February 28, 2010

The Equity Trustee

Kelli A. Alces

Available at: https://works.bepress.com/kelli_alces/1/
THE EQUITY TRUSTEE
Kelli A. Alces

Abstract

As we reel from the effects of a recent financial disaster, it is apparent that there is a significant gap in corporate governance and accountability for management. One reason why we have experienced this financial cataclysm is the inability of shareholders to do the “shareholder job.” Shareholders, as the putative owners of corporations, hold a venerated place in corporate governance. They are responsible for electing directors and monitoring management as well as valuing companies through trades in a vigorous market. The shareholder collective action problem and resulting rational apathy have kept shareholders from effectively fulfilling their role in corporate governance. Individual shareholders have interests that differ and, sometimes, financial interests at odds with those of the corporation. Even if the collective action problem could be overcome and some shareholders decided to take a more active role in corporate affairs, their decisions might not align with those of the rest of the shareholder class. Shareholder powers have always been weak, but, because of the enduring collective action problem, they are now virtually meaningless.

This article suggests a solution to the shareholder collective problem. It proposes the use of an “equity trustee,” or shareholder representative, to serve as a sophisticated party to perform the shareholder job. An equity trustee would represent the equity interest as a whole, overcoming the diverging interests of individual shareholders, to do the shareholder job of monitoring management and remaining informed about corporate affairs in a manner designed to further the goal of long-term corporate wealth maximization. The use of an equity trustee may also provide a solution to some of the market failures that led to the recent financial crisis such as an unhealthy focus on short-term increases in stock price and the seeming entrenchment of corporate officers and directors. Effective performance of the shareholder job may significantly improve corporate governance and accountability.

* Assistant Professor, Florida State University College of Law. For very helpful comments and conversations about the equity trustee idea, I am grateful to Robert Ahdieh, Jill Fisch, Brian Galle, Andrew Gold, Andrew Hessick, Jonathan Macey, Gregg Polsky, Larry Ribstein, Amanda Rose, and David Skeel as well as participants at workshops at the College of William and Mary School of Law, the University of Illinois College of Law, the University of Iowa College of Law, and the Florida State University College of Law. For excellent research assistance, I thank Abby Van Harpen and Aveed Majd.
# Table of Contents

**Introduction**........................................................................................................... 3

**I. Problems Plaguing the Shareholder Role in Corporate Governance: Collective Action and Apathy** ......................................................... 5

   A. *Diversification and Shareholders’ Differing Interests* ........................................ 8
      1. Diversification .................................................................................................. 8
      2. Empty Voting ............................................................................................... 10
      3. Short term vs. Long-term Interests ................................................................. 11
   B. *Rational Shareholder Apathy* ........................................................................... 13

**II. The Solution: An Equity Trustee** ................................................................. 17

   A. *Responsibilities and Power* ........................................................................... 17
      1. Informing and Advising Shareholders ............................................................ 17
      2. What if There is Bad News? ......................................................................... 23
      3. Advising and Negotiating with Management .................................................. 24
   B. *The Equity Committee* .................................................................................. 27
   C. *Compensation* ............................................................................................... 28
   D. *How Implemented* ........................................................................................ 30
   E. *Equity Trustee Fiduciary Duties to Shareholders* .......................................... 31

**III. Adding Another Agent – Is There Room?** .................................................. 33

   A. *An Equity Trustee Is More Than A Director* ............................................... 33
   B. *The Equity Trustee’s Relationship With the Board* ....................................... 35
      1. Capture by Management ............................................................................... 37
      2. Capture by the Equity Committee ................................................................... 38

**IV. The Equity Trustee and the Corporate Governance Market** .................. 39

   A. *Why Hasn’t the Market Thought of This Yet?* ........................................... 40
      1. Proxy Advisors .............................................................................................. 40
      2. Shareholder Committees ............................................................................. 42
      3. Director Subcommittees .............................................................................. 43
   B. *Regulation* ..................................................................................................... 45
   C. *Corporate Governance Failures* .................................................................... 47
      1. “Short-Termism” ......................................................................................... 47
      2. Entrenchment of officers and directors ......................................................... 50

**V. What’s Next** ..................................................................................................... 52

**Conclusion** ........................................................................................................... 53
INTRODUCTION

The source of both the elegance and the awkwardness of the public corporation are the same: the ownership of equity shares by widely dispersed public masses. Significant share ownership by professionally managed funds has changed this arrangement somewhat, but it has not changed the realities of an “ownership” structure in which the putative owners have no means of collaboration and no real incentive to monitor the managers of any one firm. One advantage to the dispersed nature of share ownership is that shareholders can diversify investment portfolios and spread the risk they bear across the market. The ability to diversify makes investors more willing to buy stock and allows corporations to take profitable risks.¹

But that same diversity also makes shareholders grossly inadequate monitors of corporate officers and directors. Shareholders do not invest in monitoring corporate management because the costs of doing would be born by the monitor entirely, while the benefits would be shared by all. Public share ownership and the resulting collective action problem prevent shareholders from effectively exercising the powers granted them by corporate law and also deprive corporations of an active and engaged monitor of management. When combined with the “Wall Street rule,”² dispersed share ownership leaves a significant gap in corporate governance and accountability. The shareholder collective action problem is blamed for many shortcomings of corporate law and is often seen as a necessary, unavoidable obstacle to a more effective model of corporate governance. The collective action problem, though, is neither inevitable nor insurmountable. Equally dispersed holders of public bonds can achieve uniform representation and thereby negotiate satisfactory contracts with the borrowing corporation and its management,³ and there is no reason shareholders cannot do the same.

This article develops a solution to the problem of widely dispersed share ownership. It creates and explains the role and usefulness of an “equity trustee” – a representative of the identifiable equity interest. An equity trustee allows shareholders to resolve their collective action problem and use their designated

¹ See Henry T.C. Hu, Risk, Time, and Fiduciary Principles in Corporate Investment, 38 UCLA L. REV. 277, 292 (1990) (“If shareholders are diversified and the risk associated with a project can be diversified away, managers can concentrate on expected returns and pay relatively little attention to such … risk.”).

² The “Wall Street rule” refers to the proposition that a stockholder will simply sell their stock rather than try and change the company’s management or policies. See Bernard S. Black, Shareholder Passivity Reexamined, 89 MICH. L. REV. 520, 534 (1990); Brian R. Cheffins, Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? The Case of the S&P 500, at 6 (European Corporate Governance Institute, Law Working Paper No. 124, 2009), available at http://ssrn.com/abstract=1396126.

³ The bondholder-firm relationship is subject to extensive negotiation and detailed, enforceable contracts. See Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 NW. U. L. REV. 547, 588–89 (2003) [hereinafter Director Primacy] (further stating that “arrangements … are thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to … define the corporation’s obligations to its bondholders.” (quoting Katz v Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986)).
powers effectively while leaving individual shareholders free to diversify their investments and remain rationally apathetic to the concerns of one particular firm. It gives the shareholders and the corporation the best of both worlds: widely dispersed, diversified equity investors and a proper guardian of the equity interest.

An equity trustee would be a representative for all shareholders in a corporation selected by a committee of the firm’s seven largest shareholders. An equity trustee can be introduced either at the IPO stage or in the midst of a corporation’s operations at the behest of shareholders. Its function is largely to monitor. The equity trustee would be responsible for reviewing corporate records and disclosures and relaying relevant information to shareholders. It would be responsible for advising shareholders about how to vote as well as advising the board about what the best course of action for the equity position would be. The equity trustee would have the authority to decide to sue on shareholders’ behalf in direct or derivative suits. Most importantly, the equity trustee would provide a realistic way for shareholders to actually negotiate contracts with the corporation and its management rather than relying on the murky off-the-rack implicit contracts currently provided by state corporate law. Succinctly, the equity trustee serves as a single, sophisticated representative with the power and incentives to do everything the shareholders have the power to do as a group but do not effectively achieve because of the pervasive collective action problem.

The introduction of an equity trustee would have far-reaching effects, however, and would introduce new costs as it alleviates others. Some of the agency costs associated with director control and monitoring will shift to the delegation of power to the equity trustee. Further, the equity trustee would have to be compensated by the corporation and there must be mechanisms in place to enforce the fiduciary duties it owes the corporation’s shareholders. There has been significant debate over the last decade or so about what powers shareholders should have and whether their interests are particularly important to corporate decisionmaking. This article proposes to make shareholders more powerful by

---

4 Id., at 556 n. 49 (“The set of contracts comprising the firm consists in very large measure of implicit agreements, which by definition are both incomplete and unenforceable.”). See also Yakov Amihud et al., A New Governance Structure for Corporate Bonds, 51 STAN. L. REV. 447, 464 (1999)(Various “actions that increase the business risk associated with the company's operations are difficult to specify contractually.”). Id.


6 Compare Iman Anabtawi, Some Skepticism About Increasing Shareholder Power, 53 UCLA L. REV. 561 (2005) (arguing that shareholders will use any incremental power granted to them to benefit their private interests at the expense of the firm and other shareholders), and Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 HARV. L. REV. 1735, 1751 (2006) (arguing that shareholders would make little use of the powers given to them) [hereinafter Bainbridge, Shareholder Disempowerment], and Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO L.J. 445, 452 (1991) (Rock concludes that agency costs prevent shareholders from bringing about any fundamental changes in corporate
simply allowing them to exercise the powers they already have more effectively, rather than by adding new enumerated powers. There is still a resulting change in the balance of power and shareholders would have a louder voice than they have had heretofore. Using an equity trustee to represent the equity interest rather than the interests of individual equity holder strikes a balance between the competing views of shareholder power. It allows for greater representation of the equity interest in a way contemplated by the corporate form, but does not allow individual, and often relatively uninformed, shareholders to take over corporate decisionmaking.

Putting another voice in the room to which directors and officers must respond and forcing those executives to accommodate yet another professional with something to say about how the corporation ought to be run has the potential to significantly change the structure of corporate governance, perhaps in ways that are not entirely predictable. It will be necessary to consider those effects of the equity trustee that are immediately foreseeable and to present as complete a picture as possible of what an equity trustee would be and how it would work within the current corporate governance paradigm. Only experience with the proposed innovation over time will reveal fully the consequences of adding the new representative.

The article proceeds in five parts. Part I describes the obstacles to effective performance of the "shareholder job" in corporate governance. It explores the consequences of the still prevalent collective action problem, the divergent interests of shareholders, and rational shareholder apathy. In doing so, it explains that institutional shareholders have not meaningfully resolve the collective action problem as scholars once thought they might. Part II proposes a solution to these problems in the form of an equity trustee. It outlines how the equity trustee would be chosen, compensated, and implemented as well as what the equity trustee would do on the shareholders’ behalf. Part III explains why an equity trustee is something other than a vigilant, or ideal, director and details what the equity trustee’s relationship with the board would be. Part IV explains why the market has not already developed an equity trustee. It also describes how the equity trustee fits into the corporate governance market and resolves some of the failures in that market. Finally, Part V anticipates some of the consequences of the use of an equity trustee and predicts what the future of corporate governance may look like with equity trustees in place.

I. PROBLEMS PLAGUING THE SHAREHOLDER ROLE IN CORPORATE GOVERNANCE: COLLECTIVE ACTION AND APATHY

law, though some useful reforms and innovations may still occur. “Optimists' vision of the institutional investor as the shareholders' champion, replacing the outside director as the primary monitor of managerial behavior, will prove illusory.”, with Lucian A. Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833, 835 (2005) (arguing that shareholders should be given power to “initiate and adopt rules-of-the-game decisions to change the company’s charter [and that] such power would operate over time to improve all corporate governance arrangements”), and Richard M. Buxbaum, The Internal Division of Powers in Corporate Governance, 73 Cal. L. Rev. 1671, (1985) (encouraging greater shareholder participation and power in a corporation’s governance).
Shareholders have an important job to do in corporate governance. They are expected to vote on major corporate decisions, to monitor and elect directors, to bring suit on behalf of the corporation when directors fail to bring the cause of action, and to constitute an active and engaged market that does its best to appraise the value of a particular company’s assets under current management. These are a lot of responsibilities for a widely dispersed and rationally apathetic group of investors, each with markedly different portfolios and economic interests and preferences. Many argue that the market as a whole balances these difficulties against the cumulative effects of knowledgeable trades and performs this job adequately.

One need not look far to find evidence of failures in the corporate governance market these days, however, and the shareholder collective action problem causes or enables many of the market’s infirmities. In particular, it makes it difficult for anyone to do the shareholder “job” effectively. Further, even when an investor or group of investors is able to pay attention and do a part of the shareholder job, there is no guarantee that they have the right incentives to do the shareholder job in a way that will truly maximize corporate wealth. Shareholders are not very powerful, and the powers they can exercise have been effectively muted by the combined efforts of the courts and legislators and the practical difficulties

---

7 Bainbridge, Director Primacy, supra note 3, at 552.
9 See Stephen M. Bainbridge, The Case for Limited Shareholder Voting Rights, 53 UCLA L. REV. 601, 613 (2006) (highlighting the need for fiduciary duties: “collective action problems preclude the shareholders from exercising meaningful day-to-day or even year-to-year control over managerial decisions”); Black, supra note 2, at 527 (showcasing poor shareholder activism: “collective action theory tells us, … that share- holders won’t make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort”); Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 LA. L. REV. 247, 312 (1999) (discussing bad shareholder voting: “even when shareholders are entitled to vote, … shareholders still face collective action problems. The net result is that it is always extremely difficult, and often impossible, for shareholders to use their rights to vote on fundamental changes to oppose a transaction or policy the board favors.”) [hereinafter Blair & Stout, Team Production].
10 See Anabtawi, supra note 6, at 570 (“The foregoing limitations on the effectiveness of the ability of shareholders to participate in corporate decisionmaking suggest that shareholders presently have the potential to operate as only a weak constraint on managers.”); Blair & Stout, Team Production supra note 9, at 312 (“[S]hareholders still face collective action problems. The net result is that it is always extremely difficult, and often impossible, for shareholders to use their rights to vote on fundamental changes to oppose a transaction or policy the board favors.”).
11 See Jessica Erickson, Corporate Misconduct and the Perfect Storm of Shareholder Litigation, 81 NOTRE DAME L. REV 75, 100 (2008) (“explaining that “shareholders” interests, and the interests of their attorneys are not always aligned with the interests of the plaintiff corporations” and that “shareholders who agree to serve as representative [plaintiff] do not have the financial incentives to ensure that a derivative suit is in the best interests of the plaintiff corporation”).
12 See, e.g. Shareholder Proposals, 17 C.F.R § 240.14a–8(i)(1) (2000) (regulating shareholder proposals: “[i]f the proposal is not a proper subject for action by shareholders” the directors may
presented by the collective action problem. However, shareholders occupy a
critical position in the market and an important place in the corporate governance
structure.

In order for the corporate law system of checks and balances to work, there
has to be a distinct role for shareholders to play and someone must attend to it.
Otherwise, there is no substantial monitoring of or accountability for corporate
directors. One explanation for why this part of the corporate governance system
does not work as well as it should is that shareholders are not granted an
appropriate level of power in corporate decisionmaking. Another is that
shareholders in fact are not given any power at all. A third, and more widely
accepted explanation, is that shareholders are granted and would be able to use an
optimal amount of decisionmaking and monitoring power, but they do not avail
themselves of that opportunity because of rational apathy occasioned by the
collective action problem.

This Part examines the barriers to shareholder effectiveness caused, or
exacerbated by, the shareholder collective action problem. First, it examines
rational shareholder apathy and the resulting poor performance of the shareholder
job. Second, it argues that the evolving sophistication of the securities markets
and investor diversification may have enhanced shareholder apathy and made
individual and institutional shareholders ill-equipped to fill adequately the role
intended for shareholders in corporate law.

refuse to take action); Auer v Dressel, 118 N.E.2d 590, 593 (N.Y. 1954) (holding that corporate
directors do not have an obligation to follow shareholder demands in situations like officer
reinstatement); Margaret M. Blair & Lynn A Stout, Director Accountability and the Mediating
duty of obedience to shareholders.”) [hereinafter Blair & Stout, Director Accountability]. See also
Black, supra note 2, at 527 (“[C]ollective action problems make manager proposals unlikely to
fail and shareholder proposals unlikely to succeed, almost regardless of the merits of the proposal.”).

13 The market for corporate control has provided accountability for management in the past, but
the ability of hostile acquirers to succeed in unseating poor management has been compromised by
anti-takeover decisions and legislation. JONATHAN R. MACEY, CORPORATE GOVERNANCE:
PROMISES KEPT, PROMISES BROKEN 118-126 (2008).

14 See Bebchuk, supra note 6, at 835 (indicating that “shareholders' existing power to replace
directors is insufficient to secure the adoption of value-increasing governance arrangements that
management disfavors”); see also David Hoffman, Shareholder Resolutions Ignored Even if
Passed, Academic Study Finds, PENSIONS AND INVESTMENTS, (Nov. 22, 2004), available at
have the power to initiate corporate-governance change.” (quoting Lucian A. Bebchuk)).

15 Black, supra note 2, at 556. Most states have “adopted statutes that sharply restrict [or freeze]
shareholder power.” Id.

