The Essential Unity of Shareholders and the Myth of Investor Short-Termism

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THE ESSENTIAL UNITY OF SHAREHOLDERS AND THE MYTH OF INVESTOR SHORT-TERMISM

BY GEORGE W. DENT, JR.*

ABSTRACT

The separation of ownership and control publicized by Berle and Means in 1932 persists today. Domination of public companies by self-serving and ineffective executives costs America billions of dollars every year and contributed to the current economic meltdown. Repeated efforts to solve this problem—including the Sarbanes-Oxley Act, expanded disclosure duties, and more stringent requirements for director independence—have had little benefit and have sometimes made matters worse. The flaws in our corporate governance system are a growing problem for America's economy as disillusioned investors increasingly place their capital in other countries. Nonetheless, proposals for greater shareholder power have encountered criticisms: various shareholders have conflicting goals; shareholders favor a short-term perspective at the expense of the long-term health of companies; and shareholders lack the knowledge needed to play a positive leading role in corporate governance.

This article refutes these charges. It shows that the objections to shareholder power are greatly exaggerated, often contradict elementary economic principles, and have no empirical basis; they are myths. The article delves into the latest research in financial economics to demonstrate that greater shareholder power is associated with better corporate performance in all respects, including those respects in which critics charge that shareholder influence would be detrimental.

TABLE OF CONTENTS

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I. INTRODUCTION

In 1932 Adolf Berle and Gardiner Means published *The Modern Corporation and Private Property*, which revealed to the hitherto unsuspecting public that public corporations are not controlled by their supposed owners—the shareholders—but by their top managers—the supposed agents and fiduciaries of the shareholders.[1] In the next two years, provoked by the stock market crash of 1929 and the onset of the Great Depression, Congress held hearings on the operations of the securities markets and the governance of public corporations.[2]

Congress learned, as Berle and Means had revealed that shareholders typically did not control public companies and that the managers who ran them often flouted the interests of shareholders and acted to enrich themselves instead. In theory, shareholders could, and should, have wielded

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[1]*See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (rev. ed. Harcourt, Brace & World, Inc. 1968) (1932).

[2]*See Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 Before the S. Comm. on Banking and Currency*, 73d Cong. (1934); *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. (1934).

control through their power to elect the corporation's directors. Flaws in the proxy voting system, however, enabled insiders to twist it to their own benefit. To remedy this evil, Congress adopted the Securities Exchange Act of 1934, which created the Securities and Exchange Commission (SEC) and authorized it to adopt proxy voting rules that would institute "fair corporate suffrage."[3]

The SEC proxy rules did eliminate many of the worst abuses, but the ideal of shareholder democracy was never realized. Corporate executives (especially chief executive officers) still control the proxy system and, through it, public corporations.[4] One might imagine, then, that the SEC and the investing public would unite to support changes to make shareholder democracy a reality. But such changes have not been made and are not in the works. Not surprisingly, corporate executives relish their power; they do not want to be compelled to serve shareholder interests rather than their own. To hang on to power, however, they had to contrive a theory to justify it and, correlatively, to explain why shareholder democracy is a bad idea.

This they did. Corporate managers as well as their operatives and camp followers constructed a theory that shareholder control would not serve the national interest in economic efficiency; indeed, it would not serve the interests of shareholders themselves. This theory was articulated in various ways by many advocates, but its core is that investors are ignorant, that the goals of various shareholders conflict, and that many or most shareholders disregard the long-term interests of the corporation and care only about its short-term performance. According to many of these advocates, investors at least have enough sense to realize that shareholder democracy would be a disaster. Consequently, investors gratefully accept impotence and cede

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[3]Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n (2006) (authorizing the SEC to adopt rules regulating proxies); *see* H.R. REP. NO. 73-1383, at 13 (1934) (stating that "[f]air corporate suffrage is an important right"); *see also id.* at 14 (stating the goal of "preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders").

[4]*See* Brian Cheffins & Steven Bank, *Is Berle and Means Really a Myth?* 41-49 (ECGI, Law Working Paper No. 121/2009, 2009), *available at* http://ssrn.com/abstract=1352605 (finding that separation of ownership and control persists today). Some scholars believe that CEO power is declining. *See* Marcel Kahan & Edward Rock, *Embattled CEOs* 1 (ECGI, Law Working Paper No. 116/2008, 2008), *available at* http://ssrn.com/abstract=1281516. The cancerous growth of executive compensation casts doubt on that belief. *See infra* notes 212, 221, 226, 235 and accompanying text. If any power has been lost by CEOs, it may have shifted to self-serving directors rather than to shareholders. *See* Kahan & Rock, *supra*, at 61-62. Further, any loss of power would seem to be limited and episodic. In many companies CEOs still wield great power. *See infra* notes 210-28 and accompanying text.

control to the wiser, more prudent managers. If shareholders assert themselves, they only hurt themselves.[5]

This article examines this thesis and finds it wrong. With a few small exceptions, the interests of shareholders do not conflict but converge on the goal of maximizing share value. The claim that most investors are short-term oriented is a myth. Further, although shareholders lack the knowledge needed to run public companies themselves, they have the ability to select directors who are qualified to oversee public firms and guide them toward the maximization of share value. It is only because the rules of corporate governance make it impractical for shareholders to coordinate that executives retain corporate control through the proxy system. The main arguments of the corporate establishment against shareholder power are invalid.

Part II of this article describes the claims that the interests of various investors fundamentally conflict, that many or most investors are short-term oriented, and that investors are too ignorant to choose good directors. Parts III, IV, and V show why these three claims are false. Part VI discusses the significance of these facts for corporate governance.

II. THE CASE AGAINST SHAREHOLDER POWER

A. *Different Shareholders Have Different Goals*

Most experts in corporate law and in financial economics believe that most shareholders have the same investment goal—to maximize the value of their stock.[6] Some, however, argue that the goals of shareholders

[5]The literature is voluminous. *See generally* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 624 (2006) ("[S]hareholders will prefer to irrevocably delegate decisionmaking authority to some smaller group, as, in the long run, this will maximize shareholder wealth."); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1737 (2006) [hereinafter Bainbridge, *Director Primacy*] (stating that "investors do not value" strong shareholder rights); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 803 (2002) [hereinafter Stout, *Mythical Benefits*] (stating that shareholders themselves "prefer weak shareholder rights"); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 686 (2003) (stating that shareholders and nonshareholders prefer arrangements where the board has the discretion to allocate returns). More recently Lynn Stout argued that "the modern trend toward greater 'shareholder power' has gone too far and is beginning to harm the very shareholders it was designed to protect." Lynn Stout, *Investors Who Are Too Bolshy for Their Own Good*, FIN. TIMES (London), Apr. 23, 2007, at 9 [hereinafter Stout, *Bolshy Investors*].

[6]"[S]hareholders, as residual claimants, have the greatest incentive to maximize the value of the firm." Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1267-68

fundamentally conflict in two ways. First, some want only to maximize the short-term value of the stock, while others want to maximize the long-term value. This claim will be discussed below.[7]

Second, some shareholders do not want to maximize share value because they have an overriding contradictory interest.[8] These shareholders include employees, politicized entities, and shareholders who have investments in two companies with contradictory interests.[9] An employee

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(1999); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 68 (1991) ("As the residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions . . . ."); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983) (stating that the preferences of shareholders "are likely to be similar if not identical"); Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 464 (2005) (discussing the assumption of shareholder homogeneity); E. Han Kim, *Corporate Governance and Labor Relations*, 21 J. APPLIED CORP. FIN. 57, 57 (2009) ("Shareholders . . . are in the best position to make the value-maximizing tradeoffs that all companies confront . . . ."); *id.* at 58 ("Taking their perspective ends up increasing the odds that social resources are put to their highest valued uses."); Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 ORG. SCI. 350, 353 (2004) ("Only residual cash flow claimants have the incentive to maximize the total value of the firm."). Surprisingly, these experts include some critics of shareholder primacy. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 469 n.16 (2002) ("Although investors have somewhat different preferences on issues such as dividends and the like, they are generally united by a desire to maximize share value.").

[7] *See infra* notes 19-20, 101-27 and accompanying text.

[8] *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1287 (2008); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577-93 (2006) (alleging various conflicts of interest among shareholders); Bainbridge, *Director Primacy*, *supra* note 5, at 1751, 1754-57 (positing danger of special interest shareholders); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 661 (2006).

> [I]nvestors vary considerably among such dimensions as the time frame over which they invest, the extent to which they trade versus passively holding the corporation's stock, their degree of diversification, the extent to which they hold non-equity interests in the issuer, any option or other hedging positions that they hold, and so forth.

Id.; *see* Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 368-70 (1991) (noting shareholder differences over time horizons, risk preferences, and expectations for the future); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003) ("[M]any institutional and other activist investors have competing interests that may conflict with the best interests of the public corporation and its shareholder body and other constituencies taken as a whole."); Stout, *Mythical Benefits*, *supra* note 5, at 794 ("Board power . . . protect[s] shareholders from *each other*."); Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435, 1447-48 (2005) (claiming that highly diversified shareholders may oppose share-price maximization in some firms because of their interests in others).

[9] *See* Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006) ("[I]nstitutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic

shareholder almost always has a greater stake in her employee compensation than in the value of her stock since most employees own but a tiny fraction of their employer's stock. Accordingly, employee-shareholders want to maximize their compensation, even at the cost of lowering the value of their shares.[10] A large shareholder who is not an employee might also be able to extract unfair benefits through contracts with the company—i.e., engage in self-dealing—to the detriment of share value.[11] And some investors are alleged to have particular goals inimical to the interests of other shareholders. Hedge funds are sometimes regarded this way.[12]

Some shareholders have a political agenda that overrides their desire to maximize the value of their stock. A public pension or sovereign wealth fund, for instance, might value the economic interests of its state or local area and seek to maximize a company's operations in that location at the expense of share value.[13]

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performance of the companies in which they invest."); Stephen M. Bainbridge, *Investor Activism: Reshaping the Playing Field?* 17 (UCLA Sch. of Law, Law & Econ. Research Paper No. 08-12, 2008), *available at* http://ssrn.com/abstract=1130969 (stating that union and state and local pension funds "are precisely the institutions most likely to use their position to self-deal . . . or to otherwise reap private benefits not shared with other investors"); Andrew K. Prevost et al., Labor Unions as Shareholder Activists: Champions or Detractors? (May 5, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1119328 (claiming that union pension funds may use the proxy process to promote their own agendas).

[10]*See* Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting* 30 (NYU Stern Working Paper Series Paper, No. Fin-08-006, 2008), *available at* http://ssrn.com/abstract=1285084 (presenting "evidence that suggests some labor union shareholders have board of director voting patterns that partly reflect union workers interests rather than the objectives of maximizing equity value alone").

[11]*See* Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal* 12-13 (UCLA Sch. of Law, Law & Econ. Research Paper No. 03-22, 2003), *available at* http://ssrn.com/abstract=470121. "[I]nstitutional investors may abuse their control by self-dealing and other forms of over-reaching. . . . If the board becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors." *Id.*

[12]*See* Jeffrey H. Ballabon, *Sovereign Wealth, Private Equity, and Hedge Funds . . . Oh My*, 9 ENGAGE 25, 26 (2008) ("Hedge funds also are the pariahs of the capital markets."); Andrew M. Kulpa & Butzel Long, *The Wolf in Shareholder's Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control and Governance*, 6 U.C. DAVIS BUS. L.J. 4, 4 (2005); Strine, *supra* note 9, at 1764; Memorandum from Martin Lipton et al. to Clients, Be Prepared for Attacks by Hedge Funds (Dec. 21, 2005) (on file with author).

[13]*See* MICHAEL T. JACOBS, SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA 53 (1991) (stating that public pension fund trustees are mostly political appointees with their own "political agendas"); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 795-96 (1993); Roberta Romano, *Getting Politics out of Public Pension Funds*, AMERICAN ENTERPRISE, Nov.-Dec. 1993, at 42; Roberta Romano, *The Politics of Public Pension Funds*, PUB. INT., Spring 1995, at 42. Pension fund managers lack incentives to maximize share value because their compensation is not directly tied to fund performance and, unlike mutual fund holders, dissatisfied beneficiaries cannot switch to another fund. *See infra* notes 35-42 and accompanying text (concerning fears of sovereign wealth funds).

Of late, some commentators have raised alarms about another kind of shareholder who does not want to maximize the value of a company's equity—one who has a larger investment in other securities, the value of which varies inversely with that of the company's equity. The other securities could be issued by the same company. For example, a shareholder who has a larger stake in the same company's debt securities might oppose potentially profitable but risky projects that would increase the value of the common stock but diminish the value of the debt.

The conflicting interest could also be in another company. An investor who owns stock in competing firms might seek to hinder the one in which she holds the smaller interest in order to benefit the other. For instance, if an investor owned stock in both companies in a proposed merger that promises to benefit one company but will be unprofitable for the other, that investor might favor the one in which she holds the larger interest, to the detriment of the other.

A related charge is that some shareholders do not want to maximize the value of the equity because they are risk averse. People are often risk averse. Most homeowners buy home insurance even though the premiums on the policy exceed the benefits, because most people would rather incur that small loss than risk devastation from an uninsured loss of their home. Most investors (or, at least, most with substantial investments) are risk averse with regard to their portfolios, and they grow more cautious as they approach retirement. They may oppose corporate endeavors with positive net present value that pose a risk of a large loss even though risk-neutral shareholders would favor such projects.

An obvious problem with these scenarios is that resolutions presented to shareholders generally require a majority vote, with shareholders having one vote per share. Accordingly, it would seem that shareholders will act to maximize the value of the stock unless those with a conflicting interest own a majority of the equity. This prospect alone is still disturbing—it raises the possibility that a minority might be victimized by a majority holding a conflicting interest.

More disturbing is that shareholders with a conflict of interest might alter the voting result without owning a majority of the equity. A supermajority is sometimes required for shareholder action,[14] so that a minority might be able to veto action that would enhance the stock price. Some companies have two classes of common stock with equal financial rights but

[14] *See* FRANKLIN A. GEVURTZ, CORPORATION LAW 646 (2000) (stating that "some statutes contain a more traditional supermajority requirement" for shareholder approval of statutory mergers).

different voting rights ("dual class stock"),[15] so that a minority financial interest could thwart action to raise the value of the stock.

Supermajority voting and dual class capitalization must be fixed in a company's charter; they cannot be instituted by a single minority shareholder. Even without these provisions, however, a shareholder may be able to acquire voting power beyond her equity interest. For instance, an investor can simultaneously buy a block of a company's stock and sell an equal block short by borrowing such a block and promptly selling it. The investor could then vote the shares actually purchased while holding a zero net interest in the company's equity. This decoupling of the voting and economic rights of stock has been dubbed "empty voting."[16] Its limited use has led to cries of alarm.[17]

Sometimes shareholders can also vote stock they do not own. Voting rights are established as of the "record date," which is usually thirty to sixty days before the shareholder meeting.[18] A record date owner can sell the stock between the record and meeting dates and still be able to vote the stock she no longer owns.

B. *Shareholders Are Short-Term Oriented*

Some critics of shareholder power charge that many shareholders are "short-term oriented." Martin Lipton and Steven Rosenblum say that some shareholders "may seek to push the corporation into steps designed to create a short-term pop in the company's share price so that they can turn a quick profit."[19] The Aspen Institute's Corporate Values Strategy Group, comprised

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[15]*See* DALE A. OESTERLE, MERGERS AND ACQUISITIONS IN A NUTSHELL 263-64 (2d ed. 2006).

[16]*See* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 661-81 (2008) (listing more than eighty events of decoupling around the world); Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007); *see also* Susan E.K. Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897, 2908-09 (2007) (discussing the variations of vote-trading); Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation* 39-40 (Vanderbilt Univ. Law Sch., Law & Econ. Working Paper No. 06-21, 2006), *available at* http://ssrn.com/abstract=931254 (discussing merger and risk arbitrage in regards to hedge funds).

[17]*See* Anabtawi, *supra* note 8, at 591-92; Stout, *Mythical Benefits*, *supra* note 5, at 794-95. For discussion of these cases, see *infra* notes 55-58 and accompanying text.

[18]*See* GEVURTZ, *supra* note 14, at 203 (explaining the operation of record dates).

[19]Lipton & Rosenblum, *supra* note 8, at 78; *see* Patrick Bolton et al., *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 725 (2005) (alleging a conflict between current shareholders who profit from "earnings manipulation" and future

of prominent corporations, institutional investors, labor organizations, and professionals, has voiced "concern about excessive short-term pressures in today's capital markets that result from intense focus on quarterly earnings and incentive structures that encourage corporations and investors to pursue short-term gain with inadequate regard to long-term effects."[20] Certainly many investors hold stocks briefly, but how does this behavior affect corporate governance now, or how could it do so under a system of shareholder primacy? That question will be discussed below.[21]

C. *Shareholders Are Uninformed*

Some opponents of shareholder primacy contend that investors are uninformed.[22] Further, because investors are uninformed and irrational, capital markets are inefficient.[23]

III. THE FUNDAMENTAL UNITY OF SHAREHOLDER INTERESTS

A mass of evidence shows that shareholders are fundamentally unified behind the goal of maximizing the value of the equity.[24] The exceptions to

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shareholders); William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1284 (2002) (stating that shareholder value maximization has resulted in an obsession with "short-term performance numbers"); Strine, *supra* note 9, at 1764 (discussing the increasing sway of institutional investors over corporations and focus on quarter-to-quarter earnings, leading to corporate debacles); Lynn A. Stout, *Why Carl Icahn Is Bad for Investors*, WALL ST. J., Aug. 1, 2008, at A11 (stating that "activist" shareholders are usually short-termers).

