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.

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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

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").

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

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\(^6\)[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.8 An employee

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7 See infra notes 19-20 and accompanying text.

Investors 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. 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. And some investors are alleged to have particular goals inimical to the interests of other shareholders. Hedge funds are sometimes regarded this way.

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.

performance of the companies in which they invest.

References:


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. Kilja & 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, 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

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14See 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"),\textsuperscript{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."\textsuperscript{16} Its limited use has led to cries of alarm.\textsuperscript{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.\textsuperscript{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."\textsuperscript{19} The Aspen Institute's Corporate Values Strategy Group, comprised

\textsuperscript{15}See Dale A. Oesterle, Mergers and Acquisitions in a Nutshell 263-64 (2d ed. 2006).


\textsuperscript{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.

\textsuperscript{18}See Gevurtz, supra note 14, at 203 (explaining the operation of record dates).

\textsuperscript{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."

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.

C. Shareholders Are Uninformed

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

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. The exceptions to

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).

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.").

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. 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.

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). These arrangements typically include a major role in corporate governance. 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.

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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25See McDonnell, supra note 22, at 350.
26See 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).
28Id. at 1035-44.
29Critics 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. 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, 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. 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). Although government-controlled investors are not new, anxieties have increased recently because of the rapid growth of these funds, and because many have now abandoned their

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 FN. REV. 239, 260 (2009); Laura Podditi & 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 FN. 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 FN. 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.

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

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. 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. For purposes of this law, "control" is defined

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34See id. at 4, 12-17.
37Recently, 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 Loranzo, 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.

38Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, sec. 1,
very broadly. The Treasury Department recently proposed rules that would require review of acquisitions below 10% of a company's stock. So far, problems "have not materialized in any appreciable way." 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. 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 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. 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. A fortiori, a single, outside shareholder rarely has much influence on board

39See id. sec. 2, § 721(a)(1).
41Ballabon, supra note 12, at 25.
42Gilson & Milhaupt, supra note 33, at 10, 21-30.
43See supra note 11 and accompanying text.
44See infra notes 209-18 and accompanying text.
45Indeed, the SEC amended rule 14a-8(j)(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. 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. 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. 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.

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.

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]").


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. 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, the obstacles are formidable. The quantity of stock available for such schemes is small. 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. 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, 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. 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 cases 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.

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

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. 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.

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." Despite the scholarly jeremiads over empty voting, it has never yet altered the result of a shareholder vote, and problems from it are likely to remain rare or nonexistent. 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 Kamitschnig & 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 Cl.
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. One recent analysis concludes that shareholders are better off having "the ability to dynamically change the voting structure" of their firm.

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. If any danger remains, it can be handled by tighter rules on short-selling and empty voting. 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); Alan 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 Skoulios, 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," 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. 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?

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

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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 26 (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=1020005. 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." 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.

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. One study finds that performance-based CEO pay works best when a large blockholder monitors CEO performance. Another finds that shareholder experience lower stock returns than those that follow the aggregate leverage preferences of their institutional investors. This finding supports the view that shareholder democracy would improve corporate governance.

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75 Gordon, supra note 8, at 360.
76 See id. at 368-69.
large blockholders do not reduce, but increase, firm investment. 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

79 Cronqvist & Fahlenbrach, supra note 77, at 3956.
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); Alan B. Blav 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"); Jekun 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. 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. 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.

Opponents of shareholder power warn that the election of some shareholder nominees will lead to debilitating tension and conflict on the board. 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.

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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/pgilimg/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.\textsuperscript{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.\textsuperscript{90}

\textsuperscript{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 Advisors to Advocate for Shareholders' Rights, 34 J. CORP. L. 843, 845-46 (2009) (empirical study finding that mutual fund advisors 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.

\textsuperscript{90}See Lisa M. Fairfax, Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power, 3 V.A. 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."

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. Strong shareholder rights are also associated with better operating performance, and socially responsible shareholders own a small amount of stock.


92See 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, more innovation, more successful acquisitions, more reasonable executive compensation, and less shareholder litigation.

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." 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. Disputes were more common when the CEO was powerful and independent blockholdings were lower. Disputes were also more common in firms with poor operating and stock price performance, and disclosure of disputes generally occasioned large stock price declines. 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)
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\(^{101}\) 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 Cl. "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 (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.").

principles of finance, even short-term investors have an incentive to maximize the firm’s long-term value. 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. 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.

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. This is not surprising. If the stock market did regularly overreact to short-term results, it would be easy to earn superior


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).

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.\(^{10}\) 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.\(^{11}\) 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

\(^{10}\)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).

\(^{11}\)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. Confusion sometimes arises because some targets of shareholder activism and takeover bids are well operated. 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.

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." 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. 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. 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).


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 expenditure 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. Activist hedge funds tend to target companies with below-average R&D. Institutional ownership in public companies is associated with more innovation (as measured by patents).

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, 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. 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. Commn., 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 lower 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).