16 See Bainbridge, Director Primacy, supra note 3, at 558–59 (stating that shareholders will not
expend the necessary effort to “make informed decisions . . . if the expected benefits of doing so
outweigh [the] costs”); Frank H. Easterbrook & Daniel R. Fischel, Contact and Fiduciary Duty,
36 J. LAW & ECON 425, 437 (1993) (discussing an investor's lack of “duties to fellow investors”
and their general preference to “passive diversification” of investments); Yair Listokin, If You
Give Shareholders Power, Do They Use It? An Empirical Analysis, 3 (Yale Law School John M.
383, 2009) available at http://ssrn.com/abstract=1400263 (arguing that, even if you give investors
power they “would make little use of it”).
A. Diversification and Shareholders’ Differing Interests

Even within a single class, shareholders are not a cohesive, homogeneous group. While some shareholders might be widely dispersed without the ability to communicate effectively with one another, it is often the case that the largest shareholders in a company are institutional shareholders who know each other well and could communicate easily if so inclined.17 Those investors, while potentially very similar, are competitors in the market for the services they provide and may have widely divergent interests. Although shareholders are not a homogeneous group with identical individual interests, there is some substantial identity of interest among the members of the class. That is, we may not know what shareholder A or shareholder B would prefer given their individual interests and portfolios but it is possible to identify an interest associated with a particular class of shareholders in its entirety.18 An equity trustee could adequately represent the shareholder class, regardless of the differing interests of the individual class members.

1. Diversification

Because most shareholders are well-diversified, they hold portfolios of investments that include stocks in different companies and may also include various other securities, such as bonds or derivatives.19 The goal of diversification is to protect the investor from being vulnerable to the risk of failure of any single investment, to keep the investor from putting all eggs in one basket, so to speak.20 Because the value of a shareholders’ portfolio does not rely on the performance of any one investment, investors are not particularly worried about each individual company’s health or profitability.21 Further, well-

17 See Black, supra note 2, at 535 (discussing the ease with which large, institutional shareholders can call meetings, vote, and communicate), and at 567-68 (discussing the high percentage of institutional ownership in a large company, often over 60%).
18 Hu, supra note 1, at 367–70 (finding a general shareholder interest in shareholder wealth maximization).
19 Joseph F. Jacob, The Impact of the Euro on United States Equity Markets, 13 ST. JOHN'S J. LEGAL COMMENT. 399, 414 (explaining how “[i]nvestors diversify investment portfolios to minimize risk and to cope with securities fluctuation.”); Luize E. Zubrow, Rethinking Article 9 Remedies: Economic and Fiduciary Perspectives, 42 UCLA L. Rev. 445, 564 (discussing how, “by holding a diversified portfolio combining common stock and other riskless investments, shareholders can neutralize most firm specific risk.”).
20 “Investors may exert themselves to reduce the magnitude of audit failure. A key device available to them is diversification. Under modern portfolio theory, investors can reduce the risk of a single stock price drop by owning opposite-behaving stocks or a group of differently behaving stocks. The result is that peculiar risks associated with given securities are reduced, for the price of also reducing the “risk,” or positive chance, of a single stock price surge.” Lawrence A. Cunningham, Securitizing Audit Failure Risk: An Alternative to Caps on Damages, 49 Wm. & Mary L. Rev. 711, 735-36 (2007); Richard A. Booth, The End of the Securities Fraud Class Action as We Know It, 4 BERKELEY BUS. L.J. 1, 10 (2007) (explaining how “it is irrational for a passive investor not to diversify” because of the “unnecessary risk that goes with failure to diversify.”).
21 Anabtawi, supra note 6, at 583-84.
diversified investors tend not to be concerned even with choosing specific companies to invest in. They are simply interested in having a security in their portfolio that represents a particular risk and rate of return. Therefore, well-diversified shareholders will not usually invest in specific information about a company’s management and will not take actions to guide a single company’s governance. If something goes wrong and a particular security does not perform as expected, the shareholder just replaces it with another. Even if shareholders were more active participants in corporate governance via monitoring, voting, and making proxy proposals, no single shareholder would be able to adequately represent the entire equity interest. Because different shareholders have different portfolios, their interests in how a particular stock should perform may differ. The performance of one stock in a shareholder’s portfolio might affect another security’s performance, and because shareholders’ portfolios differ from one another, the way a particular corporate outcome will affect each shareholder may differ. Those differing interests pose agency problems even if one shareholder is willing to supply a collective good in the form of disciplining management.

For instance, not all shareholders are diversified, and those exposed to firm-specific risk will have a different set of risk preferences and will want the company managed differently than those who are not so exposed. Similarly, inside shareholders, those who work for the firm, will be more risk averse than outside shareholders, because inside shareholders have made more of a personal, and, therefore, less well-diversified investment in the firm. Different risk preferences might lead to different opinions about how the shareholder job should be performed – whether a current board should be replaced or whether a particular corporate combination should be approved.

Deeper and, perhaps, more subtle differences can exist between pension funds and other shareholders. Pension funds either represent a company’s workers or

---

22 Id. at 584.
23 See id. (suggesting that a diversified shareholder is unconcerned with the specific actions of a company because “by investing in a large array of companies, shareholders become indifferent to such risk” the actions create); see also Bainbridge, Director Primacy, supra note 3, at 593 n.221 (evaluating Professor Smith’s assumption “that rational investors invest across a wide array of assets and therefore would prefer a rule requiring ‘managers [to] make the choice that will maximize the value of rational investors' diversified portfolios’”) (citing Thomas A. Smith, The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty, 98 Mich. L. Rev. 214, 242 (1999)).
24 Alicia Davis Evans, The Investor Compensation Fund, 33 J. CORP. L. 223, 263 (2007) (explaining that a buyer can find a number of different stocks with like characteristics in which to invest because “shares of stocks are largely fungible”).
25 See Anabtawi, supra note 6, at 585 (discussing how a well-diversified investor will “feel the impact of actions by one company in their portfolio on their other portfolio companies” because “through its extensive portfolio holdings, the universal shareholder internalizes many of the externalities generated by the companies in which it invests”).
27 Anabtawi, supra note 6, at 583.
28 Id., at 586 (suggesting that insiders are more risk averse because “[i]nsiders possess firm-specific human capital” and a more personal connection and heavy exposure to the firm”).
represent other workers with non-economic interests governing stock choice, while other shareholders only care about a stock’s economic return. Union pension funds may agitate for changes that would help workers at the expense of share value, and public pension funds may have public, governmental interests that conflict with pure corporate wealth maximization. Diversification and differing perspectives can lead to conflicting preferences among shareholders belonging to the same class.

2. Empty Voting

The most striking example of those differing interests is the problem of empty voting identified by Professors Henry Hu and Bernard Black. Empty voting occurs when an investor with the right to vote a company’s stock, either because it has bought or borrowed the stock for that purpose, has managed to de-couple the economic interest of stock ownership from the power to vote. The investor is thereby financially unaffected by the vote it may cast and so may vote against the interests of the equity position its vote is presumed to represent. For example, an investor holding shares in a target company could acquire voting rights in the acquiring company, either by buying or borrowing shares, and then completely protect itself from financial exposure on the target company stock, either by hedging its ownership interest entirely or just borrowing the stock to vote without taking on any economic interest in the stock. That investor could then vote the acquiring company stock it owns in favor of the merger even if the transaction is affirmatively bad for the acquiring company. Hedged shareholders may, therefore, have very different interests than unhedged shareholders. This phenomenon provides a stark example of why any given shareholder may not be able to serve as a true representative of the shareholder

---

29 See Id., at 588 (discussing the “targeted, noneconomic, interests” that some shareholder have).
31 Hu & Black, New Vote Buying, supra note 30, at 825. Professors Hu and Black analyze the Perry-Mylan example, in which “Perry combined full ownership of Mylan shares with coupled assets (equity swaps and other hedges), which offset its economic ownership . . . [leaving Perry] with 9.9% voting ownership and zero net economic ownership”. Perry also held a non-related asset—shares of King Pharmaceutical. Because “Perry was left with full voting rights, but a negative overall economic interest [in Mylan Corp]—it would profit if Mylan overpaid for King.” Id.
32 Id. at 832 (noting ways an investor can “hold votes without economic ownership”).
33 See Hu & Black, New Vote Buying, supra note 30, at 827. Professors Hu and Black discuss several case instances (i.e. Perry-Mylan, Laxey-British Land, insider hedging, and Perry-Rubicon) where an institutional investor’s voting rights substantially exceed their net economic ownership and their vote conflicted with the best interest of the company.
34 Anabtawi, supra note 6, at 590-591. For example, Professor Anabtawi showcases a shareholder that purchases one share of a firm’s stock at the market price and simultaneously purchases an at-the-money put contract option on the stock. This put insulates the shareholder from the risk that the firm’s share price will decline. The put contract insulates the shareholder against the economic consequences of a decline in the firm’s stock price and its economic interests are different than a pure shareholder. Id.
class and why individual shareholders may take actions contrary to those of the larger equity interest.

3. Short term vs. Long-term Interests

A stark difference that has become particularly salient recently is that between short-term and long-term investors. Some investors, such as hedge funds and active mutual funds, focus on current stock prices and try to profit quickly from price fluctuations, however temporary. These funds have gained special prominence in recent years and have been very profitable and important parts of the market. They have consequently been very influential. Hedge funds are known, and perhaps are infamous, for their shareholder activism. They use the powers available to them to push for profits in a way that suits their usually shorter-term time frame, disregarding the interests of long-term shareholders and even the long-term viability of the company. Both hedge funds and active mutual funds face strong pressure from their investors to produce significant profits quickly. Often, pressure from these groups can lead to accounting decisions that prefer current earnings over future earnings. Further, the tension between short-term and long-term interests can affect how takeover attempts are treated. Shareholders with short-term interests may be willing to accept a tender offer for a lower bid in the interest of getting a high current price for the stock, while shareholders with longer-term interests may hold out in favor of perceived potential for larger long-term gains under current management. Even if all of these shareholder constituencies or individual institutional shareholders use their voice to the full extent possible and become faithful activists for their causes, they serve at cross-purposes of one another, and no one voice necessarily has an interest in long-term corporate wealth maximization and viability. Any one activist shareholder may exert influence for its benefit, but to the detriment of other, even all other, shareholders.

35 Anabtawi, supra note 6, at 579 (“[E]xpected holding periods can lead to differences in shareholder preferences over corporate decisionmaking. This conflict focuses on whether managers should make decisions for long-term or immediate profits.”); see also David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 4 (Boston University School of Law, Working Paper No. 09-22, 2009) available at http://www.bu.edu/law/faculty/scholarship/workingpapers/2009.html (acknowledging how reckless short term investing is because executives in “pursuit of short-term profits . . . will have cashed out before the long-term repercussions are felt”).

36 Anabtawi, supra note 6, at 579–80 (describing such investors primarily as “financial engineers interested in the largest possible profit in the shortest period of time” (citation omitted)).

37 Walker, supra note 35, at 5 (suggesting that “institutional and individual investors alike have become preoccupied with quarterly earnings forecasts and short-term price changes” and no longer care about long-term results).

38 See Anabtawi, supra note 6, at 581–82 (acknowledging that such accounting examples as “moving expenses from the current year to the future or by moving revenues from future years to the current year . . . can enhance (or avoid depressing) a company's current share price but reduce long-run shareholder value”).

39 See Paramount Commc’ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) (showcasing how various short and long term interests affect a corporate merger); Anabtawi, supra note 6, at 582 (discussing the ways short and long term interests tend to alter mergers and takeovers).

40 Paramount, 571 A.2d at 1144.
Pressure is only as good as the effect is has on the board. The officers and directors must make decisions that favor either short-term or long-term investors. The incentives that influence them and the ways they go about making those decisions have received a great deal of attention in light of the recent market crisis.\textsuperscript{41} The enhanced use of incentive compensation has produced managers with incentives to produce short-term results, rather than to pursue long-term strategies that may take time to be profitable.\textsuperscript{42} A dollar today is worth more than a dollar tomorrow, and managers would rather produce bonus-triggering results today than tomorrow. Because bigger and bigger profits and rising stock prices are the goal, managers can focus more on the \textit{indicia} of financial success than on actually increasing the value of the corporation’s combined assets and the long-term viability of the business. As a result, managers who were once risk-averse because of their firm-specific investment of human capital have become too risk-prefering in light of the staggering, immediate profits they will earn from incentive compensation. The “short-termism” problem caused by the current incentive compensation schemes is blamed for some of the problems leading to the current financial crisis.\textsuperscript{43}

Despite many parties’ interests in short-term profits, long-term wealth maximization should remain the goal of corporate governance. Corporations are businesses. In order to grow and thrive, a business must have long-term prospects for viability and potential for growth. We build businesses with the goal and

\textsuperscript{41} See Lawrence E. Mitchell, \textit{The Age of Aquarius or, How I (Almost) Learned to Stop Worrying and Love Free Markets}, 88 MINN. L. REV. 921, 930–31 (2004). Professor Mitchell discusses the consequences of short-term performance goals and the unacceptable risks they cause managers to take:

> Fund managers are compensated for the most part on the basis of their performance each quarter. And how is that performance measured? By the increase in portfolio value. So every incentive created by modern finance theory is for portfolio corporations to concentrate on maximizing stock price. This is a problem because increasing stock price is not the same thing as creating real corporate wealth through the production of goods and services. One can readily see this in the recent collapses of corporations like Enron and Worldcom that lost virtually all of their market value and still have substantial fundamental value based upon their assets. It is true that the run-up in stock prices of many corporations in the late 1990s and 2000 meant that those who sold high had more money.

\textit{Id. See also} Lloyd Blankfein, \textit{Do Not Destroy the Essential Catalyst of Risk}, FINANCIAL TIMES 7 Feb. 09, 2009 (arguing that “[a]n individual’s performance should be evaluated over time so as to avoid excessive risk-taking. To ensure this, all equity awards need to be subject to future delivery and/or deferred exercise. Senior executive officers should be required to retain most of the equity they receive at least until they retire, while equity delivery schedules should continue to apply after the individual has left the firm.”).

\textsuperscript{42} Clint Cronkite, \textit{Value-Seeking Companies Need Valuations}, 1999 J. BUS. VALUATION 177, 181 (1999) (explaining how “[o]ne of the problems with using bonuses as incentive compensation is that they are usually based on management meeting short-term financial targets and may conflict with achieving maximum long-term shareholder returns.”).

\textsuperscript{43} Walker, \textit{supra} note 35, at 1; see Sanjai Bhagat & Roberta Romano, \textit{Reforming Executive Compensation: Focusing and Committing to the Long-Term}, 26 YALE L.J. 359, 360 (2009) (discussing the connection of short-term interests and executive compensation and the need “to cap the salaries and bonuses of executives of firms receiving” bailout money from the Emergency Economic Stabilization Act of 2008 (EESA)).
purpose of producing and marketing a product and finding innovative ways to enhance that product’s value to society over time. To the extent that a company’s financial health is compromised by short-term investment strategies, it may lose its ability to produce or advance a valuable product line, and the business may ultimately fail as a consequence. While short-term gains may be good for some shareholders for a while, eventually, the long term consequences will catch up with investors and there will not even be short term gains to be had. For these reasons businesses, as opposed to investment funds, cannot be run with short-term gains in mind, and certainly cannot sacrifice long-term viability in favor of immediate profit returns. If particular shareholders cannot be counted on to represent this preference for long-term wealth maximization, a party representing that goal, as the main interest of a firm’s equity position, is necessary.

This section has discussed differing shareholder interests and how those interests can affect governance. Shareholders holding the very same securities can want different things from their investment in the company. These different interests break down incentives shareholders may otherwise have to communicate, cooperate, or somehow overcome the collective action problem. Further, because institutional investors compete with each other for returns and clients, they do not have incentives to join together to invest resources in monitoring management. A consequence of this collective action problem is that no one is doing the shareholder job. The next section focuses further on the discussion of the collective action problem to describe the rational apathy it causes and the effect that it has on corporate governance.

B. Rational Shareholder Apathy

Where there are many shareholders in a corporation and those shareholders have multiple investments, each shareholder, whether individual or institutional, lacks incentives to invest in information gathering or monitoring of the company’s management. Any gains the shareholder receives from its increased attention or activism must be shared with all shareholders, and the shareholder must bear the expense of its hard work alone. A rational shareholder will, therefore, free-ride on the possible attention of other shareholders and the

---

44 During the rise of the institutional investor, “Many scholars came to accept that the individual shareholder would remain rationally apathetic and passive but trusted these large shareholders to take a more active role in monitoring corporate management. . . . Although such expectations were not fulfilled-- most institutional investors turned out to be less interested in spending money and effort on monitoring management. . . .” Dalia Tsuk Mitchell, The End of Corporate Law, 44 Wake Forest L. Rev. 703, 724-25 (2009); “Small individual stakes make shareholder apathy rational because many monitoring activities, if conducted by small investors, will not affect corporate decisionmaking.” Jill E. Fisch, Relationship Investing: Will it Happen? Will it Work?, 55 Ohio St. L.J. 1009, 1048 n.29 (1994).

45 Black, supra note 2, at 527–28 (noting that “shareholders won't make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort” and that “[a] shareholder proponent bears most of the cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders free ride on her efforts’’); Rock, supra note 6, at 454 (“all the shareholders benefit in the form of higher earnings and share prices, whether or not they contribute to the discipline”).
market’s evaluation of the company’s prospects through the setting of the stock price and will not pay particular attention to specific companies. A well-diversified shareholder is protected from firm-specific risk and so has nothing to gain from detecting problems with individual firms. The shareholder instead will monitor the movements of the market as a whole. If one firm in its portfolio struggles, or if bad news about that firm shows up on the shareholder’s radar, it is most efficient for the shareholder to simply sell its holdings in that company and invest elsewhere. This choice of exit over voice is commonly referred to as the Wall Street rule. The collective action problem leads to the rational apathy that renders shareholder governance mechanisms ineffective.