[20] THE ASPEN INST., LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS 2 (2007), *available at* http://www.aspeninstitute.org/atf/cf/%7BDEB6F227-659B-4EC8-8F84-8DF23CA704F5%7D/FinalPrinciples.pdf [hereinafter ASPEN CORPORATE GOVERNANCE PRINCIPLES]; *see also* THE ASPEN INST., OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2-3 (2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/business%20and%20society%20program/overcome_short_state0909.pdf (alleging "shareholder short-termism").

[21] *See infra* Part IV.

[22] *See* Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334, 335 (2008) (arguing that a benefit of employee primacy is that employees "know much that absentee shareholders do not know"); Bainbridge, *supra* note 11, at 13 ("Shareholders have neither the information nor the incentives necessary to make sound decisions on either operational or policy questions.").

[23] *See* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 637, 660, 666 (2003); Stout, *supra* note 8, at 1443 (alleging that investors are "often driven by emotion and cognitive bias"); Jon E. Hilsenrath, *Stock Characters: As Two Economists Debate Markets, the Tide Shifts; Belief in Efficient Valuation Yields Ground to Role of Irrational Investors; Mr. Thaler Takes on Mr. Fama*, WALL ST. J., Oct. 18, 2004, at A1 (comparing the irrationality of some investors with the efficient market hypothesis).

[24] *See* Note, *Should the SEC Expand Nonfinancial Disclosure Requirements?*, 115 HARV. L. REV. 1433, 1437-39 (2002).

the rule are minor and have no great consequences for corporate governance policy.

A. *Employee Shareholders*

Employee shareholders rarely own a large, unified block of stock. Generally they hold a small minority. Moreover, employees' interests are not uniform.[25] Even unionized companies (now a small and shrinking part of the private sector) often have several bargaining units and many employees (including the managers) who are nonunion. Recognizing that they cannot prevail without the support of other shareholders, unions have generally backed the same kind of governance reforms that appeal to other investors.[26]

In nonpublic companies, either all the shareholders are employees (so that there are no nonemployee shareholders) or arrangements are made to protect outside shareholders (such as venture capitalists).[27] These arrangements typically include a major role in corporate governance.[28] Thus, it is rare that public investors need to worry about abuse of control by employee shareholders, and these few cases can be resolved by specially negotiated agreements.[29]

B. *Political Shareholders*

Shareholders who prefer some political agenda to the maximization of share value are also a minor problem. Rarely do such investors own more

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[25] *See* McDonnell, *supra* note 22, at 350.

[26] *See* Paolo Santella et al., A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in Europe and in the US 12 (July 2, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1137491 (citing information provided to the authors by Capital International).

[27] *See* George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1035-61 (1992) (describing arrangements to protect venture capital investors).

[28] *Id.* at 1035-44.

[29] Critics of shareholder primacy sometimes point to cases where unions have exploited SEC rule 14a-8 to make shareholder proposals that would benefit employees at the expense of public shareholders. *See* Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Proposals?*, 73 WASH. L. REV. 41, 61-63 (1998) (describing the use of rule 14a-8 by labor unions against companies with which the union has collective bargaining or wage disputes or workplace grievances). Perhaps the rule should be revised to spare companies the costs of such abuses of the rule, but proposals to change the rule have not been implemented and the rule does not materially affect corporate governance. *See id.* at 44 (leading to the conclusion, in an empirical study, that "shareholders will vote in their own self-interest, and, if they believe that labor is acting against their interests, they will vote against labor's proposals").

than a small fraction of a company's shares.[30] The peculiar agendas of these investors also tend to cancel out one another. Taking the example of public pension funds again, the interest of each fund in favoring its home region would be offset by the interests of other public pension funds that favor their homes. It is unlikely that their interests would converge and that they would own enough stock to divert any public company from maximizing share value.

Similarly, social activist investors who have political goals (e.g., animal welfare or pollution reduction) own but a small fraction of all investment capital,[31] and that is unlikely to change soon. Further, these investors may not stray far from the principle of profit maximization. Some studies show that the stocks of "socially responsible" companies outperform the market.[32] The interests of these funds may also clash with each other or with those of other shareholders. For example, employees and unions at many manufacturing and natural resource companies oppose the agenda of environmental activists. Thus, it seems improbable that social activists could substantially impair the efforts of public companies to maximize share value.

Concern is now rising over one kind of politically motivated investor: sovereign wealth funds (SWFs).[33] Although government-controlled investtors are not new, anxieties have increased recently because of the rapid growth of these funds, and because many have now abandoned their

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[30]*See* Damon A. Silvers & Michael I. Garland, *The Origins and Goals of the Fight for Proxy Access* 15-16 (2004), http://www.sec.gov/spotlight/dir-nominations/silversgarland022004.pdf (finding that in a survey of eight large public companies, a union or public pension fund did not own more than 1% of the company's stock).

[31]*See* Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 496 (2008) ("Socially responsible investing is just a small share of the market now.").

[32]Greg Filbeck et al., *The "Best Corporate Citizens": Are They Good for Their Shareholders?*, 44 FIN. REV. 239, 260 (2009); Laura Poddi & Sergio Vergalli, *Does Corporate Social Responsibility Affect the Performance of Firms?* 34 (Fondazione Eni Enrico Mattei, Working Paper No. 52.2009, 2009), *available at* http://ssrn.com/abstract=1444333. Other studies have shown that "socially responsible" investment funds match or outperform other mutual funds. *E.g.*, Sally Hamilton et al., *Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds*, 49 FIN. ANALYSTS J. 62, 64-66 (1993); Steve Schueth, *Socially Responsible Investing in the United States*, 43 J. BUS. ETHICS 189, 192-93 (2003); Meir Statman, *Socially Responsible Mutual Funds*, 56 FIN. ANALYSTS J. 30, 34 (2000). Neither finding is surprising—in an efficient market in which many investors care about "social responsibility" and many do not (or there is substantial disagreement about the meaning of "social responsibility"), one would expect that returns to stocks of "socially responsible" companies and mutual funds would be the same.

[33]The definition of SWF is somewhat vague. *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism* 13 (Stanford Univ. Law & Econ. Olin Working Paper No. 355, 2008), *available at* http://ssrn.com/abstract=1095023 (listing different entities that might be considered SWFs).

traditional limitation to debt securities and begun to make large purchases of equities.[34] The main fear is that these funds will act for political reasons and not to maximize share value.[35] A second concern is that SWFs may use their influence to engage in industrial espionage.[36]

The first response to these fears is that they seem exaggerated. So far, SWFs appear interested only in maximizing their profits, not in political manipulation or espionage.[37] The interest of other shareholders is to oppose any pressure by SWFs (or any other investor) on portfolio companies to act for political reasons or to submit to espionage if so doing would lower share value. Such pressures should, then, be effective only if an SWF (or a group of affiliated SWFs) acquired a majority of the stock of a public company. In that case, however, the SWF would also bear most of the resulting loss in share value.

It is highly unlikely that an SWF could attain such control. Federal law requires review by the Committee on Foreign Investment in the United States (CFIUS) of any acquisition of foreign control over a U.S. company, and CFIUS can recommend that the President block an acquisition if it poses a threat to national security.[38] For purposes of this law, "control" is defined

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[34]*See id.* at 4, 12-17.

[35]*See* James Politi, *Sovereign Funds Face US Threat*, FIN. TIMES (London), Feb. 14, 2008, at 8 (quoting Senator Charles Schumer).

[36]Gilson & Milhaupt, *supra* note 33, at 9, 21; *see* Don Clark & Chip Cummins, *AMD's Infusion from Emirate May Only Be Respite*, WALL ST. J., Nov. 17, 2007, at A3; Richard Wray, *Abu Dhabi Buys into US Chip Firm*, GUARDIAN (London), Nov. 19, 2007, at 27, *available at* http://www.guardian.co.uk/business/2007/nov/19/2.

[37]Recently, three academic experts on SWFs testifying before Congress agreed that "these foreign government investments in the United States should not be feared. Sovereign wealth funds, while expanding rapidly, are largely benign as the majority of them are interested in maximizing profits rather than advancing geopolitical agendas .... Further, they provide necessary economic benefits." Aaron Lorenzo, *International Developments: Vet Sovereign Wealth Funds When Sensitive Sectors Involved, Senate Panel Told*, 40 SEC. REG. & L. REP. (BNA) 940 (June 16, 2008) (summarizing testimony by Professors Jagdish Bhagwati and David Marchick of Columbia and Professor Daniel Drezner of Tufts). A recent review concludes:

> At least to date, SWFs have acted as model investors and have not sought to leverage their position to pursue political ends. That . . . is not surprising: SWFs have strong natural incentives to avoid being perceived as strategic investors, so as to avoid a public backlash that could compromise their continued access to Western markets. . . . In our view, it would be a mistake to discourage SWFs from investing in the United States by imposing on them any additional regulations at this time . . . . When SWFs buy a stake in a US company, they also buy a stake in our domestic welfare. That's an investment we ought to welcome with open arms, not one to burden unnecessarily.

Richard A. Epstein & Amanda M. Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, 76 U. CHI. L. REV. 111, 134 (2009).

[38]Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, sec. 1,

very broadly.[39] The Treasury Department recently proposed rules that would require review of acquisitions below 10% of a company's stock.[40] So far, problems "have not materialized in any appreciable way."[41]

If, however, existing safeguards eventually prove inadequate, specific further steps can be taken. One recent proposal would strip SWFs of voting rights in public companies.[42] Certainly, whatever dangers are posed by SWFs, the solution is not to weaken shareholder power generally.

C. *Shareholders Who Do Business with the Company*

Fears of self-dealing by institutional investors[43] are also overblown, especially in light of the actual current problems of self-dealing by dominant managers and their friends. Managers must be compensated; the proper level of compensation is the only issue. By contrast, most institutional investors (mutual funds, pension funds, and hedge funds) have few opportunities to contract with the companies in which they invest. Any effort to create such contracts would draw attention and opposition from managers, analysts, and other investors.

Second, CEOs always influence, and usually dominate, the outside directors.[44] By contrast, public shareholders usually have little influence on the selection or behavior of directors. They cannot place nominees for the board, or even proposals for bylaws that would allow them to place nominees for the board, on the company's proxy statement.[45] *A fortiori*, a single, outside shareholder rarely has much influence on board

§ 721(b), sec. 6, § 721(d)(1), 121 Stat. 246, 246-48, 255 (codified at 50 U.S.C. App. § 2170).

[39] *See id.* sec. 2, § 721(a)(1).

[40] *See* Regulations Pertaining to Mergers, Acquisitions and Takeovers by Foreign Persons, 73 Fed. Reg. 21,861, 21,864-73 (proposed Apr. 23, 2008).

[41] Ballabon, *supra* note 12, at 25.

[42] Gilson & Milhaupt, *supra* note 33, at 10, 21-30.

[43] *See supra* note 11 and accompanying text.

[44] *See infra* notes 209-18 and accompanying text.

[45] Indeed, the SEC amended rule 14a-8(i)(8) to overturn the decision in *American Federation of State, County & Municipal Employees v. American International Group, Inc.*, 462 F.3d 121 (2d Cir. 2006), which required the company to include in its proxy statement a shareholder proposal to amend the company's bylaws to permit inclusion of shareholder nominees in the company's future proxy statements in certain circumstances. *See* Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 70,450 (Dec. 11, 2007) (to be codified at 17 C.F.R. pt. 240).

Moreover, although shareholders can propose bylaws that otherwise alter the ground rules for proxy voting, the resulting bylaws may not be binding on the board. *See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 235, 239-40 (Del. 2008) (holding that although a shareholder-proposed bylaw that required reimbursement of a shareholder's proxy expenses in certain circumstances was a proper subject for shareholder action, it would not bind the board if it required the board to take action inconsistent with its fiduciary duties); *see also* DEL. CODE ANN. tit. 8, § 112 (2008) (codifying this rule).

composition.[46] If an outsider could sneak a friend onto the board, any effort to exploit that contact would be obvious to managers and other outside directors and investors, who have no reason to tolerate any action that reduces the value of their stock.[47] Despite the expressed fears of self-dealing by institutional investors, no actual incidents of its occurrence with investment funds have come to light.

A few institutional investors do contract with public companies. The trust department of a bank, for example, may own a company's stock in trust while the commercial side of the bank seeks the company's banking business. A "Chinese wall" between the two departments is supposed to prevent the commercial division from pressuring the trust department, but there are doubts about how effective these "walls" are.[48] Such situations, however, pose little threat that a bank will exploit its stock ownership to extract unusual terms from the company in its commercial banking. Indeed, such situations may do more damage to the bank than to the company.[49]

If self-dealing by institutional investors who can influence board elections was a lucrative possibility we would have observed it already. That is, if the ten or twenty largest institutional shareholders of a company could profit by choosing directors who would then grant them preferential contracts, we should already discern such activity, at least occasionally. In fact, we do not. The reasons for this are not hard to guess. Even the ten or twenty largest institutional shareholders rarely own anything approaching a majority of a company's stock. Any attempt to implement such a scheme should be evident to other shareholders. If it were not noticed by outsiders, managers would have an incentive to reveal it. The other shareholders would then squelch the scheme.

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[46]There are a few exceptions, but they tend to prove the rule. For example, management resisting a takeover may issue a large block of stock to a "white squire." *See* OESTERLE, *supra* note 15, at 267 (describing this and related practices). In that case, though, the shareholder agrees to be an ally of the insiders.

[47]*See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 244-45 (1994) (stating that multiple intermediaries can form "countercoalition[s]").

[48]*See* Edward S. Herman & Carl F. Safanda, *The Commercial Bank Trust Department and the "Wall,"* 14 B.C. INDUS. & COM. L. REV. 21, 27-28 (1973); João A.C. Santos & Adrienne S. Rumble, *The American Keiretsu and Universal Banks: Investing, Voting and Sitting on Nonfinancials' Corporate Boards*, 80 J. FIN. ECON. 419, 421 (2006).

[49]*See infra* note 89 and accompanying text.

D. *Shareholders with Conflicting Investments*

The problem of shareholder action that reduces (or the obstruction of action that enhances) share value, by shareholders who have a minority equity interest and a larger conflicting interest (so-called "empty voting"), is also much exaggerated.[50] And to the extent that the problem exists, it argues for more shareholder power, not less.

Although it is theoretically possible for an investor to acquire voting rights considerably greater than her equity stake, even without dual class stock,[51] the obstacles are formidable. The quantity of stock available for such schemes is small.[52] Lenders of stock charge a fee to the borrower, and when the fee is set, the lender can weigh the risk that the borrower will act to diminish the stock's value.[53] Fees charged now may not reflect much of a risk, but that is because such ploys have been extremely rare. If they proliferate, fees will rise.

The occurrence of empty voting in a few cases has precipitated the sounding of tocsins,[54] but even these exceptions have proved the rule. Mylan Labs' proposed acquisition of King Pharmaceuticals was fought by an investor that held voting rights for many shares of Mylan, but had hedged away all its economic interest in the stock while holding a big equity stake in King.[55] This investor was sued by another Mylan shareholder, but the case

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[50] *See generally* Jarrad Harford et al., *Conflicts of Interests Among Shareholders: The Case of Corporate Acquisitions* 1, 4-5 (MIT Sloan Sch., Working Paper No. 4653-07, 2007), *available at* http://ssrn.com/abstract=947596 (discussing cares and concerns of "shareholder cross-holdings"). *See also* authorities cited *infra* note 61 (questioning whether empty voting is a significant problem). Henry Hu and Bernard Black say: "Debt and hybrid decoupling can potentially produce value-decreasing outcomes at particular companies." Henry T.C. Hu & Bernard Black, *Debt and Hybrid Decoupling: An Overview*, M&A LAW, Apr. 2008, at 5. They offer no instances, however, where such effects have occurred, and they concede that debt decoupling has "positive aspects" that are "well known" and that its "benefits may well exceed the costs." *Id.* at 5, 9.

[51] "Shareholders can do it simply by using calls and puts to create synthetic stocks and take long or short positions in them." Avner Kalay & Shagun Pant, One Share-One Vote is Unenforceable and Sub-optimal 2 (Oct. 2008) (EFA 2008 Athens Meetings Paper), *available at* http://ssrn.com/abstract=1102832. Thus vote shifting cannot be prevented in a market system. *See id.* at 8-10.

[52] *See* Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 25-26 (2006) ("[O]nly a small percentage of most common stock is available to be borrowed and an investor will be inherently limited by the supply.").

[53] *Id.* at 27-28. Of course, the lender will weigh only its own potential losses. Thus, the fee will not impound the potential losses of other shareholders. But for the borrower to have a substantial effect on the outcome of the vote, it will have to acquire voting rights to a large number of shares. So, the fee could be large.

[54] *See supra* notes 16-18 and accompanying text.

[55] *See* High River Ltd. P'ship v. Mylan Labs., Inc., 353 F. Supp. 2d 487, 490 (M.D. Pa. 2005).

was rendered moot when Mylan abandoned the proposed acquisition of King.[56]

Similarly, in JP Morgan's takeover of Bear Stearns, some of Bear's creditors bought its stock in order to vote for the merger because JP Morgan had promised to pay Bear's debt.[57] Presumably due in part to these purchases, the price of Bear's stock rose above the initially proposed acquisition price of $2 per share. Simultaneously, other investors who had short positions in Bear's debt were reported to have bought shares in order to vote against the merger so as to push Bear into bankruptcy, thereby raising the value of their short positions.[58]

Despite these machinations, the outcome was reassuring. JP Morgan raised its offer to $10 per share, and the merger was approved. Those who shorted the debt and voted against the merger lost. Bear's creditors who bought its stock and voted for the merger won, but that was hardly a defeat for the "pure" shareholders of Bear. There was considerable doubt whether even JP Morgan's initial offer of $2 per share was excessive—again, those who shorted Bear's debt believed that abandonment of the merger would lead to Bear's bankruptcy. Nonetheless, purchases of Bear's stock by investors with both long and short positions in its debt helped to raise the stock's price over the $2 bid, and thus may have helped induce JP Morgan to raise its bid to $10. No one even hinted at offering more, and Bear's shareholders overwhelmingly approved the merger. Thus it seems that Bear's pure shareholders were not harmed but rather benefitted greatly from the "decoupling" ploys.

