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Abstract: A publicly-held corporation maintains a system of governance through separation of ownership and control of the firm. Under this framework, corporations attract capital and repatriate profits to their shareholders under the authority vested in the board of directors. However, significant evidence exists that Chief Executive Officers ("CEOs") are commonly driven by self-interest, boards often indulge CEOs, and shareholders find it difficult to monitor management. Many recent reforms have sought to improve corporate governance through regulatory interventions that empower shareholders. This Article identifies the limitations of this approach and advances a new model that looks within the "black box" of the firm. Integrating legal analysis with insights from organizational management and finance scholarship, this Article argues that corporations can overcome weak governance practices through forces that are driven by self-interested behavior of internal corporate actors. Three distinct, yet interrelated, internal forces generate what this Article calls organic corporate governance: (1) compliance systems that establish and enforce internal rules of conduct, (2) firm-specific human capital that binds actors to the firm, and (3) mutual monitoring by superiors and subordinates that constrains the self-interested behavior that erodes firm value. This Article applies this model to the responsibilities of the Chief Legal Officer ("CLO"), also known as the firm's general counsel, who is an indispensable generator of organic corporate governance.

INTRODUCTION

Corporate governance scholarship remains in constant conflict in part because our understanding of how corporations are optimally governed is incomplete. In spite of decades of scholarly debate,[1] including thousands of

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[1] *See, e.g.*, Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 914 (1982) (characteriz-

articles in the past ten years alone,[2] there is no consensus about the optimal role of corporate governance in the firm. Under predominant views, a corporation is monitored by the board of directors and managed on a day-to-day basis by the CEO and other members of senior management. These actors are then ultimately accountable to shareholders.[3] However, substantial schisms remain over fundamental questions such as the propriety of executive compensation,[4] the use of corporate governance ratings,[5] and the relative primacy

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ing the corporate governance literature as "voluminous" and noting its role in fueling the "widespread perception that there is something 'wrong' with the way corporations are governed"); Patrick J. Ryan, *Corporate Directors and the "Social Costs" of Takeovers—Reflections on the Tin Parachute*, 64 TUL. L. REV. 3, 35 n.95 (1989) (calling the corporate governance literature "extensive" and citing representative works from the 1970s and 1980s). More recently, even sub-literatures of corporate governance are now considered to be populated with large quantities of research. *See, e.g.*, Hwa-Jin Kim, *Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea*, 17 BERKELEY J. INT'L L. 61, 88 n.130 (1999) (referring to "[t]he literature discussing the role of institutional investors in corporate governance in the U.S." as "voluminous"); Brett H. McDonnell, *Convergence in Corporate Governance—Possible, but Not Desirable*, 47 VILL. L. REV. 341, 345 n.15 (2002) (remarking that the literature on convergence in the context of corporate governance is "fairly extensive and growing rapidly"). Early debates date back to the 1930s. *Compare* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (discussing the appropriate duties of the board of directors), *with* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) (commencing the Berle-Dodd debate on the appropriate duties of the board of directors).

[2] Alicia J. Davis, *The Institutional Appetite for "Quack Corporate Governance,"* 2015 COLUM. BUS. L. REV. 1, 6 & n.15. The author conducted a search on Westlaw for law review articles containing the term "corporate governance" at least five times anywhere in the article. *Id.* The result produced 2845 articles, a figure that does not include the substantial number of articles written by finance, management, and other business scholars. *Id.* Performing a similar search for the ten years prior to January 20, 2017, yields 2656 articles. *Westlaw Search with "Corporate Governance" at Least Five Times*, WESTLAWNEXT, http://westlawnext.com (last visited Jan. 20, 2017) (search in "advanced: (ATLEAST5 ("corporate governance")) & DA(aft 01-20-2007 & bef 01-20-2017)," filter for "Secondary Sources" then "Law Reviews & Journals").

[3] *See* Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 198 (2004) (noting that "[m]ost corporate scholars assume for various reasons that the interests that should matter to directors of most publicly held corporations are those of shareholders").

[4] *Compare* Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (arguing that the role of managerial power is of high importance and should be considered when studying executive compensation schemes or general corporate governance), *with* Bengt Holmstrom, *Pay Without Performance and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703 (2005) (commenting on and disagreeing with some aspects of Bebchuk and Fried's views on managerial power). *See also* Richard A. Posner, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013 (2009) (discussing "excessive" executive compensation in the wake of the 2007 recession).

[5] *See, e.g.,* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1317 (2009) (contending that "[t]he quest to design a single, global rating methodology should be replaced by an effort to design two separate methodologies for assessing the governance of companies with and without a controlling shareholder"); Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indi-*

of shareholders versus directors.[6] Empirical studies examining the impact of corporate governance on firm performance[7] and the efficacy of corporate governance reforms remain frustratingly inconclusive.[8]

In spite of the widespread belief that the American system of corporate governance is one of the best in the world,[9] substantial evidence shows that

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ces, 108 COLUM. L. REV. 1803, 1808 (2008) (contending that "no consistent relation between the academic and related commercial governance indices and corporate performance" exists); Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 891 (2007) (noting the potential for conflicts of interest in firms that issue corporate governance ratings). For an example of a seminal work establishing a widely used corporate governance index, see Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003). For a proposed revision of corporate governance rating methods, see Thuy-Nga T. Vo, *Rating Management Behavior and Ethics: A Proposal to Upgrade the Corporate Governance Rating Criteria*, 34 J. CORP. L. 1 (2008).

[6] *Compare* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005) (contending that corporate shareholders should have the right to "vote to adopt changes in [a] company's basic corporate governance arrangements"), *with* Theodore N. Mirvis, Paul K. Rowe & William Savitt, *Bebchuk's "Case for Increasing Shareholder Power": An Opposition*, 118 HARV. L. REV. F. 43, 43–44 (2007) (objecting to granting such rights to corporate shareholders). This debate can become quite impassioned. *See* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 733 (2007) (characterizing Bebchuk's then-recent publication as "the most recent salvo in [his] twenty-year campaign to recast the corporate law of Delaware in the image of his own writings . . . [that ignores] decades of salutary historical development and the overwhelming lessons of observed boardroom behavior . . . .").

[7] *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529–43 (2005) (collecting studies related to corporate governance after Sarbanes-Oxley); Joanna M. Shepherd, Frederick Tung & Albert H. Yoon, *What Else Matters for Corporate Governance?: The Case of Bank Monitoring*, 88 B.U. L. REV. 991, 998–1006 (2008) (collecting studies related to corporate governance); *see also* Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out,* 2013 U. ILL. L. REV. 1131, 1167 (noting that studies related to board independence are inconclusive).

[8] Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 18 (2009) (citing Bernard Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 U. PA. L. REV. 2131, 2133–34 (2001)) ("[A]cademic testing of the hypothesis that good corporate governance improves corporate financial performance has yielded inconclusive results."); Colin Melvin & Hans-Christoph Hirt, *Corporate Governance and Performance: The Missing Links, in* THE BUSINESS CASE FOR CORPORATE GOVERNANCE 201, 201–04 (Ken Rushton ed., 2008); Chin Fei Goh, et al., *Corporate Governance: A Literature Review with a Focus on Technology Firms*, PROCEDIA – SOC. & BEHAV. SCI., May 2014, at 39, 43 (surveying the corporate governance literature and finding empirical evidence inconclusive, which may be based on varying institutional contexts); Omari Scott Simmons, *Delaware's Global Threat*, 41 J. CORP. L. 217, 262 (2015) (noting the "absence of robust empirical support or inconclusive findings surrounding an array of corporate governance reforms").

[9] BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 1 (2016). Business Roundtable is an organization of CEOs of U.S. corporations. *Id.* at i. The document explains:

> Business Roundtable CEOs continue to believe that the United States has the best corporate governance, financial reporting and securities markets systems in the world. These systems work because they give public companies not only a frame-

many CEOs frequently prioritize their own interests over those of shareholders,[10] boards excessively indulge CEOs,[11] and shareholders exert weak influence over board composition and decision-making.[12] While the market for corporate control offers some ability to discipline inefficient managerial behavior in enabling shareholders to exercise their exit power in selling their equity stock,[13] this instrument is inherently blunt and limited.[14] The rise of institutional investors, such as pension funds and mutual funds, insulates individual shareholders from corporate action, thus dulling their motivation to exercise their control rights.[15] Furthermore, ongoing changes in the capital markets cast doubt on the long-established role of equity shareholders as the most efficient means of managing agency costs.[16]

> work of laws and regulations that establish minimum requirements but also the flexibility to implement customized practices that suit the companies' needs and to modify those practices in light of changing conditions and standards.

Id. at 1.

[10] Henry L. Tosi, Luis R. Gomez-Meija & Debra L. Moody, *The Separation of Ownership and Control: Increasing the Responsiveness of Boards of Directors to Shareholders' Interests?*, 4 U. FLA. J.L. & PUB. POL'Y 39, 40 (1991) ("[T]he governance structure of many firms is not designed to effectively facilitate the motivation of the top management in a way that best represents shareholders' interests."); *see* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 458–59 (1988) (presenting evidence suggesting that outsider dominated boards are more likely and more quickly to replace a CEO due to poor company stock performance than insider dominated boards).

[11] Bebchuk, Fried & Walker, *supra* note 4, at 767. Board members may collude with CEOs to increase their own compensation. Ivan E. Brick, Oded Palmon & John K. Wald, *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403, 421–22 (2006) (finding evidence of a positive relationship between CEO and director compensation and concluding that it is consistent with cronyism or mutual back scratching between the CEO and the board of directors); *see also* LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 30 (2004) ("Directors have a natural interest in their own compensation . . . . Independent directors who are generous with the CEO might reasonably expect the CEO to use his or her bully pulpit to support higher director compensation.").

[12] *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 310 (1999) (observing that shareholder powers in publicly-traded corporations to elect the board and vote on certain corporate changes are "[i]n both theory and practice . . . so weak as to be virtually meaningless").

[13] *See* Henry R. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365, 369–70; Troy A. Paredes, *The Firm and Nature of Control: Toward a Theory of Takeover Law*, 29 J. CORP. L. 103, 109–11 (2003).

[14] Jill E. Fisch, *Teaching Corporate Governance Through Shareholder Litigation*, 34 GA. L. REV. 745, 747 (2000) ("The market for corporate control is an overly blunt tool for ongoing management discipline and is subject to extensive market and legal constraints.").

[15] *See* Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1433–34 (2008).

[16] *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 235 (2008) (noting the

In the United States, the predominant response to these trends has been to regulate corporate governance. In particular, federal securities law has become a powerful mechanism to intervene in corporate governance.[17] Despite sharp disagreements regarding their effectiveness, the Sarbanes-Oxley Act ("SOX")[18] and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[19] impose mandatory governance rules on matters understood by many academics and practitioners to be solely under the control of the board of directors.[20] SOX and the Dodd-Frank Act include numerous regulatory mandates and incentives that empower shareholders.[21] Rules enacted under SOX and the Dodd-Frank Act regulate mandatory disclosure, shareholder proxy access, executive compensation, audit committees, and internal controls.[22] Scholars have questioned whether this newfound faith in regulatory intervention is misplaced.[23]

The ability of corporations to attract enormous amounts of equity investment and return a profit to shareholders belies the above-mentioned weaknesses of modern corporate governance.[24] How can this be explained? This Article posits that the currently predominant view of corporate governance is inherently incomplete. While legal scholars have extensively examined various combinations of board, shareholder, and CEO power, little atten-

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ability of private equity owners to manage and transfer capital risks through derivatives and other risk management tools).

[17] *See, e.g.*, William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 622–23 (2006); Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685, 694–95 (2009); Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39, 39–41 (2004).

[18] Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 406(a)–(b), 116 Stat. 745, 789; 15 U.S.C. § 7264 (2012) [hereinafter SOX].

[19] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

[20] *Compare* Romano, *supra* note 7, at 1602–03 (dismissing SOX), *and* Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1796–1819 (2011) (critiquing the Dodd-Frank Act), *with* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1907–09 (2007) (supporting SOX), *and* John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1022–29 (2012) (responding to Romano and supporting SOX and the Dodd-Frank Act).

[21] *See supra* notes 18–19.

[22] *See infra* notes 86–130 and accompanying text.

[23] *See, e.g.*, Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 335 (2011) (criticizing post-financial crisis corporate governance reforms as based on "simplistic logic" premised on the belief "that if management was the problem, shareholders must be the solution").

[24] *See* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 737 (1997).

tion has been given to essential sources of corporate governance inside the firm itself. This view of the firm as a "black box" that is monolithic and coordinated obscures the important role that internal forces play in governing the firm,[25] and it is the goal of this Article to show how these internal forces serve an essential role in corporate governance.

Specifically, this Article argues that corporate governance works in part because it operates intrinsically in organizations where there is a separation of ownership and control. Integrating legal analysis with insights from organizational management and finance scholarship, this Article argues that three forces work in loose concert to motivate organizational actors to promote corporate governance in pursuit of their own self-interest. First, a robust compliance system establishes the benchmarks that govern the enterprise. Second, joint investments in firm-specific human capital tie actors to the firm and incentivize long-term organizational citizenship. Third, mutual monitoring by superiors and subordinates nudge the organization toward good governance practices and away from self-interested behavior that erodes firm value. As this Article shows, the self-serving actions of senior managers are constrained by the potential reaction of subordinates who monitor their superiors for their own interests. The combination of these three forces generates what we call organic corporate governance, which enables organizations to thrive and helps illuminate how corporate governance can protect firm value even when governance practices are weak and regulatory authority is limited.

This Article proceeds as follows. Part I describes the major theories of corporate governance—showing how the day-to-day reality of firm management may be mismatched with theoretical assumptions and explaining the challenges of managerial accountability.[26] Part II examines how federal securities regulation has been used as a vehicle for reforming corporate governance through shareholder empowerment, highlighting the appeal and inherent limitations of this approach.[27] Part III presents the three forces that generate organic corporate governance.[28] These forces—compliance, firm-specific

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[25] Thomas Clarke, *The Long Road to Reformulating the Understanding of Directors' Duties: Legalizing Team Production Theory?*, 38 SEATTLE U. L. REV. 433, 447 (2015) (criticizing agency theory for not entering the "black box" of the firm and "hopelessly misconceiv[ing] the motivations of managers [by] reducing their complex existence to a dehumanized stimulus/response mechanism"); *see also* Kenneth A. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 684 (2010) ("Public law typically has little concern with the decisionmaking processes of private actors. It usually treats regulatory targets as unitary 'black boxes,' best motivated by regulatory specificity on the one hand, and external incentives in the form of outcome-based monitoring and sanctions on the other.").

[26] *See infra* notes 31–87 and accompanying text.

[27] *See infra* notes 88–145 and accompanying text.

[28] *See infra* notes 146–249 and accompanying text.

human capital, and mutual monitoring—provide the motivation for organizational actors to act in the firm's best interests through pursuit of their own goals. Part IV shows how organic corporate governance works in practice by focusing on the CLO,[29] who is uniquely capable of generating organic corporate governance within the organization.[30] If the CLO and other key corporate actors are appropriately empowered, organic corporate governance can serve as the foundation for a *de facto* form of self-regulation that complements external regulation and diminishes the need for blanket, one-size-fits-all regulatory intervention in the governance of the firm.

I. THEORIES OF CORPORATE GOVERNANCE AND THEIR DISCONTENTS

Corporate governance has been variously defined as a structure for exerting power inside of a firm,[31] constraints that shape bargaining over firm quasi-rents,[32] or a "system of rules . . . and processes" that direct and control the enterprise.[33] Although all of these definitions hold explanatory power, corporate governance is fundamentally concerned with ensuring managers keep their promises through embedded relationships within the organization.[34] These promises and relationships protect the integrity of the firm so that it can most efficiently achieve its stated goals. Both normatively and descriptively, this process hinges on where the corporation's locus of control should exist and "toward what ends that control . . . should be exercised."[35] The following discussion examines the inter-relationships between management and the other two major corporate actors—the board of directors and

[29] The CLO is the most salient example due to its power and stature in U.S. corporations. Other corporate officers—most notably, the Chief Compliance Officer (CCO) and the Chief Risk Officer (CRO)—are also capable of furthering organic corporate governance through their mandates to preserve firm value from misuse, waste, or sanction.