Because rationally apathetic shareholders will not monitor management effectively or cast well-informed votes on major corporate issues, the jobs reserved for shareholders by corporate law are not well performed. Shareholder apathy becomes particularly acute when companies endure financial difficulty and shares are worth very little. While there is some evidence of shareholder activism in more healthy times, particularly with regard to sensitive political

---

46 Eric A. Chiappinelli, The Moral Basis of State Corporate Law Disclosure, 49 CATH. U. L. REV. 697, 733–34 (2000) (explaining that “small shareholders” are rationally apathetic and therefore inactive because their individual activism would not result in enough gains “to make the costs of monitoring and reforming management worth while”).

47 Anabtawi, supra note 6, at 585 (explaining that, because a diversified shareholder does not need to worry about firm-specific risk, a diversified shareholder will prefer the firm to choose riskier projects); Lawton W. Hawkins, Compensation Representatives: A Prudent Solution to Excessive CEO Pay, 72 BROOK. L. REV. 449, 468 (2007) (explaining how diversified shareholders who have “eliminated” firm-specific risk might advocate projects that undiversified shareholders would deem too risky); Larry E. Ribstein, Partnership Governance of Large Firms, 76 U. CHI. L. REV. 289, 295 (2009) (discussing how diversified shareholders are insulated from firm-specific risks).


49 “Rational apathy refers to the notion that the cost to shareholders of informing themselves about a particular action and casting a vote in opposition to management exceeds the expected or actual benefit gained from such voting. Given this cost-benefit analysis, shareholders rationally decide not to vote or at least not to vote in opposition to management.” Lisa M. Fairfax, The Future of Shareholder Democracy, 84 IND. L.J. 1259, 1268-69 (2009).

50 David Skeel, Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEX. L. REV. 471, 500 (1994) (describing the “black hole” effect of bankruptcy on derivative suits and corporate insolvency). Professor Skeel states that most corporations have become insolvent by the time they file for bankruptcy. Because they have little financial interest in an insolvent firm, and because most or all of any recovery would go to higher priority claimants, shareholders lose much of their incentive to promote and participate in derivative litigation. To the extent shareholders do play at least a minor role in a given suit, they are therefore likely to be indifferent (and perhaps even resistant) in the bankruptcy context.

Id. at 500–01 (internal citations omitted).
issues, and institutional shareholders have put themselves in a position to cast somewhat more intelligent votes by hiring proxy advisors, there is still a significant gap in corporate monitoring that no one investor has the appropriate incentives to fill. Even though institutional investors are more sophisticated, represent large numbers of individual beneficial owners of stock, and are able to communicate with one another, cultural norms and beneficiary expectations about actions they take on behalf of their investors keep them from effectively monitoring corporate management. For instance, managers of investment funds are expected to put together high-performing portfolios that deliver significant returns, more specifically, better returns than other money managers can muster. Investing in corporate governance issues and monitoring costs funds money and, as with all rationally apathetic shareholders, moves time and resources from developing a well-diversified portfolio to addressing firm-specific issues when the investor is not otherwise exposed to firm-specific risk. Moreover, there is no precedent for institutional shareholders being active corporate governance monitors, and so they fear taking the risk of being the first to take that step.

In order to perform their monitoring function well, shareholders must be aware of potential breaches of duty by management. That means that they must be aware of how the company is making its money and what individual managers have to do with it. They must understand the corporate business decisions upon which they vote, and they must have a basic understanding of what those decisions will do for long-term corporate wealth maximization. Someone has to be paying attention, but the market has evolved in such a way that no one is paying attention to long-term corporate viability. Further, because no one has a vested interest in a particular corporation tomorrow as long as they can sell their stock in that company to someone else today, there is no continuity of interest in the shareholder position. With incentives aligned as they are, no one is really doing the shareholder job.

Part of the reason the collective action problem has not been resolved or even been considered a priority is the belief that the market compensates for individual shareholder failures. As an efficient market responds to available information by setting a share price for each company, general information is communicated to shareholders about the value of corporate assets, corporate health, and the

51 Anabtawi, supra note 6, at 594.
53 Black, supra note 2, at 562-63.
54 Id.
55 Id. at 563.
56 Walter Werner, Corporation Law in Search of its Future, 81 COLUM. L. REV. 1611, 1646-47 (1981) (discussing how managers who were “sensitive to shareholder demands. . . tended to stress short-term earnings per share over long-term corporate viability.”).
57 Fairfax, supra note 49, at 1268–69 (suggesting that the free rider problem may cause individual shareholders failure and that it “stems from shareholders’ realization that they can benefit by relying on the actions of other shareholders, thereby undermining shareholders’ incentive to take action on their own”).
relative effectiveness of management. The information provided by rational market trades is supposed to have solved, or at least mitigated, the shareholder collective action problem. Theoretically, that seems like a plausible explanation. However, informational asymmetries and other failures have prevented the market from adequately compensating for the shareholder collective action problem. Scholars have begun to doubt the Efficient Capital Market Hypothesis, the semi-strong form of which holds that all public information about a company is incorporated into its stock price. The ability of the market to resolve, or render moot, the shareholder collective action problem relies on the viability of that economic theory. If the market is not rational or efficient, then it cannot do the shareholder job.

The collective action problem leads to rational shareholder apathy, and both problems prevent shareholders from performing the tasks of the residual claimant effectively. The combined problems keep shareholders from being vigilant monitors of management and knowledgeable consumers of corporate securities.

58 “Even if an investor does not disclose the nonpublic material information, changes in the price of a security signal changes in the value of capital assets or risk characteristics. Others react to initial price signals, causing the market to adjust until a new price equilibrium is attained. Because market forces operate quickly and accurately, on average investors can do as well by monitoring current price information as by monitoring the underlying material information that directly describes the value of an investment.” Dennis S. Corgill, *Insider Trading, Price Signals, and Noisy Information*, 71 Ind. L.J. 355, 404 (1996).

59 “[T]he concept or goal of economic efficiency is complex, elusive, and controversial. The ECMH contains inherent weaknesses…. There is some empirical evidence that small numbers of institutional and individual investors are able to achieve consistent market outperformance. There is also a growing body of scholarly material, which suggests that all market participants tend to act irrationally at times, due to human or behavioural factors…. Further, the connection between market efficiency and economic efficiency is far from precise, market efficiency goals typically result in a shift of wealth from one group of investors to another, and there is only limited theoretical or empirical academic material on the precise mechanisms for achieving market wide efficiency. Even where there is agreement on the economic or efficiency models adopted, objective market-wide measurements of efficiency are difficult to establish. Finally, the application of efficiency goals is not value free. Economic / market efficiency on its own is therefore not a totally objective or easily measurable goal.” Gill North, *Efficiency, Fairness & Irrationality: Incompatible or Complementary?*, 24 B.F.L.R. 311, 329 (2009); “In the last five years, however, each formulation of the ECMH has come under sustained empirical and theoretical attack…. Empirically, recent studies have demonstrated a tendency for stock prices to be ‘mean-reverting’ in the sense that stocks with high returns today tend to have lower future returns. This result directly contradicts the weak and semi-strong versions of the ECMH by showing that public price information can help predict future price changes.” Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 Va. L. Rev. 945, 967-68; Thomas A. Smith, *A Capital Markets Approach to Mass Tort Bankruptcy*, 104 Yale L.J. 367, 415 (1994) (discussing how “critics of ECMH have gathered evidence suggesting that capital markets are not absolutely efficient”); Carol R. Goforth, *The Efficient Capital Market Hypothesis-An Inadequate Justification for the Fraud –on-the-Market Presumption*, 27 Waseca Forest L. Rev. 895, 899 (1992) (discussing how the validity of the ECMH “depends on certain subordinate assumptions which also must be accurate… [and] [s]ubstantial disagreement exists regarding whether these secondary assumptions are accurate”); Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 Geo. Wash. L. Rev. 546, 548 (1994) (explaining how the debate over the ECHM is fundamental because the ECMH is a major premise for a substantial body of corporate and securities law, regulation, and policy).
These problems are caused in part by the rational diversification of investment portfolios and exacerbated further by the differing interests of various kinds of shareholders. An equity trustee can help solve these problems by providing one sophisticated party to do the shareholder job. The equity trustee can represent the equity interest in long-term wealth maximization and can thereby neutralize the effects of divergent shareholder interests.

II. THE SOLUTION: AN EQUITY TRUSTEE

An equity trustee could go a long way toward solving the problems plaguing the shareholder role in corporate governance. This Part of the article describes in detail exactly how the office of an equity trustee would work and what it would do. It explains how an equity trustee would be chosen, compensated, and held accountable to shareholders. More importantly, it explains what powers the equity trustee would have to act on shareholders’ behalf, as well as what its responsibilities would be. An equity trustee must be endowed with the powers necessary to do the shareholders’ job effectively, but without completely displacing shareholders. Through the description of the basic structure of a trustee, this Part will advance the argument of why such a trustee is necessary and why the particular structure chosen achieves those ends.

A. Responsibilities and Power

It is important to specify what an equity trustee would do and why that would be helpful to the equity position and the goal of corporate wealth maximization. An equity trustee will be responsible for informing shareholders about what is happening within the corporation and for providing useful, easy-to-understand analysis of that information. In performing those duties, the equity trustee would have access not only to public information, but also particular disclosures it negotiate to receive from management and, depending on the corporation’s preferences, may be able to attend presentations to the board in order to better advise shareholders or to more carefully monitor management. After gathering and analyzing the corporate information available to it, the equity trustee would advise shareholder voting and make some decisions, such as decisions to bring a derivative suit on the shareholders’ behalf. An equity trustee may even advise or negotiate with management on the shareholders’ behalf.

1. Informing and Advising Shareholders

Federal securities laws focus on mandatory disclosures about the state of a publicly traded corporation’s affairs. Those laws provide increasingly rigorous

---

60 “In addition to the shift from voluntary to mandatory disclosure, the passage of the federal securities laws created a broad opening for the federal preemption of state law corporate governance, whether through the imposition of additional statutory requirements, regulatory or enforcement actions by the SEC, or interpretations by the courts.” Sean J. Griffith & Myron T. Steele, On Corporate Law Federalism: Threatening the Thaumatrope, 61 BUS. LAW. 1, 5 (2005); Seth W. Ashby, Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot v. Required Majority Board Independence, 2005 U. ILL. L. REV.
disclosure requirements in the aftermath of each major corporate scandal or economic crisis. Still, even the most detailed and thorough financial disclosures are only useful if those making investments or advising investors read and understand them. The information has to be processed in a way that facilitates investors’ appraisals of the value of the corporation’s stock. This article is not

521, 527-28 (2005) (explaining how “[m]ost of the protection currently afforded to shareholders by federal securities laws lies in a mandatory disclosure regime whose goal is transparency in managerial conduct”).


62 Steven L. Schwarcz, The Limits of Lawyering: Legal Opinions in Structured Finance, 84 Tex. L. Rev. 1, 31 (2005) (explaining how “investors occasionally fail to understand and appreciate underlying disclosure. . .[because] some structured-finance and other business transactions are so complex that disclosure is necessarily imperfect—it either oversimplifies the transaction or provides detail and intricacy beyond the comprehension level of even the most sophisticated investors. . ..”); Thor McLaughlin, Eyes Wide Shut: Exchange Traded Funds, Index Arbitrage, and the Need for Change, 27 Rev. Banking & Fin. L. 597, 616 (2008) (explaining how analysts are able to “determine bargains in the stock market” due to their “diligence and hard work.” However, analysts often gain at the expense of “smaller and individual investors,” who are deprived “of hundreds of millions of dollars in profit.”).

63 “ECMH is a theory concerning the adjustment of security prices to different levels of relevant information. While the semi-strong form of ECMH was once so widely accepted that its validity went largely unquestioned, there is today a lively ongoing debate as to the descriptive power of ECMH. In addition to the debate over stock market efficiency generally, some observers have argued that, regardless of the extent to which stock markets accurately reflect other types of relevant information, there is little empirical evidence that the stock market accurately prices management actions or legal developments… that may be harmful to shareholders.” Kimberly D. Krawiec, Building the Basic Course Around Intra-Firm Relations, 34 GA. L. REV. 785, 804-05 (2000).
primarily concerned with the efficiency of the market or stock prices, but rather with the shareholders’ ability to understand and appropriately use the vast amounts of information available to them. There is, frankly, more information about each company available on the market than any shareholder should rationally invest in reading and understanding. If assumed by any one individual shareholder, the information costs are simply prohibitive. However, if an equity trustee can review relevant disclosures carefully on behalf of all shareholders, the shareholders may be able to share in the gains from that process.

The current economic crisis is littered with stories of blind corporate bureaucracies and executives who seem honestly not to have known of the financial problems or frauds within their companies or, having reviewed the relevant documents, simply did not understand them. Such ignorance on the part of management and the investing public (and even stock analysts) was part of the Enron debacle as well. All along, if anyone had really taken a critical look at the available information, the problems could have been discovered and catastrophe avoided. Individual shareholders and institutional investors representing numerous shareholders do not have the incentives to pay so much attention to one company. The market has already devised one solution to this problem with the advent of institutional shareholder advising firms. Such firms review proxy disclosures of several companies and advise their institutional

---

64 Of course, the two objects are ultimately related. If shareholders are able to act on information provided to them more intelligently and the information they use to inform their trades is more reliable, then the resulting trades will enhance market efficiency and stock prices will better represent the information available.


67 In *In re Citigroup Inc. S’holder Derivative Litig.*, no one understood the quantum of risk the company was taking by investing so heavily in sub-prime mortgages. 964 A.2d 106, 129-31 (Del. Ch. 2009).


69 In re Citigroup, 964 A.2d at 133-35.

70 BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 102 (Portfolio 2004) (“When investors are in love with a stock, they’ll forgive a lot. The analysis will ignore potential problems, and they’ll accept management’s word that, say, a nonrecurring charge really is nonrecurring and not part of the ordinary course of business.”).

71 Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 866 (1991) (explaining how one of the incentive problems common to traditional outside directors is that they do not “devote sufficient time to understanding the business of their portfolio companies,” resulting in “informational asymmetries”); Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Free Approach for Rating Agency Accountability*, 87 N.C. L. Rev. 1011, 1039 (2009) (discussing how there is “oversight by securities market intermediaries” of their corporate clients because of “economic incentives that rewarded a myopic short-term focus”).

72 Rose, supra note 52, at 889-90.
shareholder clients about how to vote. Their review of proxy materials and advice about how to vote can be limited to annual elections and is not aimed specifically at maintaining a general knowledge of the state of the corporation and the general information about its well-being, goals, and prospects contained in its public disclosures. The rise of such firms is an acknowledgment of the fact that the market has indicated a need for someone to undertake these shareholder “responsibilities” on investors’ behalf, as they are simply unwilling and, in many ways, unable to do it all on their own. This need is one an equity trustee could fulfill more effectively. To the extent proxy advisors already perform some of these functions by rating corporate governance or consulting for the corporations they research, they face significant conflicts of interest. These firms may rely on corporate management for significant business and so, at various times, may serve both shareholder and management masters. An equity trustee offers a superior alternative because its allegiances would be owed solely to shareholders and it would not face the conflicts of interests caused by seeking employment from both managers and shareholders.

An equity trustee would do more than offer advice about how shareholders would vote. It would perform the work of an attentive investor. It would know how healthy or unhealthy the corporation is, what its prospects for the future are, and how the corporation is making its money. It would be able to alert shareholders to potential problems, either before or after it shares its concerns with management, share good news with shareholders, and keep a finger on the company’s pulse. The equity trustee would, of course, would not have the information necessary to either make or second-guess business decisions in a credible way. An equity trustee could, however, be a better informed entity doing the shareholder job. That is, an equity trustee would be able to identify problems that may require or benefit from shareholder action in a way shareholders have not. An equity trustee could serve as a set of eyes—critically reviewing corporate documents and disclosures with shareholders’ best interests in mind—for a myriad of purposes, not at all limited to shareholder voting decisions.