In short, "stock lending[ ] is to an important degree self-policing."[59] Despite the scholarly jeremiads over empty voting,[60] it has never yet altered the result of a shareholder vote, and problems from it are likely to remain rare or nonexistent.[61] In some cases, decoupling could be beneficial, as

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[56]Hayden & Bodie, *supra* note 31, at 485.

[57]The facts of this event are taken from Hu & Black, *supra* note 50, at 4.

[58]*See* Matthew Karnitschnig & David Enrich, *Bear's Run-Up Sets the Stage for Epic Clash; Speculators Ignite Rally, Driving Shares Up 23%; Disbelief on Deal Price*, WALL ST. J., Mar. 19, 2008, at C1.

[59]Oesterle, *supra* note 52, at 25.

[60]*See supra* notes 16-18 and accompanying text.

[61]*See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 721 (2007); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1076 (2007) (questioning whether empty voting is a significant problem); *see also* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 155 (2009) (noting that "the number of institutional investors who are unbalanced in the direction of the target should balance the numbers who are unbalanced in the direction of the bidder").

when an activist investor acquires extra voting rights so as to offset the passivity of other shareholders, the managers' control of the proxy machinery, or dual class voting where insiders own superior voting stock.[62] One recent analysis concludes that shareholders are better off having "the ability to dynamically change the voting structure" of their firm.[63]

Directors also have some ability to handle problems like empty voting. In two recent cases, boards postponed scheduled shareholder meetings because many shares had changed hands after the record date and the new shareholders wanted to vote their newly acquired shares. Other shareholders sued, alleging that the boards had breached their fiduciary duties. In both cases the Delaware Court of Chancery upheld delay as a reasonable response to the existing conditions.[64] If any danger remains, it can be handled by tighter rules on short-selling and empty voting.[65] To address the threat by

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[62]*See* Onnig H. Dombalagian, *Can Borrowing Shares Vindicate Shareholder Primacy?*, 42 U.C. DAVIS L. REV. 1231, 1311 (2009) (arguing that a public share borrowing market may improve the efficiency of shareholder decisionmaking); Hu & Black, *supra* note 50, at 5 (outlining benefits of decoupling); Alon Brav & Richmond D. Mathews, Empty Voting and Efficiency of Corporate Governance 6-7 (Mar. 10, 2009) (AFA 2009 San Francisco Meetings Paper), *available at* http://ssrn.com/abstract=1108632 (presenting a model showing that "empty voting" can improve overall efficiency); Santella et al., *supra* note 26, at 33 (stating that perhaps "lenders [of shares] are not interested in voting and the borrowers make use of the voting rights" but that "separation of risk from voting rights put in place by managers and controlling shareholders limits investors' activism"); Michael Zurkinden, Corporate Vote Buying: The New Separation of Ownership and Control 33 (Feb. 6, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1338624 ("In general, the literature dealing with vote buying is rather ambiguous with regard to the desirability of the phenomenon. . . . Moreover, vote buying in general is unlikely to be a profitable activist strategy.").

[63]Kalay & Pant, *supra* note 51, at 35. The paper focuses primarily on the treatment of target shareholders in acquisitions. Even assuming that the conclusion is correct in this context, it might be less true in ordinary circumstance. The paper argues, however, that freedom to shift votes "increases the market value of the firm." *Id.* at 7. This argues against the charge that investors are seriously threatened by vote shifting. These problems arise only because "hedge funds are merely reacting to the failure of other institutions to exercise their franchise for the benefit of all shareholders." Partnoy & Thomas, *supra* note 16, at 52.

[64]Mercier v. Inter-Tel, Inc., 929 A.2d 786, 819 (Del. Ch. 2007); *In re* MONY Group, Inc. S'holder Litig., 853 A.2d 661, 676-77 (Del. Ch. 2004).

[65]*See, e.g.*, Anabtawi & Stout, *supra* note 8, at 1295-96 (advocating application of fiduciary duties to shareholders with conflicting interests); Briggs, *supra* note 61, at 706-08 (urging higher disclosure requirements); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 876 (2006) (advocating revised disclosure requirements); Thompson & Edelman, *supra* note 61, at 166 (proposing that shareholder voters be required to "certify that they are voting no more shares than they have economic interests in"); Jonathan Cohen, Note, *Negative Voting: Why It Destroys Shareholder Value and a Proposal to Prevent It*, 45 HARV. J. ON LEGIS. 237, 253-57 (2008) (proposing a private right of action by shareholders harmed by negative voting against the negative voter); David Skeel, *Behind the Hedge*, LEGAL AFF., Nov.-Dec. 2005, at 33 (proposing to "disqualify the votes of any shareholder who had entered into a contract that protected him from changes in the price of the stock he voted"); Roberta S. Karmel, *Voting Power Without Responsibility or Risk—How Should Proxy Reform Address the*

crippling shareholder suffrage would be truly to throw out the baby with the bath water.

Another alleged problem is the fully diversified shareholder, or "universal owner,"[66] whose interest is in the entire market and who might, therefore, oppose measures that would increase the value of its shares in some companies, but diminish the value of its other investments by a greater amount.[67] The first problem with this alleged problem is that it probably does not exist. Even large mutual funds are not so diversified that they are likely to oppose profitable steps by one portfolio company that would impose losses on the market generally, and it is unlikely that a profitable act by one portfolio company would cause a greater loss to another portfolio company.

If investors *were* behaving as universal owners, we should have seen some evidence of it, but none of those who are sounding this alarm offer such evidence. All the literature I know of on investor voting and corporate governance (including the pronouncements of investor advisory services), focuses on individual firms, not on the general market. In short, this alleged problem seems to be another chimera conjured by academics searching for something new to write about. But even if the universal owner exists and behaves as alleged, what threat does he pose? If some universal owners act in the interest of the entire market, is that not a beneficial market correction to the problem of externalities in a market system?[68]

The one situation that does spawn real abuses of this kind is dual class voting.[69] In these cases, however, the holders of the minority equity stake, who wield control through high-voting stock, are always insiders, not

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Decoupling of Economic and Voting Rights? 5-6 (Brooklyn Law Sch., Legal Studies Research Paper No. 146, 2009), *available at* http://ssrn.com/abstract=1397224 (recommending that the SEC "eliminate empty or discontinuous voters from any definition of shareholders eligible to propose by-law changes with regard to nominations or to nominate directors on the company ballot"); Andrea Zanoni, Hedge Funds' Empty Voting in Mergers and Acquisitions: A Fiduciary Duties Perspective 3-4 (Oct. 17, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1285589 (recommending that mergers and acquisitions in which shareholders employ empty voting should require approval by a majority of disinterested shareholders and scrutinized using a fiduciary duties perspective).

[66] JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 3-7, 21 (2000).

[67] *See* Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers*, 31 J. FIN. & QUANTITATIVE ANALYSIS 43, 53-54 (1996).

[68] *See* Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 40-41 (2006) (discussing effect of diversified owners on extranalities).

[69] *See* Ronald W. Masulis et al., *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (empirical studies finding "as insider voter rights rise relative to cash-flow rights, dual class firms tend to make less profitable capital investments, consistent with these firms making investment decisions in pursuit of private benefits rather than shareholder wealth maximization").

institutional investors.[70] If insiders hold a majority of the votes, of course, no change in proxy voting will deprive them of control; only forbidding dual class stock would do that. However, in many cases, owners of high-voting stock still have far less than a majority of the votes. They maintain control only because they also control the company's proxy statement. In these cases, shifting control of the proxy statement to the shareholders could end the abuses despite the existence of dual class voting.

E. *Different Investment Preferences*

Investors have different investment preferences. One area of difference is risk,[71] but this has little effect on investors' attitudes about the strategy of a company. First, very cautious investors tend toward investments other than common stocks, in which case they are not shareholders with voting rights. Owners of common shares tend to be risk neutral—they accept the risks of the stock market generally, but do not want the greater risks of individual stock issues. Their preferences, however, are easily satisfied without reducing returns by holding a diversified portfolio of common stocks.[72] It makes no sense to buy a company's stock and then urge it to pursue a low-risk strategy that would reduce its share value.

One exception to this risk-neutrality is employee shareholders, but they are unlikely to distort corporate governance.[73] Another exception are large shareholders that received stock as a gift or inheritance and cannot easily sell. Usually, however, these shareholders are corporate officers or close relatives of officers, i.e., they are insiders whose interests clash with those of public investors. The solution to this problem is not to maintain the current regime of CEO dominance (which favors insiders), but to institute true shareholder control.[74]

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[70]*See* OESTERLE, *supra* note 15, at 263 (stating that higher-voting stock is "sold exclusively to insiders"); *id.* at 266 (stating that in "time-phased" voting plans, "[i]nsiders hold and outsiders trade," with the result that insiders wind up holding most of the higher-voting stock).

[71]*See* BAINBRIDGE, *supra* note 6, at 116 ("Attitudes towards risk vary considerably.").

[72]*See id.* at 117 ("Investors can eliminate unsystematic [i.e., firm-specific] risk by diversifying their portfolio.").

[73]*See* Santella et al., *supra* note 26, at 13 (discussing ownership concentration).

[74]Shareholder primacy would not help if the insiders and their allies own a majority of the equity, but at least in that case the control group would bear a majority of any loss in stock value that it causes. Another minor exception to the rule of shareholder unity is instructive. A recent empirical study finds that institutional investors have varied preferences about leverage. Johan Sulaeman, Do Shareholder Preferences Affect Corporate Policies? 8-15 (Oct. 1, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1102005. What, then, is a poor CEO to do? The study finds that "firms that change leverage ratios in the opposite direction of the aggregate preferences of their

Jeffrey Gordon fears that different preferences or beliefs lead to "cycling" in which "each option selected by majority vote is in turn defeated by another option preferred by another majority coalition."[75] In the examples of cycling that he offers, however, it seems that investors in public companies would probably reconcile their differences by adjusting their respective portfolios rather than by waging a value-reducing corporate war. Underscoring the implausibility of cycling problems is the fact that all his examples are hypothetical—he offers no actual events in evidence.[76]

F. *The Impact of Institutional Investors*

The preceding sections of Part III present strong evidence that the goal of most shareholders of public companies is to maximize share value; exceptions are fairly rare and insignificant. However, the argument there rested on inferences—albeit reasonable inferences. The issue is empirically testable, though, and many empirical studies have been performed. Taken together, these studies make an overwhelming case for the essential unity of shareholders.

The most striking evidence is the many studies finding that the existence or acquisition of large block stock holdings in a company by institutional investors does not cause the company's stock price to fall but rather to rise, and the increase is greater if the shareholder is expected to be aggressive.[77] One study finds that performance-based CEO pay works best when a large blockholder monitors CEO performance.[78] Another finds that

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shareholder experience lower stock returns than those that follow the aggregate leverage preferences of their institutional investors." *Id.* at 31. This finding supports the view that shareholder democracy would improve corporate governance.

[75]Gordon, *supra* note 8, at 360.

[76]*See id.* at 368-69.

[77]*See* Brad M. Barber, *Monitoring the Monitor: Evaluating CalPERS' Activism*, 16 J. INVESTING 66, 71-74 (2007); Michael J. Barclay & Clifford G. Holderness, *The Law and Large-Block Trades*, 35 J.L. & ECON. 265, 268-69 (1992); Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22 REV. FIN. STUD. 3941 (2009); Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 44 (1980); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 470 (1986); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 756 (1997).

[78]*See* Robert Daines et al., *The Good, the Bad, and the Lucky: CEO Pay and Skill* 18 (NYU Law & Econ. Research Paper Series, Working Paper No. 04-035, 2005), *available at* http://ssrn.com/abstract=622223; *see also* Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901, 920-22 (2002) (finding the presence of large stockholders on the board of directors as a statistically significant variable affecting the relationship between CEO pay and performance).

large blockholders do not reduce, but increase, firm investment.[79] This is not surprising since the stock market tends to punish companies that cut research and development (R&D) and to "reward those with a commitment to R.& D.—often years before long-term projects reap benefits."[80]

Even hedge funds,[81] which are often denounced, have this effect. Martin Lipton accuses them of "exacerbating the tension between short-term performance and long-term success of corporations."[82] Even on its face the charge is dubious: it posits that sophisticated investors pressure companies in which they have huge investments to take certain steps, even though they know (or should know) that they could reap supra-market returns by waiting. Can it be that an entire industry behaves so foolishly? If they do, how is it that so many hedge funds have generated such handsome profits? And if the charge is true, why haven't other investors caught on to it? Are the vast majority of investors idiots? Quite simply, the investing public perceives these situations not as a threat but as a boon to share value.[83]

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[79] Cronqvist & Fahlenbrach, *supra* note 77, at 3956.

[80] Mark Hulbert, *To Make a Stock Pop, Innovate*, N.Y. TIMES, Aug. 31, 2008, § 3, at 7.

[81] *See* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 244-51 (2008) (explaining ways in which hedge funds have had a strong, beneficial effect on corporate governance); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 370 (2009) (presenting results of an empirical study, which finds that companies subjected to hedge fund activism earn positive abnormal returns, largely by forcing the target firms into takeovers); Chris Young, *Hedge Funds to the Rescue*, BUS. WK., July 31, 2006, at 86 (stating that hedge funds have become "the catalyst" for proxy fights, leading shareholders in opposing value-reducing initiatives); Alon Brav et al., *The Returns to Hedge Fund Activism* 1 (ECGI, Law Working Paper No. 098/2008, 2008), *available at* http://ssrn.com/abstract=1111778 ("The abnormal stock return upon announcement of [hedge fund] activism is approximately seven percent, with no reversal during the subsequent year."); Karen Brenner, Shareholder Activism and Implications for Corporate Governance 2 (Mar. 26, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1115474 (discussing studies that support the view that "firms targeted by activist hedge funds have earned abnormal positive returns"); Chris Clifford, Value Creation or Destruction? Hedge Funds as Shareholder Activists 25 (June 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=971018 (providing evidence that "firms targeted by activists do not earn smaller long-run returns than firms targeted by passivists"); Jiekun Huang, Hedge Funds and Shareholder Wealth Gains in Leveraged Buyouts 24-25 (May 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1086687 (finding the presence of a hedge fund as a large shareholder is associated with higher premiums in leveraged buyouts); *see also* Kahan & Rock, *supra* note 61, at 1091-92 (stating that traditional institutional investors are happy to "tag[ ] along" behind activist hedge funds); Kahan & Rock, *supra* note 4, at 16-17 (describing cooperation of mutual funds with hedge fund activism).

[82] Martin Lipton, *Some Thoughts for Boards of Directors in 2008*, 11 BRIEFLY 1, 3 (2008).

[83] *See* Partnoy & Thomas, *supra* note 16, at 52 (stating that "hedge funds are merely reacting to the failure of other institutions to exercise their franchise for the benefit of all shareholders"); *see also* Zanoni, *supra* note 65, at 15 (inferring from positive Markey reaction to hedge fund investment that investors perceive hedge fund intervention as adding value to the stock).

But even the basic claim that hedge funds are quick in-and-out investors has been disproved.[84] Moreover, studies of corporate performance show that investors are right about large blockholders. Companies with large outside shareholders tend to perform better and have less waste than other companies.[85] And when one or more investors acquire a large block of a company's stock, the company's stock price does not decline after its initial rise but tends to keep growing.[86]

Opponents of shareholder power warn that the election of some shareholder nominees will lead to debilitating tension and conflict on the board.[87] However, a recent study found that companies to which activist investors (like hedge funds) elected dissident directors (but did not win full control of the board) had much higher shareholder returns than peer companies.[88]

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[84] *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1409 (2007) (finding that activist investors are not "short term investors who extract cash and exit immediately"); Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) (finding that gains produced by hedge fund intervention do not deteriorate in the one-year period following the initial announcement of investment).

[85] *See* Cronqvist & Fahlenbrach, *supra* note 77, at 3944 (finding that firms with aggressive large shareholders had higher return on assets); Brav et al., *supra* note 81, at 1 ("Target firms experience increases in payout, operating performance, and higher CEO turnover after [hedge fund] activism."); Anup Agrawal & Tareque Nasser, Blockholders on Board and CEO Compensation, Turnover and Firm Valuation (Sept. 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1443431. Clifford, *supra* note 81, at 19-21 (finding that firms targeted by activist shareholders experienced improved operating performance (measured by return on assets) following the shareholders' investment).

[86] *See* Brav et al., *supra* note 84, at 1761-63 (finding improvement in return on assets and operating profit margins at targets of hedge funds two years after intervention, and total payout increases and book value leverage increases, on average, from the year before to the year after an announcement of intervention); Na Dai, *Does Investor Identity Matter? An Empirical Examination of Investments by Venture Capital Funds and Hedge Funds in PIPEs*, 13 J. CORP. FIN. 538 (2007) (finding positive reactions to announcements of investments by hedge and private equity funds); Klein & Zur, *supra* note 77, at 188 (finding significantly positive abnormal returns for the year following block purchases by hedge funds); Nicole M. Boyson & Robert M. Mooradian, Hedge Funds as Shareholder Activists from 1994-2005, at 1 (July 31, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=992739 (presenting results indicating that "hedge fund activism significantly improves short-term and long-term performance of target firms compared to non-targets").

[87] *See supra* notes 8-10 and accompanying text.

[88] *See* Chris Cernich et al., Effectiveness of Hybrid Boards 38 (May 2009) (unpublished manuscript), *available at* https://www.proxygovernance.com/content/pgi/img/2009hybrid_boards.pdf ("On average shareholder value at ongoing companies improved under hybrid boards by 19.1%—16.6 percentage points more than peers—from the contest period through the board's one year anniversary."); *see also* MACEY, *supra* note 81, at 90-93 (describing benefits of "dissident directors").