[30] *See infra* notes 250–334 and accompanying text.

[31] *See* Stephen J. Lubben, *Separation and Dependence: Explaining Modern Corporate Governance*, 43 SETON HALL L. REV. 893, 894 (2013).

[32] *See* Luigi Zingales, *Corporate Governance*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 4 (Peter Newman ed., 1998).

[33] *See* Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 66 FLA. L. REV. 1, 6 (2014); Curtis J. Milhaupt, *Property Rights in Firms,* 84 VA. L. REV. 1145, 1151 (1998) ("After all, corporate governance is about control structures for firms.").

[34] *See, e.g.*, JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 1 (2008) ("The purpose of corporate governance is to persuade, induce, compel, and otherwise motivate corporate managers to keep the promises they make to investors."); Robert C. Bird & Stephen Kim Park, *The Domains of Corporate Counsel in an Era of Compliance*, 53 AM. BUS. L.J. 203, 218 & n.88 (2016) (citing various sources emphasizing corporate governance as embedded in relationships).

[35] Stefan J. Padfield, *Corporate Social Responsibility & Concession Theory*, 6 WM. & MARY BUS. L. REV. 1, 6 (2015).

shareholders. It focuses on the evolution of ongoing debates about how to address a core problem: how to minimize the possibility of managerial abuse while maximizing the efficiencies of managerial autonomy.

A. The Berle-Means Corporation and Its Legacy of Director Primacy

Canonical work by legal scholars has shaped contemporary debates about the corporate form. The predominant understanding of the American corporation stems from the work of Adolf Berle and Gardiner Means, who identified the management of issues, arising from the separation of ownership and control, as the primary function of corporate governance.[36] Melvin Eisenberg's book *The Structure of the Corporation: A Legal Analysis*, asserts that publicly-held corporations cannot alone direct the operation of the firm.[37] According to Eisenberg, those with direct ties to the enterprise should no longer dominate the board of directors.[38] Instead, directors must be independent, which is a rigorous standard for directors to meet.[39] Such directors must have power as well as separation from management in order to be able "to select and remove members of the chief executive's office."[40] The board's principal function should be to monitor management's actions.[41]

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[36] ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932) ("The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear."); *see also* Padfield, *supra* note 35, at 1, 4. Although the ownership-control separation is given top billing as Berle & Means's prominent contribution, they expressed somber concern about the dominance of economic power in the hands of corporations. In their view, if allowed to continue to grow un-checked, corporations would potentially supersede the state as the dominant form of social organization. BERLE & MEANS, *supra*, at 357. Such important contributions were set aside, and the ownership-control insight was leveraged to justify corporations seeking uninhibited profit maximization to the exclusion of other social or community interests. *See* ALEXANDER STYHRE, CORPORATE GOVERNANCE, THE FIRM AND INVESTOR CAPITALISM 63 (2016) (arguing that interpreting a "shareholder welfare agenda" from Berle & Means "is a narrow-minded and essentially faulty reading of Berle and Means's work"). How Berle & Means's work, inspired by a collectivist tradition, became a hallmark for unbridled individualism remains a topic of continued study. *See* Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179, 180–81 (2005).

[37] MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 175 (1976). For contemporary reviews of Eisenberg's book, see Donald E. Schwartz, *In Search of the Corporate Soul*, 87 YALE L.J. 685 (1978).

[38] EISENBERG, *supra* note 37, at 175–76.

[39] Any person who is a firm executive, has a professional relationship with the company, or is a close relative to them is not considered independent. *Id.* at 175.

[40] *Id.* at 176.

[41] *Id.* at 175–76; *see also* Schwartz, *supra* note 37, at 686.

Michael Jensen and William Meckling famously argue that the corporation is constituted by a "nexus of contracts" among individuals.[42] These contracts are, by their nature, agency relationships, whereby one person or entity (the principal) assigns work to a second person or entity (the agent), which then performs that work,[43] typically in exchange for compensation. Agency relationships, though often beneficial, also impose agency costs when the goals of the principal and the agent conflict and when the principal cannot easily monitor what its agent is doing.[44] Without intervention, agents tend to act in pursuit of their own interests rather than the interests of the principal.[45] From the unobserved night-watchman who sleeps on the job to the CEO who surreptitiously usurps value at the expense of shareholders, agency relationships and their costs appear in all walks of economic life.[46] These agency costs, if left unchecked by a board that is unable or unwilling to monitor, may have systemic effects that go beyond the firm.[47] A fundamental goal of corporate governance is to minimize those agency costs that arise from the separation of ownership and control in the most efficient way possible, thereby increasing shareholder value.

Elaborating on these ideas, the predominant model of corporate governance in the United States is director primacy. The Delaware General Corporation Law provides for the centralization of corporate decision-making in the board of directors, stating that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."[48] Under the director primacy model, the corporation serves as a mechanism by which the board retains various factors of production for the enterprise.[49] The board generates capital by selling debt and equity securities to bondholders and shareholders, who serve as risk-bearers.[50] The board acts as a "[p]latonic guardian," serving as the central point for the various contracts that define the

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[42] Michael Jensen & William Meckling, *Theory of the Firm: Managerial, Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310–11 (1976); *see also* Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 821–22 (1999).

[43] Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 58 (1989).

[44] *Id.*

[45] *See* Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 271 (1998).

[46] *See id.*

[47] *See* Kristen N. Johnson, *Macroprudential Regulation: A Sustainable Approach to Regulating Financial Markets*, 2013 U. ILL. L. REV. 881, 890–91 (noting critics that cite the role of incentive-based compensation as a proximate cause of the 2008 financial crisis).

[48] DEL. CODE ANN. tit. 8, § 141(a) (2017).

[49] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003).

[50] *Id.* at 560.

corporation.[51] Directors have authority to control corporate assets, possess exclusive power to approve corporate actions, and are insulated from individual liability through the business judgment rule.[52]

Shareholders, by contrast, have limited rights and are, at best, only able to react to decisions the board has made.[53] These limitations may be normatively justifiable, and even preferred by the shareholders themselves,[54] as shareholders may lack the expertise to intervene in the corporation's affairs.[55] In exchange, the board furthers the interests of shareholders by pursuing the generally accepted goal of shareholder wealth maximization.[56] Boards were once thought to be passive in their interactions with shareholders as well as management.[57] Today, proponents argue, boards are more engaged and have better access to information than boards in the past.[58] They also are more likely to be financially invested in the firm's success—i.e., "to have skin in the game"—through ownership of stock.[59] The notion of board primacy has an intuitive appeal arising from the need for centralized hierarchy and authority in decision-making.[60] That appeal, combined with the increasing influence of

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[51] *Id.*

[52] *See* Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1015, 1023–24.

[53] *Id.*

[54] Lynn A. Stout, *The Mythical Benefits of Shareholder Control,* 93 VA. L. REV. 789, 802–03 (2007). Lynn Stout provocatively questions: "Are investors stupid? Why do they not avoid IPOs with weak shareholder rights? Is it possible that shareholders, like Ulysses, sometimes see advantage in 'tying their own hands' and ceding control over the corporation to directors largely insulated from their own influence?" *Id.* at 803. She concludes that "compelling empirical evidence" exists that "investors themselves often prefer weak shareholder rights." *Id.*

[55] D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation,* 81 TUL. L. REV. 829, 857 (2007) (citing Bainbridge, *supra* note 49, at 568).

[56] *Id. But see* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 738 (2005) (arguing that corporations are not legally required to maximize corporate profits).

[57] Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-First Century*, 21 J. CORP. L. 417, 449 (1996) (noting that a "vast separation" once existed between boards and corporate shareholders "created no impetus for a meaningful link" between the two). As Melvin Eisenberg explains:

> Making business policy, although widely held to be a central board function, is usually beyond the competence of the board, since a corporate organ cannot be meaningfully involved in making business policy unless its members are highly active, and it is not realistic to expect a high degree of activity from the board.

MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 169 (photo. reprint 2006) (1976).

[58] Bainbridge, *supra* note 49, at 563.

[59] *Id.*

[60] Telman, *supra* note 55, at 861.

independent board members to better detect managerial misconduct, reinforces board primacy as an appealing conception of corporate governance.[61]

Team production theory, most prominently associated with Margaret Blair and Lynn Stout, also vests decision-making authority in the board of directors but suggests a different set of responsibilities.[62] The board acts as a "mediating hierarch" that balances the interests of corporate constituencies and, as a result, successfully manages the challenges associated with coordination and investment associated with productive economic activity.[63] In this capacity, directors are not merely agents maximizing rents on behalf of other interests.[64] Rather, they balance the interests of various constituents in order to ensure that the coalition of shareholders, managers, and other interests remain intact.[65] This is similar to the essential functions of organizations themselves, whereby inputs from a variety of interest groups, such as employees, managers, and creditors, coordinate to produce outputs for the firm.[66]

B. The Problem of Agency Costs and the Rationale for Shareholder Empowerment

In practice, boards do, in fact, delegate substantial authority to management.[67] The day-to-day power of the corporation still rests primarily in the hands of the CEO.[68] The notion that corporate management should be the strategic center of the corporation is known as managerial primacy.[69] The

[61] *See id.* at 855–56.

[62] Brian R. Cheffins, *The Team Production Model as a Paradigm,* 38 SEATTLE U. L. REV. 397, 399 (2015) ("[I]t is doubtful whether the team production model constitutes a sufficiently radical departure from other theories to qualify as a new paradigm."). According to Cheffins, the original conception of team production theory sought to refine, rather than reject, prevailing models. *Id.*

[63] Blair & Stout, *supra* note 12, at 271–87. For a historical perspective on team production, see Ron Harris, *The History of Team Production Theory*, 38 SEATTLE U. L. REV. 537 (2015).

[64] Blair & Stout, *supra* note 12, at 280.

[65] *Id.* at 280–81.

[66] Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 745 (1999).

[67] *See* Usha Rodrigues, *A Conflict Primacy Model of the Public Board*, 2013 U. ILL. L. REV. 1051, 1067 (noting the ways that executives handle most corporate decisions).

[68] *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 19 (2008). However, Bainbridge also argues that the balance of power in corporations is shifting toward boards and away from CEOs. *Id.*; *see also* EISENBERG, *supra* note 37, at 140 (stating that "[a]ll serious students of corporate affairs recognize that [management of] . . . the corporation's business in the ordinary meaning of that term . . . is vested in the executives"); Telman, *supra* note 55, at 859 ("[M]anagerialism seems to have a far stronger empirical basis than the director-primacy model . . . .").

[69] *See* Robert B. Thompson, *Anti-Primacy: Sharing Power in American Corporations*, 71 BUS. LAW. 381, 397 (2016) (characterizing managerial primacy as the dominance of the CEO and top executives).

CEO and other corporate executives retain control over production, bureaucracy, and employee opportunity.[70] They act as "stewards" who guide the corporation in the interests of numerous stakeholders, including shareholders, customers, employees, and society.[71] From this perspective, "power, prestige, and job security"—rather than pure profit-seeking—motivate managers.[72]

The CEO and other corporate officers, like board directors, owe fiduciary duties as agents to the corporation under state corporate law.[73] Managerial primacy, however, enables executives to engage in self-enriching behavior and inefficient activities.[74] Executives are prone to conflicts of interest between their individual interests and those of their firms.[75] Modern corporate governance scholarship has been largely devoted to finding more effective ways to align the incentives of managers and shareholders, who hold residual claims on the firm and therefore bear most of the economic risk of managerial decisions.[76]

One way to align the incentives of managers and shareholders is through variable executive compensation, such as pay-for-performance and stock option packages.[77] Incentive pay has become a standard component of executive remuneration.[78] In a little over a decade since the early 2000s, the average compensation of CEOs has more than doubled, from approximately three million dollars to over seven million dollars.[79] Even proponents of director primacy have questioned whether directors are capable of holding managers ac-

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[70] William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1476 (1989).

[71] *Id.*

[72] *Id.* at 1494 (citing GARDINER C. MEANS, THE CORPORATE REVOLUTION IN AMERICA 171 (1962)).

[73] Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1600 n.10 (2005).

[74] Yaron Nili, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157, 162 (2014).

[75] *See* Rodrigues, *supra* note 67, at 1070–71 (citing executive compensation as an example).

[76] Gilson & Whitehead, *supra* note 16, at 232, 241; *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67–68 (1991) (explaining why shareholders are incentivized to maximize firm value).

[77] *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 225–26 (1990); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, but How*, HARV. BUS. REV., May-June 1990, at 138, 139.

[78] Carola Frydman & Dirk Jenter, *CEO Compensation*, ANN. REV. FIN. ECON., Dec. 2010, at 84–86; Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 679 (1998) (identifying various factors that dramatically increased the relationship between pay and performance).

[79] Lee Harris, *CEO Retention,* 65 FLA. L. REV. 1753, 1762 (2013).

countable to shareholders through internally-derived and internally-enforced incentives alone.[80]

Advocates of shareholder empowerment argue that shareholders—rather than boards—must be given more direct control over the levers of corporate governance to ensure that managers do not shirk their fiduciary duties by extracting private benefits from the firm.[81] Many proponents analogize shareholders as owners of the corporation and the corporation as the property of shareholders.[82] Shareholders of American corporations, however, have weak and heavily qualified independent powers under state corporate law.[83] Chris Bruner analogizes U.S. shareholders to "spectators" that must entrust the firm to management ex ante and then sue after the fact if things go wrong.[84] Under state corporate law, the primary source of shareholder authority is the power to elect and replace directors.[85] Shareholders, however, face numerous legal obstacles that impede their ability to exercise this right.[86] For the most part, shareholders have three ways to ensure the value of their investment in the corporation: they can vote, sell, or sue.[87] As a result of these limitations, cor-

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[80] *See* Ribstein, *supra* note 3, at 198 ("[T]here is a question whether 'board primacy' adequately deals with agency costs."). For example, managers have the potential to unfairly influence the board of directors and demand compensation that would be considered excessive in an arms-length negotiation. BEBCHUK & FRIED, *supra* note 11, at 62.

[81] *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 678–82 (2007); *see also* BAINBRIDGE, *supra* note 68, at 21 (defining shareholder primacy as the view that "shareholders do (and should) exercise ultimate control of the corporate enterprise"); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (declaring that there is "no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value").

[82] Bruner, *supra* note 15, at 1405; *see also* David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 230–31 (1991) (describing that shareholders hold corporations as property); Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32–33 (characterizing shareholders as owners of the firm). *But see* Daniel J.H. Greenwood, *Introduction to the Metaphors of Corporate Law*, 4 SEATTLE J. SOC. JUST. 273, 279–80 (2005) (listing traditional property rights that shareholders do not possess).

[83] *See* Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. 579, 593–603 (2011).

[84] Bruner, *supra* note 23, at 333 (contrasting with the more active "stewardship" role of U.K. shareholders).

[85] Bebchuk, *supra* note 6, at 851 (citing DEL. CODE ANN. tit. 8, § 141(k) (2013)).

[86] Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 44–46, 64–66 (2003) (noting the lack of shareholder access to the proxy statement).

[87] George S. Geis, *Ex-Ante Corporate Governance*, 41 J. CORP. L. 609, 613 (2016) ("Equity owners may expel lousy directors during annual elections, launch a lawsuit to punish bad managers, or just sell their shares in disgust and walk away."); Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 L. & CONTEMP. PROBS. 215, 216–17 (1999).

porate governance remains an imperfect system of reinforcing and aligning incentives of parties that have economic interests in the firm.

