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?

*By Leo E. Strine, Jr.**

This essay poses the question of how corporations can be managed to promote long-term growth if their stockholders do not act and think with the long term in mind. To that end, the essay highlights the underlying facts regarding how short a time most stockholders, including institutional investors, hold their shares, the tension between the institutional investors' incentive to think short term and the best interests of not only the corporations in which these investors buy stock, but also with the best interests of the institutional investors' own clients, who are saving to pay for college for their kids and for their own retirement. Although the primary purpose of the essay is to highlight this fundamental and too long ignored tension in current corporate governance, the essay also identifies some modest moves to better align the incentives of institutional investors with those of the people whose money they manage, in an effort to better focus all those with power within the corporation—i.e., the directors, the managers, and the stockholders—on the creation of durable, long-term wealth through the sale of useful products and services.

In this essay, I address one of the knottier issues that must be tackled if our system of corporate governance is to work better for society as a whole and end-user investors in particular. Although I will touch on some of the current hot topics along the way, I will spend most of my time on this central problem: why should we expect corporations to chart a sound long-term course of economic

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Although certain developments in the period immediately before publication relate to the subject matter of this essay, for example, the U.S. Securities and Exchange Commission's adoption on August 25, 2010, of rules requiring proxy access, those developments, if anything, make the subject of this essay more, not less, relevant. I have made no attempt to alter the essay in a rushed fashion to address these recent events.

growth, if the so-called investors who determine the fate of their managers do not themselves act or think with the long term in mind? I will suggest some modest moves toward addressing this substantial policy dilemma and better aligning the incentives of institutional investors with those of the people whose money they manage. But more fundamentally, I raise the basic facts regarding the short-term horizons of most equity owners because too many observers of corporate governance—and dare I say it, too many institutional investors—deny that there is a problem of this kind at all.

The Basic Social Purpose for Chartering For-Profit Corporations

In tabling this topic, I must be up front about a major underlying assumption, which relates to the basic purpose society has for chartering for-profit corporations. I believe that the generation of durable wealth for its stockholders through fundamentally sound economic activity, such as the sale of useful products and services, is the primary goal of the for-profit corporation.[1] The word durable is essential for several reasons.

Stockholders are not granted the protections of the corporate shield as a societal end in itself. Rather, limited liability encourages stockholders to entrust their capital to corporations, which will engage in risky, but potentially profitable, endeavors.[2] The hoped-for outcome of this risk taking, in the aggregate, is an increase in societal wealth, and not simply through the generation of profits. Rather, to generate profits, corporations have an incentive to employ workers and develop innovative products and services, and to engage in other activities that increase societal wealth.[3]

1. By fundamentally sound, I emphasize the non-gimmicky generation of profits through the sale of things or services of utility to others. I implicitly contrast that with financial gimmicks designed to increase GAAP accounting profits.

2. *See* William T. Allen & Reinier Kraakman, Commentaries and Cases on the Law of Business Organization 91 (2003) (noting that "the ability of the corporate form to segregate assets may encourage risk-averse shareholders to invest in risky ventures"); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 94–97 (1985) (noting that limited liability fosters diversification of investment portfolios by allowing the transferability of shares, and therefore that "limited liability facilitates optimal investment decisions" because managers "can accept [risky] ventures (such as development of new products) without exposing the investors to ruin. Each investor can hedge against the failure of one project by holding stock in other firms."); Reinier Kraakman et al., The Anatomy of Corporate Law: A Comparative and Functional Approach 91–111 (2d ed. 2009) (explaining that limited liability, which protects owners from an entity's creditors, and independent legal personality, which protects an entity from the creditors of its owners, combine to create a system of "asset partitioning," whereby separation "can increase the value of both types of assets as security for debt").

3. *See, e.g.*, Robert Charles Clark, Corporate Law § 16.2, at 677–80 (1986) (noting that corporations "increase social welfare, because without them certain large-scale business ventures would be impossible or would be carried out in a wasteful way"); Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business 1–12 (1977) (arguing that the rise of the modern professionally managed corporation has been a "source of permanence, power, and continued growth"); *see generally* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times Mag., Sept. 13, 1970, at SM17.

