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**Can We Do Better by Ordinary Investors?
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Ideological Mythologists of Corporate Law**

Leo E. Strine, Jr.

*GOVERNMENT OF THE STATE OF DELAWARE - SUPREME COURT OF DELAWARE;
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ESSAY

CAN WE DO BETTER BY ORDINARY INVESTORS? A PRAGMATIC REACTION TO THE DUELING IDEOLOGICAL MYTHOLOGISTS OF CORPORATE LAW

Leo E. Strine, Jr.*

In his essay, The Myth That Insulating Boards Serves Long-Term Value, Professor Lucian Bebchuk draws a stark dichotomy between so-called “insulation advocates” and proponents of shareholder-driven direct democracy. This Essay begins by rejecting this crude divide between “good” and “evil,” and focuses instead on the practical realities surrounding increases in stockholder power in an era where there is a “separation of ownership from ownership.” That separation arises because the direct stockholders of private companies are typically not end-user investors, but instead money managers, such as mutual funds or hedge funds, whose interests as agents are not necessarily aligned with the interests of long-term investors. These practical realities suggest that Bebchuk’s crusade for ever more stockholder power may not actually be beneficial to ordinary investors, and that his contention—that further empowering stockholders with short-term investment horizons will not compromise long-term corporate value—is far from proven. This Essay concludes with some thoughts on improvements that could be made in the system that we have. These suggestions are not radical in either direction and they do not involve rolling back the rights of stockholders. Rather, these suggestions recognize that the fiduciaries who wield direct voting power over corporations should do so in a manner faithful to the best interests of those whose money they control, include proposals to require activist investors to bear some of the costs they impose and to disclose more information about their own incentives so that the electorate can evaluate their motives, and provide incentives that better align the interests of money managers and ordinary investors toward sustainable, sound long-term corporate growth. Taken as a whole, these suggestions would create a more rational accountability system by making all of the fiduciaries for ordinary investors focus more on what really matters for

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investors, citizens, and our society as a whole—the creation of durable wealth through fundamentally sound economic activity.

According to my dear friend and colleague, the distinguished Professor Lucian Bebchuk,¹ everyone who has at any time questioned the extent to which public corporations should be direct democracies whose board of directors and managers must follow the immediate whim of a momentary majority of stockholders can be labeled and lumped together as an “insulation advocate,”² in order to create an intellectual straw man

1. These words are entirely sincere. It has been a personal and professional pleasure to be a friend and colleague of Professor Bebchuk for a period longer than either of us would find it comfortable to acknowledge. Lucian’s sincere concern for his students and colleagues and his energetic dedication to scholarship are worthy of immense respect.

2. In the original version of his essay, which was publicly disseminated, Professor Bebchuk included me in this group and labeled me an “insulation advocate.” Lucian Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, Harvard L. Sch. Forum on Corp. Governance & Fin. Reg. (Apr. 22, 2013, 9:18 AM), <http://blogs.law.harvard.edu/corpgov/2013/04/22/the-myth-that-insulating-boards-serves-long-term-value/> (on file with the *Columbia Law Review*). In the final version of his essay, Professor Bebchuk retreated slightly from this position, but he still lumps many diverse thinkers, including me, into the category. Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 Colum. L. Rev. 1637, 1640–41 (2013) [hereinafter *Bebchuk, Board Insulation Myth*]. That is not how I have ever thought of myself, except insofar as he is saying that I accept that it is important for responsible citizens and good consumers to insulate their homes adequately to keep their homes warmer in winter and reduce unnecessary energy use. If it means that I have advocated policies that would insulate corporate managers from accountability to their equity investors, that is a rather large stretch, and it is doubtful that corporate managers or those who advise them would share Bebchuk’s view. E.g., William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953, 959–61 (2003) (suggesting broadening Delaware’s consent to suit statute to enable stockholders to hold officers who are not directors responsible for breaches of fiduciary duty in Delaware courts, and calling for corporate election reforms to make the corporate election process more competitive); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 Bus. Law. 1371, 1372–74 (2002) (identifying recent corporate scandals and their implications for the independent director concept and calling for more rigorous standards for director independence); Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 Geo. L.J. 629, 635 (2009) (emphasizing duty of directors to ensure the corporation honors its legal obligations and their need to establish board structures that allow them to effectively address all areas of compliance and regulatory risk); 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, 1775–79 (2006) [hereinafter *Strine, Toward a True Corporate Republic*] (suggesting a “State-Authorized Ballot Access Statute” that would reimburse reasonable solicitation costs incurred by any qualified director candidate who received at least thirty-five percent of the vote in order to “make the process of corporate elections more effective”); Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. Corp. L. 1, 12 (2007) [hereinafter *Strine, Toward Common Sense*] (suggesting that a rational system of director accountability might involve abandoning classified boards but retaining traditional poison pills); *id.* at 13

for him to burn down easily. Bebchuk is the sincere champion of one group of “agents” wielding power and authority over others’ money—the money managers who control most of the investments belonging ultimately to ordinary Americans who are saving to pay for their retirements and for their children’s education—against another group of “agents” that he believes is somehow more conflicted—the agents who actually manage corporations that make real products and deliver useful services (i.e. “productive corporations”). The fact that he is an advocate for the power of one group of privileged “haves” against another might lead a dispassionate observer to expect that Bebchuk would be cautious in drawing stark lines, on one side of which are the good and faithful agents—the money managers—and on the other side are the suspect and presumptively faithless agents—the managers of productive corporations.³ In fact, such an unwitting observer might infer that someone passionate about constraining the agency costs of those who directly manage productive corporations would also be passionate about constraining the agency costs of the money managers who directly hold other people’s money.

But Bebchuk is not an Adolf Berle who is concerned that all who wield economic and political power in a republican democracy are accountable for their responsible use of that power.⁴ That is not how Bebchuk approaches things. For him, there is only one set of agents who must be constrained—corporate managers—and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the end-users’ money to buy and sell stocks for their benefit.

(“In the context of a larger reform to create a rationally balanced system of corporate accountability, it might be worth considering the admittedly large step of permitting stockholders to adopt non-repealable bylaws requiring that the employment contracts of top executives be subject to stockholder approval.”). But I leave to others to consider for themselves whether Bebchuk’s labeling of me is appropriate.

3. See William W. Bratton & Michael L. Wachter, Shareholders and Social Welfare, 36 Seattle U. L. Rev. 489, 524–25 (2013) [hereinafter Bratton & Wachter, Social Welfare] (“Intermediaries from the mutual fund and pension fund industries . . . do much of the work for the shareholders. Look through the beneficial owners to the actors exercising the power on the shareholder side, and corporate politics can be depicted as a field of conflict between two rich, self-interested groups.”).

4. For those interested in a nuanced analysis of Berle’s views, see generally William W. Bratton & Michael L. Wachter, Shareholder Primacy’s Corporatist Origins: Adolf Berle and *The Modern Corporation*, 34 J. Corp. L. 99 (2008); Roberta Romano, Metapolitics and Corporate Law Reform, 36 Stan. L. Rev. 923, 936–38 (1984); Dalia Tsuk, From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought, 30 Law & Soc. Inquiry 179 (2005) (book review).

In this crude divide between good and evil, Professor Bebchuk is not alone. Arrayed against him and his fellow “money manager advocates”⁵ are scholars, corporate lawyers, and businesspersons who view stockholders as having little to no utility in helping corporations generate wealth and who seem to wish stockholders would simply go away.⁶ As with Bebchuk’s fellow money manager advocates, there are differences among those who wish to constrain stockholder influence. In some cases, these skeptics go so far as to deny that boards of directors must, within the constraints of the law, make the best interests of stockholders the end goal of the governance of a for-profit corporation.⁷ Instead of accepting that a prerequisite to the application of the business judgment rule is that the directors have the same interest as the stockholders⁸—i.e., in making the

5. I do not claim that this term is fairly nuanced. But it is at least as precise and fair as Bebchuk’s blanket use of the term “insulation advocate.” See *supra* note 2. My tastes run in less cartoonishly garish and more complexly grey directions, consistent with the more complicated and subtle realities of human behavior in a commercial setting.

6. Although they come to this point from various (and quite interesting and provocative) perspectives, it is fair to read a number of distinguished scholars as embracing the view that the influence of the stockholders most important to setting market prices (the active marginal traders) and exerting pressure on public companies (activist investors) should be markedly reduced. See generally Roger L. Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL* (2011) (critiquing corporate focus on maximizing stockholder value); Lawrence E. Mitchell, *Corporate Irresponsibility: America’s Newest Export* 90–94 (2001) (criticizing the tendency to view maximization of shareholder profit as the sole goal of corporation); Lawrence E. Mitchell, *The Speculation Economy: How Finance Triumphed over Industry* (2007) [hereinafter Mitchell, *Speculation Economy*] (describing the rise of the United States’ speculative economy and its connection to increasing pressure on managers to respond to market forces and stockholder demands); Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (2012) [hereinafter Stout, *Shareholder Value Myth*] (arguing that the influence of shareholders causes companies to engage in irresponsible behavior); Lawrence E. Mitchell, *The Legitimate Rights of Public Shareholders*, 66 Wash. & Lee L. Rev. 1635, 1679 (2009) (“[P]ublic shareholders serve only a very limited function in stimulating industrial production and economic growth in the United States and are potentially detrimental to the achievement of those goals. . . . The case for empowering shareholders falls on the facts.”); *id.* at 1635 (“The logical conclusion is that public shareholders’ rights should, ideally, be eliminated, and certainly not expanded or enhanced.”).

7. See, e.g., Stout, *Shareholder Value Myth*, *supra* note 6, at 95–115 (arguing there is no legal requirement that corporate boards make the best interests of stockholders the only end of corporate governance and claiming the law allows boards to consider stockholders as just one of several constituencies and interests whose best interests may be an end of corporate governance).

8. See Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 93 (1991) (“Behind the business judgment rule lies the recognition that investors’ wealth would be lower if managers’ decisions were routinely subjected to strict judicial review.”); Stephen M. Bainbridge, *The Business Judgment Rule as [Abstention] Doctrine*, 57 Vand. L. Rev. 83, 122–23 (2004) (explaining that the justification for the business judgment rule is to encourage “optimal risk taking” and that “[t]he shareholders’ preference for [judicial] abstention [from review of directors actions] . . . extends only to board decisions motivated by a desire to maximize shareholder wealth” (emphasis added)); E. Norman Veasey with Christine T. Di Guglielmo, *What Happened in Delaware Corporate*

decision that will make the corporation the most profitable—these skeptics argue that the business judgment rule is really just a beard to give boards the cover they need to treat the stockholders' best interest as only one of many permissible ends, including the best interests of the communities in which the corporation operates, the corporation's consumers and workers, the environment, and society as a whole.⁹ In their minds, iconic cases like *Dodge v. Ford*¹⁰ and *Revlon*,¹¹ which hold the opposite, are mere aberrations; really, the law is that boards can treat all constituencies equally in terms of the ends of management.¹²

Inconvenient to this notion on two levels is an indisputable reality of American corporate law. That is the reality that if American corporate law makes all constituencies an end of corporate governance, American corporate lawmakers chose a decidedly unusual way to enable that equality. In American corporate law, only stockholders get to elect directors,¹³ vote on corporate transactions and charter amendments,¹⁴ and sue to enforce the corporation's compliance with the corporate law and the

Law and Governance from 1992–2004? A Retrospective on Some Key Developments, 153 U. Pa. L. Rev. 1399, 1422 (2005) (“The business judgment rule functions to protect the policies underlying corporate law, including maximization of stockholder value. . . . Stockholders expect a board that is not risk averse. . . . It is very much in the stockholders' interest that the law not encourage directors to be risk averse.”).

9. See, e.g., Stout, Shareholder Value Myth, *supra* note 6, at 33–43, 74–85 (contending that the business judgment rule gives “unconflicted directors” freedom “to pursue almost any [lawful] goal” in addition to shareholder wealth maximization, and arguing that managers create more value by spreading their focus over several corporate objectives); Einer Elhauge, Sacrificing Corporate Profits in the Public Interest, 80 N.Y.U. L. Rev. 733, 738 (2005) (“Corporate managers have never had an enforceable legal duty to maximize corporate profits. Rather, they have always had some legal discretion (implicit or explicit) to sacrifice corporate profits in the public interest.”); Kent Greenfield & John E. Nilsson, Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule, 63 Brook. L. Rev. 799, 831 (1997) (making the case that the business judgment rule reflects “an underlying distrust of the strict fiduciary duty to maximize shareholder returns”).

10. *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

11. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

12. See Stout, Shareholder Value Myth, *supra* note 6, at 30–31 (arguing that *Revlon* is the “exception that proves the rule” and “it is only when a public corporation is about to stop being a public corporation that directors lose the protection of the business judgment rule and must embrace shareholder wealth as their only goal” (citing *Revlon*, 506 A.2d 173)); Lynn A. Stout, Why We Should Stop Teaching *Dodge v. Ford*, 3 Va. L. & Bus. Rev. 163, 165, 174 (2008) (arguing that the Michigan Supreme Court's statement that “[a] business corporation is organized and carried on primarily for the profit of the stockholders” is neither descriptively accurate nor normatively desirable (quoting *Dodge*, 170 N.W. at 684)).

13. Del. Code Ann. tit. 8, § 211(b) (2011) (establishing stockholder right to vote to elect directors).

14. Id. § 242(b)(2) (entitling stockholders to vote on charter amendments); id. § 251(c) (requiring stockholder vote for merger); id. § 271 (requiring stockholder vote for sale of “all or substantially all” of company's assets).

directors' compliance with their fiduciary duties.¹⁵ An unsubtle mind might believe that this statutory choice to give only stockholders these powers might have some bearing on the end those governing a for-profit corporation must pursue.¹⁶ But regardless of whether that is so as a mat-

15. *Id.* § 327 (creating stockholder's right to initiate a suit on behalf of a corporation); Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 9.02 (2011) (explaining that the "common law of fiduciary duty in the corporate context . . . has crafted principles designed to resolve stockholder-director disputes"); *id.* (discussing various ways the corporation's stockholder can initiate litigation in the corporate context and differentiating between direct and derivative suits); see also R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations & Business Organizations* § 13.10 (2013) (same); 2 Edward P. Welch et al., *Folk on the Delaware General Corporation Law* § 327.2.1 (5th ed. 2013) (same).

16. Although some scholars disagree, *Revlon* settled the question as a practical matter in Delaware, by making clear that other corporate constituencies may only be considered instrumentally in terms of their relationship to creating profits for stockholders. *Revlon*, 506 A.2d at 182 (holding that even though a board may consider the interests of nonstockholder constituencies, there must always be "rationally related benefits accruing to the stockholders," and clarifying contrary language in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)); see also *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its shareholder[] owners.'" (quoting *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998))); *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 40–41 (Del. Ch. 2013) ("[T]he standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants."); *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 33 (Del. Ch. 2010) ("Promoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders."); *TW Servs., Inc. v. SWT Acquisition Corp.*, No. 10427, 1989 WL 20290, at *1183 (Del. Ch. Mar. 2, 1989) (observing that the "interests of the shareholders . . . are seen as congruent with those of the corporation in the long run" and thus, "directors may be said to owe a duty to shareholders . . . to manage the corporation within the law . . . in a way intended to maximize the long run interests of shareholders"); *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders . . ."); William T. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894, 896–97 (1997) ("[I]t can be seen that the proper orientation of corporation law is the *protection of long-term value of capital* committed indefinitely to the firm."). Indeed, the case of *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011), makes that plain. Although in that case, stockholders failed to get the Delaware Court of Chancery to order a board of directors to lift a poison pill blocking an all-shares, all-cash offer, the court's analysis made plain that the only proper basis for the directors' decision to fail to redeem the pill is that they believed that the offer was too low and would harm the stockholders if they sold at an undervalued price. *Id.* at 112. There is not one whiff of other constituency pretense in the air of the *Airgas-Air Products* struggle, and, in fact, three new directors elected at the urging of the hostile bidder concluded that the bidder's offer was too low once they took office and studied the company's prospects more thoroughly. As it turns out, they were right and, within a few months, the stock was trading well above *Air Products's* final bid of \$70.00 and has continued to trade above that threshold ever since. See *Airgas Inc. Stock Price Snapshot*, Bloomberg, <http://www.bloomberg.com/quote/ARG:US> (on file with the *Columbia Law Review*) (last visited Feb. 1, 2014) (listing the fifty-two-week low for *Airgas's* stock as \$92.86, fifty-two-week high as \$113.16, and current price as \$103.24); *Airgas Inc.*

ter of law, this allocation of power has a profound effect as a matter of fact on how directors govern for-profit corporations. When only one constituency has the power to displace the board, it is likely that the interests of that constituency will be given primacy.¹⁷

More nuanced participants in the debate do not quibble with the notion that the end goal of for-profit corporations is the best interests of stockholders.¹⁸ But these participants argue that the best way to ensure that corporations generate wealth for diversified stockholders is to give the managers of corporations a strong hand to take risks and implement business strategies without constant disruption by shifting stock market sentiment.¹⁹ Those in this more measured place are troubled by the fact that traditional rights granted to stockholders may have a less desirable impact on the ability of corporations to generate wealth given important market developments, such as the realities that: Money manager intermediaries constitute a supermajority of those wielding actual stockholder rights rather than the long-term investors whose money is actually invested; activist investors are able to engage in hedging strategies that

Stock Price Stock Chart, Bloomberg, <http://www.bloomberg.com/quote/ARG:US/chart> (on file with the *Columbia Law Review*) (last visited Feb. 1, 2014) (showing graphically that Airgas' stock has traded consistently well above \$70.00 since November 28, 2011).

17. See Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Charge of Control Transactions: Is There Any "There" There?*, 75 S. Cal. L. Rev. 1169, 1187 (2002) ("[I]n the American corporate law system, there is no reason to expect that the interests of the stockholders and top managers will not predominate over those of labor and the community. After all, in the intra-corporate republic, only capital has the right to vote!"). As I have said before, this outcome should not surprise fans of great rock and roll music familiar with Eddie Cochran's song about one alienated American youth's struggle with authority, which captures the point:

I'm gonna take two weeks, gonna have a fine vacation / I'm gonna take my problem to the United Nations / Well I called my congressman and he said, quote / "I'd love to help you, son, but you're too young to vote."

Id. at 1187 n.35 (quoting Eddie Cochran, *Summertime Blues* (Liberty Records 1958)).

18. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 550 (2003) [hereinafter Bainbridge, *Director Primacy*] (explaining that, under the director primacy model, "director accountability for maximizing shareholder wealth remains an important component"); Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. Pa. L. Rev. 1907, 1988 (2013) (concluding that a focus on shareholder wealth maximization as an end is a "tool" designed to get managers to "think and act like shareholders" in order to "build[] valuable companies").

