neither regulators nor private interests even consider what type of disclosure or information might shed light on the legality of such transactions, or how such information might be obtained.⁵⁴⁶ Plaintiffs’ attorneys neither have the tools, nor do they scrutinize such transactions.⁵⁴⁷ Similarly, regulators are limited by civil enforcement

⁵⁴¹ See, e.g., Theodor Baums, *Changing Patterns of Corporate Disclosure in Continental Europe: The Example of Germany* (European Corporate Governance Inst., Working Paper No. 04, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=345020.

⁵⁴² Black, *supra* note 540, at 786. In fact, as we have shown, they can, but *ex post* through litigation discovery, an institution that Black does not mention specifically.

⁵⁴³ See Érica Gorga, *Changing the Paradigm of Stock Ownership from Concentrated Towards Dispersed Ownership? Evidence from Brazil and Consequences for Emerging Countries*, 29 NW. J. INT’L L. & BUS. 439, 474 (2009) (noting disclosure inconsistencies regarding the number of shares bound by shareholders agreements, and the validity of these agreements on the Brazilian Securities Exchange Commission (CVM) website).

⁵⁴⁴ See *id.*

⁵⁴⁵ For evidence that litigation constrains managers from making opportunistic reporting choices, see Justin Hopkins, *Private Enforcement of Securities Laws and Financial Reporting Choices* 5 (2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1872068>.

⁵⁴⁶ See *supra* notes 524–30 and accompanying text.

⁵⁴⁷ See *supra* notes 524–30 and accompanying text.

rules and resource limitations.⁵⁴⁸ Lacking the ability for *ex post* discovery, the value of *ex ante* disclosure in Brazil is therefore compromised.

More generally, it follows that implementation of standard substantive corporate and securities laws may fail to produce expected corporate governance improvement in civil law jurisdictions, not merely because of the lack of private enforcement mechanisms, such as class actions, but because of all the other consequences that follow from the lack of litigation discovery.⁵⁴⁹

As a strategy of developing markets, introducing regulatory disclosures was an important part of eliminating information asymmetries. But to make regulatory disclosure more effective, enforcement mechanisms must be made available to obtain additional information *ex post* to assess the quality of disclosure. In some jurisdictions like Brazil, it is unlikely that regulators will have the resources to investigate material misrepresentations and omissions in issuer disclosures. Changes in the Brazilian code of civil procedure that would grant plaintiff shareholders greater authority to investigate probable corporate wrongdoing—even if only by means of a special shareholder information request proceeding that allows for more probing, discovery-like investigations—would likely be much more fruitful for policing the accuracy of securities disclosures. Large Brazilian issuers who cross-list their securities on U.S. markets are already subject to *ex post* scrutiny by litigation discovery and discovery-related mechanisms.⁵⁵⁰ In this way, U.S. discovery practices also serve to discipline a limited number of U.S.-listed foreign issuers.

2. *Exporting Aggregate or Representative Litigation Mechanisms to Europe*

In the private enforcement literature and in separate debates on securities class actions,⁵⁵¹ derivative actions,⁵⁵² and civil procedure reform,⁵⁵³ scholars

⁵⁴⁸ See *supra* notes 524–30 and accompanying text.

⁵⁴⁹ See J. Maria Glover, *The Structural Role of Private Enforcement Mechanisms in Public Law*, 53 WM. & MARY L. REV. 1137, 1140 (2012) (arguing for the centrality of private enforcement to the American regulatory system, but failing to consider issues of information production or litigation discovery).

⁵⁵⁰ See Gorga, *supra* note 543, at 486–87.

⁵⁵¹ See, e.g., Coffee, *supra* note 448 (proposing a variety of ways in which securities class action penalties would fall less on the corporation and more on those who are truly culpable); Samuel Issacharoff & Geoffrey P. Miller, *Will Aggregate Litigation Come to Europe?*, 62 VAND. L. REV. 179 (2009) (discussing various examples of securities class actions).

⁵⁵² See, e.g., Siems, *supra* note 13 (exploring the availability of derivative actions across countries).

⁵⁵³ See, e.g., CHRISTOPHER HODGES, *THE REFORM OF CLASS AND REPRESENTATIVE ACTIONS IN EUROPEAN LEGAL SYSTEMS: A NEW FRAMEWORK FOR COLLECTIVE REDRESS IN EUROPE* (2008); Richard A.

have discussed the merits of adopting U.S.-style aggregate litigation mechanisms in Europe and elsewhere.⁵⁵⁴ These literatures typically consider how far Europe might go in emulating the “unique” system of U.S. “entrepreneurial litigation.”⁵⁵⁵ While they consider standing requirements, rules on attorneys’ fees, the dynamics and agency costs of attorney-driven aggregate litigation, and the costs of such lawsuits, no one has focused on the obvious question: what mechanisms are available to private litigants in civil court to investigate the facts and circumstances of corporate internal wrongdoing?

Several European countries, including Denmark (2007), England and Wales (1999), Finland (2007), France (1990s), Germany (2005), Italy (2007), the Netherlands (2005), Norway (2008), and Sweden (2002), have adopted some aggregate litigation mechanisms.⁵⁵⁶ But it is unclear to what extent these mechanisms have been successfully employed to prosecute management misconduct.

The German Capital Markets Test Case Act (*KapMus*), passed in 2004, presents just one example of how the lack of discovery thwarts private enforcement even where certain aggregate mechanisms are introduced.⁵⁵⁷

The *Deutsche Telekom* litigation was the test case for this new “aggregate litigation” mechanism in Germany.⁵⁵⁸ Around 17,000 shareholders had sued the German telephone and communications giant, Deutsche Telekom (DT), for

Nagareda, *Aggregate Litigation Across the Atlantic and the Future of American Exceptionalism*, 62 VAND. L. REV. 1, 19–37 (2009) (providing comparative analysis of recent developments in Europe regarding aggregate litigation).

⁵⁵⁴ See, e.g., THE LAW AND ECONOMICS OF CLASS ACTIONS IN EUROPE: LESSONS FROM AMERICA (Jürgen G. Backhaus, Alberto Cassone & Giovanni B. Ramello eds., 2012); Issacharoff & Miller, *supra* note 551, at 179 (“Once decried as the perversity of rapacious Americans, class actions are now the focus of significant reform efforts in many European countries and even at the level of the European Union.”).

⁵⁵⁵ See Coffee, *supra* note 17, at 291–93.

⁵⁵⁶ See Nagareda, *supra* note 553, at 21–25.

⁵⁵⁷ Kapitalanleger-Musterverfahrensgesetz [KapMuG] [Capital Market Investors’ Model Proceeding Act], Aug. 16, 2005, BUNDESGESETZBLATT, Teil I [BGBL. I] 2437, as amended, Gesetz [G], Oct. 19, 2012, BGBL I 2182 (Ger.), translated at <http://www.bmj.bund.de/kapmug>.

⁵⁵⁸ Nils-Viktor Sorge, *Historic Lawsuit: Angry Shareholders Take on Deutsche Telekom in Court Showdown*, SPIEGEL ONLINE INT’L (Apr. 7, 2008, 2:44 PM), <http://www.spiegel.de/international/business/historic-lawsuit-angry-shareholders-take-on-deutsche-telekom-in-court-showdown-a-545827.html>.

The *KapMus* has been called “Lex Telekom,” because it was passed to provide an enforcement mechanism for outraged German investors. See Axel Halfmeier, *Recht und Kapitalmarkt: Von der Lex Telekom zum Instrument des Rechtsschutzes*, BÖRSEN-ZEITUNG, Nov. 8, 2010, available at <https://www.boersen-zeitung.de/index.php?li=1&artid=2010152040>.

misstatements in its May 2000 offering prospectus concerning its ill-fated July 2000 acquisition of the U.S. company VoiceStream.⁵⁵⁹

In *Deutsche Telekom*, the German judges investigated and considered the same questions at issue in the parallel securities class action, filed against DT in 2002 in the U.S. District Court for the Southern District of New York.⁵⁶⁰ After two weeks of oral proceedings, the German judge at the *Oberlandesgericht* in Frankfurt credited DT CEO Ron Sommer's testimony that preliminary, confidential negotiations for the acquisition of VoiceStream (now T-Mobile) in April of 2000 were interrupted, and that actual plans for the acquisition only took shape after the May 2000 offering prospectus was issued and after the June 16, 2000, filing date.⁵⁶¹ The court also held that the prospectus contained no material misstatements regarding DT's real estate valuations.⁵⁶²

But the lack of adequate discovery made it impossible for the plaintiffs to question management's dubious account of the timeline of events leading up to VoiceStream's acquisition. Andreas Tilp, the German plaintiffs' attorney, told the *Economist* that "[c]ompared with America we are at a great disadvantage."⁵⁶³ The *Economist* reported that, "[m]ost aggravating for Mr Tilp is his inability to secure documents, such as a Bonn prosecutor's report that he believes concludes there was balance-sheet fraud, and another report from the Federal Audit Court, which was pivotal in the American settlement."⁵⁶⁴

⁵⁵⁹ Sorge, *supra* note 558.

⁵⁶⁰ See *In re Deutsche Telekom AG Sec. Litig.*, 229 F. Supp. 2d 277, 278 (S.D.N.Y. 2002).

⁵⁶¹ See *OLG Frankfurt a.M.: Musterentscheid im KapMuG-Verfahren gegen die Deutsche Telekom*, EBNER STOLZ (May 16, 2012), <http://www.ebnerstolz.de/de/olg-frankfurt-a-m-musterentscheid-im-kapmug-verfahren-gegen-die-deutsche-telekom-15136.html> ("Nach den Angaben der Zeugen, zu denen auch die ehemaligen Vorstandsvorsitzenden der Telekom Dr. Ron Sommer und Kai-Uwe Ricke gehörten, war das Geschäft erst Ende Juli 2000 und somit deutlich nach der Erstnotiz am 19.6.2000 abschließend und entscheidungsreif verhandelt gewesen."). In the settlement agreement of the U.S. securities class action, plaintiffs' claim that "the Prospectus was materially false and misleading because despite the fact . . . that Deutsche Telekom was engaged in serious and advanced negotiations to acquire VoiceStream, the Prospectus merely disclosed that Deutsche Telekom was 'actively considering and discussing a number of potential acquisition transactions.'" Notice of Proposed Settlement of Class Action, Motion for Attorneys' Fees and Settlement Fairness Hearing at 4, *In re Deutsche Telekom AG Sec. Litig.*, No. 00-CV-9475 (S.D.N.Y. 2002), available at http://securities.stanford.edu/filings-documents/1016/USD00/200544_r02n_00CV9475.pdf.

⁵⁶² *OLG Frankfurt a.M.: Musterentscheid im KapMuG-Verfahren gegen die Deutsche Telekom*, *supra* note 561.

⁵⁶³ *Bad Connection*, *ECONOMIST*, Apr. 12–18, 2008, at 72, 72 (internal quotation marks omitted), available at <http://www.economist.com/node/11021139>.

⁵⁶⁴ *Id.*

Especially noteworthy for the thesis that vigorous discovery is critical for investigating corporate internal wrongdoing is that the German Court and the plaintiffs' attorneys relied, at least in part, on discovery obtained in the U.S. securities class action. The German Court required DT to produce transcripts of depositions taken during discovery in the U.S. securities class action, as well as some e-mails and other documents produced in New York.⁵⁶⁵ The plaintiffs knew to ask for the e-mails and documents only because they had become aware of them as a result of following the New York proceedings and contacted the U.S. attorneys involved. Initially, DT heavily redacted the U.S. deposition transcripts, blacking out over 50% of the testimony given in the U.S. depositions. But knowing that there was more, and that the transcripts were in the possession of the defendants' attorneys, the German court then wanted to see it all.⁵⁶⁶

Recognizing the significant advantage of conducting their fact investigations under the U.S. discovery regime, attorneys for the German investors had already applied in January 2003 to the presiding judge in the New York case, U.S. District Judge Sidney Stein, for permission to obtain discovery pursuant to 28 U.S.C. § 1782, which provides discovery assistance for foreign proceedings.⁵⁶⁷ The Court denied the application, based on the vigorous objections by German prosecutors, the German Federal Justice Department, and German civil procedure scholars, and a meek clarification by the court presiding over the DT case in Frankfurt, that its "willingness to consider such documents 'was indeed no declaration that the Court supported—in opposition to other authorities of the Federal Republic of Germany—the production of such documents.'"⁵⁶⁸

The *Deutsche Telekom* case thus proceeded on the basis of limited information. While the New York case settled in 2005 for \$120 million after discovery had been completed, the German court found in favor of the defendants.⁵⁶⁹ While other factors may have played a role in explaining this

⁵⁶⁵ Markus Zydra, *Wende im Telekom-Prozess*, SUDDEUTSCHE.DE (May 17, 2010, 9:39 PM), <http://www.sueddeutsche.de/wirtschaft/gericht-fordert-us-unterlagen-wende-im-telekom-prozess-1.574782>.

⁵⁶⁶ *Id.*

⁵⁶⁷ *In re Application of Schmitz*, 259 F. Supp. 2d 294 (2003), *aff'd sub nom Schmitz v. Bernstein Liebhard & Lifshitz, LLP*, 376 F.3d 79 (2d Cir. 2004).

⁵⁶⁸ *Schmitz*, 376 F.3d at 82.

⁵⁶⁹ See Stipulation and Agreement of Settlement at 11, *In re Deutsche Telekom AG Sec. Litig.*, 229 F. Supp. 2d 277 (S.D.N.Y. 2002) (No. 00-CV-9475 (SHS)), available at http://securities.stanford.edu/filings-documents/1016/USD00/2005128_r04s_00CV9475.pdf. The parties settled for \$120 million without DT admitting any wrongdoing. *Id.* at 4.

outcome, the lack of effective mechanisms for fact-finding in the case is striking.

Other cases that have been pursued on both sides of the Atlantic, like the case against the Italian agri-business Parmalat, confirm the German experience.⁵⁷⁰

Only two cases have been decided under *KapMus* since it was passed in 2004: the *DaimlerChrysler* case and the *LBB Fonds 13* case.⁵⁷¹ The respective courts found in favor of the defendants in *DaimlerChrysler*, but identified some material misstatements in the *LLB Fonds 13* prospectus.⁵⁷² Significantly, a 2009 study, commissioned by the German Justice Department, assessing the impact of the *KapMus* noted that in both cases, the only evidence taken by the courts was witness testimony.⁵⁷³ Based on the limited success plaintiff investors have had bringing *KapMus* cases, observers have concluded that the law has been “a flop.”⁵⁷⁴

As the example of the German securities “class action” shows, the lack of discovery is a serious impediment to the effective implementation of aggregate-style litigation. Neither securities class actions nor shareholder derivative actions are likely to produce significant disciplining effects in systems that do not also implement appropriate discovery rules.

We thus caution against transplanting aggregate litigation mechanisms without a careful analysis of the discovery rules that exist in foreign jurisdictions. On the other hand, implementing discovery in a civil law regime

⁵⁷⁰ See, e.g., Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, in AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US 159, 201 (John Armour & Joseph A. McCahery eds., 2006) (“Given the lack of efficient discovery rules, investor action against mass wrongdoing is virtually impossible in Italy as it is in the rest of Europe, unless information is gathered by public authorities.”); Paolo Giudici, *Representative Litigation in Italian Capital Markets: Italian Derivative Suits and (If Ever) Securities Class Actions*, 6 EUR. COMPANY & FIN. L. REV. 246, 254 (2009) (“Italian law does not grant any inspection right to shareholders of public companies.”).

⁵⁷¹ AXEL HALFMEIER ET AL., EVALUATION DES KAPITALANLEGER-MUSTERVERFAHRENSGESETZES: FORSCHUNGSVORHABEN IM AUFTRAG DES BUNDESMINISTERIUMS DER JUSTIZ 50 (2009), available at http://www.bmj.de/SharedDocs/Downloads/DE/pdfs/Abschlussbericht_KapMuG_Frankfurt%20School_2009.pdf?__blob=publicationFile; see also Daniela Kuhr, *Sammelklagen Floppen in Deutschland*, SUDDEUTSCHE.DE (Apr. 24, 2012, 10:07 AM), <http://www.sueddeutsche.de/wirtschaft/telekom-prozess-und-seine-folgen-sammelklagen-floppen-in-deutschland-1.1340101>.

⁵⁷² HALFMEIER ET AL., *supra* note 571, at 50.

⁵⁷³ *Id.* at 3.

⁵⁷⁴ See Kuhr, *supra* note 571.

is also not an easy task. Japan provides one prominent example of this attempt. After an extensive academic debate, Japan's new Code of Civil Procedure of 1996 implemented significant but modest changes to Japan's fact-finding regime.⁵⁷⁵ These changes in procedure took years to negotiate and involved extensive academic and public debate.⁵⁷⁶ Nonetheless, they remain very limited.⁵⁷⁷

C. *Reforming Discovery in the United States*

Our account of the benefits of discovery in Part III has a direct bearing on the persistent and often successful efforts to cut back on discovery under the Federal Rules of Civil Procedure. In 2013, the Federal Judicial Conference proposed amendments to the Federal Rules that promise to introduce yet another round of significant limitations on discovery.⁵⁷⁸ The extensive public debate and commentary reflects a widespread understanding that "the proposed amendments have the potential to radically impact the legal system."⁵⁷⁹ The most controversial changes include a new emphasis on "proportionality" in defining the scope of discovery⁵⁸⁰ and a new sanctions standard for e-discovery violations.⁵⁸¹ The proposed amendments also lower the presumptive limits on depositions and interrogatories and, for the first time, introduce limits on the number of requests for admissions.

The proposed amendments to Rule 26(b) would limit the scope of discovery to discovery that is "proportional to the needs of the case, considering the amount in controversy, the importance of the issues at stake in the action, the parties' resources, the importance of the discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit."⁵⁸² The change would allow respondents to withhold discovery materials based on an objection of proportionality, where

⁵⁷⁵ See HUANG, *supra* note 24, at 157.

⁵⁷⁶ See *id.*

⁵⁷⁷ See *id.* at 157–216 (describing the Japanese discovery regime).

⁵⁷⁸ Comm. on Rules of Practice and Procedure of the Judicial Conference of the U.S., Preliminary Draft of the Proposed Amendments to the Federal Rules of Bankruptcy and Civil Procedure (Aug. 15, 2013) [hereinafter *Proposed Rule Changes*], available at <http://www.uscourts.gov/uscourts/rules/preliminary-draft-proposed-amendments.pdf>.

⁵⁷⁹ See Adam Cohen, *Commenting on the Comments to the Proposed Amendments to the Federal Rules of Civil Procedure*, INSIDE COUNS. (Feb. 18, 2014), <http://www.insidecounsel.com/2014/02/18/commenting-on-the-comments-to-the-proposed-amendme>.

⁵⁸⁰ *Proposed Rule Changes*, *supra* note 578, at 264–69.

⁵⁸¹ *Id.* at 270–75.

⁵⁸² *Id.* at 289.

previously objecting parties had to seek an order of protection from the judge. Judge Shira Scheindlin, a leader in e-discovery, warned that the new rule may be interpreted to shift the burden of proving proportionality to the requesting party.⁵⁸³ She argued that the rules unnecessarily cut back on the scope of discovery and undermine the sanctions available for punishing parties that destroy electronic documents.⁵⁸⁴

It is clear from the comments that all sides agree that these changes to the discovery rules will primarily affect large, complex cases. The U.S. Chamber of Commerce and the corporate defense bar favor the new proposed rules because they are expected to curb the high cost of e-discovery.⁵⁸⁵ On the other side, public interest groups, plaintiffs' attorneys, as well as leading civil procedure scholars and judges, are concerned that, together with the presumptive limits on discovery, these changes to the scope of discovery will unfairly disadvantage plaintiffs suing large organizations, including corporations and governments.⁵⁸⁶ This debate is thus no different from previous debates about the costs of discovery we have discussed in Part IV.D, and no new evidence is adduced to support the conclusion that discovery costs are excessive.⁵⁸⁷

The proposed changes raise red flags, given our account of discovery for the development of the U.S. corporate governance system. The changes provide negative incentives for corporate defendants. Under the new proposed rules, corporations may have incentives to destroy documents and weaken internal governance controls. Conflicts about proportionality are likely to lead to increased involvement by the judge at the outset of discovery, thus diminishing the decentralization of fact investigation characteristic of the U.S. system.