II. Shareholder Empowerment and Corporate Governance by Regulatory Intervention

To enhance the accountability of managers, regulatory mandates enacted under federal securities law, most notably SOX and the Dodd-Frank Act, seek to empower shareholders. Regulation has boosted the ability of shareholders to monitor and intervene in corporate governance decision-making. The following discussion examines this form of regulatory intervention in corporate governance, highlighting its appeal and shortcomings, and suggesting that these measures alone cannot comprehensively resolve the conundrum of management autonomy and the principal-agent problem.

A. The Application of Federal Securities Law to Empower Shareholders

Shareholder empowerment relies on regulatory intervention through federal securities law. The enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act) created a mechanism for federal intervention in corporate governance.[88] The rulemaking powers of the Securities and Exchange Commission (SEC), created by the Securities Act, transformed corporate governance from a market-based approach, based on broad discretion afforded to boards under Delaware corporate law, to a government-sponsored approach, in which federal rules establish procedural requirements on U.S. publicly-listed corporations.[89] Federal securities regulation has been the focus of reform initiatives that constrain management's ability to disregard shareholders demands.[90] These reforms fall into two broad categories: regulations that enable shareholders to monitor manager behavior and regulations that permit shareholders to intervene in traditionally management-led corporate decision-making.

The SEC seeks to protect investors (both current shareholders and other capital market participants),[91] and "its main tool is mandatory disclosure."[92]

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[88] *See* Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 Wm. & Mary L. Rev. 2075, 2114 (2016).

[89] *See* Arevik Avedian et al., Corporate Governance and the Creation of the SEC 1–2 (Swedish House of Finance Res. Paper, No. 15–03, 2015), https://ssrn.com/abstract=2498007 [https://perma.cc/3VM2-STEG].

[90] *See* Rose & Sharfman, *supra* note 52, at 1019–20.

[91] *See* Symposium, *Micro-Symposium on Competing Theories of Corporate Governance*, 62 UCLA L. Rev. Disc. 66, 71–72 (2014), https://www.uclalawreview.org/pdf/discourse/62-4.pdf (distinguishing between "shareholder primacy" and "investor primacy" and arguing that federal corporate governance regulation follows the latter); *see also* Nili, *supra* note 74, at 170 (asking

An oft-cited rationale for disclosure is a corollary of Louis Brandeis' famous statement, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[93] Aside from providing investment-related information to investors, SEC disclosure rules are also intended to shape corporate governance by facilitating shareholder monitoring.[94] Disclosure requirements indirectly reduce agency costs by deterring managerial misconduct through the threat of public exposure.[95] SEC Rule 10b-5 fraud liability, to cite one example, strengthens fiduciary duties by enabling investors to identify an insider's wrongdoing.[96] SEC rules and regulations governing mandatory disclosure delineate the procedural and substantive scope of communication by corporations to shareholders.[97] The Exchange Act requires the ongoing disclosure of extensive information regarding a company's management, risks, operations, and financial condition, among other information.[98]

SOX embraced federal regulatory intervention into corporate governance and serves as an important means to protect and empower shareholders.[99] A key component of SOX is disclosure.[100] Among its disclosure provi-

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whether holders of bonds, convertible debt, and preferred stock should be considered shareholders).

[92] Usha Rodrigues & Mike Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 VA. L. REV. 1, 11 (2010); *see also* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 612 (2003) (noting the federalization of corporate reporting and accounting practices).

[93] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY—AND HOW THE BANKERS USE IT 92 (1914).

[94] *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1270 (1999) (citing the SEC's own stated justification for requiring disclosure of corporate governance arrangements).

[95] Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 151–52 (2006); *see also* Williams, *supra* note 94, at 1282–84 (arguing that disclosure of a firm's compliance with the law enables investors to assess the integrity of management).

[96] Roe, *supra* note 92, at 616 (stating that "[e]x ante, to force disclosure that 'this company is run by thieves' usually keeps the thieves out").

[97] Tamara C. Belinfanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789, 838 (2014) (comparing Regulation FD's process-oriented ban on selective disclosure and liability for material omissions or misrepresentations in SEC-regulated communications under SEC Rule 10b-5).

[98] *See generally* 15 U.S.C. § 78a–qq (2012).

[99] Cynthia A. Glassman, SEC Commissioner, stated:

> "[G]ood" corporate governance is intended to cause corporate decisions to take appropriate account of the various (and sometimes conflicting) constituencies whose interests the corporation must take into account[.] Sarbanes-Oxley codifies certain standards of "good" governance into specific requirements, the idea being that some responsibilities are too important to be left to loose concepts of fiduciary responsibility, and also that more severe treatment in the breach can provide a strong incentive to avoid such failures.

sions is Section 406, which requires a company to disclose its code of ethics and any waivers granted to its top three executives.[101] These disclosure requirements were specifically designed to prevent Enron-style related party transactions, which traditionally have been subject to state corporate law.[102]

The Dodd-Frank Act, the second major corporate governance reform following SOX, includes extensive disclosure-oriented provisions under federal securities law. These provisions seek to reduce information asymmetries between managers and shareholders by enhancing disclosure requirements regarding various aspects of executive compensation.[103] In addition, the Dodd-Frank Act introduced mandatory social disclosure in federal securities law.[104] These mandatory social disclosures rely on targeted disclosure of specific adverse social impacts, coupled with "due diligence, monitoring, auditing, and supply chain management requirements," to change corporate behavior.[105] Companies can use their compliance with mandatory social disclosure

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Cynthia A. Glassman, Comm'r, Sec. & Exch. Comm'n, Speech at the American Society of Corporate Secretaries: Sarbanes-Oxley and the Idea of "Good" Governance (Sept. 27, 2002).

[100] *See* Ripken, *supra* note 95, at 189 (criticizing SOX's reliance on disclosure).

[101] 15 U.S.C. § 7264 (2012).

[102] Rodrigues & Stegemoller, *supra* note 92, at 5, 16.

[103] Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 94–95 (2011).

[104] Section 1502 requires disclosure of the use of so-called conflict minerals associated with armed conflict and human rights abuses in the Democratic Republic of Congo. Dodd-Frank Act § 1502 (codified as amended at 17 C.F.R. §§ 240, 249 (2015)). Section 1504 requires disclosure of any payments to foreign governments for the commercial development of oil, natural gas, or minerals. Dodd-Frank Act § 1504 (codified at 17 C.F.R. §§ 229, 249 (2015)). Supporters and critics have disputed the relative benefit and costs of conflict minerals reporting. *Compare* Galit A. Sarfaty, *Human Rights Meets Securities Regulation*, 54 VA. J. INT'L L. 97 (2013) (arguing that securities law can further corporate accountability and human rights compliance), *with* Karen E. Woody, *Conflict Minerals Legislation: The SEC's New Role as Diplomatic and Humanitarian Watchdog*, 81 FORDHAM. L. REV. 1315 (2012) (arguing that conflict minerals reporting is overly costly and wholly ineffective as a means to address human rights). The future of these regulations is highly uncertain. The SEC's regulations on Section 1504 were rescinded in February 2017. *See* Steven Mufson, *Trump Signs Law Rolling Back Disclosure Rule for Energy and Mining Companies*, WASH. POST (Feb. 14, 2017, 2:34 PM), https://www.washingtonpost.com/business/economy/trump-signs-law-rolling-back-disclosure-rule-for-energy-and-mining-companies/2017/02/14/ccd93e90-f2cd-11e6-b9c9-e83fce42fb61_story.html?utm_term=.7e1ed9179468 [https://perma.cc/J4QL-EBPZ]. In January 2017, the SEC announced its intention to reconsider the appropriateness of Section 1502. *See* Sec. & Exch. Comm'n, Acting Chairman Michael S. Piwowar, Public Statement, Reconsideration of Conflict Minerals Rule Implementation (Jan. 31, 2017), https://www.sec.gov/news/statement/reconsideration-of-conflict-minerals-rule-implementation.html [https://perma.cc/B47C-BFTH].

[105] Stephen Kim Park, *Targeted Social Transparency as Global Corporate Strategy*, 35 NW. J. INT'L L. & BUS. 87, 123 (2014); *see also* Williams, *supra* note 94, at 1295 ("[M]easuring social and environmental effects in a consistent, comparable way could act as an impetus for management to reduce those impacts that shareholders could interpret as negative.").

requirements to signal their socially responsible conduct to shareholders.[106] Regulators, such as the SEC, can help coordinate and enforce emerging norms and best practices arising from these requirements.[107] It is unclear, however, whether shareholders—rather than other stakeholders and society generally—should be the primary beneficiaries of mandatory social disclosure.[108]

Other corporate governance reforms under federal securities law seek to reduce hurdles to shareholder intervention in management decisions.[109] Most important and prominent among these reforms is access to the shareholder proxy. The proxy process permits any shareholders that are not present at the annual meeting to vote.[110] Section 14(a) of the Exchange Act grants the SEC the authority to regulate the shareholder proxy solicitation process.[111] Proxy access implicates two distinct, yet interrelated, rights that shareholders may exercise: the right to elect directors and the right to include proposals in the corporation's proxy solicitation.[112] The expansion of these rights lies at the heart of the fierce debates among practitioners and legal scholars about shareholder power.

With respect to board elections, shareholder power is limited at times. Management, in their discretion, can exclude from its proxy materials a shareholder proposal that relates to the nomination or election of board directors, unless otherwise permitted under the corporation's by-laws.[113] Shareholders, consequently, must conduct and finance director nominations on their own.[114] Shareholder advocates have fought for SEC regulations that

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[106] *See* Park, *supra* note 105, at 124.

[107] Belinfanti, *supra* note 97, at 857 (examining integrated reporting and shareholder cultivation).

[108] Barnali Choudhury, *Social Disclosure*, 13 BERKELEY BUS. L.J. 183, 200–01 (2016) (noting disparities in national laws); John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement*, 31 J. CORP. L. 1, 11–12 (2005) (noting a lack of analysis among stakeholders about who counts as a stakeholder, besides investors).

[109] *See* Nili, *supra* note 74, at 167.

[110] David A. Skeel, Jr. et al., *Inside-Out Corporate Governance*, 37 J. CORP. L. 147, 154 (2011).

[111] Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (2012). Section 14(a) expressly grants this regulatory authority "as necessary or appropriate in the public interest or for the protection of investors." *Id.*

[112] *See* Aaron A. Dhir, *Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability*, 43 AM. BUS. L.J. 365, 375–76 (2006) (discussing shareholder proposals in proxy solicitations); Millon, *supra* note 82, at 223 (discussing the right to elect directors).

[113] 17 C.F.R. § 201.14a-8 (2017); *see* DEL. CODE ANN. tit. 8, §§ 112–113 (2017) (permitting bylaws of Delaware corporations to grant shareholders the right to nominate directors to be voted on alongside board-nominated candidates at the firm's expense).

[114] Skeel et al., *supra* note 110, at 154.

would require corporations to permit shareholders to nominate directors directly through the proxy statement, making it easier to replace directors.[115] These arguments grew stronger in the wake of the 2008 financial crisis due to questions about board oversight and accountability.[116] Under the authority granted by Section 971 of the Dodd-Frank Act, the SEC issued new proxy access rules in 2010.[117] SEC Rule 14a-11 would have required a publicly-traded company to include in its proxy materials a candidate nominated by any shareholders that held shares representing at least three percent of the voting power of the company's stock for the past three years.[118] The three-year holding period requirement was intended to address concerns about short-termism—i.e., the need to insulate board directors from pressures exerted by investors *qua* shareholders that prioritize short-term profits over longer-term considerations.[119] The D.C. Circuit Court of Appeals vacated the proxy access rules enacted in 2010, prior to their full implementation.[120]

With respect to other means to effectuate shareholder proposals, shareholders may submit proposals for consideration at the annual meeting.[121] The shareholder proposal mechanism is the most widely recognized and formal method for shareholders to exercise their voice in corporate decision-making.[122] This mechanism is the primary procedural vehicle with which shareholders can shape corporate governance practices ex ante, rather than

[115] *See* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1654 (2013); *see also* Roe, *supra* note 92, at 614 (noting SEC proposed rulemaking in 2003).

[116] Skeel et al., *supra* note 110, at 158 (quoting then-SEC Chairman Mary Schapiro).

[117] *See* Press Release, SEC, SEC Adopts New Measures to Facilitate Director Nominations by Shareholders (Aug. 25, 2010), https://www.sec.gov/news/press/2010/2010-155.htm [https://perma.cc/9VZN-PXCV].

[118] *See generally* Thomas Stratmann & J.W. Verret, *Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?*, 64 STAN. L. REV. 1431 (2012) (analyzing the potential impact of Rule 14a-11).

[119] *See* Bebchuk, *supra* note 115, at 1638–39, 1648; *see also* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,697–99 (Sept. 16, 2010). The problem of short-termism is also the rationale behind tenure (or time-weighted) voting, whereby a shareholder's voting power increases based on the duration of its ownership of the corporation's stock. While the SEC has historically favored uniform voting based on the "one share, one vote" principle, its current policy does not prohibit U.S. stock exchanges from enacting tenure voting rules. *See* David J. Berger, Steven Davidoff Solomon & Aaron J. Benjamin, *Tenure Voting and the U.S. Public Company* 72 BUS. LAW. 295, 318–21 (2017) (noting the enactment of SEC Rule 19c-4 in 1988, which was overturned by the D.C. Circuit Court of Appeals in 1990, and the SEC Voting Rights Policy that is currently in force).

[120] Bus. Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011). The 2010 proxy access rules also included an amended SEC Rule 14a-8(i)(8), which would have required corporations to include shareholder proposals regarding director nomination procedures in their proxy materials.

[121] 17 C.F.R. § 240.14a-8(b) (setting forth the criteria that a shareholder must meet to submit a proposal).

[122] *See* Roe, *supra* note 92, at 622 (declaring that "voice . . . is a means to power").

relying on their right to vote, sue, or sell their shares.[123] A shareholder proposal typically consists of a resolution that proposes a policy or a standard to be adopted and an accompanying explanatory statement.[124] Management must include shareholder proposals in its proxy materials, unless it can demonstrate to the SEC that it is entitled to exclude it.[125] Among the permissible substantive justifications for excluding a shareholder proposal is if the proposal deals with a matter relating to the company's ordinary business operations.[126] A shareholder proposal that receives a majority vote of the shareholders is only advisory—unless it concerns an action reserved for the board under the corporation's charter.[127] Nonetheless, through the shareholder proposal mechanism, shareholders can seek to influence corporate decision-making by advocating for specific causes.[128] In particular, the shareholder proposal mechanism is increasingly attractive to activist shareholders seeking to compel greater attention to social and environmental issues.[129] Even though most proposals are precatory, the mere possibility of strong shareholder support may pressure the board to respond or to negotiate an accommodation.[130] Shareholders benefit by being able to voice their concerns to

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[123] *See* Geis, *supra* note 87, at 613–22.

[124] Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 126 YALE L.J. 262, 274–75 (2016).

[125] 17 C.F.R. § 240.14a-8(g) ("Except as otherwise noted, the burden is on the company to demonstrate that it is entitled to exclude a proposal.").

[126] *Id.* § 240.14a-8(i)(7). The opaqueness of the ordinary business exclusion has spurred pro-activist scholars to argue for its abandonment or for certain topics to be carved out. *See, e.g.*, Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 89–97 (2010) (distinguishing political contributions from ordinary business decisions); Dhir, *supra* note 112, at 408 (citing calls to eliminate the ordinary business exception in order to facilitate corporate social accountability).

[127] 17 C.F.R. § 240.14a-8(i)(7).

[128] *See* Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 661 (2016) (describing shareholder proposals as "the most widely used and least expensive means of shareholder activism [that] are typically part of a multifaceted campaign of sustained engagement between an activist and the board or corporate management").