19. See, e.g., William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. Pa. L. Rev. 653, 660 (2010) [hereinafter Bratton & Wachter, *The Case Against Shareholder Empowerment*] (arguing that the corporation's managers, "[a]s long as they remain faithful, . . . are best suited to maximize the value of the corporation and thus the shareholders' residual claim"); see also Bainbridge, *Director Primacy*, *supra* note 18 at 557–59 (arguing that, consistent with Kenneth Arrow's scholarship, stockholders' best interests are served by empowering a strong central authority—the board of directors—to make business decisions and not interfering with its unconflicted judgments (citing Kenneth J. Arrow, *Scale Returns in Communication and Elite Control of Organizations*, 7 J.L. Econ. & Org. (Special Issue) 1 (1991))).

limit their exposure if their preferred strategies for the corporation do not turn out to be sound;²⁰ putting together a momentary majority is easier today because of more concentrated ownership patterns and the Internet;²¹ and institutional investors have emerged who seem to be motivated by a desire for engagement for reasons unrelated to investment value.²² Even when the debate is narrowed to focus on the best interests of equity investors, these commentators worry that the demands of money managers and their advocates for additional rights will compromise the ability of corporations to pursue the most profitable courses of action for those whose money is ultimately at stake—the end-user investors saving to pay for college and retirement—because managers will be distracted and disrupted by constant mini-referendums and continual election seasons initiated by activist investors.²³

20. See Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811, 828–35 (2006) (describing ways in which investors can use derivatives and other financial innovations to decouple their voting power from their economic interest); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1071 (2007) (“Hedge funds are set up to make money for their investors without regard to . . . shareholders generally. . . . Indeed, because hedge funds frequently engage in hedges and other sophisticated trading and arbitrage strategies, such conflicts of interest are likely to arise more frequently for hedge funds than for other institutional investors.”).

21. Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, Harvard Bus. Rev., July–Aug. 2012, at 48, 51 (explaining that “advances in technology, in the form of financial engineering as well as computing and communications hardware and software, have enabled many new forms of trading” and have contributed to short-termism).

22. See generally Stephen M. Bainbridge, *Corporate Governance After the Financial Crisis* 243–51 (2012) [hereinafter Bainbridge, *Corporate Governance*] (“Public employee pension funds are vulnerable to being used as a vehicle for advancing political/social goals unrelated to shareholder interests generally.”); Joseph A. Grundfest, *The SEC’s Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 Bus. Law. 361, 380–83 (2010) (describing interests of labor unions and state pensions that are specific to them and unrelated to interests of stockholders generally, and which might motivate them to use proxy access rules for their own purposes and not for stockholder value creation); Martin Lipton, *Twenty-Five Years After Takeover Bids in the Target’s Boardroom: Old Battles, New Attacks and the Continuing War*, 60 Bus. Law. 1369, 1377 (2005) [hereinafter Lipton, *Old Battles, New Attacks*] (arguing that special-interest shareholders “seek to conquer the corporate boardroom with their personalized agendas” by “using withhold-the-vote campaigns . . . to exercise pressure on boards to conduct their affairs in the manner desired by those shareholders—without consider[ing] . . . the long-term interests of the corporation and its shareholders”).

23. Aspen Inst., *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management* 4 (2009), available at http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf (on file with the *Columbia Law Review*) (calling for the interests of financial intermediaries and shareholders to be better aligned and worrying that many financial intermediaries holding retirement and college savings of Americans “engage in . . . activism in pursuit of short-term financial objectives at the expense of long-term performance and careful analysis of fundamental risk”); Colin Mayer, *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It* 200 (2013) (“It [is] . . . increasingly difficult for directors to do anything other than reflect what is perceived to be

As may fit their shared experiences as Dungeons & Dragons aficionados, Bebchuk and his sparring partners share an affinity for exploring “myths”²⁴ and engaging in rhetorical jousts where no real world blood is shed. One area of sharp disagreement between his money manager advocate team and the stronger insulation advocate team members is whether more wealth will be created for end-user investors by corporations if corporate managers are given more or less room to pursue strategies without fearing displacement of themselves or those strategies by stockholders.²⁵ In this new essay, Bebchuk claims that there is no rational basis to believe that operating corporations under a direct democracy model will result in any reduction in the ability of corporations to gener-

in the immediate interests of their most influential, frequently short-term shareholders,” impairing directors’ ability to act in the long-term interest of the corporation, and “[t]he calls for greater shareholder activism only . . . reinforce this.”); Stout, *Shareholder Value Myth*, supra note 6, ch. 6 (arguing that the corporation’s distinct identity from stockholders and insulation from their direct influence are critical to its ability to generate the most wealth by incentivizing important firm-specific investments, and by reducing the ability of particular stockholders to engage in opportunism at the expense of other stockholders); Bratton & Wachter, *The Case Against Shareholder Empowerment*, supra note 19, at 702 (“[W]here institutional fund managers benchmark portfolios by reference to quarterly earnings per share (EPS), sensitivity to stock market reactions implies a focus on quarterly earnings numbers. Once management prioritizes meeting the market’s EPS expectations, investments that enhance long-term value but impair near-term earnings may be delayed or [forgone].” (footnotes omitted)); see also CFA Ctr. for Fin. Mkt. Integrity & Bus. Roundtable Inst. for Corporate Ethics, *Breaking the Short-Term Cycle 3* (2006), available at http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf (on file with the *Columbia Law Review*) (“[M]anaging predominantly for short-term earnings expectations often impairs a manager’s ability to deliver [long-term] value to shareowners.”); Fox & Lorsch, supra note 21, at 56 (“Giving shareholders more things to vote on won’t change this. It may even make things worse”); Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, Harvard L. Sch. F. on Corp. Governance & Fin. Reg. (Feb. 26, 2013, 9:22 AM), <http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/> (on file with the *Columbia Law Review*) (arguing that shareholder voting power “is being harnessed by a gaggle of activist hedge funds who troll through SEC filings looking for opportunities to demand a change in a company’s strategy or portfolio that will create a short-term profit without regard to the impact on the company’s long-term prospects”).

24. See, e.g., Stout, *Shareholder Value Myth*, supra note 6, at 15–46; Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675 (2007) [hereinafter *Bebchuk, Shareholder Franchise Myth*]; Bebchuk, *Board Insulation Myth*, supra note 2; Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 Va. L. Rev. 789 (2007); Lucian Bebchuk, *The Myths of Hedge Funds as ‘Myopic Activists,’* Wall St. J. (Aug. 6, 2013, 7:00 PM), <http://online.wsj.com/article/SB10001424127887323309404578614004210782388.html> (on file with the *Columbia Law Review*).

25. Compare Bebchuk, *Board Insulation Myth*, supra note 2, at 1668 (“[A]ctivist interventions benefit targeted companies and their shareholders both in the short term and in the long term.”), with Bainbridge, *Corporate Governance*, supra note 22, at 211–12 (arguing that the separation of ownership and control currently mandated by corporate law is highly efficient and “one ought not lightly interfere with management or the board’s decision-making authority”).

ate profits in a durable manner.²⁶ Even if the money managers who directly act as stockholders do not hold stock for more than the blink of an eye in real business terms, giving them more power for constant intervention is not worrisome because there is no empirical evidence that making corporate managers accountable to direct stockholder influence at all times, rather than periodically, reduces corporate value.²⁷ In other words, Bebchuk argues that even if the activists proposing corporate action hold their shares for a few years at most and the electorate considering their proposals holds for months at a time, that does not necessarily mean that their incentives are distorted in any sense that might lead them to favor strategies that are inconsistent with the corporation's ability to create the most long-term, sustainable economic value for stockholders and to honor its obligations to creditors and society as a whole.²⁸

By contrast, Bebchuk's intellectual adversaries are skeptical that money managers, who buy and sell stocks rapidly in defiance of the core insight of the efficient capital market hypothesis (ECMH), are focused on whether strategies proposed by hedge funds are well-thought-out in terms of their effect on the corporation's capacity to comply with its legal duties and generate strong profits on a long-term basis.²⁹ Many of them view it as likely that money managers—who do not intend to be around when the consequences of corporate policies proposed by activist hedge

26. Bebchuk, *Board Insulation Myth*, *supra* note 2, at 1643–44 (arguing that even if “theoretically possible that activists might . . . want companies to act in ways that are not value-maximizing in the long term,” empirical evidence demonstrates that expected benefits from those situations exceed expected costs, and therefore “shareholder ability to intervene . . . provides long-term benefits to companies, shareholders, and the economy”).

27. *Id.* (“The data does not support the claim that activist campaigns are followed in the long term by losses to the shareholders of targeted companies or by declines in the operating performance of these companies . . .”).

28. *Id.* at 1665 (doubting that short-term activist investors have conflicts of interests with long-term investors because “[f]or the activist to sell shares at a profit in the short run, other investors must be willing to buy at the increased price and subsequently bear the long-term consequences of the corporation actions”).

29. E.g., Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 *Stan. L. Rev.* 1255, 1290–92 (2008) (arguing that activist investors' push for short-term benefits may harm long-term shareholders); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 *UCLA L. Rev.* 561, 579 (2006) (explaining that active funds alter their investment positions with high frequency and seek to profit from short-term fluctuations in price without regard to a company's long-term profits); Stephen M. Bainbridge, *Response, Director Primacy and Shareholder Disempowerment*, 119 *Harv. L. Rev.* 1735, 1751 (2006) (noting that activist investors are the stockholders most likely to take advantage of increased stockholder powers and most likely to misuse those powers for their own purposes); Bratton & Wachter, *The Case Against Shareholder Empowerment*, *supra* note 19, at 726–27 (observing that “managing to the market is the problem that needs to be addressed” and linking the 2008 financial crisis to shareholder pressures to focus on short-term price increases); Lipton, *Old Battles, New Attacks*, *supra* note 22, at 1377 (noting that special-interest shareholders seeking to “conquer the corporate boardroom with their personalized agendas” do not consider long-term interests of corporation or shareholders as a whole).

funds come to fruition—will give great weight to the short-term effect of policies, without adequately considering whether those policies create too little long-term investment or too much leverage and externality risk.³⁰ For end-user investors who depend on their portfolio's ability to generate sustainable long-term growth, bubbles in equity prices that come at the expense of more durable and higher long-term growth are counterproductive. For society as a whole, further empowering money managers with short-term holding periods subjects Americans to lower long-term growth and job creation, wreckage from corporate failures due to excessive risk taking and debt,³¹ and the collateral harm caused when corporations face strong incentives to cut regulatory corners to maximize short-term profits.³²

30. See, e.g., Anabtawi & Stout, *supra* note 29, at 1290–92 (arguing that short-term funds and activist investors tend to favor strategies that will be beneficial in the short term even if they are harmful to longer-term shareholders); Bratton & Wachter, *The Case Against Shareholder Empowerment*, *supra* note 19, at 658–59 (“A shareholder-based agency model . . . [instructs] . . . management . . . to maximize the [stock price]. . . . And that is exactly what managers of some critical financial firms did in recent years. They managed . . . to increase observable earnings and . . . failed to factor in concomitant increases in risk that went largely unobserved.”); Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 *Geo. L.J.* 1177, 1231 (2012) (“[T]he long-term implications of a short-run income-maximization strategy were apparent, but preserving long-term reputation did little to address immediate earnings pressures and was viewed by management as their successors’ problem. . . . [O]nce one firm adopted this strategy, it placed competitive pressure on other firms to follow suit.”); Lawrence Mitchell, *Op-Ed., Protect Industry from Predatory Speculators*, *Fin. Times* (July 8, 2009, 6:45 PM), <http://www.ft.com/cms/s/0/fac881b6-6be5-11de-932000144feabdc0.html#axzz2sgCsb192> (on file with the *Columbia Law Review*) (“[Fund] [m]anagers thrive by increasing their portfolios’ value. That is a hard thing to do and it takes time. So for years fund managers have increased their pay by putting pressure on corporate managers to increase short-term stock prices at the expense of long-term business health.”). Mitchell continues:

Doing business that way puts jobs and sustainable industry at risk, now and in the future. For example, managers responded to the pressure by using their retained earnings to engage in large stock buybacks. In the three years to September 2007, companies in the S&P 500 used more money to buy back stock than to invest in production. With retained earnings gone, all that was left to finance production was debt. When the credit markets collapsed, these corporations could not borrow, and thus could not produce. . . . [T]he big shareholders who have been pushing management for this kind of behaviour for years . . . are more the problem than the solution. Enhancing their voting rights will only make things worse.

Id.

31. John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value* 11 (*Columbia Law Sch. Ctr. for Law & Econ. Studies*, Working Paper No. 452, 2013), available at <http://ssrn.com/abstract=2307959> (on file with the *Columbia Law Review*) (“It is tolerably clear that the difficulties banks found themselves in by . . . 2008 were the consequence of the pursuit of high-risk, high-return strategies by bank executives. Such strategies earn good returns for shareholders, but . . . rais[e] the volatility of the firm’s cashflows, . . . increas[ing] the risk of . . . failure . . .”).

32. Colin Mayer has argued that the increasing difficulty directors face when trying to do anything not in the interest of influential short-term shareholders harms the

As I understand the primary purpose of Bebchuk's essay, it is to impose on the so-called insulation advocates the burden of proving that any limitation on the direct democracy model that money manager advocates favor is justified. Absent empirical proof that stockholder activism directed at corporations reduces stockholders' returns, insulation advocates should be mute and accept Bebchuk's view that corporations should be governed as direct democracies subject to the will of whatever majority happens to own their stocks at any particular time.³³ Bebchuk

corporation's other stakeholders and "[t]he power of the owners with the shortest horizon not only concentrates control and wealth amongst them and their agents, but is also the source of the failure to account for the interests of any generation other than their own." Mayer, *supra* note 23, at 185–86, 200, 240; see also Stout, *Shareholder Value Myth*, *supra* note 6, at 66–69 (explaining that short-term shareholders, including money managers, "pressure directors and executives to pursue myopic business strategies that don't add lasting value").

33. I do not label Bebchuk a supporter of direct democracy without reason. In his lengthy career, Bebchuk has made clear that he believes stockholder majorities should be able to displace board policy upon short notice. Thus he supports:

- Barring boards from using takeover defenses to prevent stockholders from accepting tender offers;
- Allowing stockholders to amend the corporate charter;
- Allowing stockholders to vote directly on executive pay and propose binding rules to govern compensation for top managers;
- Allowing stockholders to vote directly on corporate political spending;
- Allowing stockholders to change the corporation's state of domicile; and
- Giving stockholders with small holdings subsidized access to the corporate proxy to run proxy fights and make corporate governance proposals.

See, e.g., Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* 198 (2004) [hereinafter *Bebchuk & Fried, Pay Without Performance*] (arguing that shareholders should play greater roles in setting executive compensation and asserting that "[t]he problem . . . is that corporate law currently does not enable shareholders to propose and vote on rules relating to executive compensation that are binding on the board"); Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. Chi. L. Rev. 973, 975 (2002) (arguing that boards should not have power to "veto" takeover bids and prevent stockholders from accepting tender offers); Lucian Arye Bebchuk, *The Case For Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 865 (2005) (advocating for a regime in which "shareholders would be able to initiate and adopt any rules-of-the-game decisions," including changes to corporate charters and the state of incorporation); Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 Harv. L. Rev. 83, 97–100 (2010) (arguing that lawmakers should require shareholders to vote to approve corporate political spending); Bebchuk, *Shareholder Franchise Myth*, *supra* note 24, at 696–98 (arguing for a corporate electoral system in which shareholders would be able to directly place candidates on the ballot and in which challengers would be entitled to reimbursement for their reasonable expenses); Lucian A. Bebchuk, *How to Fix Bankers' Pay*, *Daedalus*, Fall 2010, at 52, 57–58 [hereinafter *Bebchuk, Bankers' Pay*] (arguing "advisory votes [on pay packages] by themselves cannot ensure that directors are sufficiently attentive to and focused on shareholder interests" and shareholders should have power to directly change corporation's charter or state of incorporation); Lucian Arye Bebchuk, *Streamlining Access to the Corporate Ballot*, *Corp. Governance Advisor*, Mar.–Apr. 2004, at 28, 30 (arguing that a threshold ownership level of only one percent before stockholders are allowed to submit proxy access proposals is too high).

marshals various empirical studies to support his contention that insulation advocates cannot meet the burden he puts before them. Although his essay is lengthy, his empirical claims are essentially two in nature and related. First, as to corporate governance rules of the road affecting how easy it is to replace a corporate board or effect a takeover—such as whether a corporation has a classified board—there is evidence that corporations without strong antitakeover defenses have higher values than similarly situated corporations with such defenses.³⁴ In other words, Bebchuk contends that corporate managers who are more vulnerable to displacement by the market for corporate control deliver better returns.³⁵ Second, and relatedly, Bebchuk argues that it has not been shown that long-term returns have been harmed because of the greater influence that reduced takeover defenses and increased electoral vulnerability for directors gives to activist investors such as hedge funds proposing that corporations change their business strategies.³⁶ Because Bebchuk reductively focuses on equity returns, he blinds himself to any consideration of externality effects or the larger economic outcomes of the American economy for its citizens. Although he does not say so explicitly, one would suppose that he would argue, as others have, that what is good for equity holders as the so-called residual claimants is good for everyone else, and that if corporations can produce higher returns to equity, they will be better able to pay their other bills and honor their obligations to society.³⁷

I will not pretend to have had sufficient time nor training in statistical “social science” to evaluate whether Bebchuk’s review of the empirical evidence is convincing.³⁸ I must admit to having a healthy skepticism

34. Bebchuk, *Board Insulation Myth*, *supra* note 2, at 1684–86 (claiming a documented association exists “between stronger board insulation and poorer firm performance”).

35. See *id.* (citing study results indicating that “greater insulation is associated with an economically meaningful reduction in industry-adjusted firm value, [return on assets], sales growth . . . , and net profit margin”).

36. See *id.* at 1673–76 (citing empirical studies to support the proposition that “stock appreciation accompanying activists’ initial announcement reflects the market’s correct anticipation of the intervention’s effect, and the initial positive stock reaction is not reversed in the long term”).

37. E.g., Easterbrook & Fischel, *supra* note 8, at 38 (“[M]aximizing profits for equity investors assists the other ‘constituencies’ automatically. . . . A successful firm provides jobs for workers and goods and services for consumers. . . . Wealthy firms provide better working conditions and clean up their outfalls; high profits produce social wealth that strengthens the demand for cleanliness.”).

38. Others have been bolder on this score. See Martin Lipton, *The Bebchuk Syllogism*, Harvard L. Sch. F. on Corp. Governance & Fin. Reg. (Aug. 26, 2013, 12:32 PM), <http://blogs.law.harvard.edu/corpgov/2013/08/26/the-bebchuk-syllogism/> (on file with the *Columbia Law Review*) (arguing that there are flaws in Bebchuk’s empirical study). But see Lucian Bebchuk, Alon Brav & Wei Jiang, *Don’t Run Away From the Evidence: A Reply to Wachtell Lipton*, Harvard L. Sch. F. on Corp. Governance & Fin. Reg. (Sept. 17, 2013, 9:00 AM), <http://blogs.law.harvard.edu/corpgov/2013/09/17/dont-run-away-from-the->

whenever the “law AMPERSAND” movement cranks up its machinery and tries to prove empirically a contestable proposition about a complicated question involving the governance of a human community of any kind.³⁹ I am particularly skeptical about claims that actions have no, this, or that effect in the long term by reference to short-term period effects, justified by the argument that long-term effects cannot be measured because they are drowned out by “noise.”⁴⁰ I cannot and will not claim that my respected friend Professor Bebchuk misstates the results of the studies he cites or that the one he himself conducted was done with anything but the greatest accuracy and rigor. I leave to others whose full-time job is writing academic articles to engage with the cited studies on those terms.

I do note that Bebchuk’s view—that there is no empirical reason to doubt that further moves toward the direct democracy model he favors will be good for long-term stockholder interests and those of society as a

evidence-a-reply-to-wachtell-lipton/ (on file with the *Columbia Law Review*) (responding to Lipton’s criticisms).