⁵⁸³ Comment Letter on Proposed Rules from Shira A. Scheindlin, U.S. Dist. Judge, to Comm. on Rules of Practice and Procedure 3 (Jan. 13, 2014), available at <http://blogs.reuters.com/alison-frankel/files/2014/02/ruleschanges-scheindlin.pdf>.

⁵⁸⁴ *Id.* at 3–5.

⁵⁸⁵ See Alison Frankel, *Two Judges Question Proposed Discovery Limits in Federal Rules*, REUTERS (Feb. 5, 2014), <http://blogs.reuters.com/alison-frankel/2014/02/05/two-judges-question-proposed-discovery-limits-in-federal-rules/>.

⁵⁸⁶ *Id.*; see also Comment Letter from Shira A. Scheindlin, *supra* note 583, at 6 (voicing concern that proposed rules unnecessarily cut back on the scope of discovery).

⁵⁸⁷ The claims by the defense bar also fail to take account of the likelihood that e-discovery costs will begin to drop sharply, as document review by machine intelligence is gaining acceptance with the courts and document retention is becoming cheaper as a result of improved technologies.

In spite of Article III's "case or controversy" provision, it has long been acknowledged that representative litigation, such as shareholder suits, involve courts in shaping policy and tailoring remedies for future compliance.⁵⁸⁸ The SLC process recognizes this by requiring that SLCs pursue a thorough investigation of misconduct allegations. Corporate internal investigations are not limited by proportionality to the particular damage caused by a particular breach of fiduciary duty.

Moreover, measuring the "proportionality" of discovery narrowly by reference to the value of plaintiff shareholders' claims against a corporate defendant—as the proposed new rules appear to emphasize—underestimates the value of discovery. It fails to appreciate the value of exposing inadequate compliance or accounting controls for the company over time; the positive information externalities that discovery generates for markets, regulators, and gatekeepers; the disciplining effects of the process of discovery; and, last but not least, the threat to management that the details of their daily business and management decisions may be subject to the kind of intense scrutiny that we have described in Part I.

While there may be good reasons for allowing judges discretion to limit discovery, it is hard to see why the scope of discovery should increasingly be limited presumptively by the rules. This Article questions the retreat from discovery that has occurred in shareholder litigation since the mid-1990s. While we leave proposals regarding discovery reforms for another opportunity, we note that discovery's costs might be reduced without giving up on its benefits for corporate governance. For example, one can envision cost-sharing rules among plaintiffs for allowing discovery conducted in one case to be used in another case. It may also be worth considering whether different discovery rules should apply to different types of claims.⁵⁸⁹

CONCLUSION

The literature has largely ignored the role of fact investigation and discovery for corporate governance. But litigation discovery is the "elephant in the boardroom." The U.S. information-pushing regime implemented by modern discovery rules is unique in the authority, scope, and tools of fact

⁵⁸⁸ See, e.g., Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1281 (1976).

⁵⁸⁹ See, e.g., David Marcus, *The Past, Present, and Future of Trans-substantivity in Federal Civil Procedure*, 59 DEPAUL L. REV. 371 (2010) (discussing whether discovery rules should be trans-substantive).

investigation that it affords private litigants. As we have shown, the institutional consequences that flow from the rules and practices of discovery are complex and multifaceted.

Discovery generates information and disciplines management at every stage of shareholder litigation (even prior to the motion to dismiss). Publication at trial, or at evidentiary hearings, of information obtained through offensive discovery exposes corporate internal practices, controls, judgments, and failures—regardless as to whether liability is ultimately imposed on defendants. This informs judges, regulators, and the public about the modus operandi of corporate governance failures.

Even in cases that are settled, the benefits of litigation discovery are considerable. In cases resolved on summary judgment or settled after a summary judgment motion is filed, the facts obtained through discovery are nonetheless publicly available, as the parties must file admissible evidence in support of their claims and defenses at the summary judgment stage.⁵⁹⁰ Similar positive externalities thus accrue as in the case of evidence presented at trial. Even if parties settle prior to summary judgment, litigation discovery often informs judges, regulators, and the public about corporate internal practices, because judges must approve a settlement and the parties must provide evidence that the settlement is just. While such evidence is sometimes obtained through discovery after the settlement has been negotiated, this does not vitiate the usefulness of the information publicized at settlement hearings.⁵⁹¹

More importantly perhaps, defensive discovery plays a critical role in rendering corporate practices transparent, disciplining management, and encouraging the development and adoption of best practices. Discovery can have an important corporate governance function even in cases dismissed or settled prior to the motion to dismiss. Its practices have established templates for independent corporate internal investigations.

Discovery has thus induced incremental improvements in corporate governance practices and controls. It has influenced and shaped the development of case law and corporate and securities statutory reforms. The

⁵⁹⁰ Of course, not all issues must be presented at summary judgment. But this does not vitiate the argument.

⁵⁹¹ Moreover, judges have not always approved settlements based on the evidence provided and have sometimes demanded more information. See, for example, Judge Rakoff's controversial decision to refuse approval of the settlement between the SEC and Bank of America in the Merrill Lynch case. *Supra* note 259 and accompanying text.

information revealed through discovery serves regulators and market participants. Discovery also serves as an *ex post* form of particularized disclosure that enforces and complements the standardized *ex ante* disclosures required by the SEC. All these effects combined promote the overall U.S. corporate governance culture of transparency—which has also affected corporate governance practices globally.

This Article sets forth policy proposals and implications of these insights for the empirical literature on shareholder actions, and it begins to outline a research program for addressing such complex issues as corporate law and civil procedure reforms. The Article has important implications for the legal transplant of U.S.-style securities disclosure, aggregate litigation mechanisms, and other aspects of enforcement, that fail to consider appropriate tools for investigating corporate internal wrongdoing *ex post*. And it has implications for civil procedure reform in the United States. Our account of the role and effects of discovery in shareholder litigation suggests that further research is necessary on how the rules of civil procedure could be improved to better tackle problems of corporate litigation and governance.

APPENDIX

Information Request, *Saito v. McKesson HBOC, Inc.*⁵⁹²

A. All sales agreements and documents related to sales agreements (including documents, which have been referred to as “side letter,” [sic] containing terms and conditions of any agreements not included within the agreement itself) between HBOC or the Company and [33 specified] entities[.]

B. All documents evidencing communications between the following persons and entities or representatives thereof regarding: (i) “side letters”; (ii) backdating of sales contracts; (iii) sales contingent upon terms not contained within the main sales contract; or (iv) accounting practices at HBOC, McKesson, McKesson HBOC or HBOC as the post-merger subsidiary of the Company (“HBOC sub”):

1. HBOC or HBOC sub and any entities identified in Request A(l)-(33) above;
2. Arthur Andersen and any entities identified in Request A(l)-(33) above;
3. Bear Stearns and any entities identified in Request A(1)-(33)
4. Arthur Andersen and Bear Stearns;
5. Arthur Andersen and Deloitte & Touche;
6. Bear Stearns and HBOC or HBOC sub;
7. Arthur Andersen and HBOC or HBOC sub; and
8. Deloitte & Touche and HBOC or HBOC sub.

C. All documents concerning Arthur Andersen’s pre-merger review of the internal controls of HBOC.

D. All documents concerning verification by Arthur Andersen of any representations about revenues and/or expenses made by HBOC management during the due diligence process in preparation for or in connection with HBOC’s merger with McKesson.

E. All documents relating to or reflecting the verification by McKesson, its employees, directors or advisors that the revenues and/or expenses reported in the financial statements of HBOC that were incorporated by reference in the

⁵⁹² Complaint Pursuant to 8 Del. C. § 220 for Access to Corporate Books and Records at 2–5, *Saito v. McKesson HBOC, Inc.*, No. 18553-NC (Del. Ch. Dec. 14, 2000), 2000 WL 34549543.

joint proxy statement, issued in connection with the merger between McKesson and HBOC, were properly and accurately reported.

F. All documents reflecting discussions among or communications with any members of the Board of Directors of HBOC, McKesson, or McKesson HBOC concerning (i) reports dated April 14, 1997 and August 19, 1998 by the Center for Financial Research and Analysis (CFRA); (ii) any other published public analysis of the accounting practices of HBOC prior to and following the HBOC's merger with McKesson; (iii) any public response to such published reports by any employee of HBOC; or (iv) any HBOC, McKesson or McKesson HBOC shareholder reaction to such published reports.

G. All documents relating to or reflecting communications among or between members of HBOC management and/or HBOC's Board of Directors concerning HBOC's purpose in pursuing a merger with McKesson or any other entity between January 1, 1997 and October 17, 1998.

H. All documents concerning the decision to change the structure of the merger of HBOC and McKesson from a "merger of equals" to an acquisition of HBOC by McKesson.

I. All documents, including board minutes or other documents evidencing any communications with or among HBOC's or McKesson HBOC's Board of Directors related to the termination or resignation of the following individuals: Jay Gilbertson, Albert Bergonzi, Charles W. McCall, Mark A. Pulido, David Held, Jay Lapine, Michael Smeraski and Dominick DeRosa.

J. All documents concerning SEC, Department of Justice or any other governmental agency investigation of any individual listed in Request No. 9 [sic] above, or any other employee of HBOC, McKesson HBOC or HBO sub between January 1, 1997 and the present.

K. All documents reflecting discussions among or communications with McKesson HBOC's management or members of its Board of Directors about whether to initiate litigation against any past or present employee of HBOC, McKesson HBOC or HBOC sub or against any advisor to or auditor of any of the foregoing entities in connection with the restatements of HBOC's and/or the Company's financial results for fiscal year 1997, 1998 and 1999.

on legislation. Only through that can a scientifically sound understanding of the shortcomings of the Act can be obtained.

I. HISTORICAL BACKGROUND OF THE SARBANES-OXLEY ACT

To understand the events during the legislation of the Act, it is essential to briefly overview the factors which led towards its creation. By 2002 the general exuberance which defined the capital markets of the late 90s was long gone. The bursting of the dot-com bubble and the emerging corporate scandals – WorldCom, Adelphia, Tyco and Enron – has completely eroded the public trust in the market and undermined the trust towards the government, and the various agencies tasked overseeing the market.

The reason for the corporate scandals was numerous. First of all, excessive optimism made investors overly confident, thus they did not exercise caution in their dealings. This resulted in the dot-com bubble, for example, a phenomenon sparked by the sudden interest in IT sector and prospects it promised. However, exuberance was also mixed with corporate greed. The remuneration schemes rewarded CEOs and other members of the management generously.¹ The switch to performance-based pay while also giving shares made the less scrupulous management more interested in short-term profits instead of sustainability. To make matters worse, due to the complicated agent-principal conflict between the gatekeepers (such as auditors² and attorneys), which made them dependent on each other, the interest of the shareholders and stakeholders were also neglected in favour of serving the interest of the management of the very company they were supposed to monitor.³ On 11th September 2001, the terrorist attack on the World Trade Center created an environment of uncertainty and paranoia. This all could be seen in the way stock markets performed; the government and the legislature realised that something had to be done to restore public confidence.⁴

President George W. Bush announced his 10-point program in the beginning of 2002 in which three key factors were identified for the corporate debacle: the lack of reliable information for investors, the lack of accountability for corporate officers and the failure of the audit system.⁵

¹ Zéman, Z.; Gacsi R.; Lukács J.; Hajós L., *Management control system in banks*, BIATEC, Vol. 21, No. 6, 2013, pp. 14–17 (2013).

² For some aspects of the auditing profession, see Bárczi J.; Zéman Z.; Tóth M.; Széles Zs.; *Key indices of financial controll*, Journal of International Scientific Publication: Economy and Business Vol. 2, No 1. Lentner, Cs., A pénzügyi szervezetek társadalmi felelősségvállalásának új dimenziói és a könyvvizsgálat szerepe, Számvitel adó könyvvizsgálat: szakma Vol. 53, No.7–8, 2011, pp. 348–350.

³ Regarding corporate social responsibility issues in the financial sector see Lentner Cs.; Szegedi K.; Tatay T., *Corporate Social Responsibility in the Banking Sector*, Pénzügyi Szemle/Public Finance Quarterly Vol. 60, No. 1, 2015, pp. 95–103.

⁴ See Kecskés A.; Halász V., *Stock Corporations A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers*, HVG-ORAC-LexisNexis, 2013, pp. 201–202.

⁵ See The President's 10-Point Plan – Improving Corporate Responsibility And Protecting America's Shareholders *Wall Street Journal* March 6, 2002, <http://www.wsj.com/articles/SB1015460971646141720>. Accessed October 5, 2015.

II. LEGISLATION PROCESS

The Sarbanes-Oxley Act came into force on 30th July 2002 when it was signed into law by President George W. Bush. It is widely known it enjoyed a widespread –bipartisan– support. Rep. Michael Oxley’s draft was adopted by the House on 25th April 2002 by a vote 334 to 90, whereas the Senate Banking Committee approved it on 18th July 2002 by a vote 17:4. On 15th July 2002 (3 weeks after the Worldcom scandal broke) the Senate unanimously, by a vote 79 to 0, adopted the bill. Afterwards, the conference committee formed by the House and Senate reconciled the two bills and on 25th July the conference bill was approved, which was given the name Sarbanes-Oxley Act of 2002. On the next day the bill passed with a landslide majority – by a vote 423 to 3 in the House and 99 to 0 in the Senate.⁶

The bill was introduced to the House by Michael Oxley on 14th of February 2002, originally co-sponsored by 24 other Republican representatives. Committee sessions on the bill did not start until the 13th of March. Afterwards, there were three committee hearings on the matter. Provisions of the bill could be summarised the following way: first and foremost, it set out the creation of an oversight board for the accounting profession⁷; secondly, it appropriated more funds for the Securities Exchange Commission⁸ and thirdly, it made a proposal for a series of government-sponsored studies about various corporate governance-related subjects.⁹

The House Republicans praised the bill, claiming it was a milestone in corporate legislation.¹⁰ On the other hand the bill was criticised for being too lenient on corporate wrongdoers as the provisions were mainly restatements of existing law; as the press of the time put it the bill was merely “punting” the responsibility¹¹ to the Securities and Exchange Commission which – according to the opponents of the bill – was exactly what the accounting profession wanted all along.¹² Another criticism was that the bill did not even satisfy the criteria set out in President Bush’s 10-point program.¹³ The Republicans defended their position by claiming that not only corporate scandals are far more complex than they appear and thus, legislation should neither be too hasty nor too strict, but also the corporate scandals are far and few between, thus a whole sector should not be penalised for the actions of a few.¹⁴ Nevertheless, the Republican bill got approved by a healthy margin, enjoying a bipartisan support; due to the imminent re-election campaign; which meant the Democrats could not risk rejecting the Republican bill on the grounds of being too lenient while also having supported a failed alternative before.¹⁵

⁶ See Kecskés; Halász, *op.cit.* note 1, p. 202.

⁷ See H.R. 3763. Section 2. as engrossed in House (04/24/2002).

⁸ See 148 Cong. Rec. 2002 H1541 April 24 (statement of Mr Sessions).

⁹ See H. R. 3763 Section 14–19. as Engrossed in House (04/24/2002).

¹⁰ See 148 Cong. Rec. 2002 H1541 April 24 (statement of Mr Sessions).

¹¹ Borzán A.; Lentner Cs.; Szigeti C., A pénzügyi vállalkozások felelősségvállalásának új dimenziói 2011 *Economica* (Szolnok) Vol. 4, No. 11, 2011, pp. 22–30.

¹² See 148 Cong. Rec. 2002 H1546 April 24 (statement of Mr Kanjorski) and 148 Cong. Rec. 2002 1, 548 April 24 (statement of Mr Jones).

¹³ See 148 Cong. Rec. 2002 H1546 April 24 (statement of Mr LaFalce).

¹⁴ See 148 Cong. Rec. 2002 H1552 April 24 (statement of Mr Ferguson).

¹⁵ See Romano R., *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, Yale Law Journal, Vol. 114, No. 7, 2004–2005, p. 1551.

The Senate received the engrossed bill¹⁶ from the House on 25th April 2002 and on the same day it was referred to the Committee on Banking, Housing, and Urban Affairs of which the chairman was Paul Sarbanes. Yet the bill was not passed until 15th July. The main reason for the delay was the shifts in the public mood: in the autumn of 2001 the fall of Enron temporarily stirred up the public spirit. By next April, the crisis mood became more languid as the popular opinion held that it was only an isolated phenomenon.¹⁷ The bill was only plodding forward: it took a month for Sarbanes to acquire support from both parties. The resulting situation caused a serious headache for Senate Majority Leader Thomas Daschle; the success of the bill seemed unattainable. As of 26th June, however, on the day the Worldcom scandal broke, there was a drastic change in the political climate. Suddenly the public focus shifted back to corporate abuses again, which put Republicans under pressure. Now Daschle could hope for eighty supporting votes on the voting in July. Not even Republican senator Phil Gramm the ranking member of the committee, who was the staunchest opponent of the bill, tried to oppose it.¹⁸

The popular belief holds that the most important questions of law-making in the USA are decided in the committee sessions. In many cases, however, the most important events are taking place in the Senate chamber, as the rules of procedure grant a wide-range of means to affect legislation; in certain cases, they may resort to filibuster to slow down the process.¹⁹

However, a successful cloture can deeply impact the procedure as it restricts further debates and amendments to the bill. This can only be achieved by a bipartisan agreement, as this motion requires the 3/5th of votes in the Senate.²⁰

The success of cloture was especially important in the case of the Sarbanes-Oxley Act. Making this piece of legislation would have required the support of more than a 3/5th of the Senate, which would have been hard to achieve, as there were 122 amendments proposed. Notwithstanding, the success of the cloture meant that unresolved issues from the committee sessions never made it into the Senate, thus there was no opportunity for a detailed examination of the regulations set out in the bill in this phase.

While the bill was presented by the Democrats, its content was also influenced by the Republicans, as the success of it depended on their support. Since the Democrats only had a one-vote majority in the Senate,²¹ support from both parties were required for the success of any sort of legislation.

16 When a chamber agrees on a bill, the Enrolling Clerk prepares the final version which contains the amendments. It is printed on a blue paper which then gets sent to the Senate. Technically, an engrossed bill should be referred only as an Act, but it is common to use "bill" consistently. See House of Representatives, *How Our Laws are Made: Revised and Updated*, US Government Printing Office, 2007, p. 36–37.

17 See Kim B. *Recent Developments*, Harvard Journal on Legislation, Vol. 40, No. 1, 2003, p. 238.

18 See Romano, *op. cit.*, note 15, p. 1558.

19 See *ibid.* 1554.

20 See House of Representatives, note 16 p. 40.

21 Originally both the Democrats and the Republicans held 50–50 seats in the Senate, but in 2001 Vermont Republican James Jeffords left the Republican Party to go Independent and he joined the Democratic Party's caucus. See: United States Senate, *Senate History 1964-Present The Unforgettable 107th Congress* <http://www.senate.gov/artandhistory/history/minute/unforgettable-107th-congress.htm> (October 5, 2015).

Owing to the Republican influence, there must be at least two chartered accountants in the Public Company Accounting Oversight Board (PCAOB) as Republican Senator Michael Enzi,²² the sole chartered accountant in the Senate, took special care to ensure their participation of the active accountants. His support was crucial, which depended on whether the aforementioned provisions would be included or not.

It can be seen from the reports on the committee sessions that Senator Paul Sarbanes was only able to submit a proposal by the end of May which could be agreed on by all the democratic members of the committee, and working out a deal with Michael Enzi took him another month. Enzi's conversion brought the support of his fellow party members, thus Sarbanes' bill could be passed by a bipartisan –but not unanimous– vote. Even though the Republican members had submitted more than a hundred amendments to slow down the process, the deal with Enzi provided Sarbanes the opportunity for ignoring those.

The Republicans changed tactics in the next phase of legislation. While during committee sessions they took the opposing stance to the bill, their movement to cloture in front of the Senate virtually enabled the passing of the act. They justified their radical change of heart with claiming they would have more leverage over the process in the upcoming conference committee sessions, where the House and the Senate bills would be reconciled.