To build wealth in a durable manner, corporations need to commit capital to long-term endeavors, often involving a lag time between the investment of capital and the achievement of profit, a long time during which activities like research and development occur.[4]

The Basic Social Purpose of Corporation Law Can Be Achieved Only Through a Republican Model of Corporate Democracy

The management of corporations requires great skill, attention to detail, substantive expertise, and perseverance through difficult circumstances. Indeed, many successful enterprises weather years of adversity before succeeding.[5] The deployment of diverse investors' capital by expert centralized management has been a major contributor to America's wealth.[6]

The ability of central management to innovate and pursue risky strategies has been protected by corporate law's adoption of a republican, rather than direct,

4. Many of the leading voices in the institutional investor community agree that corporations should be managed for the long term. *See* CalPERS Global Principles of Accountable Corporate Governance 7 (Feb. 2010), *available at* http://www.calpers-governance.org/docs-sof/principles/2010-5-2-global-principles-of-accountable-corp-gov.pdf ("Corporate directors and management should have a long-term strategic vision that, at its core, emphasizes sustained shareowner value. In turn, despite differing investment strategies and tactics, shareowners should encourage corporate management to resist short-term behavior by supporting and rewarding long-term superior returns."); TIAA-CREF Policy Statement on Corporate Governance 7 (Mar. 2007), *available at* http://www.tiaa-cref.org/ucm/groups/content/@ap_ucm_p_tcp/documents/document/tiaa01007871.pdf ("The board of directors is responsible for . . . overseeing the development of the corporation's long-term business strategy and monitoring its implementation . . . [and] representing the long-term interests of shareholders."); ICGN Global Corporate Governance Principles (July 1999), *available at* http://www.icgn.org/best-practice/documents/earlier-editions/-/page/441/ ("The overriding objective of the corporation should be to optimize over time the returns to its shareowners. . . . To achieve this objective, the corporation should endeavor to ensure the long-term viability of its business . . . ."); ICGN Statement on Institutional Shareholder Responsibilities § I.2 (2003) (indicating that the "general objective of . . . activities [by institutional investors] is to stimulate the preservation and growth of the companies' long-term value"); *see also* Press Release, TIAA-CREF, New TIAA-CREF Policy Brief Calls on Shareholders to Take an Active Role in Corporate Governance (Feb. 2, 2010), *available at* http://www.tiaa-cref.org/public/about/press/about_us/releases/pressrelease319.html (recommending "measures that will enable long-term institutional shareholders to uphold their responsibilities as shareholders" and noting that "[i]t is imperative that large long-term investors such as retirement systems and mutual funds—to which millions of investors entrust their savings—encourage portfolio companies to adopt governing practices that promote sustainable growth and lead to long-term value creation").

5. For an interesting example of this, see the history of the Ford Motor Company contained in M. Todd Henderson, *The Story of* Dodge v. Ford Motor Company: *Everything Old Is New Again*, *in* Corporate Law Stories 37, 37–49 (J. Mark Ramseyer ed., 2009).

6. *See generally* Stephen M. Bainbridge, Corporation Law and Economics 202 (2002) ("[I]n large corporations, authority-based decisionmaking structures are desirable because of the potential for division and specialization of labor. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize. Directors and managers specialize in the efficient coordination of other specialists. In order to reap the benefits of specialization, all other corporate constituents should prefer to specialize in functions unrelated to decisionmaking, such as risk-bearing (shareholders) and labor (employees), delegating decisionmaking to the board and senior management. . . . Separating ownership and control by vesting decisionmaking authority in a centralized nexus distinct from the shareholders and all other constituents is what makes the large public corporation feasible.").

model of corporate democracy.[7] Although stockholders have a regular opportunity to elect a new board, during the board's term, the board has the power, subject to its fiduciary duties, to pursue its vision of what is best for the corporation and its stockholders.[8] Although corporate law takes into account the differences between political polities and business entities by giving stockholders important veto rights (in the form of a required vote) over certain transactions that could end or fundamentally transform the entity,[9] corporate law clearly vests the power to manage the corporation in its directors, and not in the stockholders.[10]

For rational, diversified long-term investors, the benefits of the republican model are considerable. Through diversification, firm-specific risk is reduced and investors can benefit by the full-bodied, non-compromised pursuit of sustainable profits by various management teams.[11] If, instead of a republic, corporations become direct democracies, where every action of management is the subject of a stockholder plebiscite, the time and attention of managers will be increasingly diverted from profit-producing activities into more "political" activities centered on addressing referenda items propounded by particular stockholders, who often have no long-term commitment to remaining as stockholders and who owe other stockholders no fiduciary duties.[12] And, the success of even a republic depends

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7. Although there are obvious and important reasons not to take analogizing the governance of for-profit corporations to the governance of actual political republics too far, it is also vital not to ignore the clear influence republican principles have had on the American approach to corporate law. For an accessible discussion of how republican concepts find resonance in corporate law statutes, charters, and bylaws, see Alan R. Palmiter, *Public Corporation as Private Constitution*, 6 ICFAI J. Corp. & Sec. L. 8 (2009).

8. TW Servs., Inc. v. SWT Acquisition Corp., Nos. 10427 & 10298, 1989 WL 20290, at *8 n.14 (Del. Ch. Mar. 2, 1989) ("While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation, subject however to a fiduciary obligation.").