39. For a measured and incisive consideration of the difficulties of using empirical studies to prove the soundness of broad legal policy arguments, see Randall S. Thomas, *The Increasing Role of Empirical Research in Corporate Law Scholarship*, 92 *Geo. L.J.* 981, 983–84 (2004) (book review). Even Bebchuk has admitted that there is reason to be cautious about giving too much weight to scholarship of this kind. E.g., Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments 2* (Harvard Law Sch., John M. Olin Ctr. for Law, Econ. & Bus. Discussion Paper No. 697, 2011), available at <http://ssrn.com/abstract=1706806> (on file with the *Columbia Law Review*) (“Causal identification is notoriously difficult in empirical work on corporate finance and corporate governance.”). For example, Bebchuk’s use of cross-sectional data in his empirical analysis has recently been criticized and some scholars have concluded that the use of time series data instead of cross-sectional data leads to the opposite result. See K.J. Martijn Cremers, Lubomir P. Litov & Simone P. Sepe, *Staggered Boards and Firm Value, Revisited 3* (Dec. 19, 2013) (unpublished manuscript), available at <http://ssrn.com/abstract=2364165> (on file with the *Columbia Law Review*) (questioning Bebchuk’s empirical findings that staggered boards lead to lower firm values, presenting time series data that staggered boards lead to increased firm values, and concluding that this “result casts a doubt on the direction of causation between firm value and staggered boards as interpreted in the empirical literature”). The use of the metric “Tobin’s q,” which Bebchuk employs in his empirical analysis to measure company performance, has also been subject to criticism. See Philip H. Dybvig & Mitch Warachka, *Tobin’s Q Does Not Measure Firm Performance: Theory, Empirics, and Alternative Measures 4–5* (Sept. 2012) (unpublished manuscript), available at <http://papers.ssrn.com/abstract=1562444> (on file with the *Columbia Law Review*) (questioning whether Tobin’s q is the best measure of company performance because it can be inflated by underinvestment that can actually reduce future earnings).

40. For those who believe that a good deal of the actual complexity of the real world is ignored by studies focused on the short-term impact of certain corporate governance features or stockholder activism on corporate value, they may find of interest Mayer, *supra* note 23, which argues, among other things, that increasing stockholder influence has diminished, rather than increased, the ability of corporations to increase social welfare and stockholder wealth, and that requiring boards of directors to manage corporations with the best interests of society, other corporate constituencies, and ethics in mind is necessary to protect society from excessive externality risk and lower growth prospects.

whole—is not universally shared.⁴¹ Respected scholars who are not fans of unconstrained corporate management⁴² believe that there are substan-

41. As scholars have noted, other empirical studies have reached results in tension with the ones Bebchuk cites. See Bratton & Wachter, *The Case Against Shareholder Empowerment*, *supra* note 19, at 702–03 nn.154–155 (citing studies that have concluded that “prioritizing earning” may not “enhance[] long-term firm value”). These studies include Natasha Burns, Simi Kedia & Marc Lipson, *Institutional Ownership and Monitoring: Evidence from Financial Misreporting*, 16 *J. Corp. Fin.* 443, 444 (2010) (examining firms that restated their earnings between 1997 and 2002 and finding that ownership by “transient institutions”—those that trade often in search of profits—are associated with an increase in the likelihood and severity of an accounting restatement); Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 *Acct. Rev.* 305, 307 (1998) (finding that firms with more short-term shareholders are more likely to cut research and development expenses to meet short-term targets); John E. Core, Wayne R. Guay & Tjonne O. Rusticus, *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors’ Expectations*, 61 *J. Fin.* 655, 657, 684–85 (2006) (finding no evidence of a causal relationship between governance and returns); Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 *J. Fin.* 1857, 1882–84 (2002) (comparing IPO firms with and without takeover defenses and finding that firms without strong takeover defenses underperform for the first two years but that there are no significant performance differences thereafter); Mark S. Johnson & Ramesh P. Rao, *The Impact of Antitakeover Amendments on Corporate Financial Performance*, 32 *Fin. Rev.* 659, 686–87 (1997) (surveying a range of financial measures in connection with more than 600 antitakeover amendments adopted between 1979 and 1985, and finding no adverse effect); Aleksandra Kacperczyk, *With Greater Power Comes Greater Responsibility? Takeover Protection and Corporate Attention to Stakeholders*, 30 *Strategic Mgmt. J.* 261, 276 (2009) (claiming to demonstrate empirically that corporations less subject to the threat of takeovers take into better account other stakeholders’ interests and therefore generate higher long-term shareholder value); William N. Pugh et al., *Antitakeover Charter Amendments: Effects on Corporate Decisions*, 15 *J. Fin. Res.* 57, 65–66 (1992) (finding an increase in capital expenditures and research and development spending at firms with stronger takeover defenses); Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?* 2–3 (Apr. 1999) (unpublished manuscript), available at <http://ssrn.com/abstract=161739> (on file with the *Columbia Law Review*) (showing a weak institutional preference for near-term earnings as a whole, but a strong preference for near-term earnings among “transient” institutional investors with short investment horizons, which is associated with underweighting long-term earnings and consistent with mispricing). William C. Johnson, Jonathan M. Karpoff, and Sangho Yi have found empirical evidence that firm value is increased by the presence of strong takeover defenses in the governing instruments of corporations that are going public. William C. Johnson, Jonathan M. Karpoff & Sangho Yi, *The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms* 6 (Apr. 29, 2013) (unpublished manuscript), available at <http://ssrn.com/abstract=1923667> (on file with the *Columbia Law Review*). They concluded that “takeover defenses help to bond the IPO firm’s guarantees to its counterparties . . . [encouraging] counterparties . . . to make long-term relationship-specific investments . . . [resulting in] higher IPO valuation and improved long-run operating performance. This implies that many IPO firms adopt takeover defenses precisely because pre-IPO shareholders benefit from them.” *Id.* Finally, Robin Greenwood and Michael Shor have written:

[A]ctivism targets earn high returns primarily when they are eventually taken over. However, the majority of activism targets are not acquired and these firms earn average abnormal returns that are not statistically distinguishable from zero. . . . [T]he returns associated with activism are largely explained by the

tial reasons why a move to direct democracy might harm long-term corporate value.⁴³ As they note, it is a solar system from the central claim of the ECMH—that it is unlikely that any person pursuing an active trading strategy is likely to outperform the market as a whole—to presuming that the stock market price of a particular company on a particular day represents a reliable estimate of the company's future expected cash flows.⁴⁴

ability of activists to force target firms into a takeover, thereby collecting a takeover premium. An interesting observation, in our view, is that in many of the events in which we eventually observe a takeover, the initial demands of the activist were quite different.

Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. Fin. Econ. 362, 363 (2002).

42. As he does with me, Bebchuk lumps together as insulation advocates a variety of people who are no such thing. See Bebchuk, *Board Insulation Myth*, *supra* note 2, at 1639–40 nn.1–7 & 9. For example, Bebchuk suggests that Professor Bratton is an insulation advocate. *Id.* at 1639 n.1. But Professor Bratton wrote an important article to which Bebchuk's own article owes an intellectual debt. William W. Bratton, *Hedge Funds and Governance Targets*, 95 Geo. L.J. 1375, 1381 (2007) (studying effects of hedge fund activism campaigns against 130 companies over several years, and finding that “hedge fund activism is a more benign phenomenon than its critics would have us believe”). Likewise, my judicial colleague Justice Jacobs has authored iconic decisions vindicating the rights of stockholders. See, e.g., *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 50–52 (Del. Ch.) (holding dead hand poison pill violated fiduciary duties of board), *aff'd* on other grounds, 721 A.2d 1281 (Del. 1998); *QVC Network, Inc. v. Paramount Commc'ns Inc.*, 635 A.2d 1245, 1268–69 (Del. Ch. 1993) (enjoining preclusive deal protections that reflected a board's breach of its *Revlon* duties to take reasonable steps to maximize sale value when pursuing a change of control transaction), *aff'd*, 637 A.2d 34 (Del. 1994); *Sealy Mattress Co. of N.J. v. Sealy, Inc.*, 532 A.2d 1324, 1341–42 (Del. Ch. 1987) (granting minority shareholders injunction against an unfair squeeze-out because damages “would not be an adequate remedy” and rejecting argument that “injunctive relief has been judicially eliminated”). Believing that managers should be held accountable to stockholders in a sensible form of republican democracy—rather than the direct democracy model Bebchuk embraces—hardly makes one an insulation advocate.

43. See, e.g., Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 Yale J. on Reg. 174, 222 (2001) [hereinafter Romano, *Less Is More*] (noting a “striking absence of evidence that shareholder activism improves targeted firms' performance” and advocating reforms that would, among other things, discourage overuse of stockholder ballot initiatives to achieve a better cost-benefit ratio from activism).

44. See Michael L. Wachter, *Takeover Defense When Financial Markets Are (Only) Relatively Efficient*, 151 U. Pa. L. Rev. 787, 792 (2003) (“[Under] the prevailing view in the financial market literature that market efficiency, like perfect competition, is an ideal that is unattainable as long as there are market frictions . . . individual stock prices can still be incorrect at any point in time—either under- or overestimating the value of the corporation.”); see also Bratton & Wachter, *The Case Against Shareholder Empowerment*, *supra* note 19, at 692–93 (“ECMH does not imply that the share price equals the pro rata value of the discounted free cash flows of the corporation. . . . To say that no investment strategy can outperform the market does not . . . say anything about the stock price's accuracy in measuring the corporation's fundamental value . . .”); Bratton & Wachter, *Social Welfare*, *supra* note 3, at 505 (“[T]he efficient capital market hypothesis does not predict that the market price is a true measure of fundamental value. Rather, it makes a more modest prediction that prices will follow a random walk and that no trading strategy based on public information can systematically outperform the market.”).

They point to real world evidence that the companies most heavily engaged in and exposed to the risks of the financial practices that led to the financial crisis had received a premium in the stock market for doing so, despite the existence of public information suggesting that these practices were unsustainable in the long run and posed substantial risk.⁴⁵ Bubble run-ups in the value of these companies' stock might have provided value to stockholders engaged in rapid trading, but the companies' stuck-in stockholders (such as those who were indexed) took the whole ride, which in some cases ended in a ravine. Furthermore, these scholars note that it is difficult to measure the system-wide costs of making corporate managers more directly accountable to changing market sentiments, but point out that such accountability could be dangerous to our economy's long-term prospects for growth when a survey of corporate managers revealed that many of them would fail to pursue net present value positive capital investments if they feared that those projects would result in an inability to meet near-term earnings estimates.⁴⁶ Some of Bebchuk's debating adversaries even venture a more macro-level critique,

45. See Bratton & Wachter, *The Case Against Shareholder Empowerment*, *supra* note 19, at 716–23 (describing practices that caused high risk and returns in the years leading up to financial crisis, and arguing that management's responsiveness to shareholder demands contributed to the development of the high risk practices); see also Bratton & Wachter, *Social Welfare*, *supra* note 3, at 506 (describing perverse effects resulting from managing to the market, including that market prices are subject to speculative distortion); Mark J. Roe, *Structural Corporate Degradation Due to Too-Big-to-Fail Finance*, 162 U. Pa. L. Rev. (forthcoming 2014) (manuscript at 35), available at <http://ssrn.com/abstract=2262901> (on file with the *Columbia Law Review*) (“Financial firms that were more shareholder-oriented, firms that had managers compensated more with equity than with debt-like obligations, and banks in countries that favored shareholder governance all did worse in the financial crisis than their opposites.” (footnotes omitted)); Armour & Gordon, *supra* note 31, at 11 (accepting the link between the financial crisis and market failure and corporate pursuit of profits for stockholders).

46. See Daniel Bergstresser & Thomas Philippon, *CEO Incentives and Earnings Management*, 80 J. Fin. Econ. 511, 512–13 (2006) (“CEOs . . . whose overall compensation is more sensitive to company price shares . . . appear to more aggressively use discretionary components of earnings to affect their firms' reported performance.”); Bratton & Wachter, *The Case Against Shareholder Empowerment*, *supra* note 19, at 702–03 nn.154–155 (“[O]nly fifty-nine percent of the same group of executives would approve a high net present value project if it entailed missing earnings by \$0.10.” (citing John R. Graham, Campbell R. Harvey & Shiv Rajgopal, *Value Destruction and Financial Reporting Decisions* 9–10 (Sept. 6, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=871215> (on file with the *Columbia Law Review*))); John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. Acct. & Econ. 3, 32–35 & fig.5 (2005) (surveying 401 chief financial officers and reporting that nearly eighty percent said they would decrease discretionary spending on research and development to meet earnings targets and just over fifty-five percent said they would delay a new project for the same reason despite a small sacrifice in value); see also Jie (Jack) He & Xuan Tian, *The Dark Side of Analyst Coverage: The Case of Innovation*, 109 J. Fin. Econ. 856, 858 (2013) (studying effects of financial analysts on innovation and finding that managers, in response to pressure from analysts to meet near-term earnings targets, “boost current earnings by sacrificing long-term investment in innovative projects that are highly risky and slow in generating revenues”).

wondering why proponents of direct democracy believe that the strong directional inertia in their favor should not be braked when a forest-level look at outcomes reveals: (i) much higher executive compensation and a growing disparity between CEO and average worker pay;⁴⁷ (ii) unimpressive returns to stockholders;⁴⁸ (iii) stagnant economic growth;⁴⁹ (iv) the need for huge government subsidies for corporations and industries that engaged in speculative and excessively risky conduct in pursuit of stockholder profit;⁵⁰ and (v) sharp declines in the number of American public corporations.⁵¹ Put simply, they wonder what big-picture

47. See, e.g., Stout, *Shareholder Value Myth*, supra note 6, at 20–21 (noting that, after Congress enacted tax policies encouraging linking CEO compensation to stock prices increases, the disparity between CEO's and average worker's pay ballooned to 500 dollars to the CEO for every dollar to the average worker); Fox & Lorsch, supra note 21, at 52 (noting that "[i]n the 1980s and 1990s, under pressure from [various groups], boards shifted the bulk of CEO pay from cash to stock and stock options," which resulted in higher CEO pay, and describing this as a "case of shareholders' pushing for change and then proving incapable of controlling it"). Harold Meyerson has attributed income stagnation, employees' sharply reduced share of productivity gains, and skyrocketing CEO pay, in important part, to corporate America's embrace of the principle that stockholder wealth maximization is the sole end of corporate governance, and he has noted that if the median family household income had kept pace with productivity gains during the period 1974 to date, it would be over \$86,000 rather than the current level of approximately \$50,000. Harold Meyerson, *The Forty-Year Slump*, Am. Prospect, Sept./Oct. 2013, at 20, 20–27.

48. See Stout, *Shareholder Value Myth*, supra note 6, at 53 (arguing that returns to equity investors have declined and been "dismal" since shareholders have gained more power over corporations and the end of stockholder wealth maximization has been embraced).

49. See Pavlos E. Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* 3, 9 (2012) (arguing that increased influence by stockholders focused on short-term gains over both corporate and governmental policies in five major Western economies—the United States, the United Kingdom, the Netherlands, France, and Germany—has contributed to lower levels of capital investment by firms, overall "persistent stagnation," and lower GDP growth rates).

50. See Stout, *Shareholder Value Myth*, supra note 6, at 4–5 (noting that "Corporate America's mass embrace of shareholder value thinking has not translated into better corporate or economic performance" and citing the "near-failure and subsequent costly taxpayer bailout of many of our largest financial institutions in 2008" as an example of a costly corporate disaster that has occurred). For additional work by respected scholars on the link between the excessively risky behavior engaged in by financial firms and the subsequent financial crisis, which resulted in the need for government subsidies to those firms, see sources cited supra note 30. The 2008 financial crisis is, of course, not the only occasion on which the government has come to the rescue of a private sector firm as a result of excessively risky behavior in the pursuit of stockholder profit. For example, in 1998 the government bailed out the hedge fund Long Term Capital Management, after it made a number of "unsound, esoteric bets" and created a serious risk to our capital and financial markets. Tyler Cowen, *Bailout of Long-Term Capital: A Bad Precedent?*, N.Y. Times (Dec. 26, 2008), <http://www.nytimes.com/2008/12/28/business/economy/28view.html> (on file with the *Columbia Law Review*).

51. Stout, *Shareholder Value Myth*, supra note 6, at 5 ("The population of publicly held U.S. companies is shrinking rapidly as formerly public companies like Dunkin'

results for stockholders, or Americans more generally, have come from the sharp move in the last quarter century toward making corporations more responsive to stockholder pressure that might justify the efforts of Bebchuk and his allies to continue to push corporations even closer to the direct democracy model.⁵²

Interestingly, Bebchuk's debating adversaries have overlooked what might be seen as an admission on his part that increasing demands on corporations to manage to immediate stock market pressures might not be good for stockholders or society generally. Consistent with his distrust of agents who run actual corporations, Bebchuk has expressed concern about rewarding corporate managers for increasing the stock price without contractual protections requiring them to hold on to their equity for a long-term period.⁵³ The reason: Bebchuk fears that if managers can benefit from short-term stock price increases without bearing the long-term risks that the policies causing those increases entail, they may propose and implement measures that sacrifice long-term, sustainable growth for short-term gain.⁵⁴ In his own words: "Executives who are free to unload shares or options may have incentives to jack up short-term stock prices by running the firm in a way that improves short-term results at the expense of long-term value."⁵⁵

Likewise, although Bebchuk's career-long obsession has been advocating that corporate managers should be directly responsive to the immediate demands of the current stockholder majority,⁵⁶ in recent writ-

Donuts and Toys"R"Us 'go private' to escape the pressures of shareholder-primacy thinking, and new enterprises decide not to sell shares to outside investors at all."); see also David Weild & Edward Kim, Capital Markets Series: A Wake-Up Call for America 1 (2009), available at http://www.granthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt_wakeup_call_.pdf (on file with the *Columbia Law Review*) (noting that between 1997, the peak year for U.S. listings, and 2008, the number of exchange-listed companies declined from 8,823 to 5,401).

52. Stout, Shareholder Value Myth, *supra* note 6, at 54–55 (citing data regarding decline in publicly listed corporations in the United States during a period of great stockholder empowerment as evidence that such empowerment is not generating positive results for ordinary investors).

53. See Bebchuk & Fried, Pay Without Performance, *supra* note 33, at 191 (arguing for limits on managers' "freedom to unwind the equity-based incentives created by their compensation plans" and for prohibitions on managers "engaging in any hedging or derivative transactions that reduce their exposure to fluctuations in the company's stock price"); Lucian A. Bebchuk & Jesse M. Fried, How to Tie Equity Compensation to Long-Term Results, *J. Applied Corp. Fin.*, Winter 2010, at 99, 99 [hereinafter Bebchuk & Fried, Equity Compensation] ("[S]tandard executive pay arrangements were leading executives to focus excessively on the short-term and to boost short-term results at the expense of long-term value.").

54. Bebchuk & Fried, Pay Without Performance, *supra* note 33, at 184.

55. *Id.*

56. Early in his career Bebchuk argued that management should be prevented from taking any defensive actions that would interfere with the ability of a majority of stockholders to decide to sell the company, a position that indicates a great deal of confidence in stock market prices and that encourages managers to manage to the stock

ings he has expressed concern that paying corporate managers equity-based compensation could lead managers to implement excessively risky strategies that create a potential for bankruptcy and cause harm to creditors, employees, and society as a whole.⁵⁷ The long-term stockholders who hold the stock when such risks come to fruition would, of course, suffer too.