It is more likely they altered their stance because of the almost crisis-like change in political and popular mood. All the relevant political analyses concluded that crises are calling for quick and definite measures in legislation.

Due to the crisis, the Senate sped up the legislation and voted in favour of the cloture.

Three amendments were made on the floor, which gave additional substance to the legislation. The first was about the prohibition of non-auditing services provided by auditing firms, the so-called “Leahy-amendment”, and thirdly, the prohibition on executive loans.

The House bill contained no provisions about the organisational matters of the monitoring committees in order to allow the Securities Exchange Commission (SEC) to define them.²³ Providing non-audit services was restricted by the SEC before, to which the House bill added two more restrictions.²⁴

The source of disagreement was the Republican support for the House bill, which happened to coincide with the proposal made by Harvey L. Pitt, the chairman of the SEC at that time. His proposal was also favoured by the auditors – and through that the House proposal. However, a few years before the auditors, with the aid of Pitt, managed to obstruct the regulatory intentions of Arthur Levitt, the then-chairman of the SEC. Pitt's person, who enjoyed the support of Republicans and the ire of Democrats²⁵ was a definite factor in both parties

22 Senator Michael Enzi participated in the legislation as a member of the Committee on Banking, Housing and Urban Affairs.

23 See H. R. 3673.

24 See *ibid.*

25 Harvey L. Pitt's person was heavily contested due to his past at major accounting and law firms. On October 22, 2001, not too long after he was appointed as the head of the Securities Exchange Commission, he remarked that his intention was to make SEC a “kinder and gentler place for accountants”. See Jeanne Cummings – Yochi Dreazen – Michael Schroeder 2002: SEC Chairman Pitt Resigns Amid Webster Controversy The Wall Street Journal November 6. <http://www.wsj.com/articles/SB1036548136249093108> (October 5, 2015).

opinion. It is possible that Democrats might have held different views on certain questions had a different person presided over SEC.

The debate on prohibiting non-audit services evoked the clashes of two years ago between Levitt and the auditors. What might have been an unwarranted concern back then; in 2002 it became a well-founded foresight – at least according to the Democrats. Owing to the public outcry and the media frenzy elicited by the accounting fraud, politics came under pressure as well. Between January and July 2002, the headlines in the leading evening news programmes had 613 news items regarding business, out of which 471 (77%) were about the accounting fraud. Out of those, 80% were calling for action from the government. This greatly undermined the auditors' prestige in society.²⁶

Hardly any attention was given to three important corporate governance issues, namely the independence of audit committees, executive loans, and certification requirements. The most well-known initiative from the latter category was made by Senator John McCain and Carl Levin. It was about the accounting evaluation²⁷ of stock exchange options, which did not make it into the bill due to the lack of support from the party leadership. This should not be taken as a sign of discord, however, the reason was more practical: the initiative could have obstructed legislation. Even Sarbanes gave up on the regulations regarding stock exchange options to acquire the support of his party.

Eventually, it was the statute of limitations which served the basis for that Republican move resulting in the cloture: Senator Gramm motioned for the separation of it from the other provisions, which jeopardised the success of the bill. Thus, the parties agreed on both the statute of limitations and the cloture.²⁸

During the short period between the cloture and the passing of the bill, the Senate adopted a few amendments, including one about the prohibition of personal loans to executives²⁹. This amendment – initiated by Democratic Senator Charles Schumer – was adopted undisputed and unanimously. It is remarkable that only a few days before President George W. Bush, in his speech delivered in Wall Street, called for boards to refrain from providing such loans.³⁰ Schumer otherwise remarked in his statement that he spoke to the White House and he secured their support.³¹

The American jurisprudence discusses this with biting criticism, as they are not sure why President Bush took such a stance in this matter when earlier he received such loans. It was argued that he was trying to distance himself from such criticism.³² Whatever the reason may be, President Bush's attitude proved to be decisive regarding the fate of the provision. Beforehand, the Banking Committee rejected such proposal; even Senator Sarbanes, when he was

²⁶ Romano, *op. cit.*, note 15 1562.

²⁷ Regarding accounting policies and their role in aiding decision-making see: Lukács, J., Tóth, M., Zéman Z., *A számviteli politika döntéstámogatásának modellezése ágazati mátrix fejlesztéssel* Gazdaság és társadalom Vol. 12, No. 3–4, 2012, pp. 106–117.

²⁸ See Romano, *op. cit.*, note 15 1562.

²⁹ See Brian, *op. cit.*, note 17 249.

³⁰ See Barnard, J. W., *Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act*, Ohio Northern University Law Review, Vol. 31, No. 3, 2005, p. 337.

³¹ See *ibid.* p. 338–339.

³² See *ibid.* p. 338.

presenting his bill in the Senate, said that his commission had not even gone as far as prohibiting executive loans.³³

For a law to be considered to be passed both chambers must adopt the bill with identical texts. If there are any differences in the text adopted then there are two possible ways of reconciliation. It can either be sent back to the other chamber to have it reconsidered and amended according to the proposed text of the other bill. The other chamber could still propose amendments in their counterproposal. This process is called as the amendment exchange or “ping-pong”. It can be a rather lengthy process, but the political climate was calling for a swift solution. Thus, that is why a conference committee was requested. A conference committee is an ad-hoc committee formed in relation to a piece of legislation with the purpose of reconciling the difference between the resolutions of both chambers.³⁴ The mere difference between texts is not enough for requesting a conference committee, though. It is required that one House must amend and then adopt the bill of the other House.³⁵

The result of the conference committee was that everything was struck out from the House Bill underneath the enacting provision and it was completely replaced by the text of the Senate bill.³⁶

III. ANALYSIS OF THE SARBANES-OXLEY ACT

Before evaluating the Sarbanes-Oxley Act, it is important to the gain further insight to some of the theories regarding legislation. Both the Anglo-American and European viewpoints need to be considered for a well-rounded overview of the Act. One interesting aspect of the topic at hand is that the Anglo-American jurisprudence seems to be lagging the Europeans. Ever since the 1970’s (and perhaps even earlier) when German jurisprudence started to pay attention to the alarming tendencies such as the increasing number of laws being made which often came at the expense of their quality;³⁷ there have been numerous attempts made to understand legislation.

Meanwhile, the major rift between Anglo-American and Continental jurisprudence could be explained by Robert B. Seidman’s³⁸ observation: for a long time [common-law] court decisions have been the primary source of law instead of legislation which made them “myopically fixated on the judicial role.”³⁹ On the other hand, for Continental lawyers (meaning most of

33 148 Cong. Rec. S6332 July 8th (statement of Senator Sarbanes).

34 Library of Congress: The Legislative Process: Resolving Differences Congress.gov <https://www.congress.gov/legislative-process/resolving-differences> Accessed on October 5, 2016.

35 See House of Representatives, *op. cit.*, note 16, p. 42.

36 See House of Representatives: Conference Report July 24, 2002. (H. Rept. 107–610) 69.

37 See Hill, H., *Einführung in die Gesetzgebungslehre*, C. F. Müller Juristischer Verlag Heidelberg 1982, p. 2; Schulze-Fielitz, T., *Theorie und Praxis parlamentarischer Gesetzgebung*, Duncker & Humblot. Berlin, 1988. 1. both cited by Drinóczi, T.; Petrétai, I., *Jogalkotás*, Dialóg-Campus Kiadó, Pécs, 2004, p. 17.

38 Robert B. Seidman is a Professor of Law and Political Science at Boston University.

39 See Seidman R., *Justifying Legislation: A Pragmatic, Institutional Approach to the Memorandum of Law, Legislative Theory, and Practical Reason*, Harvard Journal on Legislation, Vol. 29, No. 1, 1992, p. 76.

the Roman-Germanic legal families) legislation has always served as the primary source of law. This means there was more of an incentive for lawyers and jurisprudence to actually look into the way laws are made and to create a basis for principled legislation. For example, in Prussia and the Austrian part of the Habsburg empire, before the introduction of large-scale civil codes (*Allgemeines Landrecht* and *Allgemeines Bürgerliches Gesetzbuch* respectively), major preparatory works were undertaken (such as partial introduction, to test the real world application of the codex) in order to ensure that legislation met its intended goals.⁴⁰ Yet, we cannot regard these actions as the application of principled legislation theory, due to the fact that none of those countries was something one may call as states under the rule of law.

Legislation itself is important in a modern (constitutional) democracy; it is the exercise of power constituted by the fundamental law.⁴¹ Its importance lies in the ability to intervene in social and economic processes to aid the stability and development. This power is not unlimited, however. There are all sorts of rules and procedures which are aimed at keeping up the democratic nature of legislation, to ensure the public good prevails.

The main characteristic of legislation is that it is always a conscious activity with the aim of influencing future behaviour of a large number of addressees –unlike judge-made law, as the decision of the judge is only binding *inter se*, and not towards the general public. This also means that legislation itself is a deliberate and willing activity. One cannot legislate accidentally, but legislation might have unintended consequences. This is the main reason why legislators must work according to plan and it is important for them to utilise scientific⁴² methods.⁴³

Optimal legislation ensures the efficacy and efficiency of law. If the legislation is sub-optimal, the efficacy and efficiency suffer. Thus, based on what has been said above, the legislators must always ensure their legislation is as optimal as possible. The usual pitfalls which make suboptimal legislation are the following:

- lack of clarity
- duplicity
- improper identification of the underlying issue
- not allocating enough resources for the execution
- political overloaded nature of the debate.⁴⁴

Justification lends moral authority to the law which is essential for the efficacy of law as the end product is more likely to be observed by the addressees. It must be emphasised that optimal legislation is always justified. So, when it comes to the evaluation of laws, it is important to study whether there was any compelling reason to the action of the law-maker, and how well it would be received by the intended addressees.

40 See Visegrády Antal: The Influence of Jerzy Wróblewski on Hungarian Legal Theory, *Prawo I Politika* 7. 96.

41 See Drinóczi; Petrétei, *op. cit.*, note 37, p. 73.

42 One must never underestimate the importance of involving the legal science in filling gaps in legislation. For example in the USA, the American Law Institute's work is invaluable at collecting and processing legislation, judgments and scientific results. See Sándor, I., *A bizalmi vagyonkezelés és a trust*, HVG-Orac, Budapest, 2014, p. 233.

43 See *ibid.* 75–77.

44 See *ibid.* 364 ff.

1. THE ANGLO-AMERICAN JURISPRUDENCE ON LEGISLATION

Most of the Anglo-American legal theoreticians are still highly influenced by the sovereign theory of Bentham, and Locke or Austin's command theory.⁴⁵ While their theories provide explanation about authority of laws, they do not really explain the reality of law-making: laws are treated as something static that have always been there or as if they came from one actor;⁴⁶ and thus instead the focus is shifted towards the application of the law.

Some of the legal positivists, such as Hart, were also interested in the way legislation worked. According to Hart, the legislature is nothing like Austin's model of "uncommanded commanders", as they are a product of society's recognition. This is demonstrated by the fact that legislative bodies are pretty much created by rules such as the Constitution, and their rules of procedures are also imposing limits on their activities. Thus, unlike a true sovereign, the legislature does not have unlimited powers and cannot be unlimited by itself. However, it must be also noted that Hart himself was not quite interested in the legislature as the "sort of body it was".⁴⁷

In his 1995 essay "The Dignity of Legislation", Jeremy Waldron⁴⁸ laid out the framework for a new kind of legislation theory which takes into account the political realities of legislation as well. He proposed that the "one-sovereign" model is insufficient, as modern legislative bodies are usually made up of multitudinous members, each with their own personal bias and agenda, thus legislation theory must not treat legislation as a "black box"⁴⁹ from which laws emanate from. He claims that the democratic legislation bases its final authority on the fact that its laws are created by a large popular assembly. He also argues that modern jurisprudence, especially American jurisprudence has a rather unattractive view on legislation, which claims that it is nothing more than "deal-making", "log-rolling", "interest-pandering" etc. instead of principled legislation.⁵⁰ This does not mean, however, that a normative theory of legislation should not be created, however, he points out that this theory should not be aimed at the legislators only, as in telling them "how they ought to behave, what laws they ought to pass, what criteria they should use for the public good, how much attention they should pay to their constituent's interests (...)" but a theory that also addresses the intended audience of the laws such as the general public or the judiciary body.⁵¹ He believes that the democratic authority of the legislator, the textual quality of legislation and the authority of both are intertwined.⁵²

Seidman is taking a pragmatic, institutionalist approach towards legislation. He states that the point of a legislative theory is to guide the legislature and not creating an ideal type of legi-

45 Mainly applies to Anglo-American jurisprudence.

46 See Waldron J., *The Dignity of Legislation*, Maryland Law Review, Vol. 54, No. 2, 1995, pp. 646–647.

47 See *ibid.* pp. 642–643.

48 Jeremy Waldron is a Professor of Law, Jurisprudence and Social Policy Program, School of Law (Boalt Hall), and Professor of Philosophy, University of California at Berkeley.

49 See Waldron, *op. cit.*, note 46, p. 647.

50 See *ibid.* p. 640.

51 See *ibid.* p. 664.

52 See *ibid.* p. 665.

slation for the academia.⁵³ When it comes to legislation in modern democracies, it is essential that it can be always justified as the sovereignty of legislature in itself is simply not enough.⁵⁴ Justification comes from “practical reason” which according to him is nothing but reason informed by experience. He rejects the justification by personal interests or power play. The addressees of legislation theory are the drafters, which include both the people creating the text and the so-called “investigators” whose task is finding the relevant facts. Justified legislation to him is about remedying social problems which are repeatedly emerging. In order to do so, all the necessary information must be gathered. In his theory, he outlines the methodology theory to be applied. He rejects the “ends-means” methodology, which does not allow empirical research of the critical aspect of decision-making as it only cares about the objectives,⁵⁵ and the “incrementalist” approach, which denies the possibility of undertaking radical changes via legislation. He aptly refers to that approach as “muddling through”.⁵⁶ Instead, he put problem-solving in the forefront. According to him, one must not forget about the importance of a “Grand Theory” – which is the overarching belief system of the legislator– that affects the language and the perception of the given problem at hand. The importance of conducting a thorough research was nominated as a key element in justified legislation. This means the examination and the evaluation of the already existing laws, the constraints and the resources regarding the addressee. He advocates the institutionalist approach as Seidman states that the addressee’s behaviour is largely affected by the by the implementing agencies.⁵⁷ He also expressed his dismay at the current state of American legislation; he states on the state level the memoranda of legislation are often missing and he does not paint a rosy picture of federal legislation either. Memoranda can be likened to the way a judge justifies his or her own decision, which gives moral authority of the judgment delivered. However, if there is no way one can retrace the thought process then it is more than likely to erode the authority of legislation.⁵⁸

2. EUROPEAN THEORIES ON LEGISLATION

Another attempt at creating a coherent legislation theory was Luc Wintgens’ idea of what he called as “legisprudence”. He argued that the development of legislation theory was stunted by what he called as “legalism”. He claimed that by separating law and politics obliterates the practical reason on legislation, as they take laws something that has always been there. Thus, the legalist approach always concentrates on the application of law only. This sort of thinking in his view impedes any further discussion on the rationality and the justification of legislation, which in turn makes it much harder to discuss optimal legislation. Thus, he proposes that legislation as the end-product must be separated from legislation as the process. He also states that legislation under legisprudence principles is “a rational, principled theory of

53 See Seidman, *op. cit.*, note 36, p. 4.

54 See *ibid.* pp. 19–20.

55 See *ibid.* pp. 29–31.

56 See *ibid.* pp. 31–32.

57 See *ibid.* 56 f.

58 See *ibid.* p. 3.

legislation”⁵⁹, where norm givers are not only political actors but also legal actors as well. Thus, law-making in his words is more than a “power game”. And because of that he also prescribes duties for the lawmaker, such as the duty

- of relevant-fact finding,
- of problem formulation,
- of weigh and balance alternatives,
- to prospection,
- to take future circumstances into consideration,
- to monitor the issued norms,
- to retrospection,
- to review.⁶⁰

Thus, legisprudence seems to be more aimed at the legislator, rather than intended addressees or the institutions, unlike Waldron’s or Seidman’s proposed theory. Wintgens’ starting point is that individuals are basically free, and legislation is the act of giving up those freedoms when they consider that they cannot effectively control that particular relation just by the basing their actions on their freedom. This is what he calls as the replacement of the “conception of freedom” with the “conception about freedom”.⁶¹

Wintgens’ proposed legisprudence theory heavily relies on the practical justification of legislation, which is built on four major principles. The first one is the principle of coherence, which requires legal norms to be viewed as a whole within the legal system. This means that each norm must make sense within the whole system. The second principle is the principle of alternativity, which means that legislation (a conception about freedom) must be a justified alternative to “failing social interaction”. The third principle is called the principle of temporality. This means that the justification of legislation may become obsolete as the time passes. A norm which made sense ten years ago might be insufficient later. Thus, he argues that legislation should not only be justified at the moment it was issued, but also needs to retain its justification over time.⁶²

Jerzy Wróblewski⁶³ argues that for optimal legislation three fields must be considered. Firstly, he identifies an axiological level, which he describes as the harmony between the theoretical and the instrumental evaluation in order to reach the socially most appropriate resolution. Since Wróblewski’s writing style can be considered extremely succinct and dense, it is advisable to give a few examples to demonstrate his ideas. In Hungary, for example, the Parliament has two chief instruments to use for legislation. One is the creation of acts and it also has the power to create resolutions. The former instrument is used for a wide-range of activities, all of them which affect the population at large, whether it is about taxation, sancti-

59 See Wintgens L. *Legisprudence*. Routledge, Abingdon-on-Thames-New York, 2016, p. 2.

60 See *ibid.* 5.

61 See *ibid.* 3.

62 See *ibid.* 3–4.

63 Jerzy Wróblewski (1926–1990) was one of the most original and most influential legal thinkers of Poland and the whole Eastern-European jurisprudence.

oning behaviour considered to be harmful to the society, or even the compensation of a large group of people.⁶⁴ The role of resolutions is two-fold. They are mainly used for program-like declarations for future legislative activities, or to regulate the inner workings of the Parliament itself. Thus, if the Parliament wished to commemorate a past event in history, it would be more advisable to pass a resolution, but if they also wanted to attach some other effect to it, then it should be done through by making an act.

Another example for demonstrating the importance of choosing the right instrument would be the procedures of the US Congress. According to its rules, both Houses are allowed to create public or private bills. Public bills are meant to affect the whole population, whereas private bills are more concerned with a limited number of individuals or private entities.⁶⁵ Thus, for example, it would be a grave mistake for the US Congress if they decided about the compensation of one or few particular individuals through a public bill. But, however, if the scope of affected individuals or entities is much larger, it must be done through a public bill.

Another field Wróblewski identified was the so-called “genuine” field of optimisation. It means that the legislator is in possession of all the required and relevant facts (maximum knowledge) for legislation and is also willing to put it into application. Reforming the tax system serves a good example. The goal is to create a just and efficient tax system, however, in the words of Csaba Szilovics,⁶⁶ “there is no one regal way”⁶⁷ of doing so as optimal tax systems do not exist in real life.⁶⁸ Many factors need to be considered, including willingness to pay taxes, the current level of redistribution, the goals of the state, etc.⁶⁹ But knowledge does not only include facts, but also the knowledge about the relevant laws so that unnecessary legislation could be avoided.

The third field Wróblewski identified is the “praxeological” field of legislation, which he equates with the “correctness” of legislation. The meaning of correctness is twofold. An enacted law can be correct from a moral point of view, as in it was based on strong moral convictions and the intended effect is within good morals. However, correctness can be defined from a legal technical point of view as well.

Further elaborating on the correctness of legislation it must be noted that legal policy is required to ensure the legislation meets the criteria for correctness. The aim of the legal policy is to filter political ends finding which ones are feasible and absolutely necessary for the legi-

64 For example, the investors affected by the Quaestor scandal in Hungary – the collapse of a brokerage firm resulting from poor corporate governance and bad business decisions – were compensated by the state in an Act of Parliament. However, the Act was challenged on constitutional grounds. The act was found to be discriminatory against those who were harmed by similar brokerage firm collapses in the same period, as they were not compensated. See Csaba Szilovics, ‘A Magyar Alkotmánybíróság Határozata A Quaestor-Károsultak Kárrendezését Biztosító Követeléskezelő Alap Létrehozásáról’ Kodifikáció és Közigazgatás, Vol. 3, No. 2, 2015, p. 4.

