

# Dissident Directors

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## *Abstract*

Dissident directors are important because of information.

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## Introduction

Corporate governance is a tough problem. Adam Smith famously thought that corporations were unworkable as business organizations, because the directors would cheat the shareholders. Somehow his objections have not been insuperable in the modern business world, but it's still a bit mysterious. If a corporation has only a few owners, it is close to being a sole proprietorship, or at least a partnership, and while the owners may have some trouble keeping the managers and employees in line, that is not a problem to be solved by legal organization. If a corporation has more owners, but at least one of them owns a substantial part of the company, that big owner, at least, will watch over the managers. The problem remains of how he can induce anybody to entrust their capital to buy shares in a company he controls for his own profit, but that is a problem well addressed by a large body of corporate law. A few principles go a long way in solving that problem: make self-dealing illegal, and require dividends per share to be equal for all shareholders.

The biggest problem, though, is how widely dispersed shareholders, each with little incentive to take any trouble, can govern the company's managers. The typical large corporation has a board of directors all of whom are chosen by the past or present CEO and many of whom are company employees that he can fire at will. The CEO is constrained by some self-dealing rules. He cannot pay himself a salary equal to the company's asset value, or buy products at highly inflated prices from another company he owns. But under the protection of the business judgement rule he can advise the directors to pay him a salary well above the market level, use company resources for personal consumption, and manage the company as incompetently as he wants.

Jonathan Macey has a useful table of possible constraints on the CEO in his book, *Corporate Governance*, which we reproduce here as Table 1.

sdfd	sdfd	sd
sd	sdf	df

**Table 1: Macey's list, Table 3.1, p. 50)**

Dissident directors are an important part of corporate governance, and are underrated.

Unless some single entity owns a lot of shares, the shareholders are not going to be able to elect directors whom they can control. Even then, with

staggered boards it may take some years to do so. The market for corporate control helps, but it requires a full-pressure takeover attempt. Even that can be thwarted by poison pills, etc.

A requirement to have outside directors is useless. The inside directors can get their outside friends elected. Indeed, the CEO has more to fear from his number two man than from an outside director.

Even if outside directors are important people, it is socially awkward to criticize management either inside or outside the boardroom. Most people don't have the guts or willingness. They will act if things get bad enough, maybe, but things have to get very obviously bad.

If things do get bad enough, and obvious enough, then the directors may act against the CEO. Partly this is to maintain their own reputations, partly because legal liability for breach of fiduciary duty does kick in at some point. In fact, criminal liability kicks in at some point, if the directors are helping the CEO commit crimes.

What is much more likely to happen is that there comes to exist a dissident director. This might happen because some shareholder has enough stock to elect one but not more directors. Or it might be that a supposed friendly inside or outside director turns out to be independent or hostile to management.

Law question 1: If a VP is a board member, and the CEO fires him, does he still remain on the board? Does the VP have any special protection from being fired by the CEO virtue of being a board member?

The existence of even one dissident makes a huge difference. That is so for four reasons:

1. He has access to inside info, and can leak it to the public, where stock analysts and government investigators and social circle of the CEO can see it. This last will be extremely important for nonprofit corporations, which have the same plus more governance problem as for-profit ones.

2. He has access to inside info, and can inform other directors, who, having been put on notice of facts they would have liked to ignore, now will act.

3. He can break the ice by criticizing the CEO. Once this social faux pas is made, it is socially acceptable for other directors to pile on too. "I would rather that Joe hadn't brought this up, but now that he has, I also was wondering whether the new factory was a good idea..."

4. He can break the ice by asking for information from the CEO and pushing aggressively to get it. Other directors might be too shy to ask but will back him up if the CEO pushes back (it is the CEO who is in the position of being rude, then).

Law question 2: What right to information does a single director have? (I assume a majority of directors can do anything they want with the company.) Does the CEO have to obey him the slightest, absent special vote by the board to grant any one of their number authority?

Law question 3: Going further, does a director have the right to attend board meetings? Can a majority with a quorum bar him from the room? Can they hold secret pre-meeting meetings and only let him in for the formal votes?