[129] *See* Bebchuk & Jackson, *supra* note 126, at 96 (noting the SEC's recognition of the depth of interest among shareholders in social policy issues); Dhir, *supra* note 112, at 382–83 (noting the growing use of shareholder proposals since the 1970s to force companies to address their human rights and labor practices). The most common social responsibility proposals relate to political contributions and lobbying disclosure, greenhouse gas emissions, climate change and sustainability. Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 223 (2018).

[130] Geis, *supra* note 87, at 614. *But see* Joseph Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 380–83 (2010) (criticizing the "megaphone externalities" of proxy access); Haan, *supra* note 124, at 300–02 (identifying the preponderance of settlements between management and shareholders regarding social and environmental proposals and suggesting that such proposals are particularly vulnerable to opportunism, conflicts of interest, and information asymmetries).

management and other shareholders.[131] However, various costs (in terms of corporate resources and shareholder attention), coupled with very low rates of success, suggest that the impact of shareholder proposals on firm value is uncertain at best.[132]

B. The Limitations of Shareholder Empowerment

Shareholder empowerment has been the focal point of immense regulatory and organizational resources in the past couple decades. Its limitations, however, suggest that faith in this approach to corporate governance should be tempered. As this Article will briefly explain, shareholder empowerment is, in itself, insufficient to minimize agency costs and justify the costs associated with regulatory intervention, at least as a general rule and practice.

First and foremost, shareholder empowerment is hampered by the challenges of collective action, thereby weakening the case for proxy access and other regulatory interventions.[133] The nature of modern capital markets diminishes both the capacity and the willingness of shareholders to participate in corporate governance, belying Berle and Means' archetype of vigilant shareholders imposing checks on management.[134] Institutional investors (e.g., pension funds and mutual funds), which manage large blocks of equity stock on behalf of individual beneficiaries, lack sufficient economic incentives to devote resources to monitor management.[135] Coordination mechanisms are too expensive and cumbersome to enable shareholders to exercise control over the firm.[136] Shareholders are too disengaged to feasibly monitor manag-

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[131] *See* Haan, *supra* note 124, at 290, 292–93 (describing shareholder proposals as a "powerful warning shot in the board's direction" and "the communication of shareholders' expressive interests"); David F. Larcker & Brian Tayan, *Gadflies at the Gate: Why Do Individual Investors Sponsor Shareholder Resolutions?* STAN. CLOSER LOOK SERIES, Aug. 2016, at 3, https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-59-gadlies-at-gate.pdf [https://perma.cc/BTD7-JYH8] (citing instances in which individual shareholder activists were able to successfully change corporate policies and practices).

[132] *See* Hirst, *supra* note 129, at 224 (noting that among the eleven most common types of social responsibility resolutions voted on at annual meetings in 2014, only one (out of 171 total) passed); *see also* Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014), https://www.sec.gov/news/speech/2014-spch032714dmg.html [https://perma.cc/J2RB-FVV4] (arguing that "the vast majority of proposals are brought by individuals or institutions with idiosyncratic and often political agendas that are often unrelated to, or in conflict with, the interests of other shareholders").

[133] *See* Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1239 (2004).

[134] *See supra* notes 36–66 and accompanying text.

[135] Nili, *supra* note 74, at 169.

[136] Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 789 (2011); *see also* Ribstein, *supra* note 3, at 200 (noting the high decision-making costs of enhanc-

ers on potential conflicts of interests and self-dealing.[137] Frequently, institutional investors *qua* shareholders choose to sell rather than exercise their governance rights.[138] Ex ante, the ability and willingness of institutional investors to exit emboldens them to overlook—or even encourage—risk-taking by managers.[139] It is unclear, at best, if regulation that addresses short-termism can combat any of these kinds of managerial behavior.[140]

In addition, the use of regulatory intervention to empower shareholders transforms the principal-agent problem from a question of internal governance to one of external mandates.[141] Many regulatory reforms under the Dodd-Frank Act, such as proxy access and say-on-pay, empower shareholders for the purpose of improving risk management.[142] This touches on an existential debate in corporate governance theory: the extent that directors and managers are legally obligated to maximize shareholder value to the exclusion of the public interest.[143] Federal securities regulation incentivizes—or forces—

ing shareholder participation). Proxy advisory firms, which provide firm-specific information for institutional investor clients, fill this informational gap. *See* Haan, *supra* note 124, at 314–16.

[137] Rodrigues, *supra* note 67, at 1082; *see also* Elhauge, *supra* note 56, at 799 (noting that public shareholders as a group do not pursue moral or social goals even if individual shareholders deem them important).

[138] 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, 893 (2013). The authors describe the decision to exit in the following terms:

> [A]ssume that the portfolio manager decides that a portfolio company is underperforming. The most assured way to grab the value of that insight is selling the stock rather than incurring the costs and speculative future benefits of a shareholder intervention. That is, the fact of poor governance or poor management at a portfolio company may be an element in comparative evaluation, but the indicated action for the institution—but not its beneficiaries—may be to "sell," not to "intervene."

Id.

[139] *See* Christopher M. Bruner, *Conceptions of Corporate Purpose in Post-Crisis Financial Firms*, 36 SEATTLE U. L. REV. 527, 557 (2013) ("There is simply no reason to believe that stronger shareholders would have mitigated risk-taking in the run-up to the crisis or could be expected to do so moving forward . . . .").

[140] *See* Simmons, *supra* note 7, at 1157.

[141] *See* Griffith, *supra* note 88, at 2115 (arguing that federal securities regulation "effectively creates mandatory terms of corporate governance").

[142] *See* Johnson, *supra* note 103, at 97–100 (describing substantive governance reforms under the Dodd-Frank Act). "Say-on-pay" rules require that corporations hold advisory shareholder votes on executive compensation. *See* Dodd-Frank Act § 951.

[143] *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 406 (2001) (noting constituency statutes that permit directors to consider the interests of non-shareholders even at the expense of stock value); Elhauge, *supra* note 56, at 756–57 (noting different views on the fiduciary duty to avoid profit-maximizing illegality); *see also* Steven L. Schwarcz, *Misalignment: Corporate Risk-Taking and Public Duty*, 92 NOTRE DAME L. REV. 1, 23–44 (2016) (proposing a public governance duty that

the firm to prioritize social goals, such as deterring insider trading or preventing short-sighted risk taking.[144] Accordingly, to the extent that shareholders prioritize profits over social welfare, regulatory intervention may trigger a conflict between non-shareholder interests and shareholder goals.[145] In sum, though all of these measures have their respective benefits, they alone cannot comprehensively resolve the conundrum of management autonomy and the principal-agent problem.

III. INSIDE THE BLACK BOX: THE THREE ELEMENTS OF ORGANIC CORPORATE GOVERNANCE

In organizational terms, a black box paradigm operates on the assumption that a company is a single, unified, and monolithic entity that makes decisions similar to the manner individuals do.[146] This entity is also assumed to make decisions entirely rationally and with the dominant goal of maximizing profits.[147] Individual features of the firm, as well as individual incentives, are generally set aside.[148] Scholars advocate opening the black box of the firm in order to better understand the minds and motivations of individual participants,[149] but the tendency to treat the enterprise as unitary remains a convenient shortcut for discussing organizations. Although more recent corporate governance research has sought to study the inner working of firms,[150] inter-

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would impose an affirmative duty on managers of systemically important firms, such as global financial institutions, not to engage in excessive risk-taking).

144 *See* Griffith, *supra* note 88, at 2124–25.

145 *See* Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 964 (2017); *see also* J. Haskell Murray, *Adopting Stakeholder Advisory Boards*, 54 AM. BUS. L.J. 61, 78–81 (2017) (describing proposals to empower social investors and long-term shareholders in order to protect stakeholders). *But see* Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1444–45 (2006) (arguing that profit-motivated shareholders are concerned about social harms that increase liability or trigger future regulation); Paul Weitzel & Zachariah J. Rodgers, *Broad Shareholder Value and the Inevitable Role of Conscience*, 12 N.Y.U. J.L. & BUS. 35, 37–38 (2015) (arguing that stakeholder-based theories of corporate governance do not accord with Delaware corporate law and advancing a broad shareholder value norm as an alternative model to shareholder wealth maximization).

146 Paul M. Schwartz & Edward J. Janger, *Notification of Data Security Breaches*, 105 MICH. L. REV. 913, 925 (2007).

147 Timothy F. Malloy, *Regulating by Incentives: Myths, Models, and Micromarkets*, 80 TEX. L. REV. 531, 532–33 & n.6 (2002).

148 *Id.*

149 Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 873 (1993) (explaining that in order to develop a viable organizational theory, one must "break open the black box called the firm, and this means understanding how organizations and the people in them work"); *see also* Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459, 1464 (2005).

150 René Reich-Graefe, *Deconstructing Corporate Governance: Director Primacy Without Principle?*, 16 FORDHAM J. CORP. & FIN. L. 465, 480 (2011).

nal forces that motivate organizational actors remain underexplored. The following discussion shows how three organizational dynamics—rules that govern, ties that bind, and incentives that control—operate together to generate behavior that is conducive to corporate governance even in environments of weak formal governance, insufficient regulation, and self-centered behavior.[151]

A. Compliance: The Rules That Govern

For organic governance to work, firms need benchmarks to establish how the firm shall be governed. The most significant source of such benchmarks is the compliance function of the organization. Compliance consists of an organization's "system of policies and controls" that "deter[s] violations of law" by its members and "assure[s] external authorities" that it is undertaking sufficient deterrence measures.[152] Compliance aligns employee conduct with the external legal and ethical obligations of the firm by ensuring that employees act lawfully and ethically, enabling the monitoring and reporting of violations, and taking measures to prevent future violations.[153] To meet these objectives, the compliance function is responsible for implementing a code of ethics and conduct, creating and managing internal procedures to ensure compliance with legal mandates, and developing legal and ethical training programs.[154] The compliance function within a given corporation encompasses a broad range of substantive legal and regulatory obligations.[155] The need to amass resources has spurred the emergence of a new professional field, devoted to compliance related to, but distinct from, the legal profession.[156] The influence of the compliance function on corporate decision-

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[151] *See supra* notes 10–13 and accompanying text; *see also* Brick et al., *supra* note 11 (finding that CEO and director compensation are positively correlated even when correcting for various factors). The author concludes that a "positive relation between these variables reflects cronyism, whereby the board and CEO are more concerned with selfish objectives than with protecting shareholder interests." *Id.*

[152] *See* Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 958 (2009).

[153] *See* David Hess, *A Business Ethics Perspective on Sarbanes-Oxley and the Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781, 1789 (2007).

[154] Tanina Rostain, *General Counsel in the Age of Compliance: Preliminary Findings and New Research Questions*, 21 GEO. J. LEGAL ETHICS 465, 466–67 (2008).

[155] *See* Michele DeStefano, *Creating a Culture of Compliance: Why Departmentalization May Not Be the Answer*, 10 HASTINGS BUS. L.J. 71, 96–97 (2014); *see also* Griffith, *supra* note 88, at 2103–04 (noting convergence towards more robust compliance functions, featuring dedicated compliance officers, across different industries).

[156] *See* DeStefano, *supra* note 155, at 101–03 (stating that the compliance function requires both legal expertise and corporate management skills); Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance?*, 34 J. CORP. L. 679, 692–94 (2009) (describing the development of the compliance profession); Rostain, *supra* note 154, at 468–69 (noting the need for multidisciplinary expertise in compliance); *see also* Bird & Park, *supra* note 34, at 204–

making has become so significant that it has prompted legal scholars to declare compliance "the new corporate governance"[157] and "a universal corporate governance activity."[158]

Compliance sets the benchmark to which governance practices adhere. Compliance drives its influence from at least two sources. The first source of compliance's authority is the growing range of criminal laws that require or encourage firms to invest in more compliance.[159] One example arises in the context of corporate prosecutions. A firm that enters into a settlement agreement with a government prosecutor or regulatory agency may be subject to a corporate monitor.[160] A corporate monitor, selected by the government, is responsible for ensuring that the firm improves its internal policies and procedures to prevent future wrongdoing.[161] As a condition of agreeing not to prosecute (through a consent decree, deferred prosecution agreement, or non-prosecution agreement), the government increasingly requires that the defendant corporation invest significant resources to reform its compliance practices.[162] Other examples arise through federal laws that incentivize companies to invest in compliance—most notably, the federal sentencing guidelines.[163] These investments in compliance—whether directly mandated or indirectly incentivized—involve the implementation of structural and institutional changes that otherwise would be under the purview of senior management or the board.[164] Further, based on the premise that a robust compliance

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07 (describing the ongoing debate about the authority of in-house counsel versus compliance officers over the compliance function).

[157] Griffith, *supra* note 88, at 2075.

[158] Baer, *supra* note 152, at 952.

[159] *See supra* notes 18–19 and accompanying text.

[160] *See* Ford & Hess, *supra* note 156, at 680 (identifying corporate monitors as "a common feature of corporate crime enforcement").

[161] *Id*. at 680, 689.

[162] Griffith, *supra* note 88, at 2088; *see also* Ford & Hess, *supra* note 156, at 708 (describing the far-reaching powers over corporate governance exercised by WorldCom's monitor).

[163] *See* U.S. SENTENCING COMM'N, GUIDELINES MANUAL § 8B2.1 (2016), http://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2016/GLMFull.pdf [https://perma.cc/BW62-6YZN] (providing for a reduced sentence if the corporation can prove an "effective" compliance program was in place to prevent the illegal activity); *see also* Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1215, 1231–33 (2017) (identifying compliance-related mandates in SOX and the Dodd-Frank Act).

[164] As Sean Griffith observes:

> [I]f boards must erect a compliance function, then the development of compliance has in fact supplanted some authority of the board . . . . Boards do not delegate authority to compliance. They cede it. In spite of the board's traditional authority to manage internal corporate affairs, the ultimate source of authority for compliance is derived not from the board, but from the government.

function alters the internal incentives of managers ex ante, these measures attempt to shape corporate governance by improving corporate culture.[165]

The second source of compliance authority comes from the multiplier effect compliance has on external regulatory mandates. This multiplier effect creates monitoring and enforcement mechanisms that—although managed by in-house lawyers or, increasingly, compliance officers—diffuse across the entire organization.[166] In particular, compliance is often integrated with a firm's risk management function.[167] Firms assess how much to invest in compliance (e.g., employee training, internal controls systems, incentives and penalties to encourage compliance) based on the risk of non-compliance or compliance risk.[168] Firm-wide policies and procedures, traditionally derived from mandates and principles established by the board, are increasingly promulgated through enterprise risk management ("ERM"). ERM involves the identification, analysis, and management of enterprise-wide risks to aid the firm's decision-making.[169] In an ERM framework, all sources and effects of risk—including compliance risk—are addressed as part of a holistic process.[170] ERM is a top-down approach that relies on the board and senior managers to create a risk culture within the organization and, therefore, ascertain

Griffith, *supra* note 88, at 2108–09; *see also* DeStefano, *supra* note 155, at 105–10 (summarizing examples of settlement agreements in which corporations detach the compliance function from the legal department and/or create a chief compliance officer with varying levels of authority and independence).

[165] *See* Baer, *supra* note 152, at 965; Griffith, *supra* note 88, at 2093; *see also* Hess, *supra* note 153, at 1793–1804 (analyzing compliance programs and concluding that when such programs follow an integrity-based approach, they can improve ethical behavior).

[166] *See* Rostain, *supra* note 154, at 468 (noting the de-centralization of compliance responsibilities).

[167] *See* Simmons, *supra* note 7, at 1146; *see also* Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 978–81 (2009) (noting the similarities between compliance and risk management).