It is likely that corporate managers, in contrast with activist investors such as hedge funds, are actually far more dependent on their employer firm's sustainable value and would thus be more, not less, immune to the temptation of forsaking long-term value for a short-term stock pop coming from an unduly risky business strategy.⁵⁸ But the logic that drives

market. See, e.g., Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 Harv. L. Rev. 1028, 1054 (1982) (“[I]ncumbent management should be barred from actions that obstruct any tender offer.”); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 Stan. L. Rev. 23, 47 (1982) (“[O]bstructive defense tactics should be prohibited; a target’s shareholders should be completely free to accept the best offer made to them.”); Lucian Arye Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 Va. L. Rev. 993, 993 (2001) (arguing for an optional federal takeover law, or “[c]hoice-enhancing federal intervention,” to give shareholders greater power to accept takeover bids and to prevent management from using defensive tactics). Bebchuk’s concern with facilitating challenges to incumbent directors through modifications to the proxy rules also has its roots in his early work. See Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Calif. L. Rev. 1071, 1076 (1990) (arguing that proxy rules should be altered to facilitate shareholder challenges to incumbent directors).

57. See Bebchuk & Fried, *Equity Compensation*, supra note 53, at 99, 104–06 (“[P]ay arrangements that reward executives for short-term results can produce incentives to take excessive risks.”).

58. There are many reasons that corporate managers would be more concerned with the long-term value of their firms than activist investors. Corporate managers, for example, typically have tenures that far exceed the short-term horizons of activist investors. See Chuck Lucier, Steven Wheeler & Rolf Habel, *The Era of the Inclusive Leader*, *Strategy+Business*, Summer 2007, at 43, 45–46, available at http://www.boozallen.com/media/file/Era_of_the_Inclusive_Leader_.pdf (on file with the *Columbia Law Review*) (finding that in 2006 average CEO tenure, globally, was 7.8 years and the average tenure of a North American CEO was 9.8 years). Plus, the bulk of the corporate managers’ wealth is likely to be attributable to compensation from their employing corporation, and they will, therefore, have far less ability to diversify the risk of firm failure or poor performance. For a comprehensive review of studies regarding executive compensation that supports the conclusion that CEO compensation and wealth is highly dependent on corporate performance, see Steven N. Kaplan, *Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges* 22–23 (Chi. Booth Research Paper No. 12-42, 2012), available at <http://ssrn.com/abstract=2134208> (on file with the *Columbia Law Review*) (summarizing executive compensation studies). Furthermore, the reputational and financial costs that the CEO and other corporate managers will suffer if the company fails on their watch are high. See B. Espen Eckbo, Karin S. Thorburn & Wei Wang, *How Costly Is Corporate Bankruptcy for Top Executives?* 40 (Tuck Sch. of Bus. Working Paper No. 2012-09, 2012), available at <http://ssrn.com/abstract=2138778> (on file with the *Columbia Law Review*) (finding data that bankruptcy is quite costly for managers who are forced to leave or who do not receive an offer of continued employment, i.e., those managers who are most likely to be perceived as having contributed to corporate failure). Not only that, top managers below the CEO level who want to climb the ladder want a

Bebchuk to worry about these temptations does not seem to trouble him when he is dealing with anyone claiming the title “stockholder,” regardless of whether their investment horizons and portfolio likely make them far less invested in the corporation’s long-term fate than a typical corporate manager. A dispassionate observer, however, might note that the analytical force of Bebchuk’s analysis of the dangers of paying corporate managers in a way that breaks the link between short-term reward and accompanying long-term risk cannot be confined to that specific context. Ideology can be blinding, even apparently when one’s secular faith involves the simple creed that those who own stocks are presumptively selfless while those who manage corporations are presumptively selfish and untrustworthy.

There is another oddment to Bebchuk’s continuing push for direct democracy. For years, he and his allies pushed to make corporate directors more accountable directly to stockholders and to shift power within the boardroom to independent directors meeting stricter definitional standards. They were successful in this effort. Most boards are comprised not simply of a majority of independent directors,⁵⁹ but almost exclusively of independent directors, with the CEO often being the only non-independent director.⁶⁰ Key board committees like compensation, audit, and nominating must be comprised solely of independent directors.⁶¹

strong company to be there when they reach the top. For all these reasons, the selfish interests of the CEO and corporate managers are likely to give them strong incentives to take actions that will keep the company strong and productive for not just the stockholders, but also the employees and other constituencies of the company. In addition to the incentives that are provided to corporate managers to manage for the long term by their employment agreements, the existing legal regime, which restricts the ability of corporate managers to engage in short-swing trading, also provides corporate managers with incentives to focus on the long-term value of their companies. See 15 U.S.C. § 78p(b) (2012) (making officers of companies liable for disgorgement of any profits received from the purchase and sale of equity securities within a six month period); Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243(a) (requiring CEO and CFO to reimburse company for incentive- or equity-based compensation and any profits from selling a security within twelve months following public release of a financial document if company is required to prepare an accounting restatement to that document due to material noncompliance with financial reporting requirements).

59. See Spencer Stuart, *Spencer Stuart Board Index 10* (2012) (reporting that eighty-four percent of directors on boards of S&P 500 companies are independent directors).

60. See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 *Stan. L. Rev.* 1465, 1490–500 (2007) (discussing the increased presence of independent directors on corporate boards).

61. Although nearly all of these committees were comprised of independent directors in 2002, *id.* at 1491–92 & nn.100 & 104, 1498, the major exchanges adopted more stringent rules on the composition of these committees between 2002 and 2007 that have resulted in these committees becoming comprised of only independent directors. See, e.g., NASDAQ OMX BX, *Equity Rules* § 5605(c)(2), available at <http://nasdaqomxbx.cchwallstreet.com/> (on file with the *Columbia Law Review*) (last visited Jan. 5, 2014) (requiring audit committees to be composed of a majority of independent directors and putting substantial restrictions on the ability of

But, rather than the increasing power of independent directors providing a relaxation of the need to move further toward a direct democracy model, Bebchuk and his fellow money manager advocates have instead proposed that these newly empowered independent directors be subject to the specific direction of stockholders on virtually every important aspect of management, including compensation,⁶² charter and bylaw changes,⁶³ and change of control transactions.⁶⁴ They also propose that these independent directors be removable from office not just when beaten at the polls by an actual human candidate, but also through a de facto recall vote in the form of a withhold campaign.⁶⁵

As, or more, important than the composition of boards, easy financing and the sharp reduction in the prevalence of antitakeover defenses have made the market for corporate control more vibrant as a disciplinary tool.⁶⁶ Although Bebchuk will likely not admit the extent to which his world view helped to form a more open market for corporate control,

nonindependent directors to serve on audit committees); N.Y. Stock Exch., Listed Company Manual § 303A.07(a) (2013), available at <http://nysemanual.nyse.com/LCM/Sections/> (on file with the *Columbia Law Review*) (last amended Aug. 22, 2013) (“All audit committee members must satisfy the requirements for independence . . .”).

62. E.g., Bebchuk, Bankers’ Pay, *supra* note 33, at 57 (arguing that shareholders should be able to veto executive compensation packages and asserting that “advisory votes [on pay packages] by themselves cannot ensure that directors are sufficiently attentive to and focused on shareholder interests”). Bebchuk generally argues that the government should intervene to increase shareholders’ oversight of executive compensation. *Id.* (“[T]he government should ensure that shareholders have sufficiently strong rights to discourage choices adverse to their interests . . .”).

63. E.g., Lucian A. Bebchuk, Reply, Letting Shareholders Set the Rules, 119 Harv. L. Rev. 1784, 1785 (2006) (“[S]hareholders satisfying some minimum ownership and holding requirements [should] be able to place on the corporate ballot proposals for changing the charter or state of incorporation.”).

64. See *supra* note 56 (reviewing Bebchuk’s longstanding support for facilitating shareholder challenges to incumbent management in takeovers).

65. As a stockholder, Bebchuk proposed a bylaw that would have made a director candidate ineligible to stand for election if she received more “withhold” votes than “for” votes. See Gen. Dynamics Corp., Notice of Annual Meeting and Proxy Statement 2006 (Schedule 14A) 40 (Mar. 31, 2006), available at <http://www.sec.gov/Archives/edgar/data/40533/000119312506069331/ddef14a.htm> (on file with the *Columbia Law Review*) (presenting Bebchuk’s shareholder proposal).

66. See Spencer Stuart, *supra* note 59, at 15 (reporting that “83% of [S&P 500] boards now have declassified structures, a notable increase from 76% in 2011” and that the “share of boards with one-year director terms has more than doubled from 40% a decade ago”); Proxy Season: Top Ten Trends for 2013, Governance, July 2013, at 4, 4 (“Eighty-one per cent of S&P 500 Companies have annual elections, up by 44 per cent since 2000, illustrating investors’ success in using shareholder proposals to reform director election practices.”); Classified Boards Year over Year, SharkRepellent.net (2013) (on file with the *Columbia Law Review*) (providing data that indicates that the number of S&P 1500 companies with classified boards dropped from 904 in 1998 to 555 in 2012); Poison Pills in Force Year over Year, SharkRepellent.net (2013) (on file with the *Columbia Law Review*) (providing data that indicates that the number of pills in force at year-end for the S&P 1500 companies dropped from 854 in 1998 to 182 in 2012).

that does not mean it is not a reality.⁶⁷ With managers regularly subject to the type of discipline that Bebchuk and others thought would keep managers on their toes, the need for further ballot initiatives is not evident. Of course, Bebchuk might note the decline in hostile takeovers.⁶⁸ But the reason is telling: Serious bidders have no need to go hostile; they can get a fair opportunity to buy just by making an offer.⁶⁹ The more expensive

67. Bebchuk's influence on corporate governance practices can easily be seen in his work with the Shareholder Rights Project he created and leads as his vehicle for turning his corporate policy ideas into actual corporate policy. See 113 Companies Agreeing to Move Towards Annual Elections, S'holder Rights Project, <http://srp.law.harvard.edu/companies-entering-into-agreements.shtml> (on file with the *Columbia Law Review*) (last visited Feb. 1, 2014) (cataloguing achievements of the Shareholder Rights Project, including ninety-nine successful declassification proposals in 2012 and 2013).

68. E.g., Gregg A. Jarrell, Takeovers and Leveraged Buyouts, in *The Fortune Encyclopedia of Economics* 605, 607 (David R. Henderson ed., 1993), available at <http://www.econlib.org/library/Enc1/TakeoversandLeveragedBuyouts.html> (on file with the *Columbia Law Review*) (noting that "hostile takeover activity has declined sharply" since the 1980s).

69. The new style "*Revlon* non-*Revlon*" wave of lawsuits that are constantly being filed makes the point. These cases are like *Revlon* in the sense that the boards owe a duty to take reasonable steps to maximize the sale value. But they are unlike *Revlon* in the sense that they almost invariably involve situations where a majority-independent board decided to go into sale mode voluntarily and thus the lawsuits nitpick their business judgment as salespersons rather than allege that the board was entrenching itself. For that reason, these cases have tended to settle for no economic value to stockholders or to be dismissed. The frequency of their filing and the use of forum shopping to increase the costs to defendant corporations (and thus their investors, who ultimately bear the costs) to a level where it is rational to settle for trifling changes in deal terms or additional disclosure that does not influence the vote outcome is perceived by sophisticated commentators as another example of agency costs imposed on end-user American investors by particular types of stockholders, with unique interests most investors do not share. See Joseph A. Grundfest & Kristen A. Savelle, The Brouhaha over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis, 68 *Bus. Law.* 325, 339–47 (2013) (explaining causes and consequences of increased foreign forum selection provisions and summarizing judicial perspectives on challenges to these provisions). The prevalence of settlements in which only the plaintiffs' lawyers get an economic benefit, and the stockholders pay (in the form of a higher cost of capital and a deal tax that acquirers must price into their offers), is worrying, but for present purposes, the point is that it is easier than ever to buy a public company, because public company boards are typically receptive to the chance to sell at an attractive price. See Robert M. Daines & Olga Koumrian, Cornerstone Research, Recent Developments in Shareholder Litigation Involving Mergers and Acquisitions: March 2012 Update 1, 3 (2012), available at <http://www.cornerstone.com/getattachment/03dcde90-ce88-4452-a58a-b9efcc32ed71/Recent-Developments-in-Shareholder-Litigation-Invo.aspx> (on file with the *Columbia Law Review*) (noting that almost every public-company acquisition valued at over \$100 million resulted in multiple lawsuits and indicating those cases typically allege that the target board violated its fiduciary duties because of flaws in a voluntary sales process run by the board); see also Rock, *supra* note 18, at 1917–26 (discussing changes in the market for corporate control since the 1980s and arguing that there is no longer a "problem" of managerial resistance to hostile takeovers . . . considering the irrelevance of takeover defenses in a world in which managers are incentivized to think like shareholders").

and risky route of hostility is not necessary, as most boards are happy to consider selling at a genuinely attractive price.⁷⁰

To the extent that Bebchuk claims that the empirical evidence regarding average increases in value at firms targeted by hedge fund activism supports deviating from board insulation at current levels,⁷¹ he must confront the possibility that increasing the leverage that hedge funds have against boards will generate less positive results. If, as Bebchuk and others posit, the market is now working well because hedge funds and the board each have clout and can debate their respective positions, leaving the solid center of the stockholder electorate to decide which is right and to encourage both hedge funds and boards to move toward policies that increase stockholder profitability in a durable way good for most investors, his contention that this relationship should be further tilted in favor of the insurgents itself requires more support. As a respected scholar notes, “[S]ince the mid-2000s . . . management has responded to shareholder demands as never before.”⁷²

The need for fuller and more timely disclosure about the interests of activist investors who propose changes in the business plans of corporations but are not prepared to make a fully funded, all-shares offer to buy the corporation is arguably made more advisable because of these market developments. At the beginning of the takeover and merger boom that began in the early 1980s, scholars sharing Bebchuk’s viewpoint that stockholders should get the final say on whether to accept a takeover bid argued that the optimal blend for stockholders was one where the traditional values of the business judgment rule gave managers room to innovate and take risks, with the takeover market acting as a protective check to ensure that stockholders could exit through a premium if a buyer believed it could do better in managing the assets than incumbent management.⁷³ With easy access to financing available for buyers and the decline in structural takeover defenses, it has never been easier to make a

70. See Rock, *supra* note 18, at 1923–24 (identifying compensation incentives that align managers’ interests with shareholders’ interests and arguing that those incentives encourage managers to sell when someone makes an offer for the company); Mark J. Roe, Can Culture Constrain the Economic Model of Corporate Law?, 69 U. Chi. L. Rev. 1251, 1254–56 (2002) (noting that stock options in managerial compensation packages that vest upon a change of control and incentivize managers to sell the company enable acquirers to make “quasi-friendly” offers instead of hostile takeover bids).

71. Bebchuk, Board Insulation Myth, *supra* note 2, at 1638 (“The belief that current or even higher levels of insulating boards serve long-term value, I conclude, has shaky conceptual foundations and is not supported by the existing body of empirical evidence.”).

72. Michael Klausner, Fact and Fiction in Corporate Law and Governance, 65 Stan. L. Rev. 1325, 1361 (2013).

73. Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 823, 847–48 (1981) (describing the tender offer “as the principal displacement mechanism by which the capital market may police the performance of management and thereby justify the central role accorded management in other displacement mechanisms”).

full company offer and get it accepted. When a buyer purchases the entire company, it signals that it and its financing partners are willing to fully absorb the future risk of its business strategy. By contrast, when an activist argues that a corporation would be more valuable if it changed its business strategy, but is not prepared to buy the company or to even commit to hold its stock for any particular period of time, there is good reason to make sure that the other stockholders have full information about the precise economic interests of that activist.⁷⁴ With the sharp decline in structural takeover defenses, the plush access to deal financing, the prevalence of boards with supermajorities of independent directors, the increasing ease of running proxy contests and withhold campaigns due to increased institutional ownership, and the inexpensive nature of internet communication, the barriers to takeover bids, corporate governance and business strategy proposals, and changes to the board itself are lower than ever.⁷⁵ Put simply, it is not clear that Bebchuk's findings do not support the conclusion that the current status quo, with all of its real world human blemishes, strikes, as a general matter, a reasonable balance between stockholder and management power. And Bebchuk's own articulation of the dynamic, which is shared by other distinguished scholars who may not agree with him on other particulars,⁷⁶ suggests that

74. In fact, there is a study showing that it was only when an activist investor's campaign led to a takeover of the company that the activists were able to generate an abnormal return. See Greenwood & Schor, *supra* note 41, at 363 (showing through empirical study that, in situations where the target of activists remained independent, activists were not able to generate value). Another study has explained that, although the average excess returns following activist interventions are positive, "the majority of targeted firms do not enjoy these gains in stock price" and "52% of targeted firms actually underperform market benchmarks over both a one- and two-year horizon." Ajay Khorana et al., Citi Corporate & Inv. Banking Div., *Rising Tide of Global Shareholder Activism* 14 (2013). "Therefore the large average improvements are driven by a relative minority of activist efforts that result in outsized stock price gains as opposed to share price improvements at a majority of companies." *Id.*

75. See, e.g., Rock, *supra* note 18, at 1921–23 (discussing a variety of factors, including declining numbers of staggered boards, the rise of independent boards, and changes in institutional ownership, that have transformed corporate governance); Dennis K. Berman et al., *As Deal Barriers Fall, Takeover Bids Multiply*, *Wall St. J.* (May 8, 2007, 11:59 PM), <http://online.wsj.com/article/SB117858664134395253.html> (on file with the *Columbia Law Review*) (describing decline in barriers to takeover offers and subsequent increase in deals).

76. See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *Colum. L. Rev.* 863, 901 (2013) [hereinafter Gilson & Gordon, *Agency Costs*] (arguing for a regulatory regime that fosters conditions where "activist shareholders specialize in framing alternatives to existing company strategies . . . thereby increasing the value of governance rights to institutional investors" who can more effectively evaluate those alternatives); Jeffrey N. Gordon, *Activist Investors and the Revaluation of Governance Rights*, *CLS Blue Sky Blog* (May 6, 2013), <http://clsbluesky.law.columbia.edu/2013/05/06/activist-investors-and-the-revaluation-of-governance-rights/> (on file with the *Columbia Law Review*) ("[S]hareholder activists should be seen as playing a specialized capital market role of setting up intervention proposals for resolution by institutional investors.").

modest policy moves that better enable the solid center of the investor community to more effectively evaluate activist proposals so that sound ones are more likely to become corporate policy and excessively risky ones are more likely to be rejected might even appeal to him.⁷⁷

I do not presume that there is any way to bridge the great divide between Bebchuk, on the one extreme, and those like Lynn Stout, on the other, as their positions are so starkly divergent. A far more modest goal might be in reach, though, suggested by the preceding discussion of disclosure regarding hedge fund activists' economic interests. That is, it may be possible to find some common ground between these dueling camps that might allow us to improve the corporate governance system we actually have, given the allocation of legal and market power that in fact exists. For example, it might be possible for all participants in the debate to acknowledge three things. First, stockholders have formidable power under our system of corporate governance. Second, the direct stockholders of productive corporations primarily consist of institutional investors who are themselves susceptible to conflicts of interests and other incentives that may lead them to act in ways that diverge from those whose capital they are controlling. Third, all fiduciaries within the accountability system for productive corporations should themselves be accountable for acting with fidelity to the best interests of the end-user investors whose money is ultimately at stake. If there is agreement on these mundane grounds, it might be possible to improve the system as it actually exists so that it works better for both investors and society more generally.

