

**IS THE SKY REALLY FALLING?  
SHAREHOLDER-CENTRIC VERSUS DIRECTOR-CENTRIC  
CORPORATE GOVERNANCE**

**JOHN F. OLSON\***

In June 2007, Pfizer announced that members of its board of directors, including the chairpersons of three of its key board committees, would meet with representatives from some of its largest institutional investors to hear their concerns.<sup>1</sup> In the aggregate, the represented investors owned approximately thirty-five percent of Pfizer's shares.<sup>2</sup> Within hours, Marty Lipton, one of America's legal legends, issued a bulletin to his clients decrying this step as "another example of corporate governance run amuck."<sup>3</sup> It is likely that he meant "amok," as in frenzied, with intent to kill, rather than "amuck," which means mired in mud; however, either word may fit his thesis. More seriously, Lipton saw Pfizer's action as a substantial step down a slippery slope toward destruction of the modern corporate model that has been a critical engine of our nation's economic growth for the past century.<sup>4</sup> Though Lipton is no Chicken Little, he saw the Pfizer announcement as a sign that the sky is falling on the traditional director-centric model of corporate governance

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\* Mr. Olson is a Partner at Gibson, Dunn & Crutcher LLP. He is currently a Visiting Professor at Georgetown University Law Center. This Article is adapted from a speech given at the University of Tennessee for the Corporate Governance Center on February 1, 2008. Mr. Olson acknowledges with appreciation the assistance of his colleagues Jennifer Ketron and Susan M. Reilly in completing the citations for this Article.

<sup>1</sup> Press Release, Pfizer Inc., Pfizer Board of Directors to Initiate Face-to-Face Meetings with Company's Institutional Investors on Corporate Governance Policies and Practices (Jun. 28, 2007), *available at* [http://www.pfizer.com/news/press\\_releases/pfizer\\_press\\_releases.jsp?rssUrl=http://mediaroom.pfizer.com/portal/site/pfizer/index.jsp?ndmViewId=news\\_view&ndmConfigId=1006533&newsId=20070628005559&newsLang=en](http://www.pfizer.com/news/press_releases/pfizer_press_releases.jsp?rssUrl=http://mediaroom.pfizer.com/portal/site/pfizer/index.jsp?ndmViewId=news_view&ndmConfigId=1006533&newsId=20070628005559&newsLang=en).

<sup>2</sup> *Id.*

<sup>3</sup> Memorandum of Martin Lipton from Wachtell, Lipton, Rosen & Katz to clients, Directors Face-to-Face Meetings with Institutional Investors on Corporate Governance Policies and Practices (Jun. 28, 2007), *available at* <http://www.realcorporatelawyer.com/pdfs/wlrk062907.pdf>.

<sup>4</sup> *See id.*

and, with that, on the efficiency of the corporate form as a capital raising and economic production model.<sup>5</sup>

Others in the corporate governance dialogue, most prominently Professor Lucian Bebchuk of Harvard Law School, argue an opposing brief.<sup>6</sup> In Bebchuk's view, the traditional corporate model has failed, not because of too much shareholder interference with corporate strategy and direction, but because of imperial, over-compensated chief executive officers ("CEOs") and uninvolved boards of directors, who are selected by corporate managers and are not effective monitors on behalf of investors.<sup>7</sup>

Professor Bebchuk, other academics, and a host of activist investor advocates have called for a number of remedies for this supposed failure of the director agency model, including:

- direct shareholder access to the corporate proxy to nominate director candidates;<sup>8</sup>
- elimination of staggered terms for directors;<sup>9</sup>
- substitution of majority for plurality voting in uncontested director elections;<sup>10</sup>

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<sup>5</sup> See generally *id.* ("There is no justification for revolutionizing corporate law and corporate practices so that shareholders replace directors as the fundamental arbiters of corporate policy. Basic corporate law and corporate practices, as they have developed and evolved over the past [fifty] years, is the only proven vehicle for organizing and deploying capital on the large and dynamic scale of the modern United States economy. It should not be overturned by desperate attempts to appease deconstructionist activists.").

<sup>6</sup> See, e.g., Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter Bebchuk, *The Myth*]; Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) [hereinafter Bebchuk, *Shareholders Set the Rules*]; Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) [hereinafter Bebchuk, *Shareholder Power*].

