Let the Money Do the Governing: The Case for Reuniting Ownership and Control

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Introduction

The classic model of corporate law is simple: Shareholders own a corporation, but because they are too numerous to run it efficiently, they employ managers to do the job. The shareholders elect representatives, the directors, to monitor the management. The directors’ task is to ensure that the managers are serving the interests of the shareholders, and not using their positions for personal gain. This is a delicate balance: The shareholder-owners cede control to the

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managers, who labor under the watchful eye of the directors, who look out for the shareholders' interests and keep management honest.

In theory, anyway. This system of corporate governance can fail, and fail spectacularly, as the corporate scandals of the recent past demonstrate. Too often boards of directors have proved to be passive spectators, either unwilling or unable to monitor the actions of management.

The litany of corporate scandal from the late nineties and early part of this decade is a familiar one. Enron is perhaps the most notorious of the recent corporate fraud cases. It set up special purpose entities whose only "purpose" was to move money and create the illusion of profitable transactions. It moved debts off its balance sheet using other special purpose entities. Another major scandal occurred at WorldCom, which mischaracterized current expenses as capital expenses to allow it to spread costs over a period of years, giving the appearance of greater financial health and inflating its balance sheet by roughly $9 billion. Similar corruption occurred at HealthSouth; management referred to the difference between Wall Street's estimates and the company's true earnings per share as "holes," and would search for "dirt"—i.e., fraudulent numbers—to fill them. In each case, controls that were supposed to prevent the defrauding of investors—boards of directors, independent auditors, attorneys, financial analysts—failed.

This Article suggests a solution to what is perhaps the central problem of corporate law: the separation of ownership and control. Events of the last few years have shown how this system of separation can break down when boards of directors are unable or unwilling to monitor the management adequately. These boards lacked "independence" from management, either because of outright conflicts of interest, a network of social ties, or simply a general culture of board passivity.

2 Id. at 4.
3 Id. at 7.
5 As the ABA described the situation in its proposed corporate governance reforms: Inordinate self-interest on the part of corporate executives in short term corporate stock price levels, and instances in which that self-interest has led to aggressive accounting or assumption of extreme business risks, were not tempered by the checks and balances which the general corporate governance scheme expected from the directors or the professional firms engaged by the corporation to provide review and advice. AM. BAR ASS'N, REPORT ON GOVERNANCE POLICY RESOLUTION 7 (2003), at http://www.abanet.org/leadership/2003/journal/119c.pdf [hereinafter ABA FINAL REPORT].
6 This is a longstanding problem for corporate law. In their 1932 book, THE MODERN CORPORATION & PRIVATE PROPERTY, Adolph A. Berle and Gardiner C. Means detailed how managers took corporations over from the shareholders that owned them.
Congress,⁷ the SEC,⁸ and public exchanges like NASDAQ and the NYSE⁹ have tried to attack this problem by increasing the proportion of independent directors and refining the definition of "independence" to prevent conflicts of interest. Rather than pursue the Platonic ideal of a perfectly "independent" board, I make a radical proposal: Certain corporations should voluntarily set aside one board seat for the largest shareholder independent of management willing to serve. This shareholder representative, as a substantial owner of the corporation, will be better motivated to monitor the management and police for fraudulent actions than board members selected by management or the board itself. Because the measure would be voluntary, it would probably only be adopted by corporations seeking to erase the taint of prior scandal and the perception of having had a board "captive" to management. MCI (née WorldCom), emerging from bankruptcy, could adopt the proposal to signal to investors: "We've changed! We have nothing to hide and to prove it, we'll let an owner on the board to see for himself."

The idea that money should do the governing alludes to Elliot J. Weiss and John S. Beckerman’s article on class actions,¹⁰ which was the direct impetus for the Private Securities Litigation Reform Act of 1995 ("PSLRA").¹¹ Weiss and Beckerman suggested that institutional investors and pension funds, the largest and arguably most sophisticated of investors, were best fitted to monitor plaintiffs' attorneys in the class action context, preventing opportunistic behavior by the plaintiffs' bar.¹² Their insight was that those with a large financial stake were best motivated, and therefore best suited, to protect the interests of shareholders.¹³

The PSLRA has admittedly not produced the results its proponents anticipated. In particular, few institutional investors have stepped in to monitor plaintiffs' attorneys.¹⁴ The title of this Article therefore tacitly acknowledges the

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⁹ NASD Manual Online, Rule 4200 (14)(B) at http://chwwallstreet.com/NASD;
¹² Weiss & Beckerman, supra note 10, at 2126-27.
¹³ Id.
potential problems raised by the proposal to rely on large shareholders for reform. It is possible that letting the money do the governing will not fare any better than the PSLRA, either because no corporations will adopt it or because shareholders are no better monitors of management than traditionally selected board members. But given recent public distrust in the validity of the financial information corporations report to Wall Street, giving corporations the opportunity to signal that they have nothing to hide from their shareholders does not seem particularly controversial.

Part I of the Article outlines the problems with the current method of board selection and functioning. Management or management-sympathetic board members often select the board nominees, who share social ties with other board members. Boards tend to avoid "rocking the boat" by questioning management's recommendations, and because of the way the proxy process is structured, shareholders cannot effectively use their votes to oust unsatisfactory board members.

Part II analyzes the SEC's recent proposals for reform, which center on granting shareholders more opportunities to nominate candidates to the board. These proposals attempt to give shareholders a greater voice in the election process, but do so circuitously. They require that nominating shareholders be independent from the candidates they nominate, missing the point that it is precisely those individuals with a stake in the corporation that will make the best monitors.

Part III presents the mechanics of the proposed solution, suggesting that the company offer the largest shareholder independent of management a spot on the company's slate of director candidates (an offer tantamount to a board seat, given the structure of the proxy process). If the largest such shareholder did not accept the position, it would be offered to the next-largest shareholder, and so on until the seat was filled. Because adoption of such a nomination process would be voluntary, only companies that strongly desired to signal their status as upstanding practitioners of responsible corporate governance would be likely to implement it. The Part concludes by pointing out that in the venture capital context, investors routinely sit on the board in order to monitor and protect their investments.

Part IV then explains how having a shareholder representative on the board solves many of the problems that other proposed reforms do not. Part IV responds to potential criticisms, chief among which is that the Sarbanes-Oxley Act and other corporate reforms render further action unnecessary. The Article's response is that regulators, like generals, always fight the last war. Sarbanes-Oxley, and the new listing rules instituted by NASDAQ and the NYSE, prohibit Enron- and WorldCom-style problems, such as loans to corporate officers, off-balance sheet transactions, and conflicts of interest in company auditors. None of these reforms contemplate structural changes that will prevent new kinds of frauds in the future.