Once again, the exceptions prove the rule. Some institutional investors do vote against resolutions that would enhance share value, but this behavior generally results from actual or potential pressure from the CEO.[89] The pressure need not be great or overt (or, perhaps, even intended) because the CEO ordinarily so controls proxy voting that voting against management is futile. The solution to the problem, then, is to end CEO domination. If nominees for the board were chosen by the ten to twenty largest shareholders, those shareholders would have little ability to coerce other shareholders to vote with them; shareholders would be free to vote in their own interests.

G. *The Absence of Shareholder Conflict*

The discussion so far suggests that each group of special interest shareholders generally owns a small fraction of public companies' equity and that the aspirations of the various groups tend to cancel each other out. Accordingly, it seems unlikely that special interest groups could divert a company from the general shareholder goal of maximizing share price.[90]

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[89] *See* JACOBS, *supra* note 13, at 52 (distributing pressure felt by pension fund managers to vote with management); ROE, *supra* note 47, at 62 ("[A]s purveyors of insurance products, pension plans, and other financial services to corporations, [insurers] have reason to mute their corporate governance activities and be bought off."); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 826 (1992) (stating that money managers that vote against management "are likely to lose any business that they conduct with the company"); Gerald F. David & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007) (finding that mutual funds with conflicts of interest, based on the management of a company's pension assets, are more likely to vote with management); Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 845-46 (2009) (empirical study finding that mutual fund advisers who have important business interests in handling defined contribution retirement plans are less likely than others to support shareholder governance resolutions); Rasha Ashraf et al., Conflicts of Interest and Mutual Fund Proxy Voting: Evidence from Shareholder Proposals on Executive Compensation 3 (Oct. 9, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1351966 ("[M]utual funds with a pension-related business tie to the firm are more likely to vote against shareholder proposals than are mutual funds that do not have a pension-related business tie."). For an informative case study, see Gretchen Morgenson, *Investors vs. Pfizer: Guess Who Has the Guns?*, N.Y. TIMES, Apr. 23, 2006, § 3, at 1.

[90] *See* Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 1, 29 (2008) ("[S]hareholder democracy may be able to weed out all but the most value-enhancing initiatives, undercutting shareholders' ability to advance personal agendas."); *Battling for Corporate America-Shareholder Democracy*, ECONOMIST, Mar. 11, 2006, at 75 ("[P]olitically motivated shareholders and hedge funds are likely to gain any real power over management only if they can persuade the usually passive majority to support them."); *see also* ROE, *supra* note 47, at 244-45 (noting the possibility of shareholder coalitions); *supra* notes 30-31 and accompanying text (noting that politically motivated

If shareholders are sharply divided over goals, we should observe many shareholder conflicts. Democracies, political parties, interest group organizations, and coalitions evolve as vehicles to compete for power. We should see similar behavior among competing shareholder groups at both the company and the national levels. But we do not. "[S]hareholders do not have the kinds of disputes one would expect if they were a diverse group of Americans engaged in a struggle to make corporations in their images."[91]

If shareholders were so divided that they preferred to be marginalized in corporate governance, we would expect strong shareholder rights to be associated with lower stock values. In fact, the opposite is true.[92] Strong shareholder rights are also associated with better operating performance,[93]

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and socially responsible shareholders own a small amount of stock).

[91]Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1043 (1996); *see also* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 466 (1991) ("[T]he potential for conflict between large and small shareholders will likely be minimal.").

[92]*See* Jianxin (Daniel) Chi, *Understanding the Endogeneity Between Firm Value and Shareholder Rights*, 34 FIN. MGMT. 65 (2005); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 922 (1996) (citing empirical evidence that appointment of outside directors positively impacts stock prices); Angie Low, *Managerial Risk-Taking Behavior and Equity-Based Compensation*, 92 J. FIN. ECON. 470 (2009) (presenting evidence that increased protection from takeovers caused managers to reduce company risk with resultant decline in stock values); Vidhi Chhaochharia & Luc Laeven, *Corporate Governance, Norms and Practices* (ECGI, Fin. Working Paper No. 165/2007, 2008), *available at* http://ssrn.com/abstract=965733 (finding pro-shareholder governance features adopted at the firm level are associated with higher market valuation of the firm); Don M. Autore et al., Do Analyst Recommendations Reflect Shareholder Rights? 7 (Apr. 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1025627 ("One interpretation of our results is consistent with a 'one-size-fits-all' categorization of shareholder rights, in which all firms should opt for strong exernal governance in order to receive favorable recommendations from analysts."). Strong shareholder rights actually "have higher IPO valuations and better long-term operating performance than their peers." Jay C. Hartzell et al., *The Role of Corporate Governance in Initial Public Offerings: Evidence from Real Estate Investment Trusts*, 51 J.L. & ECON. 539, 539 (2008). Strong shareholder rights may also improve firm asset values and thereby benefit bondholders as well. *See* Angie Low et al., The Impact of Shareholder Power on Bondholders: Evidence from Mergers and Acquisitions (Mar. 1, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=891683.

[93]*See* John E. Core et al., *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. FIN. 655, 659-61 (2006) (stating that securities analysts weigh shareholder rights when making earnings forecasts); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003) (finding in the study that firms with strong shareholder rights earned risk-adjusted annual returns 8.5% greater than firms with weak shareholder rights in 1990-99); Reena Aggarwal & Rohan Williamson, Did New Regulations Target the Relevant Corporate Governance Attributes? 6 (Feb. 12, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=859264 ("Firms with strong shareholder rights are found to have risk-adjusted returns that are 8.5% higher than those of firms with low shareholder rights."); Sanjai Bhagat & Brian J. Bolton, Corporate Governance and Firm Performance 2 (June 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1017342 (finding that standard indices of good corporate governance, including several factors strengthening shareholder power, are "significantly positively correlated with better

less empire building,[94] more innovation, more successful acquisitions, more reasonable executive compensation, and less shareholder litigation.[95]

Proxy votes also show the fundamental unity of shareholders. "Although a wide range of precatory resolutions are put forward [for shareholder vote], the ones that obtain majority support are those . . . that are widely viewed by financial institutions as serving shareholder interests."[96] One study of disputes on boards of American public companies both confirms the absence of shareholder conflicts and reveals the real source of friction. It finds that "such conflicts typically appear to be the result of power struggles between management and directors" over corporate governance and control issues.[97] Disputes were more common when the CEO was powerful and independent blockholdings were lower.[98] Disputes were also more common in firms with poor operating and stock price performance, and disclosure of disputes generally occasioned large stock price declines.[99] The problem of corporate governance is not divided or overly powerful shareholders, but autocratic CEOs.

In sum, conflicts among shareholders are fairly rare and minor. Cases where such conflicts are significant (as in companies with dual class stock)

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contemporaneous and subsequent operating performance"); Øyvind Bøhren et al., Corporate Governance and Real Investment Decisions 18 (Mar. 2, 2007) (EFA 2007 Ljubljana Meetings Paper), *available at* http://ssrn.com/abstract=891060; Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Operating Performance 2 (Dec. 7, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=814205 (finding that several pro-shareholder governance criteria are associated with higher returns on equity and on assets); C.S. Agnes Cheng et al., Shareholder Rights and the Cost of Equity Capital 26 (Feb. 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=594505 (finding the strength of shareholder rights to be significantly associated with the cost of equity capital; "[i]nvestors apparently perceive weak shareholder rights as an important source of agency costs and demand higher rates of return accordingly"). The correlation between shareholder rights and corporate performance has been confirmed in the recent financial crisis: "those banks with the strongest corporate governance controls performed the best." Marcia Milton Cornett et al., The Financial Crisis: Did Corporate Governance Affect the Performance of Publicly-Traded U.S. Bank Holding Companies? 2 (Sept. 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1476969.

[94] *See* Clara Xiaoling Chen et al., Managerial Empire Building, Corporate Governance, and the Asymmetrical Behavior of Selling, General, and Administrative Costs 4, 25-26 (Oct. 25, 2008) (AAA 2008 Financial Accounting and Reporting Section Paper), *available at* http://ssrn.com/abstract=1014088 (presenting results of empirical study).

[95] *See infra* note 204.

[96] Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1799 (2006).

[97] Anup Agrawal & Mark A. Chen, Boardroom Brawls: An Empirical Analysis of Disputes Involving Directors 1 (July 1, 2008) (EFA 2008 Athens Meetings Paper), *available at* http://ssrn.com/abstract=1101035.

[98] *Id.*

[99] *Id.*

arise not for the reasons posited by critics of shareholder power but because of abuses by insiders, whom these same critics tend to champion.

IV. SHORT-TERMISM IS NOT A SERIOUS PROBLEM

A. *Shareholder Attitudes*

Although shareholder myopia is often alleged, "there is not a lot of empirical data to back it up."[100] "[N]o one has *demonstrated* that the long/short phenomenon exists."[101] Firms targeted by shareholder activists do not suffer the ills that the myopia theory would predict. If that theory were true, activist shareholders would somehow pump up the share price of targeted companies and dump their stock at the inflated price, which would then fall (to its "proper" level). Instead, returns to stocks of companies targeted by activist hedge funds show significant positive returns in the one-year, two-year, and three-year periods following the fund's acquisition of the stock.[102]

Many shareholders, including institutions, do trade stocks rapidly.[103] Sometimes there is a reason for this behavior. Most mutual funds, for example, offer to redeem shares at any time for cash.[104] They must retain enough liquidity for this purpose. Even if rapid trading is bad investment strategy, it does not dictate myopia regarding corporate governance. In many situations people own property briefly, yet treat it as carefully as long-term owners.[105] People who hold cash briefly are not careless with it. Merchants often buy and sell goods rapidly without abusing them. Charges of myopia also conflict with standard theories of market behavior. "Under elementary

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[100]Joe Nocera, *A Defense of Short-Termism*, N.Y. TIMES, July 29, 2006, at C1. "Baruch Lev, the well-known accounting professor at New York University . . . scoffs at the notion that short-termism is even a problem." *Id.*

[101]Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 13 (1991); *see also* Luigi Zingales, *The Future of Securities Regulation*, 47 J. ACCT. RES. 391, 415 (2009) ("While popular, I do not know of any empirical support for this view.").

[102]*See* Clifford, *supra* note 81, at 23-25.

[103]In one study, mutual funds had a median portfolio turnover rate of 0.72, meaning that they held their investments somewhat more than a year on average. Ying Duan, The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds' Proxy Voting and Trading Behavior 24 tbl.2 (Mar. 7, 2008) (unpublished Ph.D. dissertation, Boston College), *available at* http://ssrn.com/abstract=1101809. Another study implies that hedge funds hold equity positions for an average of twenty-two months. Brav et al., *supra* note 81, at 8. Clearly these investors are not just gambling on quarterly earnings.

[104]*See* Duan, *supra* note 103, at 2 ("[M]utual funds must preserve liquidity to meet investors' redemption requests.").

[105]*See* Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. (forthcoming 2010) (manuscript at 38-39, *available at* http://ssrn.com/abstract=1274244).

principles of finance, even short-term investors have an incentive to maximize the firm's long-term value."[106] If myopia was endemic in American companies we should see profitable investment opportunities going begging. No one has shown this to be the case.

What evidence *do* short-term theorists offer for their charges? First, investors do react to short-term (e.g., quarterly) results. Announcement that a company has fallen (or expects to fall) short of analysts' forecasts typically causes its stock price to fall more than would be predicted by a mere problem with one quarter's earnings.[107] Second, CEOs and CFOs report that they feel pressure from investors to meet or exceed analysts' projections, and many say that they would take steps damaging to long-term value to meet those projections.[108]

This evidence hardly clinches the claims of short-termism. Failure to meet market forecasts for one quarter often augurs longer term problems. Some think that stock markets overreact to short-term developments, but the evidence is ambiguous at best.[109] This is not surprising. If the stock market *did* regularly overreact to short-term results, it would be easy to earn superior

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[106]Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 532 (2002); *see* Bebchuk, *supra* note 96, at 1802 ("If a governance provision does not serve long-term shareholder value, its adoption will likely reduce short-term prices (which reflect expectations about long-term value)."); Ronald J. Gilson, *Leo Strine's Third Way: Responding to Agency Capitalism*, 33 J. CORP. L. 47, 53 (2007) ("[A]bsent significant market inefficiency in pricing stocks, short term strategies by companies, portfolio managers, or mutual funds are not likely to succeed."); Roe, *supra* note 101, at 13 ("The long/short controversy posits a market failure. After all, institutions should know how to discount long-term value to present value.").

[107]*See* Strine, *supra* note 9, at 1764, 1772-73.

[108]MATTEO TONELLO, REVISITING STOCK MARKET SHORT-TERMISM 8 (2006) (reporting that "most business managers stated that they would rather forgo an investment promising a positive return on capital than miss the quarterly earnings expectations of their analysts and financiers"); John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 5 (2005) (reporting that more than half of CFOs surveyed said they would forgo a profitable project in order to meet quarterly earnings estimates of analysts).

[109]*See* Mary E. Barth et al., *Market Rewards Associated with Patterns of Increasing Earnings*, 37 J. ACCT. RES. 387, 410 (1999) ("[E]arnings multiples decrease . . . as a pattern of increasing earnings is followed by a pattern of decreasing earnings."); Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth Expectations, and Stock Return or Don't Let an Earnings Torpedo Sink Your Portfolio*, 7 REV. ACCT. STUD. 289 (2002) (finding the negative reaction especially severe for growth firms); M.L. Defond & C.W. Park, *Earnings Surprises Expressed in Cents Per Share: Stock Price Effects and Implications for Accruals Management* (Univ. of So. Cal., Working Paper, 2000) (on file with author); *see also* Richard Mergenthal Jr. et al., CEO and CFO Career Penalties to Missing Quarterly Analysts Forecasts 3-4 (Apr. 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1152421 (finding that "failure to meet the latest analyst consensus estimate is associated with lower bonuses and equity grants and a higher probability of forced dismissal for both the CEO and the CFO").

trading profits. One could just buy after a stock plummets after unexpectedly bad news and sell (short) after a stock rises in response to unexpectedly good news, then wait for the routine rebounds when the market corrects these overreactions.

This strategy is far-fetched because there is no evidence that stocks tend to overreact to announcements of unexpected short-term results and then rebound. This is unsurprising since any such pattern would violate basic tenets of market efficiency.[110] If such a pattern were discovered, investors would immediately alter their behavior accordingly, i.e., they would cease to overreact. But that, of course, would cause the phenomenon to cease to exist. It is telling that no one touting short-termism has advocated investing on a "rebound" strategy; it seems they do not even believe their own sermons.

Evidence of CEOs' beliefs and attitudes is equally unconvincing. People accused of behaving badly are always eager to blame outside pressure and say "the devil made me do it." CEOs are no different. They may even believe the alibi, but that does not make it true. Some may also cave in to perceived investor pressure to take steps that the CEO believes will impair long-term value, but that does not mean that the steps taken actually do impair value.

CEOs may believe in short-termism partly because they face different pressures from different constituencies. Employees (including subordinate executives) benefit from high compensation and corporate growth, even if that growth does not increase profits.[111] Communities where the firm is located also benefit when it raises employee compensation and expands operations. For shareholders, though, employee compensation and corporate expansion entail costs that should be undertaken only if they will raise profitability, in which case they will also raise share value. A CEO torn by conflicting demands from different constituencies may be tempted to dissemble by telling employees that she cut compensation or growth due only to pressure from irrational, short-term oriented investors. Moreover, since a CEO works constantly with other employees but only sporadically with investors, and is herself an employee with an employee's interests, she

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[110]The Efficient Capital Market Hypothesis holds that capital markets efficiently price securities at the present value of all expected future returns. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 347-70 (7th ed. 2003) (describing and documenting the hypothesis).

[111]*See supra* note 10 and accompanying text.

may persuade herself that the steps she takes have been forced on her by irrational shareholders.[112]

Could CEOs be right that investors *do* urge steps that increase short-term earnings to the detriment of long-term value? The evidence is overwhelming that shareholders do not behave in this manner. Rather, they favor steps that *increase* long-term value. Among the most controversial of these steps are the sale of some of a firm's lines of business and borrowing money and distributing the proceeds thereof to shareholders through dividends or stock repurchases.[113] Investors also often clash with management over corporate acquisitions and expansion and takeover bids.[114] Shareholders have also forced many public companies to abandon poison pills.[115] In all these cases, though, both the opinions of experts and the empirical evidence indicate that the shareholders' position enhances long-term value.[116]

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[112]This may help explain why high ownership by "dedicated" institutional investors is associated with a lower likelihood of a firm's disclosing material weaknesses in its internal control system, and better operating performance and stock returns, while high ownership by "transient" institutional investors is associated with a greater likelihood of reporting material weaknesses in internal controls and inferior operating performance and stock returns. *See* Alex P. Tang & Li Xu, Institutional Ownership, Internal Control Material Weaknesses and Firm Performance 3, 29 (Nov. 1, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1031270. The authors speculate that "firms with higher dedicated ownership face greater scrutiny and are thus less likely to develop serious internal control problems. On the contrary, firms with higher transient ownership might cater to the interests of these short-term traders, resulting in the deteriorated internal control mechanism." *Id.* However, they offer no evidence of pressure from "transient" shareholders causing these results. Thus, the study may offer support for increasing the power of "dedicated" (or long-term or patient) shareholders.

[113]*See* Brav et al., *supra* note 81, at 5-6 (listing issues raised by hedge funds for targeted companies, including spinoffs, reducing excess cash, and increasing leverage or dividends); Partnoy & Thomas, *supra* note 16, at 35 (stating that hedge funds often "try to persuade managers to change the capital structure of the company (typically to pay substantial dividends, repurchase shares, or take on additional debt) in ways the hedge funds believe will maximize the value of the shares").