[168] *See* Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance Into Competitive Advantage*, 19 U. PA. J. BUS. L. 285, 298 (2017); *see also* BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, COMPLIANCE AND THE COMPLIANCE FUNCTION IN BANKS 7 (2005), http://www.bis.org/publ/bcbs113.pdf [https://perma.cc/GVG5-LJM8] (defining compliance risk in the banking context as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities").

[169] COMM. OF SPONSORING ORG. OF THE TREADWAY COMM'N, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK 2 (2004), http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf [https://perma.cc/MLQ2-RBT7] (defining ERM as "a process . . . designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, [and] to provide reasonable assurance regarding the achievement of entity objectives").

[170] Michelle M. Harner, *Barriers to Effective Risk Management*, 40 SETON HALL L. REV. 1323, 1332 (2010); Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 571, 581 (2008).

the firm's risk appetite.[171] ERM, in conjunction with compliance, establishes the rules that govern the organization, and the more robust the compliance system, the more readily motivated organizational actors can enforce that system to ensure good governance.

B. Firm-Specific Human Capital: The Ties That Bind

Organic corporate governance not only needs rules, but it also requires organizational actors that are motivated to ensure that the appropriate governance rules are carried out. Assume a labor market that is freely competitive. Few transaction costs impede the movement of labor from one position to the other. Further assume that the knowledge employees possess is readily transferable from one employer to another. Under these conditions, when corporate governance erodes or the workplace becomes otherwise unsuitable, employees can simply exit the relationship and sell their labor elsewhere. Employees thus will not have a future stake in the enterprise, and certain actors in particular will lack sufficient incentive to monitor the firm for good governance practices.[172]

Firms can address this problem by encouraging investments in firm-specific human capital. Stated most broadly, human capital is the skills, knowledge, and competencies possessed by a human being.[173] This stock of knowledge includes anything that can contribute to work productivity, including formally acquired knowledge or informally obtained skills and know-how.[174] As the developed world has increasingly evolved from a manufacturing emphasis to a "knowledge society" where individual creativity and intelligence have dominant value, the utilization of human capital has become increasingly important for employers.[175]

Firm-specific human capital, by contrast, is knowledge, skills, and abilities acquired by an employee whose value resides primarily with the firm in

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[171] Harner, *supra* note 170, at 1332–33.

[172] *See* Viral V. Acharya, Stewart C. Myers & Raghuram G. Rajan, *The Internal Governance of Firms*, 66 J. FIN. 689, 703 (2011).

[173] Norman D. Bishara, *Covenants Not to Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment*, 27 BERKELEY J. EMP. & LAB. L. 287, 300 (2006). Nobel Prize-winning economist Gary Becker coined the concept in 1964. *See generally* GARY S. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS WITH SPECIAL REFERENCE TO EDUCATION (1964) (discussing the concept of human capital).

[174] Brett M. Frischmann & Mark P. McKenna, *Systems of Human and Intellectual Capital*, 93 TEXAS L. REV. 231, 237 (2015) (citing Orly Lobel, *The New Cognitive Property: Human Capital Law and the Reach of Intellectual Property*, 93 TEXAS L. REV. 789, 831 (2015)).

[175] Johannes M. Pennings, Kyungmook Lee & Arjen van Witteloostuijn, *Human Capital, Social Capital, and Firm Dissolution*, 41 ACAD. MGMT. REV. 425, 425 (1998).

which such capital was acquired.[176] For example, an employee trained in software uniquely customized for the employer's business possesses firm-specific human capital in using that software. When an automaker trains its employees on the technical aspects of a new vehicle model, the highly-specific capital accumulated by these workers disappears when the model is removed from production.[177] Firm-specific human capital can arise from skills gained via work teams[178] or through human capital skills deployed in a unique combination.[179] Such capital can also include a worker's in-depth understanding of a firm's culture, history, norms, and internal weaknesses and strengths.[180]

What makes firm-specific human capital distinct is that it lacks value outside the firm in which it was developed.[181] As a result, employees that acquire firm-specific human capital suffer a wage penalty if they change jobs.[182] The skills for which the employee was valued and compensated for will not be considered valuable for the new employer. Other firms may even negatively value such capital because it implies knowledge of norms and processes that need to be untrained. Employers may have to compensate for the employee's loss of future return to firm-specific skills.[183] A further cost is imposed on the employer who must endure a decrease in productivity as the newly hired worker learns the new firm's general and idiosyncratic processes.[184]

Firm-specific human capital is, however, important for employers to maintain.[185] Even extremely talented employees with unique skills may be of

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[176] Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm, in* EMPLOYEES AND CORPORATE GOVERNANCE 58, 60 (Margaret M. Blair & Mark J. Roe eds., 1999).

[177] Leonardo Felli & Christopher Harris, *Firm-Specific Training* 3 n.5 (Suntory Ctr., London Sch. Econ. & Pol. Sci., Discussion Paper No. TE/04/473, 2004), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.368.6355&rep=rep1&type=pdf [https://perma.cc/B5EL-46AP].

[178] OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 246–47 (1985).

[179] Edward Lazear, *Firm-Specific Human Capital: A Skill-Weights Approach*, 117 J. POL. ECON. 914, 915 (2009) (offering an example of combined general skills creating firm-specific capital).

[180] Dawn Harris & Constance Helfat, *Specificity of CEO Human Capital and Compensation*, 18 STRATIGIC MGMT. J. 895, 896 (1997).

[181] Pennings, Lee & Witteloostuijn, *supra* note 175, at 426.

[182] Russell Coff & Joseph Raffiee, *Toward a Theory of Perceived Firm-Specific Human Capital*, 29 ACAD. MGMT. PERSP. 326, 327 (2015).

[183] Harris & Helfat, *supra* note 180, at 897 ("The labor economics literature suggests that when workers switch jobs to new firms, they require compensation for the loss of future return to firm-specific skills . . . .").

[184] *Id.*

[185] *See, e.g.*, Nile W. Hatch & Jeffrey H. Dyer, *Human Capital and Learning as a Source of Sustainable Competitive Advantage*, 25 STRATIGIC MGMT. J. 1155, 1173–74 (2008). *See generally* Benjamin A. Campbell, *Rethinking Sustained Competitive Advantage from Human Capital*, 37 ACAD. MGMT. REV. 376 (2012) (developing a model of human capital based advantage that accounts for both supply and demand side mobility constraints).

limited competitive value because, in the absence of firm-specific ties, their easy mobility may inhibit the ability of the firm to build a sustainable competitive advantage over rivals.[186] Firm-specific training of employees is costly.[187] When an employee leaves, that employee takes all of their firm-specific knowledge with him or her, and the benefits of the investment in training disappear.[188] These effects, combined with other frictions ranging from family and geographic pressures to restrictions imposed by covenants not to compete,[189] cumulatively result in substantial forces that discourage employees from leaving their jobs even when offered higher wages or better working conditions.

Investments in firm-specific human capital thus form the ties that bind employers and employees together. Employers interested in retaining employees with valuable firm-specific knowledge may continue to invest in those employees to further discourage departure of that knowledge. Conversely, employees that remain with the firm increase their firm-specific investments. This, in turn, deepens the disincentive to depart as the cost of doing so only increases, as firm-specific skills also become a larger portion of their total human capital.

Employees that remain with a single employer not only have an interest in retaining their firm-specific utility in order to maximize their personal returns, but they also have a stake in the enterprise. Voluntary turnover is not the only method by which firm-specific capital is lost. A company can downsize, file for bankruptcy, or otherwise fail due to a wide range of economic, political, or consumer-related causes. If the employer disappears, then the employee's firm-specific investments are taken away. This is no mere inconvenience, as studies of layoffs reveal that long-tenured employees (presumably holding significant firm-specific human capital) who are laid off through no fault of their own, typically earn fifteen to twenty-five percent less from their next employer.[190] It stands to reason that a long-serving employee bound

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[186] Margaret A. Peteraf, *The Cornerstones of Competitive Advantage: A Resource-Based View*, 14 STRATIGIC MGMT. J. 179, 187 (1993) ("A brilliant, Nobel Prize-winning scientist may be a unique resource, but unless he has firm specific ties, his perfect mobility makes him an unlikely source of sustainable advantage.").

[187] Sharon Rabin-Margalioth, *Cross-Employee Redistribution Effects of Mandated Employee Benefits*, 20 HOFSTRA LAB. & EMP. L.J. 311, 326 (2003).

[188] *Id.*

[189] *See* Bishara, *supra* note 173, at 307–10; Brigitte C. Madrian, *Employment-Based Health Insurance and Job Mobility: Is There Evidence of Job-Lock?*, 109 Q.J. ECON. 27, 52 (1994) (finding that the need to maintain health insurance reduces voluntary turnover by twenty five percent).

[190] Blair, *supra* note 176, at 61 (citing studies). Blair notes that these estimates are conservative. *Id.* at 61 n.5.

by firm-specific human capital, therefore, is incentivized to support the present and future operations of the enterprise.

Incentives to support the future success of an individual's employer can manifest in the form of organizational citizenship, which deters employees from engaging in self-interested conduct that harms the firm. Organizational citizenship occurs when employees perform voluntary actions that benefit the organization as a whole, even when the employer has not instituted explicit commands or reward systems to do so.[191] Organizational citizenship can appear as altruism toward the enterprise, but it also manifests in ways that reinforce compliance with the norms, rules, and expectations of the enterprise.[192] One such manifestation is organizational loyalty, which involves supporting organizational objectives, defending the firm from threats, and remaining loyal under adverse conditions.[193] Another manifestation of organizational citizenship is organizational compliance, whereby an employee internalizes adherence to rules and procedures, even in the absence of employer observation.[194] Perhaps the most influential organizational citizenship behavior that promotes good governance is civic virtue. Civic virtue constitutes a loyalty by the employee to the organization as a whole that is expressed through engagement.[195] Employees with civic virtue participate actively in the governance of the firm by attending meetings, expressing viewpoints on policy, and debating ideas.[196] They also monitor the business environment for threats to the organization and seek to serve the organization's best interests, even at significant personal cost.[197]

The result of these various incentives is a class of employees that is intrinsically motivated to monitor the enterprise. Whereas lower-level employees can keep track of daily operations, senior management and C-suite executives monitor organization-wide governance practices. Deviation from good

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[191] Orly Lobel, *Citizenship, Organizational Citizenship, and the Laws of Overlapping Obligations*, 97 CAL. L. REV. 433, 437–38 (2009); *see also* C. Ann Smith, Dennis W. Organ & Janet P. Near, *Organizational Citizenship Behavior: Its Nature and Antecedents*, 68 J. APPLIED PSYCHOL. 653, 653 (1983).

[192] Brian J. Hoffman et al., *Expanding the Criterion Domain? A Quantitative Review of the OCB Literature*, 92 J. APPLIED PSYCHOL. 555, 555 (2007).

[193] Philip M. Podsakoff et al., *Organizational Citizenship Behaviors: A Critical Review of the Theoretical and Empirical Literature and Suggestions for Future Research*, 26 J. MGMT. 513, 517 (2000).

[194] *Id.*

[195] *Id.* at 525; *see also* Jill W. Graham & Lynn Van Dyne, *Gathering Information and Exercising Influence: Two Forms of Civic Virtue Organizational Citizenship Behavior*, 18 EMP. RESP. & RTS. J. 89, 91–92 (2006).

[196] Podsakoff et al., *supra* note 193, at 525; Graham & Van Dyne, *supra* note 195, at 92 ("Exercising influence as a form of civic virtue includes speaking up and making suggestions for change.").

[197] Podsakoff et al., *supra* note 193, at 525.

governance practices can have a negative impact on performance, and, in turn, on managers' own returns.[198] This motivation to monitor the enterprise arises not necessarily from altruism, but from preservation of firm-specific human capital and returns on firm investment. The ties that bind become the ties that monitor, as firm-invested employees act in their own interest to ensure the long-term success of the enterprise.

C. Mutual Monitoring: The Forces That Control

The final force that generates organic corporate governance is mutual monitoring. Mutual monitoring involves the reciprocal oversight of employees in an organization.[199] This oversight, when backed by power to influence, generates control over one another's actions. Significantly, mutual monitoring has the potential to mitigate the agency problem that is endemic to corporations.[200] Through mutual monitoring, the interests of the superior and subordinate agents are aligned. Like the above-described two forces, the alignment of interests that occurs during mutual monitoring is generated, not from external pressure or altruism, but rather as a result of self-interested motivations of organizational actors.[201]

Although mutual monitoring can happen at various levels of the enterprise, this Article focuses on mutual monitoring between the CEO and immediate subordinates. The CEO is the most important executive in the enterprise and has a profound ability to influence corporate governance.[202] Although the CEO has substantial power, this does not mean that he or she has unfettered authority and autonomy. The CEO must function as one member of a top management team.[203] The CEO must work with executives, whose responsi-

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[198] *See, e.g.*, Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (identifying six governance provisions as most significant for managerial entrenchment); Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 144 (2003) (finding a relationship between index of corporate governance measures and stock performance).

[199] *See* Kristy L. Towry, *Control in a Teamwork Environment: The Impact of Social Ties on the Effectiveness of Mutual Monitoring Contracts*, 78 ACCT. REV. 1069, 1070 (2003).

[200] *E.g.*, Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 335 (1983).

[201] *See* Acharya, Myers & Rajan, *supra* note 172, at 704.

[202] *See* Z. Jill Barclift, *Corporate Governance and CEO Dominance*, 50 WASHBURN L.J. 611, 616–21 (2011).

[203] *See* Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378, 378 (2008) (citing Mark Shanley & Margaret A. Peteraf, *Deploying, Leveraging, and Accessing Resources Within and Across Firm Boundaries: Introduction to the Special Issue,* 25 MANAGERIAL & DECISION ECON. 291, 293 (2004)) (describing top management teams as a key component of corporate strategy); Donald C. Hambrick & Phyllis A. Mason, *Upper Echelons: The Organization as a Reflection of Its Top Managers*, 9 ACAD. MGMT. REV. 193, 197 (1984).

bilities only modestly intersect with the CEO's work.[204] The CEO must regularly collaborate with subordinates to do his or her work.[205] Also, limiting the CEO's power is an opportunity for executives to leverage processes to influence the CEO through contact with the board or fellow executives.[206] In extreme circumstances, an executive can bring problems within the firm to the attention of the media or law enforcement.[207] Accordingly, the CEO must, at least minimally, pay attention to the demands of subordinate executives.

Mutual monitoring can usefully be explained through a hypothetical superior-subordinate relationship. Assume the presence of a firm in which one CEO and one manager are employed. The CEO, among many other responsibilities, controls the capital investment decisions of the firm.[208] CEOs may have selfless intentions toward the firm, either because they are entrepreneurial founders, heads of family businesses,[209] or are guided by personal values.[210] Such CEOs will be motivated by the long-term interest of the firm.[211] In this situation, organic corporate governance merges with altruism.[212] The CEO's perceptual time horizon, therefore, will match the horizons of the firm itself or the horizons of subordinate managers, some of whom may wish to remain beyond the CEO's tenure.

Not every CEO, of course, is guided by the welfare of others. A CEO's compensation, for example, is a powerful incentive to consider the well-being of him or herself over that of the enterprise.[213] If the CEO has a long time horizon, a self-interested CEO will invest toward that particular horizon as it is in the CEO's own best interest to do so. However, if the CEO has a short time horizon, either due to a plan to retire or move to another firm, the CEO can direct the firm's cash flow toward his or her own advantage. This can

[204] Zhichuan Li, *Mutual Monitoring and Corporate Governance*, 45 J. BANKING & FIN. 255, 255 (2014).

[205] *Id.*

[206] *Id.*

[207] *Id.*

[208] Acharya, Myers & Rajan, *supra* note 172, at 692.