The Article concludes that it makes sense to let corporations, and therefore the market, decide whether putting a shareholder on the board is desirable.
I. Unwatched Watchers

A. The Problem With Boards

The central problem in corporate law is the separation of ownership and control. Shareholders are the owners of the corporation. For reasons of liquidity, shareholder ownership is divided into small pieces that can be readily traded. This division creates a class of owners too numerous to run the corporation efficiently. The corporation is run by the owners' employees, the management of the corporation.

Although a board of directors generally oversees a corporation, it delegates the day-to-day running of the business to the management. The board’s primary responsibility, then, is to select the CEO and supervise the senior management of the corporation. Ideally, board members are diligent in fulfilling their duties to the corporation and the shareholders they serve. They should maintain an attitude of “constructive skepticism” to the information and recommendations management presents, asking “incisive, probing questions” requiring “honest answers.” They should be watchful not only for outright fraud, but also for inadvisable management decisions that would harm the corporation.

Unfortunately, such model director behavior seems to have been honored more in the breach than in the observance. Although the board’s primary duty may be to select the CEO, such selection occurs only every few years, or even decades. In practice the CEO has often served longer than many members of the board, and was in fact the very person that procured them their seats. Board members are


17 Stephen M. Bainbridge, The Board of Directors as Nexus of Contracts, 88 IOWA L. REV. 1, 4 n.9 (2002).


19 THE BUSINESS ROUNDTABLE, supra note 18, at 3.

frequently CEOs themselves with several concurrent board seats, and they have failed to devote enough time and attention to monitoring, instead tending to defer to management decisions. As a structural matter, board members depend on management as their sole source of information.

Even outside directors are often under the influence of management, despite nominally working for shareholders. Overall, a "culture of passivity" prevails in many corporations, with management free from "meaningful director oversight." In WorldCom, the largest bankruptcy in American history, Bernard Ebbers (WorldCom's then-CEO) "was allowed nearly imperial reign over the affairs of the company, without the board of directors exercising any apparent restraint on his actions, even though he did not appear to possess the experience or training to be remotely qualified for his position."

To make matters worse, aside from structural impediments to board functioning, conflicts of interest contribute to making outside directors independent in name only. In the past, service providers such as lawyers, bankers, and accountants have served as "outside" directors despite being "only nominally independent," because of their dependence on the goodwill of the CEO for business. Although the new rules prevent these specific relationships, they do not preclude all conflicts of interest. For example, nonprofit leaders can sit on boards of companies that donate substantial sums to the very nonprofits they head. This creates "the possibility that money flowing from companies and their executives will make nonprofit officials beholden to the corporate management they are supposed to monitor." Even if new rules correct this problem, no rules can encompass all potential conflicts of interest. The web of obligations owed and loyalties felt at some point becomes too difficult to trace.

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21 ABA Final Report, supra note 5, at 9.
22 Report of ABA Task Force, supra note 16; ABA Final Report, supra note 5, at 9; Bebchuk, supra note 18, at 772; Dent, supra note 15, at 898.
23 ABA Final Report, supra note 5, at 10; Dent, supra note 15, at 898.
24 ABA Final Report, supra note 5, at 10; Jayne W. Barnard, Shareholder Access to the Proxy Revisited, 40 Cath. U. L. Rev. 37, 77, 78 n.253 (1990) (describing the Mace study, which found that traditionally selected outside directors tend to be passive).
26 Dent, supra note 15, at 898.
27 NASDAQ now requires that independent directors receive no more than $60,000 in other compensation from the corporation. NASD Manual Online, supra note 9.
Another complication is that supposedly independent directors share social connections with management. In the case of WorldCom, many nominally independent directors "had been associated with [the CEO] for years, and some owed most of their personal net worth to his actions." Independent directors are selected by inside directors: Personal or professional relationships can create bias, even if not outright conflict of interest. The CEO often serves on the nominating committee or exerts his influence on it, even if he does not formally serve. Because of the CEO's close relationship with board members, he has the power either to expel a director who opposes him, or not renew his directorship.

There is a strong correlation between director compensation and CEO compensation. Because boards are largely composed of CEOs, they are interested in raising CEO pay levels in general. Many compensation committee members may be personal friends of the CEO. For example, two directors who were "longtime associates" of WorldCom CEO Ebbers arranged for $400 million in "loans" to Ebbers from the company. In short, management often controls the board.

Boards inherently function as groups, and both benign and malign theories exist about what that means. According to the "benign theory," the fact that the board of directors is a group means that its members monitor each other and encourage improvement. Members strive to comport with communal norms, and face reputational and social sanctions when they do not. Board members seek their positions for financial reasons, yes, but also for learning and networking opportunities.

In contrast, there is the "malign theory" of board functionality, which may ring more true given the revelations of corporate misconduct in the late nineties. According to one description:

Boards are frequently constrained by what one director has called the "cult of politeness." Another knowledgeable

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30 Breeden, supra note 25, at 31.
32 Bebchuk, supra note 18, at 766-67.
33 Id. at 770.
34 Id. at 768-69; Marino, supra note 20, at 1211-12.
35 Marino, supra note 21, at 1211 n.42.
36 Breeden, supra note 25, at 2, 28 n.27.
37 Camara, supra note 29, at 10.
38 Bainbridge, supra note 17, at 28.
commentator has described "a subtle set of unspoken norms" which inhibit robust discourse within the confines of the boardroom. . . . [M]any directors suppress their concerns in board meetings for fear of appearing disrespectful of the CEO or of indicating a vote of "no confidence."  

According to this version, board members serve on boards because of the prestige or business relationships. These factors can result in a constitutional reluctance to challenge management.  

In the worst cases, management control is concentrated in senior executives, whose motives are to maximize their own wealth by reporting the good news to the board, while concealing the bad news. Stock-based compensation, particularly compensation based on short-term options, arguably gives insiders incentives to manipulate operations, or earnings alone, to reap large short-run payoffs by selling before the market adjusts.  

The problem of boards being too closely tied to management is compounded by boards' tendency to be static and self-perpetuating. As the next section discusses, it is extremely difficult for shareholders to alter the composition of the board.  