<sup>7</sup> Bebchuk, *The Myth*, *supra* note 6, at 676-82; Bebchuk, *Shareholders Set the Rules*, *supra* note 6, at 1784-86, 1813; Bebchuk, *Shareholder Power*, *supra* note 6, at 836-37.

<sup>8</sup> Bebchuk, *The Myth*, *supra* note 6, at 696-97; Bebchuk, *Shareholders Set the Rules*, *supra* note 6, at 1795.

<sup>9</sup> Bebchuk, *The Myth*, *supra* note 6, at 700-01; Bebchuk, *Shareholders Set the Rules*, *supra* note 6, at 1795.

<sup>10</sup> Bebchuk, *Shareholders Set the Rules*, *supra* note 6, at 1797.

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- elimination of super-majority requirements for shareholder approval of changes in charter documents;<sup>11</sup>
- separation of the board chair and CEO positions;<sup>12</sup> and
- corporate reimbursement for dissidents who have partial success in a proxy contest.<sup>13</sup>

Most recently, with increased publicity and negative public reaction about senior executive compensation, activist advocates have also called for an annual, non-binding shareholder referendum on whether the directors did a good job on setting executive compensation—so-called “say on pay” resolutions.<sup>14</sup>

This year, Professor Bebchuk has also submitted proxy proposals to eleven companies asking that the corporations establish a procedure whereby any shareholder with a \$2,000 investment can initiate and adopt changes to the corporate by-laws on *any* subject, not contrary to federal or state law, through the corporate proxy statement.<sup>15</sup> This is consistent with some of Professor Bebchuk’s legal writings which have urged that shareholders should have the right to mandate basic changes in corporate direction without either persuading directors or conducting a proxy contest to replace directors.<sup>16</sup> Professor Bebchuk later withdrew these proposals after the recipient companies asked the staff of the Division of

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<sup>11</sup> Bebchuk, *Shareholders Set the Rules*, *supra* note 6, at 1794, 1799, 1803; Bebchuk, *Shareholder Power*, *supra* note 6, at 877-78, 895.

<sup>12</sup> Bebchuk, *Shareholders Set the Rules*, *supra* note 6, at 1802.

<sup>13</sup> Bebchuk, *The Myth*, *supra* note 6, at 697-700.

<sup>14</sup> See, e.g., Posting of Subodh Mishra to <http://blog.riskmetrics.com/2008/01/> (Jan. 30 2007) (reporting that companies have received more than ninety “say on pay” proposals for the 2008 proxy season compared to forty-four such proposals received during the 2007 proxy season).

<sup>15</sup> According to statistics reported in the RiskMetrics/ISS database, Professor Bebchuk submitted binding or non-binding versions of this proposal to eleven companies: Consolidated Edison, Inc., Exxon Mobil Corp., The Home Depot, Inc., International Paper Co., McDonald’s Corp., Omnicom Group Inc., The Gap, Inc., El Paso Corp., General Motors Corp., Schering-Plough Corp. and Time Warner Inc. *Board Practices: The Structure of Boards of Directors at S&P 1,500 Companies*, RiskMetrics Group (2008).

<sup>16</sup> See Bebchuk, *The Myth*, *supra* note 6, at 676-79; Bebchuk, *Shareholders Set the Rules*, *supra* note 6, at 1784-86, 1813; Bebchuk, *Shareholder Power*, *supra* note 6, at 836-37.

Corporation Finance of the Securities and Exchange Commission for no-action advice that the proposals could be excluded from the companies' proxy statements.<sup>17</sup>

At least one state legislature, that of North Dakota, embraced many of the arguments of the activist community last year by adopting a new "investor friendly" corporate statute, embodying virtually every item on the activist governance list, including prescribing the acceptable terms and duration of a "poison pill."<sup>18</sup> Interestingly, North Dakota corporations are covered by the statute only if they opt in to it.<sup>19</sup> The stated purpose of the statute was to attract public companies from outside the state that want to demonstrate that they are investor-friendly.<sup>20</sup> North Dakota offers this on a bargain basis by providing that the rate at which North Dakota imposes the corporate franchise fee is equal to *half* the rate of the Delaware franchise tax.<sup>21</sup> In other words, corporations could soar to the top on the "good-governance" checklist while simultaneously racing to the bottom on cost. To date, no corporation has taken up North Dakota's invitation. Perhaps the prospect of