127 See Jacobs, supra note 13, at 108 (citing a study by the SEC's Office of Economic Analysis); Olubunmi Fakaye, 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); Belber et al., supra note 93, at 3 ("[L]ess monitoring by owners makes managers invest less rather than more in order to enjoy the quiescent 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. 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. 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.

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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”).


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. 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.

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, managers of private firms are rewarded only if the firm succeeds. Put another way, in public companies the interests of managers and of shareholders often clash, while in private firms the managers' compensation...
is structured so that their interests largely coincide with those of the outside shareholders, i.e., the LBO firms.

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.

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. 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.

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.

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

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

133See supra note 20 and accompanying text.
134It 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.
140See 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 L. 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.”).
accounting methods that maximize reported earnings instead of share price, even though the choice requires the company to pay higher taxes. Some waste corporate funds in "empire building"; others choose a "quiet life" by underinvesting corporate funds. Thus, some call the claim that CEOs manage for the long-term "bogus." Regulation of executive compensation may have made matters worse.

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." Part of the problem is that "executives are inherently more risk averse than diversified shareholders." Also, objective measures of firm performance are never perfect. Thus, in private firms, compensation is "based more on subjective than objective performance measures." 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. However, this says nothing about the business strategy that either group of owners favor for portfolio firms.

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 I (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 Shenvy, CEO Compensation: Does Performance Matter? (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").


See Dent, supra note 121, at 1247.

Nocera, supra note 100.

See Walker, supra note 140, at 7 ("Past regulation of executive pay may have encouraged compensation design that promotes short-termism.").

Id. at 6.

Id. at 10.


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

150See Chen et al., supra note 149, at 300-01.
151See Haarmeyer, supra note 130, at 259-60.
152Id.
153See 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).
154See supra notes 22-23 and accompanying text.
156Id. 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. 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. Taking all this into account, the conditions for reasonable efficiency are clearly obtained in the major stock markets for American public companies.

B. Proxy Voting

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


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: Corolling 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.


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 I (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, which have been shown to reduce share value. More shareholder proposals are submitted to firms that have performed poorly and have weak corporate governance. 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.

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. Although this obstacle to shareholder
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

\(^{167}\) 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.

\(^{168}\) See Romano, supra note 117, at 175 ("Institutional investors have, in the past decade, increasingly engaged in corporate governance activities.").


\(^{172}\) See Alexander et al., supra note 170, at 4.

\(^{171}\) Rose, supra note 168, at 906-07; see also U.S. GOVT 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."\(^\text{173}\) Further, proxy advisors other than ISS have appeared since 2003.\(^\text{174}\) 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.\(^\text{175}\) This was especially true for index funds, which compete by "keep[ing] expenses as low as possible."\(^\text{176}\) 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.\(^\text{177}\)

\(^{173}\)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 "cliches 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.


\(^{176}\)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. 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. If they own over 10%, they can become subject to the insider reporting and short-swing trading provisions of the Securities Exchange Act. At higher levels of aggregate ownership, they may trigger poison pills.

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. 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.

Hedge fund activism has resulted in an increased number of...

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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).


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


183 See Clifford, supra note 81, at 3-5, 7-11, 50-31 (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://issn.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 receiving 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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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.

187 See 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.

188 See Briggs, supra note 61, at 686-89; Coffee, supra note 179, at 840-41.

189 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.").

190 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. In general, mutual funds have
become more active in their proxy voting. Private equity and hedge funds
have stronger motives to raise share price and, not surprisingly, are more
assertive than other institutional investors.

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

193 See id. at 15.
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 reactions"). 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 Cl.
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=935990; 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. 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. They also have more reasonable executive compensation, less shareholder litigation, and invest more in R&D. Analysts sometimes give higher ratings to firms with strong shareholder rights. Many institutional investors consider firms' governance in their investment decisions and work to strengthen shareholder rights in individual firms. 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.
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. 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. 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.

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").

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.").

110 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. 39 (1993) (stating that gains from improved corporate governance "would be enormous"); Mogensen, supra note 15, at 1 (quoting money manager and investor activist Frederick E. Row 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. 187 (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

211See 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 McCluggage, 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."").

213See 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 directorial 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. Hermelin & 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).

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

215See 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-Hyun 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).

216See MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL
ways and can threaten to remove uncooperative members. 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. 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."

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. Similarly, the use of

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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).


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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As for compensation committees of the board, Warren buffett 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 Schaef er & 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.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{223}Masulis & Thomas, supra note 130, at 245. They state further: 
\textit{[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.}

\textit{Id. at 220.}

\textsuperscript{224}See Bebchuk, supra note 188, at 559 (presenting data showing that proxy fights are rare).

\textsuperscript{225}Not surprisingly, then, staggered boards are associated with lower stock prices. See supra note 163 and accompanying text.

\textsuperscript{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. 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

227See 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).

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


230See 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.").

231See 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.").

associated with higher economic growth. Many foreign countries now have stronger shareholder rights than America does. This fact may explain why American executives receive higher compensation than their foreign counterparts. 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. 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


234See Bebchuk, supra note 155, at 840 ("[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);


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

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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238INTERIM 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.