9. *E.g.*, Del. Code Ann. tit. 8, § 251(c) (2001 & Supp. 2008) (requiring that a merger agreement be submitted to the shareholders of all constituent corporations at an annual or special meeting for a vote); *id.* § 271 (requiring that a sale of "substantially all" of a corporation's assets be approved by the holders of a majority of the outstanding shares); Model Bus. Corp. Act § 11.04(b) (4th ed. 2008) ("[A]fter adopting the plan of merger or share exchange the board of directors must submit the plan to the shareholders for their approval.").

10. *E.g.*, Del. Code Ann. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."); Model Bus. Corp. Act § 8.01(b) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors.").

11. *See* Bainbridge, *supra* note 6, at 202–03 & n.11 (noting that "[d]irectors and managers specialize in the efficient coordination" of the corporation's affairs and that shareholders can simultaneously benefit from the board's expertise and hedge their risk through a diversification strategy: "By virtue of their nondiversified investment in firm specific human capital, managers bear part of the risk of firm failure. As the firm's residual claimants, however, shareholders also bear a portion of the risk associated with firm failure. Portfolio theory tells us that individual shareholders can minimize that risk through diversification, which managers cannot do with respect to their human capital. Separating ownership and control thus unbundles the risks associated with the firm and allocates each of those risks to the party who can bear it at the lowest cost.").

12. For an excellent discussion of this problem, see Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 Bus. Law. 361, 380–82 (2010) (discussing "megaphone externalities" that lead certain stockholders to desire proxy access at a low access threshold in order to gain publicity for causes other than the promotion of long-term corporate value).

not just on whether its elected representatives comply with their duties, but also on whether its citizens fulfill their role responsibly.[13] As applied to public corporations, this reality makes it vital that stockholders have the long-term best interest of the corporation in mind, and that any wealth-generating model of reform confront,

13. Many activist investors speak in the language of republican democracies, and expect to be treated like citizens. *See, e.g.*, Press Release, CalPERS, CalPERS Urges U.S. Senate Committee to Protect Shareowner Access to Corporate Election Ballots, Seeks Strong Message to SEC About Proposed Rule Change (Nov. 14, 2007), *available at* http://governance.calpers.org/marketinitiatives/initiatives/press-releases/calpers-urges-us-senate ("The [Securities and Exchange] Commission should stand for more corporate democracy, not less democracy. For all the sophistication of our markets in the U.S., we continue to lag other countries in corporate democracy. We are the world's only developed economy that keeps shareowners from placing director nominees on company ballots."); Press Release, CalSTRS, Statement by CalSTRS and Other Institutional Investors on Marsh & McLennan's Decision to Add an Independent Director to Its Board of Directors (Mar. 18, 2004), *available at* http://www.calstrs.com/newsroom/2004/news031804.aspx ("Only through improved shareholder democracy can we ensure the true owners of the company are heard in the board room."); Press Release, AFSCME, AFSCME Employees Pension Plan Concludes Successful Proxy Season, Applauds SEC Staff Recommendations (July 15, 2003), *available at* http://www.afscme.org/press/6935.cfm ("There is an urgent need for shareholder democracy. We urge the Commissioners to quickly institute measures that allow access to the proxy . . . ." (quoting AFSCME Plan Chair Gerald W. McEntee)); Letter from the Council of Institutional Investors to Representative Michael N. Castle, U.S. House of Representatives (Dec. 2, 2008) (noting that institutional investors are "major long-term shareowners" and "significant long-term investors" in U.S. capital markets); Nell Minow, *Money Managers: If Not Them, Who?*, LENS INC. (Oct. 1994), http://www.lens-library.com/info/whart.html (calling for increased "corporate democracy" and noting that pension funds' "commitment to the long term makes them good, if not perfect, corporate citizens"). But, the rhetoric used typically does not embrace the full tradition of citizenship, particularly that part involving the obligations of loyalty that come with the status of citizenship. Dating back to ancient Athens, the concept of citizenship has involved reciprocity, the mutual obligations of citizen to state and state to citizen. *See* DEREK HEATER, CITIZENSHIP: THE CIVIC IDEAL IN WORLD HISTORY, POLITICS AND EDUCATION 1–5, 83 (3d ed. 2004) (quoting Aristotle by describing citizens as "all who share in the civic life of ruling and being ruled in turn"). In the republican tradition, it is accepted that the republic cannot thrive if citizens do not honor their duty of loyalty to the republic and act in a virtuous manor designed to advance the interests of the republic, and not simply the citizens' personal interests. *Id.* at 41 (summarizing Rousseau's views as "the true citizen seeks the realization of the General Will, the common good, not the satisfaction of his own selfish interests"); JOHN STUART MILL, CONSIDERATIONS ON REPRESENTATIVE GOVERNMENT 79 (1862) (describing a citizen as one who is "called upon . . . to weigh interests not his own; to be guided, in case of conflicting claims, by another rule than his private partialities; to apply, at every turn, principles and maxims which have for their reason of existence the common good; and he usually finds associated with him in the same work minds more familiarized than his own with these ideas and operations, whose study it will be to supply reasons to his understanding and stimulation to his feeling for the general interest"); *see also* RAYMOND ARON, PROGRESS AND DISILLUSION: THE DIALECTICS OF MODERN SOCIETY 238 (1968) ("Perhaps in a modern society there are not many citizens in Rousseau's sense of the word; that is, men who are concerned about the public good as such and willing to sacrifice their own interests for it."). By strong contrast, in the American corporate law tradition, stockholders who are not directly controlling board action are entitled to pursue only their own self-interest, without owing any fiduciary duties to other stockholders or the corporation itself. *See* Weinstein Enters., Inc. v. Orloff, 870 A.2d 499, 507 (Del. 2005); Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del. Ch. 1984); *see also* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1265–73 (2008). By essentially demanding to be regarded as citizens of a corporate polity, institutional stockholders who simultaneously cling to the corporate law tradition that stockholders owe no obligation to consider any interest other than their own are distorting an important intellectual tradition by advocating a responsibility-free notion of citizenship in the corporate realm. In an era where activist stockholders exert power that influences corporate policy, the absence of any articulated concept of the duty owed to the corporation renders the rhetorical borrowing from the republican tradition clearly selective.