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<sup>17</sup> See, e.g., Letter from Ronald O. Mueller, Gibson, Dunn & Crutcher LLP, Counsel for Consolidated Edison, Inc., to the Office of Chief Counsel, Division of Corporation Finance, Securities and Exchange Commission (Feb. 5, 2008); *available at* [http://content.lawyerlinks.com/library/sec/sec\\_14a8/2008/consolidated\\_edison\\_020508.htm](http://content.lawyerlinks.com/library/sec/sec_14a8/2008/consolidated_edison_020508.htm).

<sup>18</sup> See N. D. CENT. CODE §§ 10-35-22 to -25 (2007) (providing the laws regarding publicly traded corporations); see also *id.* at § 10-35-02 (providing definitional terms).

<sup>19</sup> *Id.* at § 10-35-03(1) ("This chapter applies only to a publicly traded corporation meeting the definition of a 'publicly traded corporation' . . . *during such time as its articles state* it is governed by this chapter.") (emphasis added).

<sup>20</sup> See generally David Marcus, *A New Delaware?*, THE DAILY DEAL, May 7, 2007, [http://www.law.harvard.edu/programs/olin\\_center/corporate\\_governance/MediaMentions/05-07-07\\_Deal.pdf](http://www.law.harvard.edu/programs/olin_center/corporate_governance/MediaMentions/05-07-07_Deal.pdf) ("The gurus of good governance are at it again. Long dissatisfied with what they see as Delaware's pro-management bias, activist investors successfully lobbied the North Dakota state legislature to pass an amendment to the state's corporate law code that includes a number of shareholder-friendly governance provisions. Gov. John Hoeven signed the bill into law on April 12, [2007,] thereby enabling a regime that provides for: majority voting; annual advisory votes by shareholders on executive compensation; direct access to the proxy; and provisions for shareholder approval of poison pills.").

<sup>21</sup> Compare § 10-35-28(3) (imposing of a fee of \$60 "for each ten thousand shares of authorized capital stock") with DEL. CODE ANN. tit. 8, § 503 (2008) (imposing a scaled fee structure based on the number of authorized shares or no-par capital value of the corporation). See generally Marcus, *supra* note 20 (noting that North Dakota's law prescribed fees that were half of Delaware's fees).

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litigating issues of corporate law in Bismarck in the winter, before a judiciary more accustomed to dealing with agricultural and natural resources matters, is not appealing, even to corporations wanting to prove their openness to shareholder influence.<sup>22</sup>

So, the question is: who has it right? Is Marty Lipton right to worry that the good governance pendulum has swung so far that we are losing efficient, centralized corporate decision-making and intelligent risk-taking to our economic detriment? Or are Bebchuk and others right that corporate directors and “imperial” CEOs have performed so poorly, and with so little heed to investor interests, that they must be subjected to direct and potentially frequent shareholder interventions and discipline?

Looking at our current economic troubles and at the oft-repeated concern that most corporate managers and directors did not see the sub-prime and credit quality issues coming, one might certainly argue that some form of stricter monitoring may have helped. However, it is unclear whether any of the prescriptions of the shareholder activists would have been effective in this regard. Would more frequent director elections, shareholder amendments to by-laws, annual “say on pay” votes, or cheaper proxy contests have made managers and directors more insightful and more conscious of the risks by sub-prime lending and securitization in an overheated real estate market? The answer appears to be a resounding “no.” In fact, the movements toward shareholder-centrism, director insecurity, and enhancing the power of activists who try to change management, might well have increased the pressure on management to produce “good” short-term financial results each quarter, rather than to focus on longer term strategy and thoughtful assessment of risks.

Early reports indicate that, of the major financial institutions, the one that was most prescient, and has, at least so far, avoided the worst of the problems of the current situation, is Goldman Sachs, which has strong centralized management, a cohesive board and little exposure to takeover risk.<sup>23</sup> This example shows the success of Goldman Sachs’ implementation of the director-centric model.

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<sup>22</sup> See generally Marcus, *supra* note 20 (discussing Delaware’s sophisticated, specialized courts, in comparison with North Dakota’s general court system).