For instance, an equity trustee could determine if litigation against officers or directors is appropriate with the best interests of the entire equity position in mind, rather than relying on an over-active plaintiffs’ bar that has poor incentives to make judgments in the corporation’s best interests. The equity trustee would

---

73 Id., at 899.
74 Id. at 909.
75 Stephen J. Choi, Jill E. Fisch, & Marcel Kahan, Director Elections and the Role of Proxy Advisors, 82 S. Cal. L. Rev. 649, 655 (2009) (explaining that mutual funds often enlist the services of proxy advisors to demonstrate their diligence in casting votes on behalf of the funds’ beneficiaries); Lucian A. Bebchuk, The Elusive Quest for Global Governance Standards, 157 U. Pa. L. Rev. 1263, 1281 (2009) (explaining how “shareholders’ inability to use effectively their power to monitor officers and directors. . . provides management with a significant measure of de facto control”).
76 Choi, et al., supra note 75, at 655.
77 Id. at 652-654.
also have the power to bring suit on behalf of shareholders. This would include the ability to bring derivative suits for shareholders on the corporation’s behalf or make a demand upon the board that it bring suit. The equity trustee would also have the right to bring direct suits on shareholders’ behalf and could bring securities class actions for which there are private rights of action against the corporation or its management. Corporations are forced to defend and settle such actions at great expense each year. This is due in no small part to a ravenous plaintiffs’ bar that works tirelessly to find any potentially colorable cause of action against corporations and their managers. These attorneys’ incentives are not always perfectly aligned with those of shareholders or the corporation, and the attorneys are often the only party to profit at all from the suits they bring. Of misincentives—focusing “chiefly on the conflicts that arise between the interests of these attorneys and their clients in class and derivative actions, and on the disputes among plaintiff’s attorneys that attend the organization, staffing, and financing of a large class action;” the system produces excessive incentive to litigate, and derivative actions “have a negative social utility”); Christine Hurt, The Undercivilization of Corporate Law, 33 J. CORP. L. 361, 382 (2008) (stating that the shareholder litigation “system is subject to abuse because at different points in the litigation the attorneys’ incentives may not be aligned with the incentives of shareholder classes [and] [i]n addition, shareholders may have heterogeneous goals that can not simultaneously be pursued’); James J. Park, Shareholder Compensation as Dividend, 108 MICH L. REV 323, 371 (2009) (finding that “plaintiffs’ attorneys may benefit more from securities-fraud actions than the shareholders”); Larry E. Ribstein, Accountability and Responsibility in Corporate Governance, 81 NOTRE DAME L. REV. 1431, 1472–73 (2006) (discussing that the plaintiff’s attorney, who has no interest in the success of the corporation, has the most incentive to bring suit). Professor Ribstein evaluates:

The derivative remedy creates conflicts between the plaintiff or plaintiff’s attorney and other shareholders, like the class-attorney conflicts in any class action. The plaintiff is a nominal holder while the real party at interest is the lawyer who stands to receive a contingency fee by winning or (more often) settling the case. This substitutes the agency costs of reposing discretion in managers with those of reposing discretion in the plaintiff’s attorney. For example, the attorney may choose to sue because he does not bear the costs the litigation imposes on the corporation, may bring a strike suit solely to provoke a strategic settlement, or may settle a good claim for less than it is worth because he does not want to risk losing at trial.

Id. 79 “Shareholder lawsuits against the board and managers enforce board duties and company disclosure. . . [T]his monitoring characterizes market capitalism: litigation against companies and their agents has become so prevalent in the Anglo-Saxon world that board members and managers cannot take any business action or make any statement about company prospects without running the risk of incurring numerous suits that are costly and time-consuming to defend and that make company management overly cautious in the future.” James A. Fanto, The Role of Corporate Law in French Corporate Governance, 31 Cornell Int’l L.J. 31, 80 (1998).

80 In criticizing “species-dependent class-action suits” against companies, Professor Burch argues that, “Popular normative criticisms distill into three primary contentions: (1) frivolous claims exhort undue settlement pressure on innocent companies; (2) collective representation makes effective attorney monitoring unlikely; and (3) the plaintiffs’ bar is entrepreneurial and self-serving so it fails to pursue economically unattractive cases, leaving gaps in ex post enforcement.” Elizabeth Chamblee Burch, Securities Class Actions as Pragmatic Ex Post Regulation, 43 Ga. L. Rev. 63, 78 (2008).

81 “In the business sector, ‘entrepreneurial attorneys’ enforce fiduciary duties by seeking out profitable causes of action on behalf of corporations’ shareholders. The plaintiff’s attorney has an incentive to file an action only if the attorney’s fees award is likely to be greater than the costs of
course, shareholders are generally not invested enough in an individual corporation to make such decisions and a plaintiffs’ attorney only needs to find one shareholder plaintiff to bring a state law derivative suit. Granting an equity trustee sole authority to sue on behalf of shareholders, with veto power in the equity committee, puts the decisionmaking authority in the hands of a single, more sophisticated responsible party charged with acting in the best interests of the shareholder group as a whole.

There are other advantages to this framework beyond discouraging frivolous suits. An equity trustee would be much less likely to enter into a settlement agreement with management, in the event of a suit against officers or directors, in which the corporation gets nothing and the only party receiving any monetary benefit from the cause of action is the plaintiffs’ lawyers. The equity trustee would only bring causes of action that it thought would result in a net positive result for the corporation, after considering the relevant costs and benefits. Further, because of the equity trustee’s relationship with management and steady, constant presence and reputation as a serious representative of shareholders and their statutory power, it may be able to effect changes from within the corporation without resorting to litigation at all. That is, it could get at least as far as most settlements without incurring litigation costs. The equity trustee would have incentives not to bring frivolous suits or to bring suits it does not think are likely to be successful. Those actions would result in harming the corporation, and thereby, the shareholders. Further, the equity trustee has strong incentives to maintain credibility with management, because that credibility allows it to be a more effective representative to shareholders and increases the

---

82 Bainbridge, supra note 3, at 568.
83 The plaintiff requirements are more stringent for causes of action under Federal Law. Steven A. Ramirez, The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top, 24 Yale J. on Reg. 313, 331 (2007) (discussing how the 1995 Private Securities Litigation Reform Act “imposed a new, more stringent pleading standard on plaintiffs seeking relief under the federal securities laws”).
84 Years ago, some scholars suggested putting together committees of shareholders to make these decisions for the group. Rock, supra note 6, 449-50 (1991). It was true then as it is now that the current practice of allowing an aggressive plaintiffs’ bar to take control of these suits is not optimal.
85 In Caremark’s settlement negotiations with federal and state government entities, “government entities agreed to negotiate a settlement that would permit Caremark to continue participating in Medicare and Medicaid programs... [i]n return for a guilty plea to a single count of mail fraud by the corporation, the payment of a criminal fine, the payment of substantial civil damages, and cooperation with further federal investigations on matters relating to the OIG investigation.” In re Caremark Int’l, Inc. Derivative Litig. 698 A.2d 959, 965 (Del. Ch. 1996); In re Texaco, Inc. S’holder Litig., 20 F. Supp. 2d 577, 596 (S.D.N.Y. 1998); Bell Atlantic Corp. v. Bolger et al., 2 F.3d 1304, 1306, 1311-12 (3d Cir.1993).
chances that the equity trustee will be able to persuade management to take
certain actions on the shareholders’ behalf.

2. What if There is Bad News?

It is much easier to understand and appreciate the equity trustee’s obligation to
inform shareholders when we think of shareholders as one cohesive group,
committed to long-term investments in the firm. Then, the equity trustee would
simply gather the shareholders for a meeting and tell them about what is
happening with the corporation, advise them about how to vote their shares, and
let them go on their way. Of course, under those circumstances an equity trustee
would not be necessary. Because the equity security holders in a corporation are
diverse, ever-changing group of public investors, information disseminated to a
firm’s shareholders is public information and can be used by the shareholders
themselves and other investors to sell or buy the company’s stock or to invest in
other derivatives that predict its value. These trades combine to heavily influence
the company’s stock price and so a revelation of bad news by an equity trustee or
a strong statement of disapproval of management may hurt the shareholders it is
intended to help by causing a sharp decline in the stock price.

There are many reasons why such a decline in stock price may not be a
problem in the first place, and why the availability of an equity trustee to deliver
bad news may enhance a company’s value and, thereby, its stock price. First,
most bad news an equity trustee would share would simply be an analysis of
information that is already public. Any market participant could conduct the
same research and independently reach the same conclusion and could then sell
the company’s stock short and thereby affect the market valuation of a company’s
stock. Hedge funds made a lot of money doing just that during the decline of the
stock market in the fall of 2008. If an equity trustee releases the bad news or
delivers a warning to shareholders of bad things to come, it simply informs the
company’s investors and gives them an opportunity to act accordingly. The
resulting pressure on management caused by a temporary depression in the
company’s stock price may result in problems within the corporation being
discovered and resolved faster than they might otherwise have been.

Alternatively, the temporary depression in the company’s stock price may
alert the market for corporate control to a company that is ripe for a takeover and
may result in the installation of management that can enhance the company’s
profitability. Recall that the equity trustee’s loyalty is owed to the equity
position as a whole, not to individual shareholders. Therefore, if a new

86 For eleven months before Lehman’s collapse, David Einhorn, “a rabble-rousing hedge fund
manager…. pilloried the venerable [Lehman] in an effort to drive down the bank’s stock price,
which he [was] betting against.” Louise Story, Lehman Battles an Urgent Investor: David Einhorn
vs. Erin Callan, N.Y. TIMES, June 4, 2008,
http://www.nytimes.com/2008/06/04/business/04lehman.html?scp=2&sq=hedge+fund+lehman+br
others&st=nyt; Landon Thomas, Jr., Funds Try to Lose Ties to Lehman, N.Y. TIMES, Oct. 2,
2008, at C11, available at
http://www.nytimes.com/2008/10/02/business/02lehman.html?scp=1&sq=hedge+fund+lehman+br
others&st=nyt.

87 MACEY, supra note 13, at 74.
management team is in the best interests of the equity position, that is, in the best interests of corporate wealth maximization, then that is the position the equity trustee will support. A control premium might be the best option for shareholders if current management is performing poorly.\(^{88}\) An equity trustee’s sharing the information may lead to the best solution for the company.

Second, having an equity trustee in a position to perform such analyses and highlight that kind of information may enhance the stock price of a firm in several ways. It may provide assurance to shareholders and the market that managers will have a harder time hiding the truth in plain sight as they have been able to in several recent corporate scandals.\(^{89}\) It may also convince the market that the corporation and its management is being monitored closely and that crucial corporate information will be discovered and highlighted for the benefit of shareholders. In other words, having an equity trustee may send a good signal about the level of discipline to which managers are subject.\(^{90}\) Then, no news may, indeed, be good news.

### 3. Advising and Negotiating with Management

The most interesting and innovative role the equity trustee could fill is that of a single voice for shareholders in an ongoing negotiation with management.\(^{91}\) Shareholders have always been plagued by the collective action problems discussed above and so have been limited to abiding by and enforcing an “implied default” contract with the corporations they invest in and the officers and directors of those corporations.\(^{92}\) If the shareholders are able to gain a single representative through the use of an equity trustee, they can engage in real negotiations with the corporation and management and can arrive at and enforce less “implied” and more “actual” contracts. This will allow shareholders much more flexibility in contracting with corporations and allow them to enforce corporate governance standards more effectively than they have been able to thus far. Further, the more predictable duties and damages upon breach that direct contracting could provide

---


\(^{91}\) Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 34 J. CORP. L. 239, 279 (2009) (stating that “[t]he existence of a shareholder representative—combined with specifically chosen rights in a shareholder contract—can afford shareholders the ability to exercise more effectively the powers granted them by corporate law”).

could make officers and directors feel more comfortable serving at the helm of corporations.

Such negotiations are not wholly unfamiliar. Through negotiations with underwriters, corporations are able to negotiate bond indentures that specify the terms of the debt instruments the firm will sell to the public. The underwriters negotiate, essentially on behalf of future bondholders, for an instrument with terms they can sell. Then, an indenture trustee takes over as the bondholders’ representative. Indenture trustees do not do much until the corporation enters bankruptcy; then, its responsibilities to represent the bondholders to management and enforce the bond indenture become very important. It is then that widely dispersed, public bondholders are able to avoid falling victim to an inevitable collective action problem through the representation provided by their indenture trustee. They also have a specific contract with specific commands that they can enforce. Many bond indenture covenants require the company to make certain disclosures to the indenture trustee so that the trustee can evaluate the company’s circumstances and proceed accordingly.

Granted, bond indentures are weak relative to the provisions of large bank loans. Bank covenants are able to dictate some governance standards and some explicit rules about the kinds of business decisions the company can make and approvals it must seek from the lender once it experiences a specified degree of financial distress. Institutional creditors directly represent themselves because,

---

93 “[P]ublic bond ... indentures are often not the product of face-to-face negotiations between the ultimate [bond]holders and the issuing company .... [U]nderwriters ordinarily negotiate the terms of [public bond] indentures with the issuers.” *Metro. Life Ins. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1509 (S.D.N.Y. 1989). Bond indentures, however, are notoriously static, form contracts most of whose terms gave remained exactly the same for a very long time. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 906 F.2d 884, 893 n.3 (2d Cir. 1990) (Leval, J., dissenting). “Kahan and Klausner offer a ‘switching costs’ explanation for the persistence of some features of bond indentures: ‘When internal learning or network benefits are present, they result in ‘switching costs’ which may induce a firm to adopt the same term repeatedly in different documents--for instance, in different indentures.’” S. Albert Wang, *We Mean What we Don’t Say: The Archer Daniels Midland Case, Reputation, and the Curiosity of Refunding Clauses*, 23 YALE J. ON REG. 121, 130 (2006).


95 Id. at 484.

96 Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1139 (2003) (explaining how a comprehensive summary firm-specific information is typically only “provided to a bank lender or indenture trustee under loan covenants”). An important distinction between bank debt and bond indentures is that unlike bank loans, bonds are classified as ‘securities’ and are therefore subject to a variety of securities laws.” *Gavin Clarkson, Tribal Bonds: Statutory Shackles and Regulatory Restraints on Tribal Economic Development*, 85 N.C. L. REV. 1009, 1032 (2007); “Anti-layering covenants are more typically found in bond indentures than in bank loan facilities.” Anti-layering covenants can weaken instrument’s power by not permitting second lien debt. Memorandum from Latham & Watkins LLP, Paul D. Tosetti, *Doing Deals 2005: Dealmaking in the New Transactional Marketplace*, 1493 PLI/Corp 453, 574 (2005).

97 Kelli A. Alces, *Strategic Governance*, 50 ARTZ. L. REV. 1053, 1058 (2008); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 141–44 & 152 (2009) (discussing the benefits of bank covenants, such as
while they may join together in groups as large as five to provide particularly large loans, they are generally loaning the money one at a time, so the corporate loan officers manage the contracts. If we were to put the power of the bank loan agreements together with the representative structure of the indenture trustee and then add a consideration of proper shareholder concerns, we begin to see what kind of document an equity trustee could negotiate and enforce on the shareholders’ behalf.

An equity trustee could negotiate a shareholder “contract” with the corporation through its management. The contract achieves the shareholder version of what creditors are able to achieve through loan agreements. Shareholders do not have fixed claims and so are not going to want to enforce the same kinds of ratios for corporate financial health. Shareholders will not seek the same terms creditors do, but there are terms shareholders would contract for if they could only solve the collective action problem. The equity trustee allows for the negotiation of a shareholder contract – terms that the shareholders are entitled to and may enforce by virtue of their purchase of the relevant equity security.

In addition to contracting, equity trustee could endorse or criticize some significant decisions. For instance, it may be helpful for equity trustees to offer their opinions to shareholders about agreements or corporate actions that may result in a significant change to the company’s capital structure. An equity trustee may also report to shareholders about the terms and possible consequences of major loan agreements or takeover defenses the company is thinking of adopting. If the equity trustee proves to have the ability to influence shareholder action and votes, then management will want to try to gain equity trustee approval where it thinks it can, particularly where important or high-profile decisions are involved. Everyone wants to find an equilibrium that is best for corporate wealth maximization and each interested party’s powers are limited in key ways. A robust system of checks and balances may prove the best path to the appropriate power equilibrium between officers, directors, creditors, shareholders, and other

---


100 Alces, supra note 98, at 1098–1100 (“Like an indenture trustee, the equity trustee would monitor the corporation and remain informed as to its financial condition and important business decisions and capital structure, ready to spring into action when its agreement with the corporation requires it.”).
parties in interest. Each contingent has some power, and their roles should cooperate in a way that allows the corporation to be as profitable as it can be. Shareholders will not be able to exert more influence than their power justifies. Still, in order to keep shareholders from using that power in a way that disrupts or unseats management, officers and directors would rather have the equity trustee on board to allow real negotiation with shareholders as an interested party through the equity trustee. Other dispersed parties – creditors, employees – are able to acquire far more power than shareholders have simply by virtue of added representation, because they have solved the collective action problem.

B. The Equity Committee

Because particular shareholders, whether individuals or institutional accounts, have different (and often conflicting) interests, asking one dominant shareholder to choose the equity trustee would defeat the purpose of selecting a trustee to represent the interests of shareholders as a whole. Bankruptcy provides an important insight here. In bankruptcy, both equity and creditors’ committees consist of the seven largest shareholders and unsecured creditors, respectively, as measured by interest in the company. These committees represent the interests of the relevant parties in bankruptcy. It stands to reason, then, that such a committee could be used to represent, in some circumstances, a widely dispersed group of claimants holding claims of the same kind and priority outside of bankruptcy. For that reason, I suggest that the equity trustee be selected by a group of the corporation’s seven largest shareholders in an election to be held once every three years.

It is important that shareholders have the power to choose the equity trustee, because the trustee will be paid by the corporation and interact frequently with management. This committee of shareholders will have the power to negotiate the contract that engages the equity trustee’s services, as well as to remove the trustee for cause as defined in that agreement. This committee of shareholders will be largely responsible for overseeing the work of the equity trustee and for disciplining it as necessary. Granted, the actual shareholders making up this group will change over time, but because their differing particular preferences should balance each other out, the specific identities of the shareholders making up the committee should not matter very much. Further, because continuity in the position of the equity trustee is in the best interests of the equity position, the committee would not have incentives to change the equity trustee for trifling reasons. Rather, only a serious problem with how the equity trustee is performing its duties would result in a change. Otherwise, the transition costs of bringing in a new equity trustee would be unduly expensive. All of this requires committee

101 Blair & Stout, Team Production, supra note 9, at 283; Stephen Bainbridge, Director Primacy, supra note 3, at 579-80.
102 Anabtawi, supra note 6, at 575.
103 11 U.S.C. § 1102 (b)(1) & (2) (explaining that each committee “shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of [claims again or equity securities of] the debtor”).
members to pay some attention to the job the equity trustee is doing. There may be doubts as to whether these investors would be willing to make such an investment of time if they are unwilling to monitor the corporation themselves in the first place.