B. The Inability of Shareholders To Effect Change  

Currently shareholders have little real power to effect change in the governance of the corporations they own. The board controls the proxy process. The shareholder proposal rule allows shareholders to submit proposals for shareholder vote, but because of subject matter limitations, shareholders cannot use the rule to nominate their own candidates. The SEC has promulgated rules that make the procedures of nominating committees more transparent, but they stop short of requiring that the committees actually accept any shareholder-proposed candidates for the board (the SEC's proposed rules on this topic will be discussed in Part II). Proxy contests currently represent the only mechanism for shareholders  

39 Barnard, supra note 24, at 77 (internal notes omitted).  
40 Id. at 75; Bebchuk, supra note 18, at 770.  
41 ABA FINAL REPORT, supra note 5, at 6.  
42 Ribstein, supra note 1, at 15. This problem was magnified in the case of WorldCom's loans to Ebbers, which were secured with his own WorldCom stock. There, the decline of WorldCom's stock price put Ebbers under enormous pressure to stave off margin calls, since they could have led to a forced liquidation of his holdings and potentially to a personal bankruptcy filing. Literally anything that would increase the price of WorldCom stock or slow its rate of decline, such as strong reported earnings, would help relieve the intense financial pressure on Ebbers. Breeden, supra note 25, at 27.
seeking to change the composition of the board, but these are prohibitively expensive and launched only when takeover of the corporation is sought.

Corporate elections work as follows: A corporation sends out materials to its shareholders each year in advance of annual elections. These materials generally ask shareholders to give the management their proxy vote, and hence are called proxy materials. Although shareholders do elect board members, in practice the proxy process strips this power of significance, except in the rare case of a proxy contest. The relationship between the shareholders and the board is not legally that of principal and agent, and the shareholders do not control the actions of the board. The board selects the slate of candidates listed in the proxy materials, with little shareholder input.

The proxy process is in reality a mere formality, little more than a rubber stamp of the board’s selection. Most corporations do not permit cumulative voting, which would allow shareholders to cast all of their votes for one candidate. Plurality voting, the default in Delaware, permits candidates with less than fifty percent of the vote to win. This means that even if a significant portion of the shareholder electorate casts no-confidence or “withhold votes,” the board candidates still win. It is no wonder investors often view corporate elections as a “rigged process.”

The resulting problem is: Who will watch the watchers?

Rule 14a-8, the shareholder proposal rule, is meant to increase management’s accountability to shareholders, but several SEC limitations render this right largely ineffective as a means of replacing directors. This rule allows shareholders with $2,000 invested in the company, or a one percent ownership interest, to offer a resolution for shareholder approval, as long as it does not pertain to elections. Even these resolutions are generally precatory, i.e., they must suggest a

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43 For further discussion of the agency analogy, see Camara, supra note 29, at 47-48.
44 Pinto, supra note 31, at 324.
45 STAFF REPORT, supra note 8, at 12.
47 STAFF REPORT, supra note 8, at 12 n.25 (“Under plurality voting, the candidate with the greatest number of votes is elected; therefore, in an election in which there are the same number of nominees as there are board positions open, all nominees will be elected.”).
48 Id. at 12.
50 Bainbridge, supra note 17, at 23.
result, not require it. If a shareholder wants a specific policy change, she has no means to require the board to adopt that change, even if the vast majority of shareholders vote for it. Although the number of shareholder resolutions has increased, shareholders cannot use the rule to replace inadequate directors because the rule excludes resolutions dealing with elections. A shareholder unhappy with the performance of an individual board member, or even the board as a whole, possesses two choices: sell her shares (the so-called “Wall Street Rule”) or launch a proxy contest for control of the company.

Proxy contests are prohibitively expensive for a shareholder who seeks to reconfigure the board, rather than replace it. Insurgents must pay their own costs and campaign without the backing of the corporation. Furthermore, the management that controls the board also controls the proxy process. Shareholders are unlikely to invest the time in investigating the pros and cons of any insurgent slate due to their passivity or “rational apathy”: because any individual shareholder will only see a fractional return (proportionate to the size of her individual equity holding) on any investigation in information that she makes, she is unlikely to investigate in the first place. If a shareholder does take the time and money to make the correct choice, she knows that she will be forced to share the benefits should her position carry the day. Shareholders’ power to replace directors is therefore no more than a myth. Derivative suits, where a shareholder brings suit on behalf of the corporation, are also difficult and again require that the shareholder who invests time and money to improve the board or governance of a corporation share any gains achieved with her fellow shareholders.

If the corporation has a nominating committee, shareholders can make suggestions for director candidates to that committee. Nominating committees have historically been “black box” affairs, however, which are free to disregard shareholder suggestions without explanation. Boards have a private interest in self-perpetuation, and a tendency to avoid the admission of failure that accepting a nomination from a shareholder might entail. Furthermore, when the problem is greatest (for example, when independent directors are falling down on the job and

53 STAFF REPORT, supra note 8, at 8 n.20.
54 REPORT OF ABA TASK FORCE, supra note 16, at 14.
55 Bainbridge, supra note 17, at 21. For a more detailed analysis of the workings of the Wall Street Rule, see Camara, supra note 29, at 35.
57 Dent, supra note 15, at 903.
58 Id. at 903-04; Pinto, supra note 31, at 326.
59 Bebchuk, supra note 56, at 2.
60 Id. at 8.
the board has been captured by management), shareholders cannot trust the nominating committee.\textsuperscript{61}

The SEC has adopted rules that require a corporation to disclose whether it has a standing nominating committee and, if not, a reason why it finds it appropriate not to have one.\textsuperscript{62} If a nominating committee does exist, corporations must disclose the committee's charter (or state that it does not have one) and whether the directors on the committee are independent.\textsuperscript{63} If the committee considers candidates suggested by shareholders, the corporation must disclose how shareholders can submit their suggestions, and the minimum qualifications and specific qualities or skills the nominating committee is looking for in candidates.\textsuperscript{64} If a committee receives a recommended nominee from a shareholder or group of shareholders that has owned five percent or more of the company's common stock for at least a year, and rejects that candidate, the committee must disclose the names of the recommending shareholders and their rejected candidates (provided each consents).\textsuperscript{65}

Logic indicates that this reform of the nominating process will not significantly increase shareholder participation. The new rule will hopefully motivate nominating committees to consider shareholder nominees more carefully. But the nominating committees are still free to reject shareholder candidates without explanation. As long as the nominating committee is not required to accept a shareholder-recommended candidate, this rule lacks the teeth to shift the balance of power in the shareholder nomination process away from the board.

Shareholders theoretically could nominate board candidates at a company's annual meeting. In almost all cases, however, voting will have already been accomplished by proxies distributed beforehand, so such a nomination would be little more than an empty gesture.\textsuperscript{66} The incumbents possess procedural advantages—such as the holding of proxies and influence over nominations—that virtually guarantee that they will win.\textsuperscript{67}

According to former Chancellor Allen of the Delaware Court of Chancery, the "ideological underpinning" for legitimacy of directorial power is the shareholder

\textsuperscript{61} Id.
\textsuperscript{63} Id.
\textsuperscript{64} Id.
\textsuperscript{65} Id.
\textsuperscript{66} STAFF REPORT, supra note 8, at 5.
But several elements conspire to keep shareholders from exercising a vote that has any real meaning:

- Shareholders effectively cannot nominate directors.
- Nominating committees have proven largely unresponsive to shareholder-suggested candidates.
- Proxy contests do not present a viable alternative to the average shareholder because of their expense.
- Shareholders are left with self-perpetuating boards sharing explicit or covert ties to management.
- These directors generally lack the time or the motivation to investigate management’s decisions adequately.