[114]*See* Brav et al., *supra* note 81, at 5-6 (listing issues raised by hedge funds for targeted portfolio companies, including acquisitions, growth strategy, takeover defenses, and sale of the company). "In 2007, institutions and hedge funds launched campaigns against approximately 40 transactions." Daniel A. Neff, *Takeover Law and Practice: 2008* 13, *in* 5TH ANNUAL INSTITUTE ON CORPORATE, SECURITIES, AND RELATED ASPECTS OF MERGERS AND ACQUISITIONS 317, 336 (2008) (on file with the author). In many cases this opposition has led to higher prices in the challenged transaction. *See id.*

[115]*See* Neff, *supra* note 114, at 15 (stating that as a "result of this activism" the number of S&P 500 companies with poison pills declined from 46% at the end of 2005 to 28% in 2008).

[116]For example, hedge fund activism produces both higher stock prices and operating improvements for target companies. *See supra* notes 81-86 and accompanying text. Takeover defenses, typically favored by managers and opposed by sophisticated shareholders, are associated with significantly lower firm value. *See* Lucian Bebchuk et al., *What Matters in Corporate Governance*, 22 REV. FIN. STUD. 783, 805-06 (2009) (empirical study). Partnership agreements often compel distribution of profits in order to curb managers' discretion to make inefficient use of cash. *See* Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 290-

Activist shareholders usually pursue poorly performing companies.[117] Confusion sometimes arises because some targets of shareholder activism and takeover bids are well operated.[118] This fact leads critics to charge that targets are undervalued in the irrational, shortsighted stock market. Knowing raiders exploit this mispricing by offering illusory premiums while really grabbing the targets at bargain prices. Activist shareholders force patient companies into imprudent changes that nonetheless cause a short-term rise in the company's earnings and, thus, stock price because of the irrational myopia of the stock market.[119]

While it is true that many corporate targets are well-managed, the charge of market mispricing is false. Despite strong cash flows, targets generally have "relatively low dividend yield and diversifying investments that might not be in the best interest of shareholders."[120] In other words, managers of targets were producing solid returns but refusing to distribute those returns to shareholders, who reasonably feared that the retained earnings might be wasted and never paid out.[121] The companies' low stock prices reflect these fears, not myopia or some other irrationality. Raiders and activist shareholders raise stock values by preventing this waste.

Short-term theorists also accuse activist shareholders of forcing companies to skimp on R&D to the detriment of long-term value.[122] Again, there is little evidence that this is true, and many good reasons to think it is false. High institutional ownership of a company's stock is not associated

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91 (2009).

[117]*See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 183 (2001) (stating that institutional investors have targeted poorly performing companies).

[118]*See* Brav et al., *supra* note 81, at 7 (stating that targets of hedge fund activism generally had above-average return on assets and "handsome cash flows"); *see also supra* notes 81-86 and accompanying text (listing benefits of hedge funds to investee companies).

[119]*See supra* notes 19-20, 82 and accompanying text.

[120]Brav et al., *supra* note 81, at 7.

[121]Michael Jensen saw this wasting of free cash flow as the reason why shareholders pressured companies to go private through buyouts. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986); *see also* George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213, 1244-49 (2008) (explaining that investors remain unclear on how and when a company's profits will be distributed due to executives and managers interest in retaining earnings or increasing corporate compensation); John J. McConnell & Chris J. Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*, 14 J. FIN. ECON. 399, 415 (1985) (study of capital expedienture announcements).

[122]*See* Michael E. Porter, *Capital Choices: Changing the Way America Invests in Industry*, 5 J. APPLIED CORP. FIN. 4, 5-6 (1992); Anabtawi & Stout, *supra* note 8, at 1291 ("[S]tock price can be driven upward temporarily by increasing short-term earnings at the expense of long-term results, e.g., by cutting research and development."); Bratton, *supra* note 19, at 1359 (stating that activist shareholders often push to cut "excess" costs like R&D).

with lower R&D.[123] Activist hedge funds tend to target companies with below-average R&D.[124] Institutional ownership in public companies is associated with *more* innovation (as measured by patents).[125]

It is significant that activist investors never declare that they want a company to cut R&D since they are not reticent when they seek other changes. If some investors secretly urged cuts in R&D, managers could divulge the fact themselves, but this never happens either. Changes sought by activists typically cause a firm's stock price to rise, but increases (rather than cuts) in R&D usually raise stock price,[126] so there is no reason to think that rational investors would want to cut R&D. If any shareholder(s) tried to lower a firm's R&D, other investors would have an incentive to oppose that effort, yet such conflicts are never reported.

Indeed, there is evidence that weak shareholders are associated with *lower* R&D. Some studies find that companies that have strong takeover defenses (which managers favor and sophisticated investors dislike) or adopt new defenses *reduce* investment in R&D and in general.[127] In sum, the charge that activist investors try to cut corporate R&D seems meretricious.

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[123] *See* OFFICE OF THE CHIEF ECONOMIST, SEC. & EXCH. COMM'N, INSTITUTIONAL OWNERSHIP, TENDER OFFERS, AND LONG-TERM INVESTMENTS 6 (1985) ("[T]he higher the institutional holdings in a firm, the higher is its R&D activity."); Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 330 (1998) (empirical study finding that "managers are significantly less likely to cut R&D to reverse an earnings decline when institutional ownership is high," with certain exceptions); Parthiban David et al., *The Influence of Activism by Institutional Investors on R&D*, 44 ACAD. MGMT. J. 144, 148-49 (2001) (finding that institutional investor activism increased R&D inputs over both short and long terms).

[124] *See* Brav et al., *supra* note 81, at 7 (showing that these targets "tended to have low[er] levels of R&D spending . . . than non-targeted firms"). *But see* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755 (2008) (questioning the statistical significance of the relationship between a firm's level of R&D and its attractiveness to hedge funds).

[125] *See* Philippe Aghion et al., *Innovation and Institutional Ownership* 3-7 (Univ. of Chi. Booth Sch. of Bus., Working Paper No. 09-05, 2009), *available at* http://ssrn.com/abstract=1348142 (empirical study).

[126] *See* J. Randall Woolridge, *Competitive Decline and Corporate Restructuring: Is a Myopic Stock Market to Blame?*, 1 J. APPLIED CORP. FIN. 26, 33-34 (1988). *See generally* McConnell & Muscarella, *supra* note 121, at 415 (comparing the effect of budget increases and decreases in several areas, including R&D).

[127] *See* JACOBS, *supra* note 13, at 108 (citing a study by the SEC's Office of Economic Analysis); Olubunmi Faleye, *Classified Boards, Stability, and Strategic Risk Taking*, 65 FIN. ANALYSTS J. 54, 61 (2009) (showing that companies with staggered boards invested less in R&D); Bøhren et al., *supra* note 93, at 3 ("[L]ess monitoring by owners makes managers invest less rather than more in order to enjoy the quiet life.").

The charge that myopic shareholders force short-termism on farsighted managers seems not only wrong but backwards. To the extent that myopia is a problem, it stems from the managers, not the shareholders.

B. *Going Private*

It is also argued that the trend of public companies to go private is spurred by investor short-termism: eliminating public shareholders frees visionary managers to build long-term value.[128] This indictment is also feeble. First, going private has benefits unrelated to operations. Private firms avoid the costs of compliance with many provisions of the Sarbanes-Oxley Act and the SEC's reporting requirements for public companies.[129] Private firms can also keep their activities secret from competitors, suppliers, customers, and others who could use information to the firms' detriment.

It is true, however, that some of the gains from going private stem from operational changes or restructuring. The question, though, is whether those changes are possible only after eliminating public investors. The answer is no. Typically, firms that go private do not take steps resisted by shareholder activists, like making corporate acquisitions, expanding operations, raising employee pay, or reducing debt. On the contrary, they tend to take the opposite steps, which are generally favored and often urged by investors.[130]

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[128]*See* Dale A. Oesterle, *Are Leveraged Buyouts a Form of Governance Arbitrage?*, 3 BROOKLYN J. CORP. FIN. & COM. L. 53, 67 (2008). In private companies "investors appreciate longer time horizons. In publicly-traded companies, executives often feel the need to focus on quarterly results and are more risk averse to longer term gambles." *Id.* (footnote omitted); *see also* Stout, *Bolshy Investors*, *supra* note 5 (stating that private companies can "avoid dealing with public shareholders' loud and often conflicting demands").

[129]The enactment of the Sarbanes-Oxley Act was followed by an increase in going private transactions. *See, e.g.*, Stanley B. Block, *The Latest Movement to Going Private: An Empirical Study*, 14 J. APPLIED FIN. 36, 36-37 (2004); Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCT. & ECON. 116, 126-27 (2007); Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, 25 J.L. ECON. & ORG. 107, 117 (2008). It was also followed by an increase in firms "going dark," i.e., deregistering without eliminating all public shareholders. *See* Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 183 (2008) ("[W]e find that the time pattern of going-dark decisions is closely associated with the passage of SOX.").

[130]*See* David Haarmeyer, *Private Equity: Capitalism's Misunderstood Entrepreneurs and Catalysts for Value Creation*, 13 INDEP. REV. 245, 246-47, 254-59 (2008) (describing how private-equity owned firms align the interests of managers and investors and avoid waste);. Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 227-30 (2009); Karen H. Wruck, *Private Equity, Corporate Governance, and the Reinvention of the Market for Corporate*

Why are these measures embraced only after a company goes private? The answer cannot be that after going private a firm gets better management, because the old managers usually remain. But the managers' incentives change. A behavioral psychologist would say that the managers' schedule of reinforcement is altered. First, shareholder monitoring changes. When a company goes private, a "private equity" or "leveraged buyout" (LBO) firm usually buys most of the equity. These investors have the same basic values and world views as institutional investors in public companies. Indeed, their funding comes largely from the very institutions often accused of myopia.[131] The behavior of companies controlled by private equity and LBO firms belies the charge—the private equity and LBO firms and their own institutional investors all want long-term value.

And they usually get it. They face none of the obstacles to control that hinder shareholders of public companies. If managers of a private firm attempt the value-destroying actions common to public companies or eschew the value-increasing steps that public companies often spurn, the LBO firm would overrule the managers and probably fire them. They stop the waste that often plagues CEO-dominated public companies.[132]

Further, the structure of executive compensation is very different in private companies. Unlike managers of public firms, who can doctor their "incentive compensation" so that they profit even if the firm slides,[133] managers of private firms are rewarded only if the firm succeeds.[134] Put another way, in public companies the interests of managers and of shareholders often clash, while in private firms the managers' compensation

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Control, 20 J. APPLIED. CORP. FIN. 8, 9 (2008) (describing "the combination of high leverage, strong governance, and increased management equity ownership as key contributors to the success" of companies taken private in leveraged buyouts). Among other things, debt in the form of bank loans results in bank monitoring, which improves corporate performance. *See* Joanna Shepherd et al., *What Else Matters for Corporate Governance?: The Case for Bank Monitoring*, 88 B.U. L. REV. 991, 991, 996, 1017-20 (2008).

[131] *See* Ballabon, *supra* note 12, at 26.

[132] *See* Haarmeyer, *supra* note 130, at 247 (stating that private-equity control "helps to check the resource waste and corporate malfeasance that often hold back, if not sink, public companies").

[133] *See* Oesterle, *supra* note 128, at 64 ("Managers in publicly-traded companies . . . do well even if investors do not."). For example, CEOs tend to get bigger compensation from making acquisitions "irrespective of acquisition performance," unless there is strong shareholder involvement in governance. Jerayr Haleblian et al., *Taking Stock of What We Know About Mergers and Acquisitions: A Review and Research Agenda*, 35 J. MGMT. 469, 475 (2009).

[134] *See* Oesterle, *supra* note 128, at 64 ("[T]he executives in buyout fund portfolio companies participate more heavily in upside gains and downside losses than do the executives in publicly-traded companies."); *id.* at 68 ("A far larger share of executive pay [in private firms] is tied to the performance of the business.").

is structured so that their interests largely coincide with those of the outside shareholders, i.e., the LBO firms.[135]

C. *The Real Problem and Its Cure*

That value-enhancing steps are often taken only after a public company goes private shows that there is a problem. The problem, however, is not that overly powerful investors with a short-term fixation force public companies into actions that impair long-term value, but rather, the opposite—investors hampered by the separation of ownership and control try, but often fail, to get managers who are pursuing their own interests to take steps that increase share value and to forego or rescind steps that impair share value.[136]

There may be some truth to the claim that going private frees executives from pressures to focus on quarterly results, but that pressure does not stem from investor short-termism. Because CEOs dominate most public companies, including their public disclosures, investors are often unsure whether they are getting accurate information. Given this uncertainty, they may take an unexpected drop in earnings as a sign of long-term trouble. Because of this uncertainty, executives must devote much of their time to public relations.[137] Nonetheless, executive reassurances are likely to be discredited as self-serving.

The cure, then, for the disadvantage that public companies seem to suffer in comparison with private firms is not to keep shareholders weak or to cripple them further, but to vest them with real control. The board would then instruct executives to maximize firm value for the benefit of shareholders—as they do in private firms. With shareholders in control, investors would also trust corporate disclosure. Explanations about unexpected short-term incidents would be taken seriously. Executives would not be pressured to focus on quarterly results.

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[135]Conversely, when companies go public, executive compensation plans are likely to change in ways that will injure corporate performance. The trend of banks to go public in the 1970s may have helped lead to the errors that caused the recent bank meltdown. *See* Cenk Uygur, *The Flaw in the System: The Bankers Don't Care About the Banks*, HUFFINGTON POST, Mar. 2, 2009, *available at* http://huffingtonpost.com/cenk-uygur/the-flaw-in-the-system-th_b_170963.html.

[136]Thus shareholder weakness is associated with *less* investment, including less investment in R&D. *See supra* note 127.

[137]*See* PAUL ARGENTI & JANIS FORMAN, THE POWER OF CORPORATE COMMUNICATION 64 (2002) (estimating that CEOs of public companies spend up to 80% of their time on "communicating to constituencies").

Even the Aspen Institute's Corporate Values Strategy Group, whose members include the Business Roundtable and the U.S. Chamber of Commerce which consider short-termism a serious problem,[138] does not call for weakening shareholders generally or short-term shareholders in particular.[139] Its primary focus is on executive compensation that may encourage myopia.[140] That focus is justified. A CEO may inflate (or depress) the company's share price by reporting false news, then dumping her own stock (or buying more) before the market learns the truth.[141] Many CEOs also choose

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[138]*See supra* note 20 and accompanying text.

[139]It does support "an amplified voice for long-term investors and . . . explicit efforts to communicate with long-term investors" and says "[b]oards and long-term oriented investors should communicate on significant corporate governance and executive compensation policies and procedures." ASPEN CORPORATE GOVERNANCE PRINCIPLES, *supra* note 20, at 2-3. Although the preference for "long-term investors" (which it never defines) may not make sense, it is no cause for concern since the interests of shareholders are largely congruent.

[140]*See id.* at 3; *see also* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 93 (2009) ("The tendency of corporate management . . . to maximize short-run profits . . . is strengthened if, as on Wall Street during the boom, executive compensation is both very generous and truncated on the downside."); Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence, in* KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 320 (John C. Coffee, Jr. et al. eds., 1988) ("Sometimes [myopic behavior] occurs when managers hold little stock in their companies and are compensated in ways that motivate them to take actions to increase accounting earnings rather than the value of the firm."); Zingales, *supra* note 101, at 413 ("[T]he 2007 to 2008 financial crisis is perceived as a manifestation of excessive risk taking by managers who were enriching themselves with short-term bonuses while destroying the long-term value of their companies."); Jeff Madrick, *How We Were Ruined & What We Can Do, in* THE NEW YORK REVIEW OF BOOKS, Feb. 23, 2009, at 17 ("The ability to take immediate [personal] profits from fees on risky loans infected the financial industry and eventually the entire economy, and made possible disproportionately large annual bonuses."); David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay* 4 (Boston Univ. Sch. of Law, Working Paper No. 09-22, 2009), *available at* http://ssrn.com/abstract=1396663 ("Perhaps the leading corporate governance concern of legislators and commentators at the present is the reckless pursuit of short-term profits by corporate executives who will have cashed out before the long-term repercussions are felt.").

[141]*See* ROBERT H. TILLMAN & MICHAEL L. INDERGAARD, PUMP AND DUMP: THE RANCID RULES OF THE NEW ECONOMY 4-5 (2005); David C. Cicero, *The Manipulation of Executive Stock Option Exercise Strategies: Information Timing and Backdating*, 64 J. FIN. (forthcoming 2009) (examining stock price patterns that suggest executives use private information to increase the profitability of stock option exercises); Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667, 667 (2007) (finding "that the likelihood of a misstated financial statement increases greatly when the CEO has very sizeable holding of in-the-money stock options"); Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 456 (2008) ("[M]anagers . . . often inflate the short-term stock price before selling to boost their trading profits."); John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ* 6-8 (Ctr. for Law & Econ. Studies, Working Paper No. 274, 2005), *available at* http://ssrn.com/abstract=694581 (noting that an industry-wide shift to equity-based compensation created incentives for market and accounting manipulation); Walker, *supra* note 140, at 4 (discussing "earnings manipulation, which often involves sacrificing long-term value to boost

accounting methods that maximize reported earnings instead of share price, even though the choice requires the company to pay higher taxes.[142] Some waste corporate funds in "empire building"; others choose a "quiet life" by *under*investing corporate funds.[143] Thus, some call the claim that CEOs manage for the long-term "bogus."[144] Regulation of executive compensation may have made matters worse.[145]

Although executive compensation can be improved to align the managers' incentives more closely with the shareholders', "even the optimal pay arrangement would be more short-term focused than shareholders would prefer."[146] Part of the problem is that "executives are inherently more risk averse than diversified shareholders."[147] Also, objective measures of firm performance are never perfect. Thus, in private firms, compensation is "based more on subjective than objective performance measures."[148] The use of subjective measures, however, requires the judgment of directors pursuing shareholder benefit.