Indeed, we are simply asking the investors to shift monitoring responsibilities from the board to another entity—the equity trustee—rather than eliminating the need to monitor entirely. For several reasons, monitoring an equity trustee should be much easier than monitoring managers protected by a business judgment rule. First, the equity trustee’s responsibilities, described in detail below, are much more clearly defined and much more specifically owing to the shareholders, and are, in turn, more transparent. For instance, the shareholder committee does not have to determine if the equity trustee has made a wise business decision for the company, because the equity trustee does not run the company at all. It may make recommendations to shareholders about how to vote, and it would have the power to decide to bring a derivative suit or demand that a suit be brought on the corporation’s behalf. However, the equity trustee is not running a day to day business and is not directly responsible for the operations of the business in any way. Its decisions are those a shareholder is expected to make. It is easier to monitor such responsibilities than those having to do with making complicated business decisions about which the monitor has little information or expertise. The shareholder committee therefore has a much easier monitoring job to do when looking over the equity trustee’s shoulder and stands to lose much less if the equity trustee does a poor job.

Further, as shareholders encounter the same equity trustees over time across many investments, equity trustees would develop a reputation, and the relevant investors develop a familiarity with the equity trustees and the job they are supposed to do. It should not be too difficult to determine if an equity trustee is doing a poor job. However, even if discovery of shirking or bad faith is delayed, it is much easier to hold an equity trustee directly accountable for its wrongs through both liability and removal from office. Because of the many obstacles to effective shareholder litigation and the relative weakness of shareholder voting, officers and directors enjoy great job security. That would not be the case for an equity trustee. The equity trustee would truly serve at the shareholders’ pleasure, while compensated by, so effectively an employee of, the corporation.

C. Compensation

An equity trustee would be paid by the corporation on a flat fee or hourly basis, just as a corporate attorney would be. That way, the trustee is effectively paid by “shareholders” because the payment effectively comes out of the firm’s equity. This does essentially make the equity trustee a creditor of the corporation and, therefore, may cause it to have personal interests that coincide with a level of risk aversion more akin to that of the creditor, rather than shareholder, position. While that may be a weakness to using this compensation method, particularly in situations where the equity trustee would be expected to advance the interests of shareholders ahead of those of creditors, other available methods of compensation
suffer from more critical weaknesses. For instance, because shareholder turnover within a given corporation is high, and because shareholders are so widely dispersed, it is unreasonable to expect them to be able to do anything together, let alone pay a professional. Further, there are many problems associated with paying an equity trustee any form of incentive compensation based on stock price that would risk undermining some of the benefits of using an equity trustee in the first place.

Incentive compensation, that is, compensation based on performance, has proven problematic in recent years. As the use of incentive compensation for corporate managers has grown, so has an appreciation of the threat it poses to corporate well-being and the perverse incentives it may give management. Incentive compensation has been largely blamed for the short-termism problem described above. It would not be in equity’s best interests for the corporation to push very hard for immediate, large short-term profits at the expense of long-term viability. It is not helpful to make managers or shareholder representatives more risk preferring than well-diversified shareholders if the goal is corporate wealth maximization. The overall health and viability of the corporation should remain an important concern. For these reasons, it is counterproductive to pay an equity trustee in a way that depends upon corporate profits or reported financial health or growth. Such compensation has shown its ability to corrupt incentives more than it aligns them by relying on easily manipulated symptoms of corporate health.

Rather than trying to devise the perfect incentive compensation package (which may well be impossible), it makes more sense simply to require the equity trustee to do a good job and develop a sound reputation in order to retain the position, and then pay the equity trustee a fair wage for the work it has done. Recall that an equity trustee would not make business decisions. Its primary responsibilities involve informing shareholders, making recommendations to them about voting, paying attention to the job management is doing, and communicating with management about what the shareholder position is and preferences are. While some of these duties require business acumen and judgment, they do not involve making business decisions or dictating those decisions to management. Again, the equity trustee does not have greater powers than shareholders do now. There is no reason to intimate in any way that the equity trustee is at all responsible for or in control of corporate returns or business decisions. Incentive compensation would give that misimpression and would run

---

105 Id; Bhagat & Romano, supra note 43, at 359-60; Robert A. Browning, Deferred Compensation for Dummies, 77-OCT J. Kan. B.A. 28, 28 (2008) (explaining how executive compensation can be deferred through forms of equity-based compensation agreements, which “provide employees with current rights to future benefits”).
106 Walker, supra note 35, at 4; Bhagat & Romano, supra note 43, at 363.
107 Hu, supra note 1, at 287-88 (suggesting that “a corporation that elects to undertake a promising but risky investment project may make loyal shareholders who are highly risk-averse worse off and those who are less risk-averse better off” and that “managers, especially those in publicly held corporations, would find it extremely difficult to ascertain the true time and risk preferences of [both] existing [and potential] shareholders”).
the risk of altering the equity trustee’s representation of shareholder interests toward one that is more focused on short-term returns and aggressive risk preference. For all of these reasons, it makes the most sense for the equity trustee to be paid a flat fee by the corporation.

Having explained the basic structure of the equity trustee position and details about how the equity trustee would be selected and compensated, the article now turns to questions of how the use of such a representative would be implemented in the first place. When adding a new representative to an already crowded field of professionals, it is important to consider how the current market players would decide to employ an equity trustee. Some party in interest must decide an equity trustee is necessary and must have the ability to credibly demand the appointment of the representative.

D. How Implemented

Since there are currently no equity trustees in use, it is important to consider how a corporation would adopt the first. Institutional shareholders are unlikely to demand an equity trustee before seeking more complete individual representation from a proxy advisor or similar consultant. Management is also unlikely to advocate the use of an equity trustee without outside pressure. As Part I explained, it is unlikely that the entire shareholder class would be able to coordinate to exert enough pressure to put an equity trustee in place. The problem of the implementation of an equity trustee is difficult, but not insurmountable. It is somewhat easier to envision the adoption of an equity trustee by a financially distressed company. Then, shareholders have lost any interest they may have had in corporate governance and have little to no incentive to pay attention to the condition of the company. Under those circumstances, it makes sense to seek one party to represent the equity interest in an attempt to provide balance against significant creditor power. Under such circumstances, significant remaining shareholders may demand representation in the hopes of preventing management from falling completely under the control of creditors.

Healthy companies present a different circumstance, however. It is less likely that any group in particular will see enough of a need to change the status quo to demand the use of an equity trustee when everything seems to be going relatively well. Change is not born of satisfaction or indifference. If it is suggested to them, institutional investors could get together to suggest or adopt the proposed use of an equity trustee, but they are unlikely to reach that conclusion without outside pressure. It may make the most sense to make the use of an equity trustee a statutory option that firms could opt into if they think a governance structure including an equity trustee would be value-maximizing. Then, shareholders could vote on whether they would favor the corporation’s retention of an equity trustee.

108 It is in the circumstances of a financially troubled company that the equity trustee was first proposed. Alces, supra note 98, at 1053.
109 Skeel, supra note 50, at 500-501.
110 Alces, supra note 98.
111 I am indebted to Professor Jill Fisch for this suggestion.
trustee. Such a vote would attract attention to the issue and push large shareholders to take a position. This would make the use of an equity trustee more likely than it would be if we simply waited for shareholders to band together to push for its adoption \textit{sua sponte}. Once we devise how shareholders may push a corporation to opt for an equity trustee in the first instance, we must provide for the equity trustee’s accountability to its shareholder constituents.

\textbf{E. Equity Trustee Fiduciary Duties to Shareholders}

An equity trustee would owe fiduciary duties to the corporation’s shareholders. Its loyalty would not be owed to any individual shareholder in particular, but, rather, the equity trustee is a fiduciary of the equity position, the interests of the shareholders as a class. It owes duties of loyalty and care to the class of common shareholders as a whole. Further, it owes a duty of obedience to those shareholders as represented by the equity committee of the company’s seven largest shareholders. If those shareholders veto an action the equity trustee proposes to take, the equity trustee must abstain. The shareholders may enforce these fiduciary duties through suit for breach of fiduciary duty brought by the equity committee.\footnote{112} The duties are flexible and can be more particularly defined or curtailed via agreement with the equity trustee.

The equity trustee will owe a duty of loyalty to the junior-most class of common shareholders, and so must put the interests of those shareholders above its own in performing its duties. That means it cannot engage in conflicting enterprises – it must be sure not to serve shareholders of competing companies and take care that the interests it is representing do not conflict. It must also abstain from making personal (or corporate, depending on whether the equity trustee is an individual or a firm) investments that conflict with the shareholder positions it is advancing. An equity trustee would be subject to insider trading liability just as any other professional such as a lawyer or accountant serving the corporation and privy to non-public information would be. The duty of loyalty (not to advance interests that conflict with its duties to its beneficiaries) should not be confused with the duty of care, which is a duty to perform to a certain degree of competence or to exercise a particular level of care in judgment.

\footnote{112} This limitation of standing would be a function of a particular company’s agreement with the equity trustee, negotiated between the corporation, the equity trustee, and the equity committee. That standing could also be altered to include all shareholders via the same agreement. It seems more sensible to allow the equity committee to make those decisions, though. They combine to hold the largest stakes in the corporation and, because most equity committee members are institutional shareholders, they represent smaller, individual investors by managing their investment portfolios. In that way, equity committee members are fiduciaries of smaller, individual investors. It is a good idea to limit standing to sue the equity trustee for the same reason derivative suit litigation has been curtailed – individual shareholders do not have the financial interest or sophistication to make litigation decisions that are aligned with those of shareholders as a whole. Plaintiffs’ attorneys may take advantage of the relative lack of savvy of rank and file shareholders and file frivolous suits that would make the equity trustee an unnecessarily expensive enterprise. Where an equity committee is already in place, it makes sense to take advantage of their well-aligned interests, business acumen, and sophistication.
The equity trustee would owe a duty of care. However, because the equity trustee would work for a fixed or hourly fee, it is important not to use monetary liability as the primary means of enforcing the duty of care. The contract enlisting the equity trustee’s services should specify removal procedures or prescribed penalties for breaches of the duty of care. It is very important that, like any professional exercising judgment, the equity trustee not be held to a negligence standard for its judgment. The equity trustee is exercising business judgment only as far as it is recommending particular shareholder votes or deciding to pursue certain litigation. It should not be held liable for a breach of the duty of care if those judgments prove poor. Instead, removal of the trustee should be the agreed upon approach in those instances. If the equity trustee is negligent in its duty to adequately inform shareholders, then perhaps penalties for that failure could be fixed by contract. Exposing the trustee to substantial monetary liability could have the effect of preventing qualified professionals from wanting to serve as equity trustees. There are better ways to agree to hold an equity trustee accountable for doing a careless job.

Finally, the equity trustee would owe a duty of obedience to the equity committee when it proposes to take action on behalf of shareholders. For instance, if the equity trustee wants to make a demand on the board that the board sue some officers or directors or if it wants to control a derivative suit for shareholders, then it is subject to any instructions the equity committee gives, including an instruction to drop the suit or pursue a different one or a command to investigate the matter further and report back to the equity committee. The equity trustee is subject to removal by the equity committee and must abide by its agreement with the shareholders, subject to enforcement by the equity committee.

Because an equity trustee is relatively easily removed, fiduciary liability is not an essential remedy in every situation. It may be far easier to enforce specific contract terms in many instances. The relationship remains fiduciary because the trustee is an agent and a representative. The equity committee allows the shareholders to monitor the equity trustee to some extent, but shareholders are still well-diversified and rationally apathetic for the most part. Further, they cannot discover or take the time to contemplate all of the different ways the equity trustee might be conflicted. They must trust the equity trustee to eliminate conflicts of interest and allow a court to decide ex post if a potential conflict violates the equity trustee’s duty of loyalty. The existence of an equity trustee will actually give shareholders, particularly those not sitting on the equity committee, incentives to pay less attention to corporate news and the corporation’s management. That enhanced vulnerability increases the degree to which shareholders must trust the equity trustee and so the degree to which they need to be able to enforce fiduciary duties. Fiduciary duties are necessary to govern some parts of the relationship. Other parts of the relationship, however, are better governed via specific contract terms, and to the extent they can be, they should be. The equity committee makes negotiating and enforcing those terms

---

113 While the duty of care is not an uniquely fiduciary duty, it is a duty all fiduciaries have and one by which an equity trustee would have to abide.
more practicable and reduces the costs associated with adding another agent to the corporate mix.

III. ADDING ANOTHER AGENT – IS THERE ROOM?

Appointing an equity trustee adds yet another agent to a field full of agents, such as corporate managers, pension and mutual fund managers, creditor representatives, and representatives of other corporate constituents such as labor union representatives. Some argue that directors, particularly outside directors, already represent shareholder interests. That would make the addition of an equity trustee at best unnecessary and, at worst, a menace interfering with directors’ ability to perform their job based on their own best judgment. Further, even if an equity trustee is a necessary representative, we have set up another situation where an agent is monitoring an agent to the extent the equity trustee is monitoring officers and directors. Does an equity trustee simply shift the agency costs imposed by corporate managers to a different agent without realizing a net reduction in those costs? While these concerns are relevant considerations when formulating the proper form and function of an equity representative, they are adequately dealt with in conception of an equity trustee I offer.

This Part begins by explaining why the addition of a new agent into the corporate mix is more beneficial than costly. An equity trustee is not just a “super-director.” It would add different value by performing much different tasks with a more clear, singular focus. This Part then explains how an equity trustee would interact with the corporation’s board and what its role would be with management. Next, it responds to concerns about why anyone would listen to an equity trustee and how the equity trustee would be able to wield any influence in the first place. Finally, this Part explains why the work an equity trustee would do on behalf of the corporation would be good for shareholders and add value to the corporate enterprise.

A. An Equity Trustee Is More Than A Director

While directors and equity trustees may share common goals, particularly to the extent that directors work toward the norm of shareholder (or corporate) wealth maximization, an equity trustee would not be like a director at all. Directors have entirely different jobs to do than shareholders. Directors are charged with managing the business operations of the firm and so must choose officers, monitor those officers, and make major business decisions on the firm’s behalf. Shareholders, on the other hand, are responsible for monitoring directors, who cannot very well monitor themselves, and for voting on corporate decisions that the law has deemed directors too conflicted to make on their own.іііі

Shareholders may vote on “the election of directors, and the approval of charter or by-law amendments, mergers, sales of substantially all of the corporation’s assets, and voluntary dissolution.” Bainbridge, Director Primacy, supra note 3, at 569. Still, the board must approve all actions but the election of directors and by-law amendments before the matter is submitted to a shareholder vote. Id.
only matter shareholders may vote on even though no director conflict is at issue is the addition of by-law amendments.\footnote{Id.} Although shareholder monitoring and voting powers are relatively weak, they may be strengthened, not necessarily by changes to the law or corporate structure, but by simply making the shareholder exercise of those powers more effective. In any event, jobs designed exclusively for shareholders cannot be performed by directors; there is an important and intentional separation of powers. Similarly, shareholders cannot and should not make business decisions for the company.\footnote{See 8 DEL. CODE tit. 8, § 141(a) (2009) (stating that generally “the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors); The Delaware Supreme Court reaffirms this in Paramount Commc’ns Inc. v. QVC Network, Inc.: The General Corporation Law of the State of Delaware and the decisions of this Court have repeatedly recognized the fundamental principle that the management of the business and affairs of a Delaware corporation is entrusted to its directors, who are the duly elected and authorized representatives of the stockholders. Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled.” Paramount Commc’ns Inc. v. QVC Network Inc., 637 A.2d 34, 41–42 (Del. 1994). See also Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (describing that the business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company”).} They are not well enough informed and do not necessarily have the requisite expertise. Even if they could unify behind a cause, which, for the reasons discussed above is unlikely or impossible, their judgments would not, on average, be as good as those made by directors and officers chosen for their business acumen.\footnote{Bainbridge explains: As to shareholder incentives, most shareholders are rationally apathetic. A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs. Given the length and complexity of corporate disclosure documents, the opportunity cost entails in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders’ holdings are too small to have significant effect on the outcome of shareholder votes. . . . [B]ecause neither shareholders, employees, nor any other constituency has the information or the incentives necessary to make sound decisions on either operational or policy questions . . . ‘it is cheaper and more efficient to transmit all the pieces of information once to a central place’ and to have the central office ‘make the collective decision and transmit it rather than retransmit all the information on which the decision is based.’ Bainbridge, Director Primacy, supra note 3, at 558. (quoting KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–69 (1974)).} Shareholders are carefully and intentionally kept out of the director job, and the distinction in their roles and responsibilities is made clear and is firmly enforced. It is primarily for this reason that an equity trustee is not, and cannot be, just a director.