The next section will describe the SEC’s proposals to remedy this problem, and then address why these proposals will fail.

II. A Failure in the Making: The SEC’s Shareholder Proposal Reform

The perceived current crisis in corporate governance (or, at least, the perception that boards were asleep at the helm during the excesses of the late nineties boom) has prompted the SEC to propose reforms to the nomination process designed to give shareholders greater access to the ballot, at least in certain circumstances. This Part will first describe the proposed reforms, and then explain why they likely will not prove effective at increasing real shareholder participation in corporate governance and at best represent a needlessly convoluted and indirect means of addressing a problem that direct shareholder representation neatly solves.

A. The Proposal Described

The SEC Staff Report, released on July 15, 2003, discussed several alternatives for reform that would allow shareholders to participate more directly in the election of directors. On October 14, 2003, the SEC proposed a rule regarding director nominations by shareholders. The proposed rule would only apply to companies permitted by state law to nominate candidates, and where a “triggering event” has occurred. The SEC has proposed two such triggering events: (1) where at

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69 These included two proposals for allowing shareholders the opportunity to add their own content to the proxy materials that a corporation regularly sends to its shareholders, a move that corporations have opposed in the past. Another proposal was to change or interpret rule 14a-8(i)(8) (which currently lets companies exclude proposals relating to elections) to permit resolutions seeking to allow shareholders access to the proxy card in a non-control context. Staff Report, supra note 8, at 28.

least one company-nominated director receives "withhold votes" totaling more than thirty-five percent of the total votes cast; and (2) where a security holder or group of security holders who have held more than one percent of the company’s securities for over one year submit a shareholder proposal subjecting the company to the proposed shareholder nomination process, and that proposal receives more than fifty percent of votes cast.\footnote{Id. at 45. The SEC is considering a third triggering event similar to the second but not limited in subject matter, where any shareholder proposal made by a qualifying shareholder or group of shareholders that receives more than 50% of the votes cast, but is not implemented by the company, would result in the right of shareholders to nominate directors. Id. at 13-14.}

Once a triggering event has occurred, a company’s proxy process is subject to certain procedures. The company must notify its shareholders that it is now subject to the SEC-prescribed security holder nomination procedures. Shareholders or groups that have owned, individually or in the aggregate, more than five percent of outstanding voting securities for at least two years, intend to own them until the election date, and have certified that they are not holding the shares with the intent of controlling the corporation, may submit eligible nominees.

To be eligible, a nominee must be independent both of the company and of the security holders that nominate her. The rules prohibit relationships between the nominee and the nominating security holder or group: The nominee may not be the nominating security holder, a member of the nominating security holder’s family, an executive director or officer of the nominating security holder, or have accepted consulting, advisory, or other fees from the nominating security holder for the past two years. The SEC proposed this restriction to eliminate the possibility that "'special interest' or 'single issue' directors would advance the interests of the nominating security holder over the interests of security holders as a group."\footnote{Proposed Rule, supra note 70.} The proposed rules also prohibit relationships between these entities and the corporation itself, in order to ensure that the nominee complies with all applicable standards regarding directorial independence at the federal, state, and security exchange level.

B. Problems with the Proposal

The major problem with the SEC’s proposal is that it clings to the notion that a perfectly independent director, one with no ties to the nominating shareholder, is the ideal.\footnote{This Article does not address the SEC’s authority to adopt the rules it has proposed. The Business Roundtable challenged this authority in its comments to the SEC. THE BUSINESS ROUNDTABLE, DETAILED COMMENTS ON THE “PROPOSED ELECTION CONTEST RULES” OF THE U.S. SECURITIES AND EXCHANGE COMMISSION (2003), available at http://www.sec.gov/rules/proposed/s71903/brt122203.pdf.} However, most of the directors serving during Bernard Ebbers’ tenure at...
WorldCom qualified as independent. Independence alone does not motivate directors to monitor diligently, and there is no reason to believe that shareholders will be more effective at nominating diligent independent director candidates than nominating committees have been in the past.

Commentators have voiced concerns that the kind of reforms the SEC has proposed would cost corporations a great deal because incumbent directors would be forced into contested elections. Board directors might have to send mailings and conduct road shows that would consume their time and the corporation's money in order to defend their seats. Others fear that the prospect of contested elections, coupled with the recent decline in the coverage of director and officer insurance, would deter individuals from serving on boards at all.

Other potential problems have to do with the character and qualifications of the shareholder nominees and their impact on the board. Because shareholders do not have a duty to act in the corporation's best interest when selecting candidates (as boards do), the nominees might not adequately represent all shareholders. Or the candidates that shareholders suggest may simply be unqualified to serve on the board. Finally, there is the objection that the introduction of shareholder-nominated board members would “alter the dynamics of the board,” and balkanize it. A polarized board could well find itself unable to function effectively because it would not be able to agree on anything.

As the criticisms of the SEC's proposal make clear, the solution it offers is a complicated one at best. I offer a different solution: Rather than empower the owners to nominate a member of the board that will watch their assets, simply put an owner on the board itself. The problems of contested elections and the identity and qualification of candidates are thus avoided. The next Part describes the mechanics of how this solution would work.

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74 Breeden, supra note 25, at 30.
75 Overall costs include higher campaign costs for incumbent directors, multiplication of decision costs among shareholders, and “external diseconomies of incorrect voting caused by inadequate incentives to investigate.” Camara, supra note 29, at 47; see also STAFF REPORT, supra note 9, at 12; Barnard, supra note 24, at 75.
76 Bebchuk, supra note 56, at 9.
78 STAFF REPORT, supra note 8.
79 Bebchuk, supra note 56, at 13.
80 Staff Report, supra note 8, at 12.
81 Bebchuk, supra note 56, at 15.
III. Letting the Money Govern

A. The Solution Described

The solution I propose is a simple one. On the record date, a corporation would tally up its stock ownership and compile a list of shareholders in order of the size of their holdings, from greatest to least. Any person deemed not independent by virtue of ties to management or the current board (but not an “affiliate” if so categorized solely by virtue of holding size) is removed from the list. The shareholder at the top of this list is then offered a seat on the board. If that shareholder refuses, the offer is made to the next shareholder on the list, and so on. Shareholders would not be permitted to aggregate their shares, because to do so would defeat the purpose of ensuring that the person serving on the board is highly motivated to monitor management on behalf of her investment.