To the extent that Bebchuk accepts his sparring partners' contention that it is important that corporations be governed in a manner likely to create the most sustainable wealth for their investors and society, this means that both he and they should want a process of corporate accountability where there is adequate and effective representation of the interests of investors who have entrusted their capital to the market for the long term. To the extent that Bebchuk believes that stockholder input on key corporate issues is valuable, one would assume he believes

77. One interesting issue for all to consider is whether the increasing prevalence of "compromise" between boards and activist investors is, on balance, a positive rather than negative development. An optimist might say it is positive because it shows that the market is working, and that boards and activists reach a sensible middle ground balancing short-term reward and long-term risk, with solid center investors pushing both sides toward responsible alterations in corporate policy that produce durable gains. A pessimist might say that diversified investors should want diverse management teams pursuing uncompromised business strategies, because the product of that collective exercise in managerial judgment is most likely to produce the best overall returns. Wealth creation can decrease, by contrast, if what companies pursue is neither the vision of their management teams or even the alternative vision of a hedge fund, but an admixture of both, shaped in large measure by the independent directors' desire (because they make much of their living as a director of three to four public companies at a time) not to upset important interest groups (such as ISS, Glass Lewis, or certain activist institutions) who might influence their ability to remain in the independent director game.

that stockholder input should be based on a genuinely thoughtful deliberative process that involves careful consideration of what is in the interests of the ultimate investors for whom the stockholder is acting. In particular, if Bebchuk believes that any dangers posed by certain stockholders who have short-term investment horizons are checked because institutional investors representing long-term investors cast most of the votes, he should support ensuring that the representatives of long-term investors in fact think and vote in the manner faithful to their investors' unique interest in sustainable, durable wealth creation. Likewise, if Bebchuk believes that facilitating a reasoned debate between management and activist stockholders about important issues where the argument is settled by mainstream elements of the institutional investor community will produce good results for investors, one would also assume that he would not want those mainstream investors deluged with thousands of annual votes that are impossible to consider in a careful, cost-effective way.⁷⁸

Although it would be difficult to find much acknowledgement in his work, Bebchuk is likely to agree that innovative and competent management remains the key driver of returns for stockholders. Certainly his sparring partners would.⁷⁹ Therefore, it might be that Bebchuk would recognize that it is counterproductive for investors to turn the corporate governance process into a constant Model U.N. where managers are repeatedly distracted by referenda on a variety of topics proposed by investors with trifling stakes. Giving managers some breathing space to do their primary job of developing and implementing profitable business plans would seem to be of great value to most ordinary investors. Likewise, Bebchuk and his sparring partners might agree that business strategies do not tend to be proven successful or not within the space of a year and that an effective system of accountability would be one where stock-

78. Institutional investors holding a broad portfolio are required to cast thousands of votes every year. In addition to the annual votes cast in director elections and the annual say on pay votes held at most Russell 3000 companies (the remaining companies hold their votes on a triennial or biennial basis), stockholders were asked to cast votes at 108 Russell 3000 companies on the frequency of say on pay votes, and on 465 other shareholder proposals. Equilar, 2013 Voting Analytics Report 6 (2013), available at <http://www.equilar.com/knowledge-network/research-reports/2013-research-reports/2013-voting-analytics-report.php> (on file with the *Columbia Law Review*). These votes come on top of the other votes that institutional stockholders are required to cast each year, such as votes to approve certain equity issuances, retain the company's auditors, and those mandated by state laws for the approval of key transactions. See *infra* notes 116–120 and accompanying text (discussing the overwhelming number of votes investors are asked to cast each year); see also James F. Cotter, Alan R. Palmiter & Randall S. Thomas, The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward, 81 *Geo. Wash. L. Rev.* 967, 979–80 (2013) (describing results of say on pay votes from the inaugural 2011 proxy season and noting say on pay votes were cast at over 2200 public companies in the United States).

79. See *supra* note 19 and accompanying text (citing scholars who would agree with that proposition).

holders periodically have an enhanced opportunity to displace the board or change corporate policies such as compensation plans based on their assessment of several years of data regarding the company's performance and the consequences of the board's policies. In other words, if it was wise of our Founders to put in place a system where Abraham Lincoln would be subject to removal based on his performance in 1864, rather than every year,⁸⁰ perhaps that sensible notion of holding vibrant elections after a rational time frame that takes into account the incumbent's performance over a period more relevant to the governance of a sophisticated entity is one that ought to be considered in determining how often to hold stockholder votes on issues like executive compensation and how often to enhance the chances of a proxy contest through subsidies like proxy access or reimbursement.

In the pages that follow, I will venture some thoughts on improvements that could be made in the system that we have. As befits someone who embraces the incrementalist, pragmatic, liberal tradition of addressing the world as it actually is, these suggestions are not radical in either direction. They do not involve rolling back the rights of the stockholders of productive corporations. Rather, they involve accepting the reality that stockholders have strong rights and trying to create a system for use of those rights that is more beneficial to the creation of durable wealth for them and for society as a whole. Consistent with Bebchuk's concern that humans controlling others' money should be accountable for faithfully using that power, they do involve some modest requirements: that the fiduciaries who wield direct voting power over productive corporations do so in a manner faithful to the best interests of those whose money they control, and that stockholders who propose corporate actions that cost other stockholders money have a sufficient economic stake to justify the substantial costs imposed by ballot measures. Likewise, they recognize that activist stockholders who seek to act on the corporation and cause it to change its business strategy are taking action that affects all stockholders, and that the electorate should therefore have information about the activists' economic incentives in considering whether their proposals are in the best interests of the corporation.

80. Would Abraham Lincoln have won reelection in 1861, 1862, or 1863? There is great reason for doubt, and thus great reason to be glad that he did not have to run until 1864. See Allen C. Guelzo, *Fateful Lightning: A New History of the Civil War & Reconstruction* 448–64 (2012) (detailing challenges Lincoln faced in his reelection bid, including movement within his own party to replace Lincoln as the Republican nominee with his Treasury Secretary, and noting “there was no period from January, 1864, until the 3[r]d of September of the same year” when Lincoln would have won (quoting A.K. McClure, *Abraham Lincoln and Men of War* Times 112 (Phila., Times Publ'g Co. 1892))); Jamie L. Carson et al., *The Impact of National Tides and District-Level Effects on Electoral Outcomes: The U.S. Congressional Elections of 1862–63*, 45 *Am. J. Pol. Sci.* 887, 889 (2001) (analyzing the 1862–1863 congressional elections and noting that historical accounts generally consider the results to be “a clear repudiation of Lincoln's administration”).

With that framework in mind, I hazard some specific thoughts about what a more sensible system of corporate accountability might involve.

A. The Need for the Most Rational Investors to Think and Be Heard

Implicit in Bebchuk's arguments,⁸¹ and more explicit in the arguments of other respected scholars such as Ron Gilson and Jeff Gordon,⁸² is the notion that the danger that activist hedge funds may induce corporations to take actions that generate short-term stock price increases at the expense of greater risk of firm failure and lower long-term investment is minimized by the reality that the bulk of the stockholder vote is wielded by mainstream mutual funds, most of whose investors are retirement savers. As they see it, mutual funds will tend to vote on the business merits, with an orientation toward supporting only changes that will make the corporation more valuable in a sustainable and fundamentally sensible manner, and not corporate finance gimmicks that involve excess leverage or shell games that do not generate truly greater durable value.⁸³

Corporate finance theory teaches that the most irrational investors are those who constantly turn their portfolios by trying to outguess the market, and that the most rational investors are those who patiently seek a solid market return through a prudently diversified buy and hold strategy that involves buying broad market indexes.⁸⁴ But the reality is that the segment of the investment community that is best positioned to vote

81. See Bebchuk, *Board Insulation Myth*, supra note 2, at 1664 (“[A]ctivist investors, including investors with short horizons, can generally expect to succeed in getting companies to take certain actions only if other shareholders support these actions.”).

82. See Gilson & Gordon, *Agency Costs*, supra note 76, at 897 (“[B]oth activist and institutional shareholders must agree for a proposal to go forward. While activist investors frame and seek to force governance/performance changes, they are successful only if they can attract broad support from institutional investors capable of assessing alternative strategies presented to them”); Ronald J. Gilson & Jeffrey N. Gordon, *Proposals to “Reform” the Section 13D Rules: Getting It Precisely Backwards*, CLS Blue Sky Blog (Aug. 7, 2013), <http://clsbluesky.law.columbia.edu/2013/08/07/proposals-to-reform-the-section-13d-rules-getting-it-precisely-backwards/> (on file with the *Columbia Law Review*) (arguing that the combination of activist investors and intermediary institutional owners “creates a kind of market stewardship—activists propose, sophisticated intermediary institutions decide”—such that “[a]ctivists cannot succeed, and cannot make money, unless the institutions vote for them”).

83. See Gilson & Gordon, *Agency Costs*, supra note 76, at 896–99 (arguing that activist proposals are only successful when mainstream institutional investors support them).

84. Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 *J. Econ. Persp.* 59, 77 (2003) (“A remarkably large body of evidence suggests that professional investment managers are not able to outperform index funds that buy and hold the broad stock market portfolio.”); see also Richard A. Brealey, Stewart C. Myers & Franklin Allen, *Principles of Corporate Finance* 192 (10th ed. 2011) (explaining that in a competitive market, where investors are unlikely to have better information than the market, “there is *no reason* to hold a different portfolio of common stocks from anybody else . . . [i]n other words, you might just as well hold the market portfolio” (emphasis added)).

with an eye toward sustainable value creation is the least active in exercising voice and judgment in American corporate governance: index funds. Although the huge mutual fund complexes have systems in place to make voting decisions, these decisions generally flow down to all funds on an issuer-by-issuer basis.⁸⁵ In the past, this has led to index funds voting both yes and no on the same merger—voting their target shares yes because of the premium and voting their acquirer shares no because the merger is deemed to be value destructive for the acquirer.⁸⁶ This is, of course, incoherent, stupid, and reflective of a lack of judgment being exercised by the index fund on behalf of its specific investors and their interests.

Precisely because index funds do not sell stocks in their target index, those funds have a unique interest in corporations pursuing fundamentally sound strategies that will generate the most durable wealth for stockholders. Index fund investors do not benefit by bubbles that burst. Index fund investors also have a more durable interest in the prospects of the corporations in the index than investors in actively traded funds. Actively traded funds turn over at a rate which makes it difficult to believe that their managers are basing their decisions on a genuine assessment of the corporations' long-term cash flow prospects as opposed to their speculation about where the market is heading.⁸⁷ When these funds

85. See Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, N.Y. Times (May 18, 2013), <http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html> [hereinafter Craig, *Giant of Shareholders*] (on file with the *Columbia Law Review*) (describing how the corporate governance team at BlackRock, made up of nearly twenty analysts, determines how BlackRock will vote all of its shares, regardless of the views of portfolio managers). A quick look at the proxy voting guidelines of other major institutional investors makes clear that they also make centralized voting decisions on how all of their funds will vote. See, e.g., Fidelity Funds' Proxy Voting Guidelines, Fidelity (Nov. 2013), <http://personal.fidelity.com/myfidelity/InsideFidelity/InvestExpertise/governance.shtml#fulltext> (on file with the *Columbia Law Review*) (indicating that the "FMR Investment Proxy Research" division decides how to vote proxies for all shares held by Fidelity Funds). Even Vanguard, which makes clear in its proxy voting guidelines that, in some cases, individual funds may decide to vote differently than the recommendation given by Vanguard's Proxy Oversight Committee, acknowledges that "[f]or most proxy proposals, particularly those involving corporate governance, the evaluation will result in the same position being taken across all of the funds and the funds voting as a block." Vanguard's Proxy Voting Guidelines, Vanguard, <https://investor.vanguard.com/about/vanguards-proxy-voting-guidelines> (on file with the *Columbia Law Review*) (last visited Feb. 1, 2014).

86. Strine, *Toward Common Sense*, *supra* note 2, at 17.

87. See Charles J. Gradante, *Comments of Hennessee Group LLC for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds 7* (May 14–15, 2003), available at <http://www.sec.gov/spotlight/hedgefunds/hedge-gradante.pdf> (on file with the *Columbia Law Review*) (stating that, in 2002, the average hedge fund turned its portfolio over three times, a thirty percent increase from 1999); see also Mitchell, *Speculation Economy*, *supra* note 6, at 277–78 ("Annualized turnover of all stock on the New York Stock Exchange was 118 percent in December 2006 as compared with 36 percent in 1980 and 88 percent even as recently as 2000. . . . American business is driven by finance. And the demands of finance have become short-term."); Anabtawi, *supra* note

are unlikely to hold a stock for much longer than a year,⁸⁸ it is not obvious why they would think deeply about the implications of proposed action on a time horizon that in the real world of business is not that long-term—five years—much less that they would consider where the proposed action would leave the corporation in a decade. Of course, in many mutual fund complexes, voting on issues that do not involve specific transactions such as mergers, but rather ongoing issues like corporate governance proposals, executive compensation, and even director elections, is not directed by the actual fund managers who buy and sell stocks, but by less highly compensated employees who work on proxy voting.⁸⁹ At smaller mutual fund complexes, voting is more likely to be influenced by outside proxy advisory firms, such as ISS.⁹⁰

29, at 579 (“The average turnover rate among stock mutual funds was 117 percent in 2004. Hedge funds trade their stockholdings nearly three times that much.” (footnote omitted)). In what could be a promising development, it appears that turnover rates are declining, but the reasons for that are unclear. The decline may be attributable to an increase in investments held in index funds and also to increased investor realization that high turnover rates are a warning sign of a poor investment strategy. See Inv. Co. Inst., 2012 Investment Company Fact Book 31 (52d ed. 2012) [hereinafter Inv. Co. Inst., 2012 Fact Book], available at http://www.ici.org/pdf/2012_factbook.pdf (on file with the *Columbia Law Review*) (finding asset-weighted annual turnover rate for mutual funds was fifty-two percent in 2011); Inv. Co. Inst., 2013 Investment Company Fact Book 29 (53d ed. 2013), available at http://www.ici.org/pdf/2013_factbook.pdf (on file with the *Columbia Law Review*) (finding that the asset-weighted annual turnover rate for mutual funds was forty-eight percent in 2012). Even with these lower turnover rates, funds are still turning over nearly all of their holdings within two years. See Inv. Co. Inst., 2012 Fact Book, *supra*, at 31 (finding asset-weighted turnover rate for mutual funds was fifty-two percent in 2011).

88. Even the study cited by Bebchuk to discount the relevancy of the increase in the volume of trading over time indicates that these funds are unlikely to hold their shares for a significant length of time. Martijn Cremers, Ankur Pareek & Zacharias Sautner, *Stock Duration and Misvaluation* 2–4, 10–13 (Sept. 2013) (unpublished manuscript), available at <http://ssrn.com/abstract=2190437> (on file with the *Columbia Law Review*) (finding that the weighted average length of time that *all* institutional investors, *including index funds*, held a stock in their portfolio was only 1.5 years in 2010); see also Bebchuk, *Board Insulation Myth*, *supra* note 2, at 1661 & n.115 (citing the study by Cremers, Pareek, and Sautner).

89. See Charles M. Nathan, *The Parallel Universes of Institutional Investing and Institutional Voting*, Harvard L. Sch. F. on Corp. Governance & Fin. Reg. (Apr. 6, 2010, 9:01 AM), <http://blogs.law.harvard.edu/corpgov/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting/#10b> (on file with the *Columbia Law Review*) (noting that many larger investment managers have internal staffs dedicated to voting all portfolio companies' shares and that this staff “typically is entirely separate from the portfolio managers and reports either to the general counsel or senior compliance officer of the investment manager, not to the investing function”).

90. See Stephen Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 *Harvard Bus. L. Rev.* 35, 52–53 (2013) (finding that small funds were more likely to rely on recommendations from proxy advisors such as ISS than were larger funds); see also *infra* note 103 (discussing 2009 amendments to New York Stock Exchange proxy voting rules, which resulted in increased power to activist and institutional investors).

If the mainstream investor community is to act as the sensible representative of durable stockholder value that Bebchuk envisions, perhaps even he would support requiring them to represent their investors more faithfully. Modest steps in that direction would include:

- Requiring index funds to do independent thinking and to vote in a manner that reflects the distinct investment philosophy of their investors and their strong interest in sustainable value creation;
- Precluding index funds from relying upon proxy advisory firms that do not provide index-fund-specific guidance; and
- Requiring mutual funds accepting 401(k) and college savings investments to have voting policies that take into account the long-term focus of their investors and their need for durable wealth creation.⁹¹

The reality is that these mundane changes are critical if our corporate governance system is not to become one in which more influence is wielded by the definitionally irrational, in a market where more of the actual invested capital is invested in the rational way, through index funds.

There are, of course, ideas in this area that might be more powerful. For example, oceans of ink have been spilled on making sure that the managers of listed corporations are paid in a manner that is linked to the performance of their companies' stock price, and increasing attention paid to making sure that they are only rewarded for durable increases in stock value.⁹² Most ordinary investors' fiduciaries are the managers of

91. Long term, it may be useful to require a separation of funds so that tax-preferred vehicles that lock in investors for long-term purposes through tax incentives are separated from more liquid investments. Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 *Bus. Law.* 1, 18 (2010) [hereinafter *Strine, One Question*]. Savings for retirement and college constitutes most of the money in these funds and their long-term needs should be paramount as a matter of fiduciary responsibility. See *id.* at 9 n.27.

92. See, e.g., Bebchuk & Fried, *Pay Without Performance*, *supra* note 33 (assessing current executive compensation practices and suggesting changes that the authors believe would better align executive pay with stockholder's interest); Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 *U. Chi. L. Rev.* 751, 761–93 (2002) (same); John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 *Mich. L. Rev.* 1142, 1159–83 (2005) (offering critique of Bebchuk & Fried, *Pay Without Performance*, *supra* note 33); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 *J. Pol. Econ.* 225, 225–27, 261–62 (1990) (analyzing performance pay and top-management incentives for CEOs and finding puzzling the “lack of strong pay-for-performance incentives for CEOs”); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 *U. Chi. L. Rev.* 847, 857–69 (2002) (offering critique of Bebchuk & Fried, *Pay Without Performance*, *supra* note 33).

their mutual funds.⁹³ Little has been done to encourage, much less require, that mutual fund manager compensation be tied in large measure to the durable increase in value of the fund they manage or that the mutual fund managers be compensated largely in restricted shares of their funds. Increasing the alignment of interests between mutual fund investors and mutual fund managers in increasing the durable value of the fund would seem to be a useful avenue to go down.

As Americans are forced, as a matter of reality, to give their money to mutual fund complexes to save for retirement,⁹⁴ the percentage of the voting power held by index funds will continue to grow. This can be a very positive thing, because it aligns the interests of the end-user investors, corporations, and society as a whole in sustainable wealth creation.⁹⁵ But that alignment will only produce positive results if those who control the index funds are required to think and vote in a way that is faithful to the interests of those whose money they control. That does not happen now, and one would think that both Bebchuk and his sparring partners would agree that it should.

B. The Need to Make More Appropriate Investment Opportunities Available to 401(k) Investors Focused on Long-Term Gains

For the longer term, it would also be useful to try to provide ordinary 401(k) investors with additional investment choices that better fit their interest in sustainable returns for sound investing, rather than more chances to invest in actively traded mutual funds that chase above-market returns. Aside from index funds and variable annuities, most of the investment products offered to 401(k) investors are not well-tailored to

93. See e.g., John C. Bogle, *The Clash of the Cultures: Investment vs. Speculation* 29–31 (2012) (explaining that the giant aggregations of capital by mutual funds and pension funds resulted in a “second agency” and that “[t]oday, these agents have become by far the dominant owners of U.S. corporations” and they owe a fiduciary duty to their principals, the mutual fund shareholders and pension beneficiaries).

94. *Id.* at 226–38 (describing America’s retirement savings system and noting that defined contribution plans, which enable stockholders to select various funds in which to invest, now dominate the private retirement savings market due to the rise of employer-sponsored 401(k) and 403(b) plans).