Further, the focus on the similar interests of a proposed equity trustee and a corporate director is misplaced. While a director may have an avowed interest in
promoting shareholder wealth maximization as a desired end of corporate
decisionmaking, that does not mean directors observe shareholder primacy means,
that is, allowing shareholders some quantum of decisionmaking control over how
to achieve that end.\textsuperscript{118} Professor Bainbridge points out that director primacy,
“accepts shareholder wealth maximization as the proper corporate decisionmaking
norm, but rejects the notion that shareholders are entitled to either direct or
indirect decisionmaking control.”\textsuperscript{119} That suggests that shareholders should not
drive managerial decisions. However, the shareholder voice is an important part
of the mix of information and interests directors must consider in making
corporate decisions. It is appropriate, then, that this voice be adequately
represented to management and a single, sophisticated equity trustee would better
represent that voice than would the current shareholder masses.

\textbf{B. The Equity Trustee’s Relationship With the Board}

It is important to find a way for the equity trustee to represent the shareholder
interest to the board without unduly expanding shareholder power. The equity
trustee is limited by the powers granted shareholders under corporate law and
according to their shareholding agreements with the corporation. The equity
trustee would increase the power of shareholders by allowing them to exercise the
powers they have much more effectively, but the nature and extent of those
powers would not necessarily change. The equity trustee will be most effective if
it can develop a good working relationship with management and if it is trusted by
shareholders to do an honest and thorough job.

The equity trustee would receive disclosures from management. Those
disclosures would, of course, include public disclosures mandated by securities
laws, but the equity trustee would also be able to require, in its arrangement with
management, other corporate disclosures or information it deems necessary to
doing its job. Management would have to agree, of course, and the two parties
would have to strike the balance necessary to retaining the equity trustee of the
shareholders’ choice without allowing shareholders to overstep their authority via
the equity trustee. This ability to review corporate information extends to the
equity trustee’s ability to review corporate books and records according to the
rights afforded shareholders to do so under current law. Further, in an effort to
become adequately informed about corporate matters, to advise shareholders
appropriately, and to make proper judgments when giving an opinion, the equity
trustee should be allowed to attend important presentations to (but not
deliberations of) the board of directors and should be kept apprised as to
negotiations involving significant changes to the corporation’s capital structure.

Although an equity trustee would not have the authority to make corporate
business decisions and would not properly advise day-to-day business operations
as part of its performance of the shareholder job, there may be valuable
opportunities for the equity trustee to negotiate with the board on behalf of

\textsuperscript{118} \textit{Id.}, at 563.
\textsuperscript{119} \textit{Id.} at 563. \textit{See id.} at 551 (“director primacy theory embraces the shareholder wealth
maximization norm even as it rejects the theory of shareholder primacy”).
shareholders. For instance, the equity trustee may be helpful in advising management in the negotiation of a corporate combination or other significant business decision or bylaw amendment that shareholders would have to vote to approve. Also, an equity trustee may be helpful in reaching agreements about appropriate corporate governance standards that may allow shareholders to monitor management without resort to expensive litigation.\footnote{Alics, \emph{supra} note 91, at 239 (proposing that an equity trustee negotiate corporate governance standards with management so that the relationship between officers and directors and the corporation become a purely contractual, rather than fiduciary, one and managers could be disciplined according to contract terms rather than through fiduciary litigation).}

The obligation to communicate with shareholders and advise them in casting their votes can give an equity trustee significant power. Because the equity trustee can more effectively and easily capture and concentrate shareholder power than shareholders can now, the equity trustee potentially carries with it a very strong expression of shareholder power, and, thereby, strong expressions of shareholder interests or preferences, that managers would ignore at their own peril. The equity trustee finds significant power in its ability to influence the market and excite public opinion with its reports to shareholders or its actions to monitor or discipline management. While the equity trustee’s power is duly limited by the relatively weak nature of shareholder rights and responsibilities, the equity trustee would be able to organize shareholders to vote not to reelect certain directors or an entire board.

Management would also be likely to heed the equity trustee, because as the parties develop professional relationships with each other and encounter each other regularly in the marketplace, each time with differing levels of power over each other or the situation, they will likely establish some sort of interdependence, a tit-for-tat relationship. So, if an equity trustee is initially cooperative, the directors will be cooperative in the hopes that the equity trustee will respond in kind in the future. If one party is unreasonably uncooperative, then the system of reciprocal cooperation breaks down.\footnote{See \textsc{Robert Axelrod}, \textsc{The Evolution of Cooperation} 8-9 (1984) (explaining that a party will only cooperate so long as it is in their self-interest, and when the other defects, or is uncooperative, it is not in their best interest to cooperate either); W. Bradley Wendel, \textsc{Busting the Professional Trust: A Comment on William Simon’s Ladd Lecture}, 30 FL. ST. U. L. REV. 659, 666 (discussing “familiar game theory strategy of ‘tit-for-tat’: cooperate on the first move, and then continue cooperating unless the other player defects, and then respond by defecting”). \textsc{See also} Franklin M. Fisher, \textsc{Games Economists Play: A Noncooperative View}. 65, 67–68, found in \textsc{Eric B. Rasmusen}, \textsc{Game Theory and the Law} (2007) (discussing game theory concepts and their application in the corporate sector).} While management may be able to ignore an equity trustee in one situation, in another situation, at another time and place, management may be in a difficult position with its shareholders or at risk of being sued on the shareholders’ behalf by the equity trustee and will want the equity trustee to cooperate with it. This mutual cooperation does not mean that the parties will necessarily agree on every point, it simply means that they will treat each other respectfully and reasonably in the performance of their duties. This sort of behavior has been documented in bankruptcy cases when the equity committee is able to negotiate for a pay-out in the reorganization plan even though the company is insolvent, and equity is, therefore, not legally entitled to
anything. Also, proxy advisors have been able to influence corporate policy with the shareholder votes they represent.

1. Capture by Management

As with any party that must develop a working relationship with management, there may be some risk that an equity trustee would be subject to capture by the board of directors or officers. Further, there is a risk that an equity trustee would become too influenced by the particular interests of the equity committee and advocate its position to the exclusion of the shareholder class as a whole. Such threats of a human agent being swayed by unquantifiable influences usually accompany agency relationships. There are ways to build in protections against these potential problems. For instance, the ability of shareholders to sue or remove the equity trustee will require the equity trustee to remain loyal to shareholders and not to be too devoted to management.

The equity trustee’s performance would be evaluated in terms of its effectiveness in advocating and guarding the shareholder interest. Shareholders will evaluate the equity trustee based on how well-informed they are about corporate affairs, how well management performs, how educated they feel about the votes they have to cast, and, of course, to some extent, the growth they see in the value of the company. While the maximization of corporate wealth is not the responsibility of the equity trustee, the advocacy for that end is, and an obvious signal, or an indicator that will inevitably be interpreted as a signal, of the equity trustee’s success in advocacy is whether the ends advocated for are reached. Further, because the make-up of the equity committee will be dynamic, committee members will not become complacent and will likely be skeptical of, and so vigilant with, equity trustees they have not selected themselves. The attention paid by the equity committee to the quality of information received from the equity trustee and the extent to which they feel sufficiently informed to do their job effectively is crucial to the success of the equity trustee as a corporate participant.

Somewhat passive monitoring of an equity trustee is likely to still be effective. That is the case because the equity trustee would not be directly responsible for troublesome business decisions. The equity trustee is merely responsible for informing shareholders and facilitating their use of power. It cannot make binding corporate business decisions, and its support of or admonitions or

---

122 In a study of the bankruptcy reorganizations of thirty insolvent companies, Professors LoPucki and Whitford found that “creditors agreed to allow shareholder recoveries ranging from $400,000 to $63 million.” Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. REV. 125, 143 (1991). Because of the intermediated nature of bankruptcy reorganizations, that is that agents of the parties in interest, and even agents of agents of agents of the parties in interest, negotiate the plan terms, those professionals “were not only representatives of the parties in interest, but also members of professions, of independent firms, and of the bankruptcy community.” Id. at 154–156. These professionals, then, expected to encounter each other professionally in the future representing various interests over time and so had incentives to engage in mutual cooperation over time. Id.

123 Choi, et al., supra note 75, at 650–51.
suggestions to the board are merely precatory. Where there are serious problems with an equity trustee, such problems should not be difficult to discover. And after problems are discovered, the equity trustee responsible may find it difficult to work as an equity trustee or other important corporate professional ever again. The costs of breaching fiduciary duties to shareholders or of acting in bad faith far exceed the benefits, because an equity trustee’s contract must be approved by the equity committee. During the approval process, any side payment or benefit to the equity trustee would be considered a breach of duty and have to be disgorged upon discovery. But another concern remains: is the equity trustee subject to capture by the equity committee and may the equity committee wield too much power at the expense of other shareholders?

2. Capture by the Equity Committee

Because the individual members of the equity committee may have interests that differ from those of shareholders with much smaller holdings, and because a group of seven shareholders could even conspire to be the equity committee of a particular corporation and do so to pursue their interest at the expense of other shareholders, it is necessary to address how abuse of power by an equity committee could be prevented or policed. The equity committee’s powers over the company are rather limited. It serves only to select the equity trustee and monitor and discipline that trustee. But in disciplining the equity trustee, the committee may exercise significant power. Still, the members of the equity committee would have to commit to a long-term presence in a particular company for that to matter very much. The membership of the equity committee would change frequently and unpredictably, so it would be difficult for particular committee members to sustain real power. At least five of the seven committee members would have to conspire in order to obtain real power, and that may not be in any of their individual interests. In that way, the equity committee members check themselves, such that no one committee member or small group of committee members can really dominate the process.

It is likely that the equity committee members, as a group, might be characterized as “controlling shareholders” for the purposes of owing fiduciary duties to other shareholders under Delaware corporate law. The equity committee members may also be bound to perform their duties for the committee in accordance with fiduciary obligations owed to all shareholders under the agreement establishing the equity trustee and equity committee for a particular company. Of course, to that end, the equity committee would have to be monitored and disciplined by the widely dispersed shareholders and our original problem returns. Except, this time, the equity committee is so far removed from

124 As noted above, Professor Rock has convincingly made the argument that fund managers for institutional investors do not have incentives to cooperate with one another because they are competing with one another for investors and so they are not interested in investing much in helping the whole. They are far more interested in distinguishing themselves. What is good for all is not necessarily good for one. Rock, supra note 6, at 473.
125 Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Iman Antwabi, Fiduciary Duties for Activist Shareholders, 60 STAN. L. REV. 1255, 1269 (2008) (noting that “controlling shareholders are subject to the duty of loyalty” and other fiduciary duties).
any real decisionmaking and there are significant checks—officers, directors, the equity trustee, the professional reputations of officers, directors, and the equity trustee, and public relations—on the equity committee and any real power or potential damage. The relatively low probability of discovering equity committee disloyalty is more than off-set by the low costs a rogue committee, or committee member, could really impose. Such costs are easily exceeded by the benefits conferred by the equity committee/equity trustee structure and service.

IV. THE EQUITY TRUSTEE AND THE CORPORATE GOVERNANCE MARKET

While shareholders are not strong monitors of management and are not able to focus their power in corporate governance very effectively, their decisions about whether or not to invest in particular companies and what kinds of investments to make are the driving force in the market for corporate securities. Economists posit that a perfect market finds equilibrium and so adopts profitable mechanisms to help achieve that equilibrium. So, where does the equity trustee fit into such

---

126 What institutional investor could survive the ad campaign, “Is Mutual Fund stealing your money? Evidently, you are with Mutual Fund or against them. We’re against them. And their thieving tactics.”?  
127 See David A. Skeel, Jr., Corporate Anatomy Lessons, 113 YALE L.J. 1519, 1536 (2004) (discussing “significant corporate actions” and regulatory interventions, which is conditioned, in part, on the “shareholders’ initial decision whether to invest, and thus is one that shareholders are competent to assess for themselves”). See also Carol Goforth, Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late, 43 AM. U. L. REV. 379, 406 (1994) (“The Wall Street Rule holds that shareholders who are dissatisfied with management decisions can ‘vote with their feet’ by selling their shares and finding a different enterprise in which to invest.”).  
128 “Neoclassical economics. . . is a static model in which the principle of diminishing returns plays an important role, as it is the primary mechanism which lead supply and demand to converge at an equilibrium point. It makes a number of simplifying assumptions - markets are in perfect competition with perfect factor mobility, and economic agents are perfectly rational with perfect information and complete insight into market processes. These assumptions make it a mathematically robust discipline, as the conduct of economic agents becomes predictable. It also is a normative discipline and capable of developing policy prescriptions to guide regulation or intervention.” Charles M. Gastle & Susan Boughs, Microsoft III and the Metes and Bounds of Software Design and Technological Tying Doctrine, 6 VA. J.L. & TECH 7, 76 (2001); “[E]quilibrium in the economic model of perfect markets is Pareto-optimal. . . [W]ithin that model, market equilibrium maximizes efficiency. . . It has thus become bound up with advocacy of laissez-faire policies, seen by some as the route to political as well as economic freedom. . . One [problem with this perspective] is that the world of perfect markets, with only small, competitive businesses in every industry, is clearly unattainable in reality. . . [T]he “theory of the second best,” established long ago by Richard Lipsey and Kelvin Lancaster, proves that if one of the requirements for Pareto optimality cannot be achieved, the best attainable (or “second best”) outcome may require deviating from all the other aspects of the unconstrained optimum.” Lisa Heinzerling & Frank Ackerman, Law and Economics for a Warming World, 1 HARV. L. & POL’Y REV. 331, 347 (2007); “[A] ‘perfect market,’ will achieve a state known as perfect equilibrium, that is, the supply of the good offered by sellers will equal the demand for the good, and the price of the good will be stable because small fluctuations in demand will be matched by similar responsive moves in supply through the entrance to and exit from the market of sellers.” Michael Bertics, Fixing Payday Lending: The Potential of Greater Bank Involvement, 9 N.C. BANKING INST. 133, 141 (2005).
an equilibrium? If equity trustees are such a good idea, why hasn’t the market already starting using them? What market imperfections could the equity trustee help to solve?

This Part addresses those questions. It begins by explaining why the market has not already “thought of” using equity trustees. The corporate governance market has begun to move slowly in the direction of better shareholder representation and has identified many of the problems this Article proposes to solve through use of an equity trustee, but the equity trustee is an innovation and has not yet been adopted by public corporations. The market has tried to solve the collective action and agency problems presented here in other, so far, ineffective, ways. The Part then addresses the widely held belief that shareholders are too widely dispersed and unsophisticated to have much of a role in corporate governance and shows that that need not be the case. Power would not have to be so intentionally withheld from shareholders if they were represented by a consistent, sophisticated trustee. Finally, this Part considers the multiple failures in the market that led to sub-standard corporate governance and how the combination of the those factors contributed to the market crash of October, 2008. This Part aims to show how the equity trustee could fit into or become a creature of the corporate governance market and how it could solve problems within that market.

**A. Why Hasn’t the Market Thought of This Yet?**

A question sure to be posed by economists about the idea for any innovation that would affect financial markets is: if it’s such a good idea, why hasn’t the market come up with it yet? The answer in this case is: well, it has come close and has flirted with similar, but different and ultimately flawed ideas. The equity trustee would be both a giant leap and a small step. The shareholder class has never found able representation before, yet it has moved slowly down a progression that may naturally culminate in the use of such a representative in the form of the equity trustee suggested here. The recent growth of the corporate governance industry is evidence of the small, but determined, movements shareholders have made toward better representation and the ability to perform the shareholder job with greater knowledge and sophistication. While the market has taken steps toward unifying the shareholder voice and overcoming the problems occasioned by rational shareholder apathy and general lack of shareholder sophistication, and scholars have suggested yet other mechanisms the market could try, the proposed mechanisms are flawed. An equity trustee would do a better job of achieving that goal.

**1. Proxy Advisors**

The use of shareholder proxy advisors allows institutional shareholders to cast their votes with greater sophistication, because they have been advised by professionals whose job it is to pay attention to corporate issues. Proxy advisors tend to advise institutional shareholders by issue, rather than by company, but still do the research and analysis that institutional investors do not have the incentives
to do. As a result, the votes recommended by proxy advisors are not necessarily blind rubber stamps of management proposals. They make significant strides in solving the problem of rational apathy as it applies to shareholder voting and, to a limited degree, enhance shareholder sophistication so that shareholders would be in a better position to advocate or fight a particular cause should such an opportunity arise. Proxy advising firms have not moved all the way to doing the job proposed for the equity trustee here.

For instance, proxy advisors focus only on giving advice about how to vote on specific issues. They do not pay attention to day-to-day activities in a particular company and therefore do not engage in careful monitoring of management or more company-specific problems. One could not rely on a proxy advisor to suggest a derivative suit or even necessarily to advise the overthrow of a particular director or board of directors. Proxy advisors certainly do not advise or negotiate with management on shareholders’ behalf. They simply tell institutional investors how they should vote on certain issues when certain proxy solicitations are issued by the company. Their role is limited, and therefore, so is their effectiveness and ability to address the larger shareholder collective action problem.

The equity trustee would do a better job of solving the collective action problem than a proxy advisor could. An equity trustee would advise all shareholders about many corporate issues, and even issues that were not put to a vote. However, most of the votes cast do favor management proposals. That is not an indication of the ineffectiveness of proxy advisors, but may simply show that management is usually doing a fine job and has done its homework itself. Also, to the extent proxy advisors counsel institutional shareholders to vote a certain way every time a particular issue arises, managers can predict how such votes would turn out. Rose, supra note 52, at 898

“Critics have expressed concerns about the influence that proxy advisors . . . can potentially exert over the shareholder voting process. Proxy advisors are depicted as powerful, yet unaccountable, institutions that can sway the outcome of corporate votes without any of their own money at stake.” Choi, et al., supra note 75, at 650; Tamara C. Belinfanti, The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control, 14 STAN. J.L. BUS. & FIN. 384, 384 (2009) (explaining how “[t]he proxy advisory and corporate governance industry plays a significant role in shareholder voting and in the formulation of corporate governance policy”).