Plurality voting and the proxy process ensure that nomination is de facto election in the world of corporate voting. The easiest way for a corporation to implement this Article’s proposal would be for its board to adopt the above-described process as a means of selecting one of its board candidates. Boards of companies needing a strong signal of trustworthiness, like those emerging from corporate scandal, might well take this action. If it wishes, the board could legitimize its action by proposing it for shareholder vote. An alternative method of allowing this result (for Delaware corporations) would be for Delaware to adopt a law that corporations could propose an amendment to their charters requiring that one seat be set aside for a shareholder-director.

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82 The record date is the date for determining which shareholders are entitled to vote at an annual meeting, fixed according to Del. Code Ann. tit. 8, § 213 (2003). Any date may, of course, be used, but the record date seems most convenient because it is already defined by the Delaware Code and by a corporation’s articles of incorporation.


84 Aggregation would also be unhelpful to the extent that a large equity holding is a proxy for financial sophistication. See infra note 102 and accompanying text.

85 See supra notes 45-50 and accompanying text.

86 This Article contemplates reform on the level of state corporate law. It analyzes this problem in the framework of Delaware law, which is the frequent state of choice for corporations to incorporate. This is largely presumed to be because its well-developed case law and sophisticated judiciary make it attractive to corporations seeking to maximize the certainty of the legal rules that form the backdrop against which they operate. See, e.g., Curtis Alva, Delaware and the Market for Corporate Charters: History and Agency, 15 Del. J. Corp. L. 885, 918 (1990) (arguing that specialized judiciary makes Delaware incorporation more attractive); Stephen J. Massey, Chancellor Allen’s Jurisprudence and the Theory of Corporate Law, 17 Del. J. Corp. L. 683, 702 n.79 (1992) (describing scholars’ reliance on Delaware case law as an explanation for its competitive success).
Adoption would be voluntary. The corporations who do adopt the proposal will likely be ones with low stock prices and a history of defrauding investors, i.e., companies perceived to have "captive boards" and those emerging from corporate scandals, eager to cleanse themselves of the taint of the past. Companies like WorldCom and Tyco might well be eager to signal to investors that they have nothing to hide from shareholders.

Certain actions could precipitate the more widespread adoption of the proposal. Organizations like Institutional Shareholders Services, Inc. ("ISS") and Standard & Poor's Corporation rate corporations on their corporate governance (and, for a fee, advise companies on how to improve their scores). If ISS and other rating institutions assign a large plus factor to corporations that adopt such a measure, then corporations outside of the limited set tainted by corporate scandal may adopt the reform. Having a shareholder-director could become another element of corporate governance "best practices."

Will any shareholders take the job when it is offered? There are two ways for corporations to structure the process, depending on whether one believes that shareholders will want to sit on the board without any extra inducement, or whether they need additional motivation. If shareholders in general want to serve on boards, then the corporation could make them assume the risk of noncompliance with insider trading laws (perhaps implementing a 10b-5(1) plan of predetermined stock sales) or require a trading standstill while on the board and a given number of days thereafter.

A more equitable solution, and one that more closely mimics the venture capital firm model discussed in the next section, rewards the shareholder-director for her service, and compensates her for the diminished liquidity she suffers during her time in office, by granting her additional restricted stock. The shareholder-director would not be able to sell this restricted stock until a specified time after leaving the board. The restrictions, unlike stock options, would discourage the shareholder-director from seeking short-term gain in stock price in order to profit before the stock fell. Because of this built-in delayed liquidity, she will make decisions that maximize long-term corporate gain. If it seems that shareholders are reluctant to take the job because of the potential liability or illiquidity, the prospect of restricted stock might persuade them.

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88 This Article presumes that the goal of corporations is to reward the long-term investor. THE BUSINESS ROUNDTABLE, supra note 18, at 25. This assumption would help deter fraud, because if the managers of a corporation are focused on long-term growth, then they will not engage in fraudulent conduct to create illusory short term gains in stock price. The move away from stock options and toward restricted stock grants, most notably made recently by Microsoft, is in part attributable to this concern. Julie Howard, Will Companies
Insider trading concerns could present another area of concern for prospective shareholder-directors with stakes in other companies. Exposure to liability for trading in the stock of these other companies on information gained while serving as a director could be severe. Section 10b-5(1) plans, where individuals provide preset directions to their brokers on when to buy and sell, represent one solution.\textsuperscript{89} Of course, this problem is not unique to the shareholder-director: Directors chosen in the traditional manner deal with insider trading concerns, often exacerbated by their service on multiple corporate boards, every day.

The current reasons individuals choose to serve on boards are reputation, networking, and professional gain. These all can prove dangerous because they can clash with the interests of the shareholders. Some corporations attempt to correct for this by granting directors stock options to try to align their interests with those of the shareholders.\textsuperscript{90} This is an artificial solution to a problem more easily solved by

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\textit{Follow Microsoft's Lead in Dumping Stock Options?}, \textit{Idaho Statesman}, Sept. 21, 2003, at Business 1. (The other reason for granting restricted stock is because of the controversy surrounding companies' ability to issue stock options without expensing them). If the shareholder-director is granted restricted stock, then the assumption of a long-term investor harmonizes her incentives with those of the other shareholders. Without this presumption, incentives would be misaligned, because investors would be looking for short-term gains in stock value, to which the long-term-biased shareholder director would be indifferent.

The presumption also removes from consideration the preferences of investors who might favor short-term run-ups in stock value caused by fraud. The point may be an obvious one, but if investors generally were indifferent to, or even favored, fraudulent practices to the extent that they represent opportunities to "time the market" and sell at a profit before the fraud was discovered, then corporate fraud would not present a problem. These investors may exist, but for public policy reasons securities regulators should not consider their interests when framing rules, and neither should corporations.

\textsuperscript{89} These plans establish an affirmative defense for individuals who trade despite having material nonpublic information provided that:

\begin{itemize}
  \item[(A)] Before becoming aware of the [material nonpublic] information, the person had: (1) Entered into a binding contract to purchase or sell the security, (2) Instructed another person to purchase or sell the security for the instructing person's account, or (3) Adopted a written plan for trading securities;
  \item[(B)] The contract, instruction or plan . . . : (1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; (2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or (3) Did not permit the person to exercise any subsequent influence . . . provided [the person was not] aware of the material nonpublic information . . . ; or
  \item[(C)] The purchase or sale that occurred was in fact pursuant to the contract, instruction or plan.
\end{itemize}


\textsuperscript{90} \textit{Bebchuk, supra} note 18, at 769.
giving a shareholder who already has the incentive to maximize his or her own value a seat on the board.