65 See Visegrády, *op. cit.*, note 40, p. 16.

66 Associate Professor, University of Pécs, Faculty of Law, Financial Law Department.

67 See Csaba Szilovics, ‘Az Optimalis Adórendszer Feltételeiről’, *Adózási pénzügytan és államháztartási gazdálkodás: Közpénzügyek és Államháztartástan II.* (ed Csaba Lentner, NKE Szolgáltató Kft 2015). pp. 281–310.

68 See *ibid.*

69 See Csaba Szilovics, *Betrug Und Rechtsbefolgung Im Steuerrecht*, Schenk Verlag, 2014, pp. 136–160.

slature to act on, and which ones should be ignored.⁷⁰ This goes against the usual (and rather imprecise) definition which defines legally policy nothing but political ends and means in law.

3. EVALUATION OF THE ACT

Unfortunately, all the pitfalls outlined in the previous section of the paper could be identified in the creation of the Sarbanes-Oxley Act which makes it the target of much criticism since its enactment. Most are targeting the perceived hastiness and unprofessionalism of the legislation which – according to the critiques – were the direct result of the media frenzy generated by the corporate scandals, and the pressure of the public and the political considerations.⁷¹

Section 402 on prohibiting of directors' loans serves as a great example. Such loans were normally issued for legitimate reasons, such as helping the directors' relocation, advancing their legal fees, or helping them to obtain stock options in the company which in turn creates an incentive for the executive officer to work harder and better. While people like Bernie Ebbers, the CEO of WorldCom, exploited personal loans to a great degree, the overwhelming majority of the corporations operating in the USA such abuse did not happen. Jayne W. Barnard⁷² argues that the outright prohibition of directors' loans was an overreaction from the legislators, which was mostly fuelled by populist sentiments.⁷³ The evidence of such populist sentiments can also be found in the spirit of SOX. The problem is, the Act is taking the activities of fraudulent corporations as a starting point. Considering Wróblewski's ideas on genuine optimisation, the legislator seemingly acted without all the knowledge necessary. While at a first glance such approach might have the proper deterrence, it does not meet the criteria for optimal legislation as it fails to take into account that most businesses operated honestly.⁷⁴ Thus, Section 402 fails to meet the standards of optimal legislation on many counts.

It was also objected with regard to the contents of the Act that at many points it only repeats (or emphasises) provisions that are already included in other laws. Therefore SOX means no real reforms, and according to critical professional viewpoints, it only reorganises the previous rules on investor protection, corporate governance and accounting. The supporters of the Act, however, consider the SOX as significant as the securities and capital markets reforms in the 1930s in the United States.⁷⁵ Having duplicate provisions also increases uncertainty, especially when there are slight differences in their content. Thus, – borrowing Wróblewski's thoughts once again – praxeologically the Act itself is far from optimal. Even if the legislators were guided by the right intention (morally correct) the technical errors committed are negatively affecting the text itself.

⁷⁰ See Visegrády, *op. cit.*, note 40, p. 88.

⁷¹ See Romano, *op. cit.*, note 15, pp. 1521–1611.

⁷² James Gould Cutler, Professor of Law at The College of William & Mary. She is specialised in corporations and securities reforms.

⁷³ See Barnard, *op. cit.*, note 25, p. 350.

⁷⁴ See Kecskés; Halász, *op. cit.*, note 1, pp. 213–214.

⁷⁵ See Elisabeth Bumiller 2002: Corporate Conduct: The President; Bush Signs Bill Aimed at Fraud In Corporations The New York Times July 31. <http://www.nytimes.com/2002/07/31/business/corporate-conduct-the-president-bush-signs-bill-aimed-at-fraud-in-corporations.html> (October 5, 2015).

Due to the hasty nature of the legislation process, the proper attention was not given to the text of the bill, thus the approved Act contained duplicate provisions on sentencing which was likely to cause confusion as their phrasing were ambiguous.⁷⁶ From a legislative point of view, this error is a cardinal sin. Even more of a problem was that seemingly the lawmakers were not familiar with the changes in the Sentencing Guidelines made in 2001 which already increased the penalties for white-collar crimes⁷⁷ which in turn resulted in a hike concerning the minimum and the maximum penalties in 2003,⁷⁸ which turned the sentencing mechanisms of economic crimes into a “one-way upward ratchet” as there was no room for downward adjustment.⁷⁹ Whether this was an oversight or a deliberate action by the legislature, regardless it marks SOX as a suboptimal legislation.

The Act is also criticised from another angle with regard to Section 404. The obligations relating to the internal control regulation cause immense costs annually, while they also result in a profit increase for audit firms. Thus, an extra cost is charged on the companies that bring down their efficiency. On the other hand, these costs practically mean considerable profit for those audit firms that were involved in the corporate scandals.

Members of the business world also complained about the five-year rotation of audit firms, as they consider the rule unrealistic. Critics claim that it results in an unnecessary stalling in the course of an audit, moreover, at the top of the business sphere, there are commitments of several directions between the issuers and the auditors, which makes the switching of auditors an uncomfortable formality.

Compliance with the Act and the related costs disproportionately encumber the smaller listed corporations the most. These companies and the Chamber of Commerce representing them criticise the Act for making them pay for the sins committed by large corporations at the turn of the millennium. The major corporations and their representative organisation, the Business Roundtable, show more willingness to comply with the Act, demonstrating how they distance themselves from the companies that were involved in the corporate scandals.

IV. CONCLUSIONS

The Sarbanes-Oxley Act was more of a reaction to the headlines rather than a principled legislation with the aim of setting standards for the future. This is evidenced by the fact that most of the provisions were simply reactions towards the then trending topics in the media. Another major problem was that there was this great incentive for parties to look tough on corporate crime to make themselves more marketable. This resulted in making overly strict regulations, which made getting listed on American stock exchanges less attractive for smaller and foreign businesses.

⁷⁶ Bowman, F. O, *Pour encourage les autres? The Curious History and Distressing Implications of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments That Followed*, Ohio State Journal of Criminal Law, Vol. 1, No. 2, 2003–2004, pp. 408–409.

⁷⁷ *Ibid.* p. 375.

⁷⁸ *Ibid.* p. 432.

⁷⁹ *Ibid.* pp. 439–440.

Yet it does not mean that corporate governance reforms with legislation are a lost cause. The Act itself closed some serious loopholes which were ripe for abuse, such as resolving the conflict of interest in the auditor profession. The main conclusion that could be drawn from the events is that finding the right instrument for resolving a problem is a key issue. Some of the problems (such as the resolution of the conflict of interest between auditors and corporations) could not have been resolved by other means (a “comply or explain” based code may not have been powerful enough to deter such behaviour).

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REFORMA KORPORATIVNOG UPRAVLJANJA PREKO ZAKONODAVSTVA U SJEDINJENIM AMERIČKIM DRŽAVAMA – SLUČAJ SARBANES-OXLEYEVA ZAKONA

Sažetak

Ovaj se rad bavi analizom Sarbanes-Oxleyeva zakona s teorijsko-zakonodavnog aspekta kroz prezentiranje nekih zakonodavnih teorija, područja kojemu se u novije vrijeme poklanja više pozornosti u angloameričkoj sudskoj praksi. Namjera je autora uspoređivanjem s nekim normativnim teorijama dokazati da Sarbane-Oxleyev zakon pripada suboptimalnim zakonskim rješenjima.

Ključne riječi: Sarbanes-Oxleyev zakon, optimalni zakoni, donošenje zakona, funkcionalnost zakona, učinkovitost zakona



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PROBLEMS OF CORPORATE GOVERNANCE IN USA

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ABSTRACT: *The United States of America is the biggest economy of the world producing twenty one percent of total world output through millions of business firms operating in its territory. It is generally assumed that US human capital is more productive and business firms are more efficient. The US firms have been obtaining efficiency gain vis-à-vis their European and Asian competitive firms. This is claimed to be due to good corporate governance. The objective of this study is to study the level of corporate governance because in spite of being efficient economy there are a large number of corporate failures and corrupt practices. The authors have intended to investigate the causes of corporate governance problems in the United States and their possible solutions. The author used secondary data taken from different relevant Books, Journals and US Bureau of Economic Analysis. The nature of the research is qualitative and as such the author used qualitative tools to study the level of corporate governance. The author founds that US business firms have also been facing agency problem, corrupt practices like inside trading in the capital market and misusing resources despite the fact that the United States have strongly regulatory framework. But this regulatory framework is rigid, having many loopholes, providing opportunity to self-interest-seeking managers to manipulate them. The authors suggest that existing regulatory framework needs to be re-examined to make it flexible, keeping in view rapidly changing corporate environment.*

KEYWORDS: Corporate Mis-governance, Agency problem, Moral Hazards

INTRODUCTION

Corporate governance is dealing with "problems that result from the separation of ownership and control." From this perspective, corporate governance would focus on: the internal structure and rules of the board of directors; the creation of independent audit committees; rules for disclosure of information to shareholders and creditors; and, control of management. A recent academic survey began with the quote: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Modern corporate governance started in 1992 with the Cadbury Report. Cadbury was the result of numerous high profile company collapses and is concerned mainly with protecting weak and dispersed shareholders against self-interested directors and managers. Corporate Governance is a step towards strengthening of the organization to face the challenges. Corporate Governance is to takeover the role of the shareholders, stakeholders, vendors, suppliers & employees by the top Managers and CEO of the company. This would

involve that as stakeholders, vendors, suppliers & employees have invested their money, material, effort and faith in the company. Top managers and CEO should give importance to these business pillars. Corporate Governance is a process and device by which the capital market monitors the actions of corporate management, which means that the company is required to act in accordance with the listing agreement of Stock Exchanges and other monitoring agency.

Corporate Governance has been defined in different ways by different writers and organizations. Some define it in a narrow perspective to include in it only the shareholders, while other want it to address the concerns of all stakeholders. Some talk about corporate governance being an important instrument for a country to achieve sustainable economic development, while some others consider it as a corporate strategy to achieve a healthy image for a long tenure. To people in developing societies and intermediary economies, it is a necessary incentive to direct in more powerful and exciting institutes of control. To other people it provides another dimension to corporate ethics and social responsibility of business. Thus corporate governance has different meaning to different people. But to all, corporate governance is means to an end and that end is being long term shareholders, and more outstandingly stakeholder's value. Thus, all authorities on the subject are one in recognizing the need for good corporate governance practices to achieve the end for which corporate are formed. They identify some governance issues being vital and critical to achieve these objectives. These are following:

Distinguishing the roles of Board and Management:

Many companies emphasize that the business is to be managed by the direction of the board. In such practices, the responsibility for managing the business is delegated by the board to the CEO, who in turn delegates the responsibility to other senior executives. Thus, the board occupies a key position between the shareholders and the company's management. As per this arrangement, the board of a listed company should perform their functions as following;

- a) Select, decide the remuneration and evaluate on a regular basis, and when necessary, change the CEO.
- b) Oversee the conduct of the company's business to evaluate whether or not it is being correctly managed.
- c) Review and, where necessary, approve the company's financial objectives and major corporate plans and objectives
- d) Render advice and counsel top management including the board of directions.
- e) Identify and recommend candidates to shareholders for electing them to the board of directors.
- f) Review the capability of systems to comply with all applicable laws and regulations.
- g) All other functions required by law to be performed

Composition of the board:

A board of directors is a "committee elected by the shareholder of a limited company to be responsible for the policy of the company. For full time functional directors are appointed there being responsible for some particular work. The composition of board of directors refers to the number directors having different kind of experience that participate the work of the board. Over a period of time there has been a change as to the number and proportion of different types of directors in the board of limited company. The board of directors of a company shall have an optimum combination of executive and non-executive directors with not less than fifty

percent of the board of directors to be non-executive directors. The number of independent directors would depend whether the chairman is executive or non-executive. In case of a non-executive chairman, at least one third of the board should comprise independent directors and in case of executive chairman, at least half of the board should be independent directors.

Separation of the roles of the CEO and chairperson:

The composition of the board is a major issue in corporate governance as the board acts as a link between the shareholders and the management and its decisions affect the performance of the company. Professionalization of family companies should commence with the composition of the board. All committees that studied governance practices all over the world, starting with the Cadbury Committee, have suggested various improvements in the composition of boards of companies.

It is now increasingly being realized that the practice of combining the role of the chairperson with that of the CEO leads to conflicts in decision making and too much concentration of power in one person resulting in unhealthy consequences. Combining the role of both the CEO and chairperson removes the check on senior management's activities. In large corporations, the job of the CEO as well as that of the chairman may be heavy and one person may not be able to deliver what is expected to, competently, efficiently and objectively. That is the reason corporate governance recommends strongly that the chairman of the board should be an independent director in order to provide counterbalance and check to the power of CEO.

Should The Board Have Committees?

Many committees on corporate governance have recommended in one voice the appointment of special committees for Nominations, Remuneration and Auditing. These committees would reduce the burden of the board and enhance the effectiveness. These committees should have written outlining their authority, duties and clear procedures for reporting back to the board. When these committees are peopled with independent directors selected for their competence, professional expertise in these chosen fields and long years of work experience would help the respective committees decide issues objectively and in a manner that would promote the long term interests of the organization.

Appointments and Re- Elections of Directors:

Shareholders elect directors to the board. Shareholders are a legion, crowd and throng in large companies also scattered. In most cases, the board selects and appoints the prospective director and gets the person formally elected by the shareholders at the Annual General Body Meeting. Shareholders in fact only endorse the board's nominees and it is only in rare case that shareholders refuse to confirm the board's nominees for directorship. There are other issues of corporate governance in relation to the board's appointment such as appointment of a nomination committee, terms of office, duties, and remuneration and reelection of directors and composition of the board on which several committees have made their own recommendations. Corporate governance tends to focus on a simple model like Shareholders elect directors who represent them. Directors vote on key matters and adopt the majority decision. Decisions are made in a transparent manner so that shareholders and others can hold directors accountable. The company adopts accounting standards to generate the information necessary for directors, investors and other stakeholders to make decisions. The company's policies and practices adhere to applicable national, state and local laws. Focusing on these

types of internal control processes, it is quite natural when the subject is corporate governance within the advanced market economies.

The essential fundamentals for which Corporate Governance has started are as following:

- **Transparency** : A company is required to transact their business in a manner which is highly transparent and their books of accounts should reflect the same
- **Accountability**: Corporate Governance ensures the accountability of Board of Directors or senior management to the various stake holders within and outside the company
- **Control** : To protect the interest of the shareholders the Apex monitoring body for example Security and Exchange Commission exercise control over the management of company through various compliances
- **Trusteeship** : Board of directors must act as the trustees of the stakeholders and good Corporate Governance ensures the same
- **Ethics**: Good ethical practices are the foundation of any successful corporate governance and ensures fairness in all its activities

Directors' and Executives' Remuneration

This is one of the mixed and vexed issues of corporate governance that came to the centre stage during the massive corporate failures in the US between 2000 and 2002. Executive compensation has also in recent time become the most visible and politically sensitive issue relating to corporate governance. According to the Cadbury Report: the over riding principle in respect of Board remuneration is that shareholders are entitled to a full and clear statement of directors' present and future benefits, and how they have been determined. Other committees on corporate governance have also laid emphasis on other related issues such as pay of performance, severance payments, and pension for non executive directors and appointment of remuneration committee and so on. However while controversy often surrounds the size or quantum of remunerations, this is not necessarily an issue of corporate governance. The key corporate governance issues are; Transparency in executive compensation, Pay for performance whether the payment is justified, Process for determination, Severance payments of pay and Pensions for non executive directors

Disclosure and Audit:

The Cadbury Report termed the annual audit as one of the cornerstones of corporate governance. Audit also provides a basis for reassurance for everyone who has a financial stake in the company. Cadbury Report stressed that the board of directors has a bounded responsibility to present the shareholders a clear and balanced assessment of the company's financial position through audited financial statements. There several issues and questions relating to auditing which have an impact on corporate governance as following:

- 1) Should boards establish an audit committee?
- 2) If yes, how should it compose?
- 3) How to ensure the independence of the auditors?
- 4) What precautions are to be taken or what are the positions of the state and regulators with regard to provision of non-audit services rendered by auditors?
- 5) Should individual directors have access to independent resource?
- 6) Should boards formalize performance standards?

These questions are being answered with different perceptions and with different degrees of emphasis by various committees and organization that have gone into and analyzed these issues in depth

Protection of shareholder rights and their expectations:

This is an important governance issue which has considerable impact on the rights and expectations of shareholders. Corporate practices and policies vary from country to country. These are a number of questions relating to this issue such as;

- 1) Should companies always adhere to one share one vote principle?
- 2) Should companies retain voting by a show of hands or by poll?
- 3) Can shareholders' resolutions be boundless? That is to place together before shareholders for approval a resolution that contains more than one discrete issue
- 4) Should shareholder approval be required for all major transactions?

These questions have drawn out answers with different emphasis from various committees and organizations that have addressed these issues

Dialogue with institutional shareholders:

The Cadbury Committee recommended that institutional investors should maintain regular and systematic contact with companies, apart from their participation in general meetings of shareholders, use their voting rights positively, take a positive interest in the compositions of the board of directors of companies in which they invest, and above all, recognize these whose money they have invested by influencing the standards of corporate governance and by bringing about changes in companies when necessary, rather than by selling their shares, and quitting the companies. If institutional investors have to exercise their rights and carry out their responsibilities, companies have to provide them the required information and facilities.

The United States is often seen as being the paradigmatic case of the shareholder oriented or market based approach to corporate governance. Ownership of corporations is dispersed, but involves high engagement from institutional investors, such as pension funds and other financial institutions. Corporate boards are small, have a high proportion of outside or independent members, and utilize committees to improve processes of board. The internal and external aspects of corporate governance are linked through the audit firms that certify the flow of information from managers to markets. The market for corporate control exerts a final discipline on poorly performing firms, who face a heightened risk of takeover. These different elements are also thought have strong institutional complementarities, operating as a positive and mutually reinforcing system of effective corporate governance. United States corporate governance system seem to be in terrible shape. The business press has focused relentlessly on the corporate board and governance failures at Enron, WorldCom, Tyco, Adelphia, Global Crossing, and others. Top executive compensation is also routinely criticized as excessive by the press, academics, and even top Federal Reserve officials.

A wave of corporate scandals in the United States early this century Enron, Tyco, WorldCom and the like other led to extraordinary focus by the White House and the US Congress on corporate governance. This concluded in the enactment in July 2002 of the Sarbanes Oxley Act, and has been followed by significant regulation and rule making affecting corporate affairs by the US Securities and Exchange Commission (SEC) as well as by stock market self regulatory bodies for example the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations, commonly known as NASDAQ

Stock Market. The full impact of these rules has not yet been felt and a number of significant proposals are still pending.

Sarbanes Oxley has not changed the basic structure of corporate governance in the United States: day to day management of a corporation is still in the hands of the management, subject to oversight by a board of directors elected by shareholders. However, the major aim of the reforms has been to establish clear accountability of a public company's chief executive officer (CEO) and chief financial officer (CFO) for the accuracy of the company's public disclosures, and to strengthen and reinforce the role played by the board of directors and key board committees especially the audit, compensation and governance committees in the oversight of corporate management. The CEO and CFO in a company that is public in the United States must personally certify as to the accuracy of the company's public disclosures, and to its disclosure controls and internal control processes. In addition, the majority of the board of a US company with a US listing, as well as the entire membership of each of those committees, will be required to be independent under new independence standards.

LITERATURE REVIEW

Literature review focuses on the problems and issues of corporate governance including responsibilities of board of directors and managers, responsibilities of stakeholders and principles of corporate governance. This review explores the development of techniques for managing and correction of ethical issues, and examines the problems of corporate governance in United State of America. Corporate governance in the United States has traditionally been a subject of state corporate law, focused on the relative roles and powers of shareholders, the board of directors and corporate officers in relation to corporate action, decision making and oversight of management. A more basic issue remains open, though: Ought government policy to support family run control pyramids or break them up. (Morck et al 2000) argue that entrusting extensive corporate control to a few old families is generally undesirable.