Institutions that hold a stock briefly monitor the issuer less than institutions that hold for longer periods.[149] However, this says nothing about the business strategy that either group of owners favor for portfolio firms.

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near-term earnings") (footnote omitted); *see also* Bruce Billings et al., Managers' Incentives to Avoid Meeting or Beating Earnings Expectations: The Role of Open Market Repurchases 1 (Jan. 12, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1266889 (empirical study finding that some managers "opportunistically avoid reporting earnings that meet or beat analyst expectations to depress stock prices and hence lower the cost of share repurchases"); Ronald R. Mau & Catherine Shenoy, CEO Compensation: Does Performance Matter? 1 (July 8, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1431490 (analyzing results that "suggest CEOs are able to increase their compensation before exceptionally bad performance through the timing of [stock] option exercises").

[142]*See* Sanjay Deshmukh et al., *Stock Option Expensing: The Role of Corporate Governance*, 20 J. APPLIED CORP. FIN. 122, 123 (2008) ("[C]ompanies often make accounting decisions designed to boost reported earnings."); David I. Walker, *Financial Accounting and Corporate Behavior* 14-15 (Boston Univ. Sch. of Law, Law & Econ. Working Paper No. 06-05, 2006), *available at* http://ssrn.com/abstract=894002; *see also* Anne Beatty, How Does Changing Measurement Change Management Behavior?: A Review of the Evidence 18 (Feb. 14, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=975234 (finding that accounting changes affect corporate behavior when they affect managers' compensation).

[143]*See* Dent, *supra* note 121, at 1247.

[144]Nocera, *supra* note 100.

[145]*See* Walker, *supra* note 140, at 7 ("[P]ast regulation of executive pay may have encouraged compensation design that promotes short-termism.").

[146]*Id.* at 6.

[147]*Id.* at 10.

[148]Cynthia E. Devers et al., *Executive Compensation: A Multidisciplinary Review of Recent Developments*, 33 J. MGMT. 1016, 1020 (2007).

[149]*See* Xia Chen et al., *Monitoring: Which Institutions Matter*, 86 J. FIN. ECON. 279, 283 (2007) (noting that "monitoring benefits increase with the size of the investment stake"); José-Miguel Gaspar et al., *Shareholder Investment Horizons and the Market for Corporate Control*, 76 J. FIN. ECON. 135, 137 (2005).

Short-term owners may not monitor much, but there is no evidence that they pressure managers to take steps that impair share value. If some investors did so, other shareholders would oppose them; "short-termists" could prevail only if they owned a majority of the stock. There is no evidence that this ever happens.[150]

To the extent that shareholders fail to monitor, it is partly due to regulations that limit their ability to do so.[151] Several restraints limit the ability of mutual funds to monitor and play an active role in portfolio companies.[152] Some of these (like the need of open-end funds to maintain enough liquidity to cover redemptions) are practical. Others, though, are regulatory and could be eliminated or relaxed.[153]

V. SHAREHOLDERS ARE KNOWLEDGEABLE

A. *Investor Sophistication and Capital Market Efficiency*

As critics of shareholder power allege, not all owners of common stocks are financially sophisticated or even rational,[154] but this fact has little relevance for the efficiency of capital markets. If uninformed or irrational investors push the price of a market commodity too low (or too high), knowledgeable investors can profit by purchasing the underpriced (or selling the overpriced) commodity. Only a critical mass of sophisticated investors is needed for a market to be efficient, and if these investors are well funded, the critical mass need not be large—perhaps as small as one. Shareholders do not need to be knowledgeable about operational questions (on which they do not vote), but only on "rules-of-the-game" issues (on which they do vote).[155] These issues "typically do not turn on inside, company-specific information."[156]

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[150] *See* Chen et al., *supra* note 149, at 300-01.

[151] *See* Haarmeyer, *supra* note 130, at 259-60.

[152] *Id.*

[153] *See id.* (listing diversification requirements, restrictions on short selling and leverage, bars on performance-based compensation, and disclosure obligations); *see also* Kahan & Rock, *supra* note 61, at 1050 (explaining how regulations complicate performance fees associated with mutual funds).

[154] *See supra* notes 22-23 and accompanying text.

[155] *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 881 (2005).

[156] *Id.* Thus, claims that investors do or should cede control to managers, see *supra* note 5, are clearly wrong. Rather, investors will delegate most operational decisions to the managers but retain ultimate control. *See* Milton Harris & Artur Raviv, *Control of Corporate Decisions: Shareholder vs. Management* 9 (CRSP, Working Paper No. 620, 2008), *available at*

The sophistication of shareholders seems to be growing, and occasionally shareholders form groups to help themselves understand issues that are especially complex or where management disclosures are opaque.[157] Moreover, the allocation of power between managers and shareholders should not depend solely on who is more knowledgeable, but also on who has the better incentives to make the wealth-maximizing choice. Managers may be better informed but, especially on rules-of-the-game issues, they often have personal interests that conflict with wealth maximization.[158] Taking all this into account, the conditions for reasonable efficiency are clearly obtained in the major stock markets for American public companies.[159]

B. *Proxy Voting*

The prudence of investors in general—and of institutional investors in particular—is evidenced by their proxy voting behavior.[160] They tend to make and to favor proposals that increase shareholders' value.[161]

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http://ssrn.com/abstract=965559 (analysis based on formal model).

[157] *See* Angela Morgan et al., *The Evolution of Shareholder Voting for Executive Compensation Schemes*, 12 J. CORP. FIN. 715, 723 (2006) (concluding that shareholders have become "more sensitive to potentially harmful [executive compensation] plan provisions"); Rock, *supra* note 91, at 449-51 (describing examples of informed activism by institutional shareholders); *see also* Gretchen Morgenson, *Hear Ye, Hear Ye: Corralling Executive Pay*, N.Y. TIMES, June 17, 2007, § 3, at 1 (describing the formation of a group of Verizon Communications shareholders and the group's criticism of compensation proposals).

[158] *See* Devers et al., *supra* note 148, at 1029.

[159] Despite the presence of irrational investors in the market place,

> logic—not blind faith—provides a compelling reason for believing that publicly traded U.S. equities are priced efficiently. The essence of the efficient market hypothesis is that if there is unclaimed money lying around that can be picked up without effort and without loss of integrity[,] people will take it until it is gone.

Mark Klock, *Contrasting the Art of Economic Science with Pseudo-Economic Nonsense: The Distinction Between Reasonable Assumptions and Ridiculous Assumptions* 23 (Penn State Univ. Dickinson Sch. of Law, Legal Studies Research Paper No. 03-2008, 2009), *available at* http://ssrn.com/ abstract=1136810; *see also* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 55 (1995) ("The public's valuation of a company in the marketplace has unique value, because it is the only judgment that cannot be manipulated."); Henry Manne, *Remarks on the Lewis & Clark Law School Business Law Forum: Behavioral Analysis of Corporate Law: Instruction or Distraction?*, 10 LEWIS & CLARK L. REV. 169, 175 (2006) ("[M]ere 'irrationality' on the part of some stock market participants cannot foil an otherwise efficient market.").

[160] *See* Bebchuk, *supra* note 155, at 876-77; *see also* Bebchuk, *supra* note 96, at 1799-1801 (arguing that shareholders only approve resolutions widely viewed as serving their interests).

[161] *See* Bebchuk, *supra* note 96, at 1799-1801; Angela Morgan et al., Mutual Funds as Monitors: Evidence from Mutual Fund Voting 1 (July 7, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1431072 (finding that "mutual funds vote more affirmatively for wealth increasing proposals and that funds' voting approval rates for these beneficial resolutions are significantly higher than those of other investors").

Shareholders often pressure companies to eliminate staggered boards,[162] which have been shown to reduce share value.[163] More shareholder proposals are submitted to firms that have performed poorly and have weak corporate governance.[164] If shareholders vote unwisely, one would expect that expanding the duty of boards to obtain shareholder approval would be perceived by the market as detrimental and cause stock prices to fall. In fact, the contrary is true. Legislation giving shareholders a "say on pay" increased share values.[165]

How careful are institutional investors in proxy voting? Traditionally, most institutions rationally spent little time and money making voting decisions since each institution (with rare exceptions) owned only a small fraction of the stock of any company and its vote was unlikely to alter the outcome of a particular resolution.[166] Although this obstacle to shareholder

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[162] *See* Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 DEL. J. CORP. L. 149, 155-58 (2008) (describing frequent efforts by institutional investors to destagger boards).

[163] *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410-11 (2005) (showing a negative correlation between the presence of a staggered board and share value); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 936-39 (2002) (establishing that staggered boards allow directors too much independence from shareholders, resulting in lower target share value after a hostile bid); Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501, 528 (2007) (finding that "classified boards entrench management by focusing on CEO turnover, executive compensation, proxy contests, and shareholder proposals"); Michael D. Frakes, *Classified Boards and Firm Value*, 32 DEL. J. CORP. L. 113, 150-51 (2007) (recognizing the negative effects of classified boards). Similarly, declassifying boards increases share value. *See* Faleye, *supra*, at 514-15; Ganor, *supra* note 162, at 185-86 (presenting results of empirical study showing a correlation between destaggering and increased share value). Companies with staggered boards also invest less in R&D. *See* Faleye, *supra* note 127, at 59-61.

[164] *See* Luc Renneboog & Peter G. Szilagyi, *Shareholder Activism Through the Proxy Process* 14-15 (CentER Discussion Paper Series, Paper No. 2009-65, 2009), *available at* http://ssrn.com/abstract=1460578 (empirical study). Also, "mutual funds are more likely to vote against management in poorly governed firms." Duan, *supra* note 103, at 18; *see also id.* at 14 (explaining how the quality of corporate governance and not a firm's performance affects mutual funds' voting decisions).

[165] *See* Jie Cai & Ralph A. Walkling, *Shareholders' Say on Pay: Does It Create Value?* 26-27 (Drexel Coll. of Bus., Research Paper No. 2008-06, 2009), *available at* http://ssrn.com/abstract=1030925 (finding adoption of federal say-on-pay bill increased share values); John C. Coates, IV, *Testimony Before the Subcommittee on Securities, Insurance, and Investments of the Committee on Banking, Housing, and Urban Affairs* (Harvard Law Sch., Public Law & Legal Theory Working Paper No. 09-56, 2009), *available at* http://ssrn.com/absstract= 147355 (reporting that say-on-pay has been beneficial in several other countries). *But see* Stephen M. Bainbridge, *Is "Say on Pay" Justified?*, REGULATION, Spring 2009, at 42 (questioning the need for shareholder "say on pay").

[166] One study finds that, on average, each mutual fund holds 0.13% of each portfolio firm's stock, and each mutual fund family holds 0.45%. Duan, *supra* note 103, at 8. Tax laws deter mutual funds from owning more than 5% of the stock of any portfolio company. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 552 (1990); Kahan & Rock,

activism persists, several factors are causing shareholders to be more assertive.[167] Institutions can cheaply follow the advice of one of the proxy advisory services, of which ISS Governance Services (ISS) is the most widely used.[168] Further, proxy advisors "often announce their recommendations to the public,"[169] so that nonsubscribers can follow them. These recommendations influence proxy voting.[170] And positive ISS recommendations are associated with a positive stock price effect.[171]

Some fears have been expressed about the influence of proxy advisors. In particular, questions have been raised about the possibility that, because of its corporate consulting, ISS is subject to conflicts of interest that subvert the objectivity of its voting recommendations.[172] A recent study

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supra note 61, at 1049. Collectively, however, institutions on average own 70.04% of portfolio firms' stock. Duan, *supra* note 103, at 9. If a fund owns less of a company's stock than do some competing funds, any success it achieves in raising the value of that company's stock would benefit those competitors more than itself. On the disincentives to activism, see *infra* notes 175-81.

[167] *See* Romano, *supra* note 117, at 175 ("Institutional investors have, in the past decade, increasingly engaged in corporate governance activities.").

[168] *See* Stephen J. Choi et al., *Director Elections and the Influence of Proxy Advisors* 3 (NYU Law and Econ. Research Paper Series, Working Paper No. 08-22, 2008), *available at* http://ssrn.com/abstract=1127282 (stating that "[m]ost institutional investors subscribe to one or more proxy advisors" and calling ISS "the dominant player in the market with over 2700 corporate and institutional subscribers"); *see also* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 889-91 (2007) (describing the breadth of influence of proxy advisory services). ISS, formerly Institutional Shareholder Services, was acquired by RiskMetrics Group in 2007. *See* RiskMetrics Group History, http://www.riskmetrics.com/history (last visited Sept. 4, 2009). Other proxy advisory firms include Glass Lewis, Egan-Jones, Proxy Governance, and CtW Investment Group. Choi et al., *supra*, at 3.

[169] Choi et al., *supra* note 168, at 3.

[170] *See* Jie Cai et al., *Electing Directors*, 64 J. FIN. (forthcoming 2009) (manuscript at 16, *available at* http://ssrn.com/abstract=1101924) (finding that a negative ISS recommendation lowers the vote for a director by 19% on average in uncontested elections); Cindy R. Alexander et al., The Role of Advisory Services in Proxy Voting (July 2009) (Nat'l Bureau of Econ. Research, Working Paper No. W15143, 2009), *available at* http://www.nber.org/papers/w15143; James Cotter et al., *The Effect of ISS Recommendations on Mutual Fund Voting* (Vanderbilt Univ. Law Sch., Law & Econ. Working Paper No. 09-20, 2009) *available at* http://ssrn.com/abstract=1477564. A recent study, however, finds "that advisor recommendations in general, and those of ISS in particular, appear to be less influential than commonly perceived." Choi et al., *supra* note 168, at 51. In effect, the advisors simply do the spade work in applying principles that investors already embrace to specific voting situations; they do not pursue a separate agenda.

[171] *See* Alexander et al., *supra* note 170, at 4.

[172] Rose, *supra* note 168, at 906-07; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, ISSUES RELATING TO SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 2-4 (2007), *available at* http://www.gao.gov/new.items/d07765.pdf; Choi et al., *supra* note 168, at 3-4. GAO found that "[v]arious potential conflicts of interest can arise at proxy advisory firms that could affect vote recommendations, but SEC has not identified any major violations in its examination of such firms." *Id.* The study, however, also said that "all institutional investors [GAO] spoke with that use ISS's services said they are satisfied with" its mitigation procedures. *Id.* at 4. Nonetheless, some believe "there remains reason to question the steps' effectiveness." *Id.*

concludes that these fears are unfounded. "[P]roxy advisors act primarily as agents or intermediaries which aggregate information that investors find important in determining how to vote in director elections rather than as independent power centers."[173] Further, proxy advisors other than ISS have appeared since 2003.[174] By introducing competition, they reduce the ability of ISS to make recommendations that harm shareholders.

The growing influence of proxy advisors is changing the cost-benefit equation for shareholder activism. In the past, most institutions hewed to the Wall Street rule—vote with management or sell. Activist shareholders could not expect much support from these institutions, even if they urged steps that would elevate share value. This lack of coordination had little to do with shareholders' having conflicting preferences. The main reason was, and still is, a collective action problem. That is, stockholders who engage in activism incur costs; but, if they succeed, the benefits are shared by all stockholders, including those who were passive. Thus, it paid to be passive and "free ride" on the activism of others.[175] This was especially true for index funds, which compete by "keep[ing] expenses as low as possible."[176] The ability of proxy advisors to help institutions become more assertive is evidenced by the backlash from some guardians of CEO primacy who now advocate restrictions on advisors.[177]

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[173]Choi et al., *supra* note 168, at 51-52; *see also* Santella et al., *supra* note 26, at 41 (concluding that "the voting of institutional investors is a collective process worked out by the voting advice providers under the collective guidance of institutional investors that subscribe to their services and interact with their voting advisors"). These conclusions belie some earlier fears that proxy advisors recommendations were based on "Wall Street superstitions" and "clichés and myths, rather than on genuine research." Jeffrey Sonnenfeld, *Good Governance and the Misleading Myths of Bad Metrics*, 18 ACAD. OF MGMT. EXECUTIVE 108, 108 (2004).

[174]*See* Choi et al., *supra* note 168, at 2, 7.

[175]*See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 849 (1999) (stating that the two traditional collective action problems facing shareholders are "costs of communication, negotiation, and coordination" and "free-riding"); Robert Monks & Allen Sykes, *Capitalism Without Owners Will Fail: A Policymaker's Guide to Reform*, 57 CTR. FOR THE STUDY OF FIN. INNOVATION 14 (2002) ("Passive institutions gain 95% or more of the benefit from any successful shareholder action at *no cost*—and with a real chance of winning business away from the more activist group."); Shann Turnbull, Invigorating Capitalism 4 (Aug. 2003) (6th Int'l Conf. on Corp. Governance & Bd. Leadership Paper), *available at* http://ssrn.com/abstract=437981 (stating that cost-benefit analysis, free riders, and uncertain outcomes prompt "institutional shareholders to be 'reluctant,' apathetic or negligent in exercising their ownership rights").

[176]Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1083 (2008).

[177]*See id.* at 1084 n.18 (proposing "prohibiting mutual and pension funds from utilizing proxy voting recommendations services unless those services publicly disclose" specified information).