95. The Group of Twenty (G20) and Organization for Economic Cooperation and Development (OECD) recently issued updated principles reflecting their continued recognition that retirement investors are well-served by policies that give pension funds incentives to align their investment strategies with their beneficiaries’ strong interest in long-term growth of not only the pension fund portfolio, but also the wealth of the nations in which they live. OECD, *G20/OECD High-Level Principles of Long-Term Investment Financing by Institutional Investors* 5 (2013), available at <http://www.oecd.org/daf/fin/private-pensions/G20-OECD-Principles-LTI-Financing.pdf> (on file with the *Columbia Law Review*) (aiming “to help policy makers design a policy and regulatory framework which encourages institutional investors to act in line with their investment horizon and risk-return objectives, enhancing their capacity to provide a stable source of capital for the economy and facilitating the flow of capital into long-term investments” (emphases omitted)).

their investment horizons. When you are twenty-five years old and putting away money that you effectively will be unable to touch until you are at least fifty-nine unless you are willing to pay confiscatory rates of taxation, you are well-positioned to be an investor whose capital is committed for a lengthy period of time. There is a type of institutional investor whose investment approach fits well with retirement investors—private equity funds—but regulatory barriers effectively lock 401(k) investors out of that market.⁹⁶

If 401(k) investors were permitted to contractually commit a percentage of their retirement funds for periods of up to ten years, then the private equity industry might be incentivized to develop vehicles in which ordinary investors could participate, because the overall inflows into 401(k) funds every month are massive and growing.⁹⁷

Compared to the typical actively traded mutual fund, private equity funds are much more patient investors. They are not focused on quarterly earnings growth, but on making the companies they purchase more valuable over a period of several years, if not a decade.⁹⁸ For 401(k) inves-

96. There are a number of regulatory barriers that would have to be overcome before this idea could become reality. Sponsors of self-directed plans under the Employment Retirement Income Security Act (ERISA) § 401(k) have a safe harbor from liability to plan beneficiaries if they structure the investment options they make available to beneficiaries in particular ways. See 29 U.S.C. § 1104(c)(1) (2012). This safe harbor is one reason that most plans do not give participants the ability to buy individual company stocks. The safe harbor acts as a barrier to the development of private equity models in another way, because it is only available if the plan offers investments from which participants can achieve readily available liquidity so they can reallocate their funds to other investments. *Id.*; 29 C.F.R. § 2550.404c-1 (2013). This requirement makes it difficult for models allowing even “funds of funds” to develop that would invest in private equity on behalf of their own individual investors. Likewise, it is not clear that ordinary investors would be permitted to invest in particular private equity funds unless private equity developed funds that were registered under the Investment Company Act of 1940, as ordinary investors would not qualify for eligibility under section 2(a)(51) of the Act. 15 U.S.C. § 80a-2(a)(51) (2012). Whether the private equity model could succeed when pursued through the form of a fund registered under the Investment Company Act is itself questionable, as that is not the industry’s traditional model. For now, what is relevant is that there is utility to regulators and the industry coming together to see if ordinary investors with long-term perspectives that align well with the private equity model can be granted access to this market. If not, the law is denying investors who the retirement system effectively requires to put their wealth away for decades at a time a chance to invest with “smart money.”

97. See Peter Brady, Kimberly Burham & Sarah Holden, *Inv. Co. Inst., The Success of the U.S. Retirement System* 30 (2012), available at http://www.ici.org/pdf/ppr_12_success_retirement.pdf (on file with the *Columbia Law Review*) (noting that, in mid-2012, there was \$3.3 trillion in assets in 401(k) plans in the private sector, and that the number of active participants in 401(k) plans has increased from 17 million in 1989 to 51 million in 2010).

98. See, e.g., Josh Lerner, Morten Sørensen & Per Strömberg, *Private Equity and Long-Run Investment: The Case of Innovation* 29–32 (Nat’l Bureau of Econ. Research, Working Paper No. 14623, 2008), available at <http://www.nber.org/papers/w14623.pdf> (on file with the *Columbia Law Review*) (finding that firms pursue more influential

tors, the investment approach and horizon of private equity—which focuses on a period of five to seven years⁹⁹—make more sense intuitively and from a matter of corporate finance theory than actively traded mutual funds that turn over their portfolios rapidly and do not buy stakes influential enough to change corporate policies. If investors are going to try to exceed the market average, why not do it in a way that makes sense, by investing in a private equity fund that takes nondiversifiable risks by buying control and trying to improve the value of portfolio companies, and, if successful in that effort, obtaining an above-market return in exchange for taking on that risk? No doubt that the private equity industry itself would have to consider how it could structure vehicles that would allow it to raise the sums of committed capital necessary for it to pursue its traditional technique of buying actual companies and transforming their operations in a manner intended to increase their profitability.¹⁰⁰ But, given the massive and growing cash flows into 401(k) funds, and the decline of traditional defined benefit pension plans, the industry would seem to have a strong incentive to do that, whether by facilitating the formation of “funds of funds” for 401(k) investors, or creating innovative models for accepting capital directly from smaller investors.

C. The Need to Reduce the Number of Votes so that Good Decisions Can Be Made and Unnecessary Costs Can Be Avoided

If stockholder input is to be useful and intelligent, it needs to be thoughtfully considered. Not only that, it simply raises the cost of capital to require corporations to spend money to address annually an unmanageable number of ballot measures that the electorate cannot responsibly consider and most investors do not consider worthy of consideration. Although certain institutional investors have staffs who have jobs and influence largely because of the proliferating number of votes that stockholders are asked to cast, and although this proliferation guarantees that proxy advisory firms will have a market for their services, those are classic examples of agency costs that someone like Bebchuk would deplore if they were caused by corporate managers rather than money managers. How actual end-user investors or corporate performance are aided by

innovations and that patent quality increases following investments by private equity firms, indicating a focus on long-term research and development).

99. Ronald W. Masulis & Randall S. Thomas, Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance, 76 U. Chi. L. Rev. 219, 222 (2009) (noting that private equity funds are generally set up as private limited partnerships with ten-year terms and seek to exit their investments by the end of their term); Susanne Craig, Proudly Private, a Wall Street Brokerage Firm Marches On, N.Y. Times: Dealbook (Sept. 14, 2013, 6:10 PM), <http://dealbook.nytimes.com/2013/09/14/proudly-private-a-wall-street-bank-marches-on/> (on file with the *Columbia Law Review*) (noting that private equity investors generally have an investment horizon of five to seven years).

100. For example, there are difficult timing issues for an investor entering a fund in midstream given valuation issues, dilution problems, diversification, and disclosure.

having a ridiculous number of votes each year is harder to understand. Mainstream mutual fund managers deplore the number of votes and recognize that they cannot rationally focus on all of them.¹⁰¹

One obvious answer to this problem is one that Bebchuk would likely not support. That involves the radical notion that if stockholders can be trusted how to vote, they should also be trusted to determine whether it makes sense to vote at all. One fundamental test for Bebchuk's belief in stockholders, therefore, is whether he would be prepared to eliminate the mandate imposed by federal regulators in the 1980s that essentially required institutional investors to vote on every measure.¹⁰² That mandate generated the market for ISS, not because institutional investors believed that ISS would improve their investment performance, but because ISS gave them a way to meet a regulatory mandate under ERISA. That mandate also created, along with other recent changes, a change in inertia from one favoring the status quo (because any proponent of change had to mobilize the electorate to actually come out and vote in favor of their proposals) to one making change easier (because the electorate had to vote and the proxy advisory firms empowered by that reality were responsive to the most activist investors).¹⁰³ If Bebchuk

101. See, e.g., Craig, Giant of Shareholders, *supra* note 85 (noting that “[d]uring the 2012 proxy season, BlackRock voted shares on 129,814 proposals at 14,872 shareholder meetings worldwide” and that because of the huge volume of votes BlackRock must cast, it is not able to assign an analyst to every proposal and instead use proxy advisory firms like ISS and Glass Lewis to help identify issues).

102. See Letter from Alan D. Lebowitz, Deputy Assistant Sec’y, Dep’t of Labor, to Helmut Fandl, Chairman of Ret. Bd., Avon Prods., Inc., Dep’t of Labor Interpretive Letter on Avon Products, Inc. Employees’ Retirement Plan, 1988 WL 897696, at *2 (Feb. 23, 1988) (“In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock.”); see also 29 C.F.R. § 2509.08-2 (2013) (“The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock.”).

103. Another example of the change in inertia includes the 2009 amendments to the New York Stock Exchange rules that eliminated discretionary broker voting for the election of directors. See Self-Regulatory Organizations, Exchange Act Release No. 34-60215, at 1–2 (July 1, 2009), available at <http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf> (on file with the *Columbia Law Review*) (approving “proposed rule change . . . to eliminate broker discretionary voting for all elections of directors at shareholder meetings held on or after January 1, 2010”). Before the 2009 amendments, brokers were given the discretion to vote the shares of beneficial owners who did not return voting instructions to the broker. *Id.* at 2. Brokers almost always voted those shares with management. See *id.* at 6 (“In the view of some commenters, brokers tend to vote in accordance with management’s recommendation.”). That was an intuitively sensible voting decision because a stockholder who elected to purchase stock in a specific individual company probably did so because she liked the company and its management’s direction and believed that the stock was a good investment. Because getting all the small investors to turn in proxies is difficult, the result of the rule change is to reduce the pro-management vote. Indeed, the rule change was described by the Wall Street Journal as “a major win for activist investors.” Kara Scannell & Dan Fitzpatrick, SEC Plans to End Broker Vote Rule, in Win for Activists, *Wall St. J.* (Apr. 24, 2009, 12:01 AM), <http://online.wsj.com/news/>

truly trusts stockholders, he should permit them to make a considered decision when to vote, including the categorical decision that they will not vote on certain types of proposals.

If, as I suspect, he does not trust money manager stockholders to do this and wishes to continue to mandate that they vote on everything, then it is important that they be mandated to vote in a manner consistent with their investors' interests (e.g., the index fund proposal made above) and also that the number of stockholder votes not overwhelm the capacity of the institutional investor community to actually think in a serious manner about how to vote. But the present system involves too many votes for the institutional investor community to address thoughtfully and creates a rational basis to suspect that even proxy advisory firms cannot afford to employ enough qualified analysts to provide a genuinely studied recommendation on every vote.¹⁰⁴ Modest moves toward a more sane approach follow.

D. *Having Stockholders Vote on Executive Compensation on a Triennial or Quadrennial Basis Consistent with the Rational Time Frame for Employment Arrangements*

When the nonbinding say on pay vote was mandated by Congress, flexibility was granted to hold the votes on less than an annual basis.¹⁰⁵ Because executive compensation should be designed to provide top executives with appropriate incentives to manage well and create sustainable increases in corporate value, it seems counterintuitive and counterproductive that compensation arrangements should run on annual terms, with constant tinkering and changing of key provisions. Rather, one would think that what the compensation committees should do is to bargain for and set employment contracts with a reasonable length during which to assess the contribution of management to the corporation. Likewise, if stockholders are going to be given voice in those arrangements, their voice should be exercised in a mature fashion consistent with the actual arrangements that will be binding on the corporation and their sensible length.

Having a say on pay vote at each corporation every third or fourth year not only would be more consistent with the appropriate contractual term, it would also allow for more thoughtful voting by institutional investors. Because a third to a quarter of firms would have their arrange-

articles/SB124052371403949911 (on file with the *Columbia Law Review*) (arguing that, because many small shareholders do not vote their shares, the rule change will give more power to activist and institutional investors).

104. See *supra* note 78 (discussing how institutional investors cast thousands of votes each year).

105. 15 U.S.C. § 78n-1(a)(1) (2012) (requiring that “[n]ot less frequently than once every 3 years” a company “include a separate resolution subject to shareholder vote to approve the compensation of executives” in its proxy materials for a shareholder meeting).

ments come up for a vote every year, institutions could concentrate their deliberative resources more effectively. And because the votes would come periodically, the institutions would have developed a track record regarding the corporation's prior approach to compensation, which would provide useful context for considering the new compensation plan up for approval.

But, at the urging of ISS and more activist institutions, the "market" standard is to have say on pay votes annually on a schedule that bears no rational relation to the time frame for the contracts granted to top managers.¹⁰⁶ This has led to situations where a corporation's executive compensation plan was approved by over a ninety percent margin in one year, but voted down the next year despite the terms of the plan itself being materially unchanged.¹⁰⁷ There are two rational explanations for

106. See Cotter, Palmiter & Thomas, *supra* note 78, at 983 ("ISS almost always recommended in favor of annual say-on-pay votes and . . . shareholders at 1347 companies in our sample . . . supported annual say-on-pay voting, compared with shareholders at only 123 companies supporting triennial voting. In other words, say-on-pay promises to be an annual event at most larger public companies."); see also Equilar, *supra* note 78, at 19 ("There has been overwhelming support for the annual vote on compensation, particularly at the largest public companies. While nearly 81% of Russell 3000 companies have an annual advisory vote on compensation, 94% of the S&P 500 holds the Say on Pay vote annually.").

107. The say on pay votes at a number of companies changed radically from 2012 to 2013. What seems to have changed most was not the underlying compensation plans themselves, which remained materially unchanged, but ISS's reaction to the actual pay generated by the terms of the plan it had recommended in favor of the previous year in comparison to how well the corporation's stock price had performed. At Biglari Holdings, Inc., for example, eighty-seven percent of stockholders voted in favor of the compensation plan in 2012 but only thirty-three percent of the stockholders voted in favor of the plan in 2013 after ISS recommended against the plan. Georgeson, *Facts Behind 2013 Failed Say on Pay Votes* tbl.II (July 29, 2013), <http://www.georgeson.com/us/resource/Pages/Georgeson-Reports/July-29-2013.aspx> [hereinafter *Georgeson Report*] (on file with the *Columbia Law Review*) (showing stockholder voting results). The primary reason for the new negative ISS recommendation appears to have been that the payments that the CEO received under an incentive plan that had been in place since it was approved by shareholders in 2010 were considered to be high relative to the company's performance. ISS Proxy Advisory Servs., *Biglari Holdings Inc. 16* (2013) (on file with the *Columbia Law Review*). Similarly, at Apache Corporation, ninety-five percent of stockholders voted in favor of the compensation plan in 2012, but after a new negative recommendation from ISS in 2013 only fifty percent of stockholders voted in favor of the plan, even though the terms of the compensation plan appear to have been unchanged. See ISS Proxy Advisory Servs., *Apache Corporation 16* (2013) (on file with the *Columbia Law Review*); Georgeson Report, *supra*, tbl.II (showing stockholder voting results). At VeriFone Systems, Inc., the stockholder vote swung from ninety-five percent of stockholders in favor in 2012 to only twenty-one percent of stockholders voting in favor of the plan in 2013. Georgeson Report, *supra*, tbl.II. The primary reason for ISS's new negative recommendation and the corresponding decline in shareholder support of the compensation plan appears to have been the decline in total stock return (TSR) rather than any changes to the compensation plan. ISS Proxy Advisory Servs., *VeriFone Systems, Inc. 21* (2013) (on file with the *Columbia Law Review*) ("ISS identified several potentially concerning features in the company's compensation program For FY2011, concerns were mitigated based on the company's

this and neither is comforting. The first is that the negative vote in the second year was not a reflection on whether the terms of the executive compensation plan were fair and appropriate, but rather on the fact that the corporation had suffered some economic adversity and the stockholders were expressing their generalized outrage by voting no in a non-binding vote on the pay plan.¹⁰⁸ The second is that the prior year's vote on the compensation plan had been "mailed in" by the electorate who had not focused upon it, and so it was only the succeeding year when they (or, as the data suggests, the leading proxy advisory firm)¹⁰⁹

solid TSR performance. However, this superior performance has not been sustained . . ."). In each case, the revised ISS recommendation resulted in drastic change in stockholder support, even though the underlying compensation plan does not appear to have changed much, if at all. The influence of ISS on say on pay voting outcomes has been documented by scholars empirically. See Cotter, Palmiter & Thomas, *supra* note 78, at 989–90 ("[A]n ISS 'against' recommendation . . . overshadow[s] the effects of TSR, CEO pay growth, and excess CEO pay. Only when the ISS gives a 'for' recommendation do shareholders do their own homework and withdraw . . . voting support when a company has high TSR, high CEO pay growth, or high CEO excess pay."); *id.* at 983 tbl.1, 990 (showing that the percentage of stockholders doing this homework is small, because plans pass overwhelmingly when ISS recommends approval and "an ISS 'against' recommendation is much more relevant to shareholder voting than the 'excess' pay and combined low TSR/high excess pay factors—even dwarfing them in predictive value"); see also *infra* note 109 (discussing the effect ISS recommendations have on stockholder votes).

108. For further evidence supporting the proposition that say on pay votes have largely been driven by stockholder dissatisfaction over poor performance in the period before the vote, rather than whether the pay plan itself is well designed, see Ryan Krause, Kimberly A. Whitler & Matthew Semadeni, *The Conference Bd., When Do Shareholders Care About CEO Pay?* 4 (on file with the *Columbia Law Review*). Krause, Whitler, and Semadeni found that stockholders only vote no on say on pay plans when company performance is poor, that otherwise the relative level of managerial compensation does not result in negative votes, and that stockholders have no concern whether managerial pay provides optimal incentives for existing managers or procures new managers to lead a struggling company. *Id.* The results of Oracle's most recent say on pay vote arguably raise this concern. At Oracle's annual meeting on October 31, 2013, stockholders overwhelmingly voted, in a precatory, nonbinding plebiscite, to disapprove Oracle's compensation policy which had resulted in a \$78.4 million pay package to the CEO and large payments to other top Oracle managers, arguably because Oracle's stock price had lagged its competitors' during the prior calendar year. See Steven M. Davidoff, *A Vote Goes Against Outsize Executive Pay, but It's Hardly a Blow*, *N.Y. Times: Dealbook* (Nov. 5, 2013, 8:33 PM), <http://dealbook.nytimes.com/2013/11/05/a-vote-goes-against-outsize-executive-pay-but-its-hardly-a-blow/> (on file with the *Columbia Law Review*) (last updated Nov. 7, 2013). But if Oracle's stockholders had truly wanted to stop rewarding top Oracle managers, they had the opportunity to do so at the same annual meeting by voting against the expansion of Oracle's incentive stock option program to authorize more shares for awards to the CEO and top managers, because that expansion could not happen without stockholder approval. *Id.* But, at the same time they voted in a nonbinding way to disapprove Oracle's pay plan, more than half of the stockholders voted in a *binding* way to approve the expansion of the plan, enabling the large option grants to Oracle's executives to continue. *Id.*; see also Oracle Corp., *Current Report (Form 8-K)* (Oct. 31, 2013).

109. Cotter, Palmiter & Thomas, *supra* note 78, at 990–91 (finding that the most important factor to determine the level of opposition to say on pay plans was a negative

bothered to examine carefully the terms of the plan. Neither scenario reflects well on our corporate governance system, especially when that system gives stockholders an annual right to vote for directors. The strong empirical evidence that the most influential explanatory factor for the outcome of say on pay votes is the recommendation made by the most influential proxy advisory firm, instead of any factor directly related to the design of a pay plan,¹¹⁰ suggests that the capacity of investors to think carefully about how to vote currently is overwhelmed by having annual say on pay votes at almost all listed companies. If the say on pay vote was really intended by its advocates to just be an outlet for stockholders to express generalized dismay, then they should say so and confess that they did not share their real motivations with Congress. By contrast, if the purpose of the say on pay vote was to provide stockholders with a powerful and reasoned voice about a key area of corporate decisionmaking that has an important incentive effect on corporate policy—the terms on which top managers are paid—its advocates should want a system of say on pay voting that optimizes the chances that compensation committees will develop sound long-term compensation plans for consideration by stockholders. These advocates should want stockholders themselves—and not just proxy advisory services—to give thoughtful feedback about them, both in advance of and in the form of a vote.