Family Firms:

Control of corporate assets by wealthy families in economies is common, and control pyramids concentrate governance powers in tiny elite in many countries. Many countries entrust the governance of their large corporations to a handful of wealthy families. These families use control pyramids to affect these powers. Such control pyramids make firms exposed to a range of serious governance problems. A concerted effort to improve a country's institutions is needed before diffuse ownership is desirable. Anderson and Reeb (2003) refer to any firm with a dominant shareholder as a family firm. Systematic differences in the governance of an economy's great corporations might affect its macroeconomic performance. New money and old family money vie for importance in Latin America, and the United States. Anderson and Reeb (2003) find evidence consistent with large shareholders in the United States improving firm performance. Empirical work to date is broadly consistent with this viewpoint. Public shareholders are myopic, and focus only on short term earnings, have long been exposed. Corrupt or inefficient courts doubtless magnify the importance of a reputation for fair dealing. A connection with such a family, however distorted by layers of pyramidal control, may be a great asset to a firm operating in a country where legal remedies for fraud are absent. A well-developed legal and regulatory system that makes public investors confident of their property rights encourages families to sell out. Heirs may come to realize that professionals can run the family's firms better, and may opt to become passive investors with diversified portfolios of

stock in firms they do not control. Poor education systems leave potentially brilliant managers to live as illiterate peasants, and may well leave the members of a few dominant families, able to afford to send their sons to elite educational institutions abroad, the most able managers.

While governance problems in widely held firms clearly can be serious, we argue that family control can give rise to other, potentially worse, corporate governance problems. Schultz, Lubatkin, Dino, and Buchholtz (2001) convincingly point out that agency problems can occur between family members. We argue that, in addition to these problems, another set of agency issues arise when family controlled firms organized into business groups obtain outside equity financing. These agency issues are: the use of pyramidal groups to separate ownership from control, the entrenchment of controlling families, and non-arm's-length transactions between related companies that are detrimental to public investors.

Role of the audit committee:

The role of the audit committee, in particular, has been significantly strengthened and expanded at corporate level. All members of the audit committee must be independent under a more stringent Sarbanes Oxley definition of 'independence'. In addition to certain stock exchange financial literacy requirements, the SEC has adopted a disclosure requirement as to whether a financial expert sits on the company's audit committee. There is a clear sense among public company directors that the personality and expertise of the chairman of the audit committee are crucial to the system of corporate governance.

One of the cornerstones of Sarbanes Oxley is a focus on the independence of the company's auditor. Sarbanes Oxley makes it law in the United States that the independent auditor of a US public company ultimately reports to the company's audit committee, not its management. Further, to avoid conflicts of interest on the part of the audit firm, the provision of many categories of non-audit services to the client is now prohibited, while any permitted category of non-audit service must be preapproved by the audit committee. The company is required to break out and disclose the amounts paid to the auditor for audit and non-audit services. To reinforce this independence theme and further avoid well-established relationships with management, the audit partner and other key personnel of that firm engaged with the client must rotate after specific duration.

Shareholder Value:

By the 1990s, the trend toward greater shareholder influence continued, but was reshaped by the responses of managers. On one hand, executives sought to defend their own power by shielding firms from unwanted takeover bids. On the other hand, managers aligned themselves increasingly with the interests of shareholders through new forms of executive pay and adopting the ideology of shareholder value (Dobbin & Zorn, 2005). Shareholder value refers to the concept that the primary goal for a company is to increase the wealth of its shareholders by paying dividends and/or causing the stock price to increase. Somewhat paradoxically, although shareholder power was tamed, shareholder value became a powerful new ideology. In 1992, federal proxy rules were revised to give shareholders enhanced latitude to communicate amongst themselves (Schwab & Thomas, 1998). The scope of issues targeted by shareholder activism expanded further to cover changes in board structure and function, as well as executive and director compensation. The influence of shareholder activism remained exciting, but modest on the whole. Even the most activist investors have limited resources devoted to corporate governance and institutional investors rarely get involved in matters of

company specific policy, make shareholder proposals or seek direct representation by nominating candidates to the board of directors (Black, 1998, Choi & Fisch, 2008).

Despite the growing importance of independence, two facts are worth noting. First, the legal definition of an independent director remained rather weakly developed and was specified only in state corporation law. Second, a majority of U.S. firms still combined the role of CEO and Chairman within the board. This problem puts some doubt on the genuine independence of other board members. A number of boards from this period note that outside directors felt strong loyalty to the CEO regarding issues such as “golden parachutes” (Wade, Charles A. O’Reilly & Chandratat, 1990) and that CEO influence led to boards with demographically similar (Westphal & Zajac, 1995). In particular, the rise of equity based pay such as stock options had given managers a greater stake in promoting restructuring and orientating their strategies toward the stock market. In 1991, the SEC changes rule 16(b) making it possible for executives to exercise stock options and sell their stocks at the same time, thereby exploiting very short term movements in stock prices to their own advantage. Despite attempts to limit the amounts of tax deductible executive pay (Jensen & Murphy, 2004), other tax incentives encouraged stock options, as did the fact that corporations could avoid expensing options in their financial statements (Suchan, 2004).

Separation of Powers in Board Leadership

Often the CEO will sit on the Board of Directors for corporations in the United States. There is a growing corporate population calling for a clear split between executive leadership and board functions. The Separation of Board and Company, Jonathan F. Foster says that a Boards’ most important function is to set an effective agenda that helps accomplish its primary objectives: "appointment, oversight and compensation of senior management; review of budgets and strategy; and oversight of financial reporting and capital structure." He goes on to say that an independent Board leader has the flexibility to set an appropriate agenda more easily than senior leadership and CEOs because they must focus on running the company, rather than running the board. Also, a CEO's immersion in the day to day operations may compromise her ability to maintain an objective oversight of senior management.

Given the limits to shareholder engagement, a key element of market oriented corporate governance is the presence of outside, independent members of the Board to represent shareholder interests. From the agency theory perspective, boards of directors and particularly independent or outside members are put in place to monitor managers on behalf of shareholders (Lynall, Goden & Hillman, 2003). The board of directors has the formal authority to ratify management initiatives, to evaluate managerial performance and to allocate rewards and penalties to management on the basis of criteria that reflect shareholders’ interests. Agency theory suggests that a board comprised of independent directors for example board members who are not dependent on the current CEO or organization is more likely to provide an effective oversight of the firm’s CEO and other executive directors. These arguments see board independence largely as a potential substitute for formal engagement by large shareholders. The evidence regarding the benefits of independent boards raises a question of why their effectiveness appears to be limited. Indeed, the failure of the Enron board to observe the warning signs as the company slid deeper into trouble remains something of a mystery. At least two issues are important in this regard. First, board members may not be sufficiently independent from the CEO (Bhagat & Black, 1999). Gilson (2006) describes the situation in the 1980s as follows, “The chief executive officer, rather than being selected by the board,

effectively selected who would be a director, and the shareholders passively endorsed the choice. The result was that directors saw themselves as advisers to senior management, not their monitors. If a director disagreed with the CEO's strategy, the proper response was the resignation of the director, rather than that the replacement of the CEO". More recently, Bebchuk (2005) finds that only a few of public companies in the USA faced contested board elections that were designed to get rid of existing directors. One of the barriers to contested board elections is associated with financial and organizational difficulties shareholders face when trying to place their own directors on a company's proxy statement. Bearing this in mind, Bebchuk supports suggestions that companies should be able to choose to provide shareholders with proxy statements via the Internet. This argument suggests the problem is that outside board members may remain insufficiently independent, particular since outside directors have little direct mandate to represent key shareholder or broader stakeholder constituencies. In the absence of stronger controls on the nominating process, most independent directors maintain a stance of "dysfunctional deference" to the CEO that limits their contribution of effective corporate governance (Sharfman & Toll, 2008). A second issue concerns the more inherent limits of independence. Outside directors may simply lack the amount and quality of information that insiders have. The information available may be too dependent on formal disclosure, too focused on finance rather than strategy and operations.

Directors' and officers' liability insurance

The wave of corporate scandals has resulted in a dramatic increase in shareholder class action suits and average settlement values. In addition, there is widespread concern that Sarbanes Oxley has made directors and officers more defenseless to lawsuits and liability with its Certification requirements, increased roles and responsibilities of directors, and the increase in the limitation period for bringing securities law violation suits. Directors' and officers' liability insurers have responded with increased premiums, reduced coverage limits, higher retentions, narrower coverage, expanded exclusions, restrictions on severability and multiyear deals. In Enron, Tyco and other recent cases, directors' and officers' insurers have sought to withdraw the policies and deny coverage on the grounds of misstatements in the applications. In order to protect, retain and recruit outside directors, companies are increasingly looking into purchasing 'individual' director liability insurance policies which provide coverage even when coverage becomes unavailable under the company's traditional directors' and officers' policy. These policies are non-rescindable except in the case of non-payment of premiums.

High-profile cases involving wrongdoing by corporate executives in the early 2000s intensified the exposure on how decisions made by those executives can impact a large number of people. For example, Enron Corporation, an energy company based in Houston, Texas, suffered a major collapse in 2001 that led to the largest bankruptcy in U.S. history. Acts of fraud on the part of corporate officers and others caused many of the problems. Employees of the company lost most of their retirement investments as a result of the company's collapse. Other companies, such as WorldCom, Tyco International, and Global Crossing, suffered similar fates. Both officers and directors of those corporations faced civil and criminal liability. Members of boards of directors for Enron and WorldCom agreed to pay millions of dollars out of their own pockets as part of settlement agreements. The U.S. Securities and Exchange Commission brought charges against top company officers, seeking to recover large fines in addition to criminal convictions. These incidents also led to major changes in federal securities laws regarding the potential liability for officers and directors.

Director recruitment and compensation

“The 1990s was the decade in which senior executive compensation shifted from being primarily cash based to being mainly stock based. With this change, management became focused not simply on the relationship between market price and breakup value which the advent of the bust up takeover compelled them to watch, but on the likely future performance of their firm’s stock over the short term. Far more than the hostile takeover, equity compensation induced management to obsess over their firm’s day to day share price.” As late as 1990, the Business Roundtable, a group of chief executives of the largest firms, advocated the notion that “the directors’ responsibility to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation or to the long term interests of its shareholders.” Yet by 1997, they argued that “the paramount duty of management and of boards of directors is to the corporations’ stockholders; the interests of other stakeholders are relevant as a derivative of the duty to the stockholders” (quotes take from Fourcade & Khurana, 2009). The era of shareholder value had arrived.

The rise of shareholder value reinforced the “downsize and distribute” strategy of the previous decade dividend payout ratios remained high, downsizing continued despite the general economic recovery, and corporations remained focused on their core businesses. CEO continued to increase, while average wages stagnated (Hallock, 1998). Ideologically, organized labor no longer posed a great challenge to management and both unions and individual employees increasingly sought empowerment through the channel of pension fund ownership or employee share schemes. Still, the concept of shareholder value evolved and became infused with range of new techniques of “speculative management” designed to influence company share prices, including road shows, stock splits, name changes, mergers, spin offs, changes to in company pension plans (Krier, 2005).

The increased time commitment being placed on directors has made director recruitment more challenging, particularly for companies seeking to fill an audit committee seat, where due diligence has become more extensive and two sided. Adding to the pinch in qualified candidates is the fact that sitting CEOs and directors are serving on fewer boards due to self-imposed restrictions and limits, suggested by the companies they serve. While the increased exposure and demands of directorship may warrant additional compensation, many boards have been reluctant to make significant changes given the critical focus of the press and shareholder advocates. However, an upward trend is evident, with the total annual package for an outside director approaching USD 250,000 at a few large blue chip companies. Most packages continue to have a cash and equity component, but stock options are being trimmed in preference of equity awards that emphasize long term goals, such as stock awards with long term holding requirements.

Absence of Employee Voice

A strong body of evidence now links employee voice in corporate governance to improved outcomes for employees and high productivity for companies. While the issue of stakeholder involvement remains controversial, the shareholder orientation of U.S corporate governance has been widely criticized by stakeholder theorists. What is less well known are the set of arguments linking increased employee involvement in the U.S. with improved functioning of various shareholder oriented mechanisms of corporate governance in the long term? In terms of shareholder engagement, union representation on pension funds has been associated with strong engagement on corporate governance issues. Union representation is not only a vehicle

for promoting employee interests, but also helps progress a number of agendas where employee shareholders and other shareholder have common interests avoiding excessive management pay, promoting transparency, assuring independent audits, etc. In terms of takeover markets, employee protection may help limit the scope of opportunistic strategies during takeovers, where new owners engage in breaches of trust to create short term gains. In terms of boards, experience has shown that employee representatives on the board of directors, either that elected via the workforce or appointed by unions; tend to be relatively independent of top management. Employee board members directly represent independent stakeholders and have access to information and knowledge of the employees, rather than being solely dependent on disclosure from management. While employees are often discussed as being company “insiders,” they are in fact quite independent relative to some “outside” board members who are essentially recruited by the top management. Similarly, debates on corporate social responsibility in the U.S. have long advocated the idea of “constituency directors” elected directly by shareholders to give weight to stakeholder interests (Brudney, 1982). In terms of managerial pay, employee representation on boards seem to have both more modest pay, but also more strictly defined long term performance criteria than in countries without employee representation (Buck & Shahrin, 2005, Fiss & Zajac, 2004, Sanders & Tuschke, 2006). Employees do not have an interest in avoiding incentivized or variable pay, but do have a strong interest in making sure such incentives are long term, consistent with the strategic goals of the organization, and compatible with the social norms of other employees in the firm.

Campaign Finance Disclosure:

With a Presidential Election in the United States in 2012, expect to see more pressure on directors to maintain oversight of corporate donations to political campaigns and adherence to proper campaign finance disclosures. According to a post by Francis H. Byrd called Top Ten Issues for Boards in 2012, "Taft Hartley and public pension funds are looking to increase the number of proposals they filed last year. Their hope is that the filed resolutions will lead to agreements with companies to limit and/or have the board oversee such contributions and corporate political activities." In house attorneys will want to keep tabs on the activities in this area and make sure that boards keep within the designated limits.

METHODOLOGY

Analytical and descriptive study method was used to understand performance of the principles and best practices of Corporate Governance and related problems in USA. Data collected were mainly from secondary sources through the use of internet searching and downloading the research papers related to the topic of the paper. About twenty research papers were downloaded and studied by the four researchers and gather the data after mutual discussion under the supervision of supervisor. The type of data was secondary data and source of data for this study is books and internet. The study has limitations of time constraint, access to limited libraries.

Objectives of Study

This study is to identify the problem related to Corporate Governance in United State of America and led us to a review of the existing literature related to corporate governance, including some recent problems.

- To establish the level of compliance with corporate governance guidelines and regulations by the organizations in USA

- To identify the relationship between corporate governance principles and problems of corporate governance in USA

Scope of Study

The study focused on problem of corporate governance issues in United State of America. The findings of this study will enhance the efforts of reader and researcher in coming up with corporate governance principles and guidelines that govern by the related department in any corporation. We gain immense knowledge aimed at creating awareness on corporate governance principles and guidelines for the benefit of the shareholders and all other stakeholders. The study will contribute to the achievement of the organization's policy of prosperity to benefit from properly run organizations and govern the corporations by correcting the problems of corporate governance.

The study will facilitate management by enhancing the knowledge of the board members. Good Corporate Governance practice provides a way to realize the idea of mitigating risk and optimizing performance simultaneously in competitive environment.

Corporate Miss-governance in USA

A collapse involves a major insolvency or bankruptcy of a failure. Following scandals were involving allegations of unethical behavior by people, acting within or on the behalf of a corporation. A corporate scandal sometimes involves accounting fraud of some sort. A wave of such scandals swept many United States companies in 2002. Some of the scandals of United States related to corporate governance after 2001 are given below.

Pacific Gas and Electric Company – 6 April 2001

It was Energy Company. After a change in regulation in California, the company determined it was unable to continue delivering power, and despite the California Public Utility Commission's efforts, it went into bankruptcy, leaving homes without energy. In 1998, a change in the regulation of California's public utilities, including PG&E, began. The California Public Utility Commission (CPUC) set the rates that PG&E could charge customers and required them to provide as much power as the customers wanted at rates set by the CPUC.

In the summer of 2001 a drought in the northwest states and in California reduced the amount of hydroelectric power available. Usually PG&E could buy "cheap" hydroelectric power under long term contracts with the Bonneville Dam, etc. Drought and delays in approval of new power plants and market manipulation decreased available electric power generation capacity that could be generated in state or bought under long term contracts out of state. Hot weather brought on higher usage, rolling blackouts etc. With little excess generating capacity of its own PG&E was forced to buy electricity out of state from suppliers without long term contracts. Because PG&E had to buy additional electricity to meet demand some suppliers took advantage of this requirement and manipulated the market by creating artificial shortages and charged very high electrical rates. The CPUC refused to adjust the allowable electric rates. PG&E Company (the utility, not the holding company) entered bankruptcy April 6, 2001. The state of California tried to bail out the utility and provide power to PG&E's 5.1 million customers, under the same rules that required the state to buy electricity at market rate high cost to meet demand and sell it at lower fixed price, the state also lost significant amounts of money.

WorldCom – 21 July 2001 [Telecomm]

CEO of WorldCom, Bernard Ebbers became very wealthy from the increasing price of his holdings in WorldCom common stock. However, in the year 2000 the telecommunications industry was in decline. WorldCom's aggressive growth strategy suffered a serious setback when, in July 2000, it was forced by the U.S. Justice Department to abandon its proposed merger with Sprint. By that time, WorldCom's stock price was decreasing and banks were placing increasing demands on Ebbers to cover margin calls on his WorldCom stock that were used to finance his other businesses. In 2001, Ebbers persuaded WorldCom's board of directors to provide him corporate loans and guarantees in excess of \$400 million to cover his margin calls. After falling share prices and a failed share buy back scheme, it was found that the directors had used fraudulent accounting methods to push up the stock price. Rebranded MCI Inc, it emerged from bankruptcy in 2004 and the assets were bought by Verizon.

As everyone now knows, events have moved swiftly in the days since that declaration. CFO Scott Sullivan, who was once regarded as an accounting wunderkind, has been sacked. The Securities and Exchange Commission has charged WorldCom with fraud. As the prospect of bankruptcy seems near-certain, Wall Street has punished WorldCom's stock, which was already in the pits even before the announcement; it closed at 10 cents on July 2. Analysts have warned that more bad news could be on the way, and that by the time the dust settles, WorldCom's failure could be more expensive than Enron's.

How did this happen? And even more importantly, how much confidence should investors place in companies' financial statements? According to experts from Wharton and elsewhere, accounting reforms are essential – but it will take much more than that to restore integrity and accountability in the corporate world.

“What's surprising about WorldCom is the very basic nature of what happened,” says Karen Nelson, a professor of accounting at Stanford Graduate School of Business. “Enron was all about complex partnerships and accounting for special purpose entities. But what WorldCom did wrong is something that's taught in the first few weeks of a core financial reporting class. That's why people are asking, given its basic nature and its magnitude, how could it have been missed.”

Enron – 28 November 2001 [Energy Company]

The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, an American energy company based in Houston, Texas, and the de facto dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. In addition to being the largest bankruptcy reorganization in American history at that time, Enron was attributed as the biggest audit failure. Chief Financial Officer Andrew Fastow and other executives not only misled Enron's board of directors and audit committee on high-risk accounting practices, but also pressured Andersen to ignore the issues. Directors and executives fraudulently concealed large losses in Enron's projects. A number of executives were sentenced to prison. This energy company created outside partnerships that helped it to hide its poor financial condition. It regularly misstated its earnings and assets, using a web of subsidiary and associate companies for the purpose. Executives paid themselves huge bonuses and also earned millions of dollars selling company's shares that were given to them at throw away prices as part of their remuneration package. The company eventually went bankrupt.

Shareholders of Enron lost USD 74 billion in the four years before the company's bankruptcy. As Enron had nearly \$67 billion that it owed creditors, employees and shareholders received limited, if any, assistance aside from severance from Enron. To pay its creditors, Enron held auctions to sell assets including art, photographs, logo signs, and its pipelines. In May 2004, more than 20,000 former employees of Enron won a suit of USD 85 million for compensation of USD 2 billion pensions that was lost. From the settlement, the employees each received about USD 3,100. The next year, investors received another settlement from several banks of USD 4.2 billion. In September 2008, a USD 7.2 billion settlement from a USD 40-billion lawsuit was reached on behalf of the shareholders.