[209] *See, e.g.*, William S. Schulze, Michael H. Lubatkin & Richard N. Dino, *Toward a Theory of Agency and Altruism in Family Firms*, 18 J. BUS. VENTURING 473, 487–88 (2003) (finding that altruism moderates performance-based incentive compensation in U.S. family-owned firms).

[210] Acharya, Myers & Rajan, *supra* note 172, at 702.

[211] *Id.*

[212] Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salarie*s, 51 BUFF. L. REV. 811, 858 (2003) ("We tend to think of altruism as unselfish behavior, acts that involve bearing costs solely for another's benefit.").

[213] *Id.* at 854 ("A rational CEO may care more about his or her own compensation than about any other corporate decision. It is hard to imagine any other area in which the CEO's interests are so directly at stake.").

occur by diverting resources out of the firm,[214] manipulating information,[215] consuming perks,[216] or shirking by converting cash to leisure.[217] Shareholders can intervene, but coordination problems are significant,[218] and the available legal remedies are difficult to exercise. Even if shareholders are a threat to CEO rapacity, the CEO can buy off the shareholders by delivering just enough dividend payments or capital investments to keep them at bay.[219]

If the selfish CEO drains the firm for personal benefit, subordinate executives will be motivated to act.[220] Subordinate executives will typically have a longer time horizon than the CEO.[221] They are motivated by the control rents that arise from long-term employment in the firm as well as promotion opportunities that will arise in the future.[222] A subordinate executive who does not respond to a CEO's selfish conduct will be left with an undercapitalized firm after the CEO's departure. The subordinate executives, therefore, have multiple incentives to act to address overly self-interested CEOs.

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[214] Renee M. Jones, *Sarbanes-Oxley's Insight: The Role of Distrust*, 3 J. BUS. & TECH. L. 437, 438 (2008) (citing example of Bernie Ebbers, former CEO of WorldCom, who diverted corporate resources to personal use and concluding that "corporate directors are positioned poorly to monitor executives when they have personal relationships and positive feelings that lead them to lower their guard").

[215] *See* David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73, 98 (2000) (finding that CEOs opportunistically disclose voluntary information in order to maximize their own stock option compensation).

[216] David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211, 241 (2006) (finding that firms permitting CEO personal consumption of company aircraft underperformed market benchmarks by a "severe shortfall" of 400 basis points (or four percent)).

[217] *See* Lee Biggerstaff, David C. Cicero & Andy Puckett, FORE! An Analysis of CEO Shirking 29 (Nov. 5, 2014) (unpublished manuscript), http://ssrn.com/abstract=2495105 [https://perma.cc/D4PW-DDJQ] (finding that frequently golfing CEOs are associated with firms having lower values and operating performance); *see also* Acharya, Myers & Rajan, *supra* note 172, at 690 (analyzing actions of a retiring CEO). *See generally* Jayne W. Barnard, *Shirking, Opportunism, Self-Delusion and More: The Agency Problem Lives On*, 48 WAKE FOREST L. REV. 745 (2013) (describing examples of executive shirking, hubris, and greed).

[218] Ethan G. Stone, *Business Strategists and Election Commissioners: How the Meaning of Loyalty Varies with the Board's Distinct Fiduciary Roles*, 31 J. CORP. L. 893, 915–19 (2006) (summarizing shareholder coordination problems).

[219] Acharya, Myers & Rajan, *supra* note 172, at 691–92 (offering further discussion on the role of dividends in mutual monitoring).

[220] *See* David F. Larcker, Stephen A. Miles & Brian Tayan, *Seven Myths of CEO Succession* STAN. CLOSER LOOK SERIES (Mar. 5, 2014), at 3, https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-39-seven-myths-ceo-succession.pdf [https://perma.cc/7PJF-8WTF] (noting that seventy-four percent of new CEOs are promoted internally).

[221] *See* Acharya, Myers & Rajan, *supra* note 172, at 695 (noting that non-CEO top executives are on average four years younger than their CEO equivalents).

[222] *Id.* at 703 n.12.

Dissent is good for organizations, and can force decision makers to rely upon objective information over their own preferences.[223] Dissent acts as a constraint on implementation of action that controls decision-making.[224] In spite of these benefits, executives that openly dissent, risk their viability as a connected member of the enterprise as well as a potential successor to the CEO. Openly dissenting against a self-interested CEO is also an easy way to get fired.[225]

In spite of these consequences, dissenting executives still maintain options for mitigating agency costs imposed by the CEO. Instead of criticizing the CEO, dissenting executives can respond by withdrawing effort toward the cash flow of the enterprise. If executives are aware that the CEO is burning out the firm, they have little incentive to exert present effort, as it will serve mainly to enrich the CEO instead of becoming future returns from which the executives can benefit.[226] This withdrawal of effort creates a problem for the CEO. The CEO relies on the present effort of the executive to maximize his or her own immediate returns. The CEO may not be interested in the future but will act with a future orientation, by investing in the firm, in order to keep subordinates satisfied and productive. The result is a form of mutual monitoring, whereby the CEO's investment impacts the executive's future income and firm-specific learning effort, and the executive's effort, in turn, affects the firm's present cash flows to the benefit of the CEO.[227] When the CEO leaves and the executive becomes the new CEO, the incentives continue, with the new CEO constrained by the learning effort of its subordinates, and the cycle continues. This monitoring by the CEO and subordinates generates mutually reinforcing checks on agency costs, generated by the self-interest incentives of key players in the firm.[228]

Like motivations produced by firm-specific human capital, mutual monitoring requires a relaxed set of incentives in order to work. Mutual monitoring operates as a logical consequence of the firm structure.[229] Although executives must collaborate in order to succeed,[230] mutual monitoring does not

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[223] Augustin Landier, David Sraer & David Thesmar, *Optimal Dissent in Organizations*, 76 REV. ECON. STUD. 761, 762 (2009) (noting that dissent encourages a challenged decision maker "to use more of the objective information in her decision process and to take less account of her own preferences, which raises the organization's profitability").

[224] *Id.*

[225] Acharya, Myers & Rajan, *supra* note 172, at 703–04.

[226] *Id.* at 690.

[227] *Id.* at 699.

[228] *Id.* at 704.

[229] *Id.*

[230] Li, *supra* note 204, at 255; *see also* Bagley, *supra* note 203, at 378; Shanley & Peteraf, *supra* note 203, at 293.

require them to coordinate. No set policy must be established beforehand, and the board of directors need not intervene. Similarly, external regulation—though sometimes necessary to enable mutual monitoring—does not necessarily need to be present or effective.[231] The pursuit of self-interest, typically seen as a deviation from governance when executives and shareholders interest diverge,[232] remains aligned with the interests of the firm's residual claimants.

As noted, mutual monitoring can apply generally to superior-subordinate relations in the firm.[233] All that is necessary to trigger monitoring incentives is that the employee has a stake in the future of the firm.[234] This stake can be created through loyalty to the company or arising from a psychological contract with the organization.[235] This stake can also result from firm-specific investments that bind the employee[236] or impeded employee mobility imposed through a covenant not to compete.[237] Personal geographic preferences or switching costs can also generate employee incentives to monitor.[238] The most effective monitors, and thus the greatest contributors to organic corporate governance, are employees with substantial time remaining in their career arc.[239] Such employees will be most likely to think, and also monitor, for the long term, and constrain the behavior of others in that time horizon.

Enterprises can generate mutual monitoring in support of corporate governance not only from the top-down, but also from the bottom-up. Subordinates can influence the governance of superiors.[240] That influence has a direct bearing on the superior's conduct and the subordinate's receipt of value. Hav-

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[231] *See infra* notes 275–334 and accompanying text (discussing incentives for the CLO to engage in mutual monitoring).

[232] Michael J. Borden, *The Role of Financial Journalists in Corporate Governance*, 12 FORDHAM J. CORP. & FIN. L. 311, 326 (2007).

[233] Acharya, Myers & Rajan, *supra* note 172, at 702–03.

[234] *See id.* at 703.

[235] *See, e.g.*, Julio J. Rotemberg, *Altruism, Reciprocity and Cooperation in the Workplace*, *in* HANDBOOK OF THE ECONOMICS OF GIVING, ALTRUISM AND RECIPROCITY 1371, 1403–04 (Serge-Christophe Kolm & Jean Mercier Ythier eds., 2006).

[236] Acharya, Myers & Rajan, *supra* note 172, at 703.

[237] *See* Norman D. Bishara & Michelle Westermann-Behaylo, *The Law and Ethics of Restrictions on an Employee's Post-Employment Mobility*, 49 AM. BUS. L.J. 1, 4 (2012).

[238] Acharya, Myers & Rajan, *supra* note 172, at 703. Conversely, if job switching for employees is costless, then incentives to monitor superiors go away.

[239] *See id.* at 703 n.12.

[240] *See* Larry Fauver & Michael Fuerst, *Better Corporate Governance Through Greater "Insider" Participation? Evidence from German Corporate Boards*, 11 CORP. FIN. REV. 16, 25 (2007) (studying employee participation on the board and concluding that "[a] bottom-up organizational design that allows discussion and consensus . . . and then the communication and representation of this information to the highest level of corporate decision makers is a critical component of an optimal corporate governance system").

ing such influence can also increase employee loyalty because having such empowerment enriches the perceived quality of one's employment.[241] Employees may be more easily induced to invest in firm-specific human capital.[242] Employee governance also increases overall job satisfaction, which enhances productivity.[243] The oft-used phrase "work like you own the company" has additional substance.[244]

Mutual monitoring also strengthens the argument that shareholders are not the only residual claimants on the firm.[245] With mutual monitoring, anyone who benefits from "rents or quasi-rents generated by the firm has [a] residual claim."[246] Whereas employees may have needed to receive performance-based compensation[247] or other corporate structure[248] to establish a residual claim, now any employee with a future-oriented stake becomes a monitor and a claimant on future returns. This, in turn, further places into doubt the notion that the firm's economic efficiency and maximization of shareholder value are uncontroversial equivalents.[249]

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[241] Brian P. Niehoff et al., *The Influence of Empowerment and Job Enrichment on Employee Loyalty in a Downsizing Environment*, 26 GROUP & ORG. MGMT. 93, 109 (2001) (finding that job empowerment indirectly and positively impacts job loyalty though employee enrichment).

[242] McDonnell, *supra* note 133, at 1239 ("Employee governance may also be an effective commitment device to induce employees to invest in firm-specific human capital.").

[243] Kimbal Fraser & Simon Kemp, *Effects of Employee Governance and Operational Control on Psychological Ownership and Perceived Justice*, 41 NEW ZEALAND J. PSYCH. 12, 18 (2012).

[244] *Id.* at 12 ("As the common recommendation to 'work like you own the company' suggests, there is widespread belief that employees will work harder and smarter and be happier if they feel in some way that they own the organisation [sic].").

[245] Residual claimants are individuals who have an entitlement to the firm's surplus. Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 658 (2006).

[246] Acharya, Myers & Rajan, *supra* note 172, at 692.

[247] Fisch, *supra* note 245, at 658.

[248] John R. Boatright, *Business Ethics and the Theory of the Firm*, 34 AM. BUS. L.J. 217, 228 (1996) ("[E]mployee pension funds may consist largely of stock in the employing firm, thereby giving employees some residual claims.").

[249] Acharya, Myers & Rajan, *supra* note 172, at 692. The equivalence of optimal shareholder value and efficiency has been an oft-presented standard account. *See* Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451 (1995) (reviewing ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993)). Fisch explains:

> Traditional conceptions of both economic theory and corporate law are based on a notion of shareholder primacy. In corporate law, shareholder primacy is defended on the possibly antiquated theory that shareholders are the owners of the corporation, hence corporate decisions should be directed toward maximizing shareholder value. Economists reach the same conclusion based on an efficiency rationale.

Id. at 468. *See generally* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (justifying wealth maximization for residual holders as most efficient method of value maximization long term).

IV. Organic Corporate Governance and the Chief Legal Officer

In order to better understand how organic corporate governance works in practice, we present a case study of a key actor within the organization: the CLO. The CLO is one of the most organizationally powerful members of top management.[250] Doing much more than providing legal advice, corporate (i.e., in-house) counsel help facilitate deals, serve as an intermediary between management and outside counsel, manage crises, and staff the firm's in-house legal department.[251] The CLO, the firm's top corporate counsel, serves no less than nineteen separate functions for the firm.[252] These include acting as a legal advisor, a member of the firm's senior management team, the legal department's administrator, and an agent of the corporation.[253] The CLO's power is ascendant,[254] and that power gives the firm's top attorney substantial ability to influence governance practices.

The CLO is not only organizationally powerful but also holds a unique position. The CLO possesses a dual role as both a legal and business advisor.[255] Unlike other executives who pursue self-interest within the bounds of the organization, the CLO holds its loyalty to a single client—not its fellow executives but rather the corporation itself.[256] Additionally, the CLO acts as a gatekeeper against misconduct by senior management, while also being expected to identify with the business goals of its fellow executives.[257] These multiple and conflicting roles of the CLO offer substantial opportunities, as well as great challenges, to the operation of organic corporate governance in the firm. The following discussion explores how the CLO operationalizes organic corporate governance.

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[250] Bird & Park, *supra* note 34, at 208.

[251] *Id.* at 209.

[252] Sarah Helene Duggin, *The Pivotal Role of the General Counsel in Promoting Corporate Integrity and Professional Responsibility*, 51 ST. LOUIS U. L.J. 989, 1002–20 (2007) (describing nineteen separate roles adopted by general counsel, including strategic planner, investigator, crisis manager, and arbitrator).

[253] Deborah A. DeMott, *The Discrete Roles of General Counsel,* 74 FORDHAM L. REV. 955, 965–74 (2005); *see* Duggin, *supra* note 252, at 1001–20.

[254] *A Guardian and a Guide: Chief Legal Officers Have More Power Than Ever Before*, THE ECONOMIST (Apr. 7, 2012), http://www.economist.com/node/21552170 [https://perma.cc/7AWV-8T3C].

[255] E. Norman Veasey & Christine T. Di Guglielmo, *General Counsel Buffeted by Compliance Demands and Client Pressures May Face Personal Peril*, 68 BUS. LAW. 57, 58 (2012).

[256] *Id.*

[257] Bird & Park, *supra* note 34, at 243–44.

A. The Challenge of CLO Monitoring

The relationship between the CLO and the CEO is a unique one. Communications between them are potentially protected under the attorney-client privilege, encouraging a trusting familiarity between the executives.[258] The need to understand the business implications of regulation, manage risk, and take into account legal factors in making strategic and operational decisions compel them to work together in a fashion that transcends traditional corporate collaboration.[259] The CLO and the CEO must be able to have frank and honest communication, and the CLO must have a platform to speak forcefully on top-level corporate matters.[260]

Yet despite the CLO's considerable authority, there are forces that impede the CLO's ability to participate in organic corporate governance.[261] First, the CLO cannot withdraw effort to exert control over a selfish CEO as easily as other executives. When a Chief Financial Officer (CFO) or Chief Operating Officer (COO), for example, withdraws effort, cash flows available to the CEO and the firm are reduced.[262] Investors, in theory, have the power to respond, but changes in management performance, especially in service industries, may be difficult to detect.[263] The blunt instrument of shareholder litigation is ill suited to punishing an individual executive, and shareholder proxy procedures are arguably too slow and indirect.[264]

By contrast, the withdrawal of effort by the CLO can activate visible legal and regulatory problems. Lack of monitoring can trigger non-compliance that generates amplified sanctions for misconduct in comparison to law-breaking firms with robust internal monitoring in place.[265] Weak governance

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[258] *Id.* at 238 (noting the unique relationship between CLO and CEO facilitated through the attorney-client privilege).