<sup>23</sup> See generally Katie Brenner, *Mike Mayo on Battered Banks*, FORTUNE, Nov. 27, 2007 (noting that “[a]mong the investment banks, Goldman Sachs . . . management has done an excellent job”); Ruth Sunderland, *Money Meltdown: The Unstoppables: Goldman: Is It Really Glittering?*, The Observer, Dec. 16, 2007 (noting that “Goldman has avoided the worst of the mortgage mayhem in the US”).

Surely, Lipton has a point when he worries that a corporate environment in which management is more monitored and criticized than advised by directors who are selected by, and meeting directly and regularly with, forceful shareholders may be an environment that does not lead to sound decision-making and effective long-range planning.<sup>24</sup> A management that is always looking over its shoulder may not do a good job of seeing the road ahead and charting a course that avoids potholes and maximizes benefits.

The genius of the corporate business model, as recognized even by Berle and Means in their criticism of unaccountable managers, centers on the idea that investors can pool large amounts of capital, limiting their liability for loss to the capital they contribute, in an enterprise that is centrally and, presumably, more effectively and nimbly led by professional managers.<sup>25</sup> In this model, both the managers and the directors who monitor them, have fiduciary duties to the investors and face some risk of personal liability beyond their investment if those duties are not met.<sup>26</sup>

Even moderate corporate governance observers who disagree with the level of Lipton's alarm, such as former Delaware Chief Justice Norman Veasey and Ira Millstein, are concerned that we not upset the historic balance that has generally worked well between the limited role and limited liability of shareholder investors

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<sup>24</sup> See Lipton, *supra* note 3 (stating that “[t]here is no justification for revolutionizing corporate law and corporate practices so that shareholders replace directors as the fundamental arbiters of corporate policy”); see also Martin Lipton, *Some Thoughts for Boards of Directors in 2008* at 7 (Dec. 6, 2007), available at <http://blogs.law.harvard.edu/corpgov/2007/12/10/some-thoughts-for-boards-of-directors-in-2008/> [hereinafter Lipton, *Some Thoughts*] (positing that “[w]hile direct communications with shareholders is an important and often uniquely effective element of a company’s response to activism, the advent of working groups [or] a corporate officer position whose role is to appease shareholder activists heralds yet another new avenue of shareholder influence into boardroom deliberations”).

<sup>25</sup> See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 131 (Rev. ed. 1967) (stating that “through various statutory changes, general permission to incorporate and inclusion in charters of increasing grants of power to the management, the stockholders’ position, once a controlling factor in the running of the [corporation], has declined from extreme strength to practical impotence. . . . It is fairly probable that the reason for the weakening of the shareholder’s position lay as much in his inability to manage as in the obvious willingness of the ‘control’ to take over the task.”).

<sup>26</sup> *Id.*

SHAREHOLDER-CENTRIC VERSUS DIRECTOR-CENTRIC CORPORATE GOVERNANCE and the active role, fiduciary duties, and potential liability of managers.<sup>27</sup> This “*quid pro quo*” notion of shareholders exchanging the rights to manage the company for limited liability while the directors manage the company and owe an ongoing duty to the shareholders creates the balance that both shareholders and directors that benefits both shareholders and directors.<sup>28</sup>

Having addressed what other observers of the corporate governance scene think, one may well ask what I think. The remainder of this Article explains my position.

First, the meeting between several of Pfizer’s independent directors and some of the company’s largest shareholders, which occurred a few months after the June 2007 announcement despite Lipton’s concerns, was not a “sky is falling” event or an emblem of the end of director-centric governance and the traditional corporate economic model. Rather, the meeting was a perfectly understandable response to issues at Pfizer on various fronts, including executive compensation and product pipeline issues, which had received extensive press attention and concerned Pfizer