B. The Venture Capitalist Model

Although the reuniting of ownership and control might seem revolutionary, this model already exists in the world of privately-held companies. Indeed, it is the norm among companies backed by venture capitalist firms. These firms pool the money of sophisticated investors who invest in companies that are still private, and obtain a return on their investment when the company is acquired or goes public. Venture capitalist firms structure transactions to retain control of the board, and venture capitalists and founders generally constitute the boards of startups. Venture capitalists use board representation and voting control to manage or withdraw investments by liquidation, financing, or forced sale.

One could perhaps object that recent failures of venture funds do not inspire faith that theirs is a model worthy of emulation. But securities regulation does not promise that every corporation has a board that will lead it to profitability and yield its shareholders commensurate returns on their investment. The rationale behind regulation is instead to ensure that the market has complete and reliable information so that investors can make their own conclusions as to the worth of the companies whose stock they buy. This Article's proposal should lead to wealth maximization because complete disclosure gives a shareholder reliable information. Armed with full knowledge, he can assess the risks and prospective returns of investment options accurately, and build a diversified portfolio accordingly. There will always be venture capital funds (just as there will always be companies) that pursue high risk ventures and fail, particularly in economic downturns. As long as investors have an accurate picture of the risks, and can rely on the information they are given, the failure of venture capitalist funds is not a sign of a malfunctioning system.

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95 This Article embraces the principle that the goal of corporate law is shareholder wealth maximization, and not consideration for stakeholders such as members of the community or employees.
96 This Article stresses the fraud-fighting effect of installing a shareholder-director because that seems the most immediately obvious benefit. Shareholder-directors could also enhance shareholder wealth by making affirmatively profitable board decisions, and their bias
Of course, the venture capitalist-funded firm is not an exact analog for public corporations. Venture capitalists make a large upfront commitment to a long-term investment, accepting less liquidity than if they were to invest in a public company. Their gain is a bigger upside than the common shareholder’s: Venture capitalists receive dividends first and are paid first when the company liquidates. Also, there is less scrutiny of the board because the corporation is privately held. But the venture capitalist model does suggest that there might be a place for a motivated owner on the board of a corporation.

C. Advantages over the SEC Proposal

The chief advantage of this Article’s proposal is that it effects a structural change by introducing a new actor to the corporate governance arena, one uniquely motivated to monitor both management and his or her fellow directors. The SEC’s proposed reforms, like the Sarbanes-Oxley Act, accept the separation of ownership and control as a fixed feature of the corporate landscape, and attempt to increase independence and shareholder participation in the proxy process. But adherence to “best practices” and definitions of “independence” are no guarantee of good governance: “At least 80% of WorldCom’s directors during the Ebbers era would probably meet today’s standards for director independence, as well as the standards of the time.”

Another major advantage of this Article’s proposal over the SEC’s solution is that it can be implemented quickly and inexpensively. Rather than waiting for the lengthy process of SEC rulemaking and then for the rule’s triggering events to occur, corporations wishing to signal their commitment to corporate governance can take the easy step of nominating their largest shareholder to the board at the next annual election.

Furthermore, many of the criticisms leveled against the SEC’s proposed reform do not apply to this proposal. First, there would be no contested election; one seat would simply be designated for the largest independent shareholder willing to serve. The other traditionally elected directors would not face the stress of campaigning to defend their seats, and companies would be spared those costs.

A second criticism made of the SEC’s proposal is that the nominees might be loyal to their nominator, and not serve the interests of the shareholders at large. This proposal is vulnerable to a similar criticism, because the shareholder-director could have personal reasons for advocating a given transaction or position, and be able to profit on her position at the expense of the other shareholders. To the extent towards the long-term would certainly help focus corporate energies on creating sustainable revenues.

97 Breeden, supra note 25, at 30.
a shareholder-director has an interest in a transaction as a shareholder, this interest is beneficial because, in maximizing the value of his own shares, he will be maximizing the value of the shares of all other shareholders. But if the shareholder-director had a financial interest in a transaction that he did not share with all other shareholders, then the interest presents a problem because if he were to act to maximize his interest (as presumably he would, unconstrained by law), that action would not benefit the other shareholders.

The first response to this criticism is that it explains why the optimal number of shareholder-directors is one. To the extent that the shareholder-director is not beholden to the CEO or management for her seat, she will be less likely to defer to their opinions. Said more positively, one diligent director encourages others, who will work knowing that an owner is looking over their shoulders. But one board member, acting alone, is relatively unlikely to persuade the board to take action that is not in the interest of the corporation as a whole. One may actually be the optimal number, because it is enough to police the rest of the board, and motivate it to act responsibly. At the same time, one director is relatively unlikely to sway the board towards an agenda that the rest of the shareholders do not benefit from, thus minimizing the danger that, fiduciary duties notwithstanding, a faction could sway the board for its own interests.

Secondly, the danger of a director acting to advance personal interests rather than those of the shareholders exists for every director, and Delaware has a well-developed body of law to deal with the situation. A director's duty of loyalty to shareholders as their fiduciary would forbid her from capitalizing on the opportunity for private gain. A director is well-advised to disclose any private interest in a transaction the board is contemplating, and either abstain from voting or obtain shareholder ratification. The shareholder-director would not be exempt from the fiduciary duties a director owes the corporation. For example, if the board was considering outsourcing a large portion of its business to a corporation in which the shareholder-director had a sizeable stake, she would be obliged to disclose this fact and abstain from voting, just as any traditionally selected director would.

In fairness, the SEC's reform proposal can be defended against the criticism that shareholder nominees will be loyal to their nominator on the same grounds: Fiduciary duties apply. However, making the shareholder a board member does solve a problem with reform proposals that would make shareholder resolutions binding. Shareholders making resolutions have no freestanding duty to act in the best interests of the corporation. A shareholder with an interest in another entity

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98 Barnard, supra note 24, at 78.
99 If a director discloses the material facts of the relationship or interest and a majority of disinterested directors or the shareholders approves the transaction, it is not void or voidable due solely to a director's financial interest. DEL. CODE ANN. tit. 8, § 144 (2003).
might propose to acquire that entity for self-serving reasons that have little to do with the best interests of the acquirer corporation.\textsuperscript{100} Such a shareholder would be unconstrained by fiduciary duties. Making the shareholder representative a board member introduces the useful corrective of fiduciary duties to ensure that the shareholder-director acts primarily as a shareholder of the company in question.