At least, they do not do so formally. Because they hold so much potential power in their ability to advise a significant number of votes, management may negotiate with proxy advisors in order to secure their recommendation of a particular matter up for a vote. Id.

“[I]nstitutional investors understand the basis for voting recommendations of the various proxy advisors, they can subscribe to and follow the recommendations of those advisors that best match their assessment of which votes maximize corporate value. On the other hand, if institutional investors lack such understanding and choose to follow a proxy advisor based on other criteria, then proxy advisors are indeed, as charged by their critics, powerful, unaccountable, badly incentivized, and able to pursue their own agenda in issuing voting recommendations.” Choi, et al., supra note 75, at 651; Belinfanti, supra note 130, at 394 (explaining how “[i]nstitutional investors’ reliance on proxy advisors has become a permanent and central feature of today’s corporate vote”).

129 However, most of the votes cast do favor management proposals. That is not an indication of the ineffectiveness of proxy advisors, but may simply show that management is usually doing a fine job and has done its homework itself. Also, to the extent proxy advisors counsel institutional shareholders to vote a certain way every time a particular issue arises, managers can predict how such votes would turn out. Rose, supra note 52, at 898
130 “Critics have expressed concerns about the influence that proxy advisors . . . can potentially exert over the shareholder voting process. Proxy advisors are depicted as powerful, yet unaccountable, institutions that can sway the outcome of corporate votes without any of their own money at stake.” Choi, et al., supra note 75, at 650; Tamara C. Belinfanti, The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control, 14 STAN. J.L. BUS. & FIN. 384, 384 (2009) (explaining how “[t]he proxy advisory and corporate governance industry plays a significant role in shareholder voting and in the formulation of corporate governance policy”).
131 Rose, supra note 52, at 905.
132 Id.
133 See generally Choi, et al., supra note 75, at 651–60 (discussing the generally accepted roles of a proxy advisor).
134 At least, they do not do so formally. Because they hold so much potential power in their ability to advise a significant number of votes, management may negotiate with proxy advisors in order to secure their recommendation of a particular matter up for a vote. Id.
135 “[I]nstitutional investors understand the basis for voting recommendations of the various proxy advisors, they can subscribe to and follow the recommendations of those advisors that best match their assessment of which votes maximize corporate value. On the other hand, if institutional investors lack such understanding and choose to follow a proxy advisor based on other criteria, then proxy advisors are indeed, as charged by their critics, powerful, unaccountable, badly incentivized, and able to pursue their own agenda in issuing voting recommendations.” Choi, et al., supra note 75, at 651; Belinfanti, supra note 130, at 394 (explaining how “[i]nstitutional investors’ reliance on proxy advisors has become a permanent and central feature of today’s corporate vote”).
shareholder vote could influence the advice the equity trustee gives when it is time to elect new directors. Further, the equity trustee is able to make decisions about how shareholders could enforce corporate governance standards that a proxy advisor is simply not hired, or really even equipped, to make. Perhaps the biggest difference between the two is that an equity trustee would be able to represent the entire equity interest and really invest in the information necessary to monitor a particular company, while a proxy advisor is hired by one shareholder at a time to give advice on a narrow set of issues.

2. Shareholder Committees

In the past, both shareholder groups and scholars have suggested the use of shareholder committees\textsuperscript{136} to monitor or advise management on behalf of shareholders. Such committees were used as long ago as the 1800s and enjoyed renewed popularity in the 1980s and 1990s when they were the subject of popular, but ultimately unsuccessful, shareholder proposals.\textsuperscript{137} Shareholders proposed to use those committees, to be made up of the seven or so largest shareholders “willing to serve,” in various ways from a general advisory or monitoring function over management to addressing more specific issues such as whether derivative suits against management should proceed.\textsuperscript{138} Rather than look to a special committee of directors, the argument goes, why not compose and ask a special committee of shareholders about whether a derivative suit is in the best interests of the corporation?\textsuperscript{139}

The proposed shareholder committees come closer to approximating the role envisioned for an equity trustee, but still miss the mark in important ways that may explain why the committees were never adopted into common use. Shareholder committees require shareholders with large holdings in a particular company to do a significant amount of work for the benefit of all shareholders, while only capturing a small portion of the gain. The proposal asks shareholders to overcome the disincentives caused by the collective action problem without solving the part of the collective action problem that leads to those disincentives. It is not surprising, then, that shareholders were not willing to take on the responsibility. Shareholders seemed to like the idea, though, of someone else doing so as proposals for shareholder committees received significant support in shareholder votes, even over the objection of management.\textsuperscript{140}

Still, relying on shareholders to represent an entire class in spite of the conflicting interests highlighted above may not be realistic. If they wanted to, institutional shareholders could simply work together to monitor management effectively and come together to support shareholder governance issues they care

\textsuperscript{136} The “equity committee” suggested by this Article should be distinguished from the “shareholder committees” discussed here. When I refer to “shareholder committees” I mean the committees suggested in the past to monitor management and make decisions on behalf of all shareholders. The “equity committee” is the committee I suggest to select and monitor an equity trustee.

\textsuperscript{137} Rock, \textit{supra} note 6, at 491.

\textsuperscript{138} \textit{Id.} at 449-50.

\textsuperscript{139} \textit{Id.}

\textsuperscript{140} \textit{Id.}
about. We see no such cooperation among institutional shareholders, and evidence of the collective action problem persists. These major investors simply do not want to do more work for the greater good. It is just not worth it to them. While the equity trustee proposal relies in part on the creation of an equity committee, the equity committee’s duties are more or less limited to activities the equity committee members would be doing anyway to monitor their investments. It does not ask a group of shareholders to sacrifice significant time or even judgment for the benefit of others. The equity committee members will simply cast a vote about what they think is best for corporate returns, and their collective vote should approximate the interests of the shareholder class more closely than it does their individual idiosyncratic preferences.

An equity trustee can do a better job of aggregating shareholder preferences and representing the shareholder class as a whole than a committee of self-interested shareholders could. To the extent that the shareholders on a committee would be fund managers with fiduciary duties to their investors, they could not represent the interests of the shareholder class to the extent that those interests conflict with those of their fiduciary beneficiaries. When an equity committee has to choose or monitor an equity trustee, that decision is much less specific than other issues a shareholder committee charged with representing shareholders in a significant way would have to encounter. The choice of an equity trustee can involve many factors. Compromise is important, and it would be expensive for all shareholders to change the equity trustee regularly. Therefore, this relatively limited use of an equity committee presents fewer risks for serious conflicts of interests than giving shareholder committees a more significant role would. Further, it would be much easier for an equity trustee to represent all shareholders because it will not have, and may not have, directly conflicting interests. An equity trustee can represent shareholders on a number of different and specific issues without worrying about serving any other beneficiary. An equity trustee is also a way to concentrate that representation in one party, rather than spreading it among the ever changing committee of shareholders. An equity trustee has a better institutional memory and can provide important continuity in representation and decision making, particularly during turbulent times.

3. Director Subcommittees

141 Bainbridge, supra note 9, at 613 (highlighting that “collective action problems preclude the shareholders from exercising meaningful day-to-day or even year-to-year control over managerial decisions”); Black, supra note 2, at 527 (showcasing poor shareholder activism and cooperation and that “collective action theory tells us, … that shareholders won’t make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort”); Blair & Stout, Team Production, supra note 9, at 312 (stating that “even when shareholders are entitled to vote, . . . shareholders still face collective action problems. The net result is that it is always extremely difficult, and often impossible, for shareholders to use their rights to vote on fundamental changes to oppose a transaction or policy the board favors.”); Rock, supra note 6, at 452–53 (concluding that agency costs prevent and fundamental changes in corporate law and that shareholders will remain uninformed and dispersed).
Acknowledging both that the equity class of a company has an identifiable, unitary interest and that management may not adequately take that interest’s risk preferences into account, Professor Henry Hu has suggested a subcommittee of directors whose job it would be to particularly represent the shareholder interest to the rest of the board.142 Rather than relying on shareholders to be willing to serve on an advisory committee or to invest in one company long enough to be effective, Hu calls on the people who are already responsible for paying attention to such matters to consider and then represent the shareholder interest to the rest of the board.143 This might be a more effective way to devise a representative committee, but it glosses over significant debates about director duties and the appropriate realm of director focus.144

A proposal for the use of director subcommittees to represent shareholder interests has the disadvantage of suggesting that directors divide their focus in making corporate decisions. If a subcommittee of directors has to be charged with paying attention to shareholder interests, that suggests that all directors do not already pay attention to those interests and that, if they don’t, they should. What happens if a well-diversified shareholder would prefer that the corporation take a risk that would not be value maximizing for the firm?145 What is the subcommittee to do? How will their input be weighed? Do they not still have an obligation to do what is in the best interests of the firm even if the risk preferences of the shareholders differ? Also, a director subcommittee cannot take over the shareholder responsibilities of monitoring and disciplining management. A

142 Hu, supra note 1, at 281-83.
143 Id. at 282-83.
144 Namely, shouldn’t all directors be focusing on the shareholder wealth maximization interest anyway? Grant M. Hayden & Matthew T. Bodie, One Share, One Vote and the False Promise of Shareholder Homogeneity, 30 CARDOZO L. REV. 445, 503 (2008) (explaining how the shareholder primacy “norm assumes that shareholders all prefer wealth maximization and then requires the corporation to be run accordingly”). Or, should none of them be focusing on that interest to the exclusion of their duties to the corporate enterprise and all of its relevant constituents. Director’s “duty is to serve the interests of the corporate enterprise, encompassing all its constituent groups, without preference to any. That duty, therefore, requires directors to take creditor interests into account, but not necessarily to give those interests priority.” In re Ben Franklin Retail Stores, Inc. v. Kendig, 225 B.R. 646, 655 (N.D. Ill. 1998) (considering a financially distressed company); Vice Chancellor Leo Strine argued that “[t]he obligation of directors in the context of high risk and uncertainty ... was not ‘merely to be the agent of the residue risk bearers’ but rather to remember their fiduciary duties to ‘the corporate enterprise’ itself, in the sense that the directors have an obligation ‘to the community of interest that sustained the corporation ....’ and to preserve and, if prudently possible, to maximize the corporation’s value to best satisfy the legitimate claims of all its constituents, and not simply to pursue the course of action that stockholders might favor as best for them.” Stephen M. Bainbridge, Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency, 1 J. BUS. & TECH. L. 335, 347 (2007). The shareholder primacy debate rages on, and is not one directly taken up by this article. I simply mean to point out that Hu’s suggestion, while seeming to come down on the shareholder primacy side, doesn’t really take that debate into account by explaining either why all directors aren’t already doing the job of the “special committee” or, if they should not all be, why some would be able to focus so exclusively on shareholder interests without breaching their other duties. Henry Hu, Risk & Time, supra note 135, at 347-54.
director could not fully occupy the separate role of shareholder representative without compromising her obligations to the firm as a director. One simply cannot wear both hats at once.

Again, an equity trustee is better equipped to serve the collective shareholder interest, because it serves no other masters. The equity trustee can represent the shareholder interest to the board without having to change its mindset or abandon another way of thinking about the problem. Its effect on the board is limited by the relatively limited nature of shareholder powers. This way, the board hears what it needs to about shareholder interests, but can then put matters in proper perspective.

**B. Regulation**

The shareholder collective action problem is no secret, and legislators have not been insensitive to it in designing corporate and securities law. State law gives shareholders certain powers, supposedly commensurate with the degree of risk shareholders assume as a firm’s residual claimants, such as the right to vote on directors and other major issues, the right to amend bylaws, and the ability to file derivative suits on the corporation’s behalf to vindicate the corporation’s rights against others. Those statutory rights and duties are of limited use to shareholders, or the equity position as a collective whole, because of the consequences of the collective action problem and rational shareholder apathy, discussed above. When the gaps in the governance structure become clear, that is, when something goes horribly wrong, say a corporate scandal erupts or the market experiences a catastrophic collapse, legislators look at the laws governing corporations to try to find solutions and prevent a similar problem in the future.

Congress took its first such steps in the wake of the Great Depression when it enacted the Securities Act of 1933 and the Securities Exchange Act of 1934.146 The main focus of those statutes was disclosure.147 The government did not seek to regulate risk-taking, but rather sought to solve the problem of informational

---

asymmetries by requiring enhanced disclosures about firms offering their securities to the public.\textsuperscript{148} The new disclosure requirements have filled gaps in monitoring of corporate managers and have provided the market with information necessary to its proper functioning. They have been helpful, but, as is all legislation (particularly corrective legislation) the new laws were retrospective. They sought to correct the problems that had already arisen, but made no effort to anticipate future issues. They neither critically evaluated the existing law in its entirety, nor took account of the entire corporate governance system. Instead, they identified one market failure and sought to plug the one leak they could find.

Similarly, Sarbanes-Oxley responded to particular problems that led to, or allowed for, the corporate scandals that occurred in the early 2000s.\textsuperscript{149} It responded to clear problems with the accounting industry, including a lack of auditor independence and accountability for material misrepresentations.\textsuperscript{150} It also sought to increase the accountability of corporate executives for misstatements to the market.\textsuperscript{151} Further, it encouraged the public stock exchanges to adopt corporate governance rules for listing companies that addressed board composition and executive compensation. The resulting rules were broad and not novel enough to make a real difference to corporate governance.\textsuperscript{152} Additionally, they were not necessarily the rules the market needed to make necessary improvements.\textsuperscript{153} The focus was again on enhanced disclosure without regard to the risks of investments made.

While regulation may have been insufficient to resolve problems with corporate governance, the federal government is not supposed to regulate


\textsuperscript{149} Mark J. Loewenstein, The Quiet Transformation of Corporate Law, 57 SMU L. REV. 353, 358 (2004).

\textsuperscript{150} “In passing The Sarbanes-Oxley Act of 2002, Congress adopted a wide-ranging approach to the perceived causes of the financial crises typified by Enron and WorldCom. To the extent that these crises reflected a weakness in the regulation of the accounting profession, for instance, Sarbanes-Oxley created an accounting oversight board. Similarly, perceived weaknesses in the independence of the company’s auditors were addressed with new rules to limit non-audit services, to require audit partner rotation, etc.” Id.

\textsuperscript{151} “The 2002 Sarbanes-Oxley Act is the centerpiece of a movement to increase the accountability of corporate executives and auditors to shareholders, the market, and the public.” David Mills & Robert Weisberg, Corrupting the Harm Requirement in White Collar Crime, 60 STAN. L. REV. 1371, 1442 (2008); Keith L. Kearney et al., Lawyers as Gatekeepers in the Underwriting Process, 1734 PLI/Corp 579, 607 (2009) (explaining how, “[a]s for accountability, Sarbanes-Oxley requires public company CEOs and CFOs to certify that the financial statements their companies issue are accurate”); Robert J. Jossen, Dealing with the Lawyer’s Responsibilities Under the Sarbanes-Oxley Act of 2002: Ethical Dilemmas and Practical Considerations, SNO71 ALI-ABA 167 (2008) (discussing the “twin themes” of Sarbanes-Oxley: “significantly enhanced personal accountability at the top... [and] stiff sanctions for corporate executives who fail in their duties”).

\textsuperscript{152} See generally MACEY, supra note 13, at 112–13 (discussing organized stock exchanges adoption of corporate governance rules and their general “inability to enforce [their] own corporate governance rules”).

\textsuperscript{153} Id., at 90–93 (analyzing why directors, with the notable exception of dissident directors, are susceptible to capture).
corporate governance. The internal affairs of corporations are subject to state law.\(^{154}\) State law and market experiments have conspired to create corporate governance problems to which federal law does not respond. A market-based response, such as an equity trustee, is required to address problems such as those considered in the next section.

## C. Corporate Governance Failures

There can be little doubt that there has been a failure in the corporate governance market. It would appear that the securities market took an unprecedented tumble in the face of poorly understood, unprecedented risk-taking.\(^{155}\) Gaps in monitoring and a failure of any one party to pay close attention to what some companies were doing and how they were doing it led to a crash whose scope and timing came as a bit of a surprise.\(^{156}\) No one liked being surprised, and unsuccessful litigation ensued in an attempt to hold someone personally responsible for the crisis. There was enough responsibility, though not accountability, to go around. In seeking to prevent such problems in the future, we should discover where exactly the gaps were, what caused them, what we are willing to change, and what must stay the same for the system to work as intended. Such an in-depth evaluation of the corporate governance market is beyond the scope of this paper. For now, this Article will focus on a few particular failures the equity trustee could help to correct.

### 1. “Short-Termism”

In an attempt to align managerial personal interest with the goal of corporate profit maximization, corporations moved to a system of executive compensation that relies heavily on incentive compensation and the granting of stock options.\(^{157}\) Incentive compensation rewards executives when the

---

\(^{154}\) E.g., CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987) (holding that Indiana’s takeover statute applies and not the federal Williams Act); Santa Fe Industries v. Green, 430 U.S. 462 (1977) (holding that Delaware’s short-form merger statute controls).