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<sup>27</sup> See, e.g., John F. Olson, *Professor Bebchuk’s Brave New World: A Reply to “The Myth of the Shareholder Franchise”*, 93 VA. L. REV. 773, 783 (2007) (noting that Professor Bebchuk’s “concerns about [issues such as] executive compensation excesses can best be addressed by greatly enhanced disclosure requirements within the present director nominations and proxy regime, rather than by fundamentally altering the balance between directors and shareholders”); E. Norman Veasey, *The Stockholder Franchise Is Not a Myth: A Response to Professor Bebchuk*, 93 VA. L. REV. 811, 811-12 (2007) (arguing that “[w]hat is not needed at this juncture is a lurching change in the name of ‘reform’ that might upset the existing balance of law and culture”); Lipton, *Some Thoughts*, *supra* note 24, at 3 (stating that when “decision-making power shifts from boards to activist shareholders and shareholder advocates, boards are increasingly vulnerable to pressures for short-term share price performance and other agendas”); Corporate Advisory Governance Memorandum of Ira M. Millstein, Holly J. Gregory & Rebecca C. Grapsas, *Rethinking Board and Shareholder Engagement in 2008* at 3 (Jan. 2008), available at <http://www.weil.com/news/pubdetail.aspx?pub=6382> (stating that “[w]e may well miss the opportunity to achieve lasting balance in the corporate power structure if shareholders fail to recognize and respect that there are limits on the issues that are appropriate for shareholder initiatives”); Memorandum of Ira M. Millstein et al., *Meetings Between Directors and Institutional Investors on Governance Matters Are a Constructive Step* (Jun. 29, 2007), available at [http://www.shareholderforum.com/op/Program/20070629b\\_report.htm](http://www.shareholderforum.com/op/Program/20070629b_report.htm) (stating that “[c]ompanies have an interest in moving their relationships with large shareholders . . . to a positive and constructive tone”).

<sup>28</sup> Corporate Advisory Governance Memorandum of Ira M. Millstein, Holly J. Gregory & Rebecca C. Grapsas, *supra* note 27 (“[T]he corporation, by law is ‘managed by or under the direction of the board. Indeed, this legal empowerment of the board goes hand in hand with the limited liability that shareholders enjoy.’”).

investors. Importantly, the meeting was an initiative of the Pfizer board, undertaken to gather information and listen to key investors; it was not a decision-making forum. Thus, the meeting was director-centric in that it was not the result of a referendum or a shareholder-initiated by-law, but a decision by the board of directors, fully and publicly supported by the Pfizer CEO, Jeff Kindler.<sup>29</sup> Pfizer is not the only public company that found such meetings useful. The Business Roundtable 2007 survey of governance practices indicated that nearly thirty-eight percent of member companies had informal meetings between directors and shareholders during the year.<sup>30</sup> Thus, director-initiated and, in some cases, shareholder-initiated meetings for the purpose of having directors listen to investor concerns or answer questions, so long as they are not a vehicle for selective disclosure of potentially market-moving information, are appropriate and consistent with the corporate model.

Furthermore, the trends to majority voting for directors or declassification of staggered boards are concerning.<sup>31</sup> A good case can be made that the stability provided by staggered board terms benefits investors by providing a more stable platform and better directorial continuity for long-range planning and dealing with management succession issues. The success of McDonald's in adapting to changing markets and in dealing with several recent, unexpected CEO losses as the result of sudden illness, may, in part, be attributable to the stability of its classified board.<sup>32</sup> However, the declassification train has left the station and we will all survive.

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<sup>29</sup> Press Release, Pfizer Inc., *supra* note 1.

<sup>30</sup> Business Roundtable Corporate Governance Survey, Key Findings (Oct. 2007), *available at* <http://www.businessroundtable.org//publications/publication.aspx?qs=2A86BF807822B0F19D44484>.

<sup>31</sup> As of February 2006, only 16% of S&P 500 companies had either a director resignation policy or a majority voting standard; by November 2007, this percentage had jumped to approximately 66%. Claudia H. Allen, *Study of Majority Voting in Director Elections*, (Nov. 12, 2007), *available at* <http://www.ngelaw.com/files/upload/majoritystudy111207.pdf>. In 2007, 40% of S&P 500 companies had classified boards compared to 45% in 2006 and 53% in 2005. *Board Practices: The Structure of Boards of Directors at S&P 1,500 Companies*, *supra* note 15.