Theoretically, the criticism that the SEC’s proposal could lead to unqualified nominees could also apply to this proposal. Lucian Bebchuk has rightly labeled this view as “paternalistic.”\textsuperscript{101} An investor with a large enough investment to qualify for a directorship under the proposal would be sophisticated enough to monitor management. Although the shareholder-director may not have expertise in the company’s specific industry, or have the knowledge to qualify as a financial expert, other board members can and will.\textsuperscript{102}

The fourth criticism leveled at the SEC’s reform proposal is that it will balkanize the board. To the extent that such balkanization is caused by the rancor and acrimony stirred up by contested elections, this proposal will hopefully avoid the problem. In the limited set of companies expected to adopt the proposal (those emerging from scandal), incumbents are likely to be newly installed and more receptive to new membership. This is not to discount the criticism completely; shareholders presumably want boards to function fairly well and not deadlock at every turn. But these critics should remember recent problems with “rubber stamp” boards, and accept that “constructive skepticism” may lead to disagreements on the road to resolution.

\section*{IV. Four Criticisms and Four Responses}

This Part responds to potential criticisms of the proposed solution. The best response to all of these criticisms may be that because of its voluntary nature, it will likely do no harm to offer the opportunity for corporations to signal their exemplary corporate governance if they choose to.

\begin{enumerate}
\item Camara, supra note 29, at 40.
\item Bebchuk, supra note 56, at 15.
\item For the purposes of private investments, the SEC presumes investor sophistication where an investor has an individual net worth greater than $1 million in net worth, or income exceeding $200,000 for the past two years. 17 C.F.R. § 230.501(a) (2003). Although the position of director of a public company is qualitatively different from that of an investor in a private company, if companies have concerns about the qualifications of potential shareholder directors, they can establish similar floors.
\end{enumerate}
A. It Is Not Necessary

The most obvious response to this proposal is that it is unnecessary. Several forces work together to police director behavior. Shareholders can vote directors out annually. Directors who breach their fiduciary duties of care and loyalty risk liability in court. Underperforming directors cause the products companies make to fail relative to more efficiently run companies, with correspondingly better products.103 Similarly, companies with sub par directors will fare worse in the capital markets.104 Most notably, the extent and advisability of the "market for corporate control" have for twenty years been the subject of scholarly debate. Proponents of this view argue that boards that do not monitor management adequately will cause their companies to lose money, the stock price to sink, and the board to face takeover by a corporation that can make better use of its resources.105

Some even question whether the shareholder vote is, or ought to be, of any significance at all. One critic writes: "Seventy years ago it was fashionable among intellectuals to talk about large, publicly held corporations as if they were little republics."106 He derides this thinking as coming from an "intellectual time warp," arguing that corporate democracy "never made any sense."107 "Management and the board are constituent parts of a team that runs a corporation. Each monitors the other, and reciprocity in their selection is precisely what we should expect in a well run company."108

The problem, as Enron et al. demonstrate, is that companies are not always well run, and so the constituent parts of a corporation do not always monitor each other. Investors need to be able to rely on the information companies disclose in order to determine if they are investing in well-run companies. It seems logical, then, to give companies the chance to signal their reliability by putting a shareholder on the board.

Moreover, as many commentators have observed, the market for corporate control is hardly an efficient one.109 State antitakeover laws form one barrier to efficiency.110 Boards are allowed to enact many antitakeover measures to ensure that

103 Bebchuk, supra note 18, at 778.
104 Id.
105 Id. at 777. The extent to which antitakeover measures have hampered or the market for corporate control remains the subject of debate. See Camara, supra note 29, at 4-5.
107 Id.
108 Id.
109 Barnard, supra note 24, at 85; Carole Goforth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late, 43 AM. U. L. REV. 379, 446-47 (1994).
110 Barnard, supra note 24, at 85.
any hostile bidder will need the board’s consent to succeed. Poison pills make it mechanically impossible for a hostile bidder to gain control by buying up shares without the board’s consent, and classified boards limit the number of directors a successful bidder can vote into office in a single year. Like the market for corporate control, capital markets may not provide the disciplining mechanism advocates of the status quo believe: “Capital markets discipline managers only when they need outside funds. Most companies can survive and even grow with internally generated capital.”

Certainly companies can only inflate and manufacture revenue for so long before the exigencies of reality become too great and the true value of the company and its stock becomes clear. However, the numbers are manipulable. HealthSouth’s management, incredibly, talked about having to find “dirt” to “fill the holes” in their financial reports, to disguise the true health of the business. Some investors (those in Enron and WorldCom come to mind) inevitably will be left with large losses prior to the inevitable correction of the marketplace.

Even in cases where no fraud exists, shareholder-directors will increase disclosure so that investors can make better assessments of the worth of the stock. Shareholder-directors would particularly focus on long-term value-maximizing and could encourage companies to better uses of existing resources, thus helping to maximize value for shareholders.

A possible, but easily dismissible, response to this argument is that investors should take into account that the numbers on which they base their investment decisions may be untrustworthy and allocate risk accordingly. They should be skeptical of financial results, especially in the face of meteorically rising rates of return. But the market as a whole will function more efficiently if investors can trust the numbers companies report, and allocate the risks and potential rewards of their portfolio against a background of reliable information without having to hedge against the risk of corporate fraud.

A related argument is that the proposal is unnecessary because institutional investors already protect shareholders’ interests. Theoretically these investors could monitor corporations, if they owned large blocks and had an incentive to develop specialized expertise in making and monitoring investments. But large blocks are rare, and few funds hold more than five to ten percent of any one company’s stock. Pension funds specifically are limited by political and geographic pressures that

111 Camara, supra note 29, at 5 n.12.
112 Dent, supra note 15, at 887.
113 Bainbridge, supra note 17, at 22; Pinto, supra note 31, at 330.
114 Bainbridge, supra note 17, at 93.
constrain their investments. Furthermore, hostility towards institutional shareholders exists in corporate governance because of their perceived “short-termism,” although the validity of this charge remains in question. Finally, recent mutual fund scandals involving market timing and late trading indicate that institutional investors may not even be protecting their own shareholders’ interests, and therefore might prove unfit monitors of the companies in which they invest.

B. Interests of Large and Small Shareholders May Diverge

The SEC Staff Report asks: “Do large and small shareholders share the same interests? If not, how do they differ and how would each be served under a shareholder access rule?” The question is highly relevant for the model I propose because, if the interests of small and large shareholders do diverge, then we cannot trust large shareholders, even those genuinely independent of management, to represent shareholders as a class and protect their interests.

Large institutional investors, particularly pension funds, can less easily sell their large holdings on the open market. They must therefore take more of a long-range view than individual investors, who have more liquidity. Some disagree with this analysis, and believe that institutional investors are interested in short-term results. Index funds in particular cannot liquidate their holdings, and their

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116 The argument is that institutional investment managers have an interest in reporting good results and may not scrutinize the validity of short-term stock price performance, if it is positive. REPORT OF ABA TASK FORCE, supra note 16, at 14; see also Barnard, supra note 24, at 41.