Arthur Andersen – 15 June 2002 [Accounting]

Arthur Andersen, based in Chicago, was a holding company and formerly one of the "Big Five" accounting firms, providing auditing, tax, and consulting services to large corporations. In 2002, the firm voluntarily surrendered its licenses to practice as Certified Public Accountants in the United States after being found guilty of criminal charges relating to the firm's handling of the auditing of Enron, an energy corporation based in Texas, which had filed for bankruptcy in 2001 and later failed. The other national accounting and consulting firms bought most of the practices of Arthur Andersen.

Adelphia Communications Corporation – 13 Feb 2002 [Cable TV]

Adelphia was the fifth largest cable company in the United States before filing for bankruptcy in 2002 as a result of internal corruption. Adelphia was founded in 1952 by John Rigas in the town of Coudersport, which remained the company's headquarters until it was moved to Greenwood Village, Colorado, shortly after filing for bankruptcy. The Directors of the company were sentenced to prison. The founders of Adelphia were charged with securities violations. Five officers were indicted and two (John Rigas and Timothy Rigas) were found guilty. Rigas founded Adelphia with a \$300 license in 1952, took the company public in 1986 and built it by acquiring other systems in the 1990s. The company collapsed into bankruptcy in 2002 after it disclosed \$2.3 billion in off-balance-sheet debt.

The majority of Adelphia's revenue-generating assets were officially acquired by Time Warner Cable and Comcast on July 31, 2006. LFC, an internet-based real estate marketing firm, auctioned off the remaining Adelphia real estate assets. As a result of this acquisition, Adelphia no longer exists as a cable provider. Adelphia's long-distance telephone business with 110,000 customers in 27 states was sold to Pioneer Telephone for about \$1.2 million.

REFCO – 17 October 2005 [Brokering]

REFCO was a New York-based financial services company, primarily known as a broker of commodities and futures contracts. It was founded in 1969 as "Ray E. Friedman and Co." Prior to its collapse in October, 2005, the firm had over \$4 billion in approximately 200,000 customer accounts, and it was the largest broker on the Chicago Mercantile Exchange. The firm's balance sheet at the time of the collapse showed about \$75 billion in assets and a roughly equal amount in liabilities. Though these filings have since been disowned by the company, they are probably roughly accurate in showing the firm's level of leverage.

Refco Inc. entered crisis on Monday, October 10, 2005, when it announced that its chief executive officer and chairman, Phillip R. Bennett had hidden \$430 million in bad debts from the company's auditors and investors, and had agreed to take a leave of absence. After

becoming a public company in August 2005, it was revealed that Phillip R. Bennett, the company CEO and chairman had concealed \$430m of bad debts. Its underwriters were Credit Suisse First Boston, Goldman Sachs, and Bank of America Corp. The company entered bankruptcy and Bennett was sentenced to 16 years prison.

CONCLUSION

Major corporate problems and issues were included the issue of shareholder value, definition of independent directors, composition of the board, boards should have audit committee, appointment and re-election of directors, transparency, accountability, control, ethics, disclosure of audits, protection of shareholder rights, combined role of CEO and the chairman within the board and equity base pay of directors such as stock options. In the case stock options managers focus more of the rise of short term stock price in market and exercise their stock options. Taken as a whole, U.S. corporations have voluntarily pursued shareholder friendly policies in the 1990s. We believe management's acceptance of the shareholders' perspective was greatly aided by profitable stock option plans, which allowed executives to reap big financial gain from increased in share prices. The focus was on forcing corporate assets out of the hands of managers who could not or did not want to use them efficiently. The results included takeovers and restructurings of companies with excess capacity.

The move towards shareholder and market preeminence is apparent in the way corporations have reorganized themselves. There has been a broad trend towards decentralization. Large companies are trying hard to become quicker and to find ways to offer employees higher powered incentives. At the same time, external capital markets have taken on a larger share of the reallocation of capital. Corporate managers still reallocate vast amounts of resources in the economy through internal capital and labor markets; the boundary between markets and managers appears to have shifted. As managers have given up authority to the markets, the scope and independence of their decision making have narrowed.

Corruption is out of control throughout the world. Evidences show that basically there are two causes of corruption namely: greed and need. While needs can be met by reviewing pay packages, etc, no package can take care of the greed which has no end. As a consequence of moral bankruptcy and consequences of devaluation of man plaguing practically all including developing and developed countries there is an increasing tendency to channel funds to get rich too soon to maintain unproductive/ non performing assets.

Having addressed where the U.S. system is today and how it got there, we finally consider the probable near term effects of the legislative, regulatory, and market responses to the perceived corporate governance problem. We conclude that the current changes are likely to make a good U.S. system a better one, although not without imposing some unnecessary costs. In fact, the greatest risk now facing the U.S. corporate governance system is the possibility of overregulation. How could an inefficient governance system produce so much wealth? And what about all the family firms that became conglomerates? Family firms are subject to fewer agency problems than widely held companies, yet many of them followed the general trend. Capital markets have come to play a bigger role not because they have become better at allocating resources and not because managers misbehaved, but rather because the market's comparative advantage has been favored by economy wide trends in deregulation, globalization, and information technology. If the shifts in corporate governance have been

driven by these factors, then the market's strong influence on corporate governance may be more transitory.

Employees know that their firm specific knowledge is likely to become less valuable once the firm changes course and starts pursuing new lines of business. A new firm, with a lack of commitments and old baggage, can offer a distinctive competitive advantage in rapidly growing industries. From this perspective, forcing older companies to adhere more rigorously to maximization of shareholder value reduces those activities of employee influence that cause costly delays, distorted investment decisions, and misguided efforts to save jobs. If decisions of where to cut and where to expand jobs were left to a democratic body of workers, the heterogeneity in employee preferences would make the process of change slow and costly.

U.S. corporate governance has changed substantially in the last 20 years. The underlying substance of this transformation has been that U.S. managers have become much more focused on stock prices. We have argued that at least some of the efficiency gains associated with these changes can be traced to the comparative advantage of markets in undertaking large scale change. Since these effects are temporary, it is possible that the current level of market influence on the governance and organization of firms is going to decrease.

SUGGESTIONS – HOW TO SOLVE THE IDENTIFIED PROBLEMS

1. Companies must comply with applicable governance related provisions required by the Sarbanes Oxley Act of 2002, related regulations of the Securities & Exchange Commission (SEC) and applicable listing standards as well as with all other applicable laws, regulations, and company articles and bylaws. For example, it is assumed that most publicly traded United States corporations those that do not qualify for certain controlled company exemptions now have a majority of independent directors; that independent directors hold periodic executive sessions without members of management present; that such sessions are convened and presided over by an independent director chosen by the independent directors; and that audit, compensation, and nominating/governance functions are undertaken by independent directors usually organized in committees. The Key Agreed Principles that follow are grounded in the common interest of shareholders, boards, and management teams in the corporate objective of long term value creation through ethical and legal means, the accountability of management to the board, and ultimately the accountability of the board to shareholders for such long term value creation. The Principles provide a framework for board leadership and oversight in the especially critical areas of strategic planning, risk oversight, executive compensation, and transparency. First; principle emphasizes the responsibility of every board to design its own governance structure and practices, and secondly, principle emphasizes the importance of the board explaining how it has tailored governance structures and practices to meet its own needs. Thirdly, principles describe the key fundamentals that boards should take into account in designing and explaining structures and practices.
2. Governance structures and practices should be designed by the board to position the board to fulfill its duties effectively and efficiently. The board of directors, as the central mechanism for oversight and accountability in corporate governance system, is charged with the direction of the corporation, including responsibility for deciding how the board itself should be organized, how it should function, and how it should order its priorities.
3. The board's fiduciary objective should be long term value creation for the corporation; governance form and process should follow by the boards.

4. Shareholders and management should have important viewpoints about governance structures and processes, and shareholders elect directors and have authority for certain critical decisions.
5. Boards should take extra care with selecting and evaluating senior executives, planning for succession, monitoring performance, overseeing strategy and risk, compensating executives, approving corporate policies and plans, approving material capital expenditures and transactions not in the ordinary course of business, ensuring the transparency and integrity of financial disclosures and controls. Board should provide oversight of compliance with applicable laws and regulations and the board must decide how best to position itself to fulfill its fiduciary obligations.
6. The NYSE rules require boards and core board committees to perform annual self-evaluations. While the idea of group and peer evaluation has typically been acknowledged with mixed feelings by directors, it is expected that many boards will begin to see these evaluations as an opportunity to improve board and committee process to optimize their approach to strategic planning, goal setting and monitoring. Boards should begin to rely more heavily on outside consultants, who can help to guide the evaluation process to make it as trouble-free and productive as possible.
7. Corporations should facilitate and encourage the weak and dispersed shareholders to attend the board meetings by arranging the board meetings at nearby city of these shareholders and paying travelling expenses to them. This will lead to more participation of shareholders and can provide corporations more opportunity to gather the ideas for the improvement of the organizations.
8. Financial accounting audit firms should be changed after specific period of time. Similar accounting audit firms do audit repeatedly in same corporation can develop relations with the management of corporation and can lead to hiding accounting facts and can causes corruption.
9. Accounting audit firms should be well reputed, honest and fair. There should be no evidence of even a minor scandal and involvement of that accounting audit firm in any fraudulent or corruption.
10. Directors are a company's soul and we agreed with the Chinese saying, "Water can carry a boat; it can also sink a boat" applies. They have to understand the nature of the trust shareholders place in them and not for one moment pronounce free from blame themselves of the fiduciary duties. We believed that independent non-executive directors played a pivotal role in overseeing the internal control and financial reporting systems of issuers, and providing checks and balances over the board's decision making on significant transactions.
11. For professional advisers, their privileged position carries with it special responsibilities. The professions had to demonstrate their ability to monitor adherence of their members to professional and ethical standards. Any self-regulatory regime has to be effective, transparent and accountable.
12. Free flow of information through the media has been vital to both our own healthy market development and the confidence of overseas investors in our market, the media also has a particular responsibility for the fairness and accuracy of the information and the assessments it publishes.
13. Shareholders, as owners of companies, should have a legitimate interest in how their company behaves; and legitimate rights in expressing their views. "Empowering them and facilitating their exercise of their rights are indispensable elements of ensuring good corporate governance.
14. Board composition should relate to the company's strategic needs, which change as a company and its business environment evolve. Shareholders and key constituents are interested in the value that diverse perspectives bring, including those related to gender and racial diversity.

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5

Corporate Governance in the United States of America

5.1 General

The United States struggles with its corporate governance framework. The US corporate governance is made of multiple facets: legal, securities, and accounting rules designed to protect the interests of shareholders in a transparent means. The overall system lacks rigorous implementation or at least is perceived as such.

Despite the existence of a diverse and inarticulate legislation thereon, the overall perception is that the country has a broken corporate governance record, with most white crime unpunished. The reasons are multiple. The most currently cited are:

- the excessive concentration of power in the hands of top management;
- the lack of personnel, both qualitatively and quantitatively, on the part of the agencies such as the Securities and Exchange Commission (SEC), the Internal Revenue Service (IRS), the Federal Reserve (FR), and others;
- the complacency of professional organizations in charge of self-regulating their professions, such as the Public Company Accounting Oversight Board (PCAOB);
- the lack of expertise, training and willingness on the part of prosecutors to prosecute efficiently the crimes brought to their attention;
- the revolving door culture between the representatives of the white-crime delinquents, whether lawyers or accountants, and the regulators before whom they appear;
- the existing loopholes engineered by Congress under the mandate of Washington DC lobbyists.

Contrary to the EU countries and Asia-Pacific, the top 1000 US firms are owned by institutional investors.¹

With more and more companies registered with the SEC and raising money from the public, the US has come to fictionally elaborate a corporate governance structure based on a theoretical and legal principal-agent concept, despite the flaws and inadequacies of such approach. The overall corporate governance lacks conceptual analytical approach in term of checks and balances. A comparison with its neighboring Canada reveals that the US is lagging far behind.

5.2 The agency approach

The US corporate governance is based on the conventional agency relationship, which relies on the separation of ownership and control. The underlying idea is that the board shares mutual interest with shareholders in protecting the corporation.

In theory, the board acts as the agent of the shareholders ('the principal'). Thus, the board must comply with all rights and duties under the principal-agent relationship.

The board of directors owes fiduciary duties to the shareholders: duty of care, duty of loyalty, duty of candor. Breaches of these duties can result from shareholders' specific suits and damages stemming from the actions of the board.

5.2.1 The board fiduciary duties

Courts in the US, and particularly the Delaware Chancery and Supreme Courts, have developed specific standards to ascertain the board actions. The directors of Delaware corporations have a triad of primary fiduciary duties: (i) due care, (ii) loyalty, and (iii) good faith. However, the Delaware courts adhere to the view that management owes fiduciary duty of care and loyalty to the corporation and its stakeholders simultaneously.² Such an approach has been characterized by Professor Christopher Bruner as a 'decided reluctance to focus solely on the shareholders, to the exclusion of the other constituencies contributing to the corporate enterprise'.³

5.2.1.1 Duty of care

Directors must discharge their duty in good faith, with such a degree of diligence, care and skill than an ordinary prudent person would exercise under similar circumstances. Directors would be held responsible for either non-feasance or misfeasance, any time their inaction or action causes harm to the corporation.

The duty of care requires directors to take certain responsibilities or actions. In *Francis v. New Jersey Bank*,⁴ the New Jersey Supreme Court held that:

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Eric Hilt
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ABSTRACT

This paper presents an overview of the history of corporate governance in the United States, emphasizing the period before the advent of federal securities laws and the Securities and Exchange Commission (SEC). Recent research has overturned many widely accepted beliefs about corporate governance during this period. In particular, the evolution of American corporate governance has not followed a simple, linear trajectory, beginning with small, well-governed firms and ending with large, poorly governed ones. Over time, economic and institutional changes have given rise to successive generations of corporations with their own governance problems and their own mechanisms to address those problems. When existing governance mechanisms failed, the United States experienced corporate governance crises—episodes that shattered investors' faith in corporate management and the legal institutions intended to protect their rights. The resolutions of these crises have sometimes been found in legal innovations, and in other cases, in institutional or market-based solutions.

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1. Introduction: History and the American Corporation

Across the world today, there is a striking relationship between legal institutions and financial development. Countries with legal systems that offer robust protections for minority shareholders have larger equity markets, and firms in those countries make greater use of outside finance (La Porta et al. 1997). The United States in particular offers relatively strong legal protections to investors and possesses deep capital markets. Its corporations' ownership structures are also distinctive: America's public companies are usually not dominated by controlling investors, and in particular family business groups, pyramidal structures, ownership by banks, and dual-class shares that allocate control to minority owners are all uncommon. Widely dispersed ownership is more typical of American public corporations than those of most other countries (La Porta et al. 1999).

When did this distinctive style of corporate ownership, and the legal institutions that support it, emerge in the United States? Did American corporate ownership and governance once resemble those of other countries, or was it always relatively unique? If it evolved over time, what accounts for this evolution? Answers to these questions can help evaluate competing explanations of the ownership patterns of American companies, such as those suggesting that populist politics has restrained financial institutions and large investors (Roe 1994) or that strong legal protections for investors, originating in the common law, have made dispersed ownership possible (La Porta et al. 1998). Moreover, they can shed light on the level and nature of the investor protections offered in the United States when it was an emerging market---which is in some ways the relevant comparison to today's developing countries (see Morck 2011 for an overview).

This article presents an overview of the history of corporate governance in the United States, emphasizing the period before the advent of federal securities laws and the Securities and Exchange Commission (SEC) in the 1930s. The legal and institutional protections of investors, and their evolution, are analyzed, and data on the ownership structures of corporations at different points in time are presented. The discussion emphasizes large, publicly traded corporations, the historical equivalents of the modern enterprises that are the focus of the literature on corporate governance today. The

ownership data presented include New York Stock Exchange (NYSE)-traded firms in the 1820s, which mostly consisted of banks and insurance companies; Boston Stock Exchange--traded industrials and utilities in the 1870s, when the Boston Stock Exchange was the premier market for industrials in the United States (Atack and Rousseau 1999); and finally, NYSE-traded railroads in 1910, when railroads were the largest American business enterprises.

Until relatively recently, the early history of the corporation in America has been a somewhat neglected subject. In part, this reflects the influence of a literature on the evolution of business enterprise that has mostly ignored issues relating to the law or to the internal governance of corporations (for example, Chandler 1977). But it also reflects the frustrating complexity of early legal history. Corporation law in the United States is state law, and early enterprises could only incorporate in their home states (see Henderson 1918). Studying the history of the corporation requires analyzing many states' early laws, and any existing data on early corporate ownership likely resides in the archives of state governments. The early nineteenth century is a statistical dark age, particularly for business records (David 1967).

Among the literature that does exist on the topic, Berle and Means' (1932) work is the most important and influential. They argue that the separation of ownership from control was a recent development and that that in the early nineteenth century, it had not occurred. Berle and Means (1932, p. 135, footnote 14) claim that for early American corporations, "the number of shareholders was few; they could and did attend meetings; they were business-men; and their vote meant something." They then argue that legal, organizational, and technological developments in the late-nineteenth and early-twentieth centuries led to the emergence of large, diffusely held enterprises controlled by professional managers or by minority interests. Much of the scholarship on corporate governance that has been produced since Berle and Means has accepted their characterization of the history of American corporations (see, e.g., Dodd 1938, Hovenkamp 1991, and Coffee 2001; an important exception is Werner 1986). But the early history of American corporations has not been well documented, and the arguments of Berle and Means may have been accepted simply because they seemed

appealing and persuasive in light of what is known about corporate governance in the twentieth century.

Recent years have seen a wave of research on early corporations and their governance that has made use of archival data.¹ Much of this research has concluded that the Berle and Means view of early corporate governance is simply incorrect: Evidence of substantial governance problems has been found among early American companies. Although the average size of public corporations certainly grew over time, the evolution of American corporate governance has not followed a simple, linear trajectory, beginning with small, well-governed organizations in which shareholders participated actively and eventually ending with large, poorly governed organizations with absentee owners and opportunistic managers.

Over its long history, American corporate governance has been concerned with three interrelated problems (see Lamoreaux 2009). The first, which I term Problem 1, is the familiar managerial incentive problem that arises when ownership is highly diffuse: Control falls into the hands of managers, who may act in self-interested ways. Problem 2, which is also familiar today, and arises in circumstances where Problem 1 is unlikely to be present, is that of controlling shareholders taking actions that benefit themselves at the expense of minority or outside investors. Finally, Problem 3, which is now far less familiar in the United States, arises from the power of the state to control the creation of corporations or expropriate existing enterprises.

Today, much of the scholarship on corporate governance in the United States is focused on Problem 1 (see, for example, Jensen and Meckling 1976), whereas much of the research on developing country firms is focused on Problem 2 (for example, Bertrand, Mehta and Mullainathan, 2002). But the history presented in this article indicates that Problem 2 and also Problem 3 were significant sources of concern in the United States during the early nineteenth century. Episodes where Problem 1 plagued the governance of some early American corporations also occurred. Over time, economic

¹ This work is not confined to the history of the United States (see, e.g., Acheson et al. 2014; Franks, Mayer and Rossi 2009; Freeman, Pearson and Taylor 2012; Guinnane et al. 2007; Hannah 2010; Morck 2005a; and Musacchio 2009).

and institutional changes gave rise to successive generations of corporations with their own governance problems and their own mechanisms to address those problems. When existing governance institutions failed on a large scale, the United States experienced what might be termed corporate governance crises—episodes that shattered investors' faith in corporate management and the legal institutions intended to protect their rights. The resolutions of these crises have sometimes been found in new laws, and in other cases, in institutional or market-based solutions.

Another major theme of the literature on modern corporate governance has been the absence of pyramidal business groups in the United States (Becht and Delong 2005, Villalonga and Amit 2009). It has been argued that the United States once had such groups on a large scale but that the imposition of taxes on intercorporate dividend payments during the New Deal made pyramids unattractive and broke them apart (Morck 2005b). In contrast, this article argues that pyramidal business groups were never important in the United States. They failed to arise on a large scale because historically, wealthy families and important businesses have not felt they were necessary.