[259] Erin E. Harrison, *Milestones and Giving Thanks*, INSIDE COUNSEL (Nov. 1, 2014), http://web3.insidecounsel.com/2014/11/01/milestones-and-giving-thanks [https://perma.cc/RBP8-9N5B]. The CEO of United States Steel commented that, "[t]he CEO and the GC must have the kind of relationship in which they're able to practically finish each other's sentences." *Id.*

[260] E. NORMAN VEASEY & CHRISTINE T. DI GUGLIELMO, INDISPENSABLE COUNSEL: THE CHIEF LEGAL OFFICER IN THE NEW REALITY 61 (2012) (noting the close working relationship between the CLO and other senior managers); Lawrence A. Hamermesh, *Who Let You into the House?*, 2012 WISC. L. REV. 359, 383 (noting that a close relationship between the CLO and the CEO is generally expected).

[261] And with these forces the troubling implication that the CLO may, in certain circumstances, participate in corporate governance only because it is compelled to do so by exogenous pressures placed upon the firm.

[262] *See* Acharya, Myers & Rajan, *supra* note 172, at 690.

[263] *Id.* at 716.

[264] *See supra* notes 88–132 and accompanying text.

[265] Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1231 (2003).

structures can erode rule-following behavior and promote unethical practices that create unwanted public attention.[266] As a visible and operative agent of the enterprise, the CLO serves as the ambassador for the firm's regulatory posture and image,[267] thereby readily recognizable and perhaps vulnerable to sanction. When a regulator or law enforcement body penalizes a firm for violating the law, blame is easily concentrated on those responsible for monitoring, such as the CLO.[268] The CLO cannot withdraw effort to curtail a selfish CEO without significant potential consequences to its own career and the organization as a whole.

Second, the CLO's future stake in the firm, a precondition to monitoring,[269] is not readily apparent. Unlike other executives, CLOs are significantly less likely to participate in executive succession.[270] The CLO is one of the least likely C-suite executives to become CEO. As few as five to seven percent of CEOs have ever worked in legal positions before becoming the CEO.[271] Instead, a majority of CEOs are internal appointments from operations, marketing, finance, sales, and related fields, with an average career path

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[266] *See* Norman D. Bishara, *Governance and Corruption Constraints in the Middle East: Overcoming the Business Ethics Glass Ceiling*, 48 AM. BUS. L.J. 227, 247 (2011).

[267] Steven L. Lovett, *The Employee-Lawyer: A Candid Reflection on the True Roles and Responsibilities of In-House Counsel*, 34 J.L. & COM. 113, 131 (2015).

[268] David A. Delman & Paul A. Bruno, *Up the Ladder and Out the Door: Saying "No" to the CEO*, 46 INT'L LAW. 1007, 1017 (2012). The authors explain:

> A large part of the rationale underpinning the 2002 passage of SOX in the wake of the Enron, Arthur Andersen, and Tyco corporate implosions was the widely held view that lawyers, particularly in-house lawyers, shared a large portion of the blame. Many believed that these lawyers not only failed to interdict the fraud occurring under their noses, but were also either actively or passively complicit in the fraudulent acts.

Id.

[269] Acharya, Myers & Rajan, *supra* note 172, at 703.

[270] *See* David F. Larcker & Bryan Tayan, *CEO Succession Planning*, STAN. BUS: CORP. GOV. RES. INITIATIVE, https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-quick-guide-07-ceo-succession-planning.pdf [https://perma.cc/9DLK-8E6G]; Anna Loyeung & Helen Spiropoulos, Who of the Top Five Executives Is More Likely to Be Promoted and Why? 4 (unpublished manuscript), https://www.uts.edu.au/sites/default/files/ADG_Cons2015_Anna%20Loyeung.pdf [https://perma.cc/X9V9-JMWX] (finding positive association between being COO and the likelihood of being appointed CEO)*; see also* Anup Agrawal, Charles R. Knoeber & Theofanis Tsoulouhas, *Are Outsiders Handicapped in CEO Successions?*, 12 J. CORP. FIN. 619, 643 (2006) (finding that CEO succession generally favors internal candidates over external ones).

[271] SPENCER STUART, 2008 ROUTE TO THE TOP 13 (2008); *see also* Menachem Wecker, *Where the Fortune 500 CEOs Went to Law School*, U.S. NEWS & WORLD REP. (June 26, 2012), http://www.usnews.com/education/best-graduate-schools/top-law-schools/articles/2012/06/26/where-the-fortune-500-ceos-went-to-law-school (reporting that less than ten percent of Fortune 500 CEOs have a law degree).

of sixteen years within the firm.[272] With fifty years old being the average age of a CEO's appointment, and ascension beginning when executives are in their early thirties,[273] this path is generally unavailable to aspiring corporate counsel hired from outside law firms and working mainly in the firm's legal department. A CLO, whose average age is already fifty,[274] that aspires to be a CEO will have a difficult time catching up with internally groomed competition. These forces present a challenge to effective organic corporate governance by the CLO, despite the many benefits realized by such an arrangement.

B. Incentives for the CLO to Monitor

In spite of the lack of succession opportunities and the negative consequences of effort withdrawal, there are substantial countervailing forces that motivate the CLO to strengthen organic corporate governance for its own purposes and for the good of the enterprise. First, many CLOs increasingly receive performance-sensitive compensation, such as stock options, as part of their total compensation package.[275] Such compensation aligns the recipient's incentives with the incentives of investors.[276] Cash starved firms can use stock instead of cash to pay for necessary legal services.[277] When risk-seeking attorneys compete for legal services, a broader array of services reaches a larger number of corporations.[278] The CLO will be rewarded when the corporation's value (represented by its share price and market capitalization) increases, and will thus lengthen its time horizon to coincide with the interests

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[272] Eric Savitz, *The Path to Becoming a Fortune 500 CEO*, FORBES (Dec. 5, 2011), http://www.forbes.com/sites/ciocentral/2011/12/05/the-path-to-becoming-a-fortune-500-ceo/#3eccf31828c9.

[273] *Id*; *see also* Acharya, Myers, & Rajan, *supra* note 172, at 695 (reporting that the average age of a non-founder CEO is 53.8 years old).

[274] *One Quarter of General Counsel Report Their Companies Hit by Data Breaches, ACC Chief Legal Officers 2015 Survey Reveals*, ASS'N OF CORP. COUNS. (Jan. 29, 2015), https://www.acc.com/aboutacc/newsroom/pressreleases/accclo2015survey.cfm.

[275] Z. Jill Barclift, *Corporate Responsibility: Ensuring Independent Judgment of the General Counsel—A Look at Stock Options*, 81 N.D. L. REV. 1, 9–10 (2005) (noting increase in stock option grants to CLOs during the late 1990s and early 2000s); *ALM's Corporate Counsel Releases 2015 General Counsel Compensation Survey—Disney GC Tops List of High Earners*, GLOBENEWSWIRE (July 15, 2015), https://globenewswire.com/news-release/2015/07/15/752314/10141729/en/ALM-s-Corporate-Counsel-Releases-2015-General-Counsel-Compensation-Survey-Disney-GC-Tops-List-of-High-Earners.html (reporting that CLO stock compensation increased by 49.4% in 2014).

[276] Barclift, *supra* note 275, at 8–9.

[277] Jason M. Klein, *No Fool for a Client: The Finance and Incentives Behind Stock-Based Compensation for Corporate Attorneys*, 1999 COLUM. BUS. L. REV. 329, 362; *see also* Darian M. Ibrahim, *How Do Start-Ups Obtain Their Legal Services?*, 2012 WIS. L. REV. 333, 346–47 & n.42.

[278] Klein, *supra* note 277, at 362.

of the firm.[279] That lengthened horizon, in turn, motivates the CLO to curb a selfish CEO that might impair the receipt of future cash flow.

Providing CLOs unrestrained, stock based, performance-sensitive compensation, however, may not optimally motivate mutual monitoring. Such compensation, in the form of bonuses, stock options, or other methods, can exceed the negotiated salary CLOs receive, especially in the United States.[280] With such a powerful lure comes the ability to impair the objectivity of the CLO, incentivizing its interest in the firm's equity position over the protection of the firm's long-term interests.[281] Corporate counsel would be nudged away from risk aversion and towards risk aggression, motivated by the potential hefty returns on their compensation, especially when advising small, high-growth enterprises.[282] Ethical professional violations can also arise from corporate counsel who are compromised by such compensation.[283] At worst, CLOs motivated by performance-based returns shed their duty to represent the interests of the firm and over-identify with the executives they serve.[284] This client capture[285] effect subordinates the long-term needs of the enterprise

[279] *See id.* ("Allowing compensation of lawyers with client stock or options should be encouraged not only because it is market-driven, but also because it adds value to the client, the lawyer, the economy, and society").

[280] *See* Brian R. Cheffins & Randall S. Thomas, *The Globalization (Americanization?) of Executive Pay*, 1 BERKELEY BUS. L.J. 233, 244 (2004); Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1183 (2004); *see also 3 Insights About In-House Counsel Compensation*, ABOVE THE LAW (Apr. 24, 2015), http://abovethelaw.com/2015/04/3-insights-about-in-house-counsel-compensation (citing examples of incentive compensation awards that far exceed base pay).

[281] Barclift, *supra* note 275, at 17 (citing ABA TASK FORCE ON THE INDEPENDENT LAWYER, LAWYERS DOING BUSINESS WITH THEIR CLIENTS: IDENTIFYING AND AVOIDING LEGAL AND ETHICAL DANGERS (2001)); Mark W. Everson, *Lawyers and Accountants Once Put Integrity First*, N.Y. TIMES (June 18, 2011), http://www.nytimes.com/2011/06/19/opinion/19everson.html [http://perma.cc/KB67-UWPV] (arguing that payment of large fixed salaries without equity participation would "sharply limit the temptation to inflate shareholder value at the expense of business substance").

[282] *See* Gwyneth E. McAlpine, Comment, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?*, 47 UCLA L. REV. 549, 582 (1999).

[283] *See, e.g.*, MODEL RULES OF PROF'L CONDUCT r. 1.7(b) (AM. BAR ASS'N 2017) (stating that a lawyer "shall not represent a client if the representation involves a concurrent conflict of interest" such as "a significant risk that the representation . . . will be materially limited . . . by a personal interest of the lawyer").

[284] R. William "Bill" Ide & Crystal J. Clark, *The Chief Legal Officer's Critical Role in the Compliance Function*, BLOOMBERG LAW (July 1, 2014), http://www.bna.com/chief-legal-officers-n17179891712 [https://perma.cc/X2VQ-QVHB] ("In the company-lawyer context, lawyers are lawyers who happen to be employees, not employees that happen to be lawyers. Under their ethical obligations, lawyers are bound to represent the interests of the entity—not the board, management or themselves.").

[285] Ronit Dinovitzer, Hugh P. Gunz & Sally P. Gunz, *Reconsidering Lawyer Autonomy: The Nexus Between Firm, Lawyer and Client in Large Commercial Practice*, 51 AM. BUS. L.J. 661, 692–93 (2014) (discussing types of client capture in the attorney-client context); Hugh G. Gunz &

to the immediate goals of management. The CLO becomes just another executive, thereby losing its unique effectiveness as a gatekeeper and signaling to lower-ranking managers and corporate counsel that legal compliance is subordinate to maximization of personal returns. As performance sensitive compensation increased for general counsel by 49.4% in 2014,[286] and shows no signs of slowing, the potential impact of such compensation is significant.

In order to motivate mutual monitoring, therefore, the solution may not be to discourage performance-based compensation altogether, but rather to award it in a manner that encourages long-term thinking, necessary for organic corporate governance to function. Imposing board responsibility for CLO compensation would keep control and influence out of management's hands.[287] Compensation would reward exceptional and independent legal work rather than rising stock prices.[288] Options and awards can be based on time served instead of, or in conjunction with, financial performance.[289] These measures lengthen the CLO's individual time horizon and incentivize the CLO toward agency checks of the CEO. Socialization effects of a CLO working closely with management can be re-directed toward coalition behavior that monitors the CEO for rapacity rather than colludes against investors.[290] This opens up the intriguing question of whether subordinate manager-network effects can better prevent leader-driven opportunism in an organization.[291]

A second mechanism that motivates organic corporate governance behavior is bonding costs, which are expenditures made by the agent that ensure

Sally P. Gunz, *Client Capture and the Professional Service Firm*, 45 AM. BUS. L.J. 685, 696 (2008) (similar).

[286] *ALM's Corporate Counsel Releases 2015 General Counsel Compensation Survey—Disney GC Tops List of High Earners*, *supra* note 275.

[287] VEASEY & DI GUGLIELMO, *supra* note 260, at 58–59.

[288] *Id.* at 59; *see also* E. Norman Veasey & Christine T. Di Guglielmo, *Tensions, Stresses, and Professional Responsibilities of the Lawyer for the Corporation, in* A CENTURY OF LEGAL ETHICS: TRIAL LAWYERS AND THE ABA CANONS OF PROFESSIONAL ETHICS 23, 33 (Lawrence J. Fox, Susan R. Martyn & Andrew S. Pollis eds., 2009) ("[T]he corporation should design a compensation plan for in-house counsel that rewards exceptional and professionally independent legal work, as distinct from pure financial performance.").

[289] MAJOR, LINDSEY & AFRICA AND TOWERS WATSON, COMPENSATION TRENDS AND REWARD PRACTICES (2014) (noting the prevalence of both time and performance based awards for CLOs), https://www.dlapiper.com/~/media/Files/Insights/Events/2014/11/NJCompReportGCSeminar.ashx [https://perma.cc/6SAW-EYBL].

[290] DeMott, *supra* note 253, at 967–68 (describing CLOs socializing into the culture and norms of senior management).

[291] *See* Amitai Aviram, *Regulation by Networks*, 2003 BYU L. REV. 1179, 1194 (noting the impact of network effects on mitigating opportunism).

that the agent's actions will not undermine the principal's interests.[292] In the Jensen-Meckling principal-agent relationship,[293] the separation of ownership and control creates divergent interests between the owners of the firm and the managers who run daily operations.[294] In addition to developing incentives that motivate the agent to act in the principal's interest, principals can create disincentives for agents to behave.[295] Monitoring costs expended by the principal deter agents, and thus reduce agency costs, by making divergent behavior more difficult to achieve and easier to detect.[296]

Compared to other executives, bonding costs have different effects when applied to the CLO.[297] CLOs are likely the only executives in the C-suite that shoulder these costs in their day-to-day functions.[298] According to the American Bar Association's Model Rules of Professional Conduct, a lawyer is "an officer of the legal system and a public citizen having special responsibility for the quality of justice."[299] Attorneys are professionally expected to refer to "moral, economic, social and political factors," as well as legal issues, when applicable to advising clients.[300] Lawyers also have affirmative duties to exert professional independence and to render candid advice even if the client does not want to hear it.[301] This may compel corporate counsel, including the CLO, to render advice that is unpalatable or frustrates a company's business

[292] Jensen & Meckling, *supra* note 42, at 308; *see also* Cassandra Burke Robertson, *A Collaborative Model of Offshore Legal Outsourcing*, 43 ARIZ. ST. L.J. 125, 145 (2011) (defining bonding costs).

[293] Jensen & Meckling, *supra* note 42, at 309.

[294] *See* BERLE & MEANS, *supra* note 36, at 119–26; *see also* Deborah A. DeMott, *Organizational Incentives to Care About Law*, 60 L. & CONTEMP. PROBS. 39, 46 n.33 (1997).

[295] *See* Jensen & Meckling, *supra* note 42, at 323 ("In practice, it is usually possible by expending resources to alter the opportunity the owner-manager has for capturing non-pecuniary benefits. These methods include auditing, formal control systems, budget restrictions, and the establishment of incentive compensation systems which serve to more closely identify the manager's interests with those of the outside equity holders . . . .").