E. Ensuring that Proponents of Corporate Action Share in the Costs They Impose on Other Stockholders

Law and economics adherents like Bebchuk understand that when someone can take action that is personally beneficial and shifts the costs to others, he will tend to do so more than is optimal for anyone other

recommendation from the proxy advisory service ISS, indicating that ISS's recommendations were more important than corporate total stock return or specific features of executive compensation in explaining stockholder votes); id. (suggesting that institutional investors rely upon ISS to identify compensation plans that should be voted down because corporations with performances and pay plans similar to those voted down receive affirmative support in the absence of an ISS negative recommendation). Another recent empirical study concludes that ISS is the most influential factor in the say on pay voting outcome, that corporations often change their compensation plans to avoid a negative ISS recommendation, that the stock market's reaction to the changed plans was "statistically *negative*," and that the "most parsimonious and plausible conclusion is that the [proprietary SOP policies] of proxy advisory firms . . . induce the boards of directors to make compensation decisions that *decrease* shareholder value." David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms* 8–9, 44–45 (Rock Ctr. for Corporate Governance at Stanford Univ. Working Paper No. 119, 2013), available at <http://ssrn.com/abstract=2101453> (on file with the *Columbia Law Review*).

110. See *supra* notes 107, 109 (citing empirical evidence which shows that the ISS recommendation is the most influential explanatory factor for the outcome of say on pay votes).

than himself.¹¹¹ Most investors would prefer that corporate managers not be distracted by the need to address shareholder votes unless those votes are about issues, such as a merger, that are economically meaningful to the corporation's bottom line. Under current law, however, a stockholder need only own \$2,000 of a corporation's stock to put a non-binding proposal on the ballot at the annual meeting of an American public corporation and need pay no filing fee.¹¹² By putting a proposal on the ballot in this way, a stockholder will necessarily require the corporation to spend hundreds of thousands of dollars on legal, administrative, and other costs,¹¹³ and require all other investors to bear the costs of having to have their money manager agents spend time and money considering how to vote and ultimately casting a vote. And even a stockholder whose proposal has failed miserably can resubmit an identical proposal at the expense of the company's other stockholders.¹¹⁴ The SEC requires the company to put a proposal that has failed once before on the ballot again unless it has been defeated within the past five calendar years by a vote of more than ninety-seven percent¹¹⁵—redolent of Ceausescu-style vote rigging.

These nonbinding votes, of course, come on top of the plethora of other votes shareholders are called upon to cast each year, including the annual vote on directors, the say on pay vote, votes to approve perfor-

111. See Garret Hardin, *The Tragedy of the Commons*, 162 *Science* 1243, 1244 (1968) (explaining the tragedy of the commons with the classic example of herdsmen sharing a pasture, in which each will maximize his personal gain by increasing his herd until overgrazing depletes pasture); *id.* (observing that “[r]uin is the destination toward which all men rush, each pursuing his own best interest in a society that believes in the freedom of the commons”); see also Romano, *Less Is More*, *supra* note 43, at 230 (“When a party does not bear the full cost of its activity, it will engage in more of the activity, for in equating the marginal benefits and costs of the enterprise, a lower level of benefit from the activity suffices to meet the reduced cost.”).

112. 17 C.F.R. § 240.14a-8(b)(1) (2013); see also Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 *Bus. Law.* 1079, 1100 (2008) (citing 17 C.F.R. § 240.14a-8(b)(1) (2008)).

113. For a thoughtful article that considers the inefficiencies and costs imposed by the current shareholder proposal regime, see Romano, *Less Is More*, *supra* note 43, at 182–219.

114. 17 C.F.R. § 240.14a-8(i)(12) (2013) (detailing requirements for resubmission).

115. *Id.* The SEC permits a company to exclude a submission from its proxy materials only in very limited circumstances. If the proposal has only been proposed once within the preceding five calendar years and received less than three percent of the vote, then it can be excluded. *Id.* § 240.14a-8(i)(12)(i). If the proposal has failed twice within the preceding five calendar years, and on its last submission received less than six percent of the vote, the company can exclude the proposal. *Id.* § 240.14a-8(i)(12)(ii). The company can also exclude a proposal that has failed three times within the preceding five calendar years if on its last submission it received less than ten percent of the vote. *Id.* § 240.14a-8(i)(12)(iii). No matter how many times a proposal has failed in the more distant past, a company cannot exclude a proposal if it has not been submitted within the preceding five calendar years. *Id.* § 240.14a-8(i)(12).

mance-based compensation required by federal tax law,¹¹⁶ binding votes on certain equity issuances that are required by the stock exchanges,¹¹⁷ votes to retain the company's auditors,¹¹⁸ as well as state law requirements that stockholders approve certain key transactions, such as mergers¹¹⁹ and very substantial asset sales.¹²⁰

In many states, candidates for office are required to pay a filing fee tied to a percentage of the salary of the office they seek. In California, for example, a United States Senate candidate must pay a fee equal to two percent of the salary of a Senator, or \$3,480, and a candidate for even the State Assembly must pay a filing fee equal to one percent of her salary, or nearly \$1,000.¹²¹ Given the economic motivation of investors and the absence of larger reasons that exist to foster candidacies in election in actual politics, requiring sponsors of economic proposals filed under Rule 14a-8 to pay a reasonable filing fee to bear a tiny fraction of the much larger costs their proposal will impose on the corporation (and therefore other stockholders) seems a responsible method to better recalibrate the benefit-cost ratio of Rule 14a-8.¹²² For example, the SEC could impose a

116. 26 U.S.C. § 162(m) (2012) (prohibiting public companies from deducting more than \$1 million in compensation for the CEO and four highest-paid employees unless such compensation is performance-based and approved by shareholders).

117. E.g., N.Y. Stock Exch., *supra* note 61, § 312.03(c) (requiring a shareholder vote to approve an issuance of common stock equal to or in excess of twenty percent of the voting power outstanding before the issuance).

118. Although the SEC does not require shareholders to vote on the retention of the company's auditors, such a vote has become standard. See Ernst & Young, *Audit Committee Reporting to Shareholders: Going Beyond the Minimum 1* (2013), available at [http://www.ey.com/Publication/vwLUAssets/Audit_committee_reporting_to_shareholders_going_beyond_the_minimum/\\$FILE/Audit_committee_reporting_CF0039.pdf](http://www.ey.com/Publication/vwLUAssets/Audit_committee_reporting_to_shareholders_going_beyond_the_minimum/$FILE/Audit_committee_reporting_CF0039.pdf) (on file with the *Columbia Law Review*) (reporting that more than ninety percent of Fortune 100 companies seek annual shareholder ratification of the auditor chosen by the audit committee).

119. Del. Code Ann. tit. 8, § 251(c) (2011).

120. *Id.* § 271.

121. *Frequently Asked Questions—2012 Candidate Filing*, Cal. Sec'y of State, <http://www.sos.ca.gov/elections/statewide-elections/2012-primary/faq-2012-candidate-filing.htm> (on file with the *Columbia Law Review*) (last visited Feb. 2, 2014); see also Tex. Elec. Code Ann. § 172.024 (West 2010) (charging a filing fee of \$5,000 to be a candidate for U.S. Senate, and \$750 to be a candidate for state representative); 2014 Qualifying Fees, Div. of Elections, Fla. Dep't of State, available at https://doe.dos.state.fl.us/candidate/pdf/2014_Qualifying_fees.pdf (on file with the *Columbia Law Review*) (last visited Feb. 2, 2014) (charging a filing fee of \$10,440 to be a candidate for U.S. representative, and \$1,781.82 to be a candidate for state representative). It is common for a state to charge one percent of the salary of the office sought as a filing fee, as is done in Delaware, Kansas, Nebraska, North Carolina, and Washington. Del. Code Ann. tit. 15, § 3103 (2007); Kan. Stat. Ann. § 25-206 (2000); Neb. Rev. Stat. § 32-608 (2008); N.C. Gen. Stat. § 163-107 (2011); Wash. Rev. Code Ann. § 29A.24.091 (West 2005 & Supp. 2013). In Virginia, the fee is two percent. Va. Code Ann. § 24.2-523 (2011).

122. Roberta Romano has also advanced well-reasoned arguments in support of a proposal that would recalibrate the benefit-cost ratio of Rule 14a-8. See Romano, *Less Is More*, *supra* note 43, at 230 (suggesting that “eliminat[ing] the subsidy of losing proposals

modest filing fee of \$2,000, or even \$5,000, for any stockholder proposal addressing economic issues and increase the holding requirement to a more sensible \$2,000,000¹²³ while still allowing proposing stockholders to aggregate holdings if they make appropriate disclosures.¹²⁴ If the advocates of a proposal cannot put up \$2,000 to \$5,000 and find other investors with an ownership interest of at least \$2,000,000, they have no right to force other stockholders to subsidize the cost of their desire for voice, when our free society gives them many other ways to exercise their free expression rights. Likewise, corporations should be permitted to exclude from the proxy Rule 14a-8 proposals in later years if they do not get at least twenty percent affirmative support in their first year, and if after the first year, they obtain less than thirty percent support.¹²⁵ None of these proposals, of course, would preclude proponents from using their own resources to fund a proxy contest to propose a bylaw, but it would reduce the ability of stockholders to use corporate funds (and thus indirectly the capital of other stockholders) on a subsidized basis to press initiatives that the electorate has soundly rejected and help to temper the proliferation of votes that overwhelm the institutional investor community's capacity for thoughtful deliberation.¹²⁶

F. Creating a More Credible and Responsible Director Election Process

Stockholders now have considerable, undisputed authority to adopt reforms to the electoral processes of Delaware corporations.¹²⁷ These

under the SEC's proxy proposal rules" could incentivize cost-effective activism because fund managers would "scrutinize . . . the fund's corporate governance program, to determine which proposals are most likely to attract voting support, because their cash position will be affected if they do not").

123. In reality, this number could be rationally increased to \$20 million or higher so long as aggregation was permitted.

124. Strine, *One Question*, supra note 91, at 23 (suggesting this approach).

125. See supra note 115 (discussing the very limited circumstances in which companies are permitted to exclude submissions from their proxy materials).

126. Respected scholars have recommended even stronger medicine than what I have recommended here, including allowing investors to vote to have their funds opt out of the SEC shareholder proposal apparatus entirely. See Romano, *Less Is More*, supra note 43, at 238 (explaining a potential reform to the shareholder proposal system that would "permit firms, by shareholder vote, to choose their proxy proposal regime, opting from among full, partial, or no subsidy regimes, for all or some proposals or proposal sponsors").

127. E.g., Del. Code Ann. tit. 8, § 112 (2011) ("The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required . . . to include in its proxy solicitation materials . . . , in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder."); id. § 113 ("The bylaws may provide for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors . . ."); id. § 216 ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").

reforms can take the form of so-called majority voting rules, which require a director to be elected with an affirmative majority of the votes cast, regardless of the fact that he had no human opponent. Majority rules have thus turned a decision to withhold a proxy vote for a director into a non-retention vote. This allows activist investors to seek to unseat directors without proposing their own candidates, who, because they would be humans, would have flaws, too. Institutional investors can essentially launch recall elections based on some discontent with corporate decisions or results, but without having to propose anyone who would do a better job.

It would seem more responsible for stockholders to take advantage of the chance to create a genuine choice between actual candidates by adopting bylaws that would provide a reimbursement of expenses to a proxy contestant whose slate achieved victory or a credible percentage of the vote, such as thirty-five percent.¹²⁸ Under Delaware law, stockholders could combine this approach with a form of proxy access, in which qualifying nominees would appear on a company-prepared proxy ballot.¹²⁹ In keeping with the need to balance benefits and costs responsibly, one could imagine having such a reimbursement and proxy access scheme operate in the same year that the company had the required say on pay vote. If a triennial approach to proxy reimbursement at companies without a classified board and voting on pay were adopted, that would create a vibrant accountability mechanism that would operate on a sensible schedule and give the stockholders a chance to observe how the directors had performed during a reasonable number of years in considering whether to continue them in office.¹³⁰

In between, stockholders would still be protected by the American approach to corporate law, which, unlike most of Europe,¹³¹ mandates annual director elections.¹³² Because hedge funds, moreover, prefer to run their own proxy contests using their own proxy cards, the possibility for proxy fights would exist every year, as the increase in such contests

128. See Strine, *Toward a True Corporate Republic*, *supra* note 2, at 1778 (recommending such a system).

129. Del. Code Ann. tit. 8, § 112.

130. See Strine, *Toward a True Corporate Republic*, *supra* note 2, at 1780 (evaluating benefits of such a system).

131. See Holly J. Gregory & Robert T. Simmelkjaer, II, Weil, Gotshal & Manges LLP, *Discussion of Individual Corporate Governance Codes Relevant to the European Union and Its Member States*, Annex IV (2002), available at http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part2_en.pdf (on file with the *Columbia Law Review*) (reviewing corporate governance codes of European Union member states that show it is common for directors to serve for a term of multiple years, with terms of four years or more being common); see also Index of Codes, European Corporate Governance Inst., http://www.ecgi.org/codes/all_codes.php (on file with the *Columbia Law Review*) (last visited Feb. 2, 2014) (collecting codes of various EU member states).

132. E.g., Del. Code Ann. tit. 8, § 211.

illustrates.¹³³ Furthermore, because of the concentration of institutional ownership and the ease of communication facilitated by the Internet, the affordability and viability of a proxy contest has been enhanced.

If a system of this kind were adopted at a corporation, Bebchuk would have to consider why the traditional plurality voting rule for elections—the candidate getting the most votes is seated—should not be restored. Under this rule, someone seeking to unseat a director should have to do so in the manner that enables for the most open and responsible choice by all the stockholders: by nominating an actual human who will serve in place of the incumbent who is targeted for removal. If proponents of board change prefer the withhold technique because it enables them to put pressure on the board to add candidates of their choice (or drop their withhold campaign in exchange for substantive changes in corporate policy such as a special dividend financed by reductions in future capital spending) after secret, backroom discussions to which all investors are not privy, that should lead someone like Bebchuk, supposedly a champion of all stockholders, to be suspicious.

G. The Need for the Voting Electorate to Know More About the Economic Interests of Activist Stockholders Proposing to Influence and Alter Corporate Business Strategies

There is a vigorous debate now raging about whether section 13(d) of the Securities Exchange Act of 1934 should be reformed to require public disclosure within twenty-four hours rather than ten days of when someone acquires more than five percent of any equity security of a public company.¹³⁴ Advocates of such change argue that the United States lags behind other nations by keeping a filing time period crafted in 1968, when it took much longer to prepare and file public disclosures with the SEC.¹³⁵ These advocates also note that market and technological develop-

133. See Vyacheslav Fos, *The Disciplinary Effects of Proxy Contests* 36 fig. 1 (Mar. 2013) (unpublished manuscript), available at <http://ssrn.com/abstract=1705707> (on file with the *Columbia Law Review*) (illustrating time distribution of proxy contests).

134. Compare Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Mar. 7, 2011) [hereinafter *Wachtell Lipton Petition*], available at www.sec.gov/rules/petitions/2011/petn4-624.pdf (on file with the *Columbia Law Review*) (recommending that the Commission require the initial Schedule 13D filing to be made within one business day following the acquisition of five percent of a company's stock), with Letter from Lucian A. Bebchuk & Robert J. Jackson, Jr. to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (July 11, 2011) [hereinafter *Bebchuk & Jackson Petition*], available at www.sec.gov/comments/4624/4624-3.pdf (on file with the *Columbia Law Review*) (arguing that there are substantial benefits associated with outside blockholders and that shortening the time period for disclosure would make it less likely that outside blockholders would emerge).

135. *Wachtell Lipton Petition*, supra note 134, at 4 (arguing that changes in technology, acquisition mechanics, and trading practices have rendered a ten-day reporting window outdated, "shortened deadlines have been required for years" in other developed financial markets, and "[t]he U.S. should . . . offer investors an equivalent level

ments¹³⁶ make it possible for an investor to acquire much more stock within a ten day period than was possible in 1968 when the Williams Act was enacted, and thus when investors go public, it can be with ownership stakes far in excess of the five percent level that triggers the requirement for public filing.¹³⁷ They argue that all stockholders should know as soon as practicable when an investor crosses the five percent threshold, and not wake up to find that a quarter of the company's stock is now in the

of available information on as timely a basis as other markets"). Compare Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2012) (requiring disclosure of any acquisition over five percent within ten days), with Takeovers Panel, Guidance Note 20, at 9 (2008) (Austl.) (requiring disclosure of any acquisition over five percent within two business days), Autorité des Marchés Financiers, General Regulations, Art. 223-14 (2013) (Fr.) (requiring disclosure within four trading days of crossing the acquisition threshold), Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], Sept. 9, 1998, Bundesanstalt für Finanzdienstleistungsaufsicht [BaFin] pt. 4 (Ger.) (requiring disclosure "immediately" after crossing acquisition threshold, but in no event later than four days), Securities and Futures Ordinance, (2012) Cap. 571, 212, § 325(1) (H.K.) (requiring disclosure of a "notifiable interest" within three business days), Regulation Implementing Decreto Legge 24 febbraio 1998, n. 58, art. 121 (It.) (requiring disclosure "without delay" after crossing the acquisition threshold, but in no event later than five trading days), Disposiciones generales art. 35 (B.O.E. 2007, 1362) (Spain) (requiring disclosure of any acquisition over three percent within four trading days), and Disclosure Rules and Transparency Rules, 2013, Stat. R. & O. 2013/142, art. 8, ¶ 3 (U.K.) (requiring disclosure of any acquisition over three percent within two trading days). Even in Brazil and Malaysia, which are less developed markets, stockholders who acquire more than five percent of a company's stock are required to report their holdings in a shorter time period than in the United States. See Companies Act, 1965, pt. IV, div. 3A, §§ 69D–69E (Malay.) (requiring disclosure of any acquisition over five percent within seven days); Ministry of External Relations, Dep't of Trade & Inv. Promotion, Legal Guide for Foreign Investors in Brazil 86–87 (2012), available at http://www.brasilglobalnet.gov.br/arquivos/publicacoes/manuais/pubguiale_gali.pdf (on file with the *Columbia Law Review*) (requiring the disclosure of any acquisition over five percent within seven days).

136. See Wachtell Lipton Petition, *supra* note 134, at 3 (noting that "[t]he advent of computerized trading has upended traditional timelines for the acquisition of shares, allowing massive volumes of shares to trade in a matter of seconds" so "[i]n today's world, ten days is an eternity").