2. Early American Corporations and their Governance

2.1. Corporate Ownership in the Early Nineteenth Century

The earliest existing data on the ownership of a relatively large cross-section of American public companies can be observed is from NYSE-traded companies in the 1820s. By that time, the growing concentration of wealth from trade and finance within New York City made the NYSE the most active market for corporate securities in the United States. The exchange had no formal listing requirements; it simply facilitated trade in shares of corporate stock, as well as in the bonds of the federal, state, and city governments. In 1825 the shares of 67 corporations, mostly those of banks and insurance companies, saw trading.² These firms, whose headquarters were overwhelmingly located on or near Wall Street, were often enormously profitable, partly

² There were 19 banks and 44 insurance companies; the remainder included a water company, a gas company, and two coal companies.

Table 1:
Ownership of NYSE-Traded Firms, 1826

	Total Shareholders	% Widely Held:		% of Votes: Shares Owned by Directors	% of Votes: Shares Controlled by Directors
	(1)	10% Cutoff	20% Cutoff	(4)	(5)
All NYSE- Listed Companies	139	52	75	21.7	39.6
Above-median capital	201	71	94	15.9	25.2
Median capital or below	101	42	65	26.0	47.4

Sources: Author's calculations from data presented in Hilt (2008).

because of the robust demand for financial services in America's growing economy, but also because the state government tightly rationed access to corporate charters with the power to enter the banking industry, an issue we will analyze below.

Ownership records from this era are extremely scarce, but in the 1820s New York State implemented an unusual capital tax that required all corporations to submit lists of their stockholders to the state government. These were first uncovered and analyzed in Hilt (2008). Table 1 presents ownership data for the companies that were traded on the NYSE in 1826. The mean paid-in capital of these enterprises was \$605,000, equivalent to \$14.5 million in 2012 dollars, and the median capital was \$500,000.

The data in Table 1 indicate that even as far back as 1826—prior to the introduction of virtually any statutory investor protections in the modern sense—publicly traded companies had a wide range of ownership structures, and there were some widely held firms. NYSE-listed companies had on average 139 shareholders, a number that might seem miniscule today, but which nonetheless is consistent with these firms having substantial numbers of owners holding small stakes. Columns 2 and 3 present the rates at which the firms were widely held by the definitions of La Porta et al. (1999). Just over 50% were widely held in the sense of not having a 10% owner; 75% did not have a 20% owner. The lower two rows present the ownership of the corporations by size. Those with median capital or above were widely held at rates similar to those of the modern American corporations in the La Porta et al. (1999) dataset. Column 4 of the data presents the percentage of the votes represented by the shares standing in the

names of the directors. For all firms, this was approximately 20% and it was approximately 5% lower than that for the large firms and 5% higher for the smaller firms.

With regard to the governance of these enterprises, Problem 2 would seem to have been much more likely to be a concern than Problem 1. But in order to analyze the problems these enterprises actually faced, we must first examine the legal rights of early shareholders, and the political context within which they were determined.

2.2. Early Corporate Charters

Today, the procedure for incorporating a business in the American states is routine and inexpensive: One simply submits a certificate of incorporation—usually a one-page form—to the secretary of state and pays a nominal fee. The documents that govern the internal relations of the firm are drawn up separately by the incorporators, who have broad freedom to structure their corporation as they wish. In this sense, the formation of a corporation is fundamentally a contracting process among the incorporators, which is simply registered with the state. Businesses can in fact choose to incorporate in any state, irrespective of where their operations are located; approximately 85% of those incorporating out of state choose Delaware (Bebchuk and Hamdani 2002).

Until the mid- to late-nineteenth century, the process of forming a corporation was radically different. The only procedure for incorporation was to appeal to the state government for a special legislative act: For a business to become a corporation, the state had to pass a law, and the contents of that law—the corporation's charter—were the outcome of a negotiation between the incorporators and the state government. The formation of early corporations was not merely a contracting process among the incorporators; it was also a contract between the incorporators and the state. And the state frequently renegotiated the terms of that contract by granting charters of limited duration and imposing changes or exacting concessions or payments in exchange for renewals. The state also carefully rationed charters in some industries, particularly banking, to raise the value of the charters it granted and thereby enhance the power of the political factions in control of the government (Bodenhorn 2006). Early

corporations were intimately tied to politics, and Problem 3 was an issue of central concern.

What rights did early corporation law grant to shareholders? In contrast to other areas of the law, the United States did not inherit a well-developed set of judicial precedents or regulatory statutes relating to business corporations from England (Gower 1956, Harris 2000). Although English business corporations were created beginning in the sixteenth century, they were not common, and English corporation law remained in a relatively primitive state at the time of the American Revolution. Among early American corporations, practices that followed tradition rather than law were generally adhered to. On many issues relating to the rights of stockholders or the authority and responsibilities of directors, the law was silent. Were directors obligated to disclose their own transactions with the corporation to the shareholders? To what extent could they engage in self-dealing or utilize the resources of the firm for their own personal gain? Did shares that were borrowed from a broker, or repurchased by the company, or subscribed for but not fully paid-in, entitle their holders to votes? Traditional practices offered answers to each of these questions, but the law did not. Stockholders who felt they had been wronged in such matters might claim they had been the victim of fraud, which is a civil tort at common law, or attempt to hold directors accountable as fiduciaries, a strategy for which there was a strong foundation in English case law (Dodd 1954). But in the early years of the American republic, these strategies were still untested.

Most of the legal rights to which shareholders were entitled were specified in the corporations' charters. Voting in annual meetings was the principal mechanism by which stockholders participated in the governance of corporations, and the charters typically dictated how director elections would be conducted and how the president would be chosen. Although voting in early corporations was relatively similar to modern shareholder voting, one striking difference is that many early charters configured the voting rights of stockholders in a way that enhanced the relative influence of small investors, using what has been termed graduated voting rights. With graduated rights, the votes per share to which an investor was entitled was a decreasing function of the

number of shares held.³ The effect was the opposite of most of today's dual-class shares, which typically increase the voting power of a founding blockholder (Gompers Ishii and Metrick 2010).

Hilt (2008) develops an index of the degree of diminishment of the voting power of large shareholders by graduated voting rights schemes, based on the average level of votes per share across all possible levels of shareholdings. The index increases in the voting power of large blocks of stock, and ranges from approximately 0 for a rule of one vote per shareholder, to 1 for the rule of one vote per share.⁴ In an analysis of all 812 corporate charters granted up to 1825 in New York—the largest and most legally influential state at the time—the average value of this index was 0.63. It was highest among firms in industries that did not typically seek the participation of small investors, and lowest among firms in industries that did. This is an indication that graduated voting rights were imposed with the intention of helping incorporators address Problem 2 and attract investments from small shareholders.⁵ However, there is some evidence that these schemes were sometimes circumvented by dividing individuals' blocks of shares into small holdings in the names of different family members (Hammond 1957; Dunlavy 2004). This may account for the diminished use of graduated voting rights over the nineteenth century.

Two other elements of early corporate governance are worth noting. The first is dividend payments, which were likely used to address Problem 2. To outside investors,

³ For example, the original 1791 charter of the bank of New York specified that the stockholders were entitled to “one vote for each share not exceeding four, five votes for six shares, six votes for eight shares, seven votes for ten shares, and one vote for every five shares above ten” (*Laws of New York*, 1791, chapter 37.) Thus an owner of four shares received four votes, but an owner of 20 shares received nine votes, or 0.45 votes per share.

⁴ The impact of a graduated voting rights scheme on the voting power of each shareholder depends on the actual distribution of shares; only in the presence of small shareholders does the proportion of votes held by blockholders fall. The index is therefore a measure of the *potential* of a voting rights configuration to restrict the voting power of large shareholders.

⁵ Graduated voting rights originated among early business corporations in England; see Scott (1912). A substantial literature has developed that analyzes the purpose and effects of graduated voting rights in the American context; on their political significance, see Dunlavy (2004, 2006); on their effects among nineteenth-century American banks, see Bodenhorn (2014); and see Hansmann and Pargendler (2010) on their effects on consumers. Hilt (2013) presents a synthesis.

the operations and finances of corporations were likely quite opaque, and the extent of self-dealing by insiders may have been impossible to observe. By committing themselves to making regular dividend payments, managers may have signaled to investors that they would not expropriate the assets of the company (see Baskin and Miranti 1997). The second is the composition of the boards. Among the directors of early corporations were many wealthy, prominent, and politically connected men (see Hilt and Valentine 2012), and the names of the directors were well publicized. A board seat likely signaled that such men were willing to stake their own reputations on the business' success, or at least that the managers would operate the firm according to principles suitable to such men. This may also have helped the corporations address Problem 2. However, the political connections of the directors were perhaps even more important. Boards of directors often included sitting officeholders or important figures from political parties. This identified the business with the political forces responsible for its incorporation, and indicated how well the corporation's interests would be represented in the state government, for example by blocking entry by potential competitors, or by renewing the charter on favorable terms when it expired. This helped the corporation address Problem 3.

Finally, it is also likely that the firms relied on what has been termed “informal relations of trust” (Franks, Mayer and Rossi 2009). The ownership of these corporations was predominantly local, which may have facilitated personal contact and trust between investors and the directors and managers.

The mechanisms developed to address the fundamental problems of the governance of early corporations functioned reasonably well under ordinary circumstances. But they were mostly informal and based on tradition, rather than law—and even those that did carry the force of law could be circumvented. When aggressive entrepreneurs who had little patience for those traditions obtained control over several prominent corporations, spectacular governance failures resulted.

2.3. Breakdown: Wall Street's First Corporate Governance Crisis

The year 1826 was a tumultuous one in New York. Several of New York's insurance companies, operated by men who were not politically connected enough to obtain a

bank charter, had defied state law and entered the banking business, issuing banknote-like instruments to finance their lending (see Hilt 2009a). Effectively, their solution to Problem 3 was to act as proto-shadow banks and evade the state's banking statutes and regulations. To do this, the managers of insurance companies engaged in financial transactions that violated tradition, but not necessarily any law. For example, they used the assets of companies they controlled as collateral for loans to acquire other companies, sometimes in their own names. And in cases where their firms held large blocks of stock that had been subscribed for but not paid in, or repurchased by the company from subscribers, the directors voted those shares to perpetuate their control.

Column 5 of Table 1 illustrates the effect of these transactions: Many of the directors controlled, and voted, shares held in the name of other corporations, as well as treasury shares. These holdings often created substantial wedges between the directors' cash-flow rights and their control rights, as in modern pyramidal structures. For 12 of the corporations, the additional votes gave the directors majority control over their corporations.

An economic downturn began in 1825, as a serious financial panic hit England. As the recession spread to New York, stock prices fell, and risk spreads in financial markets widened. In the summer of 1826, a New York newspaper began publishing letters and editorials claiming that the speculators running several insurance companies were utilizing fraudulent transactions among the companies they controlled to meet their growing interest obligations. When one of the most vulnerable of these firms stopped payments on its liabilities, panic broke out, and several large banks and insurance companies faced runs and closed. It was quickly revealed that many of these firms were deeply insolvent and had been so for long periods of time. Insiders had successfully concealed the state of their enterprises by continuously paying substantial dividends, apparently with borrowed money. It was also revealed that several of the wealthiest and most prominent of the directors of the failed corporations had not attended any board meetings in years and had not bothered to even monitor the activities of the other directors. The traditional solutions to governance problems had clearly failed.

The public was shocked and outraged. New York's district attorney obtained at least six different indictments against the men at the center of the scandals, which resulted in a series of spectacular criminal trials (see Hilt 2009b). More importantly, a wave of litigation initiated by the stockholders and creditors of the failed companies quickly overwhelmed New York's chancery courts. The stockholders of the New York Coal Company, whose capital had been used by its directors as collateral in an unsuccessful attempt to take over City Bank (the predecessor of today's Citibank), successfully argued that minority stockholders had the right to sue directors of a corporation for malfeasance. The court's ruling in the 1832 case *Robinson v. Smith* became a general principle of equity jurisprudence and established the basis of the shareholder derivative suit (see Boyle 1965).⁶

The state government also responded with sweeping changes to its laws, particularly intended to address issues relating to Problem 2. In 1828, New York enacted a series of detailed statutes that specifically prohibited many of the transactions at the heart of the failures and also imposed financial reporting requirements, prohibited large loans to directors, and created a presumption of fraud, and with it, personal liability for directors and stockholders, in all bankruptcies. (This latter term was quickly found to be too severe, and was repealed.) The provisions also clarified and strengthened the rights of stockholders and creditors to use the court of chancery to seek injunctions against malfeasant directors and place insolvent corporations in the hands of receivers. This legislation was probably the first major investor protection law enacted in any common law jurisdiction.

New York's experience was extreme, but as corporations proliferated, American state legislatures sought to define the rights of these organizations and their stockholders and creditors through an enormous body of statutes. Many states adopted significant portions of New York's 1828 law (Kehl 1939). As the first treatise on American corporation law noted in 1832 (Angell and Ames 1832, p. 357), "the statute books of many states will show that an opinion has strongly and extensively prevailed

⁶ This is a suit brought by a shareholder on behalf of a corporation, generally against a controlling insider.

that the common law relative to commercial corporations is not adequate to their proper regulation and government.” Gradually, an indigenous corporation law developed in the United States that blended common-law institutions with American innovations. In response to this corporate governance crisis and others like it, more robust mechanisms to address Problem 2 were sought in the form of stronger legal protections for investors.

Over time, reformist political factions in New York and other states attempted to eliminate Problem 3 by adopting general incorporation acts. General acts provided open access to incorporation, replacing the regime of granting charters by special legislative act (see North, Wallis and Weingast 2009). The early versions of these laws often imposed a rigid governance template on the businesses created through their terms, for example requiring a rule of one vote per share and regulating the size of the board. In some cases, this one-size-fits-all approach may have prevented incorporators from having the freedom to adopt their own solutions to Problem 2. That is, the solution found to Problem 3 aggravated other problems (Lamoreaux 2009).

2.4. Industrial Companies in the Mid-Nineteenth Century: Massachusetts

The next point at which we can observe corporate ownership is in mid-nineteenth-century Massachusetts. At the time, that state had the greatest number of business corporations per capita in the United States, and possessed sophisticated corporation laws (see Wright 2014). Massachusetts was the center of several important manufacturing industries, especially textiles, and its manufacturing corporations were unusually large and widely held, relative to their peers in other states (see Scranton 1983).

Although most of the states’ major manufacturing corporations were quite successful, a number of prominent figures in the Massachusetts’ business community argued that the diffuse ownership of large corporations caused their governance, and operating results, to suffer. The issues they described often related closely to Problem 1. One investor named J.C. Ayer (1863) produced a pamphlet that claimed that the directors of these firms were paid excessively high salaries; hired their relatives for lucrative managerial positions; sold the corporations’ finished products through mercantile firms they owned, and paid themselves excessive fees for those services; and

concealed the effects of these practices from the shareholders. Ayer specifically ascribed these problems to the passivity of the firms' many small shareholders. He also argued that the directors, whose ownership stakes were quite low, perpetuated their control over their firms by soliciting proxy votes from the shareholders through duplicitous means, and, where necessary, by holding the annual meetings of companies with shareholders in common simultaneously, thereby preventing many shareholders from participating in more than one.

These problems were probably not acute or widespread enough to threaten investors' confidence in the governance of firms generally—there probably was no full-blown corporate governance crisis among these firms. However, in response to the complaints of shareholders, Massachusetts enacted at least two changes to its corporation laws in the 1850s and 1860s in order to help protect investors. One required corporations to make their books accessible to stockholders, and the other prohibited directors from voting more than 20 shares by proxy. Also, beginning in the 1870s, Massachusetts law required all of the state's manufacturing corporations to submit certificates of condition to the state government, which included basic balance sheet information, as well as the names of all stockholders and directors. These forms provide a window into the firms' ownership and governance.

Hilt (2014) analyzes these data. In 1870, the shares of 58 of the largest and most important manufacturing firms, and also 11 utilities, traded on the Boston Stock Exchange. Table 2 presents ownership data for the publicly traded companies from that year. Total paid-in capital for these firms was on average approximately \$716,000, equivalent to \$13 million in 2012 dollars. Median capital was \$550,000. Although the firms of 1870 were similar in size (as measured in paid-in capital) to New York's financial companies from 1826, they were much larger than manufacturing firms from 1826.

The data in Table 2 indicate that the 1870 manufacturing firms were quite widely held. Although the total numbers of shareholders were not that different from the 1826 New York corporations, their ownership was far less concentrated. The directors of the 1870 firms held only approximately 7% of the shares in their own names—complaints that the firms were managed by boards with small ownership stakes seem well-founded.

Table 2:
Ownership of Boston Stock Exchange Traded
Manufacturing Firms and Utilities, 1870

	Total Shareholders	% Widely Held:		% Owned by Directors	% Controlled by Directors
		10% Cutoff	20% Cutoff		
All Boston Stock Exchange Corps	184	80	98	6.8	8.7
Above-median capital	261	86	95	8.6	9.6
Median or below	110	75	100	5.3	8.2

Source: Author's calculations from data presented in Hilt (2013b).

The directors were in a position to vote approximately 2% more—these were nearly always shares held in family trusts where the director was a trustee—entitling them to about nine percent of the total votes. The governance issues related to Problem 1 that Berle and Means claimed were new among the enormous enterprises of the early twentieth century were in fact likely to have been present among industrial firms decades earlier than they claimed.

The Massachusetts corporations also exhibit a reliance on some of the same governance mechanisms as the New York corporations from 50 years earlier. Their ownership was overwhelmingly local (Davis 1958), and their boards of directors were dominated by wealthy and prominent men. Regular dividend payments were also regarded as critically important (McGouldrick 1968).

3. Economic Transformation: Railroads, Big Business, and Bankers

Over the course of the nineteenth century the development of railroads helped facilitate the economic integration of the different regions of the United States, which as we will see led to subsequent changes in the scale and organization of firms in other industries. However, the railroads themselves quickly grew into businesses of unprecedented size, and faced their own governance challenges. By the 1860s, several railroad corporations had been created with paid-in capitals of \$20 million or more; the capitalization of the largest of these enterprises was equal to approximately 40% of the total capital

capitalization of all manufacturing enterprises traded on the Boston Stock Exchange at that time.

As with early nineteenth century banks, the creation of railroads and their operations were intimately tied to government policy. The entrepreneurs who founded railroad enterprises often allied themselves with political parties, purchased control of newspapers, or held public office. But the railroads' solutions to Problem 3 severely exacerbated Problem 2. Railroad insiders engaged in numerous forms of self-dealing or tunneling—including paying themselves exorbitant salaries, contracting with firms they controlled, borrowing their firm's securities for their own use, and issuing themselves shares of stock in exchange for worthless securities—and used their political influence to perpetuate their control.⁷ The construction of the transcontinental railroads in particular was subsidized by the federal government, and railroad insiders used those subsidies to enrich themselves personally at the expense of the public and the other shareholders. The directors of the Union Pacific, for example, created their own construction company, which they named *Crédit Mobilier of America*, and awarded it lucrative contracts to build the line and also distributed *Crédit Mobilier* shares to important congressmen. White (2012) chronicles this and many other such episodes among the transcontinentals. Other railroad insiders enriched themselves by coordinating the release of rumors or insider information with their own trading in their companies' stock; insider trading was not prohibited by law or regarded by jurists as a breach of directors' fiduciary responsibilities.⁸

In the 1860s and 1870s, these practices led to a series of corporate governance crises among major railroads. Addressing the problems exposed in these crises required substantial institutional innovations, which would have long-lasting implications for the governance of all major American corporations.

⁷ See Lamoreaux and Rosenthal (2006, pp.126--27) and the legal cases cited therein. It is perhaps worth noting that in this industry, tunneling occurred in both the literal and figurative sense.

⁸ Banerjee and Eckhard (2001) analyze insider trading associated with merger announcements

3.1. Railroads and Contests for Control

The enormous cash flows that could be generated by a large railroad attracted the interest of politically powerful groups of investors who sought to dislodge sitting directors and obtain control so that they could enrich themselves. Incumbent managers of course resisted the attempts of such men to take over their enterprises, using whatever tactics they could. When a formidable group of investors sought to unseat equally powerful and well-connected directors, spectacular contests for control—railroad “wars”—were the result. The competing sides each used their influence over the judiciary or members of the legislature in their campaigns, which often generated dozens of different lawsuits and even specific pieces of legislation.