<sup>32</sup> See McDonald's Corporation, 2004 Summary Annual Report, at 5 (2004), *available at* [64.26.27.40/interactive/mcd2004summaryannualreport/download.php?fn=mcd2004summaryannualreport.pdf](http://64.26.27.40/interactive/mcd2004summaryannualreport/download.php?fn=mcd2004summaryannualreport.pdf) (noting that CEO Jim Cantalupo died of a heart attack in April 2004 and successor CEO Charlie Bell stepped down from his position seven months later due to illness); see also Parija Bhatnagar, *Sad Day at McDonald's*, MONEY, Apr. 19, 2004, *available at* [http://money.cnn.com/2004/04/19/news/fortune500/mcdonalds\\_ceo/index.htm](http://money.cnn.com/2004/04/19/news/fortune500/mcdonalds_ceo/index.htm) (discussing the death of McDonald's CEO Jim Cantalupo and the appointment of CEO Charlie Bell).

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Neither board declassification nor majority voting trends threaten the life of the successful corporate model.

Unlike Lipton, I am not deeply disturbed that shareholders might express an after-the-fact view on the board's success in setting executive pay by comparing their corporation with those in other countries. There are some downsides in making this comparison, primarily the stifling of innovation and homogenization of pay and incentive plans to meet whatever model Risk Metrics / ISS creates. However, in view of the recent concern over pay issues, this may be attractive to boards and managers as a way of moving away from an undue focus on what is, ultimately, an issue of modest importance for most companies.

Of greater concern are the proposals that strike directly at centralized management by the board of directors, including proposals for direct shareholder nominations of board candidates and unlimited power to amend by-laws through the corporate proxy statement and by corporate funding of proxy contests.<sup>33</sup> Under the new North Dakota statute, shareholders can initiate and adopt an amendment to the certificate of incorporation, the basic contract between investors and managers, without board involvement.<sup>34</sup> These steps are a threat to stable, effective management and to the implementation of valid long-range goals for the enterprise.

Such "reforms" constitute a step too far down a slippery slope. Such investor "rights" are more consistent with a general partnership than with the corporate form or a limited partnership. Legitimate questions are raised as to whether investors with such powers should continue to have limited liability when things go wrong in the business or the enterprise engages in unlawful conduct.<sup>35</sup> More importantly, however, such changes create a substantial risk that boards of directors and CEOs will no longer see themselves as primarily responsible for the

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<sup>33</sup> See Bebchuk, *Shareholder Power*, *supra* note 6, at 857, 865 (arguing that shareholders should be able to initiate and approve amendments to the articles of incorporation, to have access to the corporate ballot to nominate directors, and to have certain campaign expenses reimbursed by the company).

<sup>34</sup> N. D. CENT. CODE § 10-35-15 (2007).

<sup>35</sup> For a further discussion of the correlation between shareholders' involvement in the management of the company and the extent of shareholder liability, see Iman Anabtawi & Lynn A. Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. (forthcoming Mar. 2008), available at <http://ssrn.com/abstract=1089606>.

direction and success of the enterprise, but rather as mere agents implementing shareholder decisions.

Further such provisions are, at least in part, a dismantling of defenses that have given boards of directors tools to maintain leverage either to refuse an offer or get a better deal for investors when an uninvited takeover proposal is received. Such steps will clearly increase the leverage of hedge funds and other opportunistic investments with short term “quick profit and run” goals. In turn, these investments may lead to defensive, short-term, less-than-optimal decision making and long-term damage to the effectiveness of the corporate model.

Listening to investors is important. When directors and managers listen, different voices and disparate ranges of investor interest, from immediate gratification to long-term growth, will be heard. However, if corporate governance reform moves beyond listening and thoughtful response, abandoning the traditional, successful model where shareholders do not manage and their decisions are generally limited to elections of directors and approval of fundamental changes in ownership rights, the economic efficiency of our corporate model may indeed be damaged.

In challenging times, such as today, we need boards of directors who can counsel, warn, and challenge corporate managers in a collaborative manner rather than directors who are merely agents acting on shareholder instructions or “hall monitors” guarding against management misconduct. In the post Sarbanes-Oxley environment, there is an important monitoring role for the board. However, truly effective boards of directors do more than monitor management—they also serve as vehicles for conveying shareholder concerns and desires. The boards are more than mere “agents,” carrying out detailed instructions of shareholder “principals.” Rather, members of boards of directors are fiduciaries who, by law, are charged to manage or provide for the management of the business and affairs of the corporation. That role is the core concept of the modern business corporation and is central to effective corporate governance. Accordingly, it should not be diminished or neglected.