137. *Id.* ("[Aggressive] investors may—and frequently do—secretly continue to accumulate shares during [the ten day] period, acquiring substantial influence and potential control over an issuer without other shareholders (or the issuer) having any information about the acquiror or its plans and purposes at the time stockholders sell their shares." (footnote omitted)); *id.* at 5–6 (noting, as example, that during ten day window after crossing five percent ownership threshold in J.C. Penney stock, Pershing Square Capital Management and Vornado Realty Trust were able to acquire approximately twenty-seven percent ownership prior to filing their initial Schedule 13D); see also Andrew Ross Sorkin, Big Investors Appear Out of Thin Air, *N.Y. Times: Dealbook* (Nov. 1, 2010, 8:25 PM), <http://dealbook.nytimes.com/2010/11/01/sorkin-big-investors-appear-out-of-thin-air/> (on file with the *Columbia Law Review*) (noting examples of investors accumulating large stakes in companies within ten days of crossing the five percent ownership threshold but before they are required to make their initial SEC filing and questioning whether it should be legal for investors to do so given push for more market transparency).

hands of a particular investor.¹³⁸ Bebchuk has jumped in on the side of hedge funds, who argue that despite technological changes enabling easy filing of a public disclosure within a short period, they should not be deprived of the opportunity to purchase as much stock as they can within a ten day period so as to have an adequate incentive to propose business plans to the company that, if adopted, will increase the value of the corporation for all stockholders.¹³⁹

Without wading into that part of the debate, one can fairly ask Bebchuk and his allies why they are not joining in the call to reform section 13(d) in one critical respect, which is to require that filers have to disclose completely their ownership interests in instruments of any kind tied to the value of the company's stock.¹⁴⁰ If their argument is that there is no reason to fear that hedge funds or other activist investors can threaten long-term value because longer-term investors will hold the balance of voting power, it logically follows that the voting electorate should have up-to-date, complete information about the economic interests of a hedge fund holding a large bloc of a corporation's shares and proposing that the corporation make business strategy changes it is suggesting. Precisely how "long" the fund's investment in the company is and in what manner the hedge fund is long is relevant information for the electorate to consider in evaluating the hedge fund's interest. So is how "long" the activist is committed to owning its shares. This is consistent with Bebchuk and his allies' belief that corporate managers should fully disclose their interests. When an investor is seeking to influence corporate strategies, especially by seeking status as a fiduciary or by using threat of an election campaign to gain concessions, that investor is taking action that affects all the company's investors. If the electorate is to play the role Bebchuk envisions, he should support requirements to make sure that up-to-date, complete information about the proponents' economic holdings and interests is available. And once the proponent has had the initial period to gather their stake and make their initial filing, there is no further basis

138. Wachtell Lipton Petition, *supra* note 134, at 7 (explaining that a shortened reporting window would be more in line with "the overall purposes of the 13D reporting requirements—namely, to inform investors and the market promptly of potential acquisitions of control and influence so that investors have equal access to this material information before trading their shares").

139. Bebchuk & Jackson Petition, *supra* note 134, at 6 ("It has long been recognized in the literature that an important source of incentives to become an outside blockholder is the blockholder's ability to purchase shares at prices that do not yet fully reflect the expected value of the blockholder's future monitoring and engagement activities."); *id.* ("Once the presence of an outside blockholder is publicly disclosed, prices rise to . . . reflect[] these expected benefits. If an outside blockholder could not purchase . . . at prices below this level, the returns to becoming an active outside blockholder would fall, and shareholders would lose the benefits of blockholders' presence.").

140. See, e.g., Wachtell Lipton Petition, *supra* note 134, at 8 ("[T]he current definition of beneficial ownership does not account for the realities of how derivatives and other synthetic instruments and ownership strategies are used today in complex trading strategies.").

to argue that they should not invariably have to meet filing standards consistent with current technological and market developments,¹⁴¹ by updating their filing within twenty-four to forty-eight hours if their ownership interest changes by one percent in any direction, long or short.¹⁴²

H. The Need for Institutional Investors to Get Smart and Learn to Love the Pill at Companies Without Classified Boards

There is an interesting debate about the utility of classified boards. Bebchuk's distinguished coauthor Guhan Subramanian wrote an article with John Coates and Bebchuk advocating for searching judicial review of any use of a poison pill by an incumbent board majority on a classified board over the objection of new directors elected by stockholders on the platform that they supported a pending takeover bid.¹⁴³ But Subramanian, in contrast to Bebchuk, believes that classified boards have their place.¹⁴⁴ And many others share that belief.¹⁴⁵ But the reality is that

141. For a discussion of the changes in technology that have occurred since the adoption of the ten day reporting period, see Wachtell Lipton Petition, *supra* note 134, at 3–4.

142. Schedule 13D must be amended “promptly” to reflect any change of one percent or more. See Filing of Amendments to Schedules 13D or 13G, 17 C.F.R. § 240.13d-2 (2013). The SEC has refused to define what “promptly” means, see Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 39538, at 8 n.14, 1998 WL 7449, at *3 (Jan. 12, 1998) (noting that it is “based upon the facts and circumstances”), but it is generally interpreted to mean the following business day. See Wachtell Lipton Petition, *supra* note 134, at 5 (recommending “Schedule 13D filing[s] be made within one business day” to mirror the “‘prompt’ disclosure standard that the Commission requires with respect to material amendments to existing Schedule 13D filings”). The United Kingdom requires the disclosure of any material change, defined as one percent or more, within two days. Disclosure Rules and Transparency Rules, 2013, DTR 5.6.1 (U.K.).

143. Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 *Stan. L. Rev.* 887, 944–48 (2002).

144. Guhan Subramanian, *Op-Ed.*, Board Silly, *N.Y. Times* (Feb. 14, 2007), <http://www.nytimes.com/2007/02/14/opinion/14subramanian.html> (on file with the *Columbia Law Review*) (opining that it would be a mistake to completely eliminate staggered boards because “[w]hat shareholders object to is not staggered boards themselves, but how staggered boards block takeovers”).

145. See, e.g., Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 *Stan. L. Rev.* 791, 812–13, 817 (2002) (arguing against a proposal that would amount to a “prophylactic rule” which forbids tandem use of classified boards and poison pills); Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 *Stan. L. Rev.* 819, 837 (2002) (arguing that staggered boards can play an important role by “ensur[ing] that the balance of bargaining power between acquirors and targets does not ebb and flow based solely on the timing of the target’s annual meeting”); Martin Lipton & Theodore Mirvis, *Harvard’s Shareholder Rights Project Is Wrong*, *Harvard L. Sch. F. on Corp. Governance & Fin. Reg.* (Mar. 23, 2012, 10:38 AM), <http://blogs.law.harvard.edu/corpgov/2012/03/23/harvards-shareholder-rights-project-is-wrong/> (on file with the *Columbia Law Review*) (“There is no persuasive evidence that declassifying boards enhance stockholder value over the long-term, and it is our

institutional investors as a class, including the mainstream mutual funds, prefer an open market for corporate control and believe that classified boards act as a genuine impediment.¹⁴⁶ Whether that is in fact true is a matter for another time, for now another more important point can be made.

The debate is becoming increasingly marginal because classified boards are becoming rare and are on their way toward endangered-species status.¹⁴⁷ Within the next few years—at the end of the day as it were—classified boards will be rarer than novel turns of phrase by political pundits. The typical company now does not have a classified board. When a corporation lacks a classified board, it risks bordering on malpractice for it not to have a standard form of poison pill to allow the board, in the event of an offer for the company, to: (i) negotiate on behalf of the stockholders to secure a better price; (ii) encourage market competition by seeing whether other bidders will pay a higher price; (iii) educate the stockholders about the board's view of the merits of the offer in light of the company's standalone prospects; and (iv) channel the debate over whether a bid represents a better value for the stockholders than if the company remains independent into the less coercive context of an election contest for control of the board. Without a pill, a bidder can act quickly under the tender offer rules without the board having the chance to act for stockholders to get the highest price reasonably available.

The presence of a garden variety poison pill preventing the acquisition of more than ten to twenty percent of the corporation's equity without board approval has another important, but often overlooked, protective effect for stockholders. The pill works to prevent a creeping takeover whereby effective negative control over a corporation is acquired without the payment of a control premium. Given the amount of stock that can be acquired before disclosure is required under Rule 13d, a reality discussed elsewhere in this Essay,¹⁴⁸ the absence of a pill can leave stockholders in a corporation that has activist stockholders owning an amount of stock that would act as a huge deterrent to any potential acquirer without having had to pay a control premium; indeed, an amount that in

experience that the absence of a staggered board makes it significantly harder for a public company to fend off an inadequate, opportunistic takeover bid . . .”).

146. This is demonstrated by the overwhelming support for precatory proposals to repeal the classified board structure. See S'holder Rights Project, *supra* note 67 (discussing success of board declassification proposals).

147. See Spencer Stuart, *supra* note 59, at 15 (noting eighty-three percent of S&P 500 companies now have declassified boards); Classified Boards Year over Year, *supra* note 66 (demonstrating that the number of S&P 1500 companies with classified boards has dropped from 904 in 1998 to 555 in 2012).

148. See *supra* notes 134–137 and accompanying text (discussing the opportunity for investors to acquire large amounts of a company's stock that is created by the ten day window investors have to file a Schedule 13D with the SEC after they cross the five percent ownership threshold).

the European Union would often trigger an obligation to make a mandatory bid for all shares.¹⁴⁹

Despite these obvious realities, it remains the case that certain proxy advisors and institutional investors continue to oppose poison pills even by corporate boards that are not classified.¹⁵⁰ This is an example of the need for the now powerful institutional investor community to mature, and to strike a more sensible balance for those they represent. Once a board is declassified, the chance for a bidder to secure control at the ballot is never more than a year away. That being the case, it is counterproductive to the interests of stockholders for a board of that kind not to have a solid, well-designed standard rights plan in place, and for it to be distracted by precatory proposals regarding the plan. As important, it is silly for a board to have to waste time in the important period following the receipt of a takeover bid on “taking a pill off the shelf” simply because institutional investors have a reflexive hostility to the pill, when the board’s time would be much better spent considering how to react to the offeror in a substantive manner that is designed to achieve the best economic outcome for stockholders.

Imagine an American market which incorporated these ideas, where it was more common than not that:

- Corporate boards were not classified but could protect their stockholders from inadequate bids and creeping takeovers and maximize stockholder value by using the combination of a poison pill and a campaign in a subsequent proxy fight to, among other things, convince stockholders that they are better off if the bid is rejected and the company remains independent, bargains for price increases, or finds a better deal;

149. See Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2002 O.J. (L 14) 12 (setting forth the “mandatory bid rule” which requires a stockholder that crosses a certain ownership threshold, to be set by individual European countries, to make a bid for all of the company’s outstanding shares); Commission of the European Communities, Report on the Implementation of the Directive on Takeover Bids, SEC (2007) 26 final (Feb. 21, 2007), available at http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf (on file with the *Columbia Law Review*) (summarizing the ownership thresholds adopted in European jurisdictions for the mandatory bid rule, typically around thirty percent).

150. See, e.g., Institutional S’holder Servs., 2013 U.S. Proxy Voting Summary Guidelines 25–26 (2013), available at <http://www.issgovernance.com/files/2013ISSUSSummaryGuidelines1312013.pdf> (on file with the *Columbia Law Review*) (setting forth guidelines indicating a general wariness toward boards of directors adopting poison pills without shareholder ratification and failing to list whether the company has a classified board as a factor that should be considered in determining how to vote on proposals related to poison pills); Proxy Voting Policies, T. Rowe Price, <http://corporate.troweprice.com/ccw/home/responsibility/conductingBusinessResponsibly/proxyVotingPolicies.do> (on file with the *Columbia Law Review*) (last visited Jan. 25, 2014) (setting forth its policy of generally voting against management proposals to adopt or amend poison pills regardless of whether the company has a classified board).

- Say on pay votes occurred triennially or quadrennially and stockholders had a track record by which to assess how the corporation's pay policies had worked, and had more time to focus on casting an informed vote because only a third to a quarter of the companies would have a vote every year; and
- The election process was enhanced by proxy reimbursement and access in the year of the corporation's periodic say on pay vote.

Imagine further that the interests of American investors were better represented in the corporate electoral process and better protected from excess costs imposed by institutional investors and individual stockholders with idiosyncratic interests in proliferating votes on myriad issues because:

- Proponents of economic proposals had to pay a filing fee of \$2,000 to \$5,000 and own at least \$2 million or one percent of the company's stock;
- Proposals that did not receive at least twenty percent in the first year could be excluded in subsequent years and proposals not receiving thirty percent over a three year period could be similarly excluded;
- Institutional investors, including mutual and pension funds, had to have voting policies that were specifically tailored to the investment horizons of their investors;
- Index funds were required to have voting policies reflecting the unique permanent investment philosophy of their investors and thus their particular interest in ensuring that corporations implement responsible strategies to generate durable increases in corporate profitability;
- Institutions holding the capital of investors saving to pay for retirement and college were required to have voting policies reflecting their investors' need for sound and durable value creation;
- Institutional investors could not rely upon proxy advisory firms' recommendations that did not reflect the investment horizons and investing strategy of their investors, and in particular, index funds could not rely upon proxy advisory firms that did not provide index fund-specific voting recommendations; and
- There was complete, up-to-date information about the economic interests of stockholders who have to file under Schedule 13D, thus providing the voting electorate with a more adequate understanding of the economic interests of activist investors proposing changes in corporate business strategy affecting all investors.

Heck, while we are going about rationalizing incentives so as to create a corporate governance system that serves ordinary investors and our society better in terms of its ability to generate durable gains in wealth,

we might also recognize the potential utility of changes in tax policy that would provide better incentives for institutional investors and long-term capital investment in our economy. By enacting a fractional tax on all securities trades and sensible alterations in capital gains taxation so that the lower long-term capital gains tax rates of fifteen or twenty percent¹⁵¹ are only available to those who actually hold for a period of four or five years rather than the current oxymoronic “one year, longterm” rate approach,¹⁵² several useful results would follow: (i) stock and derivative trades based on ephemeral market anomalies would be discouraged and trades would have to be justified by more durable reasons more rationally related to the long-term prospects of the issuer or assets underlying the derivative; (ii) mutual fund managers would be given room to be more patient because the current opportunity for irrational cost-free fund-hopping by 401(k) and other investors on the last quarterly Morningstar ratings would be made more costly; and (iii) the nation would raise revenues to fund the infrastructure investments broad segments of the business community understand are needed for long-term U.S. competitiveness and to address the challenge of climate change, as well as to close the long-term budget deficit.¹⁵³ Because most American investors have to entrust their capital to the market for decades to fund college tuitions and retirements, and because most Americans are still more dependent on their ability to get good jobs than on equity returns, their narrower interests as investors and broader economic interests are harmonic in the sense that both are advanced by policies that facilitate durable increases in American wealth, productivity, and job creation, through sustainable, nongimmicky business plans.¹⁵⁴ Tax policies that discourage speculation

151. Under the American Taxpayer Relief Act of 2012, there was an increase in the long-term capital gains rate from fifteen percent to twenty percent for certain high income individuals. Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318–19 (2013) (to be codified at 26 U.S.C. § 1).

152. 26 U.S.C. § 1222(3) (2012) (defining “long-term capital gain” as “gain from the sale or exchange of a capital asset held for more than 1 year”).

153. See Paul Davidson, U.S. Businesses Seek a More Competitive Economy, USA Today (Nov. 8, 2012, 8:31 PM), <http://www.usatoday.com/story/money/business/2012/11/08/economy-growth-competitiveness/1689911/> (on file with the *Columbia Law Review*) (listing “upgrading the nation’s crumbling infrastructure” as a priority for business leaders); John D. Schulz, U.S. Chamber of Commerce Head Says Rebuilding Infrastructure Is a 2012 Business Community Priority, Logistics Mgmt. (Jan. 12, 2012), http://www.logisticsmgmt.com/article/u.s._chamber_of_commerce_head_says_rebuilding_infrastructure_is_a_2012_busi (on file with the *Columbia Law Review*) (noting that a “key ingredient” in economic growth is “maintaining and improving the nation’s transport and infrastructure system”); Infrastructure, U.S. Chamber of Commerce, <http://www.uschamber.com/infrastructure> (on file with the *Columbia Law Review*) (last visited Feb. 2, 2014) (discussing the need to “improve the quality of America’s infrastructure” as part of its American Jobs & Growth Agenda).

154. For a thoughtful essay proposing state corporate law reforms that would encourage sustainable wealth creation for the benefit of stockholders and society generally, see Jack B. Jacobs, “Patient Capital”: Can Delaware Corporate Law Help Revive It?, 68 Wash. & Lee L. Rev. 1645 (2011); see also William T. Allen, Jack B. Jacobs & Leo E.

and encourage the thoughtful deployment of capital would therefore seem to be a useful element of a corporate governance system that works in their interest.

Taken as a whole, it is difficult to see how this would be a system that would “insulate” corporate managers from accountability to their equity investors. Rather, it would be one that made them strongly accountable to stockholders in a form of republican democracy supplemented by required stockholder votes on many important items, but in a more rational framework where end-user investors focused on sustainable, long-term growth were better represented, where there was fuller information for the electorate to consider, and where there was more time for them to give thoughtful consideration to how to vote without being overwhelmed by an unmanageable number of annual votes. Likewise, this strong but more sensible approach would better balance costs and benefits, by reducing the externalization of the costs of sport from those who enjoy making proposals for the sake of the process to the actual investors dependent on corporate America’s success to fund their retirements and children’s college educations. And without reducing their accountability for producing good results, by having stockholder votes on pay occur on a rational schedule, corporate managers and directors would have a bit more time to focus on doing their most important function well, which is implementing a sound and sustainable business strategy to deliver profits for the corporation’s investors.

If this approach would, in Bebchuk’s view, leave corporate managers insulated, then my distinguished friend should admit that he will not be satisfied until American corporations are in fact direct democracies in which fiduciary accountability only operates against corporations, but not money managers. In that direct democracy, anyone with a trifling holding could make proposals without bearing any of the costs. In that direct democracy, a vote on pay would occur every year despite the fact that no one would reasonably pay top managers on a year-to-year incentive scheme and stockholders cannot rationally think about how to vote on so many pay plans annually. In that direct democracy, stockholders could unseat directors by recall elections without the responsibility to name human candidates to fill the seats. In that direct democracy, stockholders with small holdings would also have subsidized annual access to the corporation’s proxy to run an annual proxy contest. In that direct democracy, stockholders could enact bylaws and charter changes that could not be reversed by the board. In that direct democracy, bidders could buy companies by a tender offer after the twenty-day period under the Williams Act expires, without boards being able to use a rights plan to

Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. Chi. L. Rev. 1067, 1096–100 (2002) (floating, for discussion purposes only, a similar idea).

protect the stockholders from being coerced into an uninformed bargain sale.

And in that system of direct democracy, we would not worry about the reality that those casting the votes were overwhelmingly not the ultimate beneficiaries of the investment capital at stake. The reality that the ultimate beneficiaries were dependent on another level of corporate governance agency, at which far fewer protections for stockholders are in place compared to those that constrain the managers of productive corporations, would not be troubling. The reality that the most rational end-user investors—index investors—do not have votes cast on their behalf that reflect their unique interest in sustainable wealth creation does not undermine the reliability of stockholder voting as a protection. Nor does the fact that these investors are, as a practical matter because of 401(k) regulations, unable to exit and have far less investment choice than is true of direct investors in public corporations create a problem, even though Bebchuk has long viewed the Wall Street rule as an inadequate safeguard for public company investors with many more investment options.

Bebchuk has spent his entire career obsessed with ensuring that stockholders are not harmed by corporate managers, whether intentionally or because those managers have incentives that do not align exactly with those of the stockholders. He has been remarkably successful in seeing his agenda to make corporate managers more directly responsible to stockholders become the predominant market reality. Fidelity to his own insights would seem to suggest a new agenda, which is ensuring that the entities of which most ordinary Americans are in fact equity investors—money managers in the form of mutual funds and pension funds—are as accountable as the managers of the productive enterprises on which our nation's economic future is largely dependent. Until he broadens his lens to make sure that all who wield power using the funds of American investors are accountable, Bebchuk is himself fairly labeled an insulation advocate.