I imagine that the by-laws or charter could be written to give the director more rights, in any case. If the by-laws can be rewritten by majority vote of directors, it might be good to put single-director rights in the charter. But even in the by-laws such rights would be highly useful, since it would be socially awkward to rewrite the rules to target a specific dissident.

Law question 4: Can a corporate charter be written to give special rights to single directors? (not by name, of course, but saying that any one director would have the rights to do this or that.)

This paper maybe or maybe not would benefit from a formal model. Players: 3 directors. Actions: vote for a project or against, investigate info or not. The project might be honest, or might be a dishonest scheme by the CEO. Payoffs: Most directors want to vote for the project unless they have been informed that it is dishonest, even if the probability it is dishonest is very high. The dissident director wants to investigate the project first and find out whether it is dishonest, and then vote accordingly. If he investigates, all directors become informed.

It's a good point that the incentive of the rating agencies came to be to rate anything AAA if given money to do so, since government regulation certification was what they were selling, not information.

On the other hand, suppose that the government would actually Decertify S+P if S+P started inflating its ratings. Then S+P \*would\* be careful to give informative ratings. And the govt. would even want to keep the number of certified raters small, to keep prices high, to keep profits high, so decertification would be a big punishment. That's an efficiency wage story.

What might be best of all would be to have the govt. choose, every 5 years, 2 raters to be certified for that period. Other raters could operate, and would so they could accumulate performance histories that would allow them to challenge the incumbent when the 5 year term is up. Corruption would enter in, with bribes having an influence on who wins the 5-year licenses, but the politicians wouldn't be able to pick a really incompetent or rascally winner because it would be too obvious to voters.

Suppose we had a laboratory that certified that food didn't have unsafe levels of chemicals, and they were so sloppy that lots of people got killed by unsafe products. Those labs would lose their certification immediately. Why haven't the rating agencies?

How about Dun and Bradstreet? Is it still doing fine? I'm not sure, but I think they give accurate info on business credit, and that's because it has no official government certification value. Does Dunn and Bradstreet give a bottomline rating for a business? (e.g., AAA, BB, as opposed to listing judgements against them, etc.) Credit scores are still another example. Those are semi-official, though, so maybe they're corrupt too.

Another possibility is that S+P has had an end-period problem. Up to 2005, there was a duopoly, with two inefficient raters with high operating costs who were protected from competition unless they did a really rotten job. Then in 2005 the law was changed, and 6 lean-and-mean low-cost high-quality raters entered. Seeing the handwriting on the wall, S+P decided to use up its reputation and make short-term profits.

1. What if a dissident director reveals a corporate board crime or failure to the public, KNOWING that it will reduce the firm's value. Has he breached fiduciary duty? (not your book, but a question I have).

2. What about a by-law requiring all self-interested transaction proposals to be reported to the shareholders? (not approved, just reported).

3. What about a by-law requiring compensation contracts to be reported?

4. The book doesn't say much of anything about the problem of protecting minority shareholders. That's OK, but that's half of corporate law missing.

In *Smith v. Van Gorkom*, did minority shareholders win on separate grounds— that even if the decision was a wise one for majority shareholder, and well thought out, it was negligent not to structure it to protect them?

What is gross negligence in director behavior? Would the behavior in *Smith v. Van Gorkom* count? how about the approval of self-dealing and the

lack of monitoring of terms in Enron?

5. Wouldn't by-laws making it easy to vote in a dissident director help a lot?

6. What rights does a dissident director have? Can he ask for info?

7. A HUGE use for a dissident director (or private equity, hedge fund, etc.). He can put the directors on notice that something bad is doing on. Then they are on the hook for gross negligence.

Maybe I should write on this with Ramseyer. Macey's chapter on Dissident Directors misses the point entirely. The point is this: 1 director can make a huge difference, ESPECIALLY if the by-laws are structured right.

He makes a huge difference by being a whistleblower, in effect. He can put the other directors on notice, which give them legal liability AND helps by introducing the socially awkward issue nobody wants to bring up.