[296] *See* Wendy Netter Epstein, *Public-Private Contracting and the Reciprocity Norm,* 64 AM. U. L. REV. 1, 18 (2014) ("Monitoring is costly, but it is generally required to reduce an agent's temptation to engage in self-interested behavior that will harm the enterprise or, in other words, to reduce the information asymmetry that contributes to agency costs in the first place."). The market can also perform this monitoring function when monitoring is significant. *Id.*

[297] *See infra* notes 298–302 and accompanying text.

[298] *See* MODEL RULES OF PROF'L CONDUCT Preamble. (AM. BAR ASS'N 2017) (applying the Model Rules to lawyers only).

[299] *Id.*

[300] *Id.* r. 2.1.

[301] Pam Jenoff, *Going Native: Incentive, Identity, and the Inherent Ethical Problem of In-House Counsel*, 114 W. VA. L. REV. 725, 734–35 (2005); *see also* MODEL RULES OF PROF'L CONDUCT r. 2.1.

objectives.[302] Contravention of these obligations can result in disciplinary action in state court and potential disbarment.

Bonding costs also arise from specific legal obligations. CLOs, like other officers, have fiduciary duties of care and loyalty to the enterprise.[303] These duties include a duty to act in good faith and in the best interests of the corporation as well as a duty to monitor firm actions and investigate misconduct.[304] SEC Rule 205 requires corporate counsel that uncovers any material violation by an officer, director, employee, or agent to report that evidence to the firm's CLO or CEO.[305] The CLO has an obligation to respond to the inquiry or report the evidence of the violation to the legal compliance committee.[306] If the reporting corporate counsel concludes that the issue has not been sufficiently addressed, they can elevate the issue to the board of directors.[307] The effect of these duties may not be overwhelming, but they remain backstop obligations to which corporate counsel must conform if the circumstances demand.

Bonding costs also arise from preservation of reputational capital, a driving career concern for CLOs.[308] A lawyer's legal advice is his or her stock and trade, and it is difficult to show the value of that advice directly to investors. As a result, the CEO must rely significantly on perceived reputation as a measure of performance, which in turn serves as an assurance for the legitimacy of the firm's transactions.[309] CLOs build that capital through acting as a repeat player in numerous transactions over many years.[310] Hard to gain and easy to lose,[311] the CLO's professional reputation acts as a signaling function

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[302] Jenoff, *supra* note 301, at 735.

[303] Johnson & Millon, *supra* note 73, at 1613–14.

[304] VEASEY & DI GUGLIELMO, *supra* note 260, at 210–11.

[305] 17 C.F.R. § 205.3(b)(1) (2017). Discretion of what constitutes a material violation remains with the individual attorney. Caroline Harrington, *Attorney Gatekeeper Duties in an Increasingly Complex World: Revisiting the "Noisy Withdrawal" Proposal of SEC Rule 205*, 22 GEO. J. LEGAL ETHICS 893, 903 (2009).

[306] 17 C.F.R. § 205.3(b)(2).

[307] *Id.* § 205.3(b)(3).

[308] Deborah A. DeMott, *The Stages of Scandal and the Role of General Counsel*, 2012 WIS. L. REV. 463, 471–75 (explaining the role of reputational factors on corporate counsel); Jennifer M. Pacella, *Advocate or Adversary: When Attorneys Act as Whistleblowers*, 28 GEO. J. LEGAL ETHICS 1027, 1065 (2015) (noting that "in-house counsel should be equally concerned about reputational factors and adherence to ethical standards as outside lawyers"). *Cf.* Fredrick P. Schadler & Timothy L. Manuel, *Underwriter Choice and Announcement Effects for Seasoned Equity Offerings*, 7 J. FIN. & STRATIGIC DECISIONS 53, 53 (1994) (explaining in the context of initial public offerings that "[t]he bonding cost incurred by the investment banker is the potential loss of reputational capital if the issue is mispriced").

[309] *See* Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 23–24 (1995).

[310] *See* Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 424 (2008).

[311] *Id.*

to the market that firm value is being adequately protected.[312] CLOs must maintain a long time horizon, and monitor the conduct of the CEO, to sustain that reputational capital. CLOs lose that reputational capital, which is necessary for their effectiveness as legal counsel at their current or future employers,[313] if they earn a reputation of acquiescence to corporate misbehavior.[314] CLOs who lack this reputational capital, furthermore, cannot charge a premium for utilizing this capital on the firm's behalf when representing it before other regulators, courts, and other firms.[315] Put more bluntly, "lawyers cannot charge a premium for providing this service if they are perceived as a shill for their clients."[316]

Bonding costs thus encourage CLO monitoring by placing constraints on the CLO's incentive to act against the firm's interests. This creates a feedback loop that drives the CLO's value protecting function.[317] When the CEO improperly withdraws value from the firm, the CLO is exposed to the risk of professional and statutory sanctions if the CLO fails to respond.[318] These affirmative duties obligate the CLO to consider the interests of not only the firm, but also the legal system as a whole. The CLO is incentivized to act because of bonding costs that arise as a prerequisite to the practice of law.[319] Because these are ongoing obligations, they lengthen the decision-making time horizon of the CLO to coincide with that of the enterprise.[320] That, in turn, motivates the CLO to engage in long-term planning and monitoring to discourage rapacity of the CEO.

Bonding costs also act as a constraint on the CEO. The CLO is not only sensitive to its own reputational capital, but also serves as a guardian of the

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[312] This is a similar function to reputational intermediaries, such as accountants and auditors, who in essence rent their reputation to firms, who lack their own, to signal the objectivity of the firm's financial statements. *See* Hua Cai, *Bonding, Law Enforcement, and Governance in China,* 13 STAN. J.L. BUS. & FIN. 82, 92 n.34 (2007).

[313] *See* Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Concerning Lawyers,* 19 J. CORP. L. 1, 29 (1993) (noting that bonding costs make an attorney's statements more credible because of the associated penalties if the attorney misleads).

[314] Adair Morse, Wei Wang & Serena Wu, Executive Lawyers: Gatekeepers or Totems of Governance? 9 (Mar. 2016) (unpublished manuscript) http://ssrn.com/abstract=2469931 [https://perma.cc/K83G-XKE6] (referring to "steep reputation costs to infractions" of compliance borne by CLOs).

[315] Fred C. Zacharias, *Effects of Reputation on the Legal Profession,* 65 WASH. & LEE L. REV. 173, 202 (2008).

[316] *Id.*

[317] *See supra* notes 298–302 and accompanying text.

[318] *See supra* notes 298–302 and accompanying text

[319] *See supra* notes 298–302 and accompanying text

[320] *See supra* notes 298–302 and accompanying text

corporation's public reputation and integrity.[321] When the CLO's reputation is questioned, it impacts both the attorney as well as the firm.[322] An impaired CLO reputation impedes his or her signaling function and, in turn, raises doubt about the quality of the firm's corporate governance. In turn, the CEO—even one who is solely motivated by self-interest—is forced to monitor and maintain the integrity and reputation of the CLO in order to maintain his or her own maximal cash flows from the firm. This shows how intra-firm checks on agency are reciprocal: bonding costs on the CLO generate an integrity metric valued in the market, which motivates the CEO to monitor the CLO to ensure that the CLO's integrity, and its associated cash flows, remains unchallenged.

C. The Exercise of Organic Corporate Governance by the CLO

A fundamental question remains: how should the CLO respond to self-interested CEO behavior in order to facilitate mutual monitoring? The dynamic of mutual monitoring curbs the otherwise rapacious CEO by the subordinate executive withdrawing effort. This works because withdrawn effort erodes the CEO's future cash returns, thereby forcing the CEO to lengthen his or her time horizon to that of the firm, or at least to the subordinate executive.

If the CLO chooses to withdraw effort, however, this would erode the very organic corporate governance that the CLO seeks to create. In addition to the aforementioned professional and financial disincentives,[323] such withdrawal would lubricate further CEO misconduct. A CEO not investing for the future, either through monitoring or learning efforts, paves the way for the CEO to engage in even greater future rapacity.[324] The selfish CEO would be assured that the CLO is not monitoring its conduct, and would thus be able to exploit the opacity of information that weak monitoring creates to obscure rapacity. Once that happens, the CLO, as well as other corporate executives, is less capable of assessing the rapacity of the CEO in the first place. This, in turn, can generate false negative (type II) and false positive (type I) errors,[325] with the former allowing rapacity to go unchecked and the latter unnecessari-

[321] Ben W. Heineman, Jr., *Caught in the Middle*, CORP. COUNSEL (Apr. 2007), http://www.law.harvard.edu/programs/corp_gov/articles/Heineman-CC-Caught-in-the-Middle-April07.pdf [https://perma.cc/DHR3-RT96].

[322] DeMott, *supra* note 308, at 474 ("For a general counsel, in contrast to external counsel, individual reputation as a professional is closely linked to that of the client.").

[323] Acharya, Myers & Rajan, *supra* note 172, at 703.

[324] *See supra* notes 213–219 and accompanying text.

[325] *See* Jasper P. Slujis, *Network Neutrality Between False Positives and False Negatives: Introducing a European Approach to American Broadband Markets*, 62 FED. COMM. L.J. 77, 103–04 (2010) (describing false positives and false negatives).

ly punishing investors for unnecessary withdrawal of effort on behalf of the enterprise.

So how do CLOs generate organic corporate governance? Unlike other executives who withdraw, CLOs can generate organic corporate governance by *increasing* their effort to respond to CEO selfishness, bringing the executive to heel, and compelling extension of the CEO's investment time horizon to the CLO's own timetable. CLOs have the capacity to increase their effort, and thus their effectiveness, by doing one of the things that lawyers do naturally—monitoring the firm for evidence of improper conduct.[326] Lawyers are also good at it, and there is significant empirical evidence that CLOs can, and do, serve as effective monitors of the firm.[327]

Heightened CLO monitoring is not only important in it of itself,[328] but due to the motivations behind the monitoring. The CLO is motivated to monitor because it has a future stake in the cash flow or control rents of the firm.[329] This future stake arises from rents or quasi-rents combined with firm-specific investments or costs of leaving the firm.[330] Required statutory mandates, the threat of shareholder litigation or shareholder proposals, employee coordination, or the pressure of the board of directors are not required to effectuate the CLO's monitoring function. The CLO acts in order to prevent a reduction in its rents, and will pressure the CEO to ensure that future returns are forthcoming unimpeded from CEO rapacity. Thus, governance from the CLO arises organically as a result of the separation of ownership and control of the enterprise.

The option to withdraw effort is available to the CLO but only in unusual circumstances. An attorney may choose to withdraw representation as a response to CEO rapacity and in order to signal a corporate governance problem otherwise unobservable by external market participants, analogous to the "noisy withdrawal" rule proposed by the SEC.[331] If severe enough, the CLO may exit the firm altogether, presuming that firm-specific investments and labor market mobility permit such exit. The CLO who exits for disclosure

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[326] *See* Robert L. Nelson & Laura Beth Nielsen, *Cops, Counsel, and Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations*, 34 L. & SOC'Y REV. 457, 463–64 (2000).

[327] *See* Bird & Park, *supra* note 34, at 223–27 (examining empirical evidence of the CLO's impact on corporate governance behavior).

[328] For example, developing and maintaining a compliance function is one of the most common methods by which CLOs monitor the firm and their fellow executives for misconduct. *See, e.g.*, *id.* at 220–23.

[329] *See* Acharya, Myers & Rajan, *supra* note 172, at 703 & n.12.

[330] *See id.* at 703.

[331] *See* Harrington, *supra* note 305, at 903; *see also* Press Release, Sec. & Exch. Comm'n, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003), https://www.sec.gov/news/press/2003-13.htm [https://perma.cc/JKP3-DG8A].

reasons may be perceived as willing to take action to preserve his or her reputational capital. A CLO voicing concerns about CEO rapacity may be subject to risk of discharge by the CEO, but under certain circumstances the CLO could respond with a lawsuit asserting a claim of retaliation under SOX or under common law rules related to wrongful discharge.[332] Furthermore, although removing a CLO can signal a commitment to rebuilding integrity in tarnished firms,[333] termination of a CLO from a firm, usually perceived as clean, can raise questions about whether a corporate governance problem exists implicating the CEO. It may also create spillover effects and tarnish the reputation of the CLO, which, by mere association with the impropriety, may be viewed by the labor market as part of the blame.[334] Consequently, the CEO has a disincentive to fire the CLO, and the CLO has a disincentive to leave, because it will impact both of their abilities to collect rents. Thus, because its costs are so high, withdrawal is only exercised in rare instances.

CONCLUSION

The role of incentives in ensuring the accountability of corporate managers has been the subject of a prolonged and inconclusive debate. Regulatory intervention and scholarly research have failed to resolve key fundamental questions about how corporate governance works. This Article adds a new piece to the puzzle by presenting the theory of organic corporate governance as a new way to typologize the self-regulating conduct of corporate actors.

If internal checks and balances are ineffective, and no substantial coalition can agree on an optimal system, one could be reasonable in expecting a more chaotic system of corporate governance. Board membership would have limited value. Management would be overrun by personal greed. Shareholders would either be in a constant state of litigation or exit the market for greener pastures. There would be little that the U.S. market could offer as model of accountability and responsibility. Corporate governance would accomplish few of its intended goals.

Fortunately, however, this disconcerting scenario has not come to pass. Although it may be useful to find answers in other corporate governance systems,[335] the United States is still perceived as having one of the best corporate

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332 LITTLER REP., RETALIATION AND WHISTLEBLOWER CLAIMS BY IN-HOUSE COUNSEL 1–4, (2013), https://www.littler.com/files/press/pdf/LittlerReportRetaliationAndWhistleblowerClaimsByIn-HouseCounsel.pdf [https://perma.cc/7HDY-FUE9].

333 DeMott, *supra* note 308, at 488.

334 *Id.* at 474 (noting that reputation of the firm and its CLO are closely linked).

335 *See* F.H. Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J. 733, 738 (1994) (noting that "it is fashionable to look for guidance from Japanese and German systems of corporate governance"); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Be-*

governance systems in the world.[336] There are certainly structural and regulatory reasons for this success, including strong legal and regulatory frameworks[337] and an inherent flexibility that facilitates adaptation of corporate governance practices to meet changing economic realities.[338]

The model of organic corporate governance presented in this Article is a key component. Driven by mutually reinforcing checks on agency, employees of the firm engage in mutual monitoring that keeps other employees honest. A CEO who shirks responsibilities will destabilize the incentives of subordinate executives upon whom future returns depend. Subordinate executives who shirk responsibilities will reduce the residual value of the firm after the CEO departs, impairing the growth and success of their own careers. Executives and employees play a role in organic corporate governance, with certain executives—most notably, the CLO—providing an essential check on agency arising from their professional bonding costs and reputational effects of failing to defend value from unnecessary loss.

Although organic corporate governance is neither exclusive to other theories of corporate governance nor a panacea to the many concerns regarding the corporate form, it is an indispensable piece of the corporate governance puzzle, without which no understanding of corporate governance can be complete. This Article is the starting point for further discussion about the merits of organic corporate governance, its implications of regulatory interventions in corporate governance, and the scope of internal checks-and-balances within the firm.

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tween Corporate Governance and Industrial Organization, 102 YALE L.J. 871, 895–905 (1993) (examining the Japanese corporate governance system for opportunities to reform the American one); *see also* Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L.Q. 367, 368 (1996) ("The intuition that one can fruitfully transplant legal rules or institutions from one system to another is as old as the law itself. The temptation is to try to get something for nothing, or at least at a discount.").

[336] BUSINESS ROUNDTABLE, *supra* note 9, at 1.

[337] *Id.*; *see also* Paul Rose, *supra* note 5, at 888–89 (citing ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993)).

[338] *See* Dan W. Puchniak, *The Japanization of American Corporate Governance? Evidence of the Never-Ending History for Corporate Law*, 9 ASIAN-PAC. L. & POL'Y J. 7, 14 (2007) (citing Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 131, 136 (2001)).