\(^{155}\) In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009). The court continues by discussing the doubt and uncertainties that occur in investing:

> When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got “unlucky” in that a huge loss—the probability of which was very small—actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.

_id._

\(^{156}\) See Dellastatious v. Williams, 242 F.3d 191, 196 (4th Cir. 2001) (noting that even Chancellor Allen realized the difficulty in monitoring corporations by “pointedly describe[ing] claims for failure to adequately monitor corporate activities as ‘possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.’ His statement reflects the reality that service as director of a corporation should not be a journey through liability mine.” (quoting In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996))); Bernard S. Sharfman, *Enhancing the Efficiency of Board Decision Making: Lessons Learned From the Financial Crisis of 2008*, 34 Del. J. Corp. L. 813, 847 (2009) (discussing Caremark and Chancellor Allen’s request for additional board oversight).

\(^{157}\) “[T]he conflict between managers and shareholders interests can be mitigated through the use of incentive compensation packages which align the incentives of managers with those of..."
corporation they manage performs well. The incentive compensation may be a short-term, discretionary bonus, or a longer term reward for reaching particular growth or earnings targets. Executives are also commonly compensated with stock options that allow corporate managers to buy stock at a given price and then sell it for a profit when the stock price exceeds the option’s strike price. Such compensation gives executives incentives to cause the corporation to reach the benchmarks that would trigger bonuses. Executives also have incentives to achieve quick, dramatic increases in the stock price to allow them to cash out bonuses for a substantial profit. Long term growth of the company and increased value in the stock price over time would also result in lucrative compensation, but a rational actor is not likely to invest resources in a long-term return when a relatively higher short-term return can be achieved more immediately. This consequence of the current compensation structure is blamed for some of the risky investing responsible in part for the recent economic crisis.

There are, indeed, benefits to tying managers’ personal interests to growth in the corporation’s profitability. Corporate health, however, is generally believed to be better served by focusing on long-term wealth maximization, that is, growth in the firm’s business and profitability that holds up over time and

shareholders. Stock options can be used to provide managers with an equity interest in the corporation. As executives' level of stock ownership increases, they will bear a greater percentage of the costs of any deviations from the standard of profit maximization. In this situation, self-interest will lead managers to act in shareholders' best interests.” Randall S. Thomas & Kenneth J. Martin, The Effect of Shareholder Proposals on Executive Compensation, 67 U. CIN. L. REV. 1021, 1081 n.40 (1999); Galbraith Redux, Economics and the Public Purpose, 83 YALE L. J. 1291, 1297 (1974) (explaining how “[i]ncentive compensation of executives generally is geared to profit performance and share values”).

“Equity incentives in the form of stock options increase the motivation to produce earnings that propel share prices.” Bernhard Grossfeld, Global Corporate Governance and Legal Education, 11 L. & BUS. REV. AM. 185, 195 (2005).

“Some analysts have argued that the equity-based executive compensation which became increasingly important, particularly stock options, created incentive for executives to massage accounting data to make profits appear high in the short-run and thus drive up the company's stock price.” Brett H. McDonnell, Sox Appeals, 2004 MICH. ST. L. REV. 505, 514 (2004); Stephen M. Cutler, Secretary of Staff, Speech at the University of Michigan Law School, 1515 PLI/Corp 23, 27 (2005) (explaining how CEO’s “short-term focus gr[jows] even sharper” as a result of “an ever-increasing reliance on stock options and other stock price-dependent compensation for executives”).
results in stable increases in the value of the corporation’s assets. Of course, there is not always someone to fight for that interest. Most parties in interest, from institutional investors, to short-term traders, to managers, want to report a large profit, and they want to do so now, rather than later. Even well-diversified investors assume they can take advantage of current profits and simply move their money when a particular company’s fortunes decline. Of course, this assumes that investors receive much more notice of when a company is about to decline than they actually do (or can). The failure of the parties enjoying the benefits of a firm’s short-term profits to question the source of those profits or the consequences of pursuing short-term gains may also perpetuate problems associated with excessive, or poorly understood, risk taking. By the time those costs are realized, it is too late to prevent, or recover, the loss. The incentive compensation structure, combined with investors’ rational apathy and apparent satisfaction with high returns regardless of the long-term consequences for the value of the company, create difficulties in finding the most appropriate way to pursue the goal of long-term corporate wealth maximization.

An equity trustee helps to resolve this market failure. It represents the entire equity interest in long-term corporate wealth maximization, rather than focusing on the preferences of individual shareholders. An equity trustee can pay

---

161 Clint Cronkite, *Value-Seeking Companies Need Valuations*, 1999 J. BUS. VALUATION 177, 181 (1999) (suggesting that “[c]orporate boards should therefore establish performance targets and incentive compensation that strongly motivates management to achieve superior shareholder returns over time”).


163 Norman S. Poser, *Why the SEC Failed: Regulators Against Regulation*, 3 BROOK. J. CORP. FIN. & COM. L. 289 (2009) (discussing an investors have been “whipsawed” by “bear raids,” which is a term invented to describe the phenomena of stock prices being driven down “without warning and at breakneck speed”).


close attention to corporate investment strategies and ask the important questions about where corporate gains are coming from. In that regard, the equity trustee would duplicate work the board of directors is supposed to do. A monitoring board is supposed to understand the sources of the corporation’s income and raise concerns if that income is not earned in a manner consistent with long term wealth maximization. This duplication of effort is not the equity trustee’s main task and is only incidental. The equity trustee’s primary function is to represent the equity interest to the corporation’s board and managers. An equity trustee can also provide continuity that can overcome the consequences of a fluid investor pool. As various investors prefer exit to voice and leave a firm they believe is performing poorly or that no longer fits into their portfolio, the identity of the equity holders constantly changes. An equity trustee can provide continuity in the representation of that interest and enjoys the advantage of institutional memory.

2. Entrenchment of officers and directors

Officer and director jobs are usually very secure because it is very difficult for shareholders to remove managers. In order to remove directors, or to elect a new board not nominated by the current slate of officers, shareholders must launch expensive proxy contests. Such contests are rare and not usually successful. Incumbent management has an advantage in proxy fights, because they have access to corporate assets for the purpose of funding their own proxy solicitation, they have access to shareholder lists, and they have the advantage of being the devil the shareholders know. If shareholders want to change the company’s senior executives, they must exert pressure on the board. Board members supervise and appoint officers and are the only ones with the power to change the personnel at the top of the company’s executive structure. Shareholders rarely care enough to change the board’s make-up. They certainly

166 “Professor Lucian Bebchuk elegantly argues that the notion that shareholders in public corporations have the power to remove directors is a myth. Although a director facing a proxy contest might find this to be a bit of an overstatement, the core idea is sound. In a public company with widely dispersed share ownership, it is difficult and expensive for shareholders to overcome obstacles to collective action and wage a proxy battle to oust an incumbent board.” Lynn A. Stout, The Mythical Benefits of Shareholder Control, 93 VA. L. REV. 789, 789 (2007).

167 “Despite the rule changes described above, and notwithstanding the occasional burst of well-publicized shareholder revolt, institutional investor activism remains today the exception, not the rule. The number of shareholder-initiated resolutions and proxy contests has increased only slightly since 1990, and such efforts achieve success only in rare instances.” Robert C. Illig, What Hedge Funds can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight, 57 AM. U. L. REV. 225, 258 (2007); Carl L. Reisner, The Use of the Proxy Machinery as a Catalyst for Change, 696 PLI/Corp 649, 663 (1990) (discussing a letter to shareholders, which argues that “running a proxy contest to remove an existing board and elect a new board [should be] an action of last resort”).

168 MACEY, supra note 13, at 120.

169 “Corporate and securities laws require companies to adopt governance processes under which shareholders possess powers to select or change the members of a company's board of directors. Company managers are, at least formally, accountable to the board members whom the shareholders select.” Richard S. Grunner, Corporate Patents: Optimizing Organizational Responses to Innovation Opportunities and Invention Discoveries, 10 MARQ. INTELL. PROP. L. REV. 1, 79 n.85 (2006).
do not organize to quibble over who serves as a company’s chief executives. These factors combine with a market for corporate control that has been weakened by state and federal law to make corporate officers and directors virtually impossible to remove.\textsuperscript{170} Because the market cannot easily fire officers or directors for poor performance, it has to rely on other, less effective corporate governance mechanisms, such as derivative fiduciary litigation and the shareholder proposal mechanism.\textsuperscript{171}

Some argue that officers and directors make firm- and industry-specific investments when they serve at the helm of a company and would refuse to serve without significant job security protecting that investment.\textsuperscript{172} This is particularly true of officers, as they have to invest all of their working time and energy in one corporation. The director job is not a full-time one and so does not impose the same kinds of opportunity costs. Still, both officers and directors want to feel that they have some job security before learning about a corporation’s affairs and before they stake their professional reputations on improving the corporation’s business.\textsuperscript{173} It is far from obvious that corporate officers and directors need more

\textsuperscript{170} MACEY, supra note 13, at 130-33. Macey argues that managers have formed an influential lobbying group that has successfully pressured law makers to enact laws that have erected significant obstacles to corporate takeovers to the detriment of shareholders.\textsuperscript{171} Despite being relatively ineffective and generally unsuccessful, fiduciary litigation and shareholder proposals have received significant attention from corporate governance scholars and legislators, alike. String cite of examples of this. MACEY, supra note 13, at 130 (“With the possible exception of corporate boards or directors, litigation in the form of class actions and shareholder derivative actions I conventionally believed to be the most important corporate governance mechanism available to U.S. investors. This belief is both inconsistent with the corporation-as-promise approach taken in this book and wrong.”)

\textsuperscript{172} “Officers will not have incentives to develop firm-specific skills or expertise if it is apparent that such investments will be lost as a result of a takeover. In addition, they will not be willing to defer compensation if there is an inherent risk of termination or change of position. The corporation can compensate managers for the risk of termination by either offering to pay a risk premium or using ‘bonding devices, such as the ‘golden parachute,’ which compensates only those who are in fact terminated.’” Alexander C. Gavis, A Framework for Satisfying Corporate Directors’ Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts, 138 U. PA. L. REV. 1451, 1479-80 (1990); Murali Jagannathan & Srinivasan Krishnamurthy, Investment Banker Directors and Affiliated Analysts’ Forecasts, 3 J. INV. MGMT. 4, 19 (2005) (arguing that firms with investment banker directors issue more accurate forecasts because they have better access to firm-specific information); Martin Lipton, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel, 55 N.Y.U. L. REV. 1231 (1980) (explaining that director’s and officer’s long-run focus should include encouraging members of the management team to make firm-specific investments by giving members security against removal through takeovers).

\textsuperscript{173} In Buckhorn, Inc. v. Ropak Corp., “[t]he court . . . analyzed certain amendments to the CEO’s employment contract under the business judgment rule. . . [and] concluded, under the first prong of Unocal, that the directors’ desire to provide job security in light of the uncertainty created by Ropak’s offer was legitimate because the Board believed that (i) the company’s future was dependent on the CEO’s performance, and (ii) the Ropak offer was ill-timed and threatened Buckhorn’s transition from a holding company to an operating company.” Alan C. Myers, Marc J. Segalman & Ilan S. Nissan, Introduction to Mergers and Acquisitions, 637 PLI/Corp 155, 526 (1989); Scott W. Fielding, Free Competition or Corporate Theft?: The Need for Courts to Consider the Employment Relationship in Preliminary Steps Disputes, 52 VAND. L. REV. 201, 231
job security than any other market professional. There is significant CEO turnover in troubled companies, with firms replacing embattled CEOs with restructuring officers who have developed expertise in reviving dead or dying firms. 174 Further, the threat of removal makes reputational costs more meaningful. Managers who are allowed to keep their jobs despite poor performance have no incentives to perform better. Lacking a market for corporate control and ready mechanisms for removing underperforming managers makes the lack of a meaningful duty of care in corporate law all the more costly. There is simply no reasonable recourse against inattentive or incompetent managers. 175

By proposing the use of an equity trustee, I do not advocate an increase in shareholders’ specific rights or powers. Instead, I suggest that shareholders be able to use their powers over corporate management more effectively by appointing someone to monitor management for them and rally them to take action when necessary. Doing so may make it easier for shareholders to remove poor management, but not so easy that managers feel unduly insecure in their positions or that turnover would become so common as to impair corporate performance. An equity trustee, on shareholders’ behalf, would not really have an interest in turning over management unless a change was really necessary. Instability in management could prove costly to the corporation, and an equity trustee who abused its power in this regard would quickly develop a bad reputation for representing shareholder interests in long term wealth maximization.

Considering the consequences of an equity trustee’s presence and determining how powerful an equity trustee would be and how its power should be balanced against management’s authority is an important next step in moving toward a better system of corporate governance. The next part of the paper briefly considers these issues and plots a course for how corporate governance might proceed should equity trustees be widely adopted.

V. WHAT’S NEXT

Introducing an equity trustee to the mix of corporate professionals involved in the governance of a corporation may be a significant change. An equity trustee whose recommendations are followed by large numbers of shareholders could wield serious power over corporate officers and directors and influence their decisionmaking. This may have the effect of enhancing shareholder power without changing shareholder rights. In the face of a more powerful shareholder class, corporate governance could notice important changes that may lead to different arrangements and enforcement mechanisms.

(1999) (discussing how directors and officers are in the best position to bargain for “fixed-term agreements or any kind of job security”).


175 Alces, supra note 98, at 1106 n.33.
For instance, to the extent that an equity trustee could negotiate specific governance contracts with the firm and its management, shareholders may have a more direct way to enforce more clearly defined standards more predictably.\textsuperscript{176} Grounding the discipline of corporate management more firmly in contract may change how officers and directors perform their duties. The contracts contemplated by this scheme would resemble, in some ways, a combination of the terms provided by individual firms’ codes of ethics and bank loan covenants that dictate matters of corporate governance. On the one hand, such a structure would make the enforcement of governance standards more predictable and more likely. On the other, the remedies likely would be less severe than current liability rules provide. The resulting certainty would probably complete the demise of the relevance of fiduciary standards in corporate law.\textsuperscript{177}

The use of equity trustees and a move to a governance regime based more firmly in contract would significantly change the shareholder role in corporate governance, and the increased power and sophistication of the shareholder voice would likewise alter the balance in corporate governance. Thirty years ago, the economist Eugene Fama predicted that the corporate board would evolve to be made up of representatives of corporate investors and “team members.”\textsuperscript{178} The addition of an equity trustee would make that evolution more probable. As it is, creditors are exerting significant power over corporate governance through the enforcement and renegotiation of loan covenants.\textsuperscript{179} Putting various creditors’ representatives together with a shareholder representative to decide important corporate matters according to the powers each has in its contract with the firm would allow for more direct and informed governance through negotiation and compromise than current monitoring boards could achieve. The monitoring board would become an irrelevant, ill-informed part-time intermediary by comparison. Officers would still run the day-to-day operations of the firm, but the board would be composed of the direct representatives of the very interests part-time directors now have to balance. It is not the investor representatives who would be redundant agents watching agents, it is the independent monitoring board that would lose its salience. As this change would reflect a reconstitution of the board of directors, much of corporate law giving ultimate governance authority to the board would not have to change.

\textbf{CONCLUSION}

The shareholder collective action problem and the relative lack of sophistication of widely-dispersed shareholders have long been considered intractable problems in corporate governance. As a result, shareholder powers

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{176} Alces, \textit{supra} note 91, at 239.
\item\textsuperscript{177} \textit{Id.}
\item\textsuperscript{178} He wrote, “In the team or nexus of contracts view of the firm, one cannot rule out the evolution of boards of directors that contain many different factors of production (or their hired representatives), whose common trait is that their marginal products are affected by those of the top decision makers.” Eugene F. Fama, \textit{Agency Problems and the Theory of the Firm}, 88 J. Pol. Econ. 288, 294 (1980).
\item\textsuperscript{179} Tung, \textit{supra} note 98.
\end{enumerate}
\end{footnotesize}
have grown so weak as to be practically irrelevant. The equity interest remains an important one in a world honoring a shareholder wealth maximization norm in corporate governance, however, and although we may not be able to rely upon individual shareholders to represent that interest, it should not be lost.

An equity trustee provides a sound solution to the problems plaguing the shareholder role, or “job,” in corporate governance. It lends sophistication to the shareholder voice and allows coordination and concentration of shareholder power behind an informed representative. An equity trustee would remain accountable to equity holders through an equity committee, but would work to represent the equity interest in long-term corporate wealth maximization, rather than advocate the idiosyncratic interests of individual shareholders. The presence of such a representative would provide continuity in the shareholder position and in the monitoring of management, regardless of a corporation’s financial health or circumstances.

The large-scale effects of an equity trustee are subjects for future research. For now, it is important simply to understand where the use of an equity trustee might lead and to begin to think about the consequences of adding such a figure to the corporate governance landscape. An equity trustee presents many potential advantages for more effective corporate governance, but may impose unforeseen costs as any powerful representative may. As the ways in which an equity trustee could abuse its position or effect a particular company’s governance more strongly than intended come to light, the contours of the position will have to be refined and surrounding governance entities and mechanisms will have to adjust to accommodate the new shareholder representative.

The use of equity trustees could seriously change the face of corporate governance and lead to an evolution to more effective mechanisms of corporate decisionmaking. We may find that managers are monitored better and that managerial indiscretions can be discovered and remedied more easily and predictably. Finally, there will be a single, sophisticated party to do the shareholder job.