Notice that an outsider can fulfill the same role— a hedge fund shareholder could INFORM the directors of something the hedge fund discovered by outside research, and put them on notice. The director has better access of info, tho.,

What is especially useful is if the director can get info. A majority of the board can get whatever info it wants from the company. What can one do? Nothing, maybe, at the moment. Can he even assert a right to attend board meetings, other than to vote? I suppose he can. That gives him some info. But it would be good to give him subpoena power too, in the company. Maybe that could be the default, with such power removed only by a public vote of the other directors. What would happen if the subpoena were flouted? We could require the company to pay the director a million dollars a day. This would be by contract— the standard director's contract specified in the by-laws.

Another idea: the Devil's advocate director. The by-laws say there must be one. He gets a bonus of 10 million dollars if the CEO is removed by the board. This gives him a good incentive to try to persuade his colleagues. This is a way to CREATE the dissident director. Even if the CEO gets his friend appointed to the dissident director post, he can't trust his friend.

GM— Ross Perot had special GM-EDS stock that had one director slot of its own. He was bought out for twice his original price.

Corporate law requires that a director be allowed to see ALL info in the corporation. Oliver Goodenough. And a director is allowed to disclose

criminal behavior even if it hurts the firm to do so— his duty is to act for the shareholders ACCORDING TO THE LAW.

Under Sarbanes-Oxley, maybe a director has a duty to disclose.

DISSIDENT. Dartmouth U. Zywicki as trustee. They have a bad rule that members of the board cannot talk about things said at board meetings. A good example of the kind of by-law that can be good or bad.

Philadelphia City requires one city councillor to be of a minority party. "The 1951 Home Rule Charter established the council as the legislative arm of Philadelphia municipal government, consisting of seventeen members. Ten council members are elected by district and seven from the city at large. At-large council members are elected using limited voting with limited nomination, guaranteeing that two minority-party candidates are elected." <sup>1</sup>.

"Each elector shall have the right to vote for one district councilman and for five councilmen-at-large. To this end not more than five candidates for councilmen-at-large shall be nominated pursuant to law by any party or other political body." <sup>2</sup>

Jill Fisch: Ackman Private Equity Fund, Targeting Target. Dissident.

SHow to Pastory Bayly. Church organization.

Bainbridge book highly relevant. He has no clue. Fits with his notion, though.

Write a short DISSIDENT book with Ramseyer.

Jill Fisch suggests looking at Ackman's private equity fund and their current target, Target.

There is a problem for a director who implements a shareholder proposal, for his reputation. He has shown himself responsive, but also shown that he made the wrong decision in the first place, and he is admitting it. Cite on shareholder proposals Fabrizio Ferri, Yonca Ertimur and Stephen Stubben, Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals.

Shareholders cannot propose charter amendments for a vote. Only the Board can. How about giving any single director the right to make an

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<sup>1</sup>"Philadelphia City Council," [http://en.wikipedia.org/wiki/Philadelphia\\_City\\_Council](http://en.wikipedia.org/wiki/Philadelphia_City_Council)

<sup>2</sup>"PHILADELPHIA HOME RULE CHARTER," "Section 2-101: The Election of Councilmen," <http://www.phila.gov/personnel/homerule>(April 17, 1951, revised later).

amendment?

Dissident: Should the board be larger, to increase the probability of having a dissident? If there is a big shareholder, do we need a dissident? (no, it would seem)

[Todd Zywicki, May 30, 2009 at 2:19pm] Trackbacks What Do Steve Forbes and I Have In Common? Unfortunately for me and fortunately for him, it is not the size of our bank accounts. But as Anne Neal reports, we both did get reprimanded by our respective boards of trustees for speech crimes, Forbes for criticizing Princeton's hiring of Peter Singer while he was serving on the board there. She also reports that University of California Regent John Moores got in trouble for asking scandalous questions about whether UC was violating state law in its admissions practice. Dartmouth U. Zywicki as trustee. They have a bad rule that members of the board cannot talk about things said at board meetings. A good example of the kind of by-law that can be good or bad.



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