There are also limits on what shareholders can do even if they muster a majority. In Delaware, shareholders alone cannot amend the corporate charter.[178] Shareholders who cooperate in activism can be deemed a "group." If together they own over 5% of a company's stock, they all must comply with the burdensome disclosure requirements of section 13(d) of the Williams Act.[179] If they own over 10%, they can become subject to the insider reporting and short-swing trading provisions of the Securities Exchange Act.[180] At higher levels of aggregate ownership, they may trigger poison pills.[181]

Although deterrents to shareholder activism have not vanished, other developments are abetting activism. In addition to tacit cooperation through proxy advisory services, the percentage of shares of public companies held by institutions continues to grow.[182] The recent emergence of hedge funds is also significant. They are more assertive than other shareholders because they have fewer regulatory restrictions and have different incentive structures.[183] "Hedge fund activism has resulted in an increased number of

[178]*See* DEL. CODE ANN. tit. 8, § 242(b) (2001) (requiring a board resolution before shareholder approval to amend the charter). The Model Business Corporation Act, which is followed in many states, is the same. *See* MODEL BUS. CORP. ACT § 10.03 (2007). States that do allow the shareholders to amend the charter sometimes require a supermajority vote to do so. *See* OHIO REV. CODE ANN. § 1701.71 (LexisNexis 2004) (requiring a two-thirds shareholder vote to amend the charter).

[179]*See* Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2006); *see* Black, *supra* note 166, at 544 (discussing the deterrent effect of section 13(d)); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 840-42 (1994).

[180]Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p(a)-(b).

[181]*See* Black, *supra* note 166, at 550-51 (describing the typical flip-in pill's ownership threshold as between 10% and 20%).

[182]In 1965, institutions owned 16% of U.S. equities; by 2001, they owned 61%. *See* SEC. INDUS. ASS'N, SECURITIES INDUSTRY FACT BOOK 2002, at 66 (2002). More recently their ownership passed 70%. *See* Duan, *supra* note 103, at 9.

[183]*See* Clifford, *supra* note 81, at 3-5, 7-11, 30-31 (discussing the advantages of hedge funds over other institutional investors); Zanoni, *supra* note 65, at 4-5 (describing the ability of hedge funds to employ greater leverage, engage in short selling, and invest in illiquid assets). Robert Illig ascribes the greater activism of hedge funds to greater compensation incentives for their executives than for executives of other institutional investors. Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 231, 282-87 (2007). He suggests that the executives of mutual funds be granted similar incentives to make these funds more assertive. *Id.* at 231, 332-35. Hedge funds usually get a percentage of the fund profits as "performance fees." *See* Hennessee Group LLC, 13th Annual Hedge Fund Manager Survey (2007), http://www.hennesseegroup.com/information/index.html (last visited Oct. 24, 2009) (charting performance fees of hedge funds). Hedge funds are also free of some of the regulatory restrictions that apply to other investment companies. Private equity funds also have performance fees labeled "carried interest." *See* Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. (forthcoming 2010) (manuscript at 4, 9-10, 30, *available at* http://ssrn.com/abstract=996334); Ludovic Phalippou & Oliver Gottschalg, *The*

election contests" for corporate boards.[184] Activist hedge funds often enlist other institutions for joint action.[185] Coordination of shareholders is further abetted by the creation of the Investors for Director Accountability, which intends to organize investors to "press directors to act in the interests of the stockholders."[186]

Some ground rules are also changing to the advantage of shareholders. Traditionally, in board elections, seats were filled by the candidates receiveing the most votes, no matter how few those votes were.[187] Since the official board nominees almost always run unopposed,[188] they generally needed only one vote each to prevail. Now, a growing number of companies are adopting rules requiring a majority vote to elect directors.[189] This greatly increases the ability of shareholders to remove unsatisfactory directors. The SEC's 1992 proxy rule changes also facilitate cooperation among share-holders.[190]

The behavior of institutional investors shows that they particularly value voting rights in certain situations. Mutual funds sometimes buy shares of a company shortly before the record date and then vote against management.[191] Investors dissatisfied with management can "exit" by selling their stock, rather than "fight" by voting against management. However, when ISS recommends a vote against management, mutual funds are much more likely to vote against management than to sell.[192] Mutual funds with large holdings are also more likely to vote against management when their votes

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Performance of Private Equity Funds, 22 REV. FIN. STUD. 1747, 1764-67 (2009); Charles F. Beauchamp, Performance and Fee Structure Within the Private Equity Industry (Mar. 2007) (Middle Tennessee State University Finance Presentation at the Financial Management Association 2007 Annual Meeting, on file with author).

[184] Choi et al., *supra* note 168 at 4.

[185] *See* Briggs, *supra* note 61, at 691, 697-98, 721 (describing "wolf pack tactics"); Mara Der Hovanesian, *Attack of the Hungry Hedge Funds*, BUS. WK., Feb. 20, 2006, at 72 (describing coordinated efforts, including the seeking of board seats).

[186] Gretchen Morgenson, *Fund Manager, It's Time to Pick a Side*, N.Y. TIMES, Mar. 26, 2006, § 3, at 1. The organization has "urged investors to keep the heat on their companies' boards." Gretchen Morgenson, *Too Many "No" Votes To Be Ignored*, N.Y. TIMES, Sept. 20, 2009, § 3, at 1, 2 [hereinafter Morgenson, *No Votes*].

[187] *See* Denise F. Brown, *Updated Study Shows Majority Voting Being Adopted at "Breathtaking Speed,"* 5 BNA CORP. ACCOUNTABILITY REP. 190 (2007).

[188] Proxy fights are extremely rare. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 559 (2005).

[189] Brown, *supra* note 187. This shows that "in the battle between owners and managers[,] . . . investors are gaining power." Jena McGregor, *Activist Investors Get More Respect*, BUS. WK., June 11, 2007, at 34.

[190] *See* Briggs, *supra* note 61, at 686-89; Coffee, *supra* note 179, at 840-41.

[191] *See* Duan, *supra* note 103, at 4 ("Mutual funds are more likely to buy stock in younger, growth firms (low book-to-market ratios) before the vote when they vote against management in these firms.").

[192] *See id.* at 12, 18. The tendency is especially strong for institutions with larger holdings. *Id.* at 13.

are more likely to alter the outcome.[193] In general, mutual funds have become more active in their proxy voting.[194] Private equity and hedge funds have stronger motives to raise share price and, not surprisingly, are more assertive than other institutional investors.[195]

Support for shareholder proposals has grown, especially for those opposing antitakeover devices.[196] More shareholder proposals are for binding bylaw amendments, rather than the traditional precatory requests.[197] There have been "more and more closely fought merger votes."[198] Such behavior belies claims that shareholders prefer to be powerless and cede control to directors they have not chosen.[199] Corporate boards are getting the message and paying greater heed to successful shareholder resolutions.[200]

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[193] *See id.* at 15.

[194] *See* Daniel Gross, *Some Mutual Funds Are Joining the Activist Bandwagon*, N.Y. TIMES, Jan. 15, 2006, § 3, at 5.

[195] *See supra* notes 183-85 and accompanying text.

[196] *See* Renneboog & Szilagyi, *supra* note 164, at 11 (presenting results of an empirical study showing that average support rose from 28.7% in 1996 to 37.1% in 2005); *see also* Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 369, 377-78 (2007). "[P]roposals targeting antitakeover devices achieved by far the most voting support at an average of 53.4% of the votes cast. In fact, . . . 84% received majority support in 2005." Renneboog & Szilagyi, *supra* note 164, at 11. The number of annual proposals from 1996-2005 was also twice that for 1987-1994. *Id.* at 10. Investors generally react favorably to shareholder proposals. *See id.* at 12 (documenting "significantly positive market reations"). Investors were also able to distinguish beneficial proposals from others based on both the nature of the proponent and the subject matter of the proposal. *See id.* at 13.

[197] *See* Mark Maremont & Erin White, *Stock Activism's Latest Weapon*, WALL ST. J., Apr. 4, 2006, at C1.

[198] Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1229 (2008). Even the number of "no" votes for corporate directors running unopposed his increased. *See* Morgenson, *No Votes, supra* note 186.

[199] *See supra* note 5 and accompanying text.

[200] A recent study of 620 nonbinding shareholder resolutions that obtained majority support found that the rate of board implementation almost doubled after 2002, reaching more than 40%. Yonca Ertimur et al., *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53 (2010). The study also found a lower likelihood of board turnover at firms that implemented shareholder approved proposals. *Id.* at 54, 69. In another study, of fifty companies where shareholders had approved a precatory proposal to declassify the board in 2004-2005, fifteen (30%) did so. Ganor, *supra* note 162, at 158. More boards have bowed to shareholder demands to eliminate poison pills despite management support for them. *See* Ali C. Akyol & Carolyn A. Carroll, Removing Poison Pills: A Case of Shareholder Activism 9-13 (Sept. 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=935950; *see also* Diane Del Guercio et al., *Do Boards Pay Attention When Institutional Investor Activists "Just Vote No?,"* 90 J. FIN. ECON. 84, 102 (2008) (finding, in an empirical study, that "just vote no" campaigns are "effective in prodding boards to either fire an underperforming CEO or to take other actions consistent with shareholders' interests").

Once more, exceptions prove the rule. Mutual funds and banks with conflicts of interest (based on management of company pension funds) vote more often with management.[201] If this is a problem, though, keeping shareholders weak is not the solution. Sweetheart deals would be harder for institutions to arrange if public companies were really directed by boards chosen by the shareholders.

C. *Shareholder Rights in General*

If investors are conflicted or ignorant, or if they stress the short-term at the expense of long-term performance, corporations with weak shareholder rights should outperform others. They do not. Firms with strong shareholder rights are superior performers.[202] They also have more reasonable executive compensation,[203] less shareholder litigation,[204] and invest more in R&D.[205] Analysts sometimes give higher ratings to firms with strong shareholder rights.[206] Many institutional investors consider firms' governance in their investment decisions and work to strengthen shareholder rights in individual firms.[207] Again, all this behavior contradicts the charge that investors choose to be weak in corporate governance.

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[201] *See supra* note 89 and accompanying text.

[202] These firms have better operating performance and higher share prices. *See supra* notes 92-95 and accompanying text. Higher shareholder monitoring is associated with increased innovation. *See generally* Haresh Sapra et al., *Corporate Governance and Innovation: Theory and Evidence* 1-4 (Univ. of Chi. Booth Sch. of Bus., Working Paper No. 08-05, 2009), *available at* http://ssrn.com/abstract=1103676. Strong shareholder rights are associated with more successful acquisitions. *See* Cong Wang & Fei Xie, *Corporate Governance Transfer and Synergistic Gains from Mergers and Acquisitions*, 22 REV. FIN. STUD. 829, 840-42 (2009). The benefits of strong shareholder rights are greater among companies with high free cash flow. *See* Jianxin Daniel Chi & D. Scott Lee, *The Conditional Nature of the Value of Corporate Governance*, 34 J. BANKING & FIN. 350, 360 (2010) ("[W]hen free cash flow is high, firm value is significantly enhanced by improvements in governance quality.").

[203] *See* Pornsit Jiraporn et al., *CEO Compensation, Shareholder Rights, and Corporate Governance: An Empirical Investigation*, 29 J. ECON. & FIN. 242, 243 (2005); Daines et al., *supra* note 78, at 17; *see also* Angela Andrews et al., Corporate Governance and Executive Perquisites: Evidence from the New SEC Disclosure Rules 22-23 (Mar. 17, 2009) (AAA 2009 Fin. Acct. & Reporting Section (FARS) Paper), *available at* http://ssrn.com/abstract=1268087 (presenting results of an empirical study finding that firms with weak corporate governance are more likely to award perquisites to executives).

[204] *See* George Kaltchev, Corporate Governance and Shareholder Litigation (Dec. 1, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1309555 (finding, in an empirical study, that stronger shareholder rights are associated with less shareholder litigation).

[205] *See supra* notes 123-37.

[206] *See* Autore et al., *supra* note 92, at 7; *see also id.* at 24 (providing a table with descriptive statistics).

[207] A recent study finds that "approximately 10 percent of institutions [examined] are

VI. COMPARED TO WHAT?: IMPLICATIONS FOR CORPORATE GOVERNANCE

Parts III through V of this article discussed whether shareholders of public companies are knowledgeable and unified behind the goal of maximizing long-term share value or, on the contrary, uninformed and deeply divided. The discussion found the former to be true, but that discussion is peppered with words like "generally," "usually," "typically," and notes numerous exceptions. Even if one accepts the analysis there, what are its implications for corporate governance? Since shareholder unity and understanding are imperfect, should true shareholder governance be rejected?

Not necessarily. The proper question is not whether shareholder primacy is perfect—obviously it is not—but whether it is better than any alternative.[208] Most public companies are now dominated by their CEOs. As Berle and Means noted long ago, CEOs who control tend to elevate their own interests over the shareholders' interest.[209] The effects of this dominance—including bloated executive compensation, retention of unprofitable operations, empire building through wasteful acquisitions, and manipulation of financial disclosure—are well documented.[210]

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sensitive to each set of governance mechanisms" out of several posited. Brian J. Bushee et al., Institutional Investor Preferences for Corporate Governance Mechanisms 21 (Mar. 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1070168. The study also finds evidence "implying that these institutions engage in shareholder activism." *Id.* at 3; *see also* Kee H. Chung & Hao Zhang, *Corporate Governance and Institutional Ownership*, 45 J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2010) (manuscript at 6, *available at* http://ssrn.com/abstract=1409222) (empirical study finding that "institutional investors' gravitation to stocks of companies that have better governance structure is likely to be stronger than that of individual investors").

[208] *Cf.* Bebchuk, *supra* note 96, at 1803 ("The choice is between giving shareholders power to influence the rules of the game and maintaining boards' indefinite control over these rules.").

[209] *See* BERLE & MEANS, *supra* note 1, at 197-201.

[210] *See supra* notes 132-35 and accompanying text; *see also* Ole-Kristian Hope & Wayne B. Thomas, *Managerial Empire Building and Firm Disclosure*, 46 J. ACCT. RES. 591, 622 (2008) (finding that unconstrained managers make self-maximizing decisions, including value-reducing expansions of the firm); Wruck, *supra* note 130, at 10 (stating that corporate managers frequently focus "on growth and diversification, often at the expense of profitability and value"). The costs of poor corporate governance are immense. *See* Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 145 (2003) (stating that gains from improved corporate governance "would be enormous"); Morgenson, *No Votes, supra* note 186, at 2 (quoting money manager and investor activist Frederick E. Rowe as estimating that "the excess costs associated with management compensation, Wall Street fees and political expenditures reduce investor returns about 3 percent on average every year"). For a discussion on market reactions to diversifying mergers, see Philip G. Berger & Eli Ofek, *Diversification's Effect on Firm Value*, 37 J. FIN. ECON. 39 (1995); Robert Comment & Gregg A. Jarrell, *Corporate Focus and Stock Returns*, 37 J. FIN. ECON. 67, 68 (1995); Larry H.P. Lang & Rene M. Stulz, *Tobin's q, Corporate Diversification, and Firm Performance*, 102 J. POL. ECON. 1248, 1277-78 (1994).

For decades there have been efforts to curb CEOs by infusing boards of directors—the ostensible governing bodies—with independence. Despite some claims to the contrary,[211] these efforts have failed.[212] CEOs always influence, and often dominate, the selection of outside directors.[213] Naturally they prefer candidates who look kindly on high executive compensation and perquisites and on managerial self-dealing.[214] Many outside directors themselves have conflicts of interest.[215] CEOs also control the information received by outside directors.[216] The CEO can curry their favor in various

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[211] *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 155-200 (2008) (claiming that outside directors effectively monitor the CEO and each other and exercise real control).

[212] "The most significant problem facing corporate America today is the management-dominated, passive board of directors." Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127 (1996); *see also* Coates, *supra* note 175, at 847 ("Both theoretical and empirical reasons exist to believe that boards of a substantial minority, and perhaps a substantial majority, of U.S. public corporations are dominated by managers."); Glyn A. Holton, *Investor Suffrage Movement*, 62 FIN. ANALYSTS J. 15, 19-20 (2006) (stating that "[r]ecent market crashes and financial scandals are symptomatic of a capitalism in which shareholders have lost control over the corporations they own," and urging the implementation of measures to make shareholder voting more effective); Lin, *supra* note 92, at 898-903, 913-17 (cataloging the many ways that CEOs dominate outside directors); Romano, *supra* note 117, at 192 ("[F]irms whose boards have a majority of independent directors . . . do not perform significantly better than those whose boards . . . have fewer outside directors."); James Surowiecki, *Board Stiff*, NEW YORKER, June 1, 2009, at 34 ("All these changes [in board composition], though, have had a much smaller impact than expected."). Sophisticated investors realize this. *See* Rachel McTague, *Advisers, High-Net-Worth Investors Think Boards Serve Executives, Survey Says*, 39 BNA SEC. REG. & L. REP. 1662, 1662 (2007) ("A survey of more than 200 investment advisers and high-net-worth investors found that the respondents clearly perceive that corporate boards primarily answer to management, rather than shareholders.").

[213] *See* MONKS & MINOW, *supra* note 159, at 193 (noting that "in 1991[,] . . . 82 percent of board vacancies were filled via recommendations from the chairman," who is also usually the CEO); *see also* Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 34 (1993) (finding in a small survey of the 500 largest companies in 1989 that "the CEO initially recommended 90-100% of all directoral nominees"); Kevin F. Hallock, *Reciprocally Interlocking Boards of Directors and Executive Compensation*, 32 J. FIN. & QUANTITATIVE ANALYSIS 331, 332 (1997) (stating that CEOs often choose new directors); Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, 96-97 (1998) (stating that CEOs choose or approve of board nominees).

[214] *See* Dent, *supra* note 121, at 1241 and authorities cited therein.

[215] *See id.* at 1242-43. For example, many directors who satisfy current rules of independence because they have neither financial nor familial ties to the CEO or to the firm still have social ties to the CEO, and these ties seem to undermine board independence. *See* Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays to Have Friends*, 93 J. FIN. ECON. 138, 145 (2009) (finding that boards that were socially as well as conventionally independent, *inter alia*, awarded significantly lower levels of compensation and showed stronger pay-performance sensitivity than boards lacking such independence).