These contests of control were important because they revealed the limits of states’ legal protections of investors in an era of politically powerful investors—who were denoted by contemporaries as railroad barons. In the most egregious cases, laws intended to protect minority investors were utilized in ways that were the opposite of what their legislative authors intended: Rather than a powerless minority owner as presumed in the statute, major shareholders wielded these laws in their attacks on one another.

The nature of these conflicts is best illustrated with an example from New York, whose corrupt state government and judiciary during the Gilded Age created an ideal environment in which railroad barons could operate. Consider the Albany & Susquehanna (A&S) railroad, which Jay Gould attempted to take over in 1869. In the face of large stock purchases by Gould’s men, the president of the A&S “sold” to his allies on the board thousands of newly issued shares, lending them the required initial payment for the shares by issuing company bonds as collateral for a loan from a broker. The A&S’s president then hid the company’s books in a nearby cemetery. Meanwhile Gould’s attorneys used a provision of New York law that originated in the legal protections of investors enacted in 1828 (which were detailed above) to obtain an injunction from a judge affiliated with their political party—New York’s Tammany Hall Democrats. The injunction suspended the president and most of the board from their offices. At the same time, the A&S board obtained a competing injunction from a judge they could influence, vacating the original injunction, and suspending the one A&S

director loyal to Gould. Ultimately, both sides sued to have the railroad put in receivership, obtaining many more injunctions in the process. In an attempt to enforce their side's legal dicta, Gould's men raided the A&S headquarters and, unable to locate the company's books, ultimately resorted to a campaign to physically take possession of the railroad. With a gang of hired thugs, Gould's men took over an A&S train and rode down the line, taking control of stations as they proceeded. Some A&S men responded by derailing the Gould-controlled train, provoking a physical battle between the two sides. Ultimately, the governor ordered the state's militia to take charge of the road, amid many further suits and countersuits, and efforts to bribe legislators to pass laws to legitimate each side's position. The details of this and several similarly outlandish episodes are presented in Adams and Adams (1871).

The confidence of railroad securities holders was shattered, and the financiers involved in distributing those railroad securities were appalled. One New York lawyer (George Templeton Strong; see Nevins and Thomas 1952, p. 264), observing a wave of railroad wars and the legal tactics employed, noted that "the abused machinery of the law is a terror to property owners." Ultimately, the situation was resolved when a brash young banker was elected vice president of the A&S and presided over negotiations with a different railroad for an alliance that would keep the A&S out of the reach of Gould, and also his rivals (Carosso 1987). That banker was the 32-year-old J. Pierpont Morgan, who later founded the investment bank bearing his name, and would make his reputation not just as a financier, but as an organizer and reorganizer of railroads and later, industrial giants.

In response to this and similar episodes, the NYSE in 1869 required the registration of securities by listed companies, making it more difficult for insiders to secretly issue huge amounts of stock, as the A&S directors did. And efforts were made to reform the jurisdiction of New York's courts, to prevent rival factions from utilizing different judges in order to invalidate each other's injunctions.

But the most important solution to the problems posed by the railroad barons for investors and creditors was not legal in nature, for the railroad barons were more than powerful enough to subvert the law for their own ends. The solution that was ultimately found was for investment bankers to assume an active role in the governance of

railroads. With their influence over access to capital, and with their incentives aligned with those of securities holders, investment banks sought to rein in the worst excesses of railroad managers (Carosso 1970; Redlich 1951). Firms such as J.P. Morgan & Co. hired partners with elite social backgrounds and worked assiduously to maintain prestigious reputations (Pak 2013). The value of the firms' high social standing may have helped to signal that they would ensure that their clients would be free of scandals or unscrupulous management. Ultimately financiers began assume a significant role in the governance of industrial corporations as well.

3.2. Bankers and Railroad Governance

In the 1860s and 1870s, a relatively small number of investment banks capable of raising large sums of capital began to dominate the industry and establish relationships with prominent railroads.⁹ Initially, railroads' relationships with their bankers were arms-length in nature, and they might have used different banks over time. But eventually, following the scandals of the 1860s and 1870s, and particularly after the financial panic of 1893, major railroads established durable relationships with an investment bank (Carosso 1970). Those relationships were frequently cemented with board seats, as the partners of investment banks began to actively participate in the management and governance of railroads. In restructurings out of bankruptcy, a circumstance in which many of these relationships were first established, the shares of the railroad's stock were often placed in what was known as a voting trust, with the bankers as trustees, giving them total control over the enterprise for a specified period of time, usually several years.

⁹ These included Drexel, Morgan & Co. (the predecessor to J.P. Morgan & Co.), J & W Seligman & Co., and Speyer & Co., as well as the Boston firms Lee, Higginson & Co., and Kidder, Peabody & Co. (see Davis 1963 and Carosso 1970). Benmelech (2010) studies railroad capital structures.

Table 3:
Ownership of NYSE-listed Railroads, 1910

	Total Shareholders	% Widely Held:		% Owned by Investment Banks	% Owned by Other Railroads
		10% Cutoff	20% Cutoff		
NYSE - Listed Railroads	14,928	32	44	5.9	22.8
Above-median capital	17,724	48	65	2.8	15.8
Median or below	3,740	16	25	8.9	29.6

Sources: Author's calculations from data presented in *New York Times*, 16 January 1909. Total shareholders from Warshaw (1924).

With their growing influence over railroad management, investment banking partnerships sought to curb practices in the industry that were harmful to the interests of the firms' creditors or led to instability. Competing railroads sometimes engaged in rate wars, and some entrepreneurs even constructed new routes that competed with successful railroads, with the intent of forcing the incumbent firms to buy them out on favorable terms. Although their power in some contexts was limited, investment bankers, particularly J.P. Morgan, actively worked to halt such practices.

Railroads were regulated by the Interstate Commerce Commission (ICC), created in 1887, which compelled them to produce detailed annual financial reports. The ICC at times collected ownership data, and in 1910 they published data on the largest owners of major railroads. These data are presented in Table 3. At the time, the shares of 72 railroads were listed on the NYSE, and the average paid-in capital of the firms was \$75.5 million (equivalent to \$1.9 billion in 2012 dollars). Median capital was \$47 million.

The data in the table show that the ownership of these very large enterprises was rather concentrated, with relatively few of them widely held. Ownership by the board cannot be computed from the available data, but ownership by other railroads can, and this was often quite substantial. Often a parent railroad owned substantially all the stock of a smaller one but did not actually combine the assets of the two firms and dissolve the smaller one as a separate enterprise because of obstacles created by state corporation laws or railroad regulations, or because of the bond covenants of some of the companies.

3.3. Industrial Mergers: 1895--1904

With the economy becoming more integrated, industrial firms in distant regions that once enjoyed some measure of local monopoly power found themselves in competition with one another. In the face of overcapacity and ruinous price cutting, firms in some industries began to establish cartels, sometimes through trade associations.

Horizontal mergers became common in the late 1890s, in response to conditions that both strengthened the impetus to combine and helped facilitate combination. The Sherman Antitrust Act of 1890 made collusive agreements among competitors illegal, but in its 1895 decision *United States v. E. C. Knight Co.*, the Supreme Court held that mergers among competing manufacturing firms did not violate the Sherman Act, even if the merged firm controlled virtually all capacity in its industry. Around this time, the state of New Jersey liberalized its corporation laws, granting businesses incorporated in that state the right to operate in any other state and also the right to own shares in other corporations, thus creating a legal vehicle to facilitate mergers across state lines.

Between 1895 and 1904, an enormous number of industrial mergers occurred, most of which were incorporated in New Jersey (Lamoreaux 1985). The outcome of this wave of consolidation, which was the largest in American history when measured relative to GDP, was that for the first time large industrial corporations were created that dominated national markets. Thousands of firms such as those from the Boston Stock Exchange in the 1870s were rapidly combined into industrial giants. These industrial mergers typically resulted in consolidations in which the assets of the constituent companies were combined into a single new firm, rather than into a pyramidal holding company structure (Bonbright and Means 1932).

The investment bankers who organized and promoted mergers typically retained strong affiliations with the companies they created (see Moody 1904). As was the case with railroads, the participation of financiers was a critical element in the governance of these new enterprises. That is, investors were protected only to a limited extent by the law, and in much more important ways through the delegated monitoring that occurred with bankers participating on boards of directors. There were, of course, limits to the effectiveness of this mechanism. Some of these mergers failed quickly, and the

promoters of some of the failed mergers resorted to accounting fraud and paid dividends out of their firms' capital, in order to quickly market their firms' securities to outsiders (Dewing 1914).

Berle and Means' (1932) study of the governance of the 200 then-largest enterprises in the United States includes many of the industrial giants created at the beginning of the twentieth century. They present a typology of different control structures, and document the extent of the separation of ownership from control among their sample firms. In their focus on control rights flowing from ownership stakes, however, Berle and Means omit any role for financiers, whose power may have been much greater than the votes their securities holdings entitled them to.

4. The Twentieth Century

4.1. Progressive Backlash Against Bankers

The role of financiers in creating and operating the new industrial giants, as well as major railroad systems, aroused considerable populist hostility. Like the so-called trusts that monopolized many industries, critics argued that a money trust consisting of a small number of New York financial institutions controlled access to finance, and dominated the American economy.¹⁰ The Panic of 1907, which began with runs on the shadow banks that had been heavily involved in financing major corporations (Frydman and Hilt forthcoming), further increased anti-banker sentiment. In 1912, the US House of Representatives authorized an investigation of the money trust by a committee headed by Representative Arsène P. Pujo (Pujo Committee, 1913). The committee's findings were popularized by progressive lawyer Louis Brandeis (1914) in a series of essays published as the book *Other Peoples' Money and How the Bankers Use It*. Brandeis argued that the money trust dominated many of the largest nonfinancial

¹⁰ The term trust is used in connection with monopoly in the United States because in the early 1880s Standard Oil and a few other early giants organized themselves in the legal form of the trust in order to circumvent the limitations of corporation laws. Standard Oil's trust agreement was ruled to be an illegal restraint of trade in 1892, and that firm, along with the others that had used the trust form, later reorganized as New Jersey corporations. Nonetheless the firms continued to be known as trusts.

corporations, and used its position in numerous ways to enrich itself at the expense of ordinary investors.

Many found these arguments persuasive. A new sort of corporate governance crisis occurred—one of the most important mechanisms in the governance of American institutions was criticized not for being ineffective (although critics did make this argument), but for creating a politically unacceptable concentration of economic power. Thus, one of the solutions developed to address both Problem 1 and Problem 2 was seen as creating a different set of problems, and a wave of new regulations restricting the role of financiers followed.

At the federal level these new regulations included the Clayton Antitrust Act of 1914, which contained several provisions intended to curtail the role of bankers in corporate governance. At the state level, numerous so-called Blue Sky Laws were passed, which regulated the issuance of securities.¹¹

Financial historians have expressed skepticism of the progressives' negative view of financiers' influence on nonfinancial corporations (Morrison and Wilhelm 2007). De Long (1991) and Cantillo Simon (1998) find the presence of J.P. Morgan partners on a firm's board to be associated with higher firm values, and Ramirez (1995) find them to be associated with better access to credit. Others have argued that the progressive view of the role of bankers significantly exaggerated their influence (Carosso 1970, Redlich 1951). In more recent work, Frydman and Hilt (2014) use a provision of the Clayton Act that compelled investment bankers sitting on railroad boards to resign or stop performing any underwriting services for their railroads to estimate the effects of investment bankers' roles in corporate governance. They find no evidence in support of the view that banker-directors harmed their client firms, and in fact following the implementation of the Act railroads with strong financial relationships with

¹¹ Although marketed as investor protections, Blue Sky Laws effectively protected local banks and savings institutions from competition from major securities underwriters (Macey and Miller 1991). However, Agrawal (2013) finds evidence that Blue Sky Laws actually did induce the riskiest class of securities issuers – mining companies – to increase dividends, and raised their market valuations.

underwriters saw their investment rates, market values, and borrowing levels fall, and their borrowing costs rise.

4.2. The Roaring Twenties

Similarly to the 1990s, the 1920s in the United States witnessed relatively stable macroeconomic growth, technological innovations, and, of course, rapid increases in stock prices (White 2006). Ordinary households, many of which were induced to purchase financial assets for the first time during the Liberty Bond drives of World War I, began to participate in the stock market at ever higher rates (Mitchell 2007). And the number of listed companies increased substantially, as many innovative industrial firms were founded and went public.

Within these ebullient markets, changes occurred in the composition of public companies and in their governance. Many of the companies entering the market were incorporated not in New Jersey—which had been taken over by progressives who repealed the state’s liberal corporation laws in 1917—but in Delaware, which had adopted the most liberal provisions of New Jersey’s former statutes into its own laws and further liberalized them in several ways (Larcom 1937). Delaware’s corporation laws eroded or eliminated some rights of stockholders that had been traditionally part of most states’ corporation statutes, such as the preemptive rights of existing stockholders to participate in new share issuances, prohibitions against changes in the dividend requirements of certain classes of stock, and changes to the voting rights of shares (Seligman 1976).

Perhaps more importantly, in the 1920s pyramidal holding company structures emerged in the United States for the first time. Making use of Delaware’s liberal corporation statutes, financiers and corporate promoters created some very large pyramidal groups that sometimes included hundreds of small operating companies (see Berle and Means 1932). The governance problems that can be created by such structures are well known, and recent research has ascribed substantial importance to those enterprises (e.g., Morck 2005b, Morck and Yeung 2005).

But it remains true that pyramidal business groups never actually became common in the United States.¹² They were almost never created among industrial companies (Bonbright and Means 1932), which were by far the dominant category of public firms and also the fastest-growing.¹³ Instead, they were prevalent mostly among utilities and to a lesser extent, among railroads. Among utilities, the complex holding company structures that emerged in the 1920s were created principally in response to local utilities regulation and public service commissions. Among railroads, the principal motive for their creation also appeared to be circumventing certain industry regulations. There were many family firms, but just as today, there were almost no family business groups organized as pyramidal organizations (Villalonga and Amit 2009).

4.2. The Great Crash, Financial Crisis, and New Deal Reforms

The Glass-Steagall Act, contained within the Banking Act of 1933, prohibited investment banks from engaging in deposit banking or holding directorships with commercial banks. The Securities Exchange Act of 1934 resulted in the creation of the SEC, required publicly traded companies to file periodic financial statements with the SEC, required company insiders to report their securities transactions and outlawed insider trading, and regulated proxy solicitations and the stock exchanges themselves. The registration and disclosure requirements of the Securities Exchange Act likely diminished the influence of investment banks in the certification of new issues. And the Glass-Steagall Act cut them off from important sources of clients, funding, and customers. Together, these changes likely diminished the role of investment banks in corporate governance. With their influence over access to capital markets weakened, their power and importance as voices in corporate management were likely also weakened.

¹² In recent work, Kandel et al (2013) argue that pyramids were common and persistent. It is worth noting that a large fraction of the business groups identified in that paper are railroads and utilities.

¹³ Holding company structures were indeed created in connection to industrials in the 1920s, but mostly to facilitate consolidations in which substantially all of the stock of the subsidiary companies was acquired by the parent, and in which there was only two “layers.” These were therefore not pyramidal business groups in the definition of La Porta et al. (1999) or in the sense of extending control over subsidiary companies without proportionate ownership stakes. See Bonbright and Means (1932).

Did the stronger disclosure requirements enforced by the SEC actually have any meaningful effects for shareholders? The NYSE had already required listed companies to produce annual financial reports, although it did not rigorously enforce any standards regarding the level of detail of those reports, and the disclosures did not include the identities and stakes held by large shareholders, the extent of ownership of the board, or the level of executive compensation. For companies listed on the NYSE, the requirements of the SEC should be considered much more detailed and more strictly enforced versions of the private rules they were already subject to. Careful empirical evidence by Simon (1989) indicates that following the creation of the SEC, the risks of new issues, as measured by the variance of returns over various time horizons, fell by statistically significant margins. Prior to the SEC, investors' expectations regarding new issues had not been biased—the average level of returns of new issues did not rise—but their forecast errors were larger.¹⁴

Morck (2005b) argues that New Deal changes in taxation policy, and in particular the imposition of taxes on intercorporate dividends, eliminated pyramidal business groups in the United States. Others are skeptical of this view and have claimed that tax changes had little effect on patterns of intercorporate ownership (Cheffins and Bank 2010). Certainly other New Deal regulations contributed to the decline of pyramids in the United States; the Public Utility Holding Company Act of 1935, for example, required that those enterprises simplify their structure and adopt stricter financial standards. But whatever the ultimate source of change, pyramidal groups were never commonplace.

¹⁴ For new issues on other exchanges with lower standards and weaker disclosure requirements than the NYSE, Simon (1989) finds that average abnormal returns of new issues did in fact rise following the creation of the SEC—relative to the post-SEC era, initial public offerings had been systematically overpriced.

5. Conclusion: Insights from American History

The business corporation has a long history in the United States. Over time, economic changes have given rise to successive generations of these enterprises, each operating within its own institutional context and facing its own governance problems. The solutions to those problems have sometimes been sought in legal innovations, and in other cases, institutional or market-based solutions emerged. And the changes made to address one set of problems in some cases may have made others worse, and in other cases were later rejected as politically unacceptable. What are the main insights from all this history, and what unresolved questions have been raised?

First, the evolution of the corporation in the United States has not followed a simple, linear trajectory, beginning with small, well-governed organizations in which shareholders participated actively and eventually ending with large, poorly governed organizations with absentee owners and opportunistic managers, as claimed by Berle and Means (1932). Early corporations were smaller than modern industrial firms, but they were quite large relative to the early economy. Perhaps more importantly, they sometimes suffered acute governance failures, often arising from the predations of controlling insiders.

Second, the United States has experienced significant episodes of what might be termed corporate governance crises—events that shatter investors' faith in corporate management and the governance institutions intended to protect their rights. Economic change brought about new enterprises, new business strategies, and new financial manipulations that rendered existing protections of investors ineffective. In some of these episodes, a resolution has been found not through legal change but through other institutional changes. For example, in the late nineteenth century, politically connected railroad barons capable of subverting the law emerged. They were restrained through greater participation by financiers in corporate governance, rather than through new legal reforms. In other cases, new legislation, not unlike Sarbanes-Oxley, has been enacted, as in 1820s New York.

Third, with the exception of utilities and to a lesser extent, railroads, pyramidal business groups have never been important in the United States. At times, wealthy

families held sufficient stakes in sufficient numbers of major corporations to create such groups; however, they never cemented their control into pyramidal business group structures. This may have been due to the limitations of corporation laws at the time or to fears regarding antitrust prosecutions. Perhaps the right combination of capital market conditions, lax antitrust enforcement, and liberal corporation laws emerged only briefly in the 1920s. But it is also possible that wealthy families did not perceive any need to organize their holdings in the way that families in other countries do. The reason that the United States does not have pyramidal business groups today may be due to wealthy families not having felt they were necessary, rather than to the taxation of intercorporate dividends, as has been suggested (Morck 2005b).

Fourth, there is the question of legal origins. The common-law origins of America's legal system, it has been argued, has produced laws that protect the rights of investors well. But the history presented in this article has shown that many of the legal rights of shareholders did not come from English law or from judicial precedent but were written by state and federal legislators. When problems have been found in American corporate governance, legislators have responded in ways antithetical to common law: by writing codes. Some of those codes have been deeply flawed, and the role of common-law courts in adjudicating them has also been quite important. But the modern American legal system is a partially codified hybrid of common-law institutions and indigenous innovations. It is difficult to determine which has been more important in producing the beneficial characteristics of America's legal system today.

Finally, politics has been critically important in the evolution of the American corporation. Popular hostility to monopolies and the corrupting influence of political control over access to corporate charters led to the enactment of general incorporation laws that made the corporate form with strict regulations freely accessible. And antibanker sentiment has led to measures that constrained the role of financiers in the economy, and in nonfinancial corporations in particular. These deeply American sentiments have been quite influential in shaping the evolution of modern corporations and the governance problems they face, as well as the solutions available to address them.

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