118 STAFF REPORT, supra note 8, at 16.

119 One could argue that having large shareholders’ interests represented, even if they diverge from those of small shareholders, signifies an improvement over the status quo (i.e., something is better than nothing). But if institutional investors already have the clout to protect their interests, there is no need to offer them another means to assert themselves. How much power institutional investors actually have is unclear. For example, pressure from state pensions fund leaders forced Dick Grasso from his position as head of the NYSE (although this is a private non-profit, and not a public corporation). Ben White, Pension Fund Officials Seek NYSE Split, WASH. POST, Sept. 25, 2003, at E1. On the other hand, numerous institutional investors submitted shareholder resolutions to limit executive compensation packages, but none of the companies adopted them. Tamara Loomis, Shareholder Activism Seen In Proxy Proposals, N.Y.L.J., June 17, 2003.

managers are more likely to take an active role in the corporate governance of the companies in which they invest. When quick sale is difficult, exerting influence on a company can offer an easier path to higher returns on an investment.

A related criticism of the proposal is that the institutional investors that would be first in line to accept the shareholder’s spot on the board are part of the same “club” as current board management. The head of a pension fund or the manager of a mutual fund might not adequately guard shareholder interests, not because of interests divergent from those of small shareholders, but because of conflicting motives to maintain their reputation in the larger business community.

Recent settlements suggest that mutual funds are willing to put their own interests ahead of investors. If this is the case, they will not prove trustworthy monitors for the shareholders. This risk may well be discounted, however, because the insider trading problem would likely discourage most institutional investors from accepting a board position. They would, of course, be free to assume the risk of liability and construct adequate internal screens to wall off their board representative and ensure that no information is conveyed to the fund’s decision makers.

But institutional investors have historically tended to be passive. Their response to the PSLRA’s reform was to avoid, not embrace, the role of lead plaintiff. Different reasons are offered for this: desire to maintain valuable relationships with the company or fear of the responsibilities lead plaintiff status entails. Implementing the proposal may pose too many practical problems for institutional shareholders. To avoid insider trading violations, they would be forced to develop ethical walls that prevent their directors from communicating inside information to others within the institution. These same fears, coupled with the danger of increased liability from insider trading, may keep institutional investors from accepting the job of shareholder board representative.

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121 Romano, supra note 115, at 833.
122 Pinto, supra note 31, at 344.
123 Lauricella, supra note 117, at R1; Randall Smith & Tom Lauricella, Spitzer Alleges Mutual Funds Allowed Fraudulent Trading, WALL ST. J., Sept. 4, 2003, at A1 (involving mutual funds that permitted a hedge fund manager to trade after hours and engage in “timing trades”).
124 Bebchuk, supra note 56, at 7.
125 See Geoffrey P. Miller, Payment of Expenses in Securities Class Actions: Ethical Dilemmas, 22 REV. LITIG. 557 (2003) (describing the interaction between PSLRA and state ethics rules); Samantha M. Cohen, Note, "Paying-to-Play" is the New Rule of the Game: A Practical Implication of the Private Securities Litigation Reform Act of 1995, 99 U. ILL. L. REV. 1331 (1999) ("It seems that institutional investors are wary to accept the role of lead plaintiff, fearing that the benefits associated with the status will be outweighed by the position's cost and adverse consequences.")
126 Cohen, supra note 125.
I propose that adoption of a shareholder-director be voluntary in order to avoid imposing a universal reform that may not work at all. Indeed, implicit in this Article's title is the acknowledgement that this proposal, if implemented, might have as little success as did the PSLRA in achieving its goals of reform. Although institutional investors have exhibited more interest in involving themselves in the governing of the corporations they own, there is no way of knowing whether they will wish to take a seat on the board, or whether private individual owners will wish to do so. This is one reason for not mandating a rule of shareholder-directors, but leaving it for corporations to decide.

C. The Proposal Will Not Benefit Shareholders

It could be argued that the proposal will not maximize shareholder revenue. The response, as discussed earlier in Part IV.B., is that although individual shareholders may not benefit from the reform, overall shareholders will benefit because of the gain in reliability of information. Disclosure, not wealth maximization, is the premise underlying the securities laws. If the market distrusts the information it receives, the value of the market as a whole declines. Imperfect information creates transaction costs. The gain in the reliability of the information that the corporation discloses allows shareholders to balance their portfolios based on accurate financial information.

D. This Is Not the Time

Some will argue that the reforms of Sarbanes-Oxley still need to be digested. Desperate times, however, call for desperate measures. This is the only time this proposal could be implemented. A relatively narrow window currently exists when public sentiment is behind initiatives for corporate reform, and corporations are willing to adopt them. Reforms should be instituted now that will restore the value and power of the board, so that when the next bubble emerges, boards will be better structured to monitor management on behalf of the owners of the companies. The Sarbanes-Oxley Act and the reforms by the public exchanges

127 Dent, supra note 15, at 895; Ribstein, supra note 1, at 11.
128 Ribstein, supra note 1, at 10.
129 Scholarship on the topic of the advisability of increased shareholder participation in the control of corporations (be it in the form of shareholder nominations or making shareholder resolutions binding) has often focused on whether a given proposal would maximize shareholder wealth. See Camara, supra note 30, at 11. In the aggregate, this proposal would probably increase shareholder wealth by making corporate decisions and data more transparent.
130 Bebchuk, supra note 56, at 18.
131 Id. at 19.
respond only to the most egregious examples of corporate fraud: personal loans to executives, board members with financial ties to the corporation being classified as "independent," and auditors viewing their services as "loss leaders" that provided an entrée into more lucrative consulting contracts. As SEC Chairman William H. Donaldson has remarked:

A "check the box" approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting, "politically correct" dictates. If this was the case, ultimately corporations would not strive to meet higher standards, they would only strain under new costs associated with fulfilling a mandated process that could produce little of the desired effect.132

Some unmonitored managers will inevitably succumb to the temptation to profit from their positions by fraudulent means. More basic structural reform is needed to prevent a future generation of corporate mismanagement.

V. Conclusion

The SEC’s proposed rules offer shareholders a limited opportunity for an increased voice in selecting their own agents. A more direct approach, and one that is the norm in the venture capital arena, is to place a shareholder on the board. Including a shareholder on the board of directors signals that a corporation has nothing to hide. Corporations that do so will have a director with a long-term financial incentive to monitor the other directors’ actions and to ensure that they advance the shareholders’ interests. Letting the money do the governing gives the task to those most inclined to govern well.