[216] *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL

ways and can threaten to remove uncooperative members.[217] The CEO (who is almost always a director) and her allies on the board can seize the board's initiative, and "groupthink" discourages anyone inclined to oppose them.[218] Further efforts to ensure board independence are probably doomed to failure because of the boards' "unique susceptibility to capture by the managers they are supposed to monitor."[219]

The repeated failures of outside board majorities to curb CEO autocracy have led to repeated tightening of the definition of director independence in the hope that this will finally achieve the desired result. This strategy is doomed to defeat. The law can exclude directors who have certain affiliations that could negate independence, but that does not guarantee that the board will act diligently to maximize share value. CEOs have twisted the outsider board, which is intended to restrain them, into a tool for increasing their power. One tactic is the growth of interlocking directorates, where CEOs sit on each other's boards.[220] Similarly, the use of

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ANALYSIS 144 (1976) (stating that "the board must rely on the executives" to provide them with information).

[217]*See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 874-75 (1991) (stating that dissident directors were often not renominated).

[218]"Groupthink" is the tendency of members of a group to "adopt[] the goals and methods of the group uncritically." Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 124 (2006); *see also* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 83-84, 99-108 (1985) (describing bases of ingroup biases among directors); Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 37-43 (1981) (discussing board conformity); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 139-41 (2006) (discussing board conformity); James D. Westphal & Poonam Khanna, *Keeping Directors in Line: Social Distancing as a Control Mechanism in the Corporate Elite*, 48 ADMIN. SCI. Q. 361, 362-63, 367-71 (2003) (showing that dissident directors are subjected to shunning). In general, "the very things that make people likely to join a board—connections, business experience, sociability—are also the things that make them less effective once they do." James Surowiecki, *The Sky-High Club*, NEW YORKER, Jan. 22, 2007, at 32; *see also* Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 248-51 (discussing the inevitable cognitive bias of even ostensibly independent directors).

[219]MACEY, *supra* note 81, at 57.

[220]Some years ago it was reported that CEOs of other companies comprised about 63% of outside directors. Gilson & Kraakman, *supra* note 217, at 875. "These directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards." *Id.* These current and former CEOs now comprise a network. *See* Ernie Englander & Allen Kaufman, Sarbanes-Oxley and the New Corporate Governance in the United States 6-7 (Mar. 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1030804 ("The corporate sector established a private independent interlocking network in response to regulatory threats for increased federal oversight," and "[t]he Business Roundtable . . . has used the independent director to protect managerial discretion."). Further, "[t]o articulate their collective concerns on public policy matters, including those that directly affect corporate director duties, the directorship requires a public, a collective voice. The directorship currently relies structurally on The Business Roundtable (BRT)."

independent compensation committees and consultants, which was intended to institute real pay for performance, has been twisted into another ploy for further inflating already bloated CEO compensation.[221] Tightening the criteria for director independence may actually be damaging to corporate governance by excluding "informed and interested outside directors with significant equity stakes"[222] at a time when "firms are becoming more

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Id. at 5. Interlocking boards are associated with lower stock prices and sub-optimal sensitivity of CEO compensation to performance. *See* Erik Devos et al., Are Interlocked Directors Effective Monitors? 33 (Jan. 15, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1084117; Olubunmi Faleye, *CEO Directors, Executive Incentives, and Corporate Strategic Initiatives* 1 (July 25, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1184342 (finding that "shareholders incur significant costs when other CEOs serve on the board"); *see also* Hallock, *supra* note 213, at 332.

[221] *See, e.g.*, Kevin J. Murphy & Tatiana Sandino, *Executive Pay and "Independent" Compensation Consultants* (Marshall Sch. of Bus., Working Paper No. FBE 10-09, 2009), *available at* http://ssrn.com/abstract=1148991 (empirical study finding that executive pay is higher in companies where the consulting firm also provides other services); *see also* James D. Cox, *Fair Pay for Chief Executive Officers*, *in* LAW AND CLASS IN AMERICA: TRENDS SINCE THE COLD WAR 99, 106 (P.D. Carrington & T. Jones eds., 2006) ("The role of the compensation consultant is fraught with conflicting interests."); Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 63-64 (2007) ("[M]anagers use the compensation consultants as 'camouflage' to extract premium rents from the compensation committee."); Gretchen Morgenson, *Corporate America's Pay Pal*, N.Y. TIMES, Oct. 15, 2006, § 3, at 1 (chronicling how one consulting firm repeatedly boosted executive compensation for more than 1,800 clients); Gretchen Morgenson, *Outside Advice on Boss's Pay May Not Be So Independent*, N.Y. TIMES, Apr. 10, 2006, at A1 (discussing the "long and lucrative relationship" between one executive-compensation consulting firm and its client).

As for compensation committees of the board, Warren buffet calls them "tail-wagging puppy dogs." *See* Surowiecki, *supra* note 218, at 32. Most boards want the CEO to be in the top half of the CEO peer group because they think it makes the company look strong. This attitude, of course, propels an endless upward spiral in CEO pay. *See* Scott Schaefer & Rachel M. Hayes, *CEO Pay and the Lake Wobegon Effect*, 94 J. FIN. ECON. 280 (2009) (employing a game-theoretic model); *see also* POSNER, *supra* note 140, at 93-94 (explaining how relations among managers, outside directors, and compensation consultants tend to inflate executive compensation); Maria Bartiromo, *Facetime*, BUS. WK., Mar. 2, 2009, at 15, 16 (interview with Nell Minow who says of the role of compensation committees in the explosion of executive compensation: "I absolutely blame them 100%").

[222] Haarmeyer, *supra* note 130, at 260 (naming the Sarbanes-Oxley Act and stock exchange listing rules as culprits); *see also* Masulis & Thomas, *supra* note 130, at 246 ("'[I]ndependent' directors may . . . lack the knowledge and appropriate skill set to engage in effective risk monitoring."); Simon C.Y. Wong, Uses and Limits of Conventional Corporate Governance Instruments: Analysis and Guidance for Reform (Integrated Version) 1 (Aug. 2003) (Private Sector Opinion, Global Corp. Governance Forum, 2009), *available at* http://ssrn.com/abstract=1409370 ("In the financial sector, the shift toward a board dominated by independent directors . . . ultimately proved to be its Achilles' heel as weak industry knowledge meant that non-executive directors were unable to pick up on warning signs of imprudent risk taking by management."). Note that private companies do use directors who are experts and might not qualify as "independent" for public companies. *See* Oesterle, *supra* note 128, at 64.

complex (geographically and technologically) and bigger, making them more difficult to monitor."[223]

These forces are formidable, but they still would not thwart outsiders comprising a majority (as they do on most boards) if the outsiders were motivated to take control and maximize share value. Sadly, there is little incentive for them to do so. Shareholders may grumble, but, except in the rare case of a serious proxy fight for control,[224] they can do little to punish CEO lap dogs on the board or to reward directors who do fight for the shareholders. The usual obstacles shareholders face, if they attempt a proxy fight, can be significantly bolstered by "staggered boards," where only one-third of the directors are elected each year, so that insurgents must win at least two consecutive proxy fights, rather than one, to gain board control. This situation heightens directors' realization that shareholders cannot punish them for kowtowing to the CEO.[225]

The secret backdating and "spring-loading" of stock options by thousands of companies shows that CEO dominance has not abated and may have worsened.[226] These incidents are particularly distressing because CEOs and directors not only padded executive compensation, but deliberately deceived investors in order to do so. Not surprisingly, the stock market took

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[223]Masulis & Thomas, *supra* note 130, at 245. They state further:

> [T]he growing use of, and trading in, derivative instruments by corporations . . . has increased the importance of attracting financially sophisticated, highly motivated corporate directors, who can deliver intensive monitoring of corporate risk management strategies, who are capable of independently and effectively controlling firm management to regulate derivative exposure, and who set senior management financial incentives to ensure that these executives' [incentives] . . . are aligned with those of firm owners.

Id. at 220.

[224]*See* Bebchuk, *supra* note 188, at 559 (presenting data showing that proxy fights are rare).

[225]Not surprisingly, then, staggered boards are associated with lower stock prices. *See supra* note 163 and accompanying text.

[226]*See* Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 886 (2008) ("Secret backdating . . . provides further support for the view that managerial power has played an important role in shaping executive compensation arrangements."). "'Spring-loading' describes the practice where a corporate executive receives stock options shortly before the release of favorable company news that is expected to raise the company's stock price." Matthew E. Orso, Comment, *"Spring-Loading" Executive Stock Options: An Abuse in Need of a Federal Remedy*, 53 ST. LOUIS U. L.J. 629, 631 (2009). The practice does not seem to be uncommon. *See* David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996); *see also* Lucian Bebchuk et al., Lucky CEOs and Lucky Directors (May 2009) (unpublished manuscript) (finding that an unusually large number of stock options have been granted at the stock's lowest price in the month of the grant). It is unclear whether the practice is illegal, but the ability of executives to profit from events that have already occurred, but have not yet been publicly disclosed, clearly contradicts the premise that executive stock options are granted to give managers an incentive to work hard to raise the company's stock price.

this news badly.[227] More generally, there may actually be a *negative* correlation between the ratio of outside directors on a company's board and the value of its stock.[228]

Despite the persistence of CEO domination and its damage to investors, some commentators feel that shareholders have become too powerful and their rights should be curtailed. Delaware's Vice Chancellor Leo Strine, for example, wants to deny voting rights altogether to stockholders who have held their shares for less than a year or who seek control.[229]

Tinkering with the rules for shareholder voting will accomplish little.[230] Matters would be different if boards were actually chosen by shareholders. Directors then would know that they would be rewarded if they effectively represent the shareholders, and dismissed if they did not.[231] If shareholders chose boards, the rewards to able directors would include a reputation that could lead to further and more lucrative directorships.

The disempowerment of shareholders is now a threat to America's ability to attract investment capital. Investors care about shareholder rights and try to improve them in other countries.[232] Investor protection is

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[227] *See* Gennaro Bernile & Gregg A. Jarrell, The Impact of the Options Backdating Scandal on Shareholders (June 1, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=971137 (study showing that stocks of firms accused of backdating experienced major losses). The damage to shareholders far exceeded the benefits to executives. *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1600-01 (2007) (finding that the average loss per firm to shareholders was about $389 million while the average potential gain to all the optionees in each firm was under $500,000).

[228] *See* Yermack, *supra* note 226 (noting an inverse relationship between board size and firm value).

[229] Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 15 (2007).

[230] *See* MACEY, *supra* note 81, at 199 ("[I]t is irrational in my view to think that expanding shareholder voting can possibly improve the daily governance and operation of a large public corporation.").

[231] *See* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907-11 (proposal for shareholders to choose directors); *see also* Zingales, *supra* note 101, at 414 ("[I]t is necessary to allow institutional investors to propose their own slate of directors."); Surowiecki, *supra* note 212 ("Investors need to be able to play a much bigger role in determining who ends up on boards.").

[232] *See* Reena Aggarwal et al., *Does Governance Travel Around the World? Evidence from Institutional Investors* 4, 31 (Fisher Coll. of Bus. Working Paper Series, Working Paper No. 2009-03-008, 2009), *available at* http://ssrn.com/abstract=1361143 (finding a "strong positive relation between firm-level governance and institutional ownership" and that "institutional investors promote good governance practices . . . around the world"); *see also supra* note 207 (citing studies finding that institutional investors care about the quality of corporate governance in American companies).

associated with higher economic growth.[233] Many foreign countries now have stronger shareholder rights than America does.[234] This fact may explain why American executives receive higher compensation than their foreign counterparts.[235] Rupert Murdoch even shifted the incorporation of News Corp. from Australia to Delaware in order to escape the stronger shareholder rights provided by the former.[236] The Committee on Capital Markets Regulation (the "Paulson Committee") concluded that "[o]verall, shareholders of U.S. companies have fewer rights . . . than do their foreign

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[233]Rui Castro et al., *Investor Protection, Optimal Incentives, and Economic Growth*, 119 Q.J. ECON. 1131, 1131-35, 1166-67 (2004); Binyamin Berdugo & Sharon Hadad, How Does Investors' Legal Protection Affect Productivity and Growth? 1-3, 28, 30, 32-33 (May 21, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1412324 (showing that better investors' legal protection expands the range of high-tech projects that can be financed by non-bank investors and enhances productivity and economic growth).

[234]*See* Bebchuk, *supra* note 155, at 848 ("[T]he corporate law system of the United States . . . stands out among the corporate law systems of developed countries in how far it goes to restrict shareholder initiative and intervention."); Fairfax, *supra* note 90, at 12-13 (stating that most other developed nations require a majority vote for director elections rather than a plurality vote, as in the United States); Jennifer G. Hill, *Regulatory Show and Tell: Lessons from International Statutory Regimes*, 33 DEL. J. CORP. L. 819, 829 & n.66 (2008) (stating that laws in the United Kingdom and Australia now require an annual shareholder vote on executive pay); Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUD. 17 (2007) (finding that U.S. law on shareholder protection was weakest of five countries studied); Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139, 183 (2009) (stating that "[s]ome of the key rules favoring director primacy . . . in American, and especially Delaware, corporate law do not exist in other countries"); Arthur R. Pinto, *The European Union's Shareholder Voting Rights Directive from an American Perspective: Some Comparisons and Observations*, 32 FORDHAM INT'L L.J. 587, 612-13 (2008) (stating that shareholders in EU nations now have broader rights than do shareholders in America to call shareholder meetings and to place items on the agenda for shareholder meetings); Gretchen Morgenson, *Belated Apologies in Proxy Land*, N.Y. TIMES, Aug. 20, 2006, § 3, at 7 (quoting a British investment manager as saying, "globally, the U.S. is probably one of the most difficult environments to work in"); Jennifer G. Hill, *The Shifting Balance of Power Between Shareholders and the Board: News Corp's Exodus to Delaware and Other Antipodean Tales* 14-16 (Univ. of Sydney, Sydney Law Sch., Research Paper No. 08/20, 2008) [hereinafter Hill, *Shifting Balance*], *available at* http://ssrn.com/abstract=1086477 (describing greater shareholder rights in the United Kingdom and Australia, e.g., poison pills are illegal in Australia); Simon C.Y. Wong, *Shareholder-Company Engagement: A Comparative Overview*, 60 (International Corporate Governance Network Yearbook), *available at* http://ssrn.com/abstract=1490724 (reporting that engagement between boards and shareholders is much greater in several other countries than in the United States).

[235]*See* Nuno Fernandes et al., *The Pay Divide: (Why) Are U.S. Top Executives Paid More?* 2-3 (ECGI, Fin. Working Paper No. 255/2009, 2009), *available at* http://ssrn.com/abstract=1341639 (failing to find any firm-level explanation for the "pay premium" received by U.S. CEOs, the authors positing that the explanation is country-specific).

[236]*See* Hill, *Shifting Balance*, *supra* note 234, at 26-45; *see also* Mathias M. Siems, *Shareholder Protection Around the World (Leximetric II)*, 33 DEL. J. CORP. L. 111, 111, 113, 144 (2008) (describing improvement in shareholder protections in many countries).

competitors" and that this situation was impairing investment in the United States.[237] It recommended strengthening shareholder rights in several respects.[238]

Human beings are imperfect. No system that depends on them can be perfect; some people will always contrive to game every system. Accordingly, nomination of directors of public companies by a committee of the ten to twenty largest shareholders will not prove flawless, but that is no reason to reject it. The question is whether it is likely to work better than any alternative. It definitely should be superior to the dysfunctional status quo, and I am not aware of any different proposal for a new system that would be preferable.

VII. CONCLUSION

The separation of ownership and control publicized by Berle and Means in 1932 persists today. Domination of public companies by self-serving and ineffective executives costs America billions of dollars every year and contributed to the current economic meltdown. Various efforts to resolve this problem—including the Sarbanes-Oxley Act, expanded disclosure duties, and more stringent requirements for director independence—have had little benefit and occasionally have made matters worse.

Proposals for greater shareholder power, however, have encountered criticisms: various shareholders have conflicting goals; shareholders favor a short-term perspective at the expense of the long-term health of companies; and shareholders lack the knowledge needed to play a positive leading role in corporate governance. Evidence demolishes these charges. With minor exceptions that could be handled by narrow rules, shareholders are remarkably united in their desire to maximize share value, which is also generally the best measure of the long-term health of a corporation. A critical mass of investors also has the sophistication needed to contribute

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[237] INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 16 (2006) [hereinafter INTERIM REPORT], *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. The connection is logical: "foreigners invest less in firms that reside in countries with poor outsider protection and disclosure *and* have ownership structures that are conducive to governance problems." Christian Leuz et al., *Do Foreigners Invest Less in Poorly Governed Firms?*, 22 REV. FIN. STUD. 3245 (2009); *see also* Randall K. Morck & Lloyd Steier, *The Global History of Corporate Governance: An Introduction* 40 (Nat'l Bureau of Econ. Research, Working Paper No. W11062, 2005), *available at* http://ssrn.com/abstract=652361 ("Financial development seems intimately tied to corporate governance.").

[238] INTERIM REPORT, *supra* note 237, at xiii, 5. It proposed, among other things, that "any policy proposal should adopt as a default the option most favorable to shareholders, given the fundamental asymmetry of power between managers and shareholders." *Id.* at 103.

beneficially to corporate governance. Strong shareholder rights and shareholder activism are strongly associated with better results in myriad ways.

The damage to America's economy from the continuing emasculation of shareholders of American public companies is growing. Capital is increasingly mobile, and America's status as the safest locus of investment is eroding as many foreign countries now offer shareholders better protection. Tired of the abuse they suffer here, investors are gradually taking the funds needed to finance American growth and depositing them abroad.

Fortunately, this trend can be quickly reversed. The costs of CEO domination can easily be stemmed by enhancing shareholder power. Views differ about how best to do that, and no single reform is likely to be the magic bullet that solves all corporate governance problems forever; important policy initiatives always turn out to have imperfections requiring further adjustments. The general direction for change, however, is clear. The critiques of shareholder power are wrong; a better economy requires greater shareholder power.