and not duck, the obligations that activist stockholders should have toward the corporation, their fellow stockholders, and society.

Because the Corporation Is a Republic, Stockholders Have a Legitimate Expectation that the Election System Will Function Fairly and that the Opportunity to Run Competing Candidates Will Not Be Unduly Burdensome

Precisely because the corporation is a republic that invests potent managerial oversight power in the board members during their terms, stockholders are entitled to expect that boards will be attentive to the stockholders' interests, communicate with them about important corporate issues, and be open to their feedback and suggestions about ways the corporation's performance, and the board itself, might be improved. Although one useful by-product of such thoughtful consideration of stockholder interests should be a reduction in election contests and other disputes, the very nature of the republican model gives stockholders a legitimate interest in the fairness and competitiveness of the board election system, because that is the model's ultimate accountability mechanism.[14] This is especially the case when directors have the authority, subject to compliance with their fiduciary duties, to use defensive tactics that slow or impede the procession of a tender offer for control.[15] Moreover, because of regulatory and other issues, there are some public corporations that are not easy to discipline through the market for corporate control. Likewise, there are many investors who, because they hold the market, through index funds, do not have the option of "exit," and who therefore have a special interest in ensuring that all the companies in key indices have a sound corporate strategy, operate in compliance with the law, and avoid imprudent leverage and risk.

Because the management slate can fund its own re-election campaign with corporate funds and because investors face collective action problems, there is merit to responsible measures to ensure that electoral challenges can, on a sensible, periodic basis, be affordably mounted.[16] Consistent with allowing stockholders and managers to engage in private ordering,[17] the most flexible and efficient method

14. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 658 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

15. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985) (holding that the board's managerial power extended to deploying takeover defenses so long as they did so reasonably and in good faith).

16. For my previous musings on this subject, see Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 Harv. L. Rev. 1759, 1775–77 (2006) [hereinafter Strine, *Toward a True Corporate Republic*]; 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, 999–1001 (2003).

17. *See* Del. Code Ann. tit. 8, §§ 112, 113 (2001) (giving stockholders broad authority to shape the corporate election process, provide for reimbursement costs to insurgent slates, and permit access to the corporation's proxy).

to move in this direction would be to permit stockholders to use an enhanced and more flexible Rule 14a-8 to adopt bylaws that shape a more open election system, using techniques such as reimbursement for insurgent slates receiving a certain level of support or access to the company's proxy statement.[18]

An investor-driven, rather than government mandated, approach to election reform will ensure that majorities—I underscore that I mean majorities—of stockholders decide how the election system should work. This will better prevent the use of corporate—and thus investor—dollars for nuisance campaigns and allow a variety of innovative approaches to be test-driven at specific companies. By this process, the market can assess what works best without the high costs that come with the imposition of an unproven, invariable mandate. Importantly, letting investors decide will permit stockholders to consider for themselves whether subsidies to proxy insurgents should be provided annually or on a more periodic basis, and what level and duration of ownership or success at the ballot box should be required of those seeking such subsidies.[19]

If a more open election system can be put in place through the bylaws, a useful incentive would also be created for boards to communicate with stockholders about important corporate issues, including the factors that boards use in their own nominating processes. By being more open about the qualities that their nominating committees consider vital—such as business acumen, substantive expertise in key areas, international experience, and diversity—and seeking out input from long-term stockholders over the important issue of board composition and chemistry, boards could foster greater understanding, provide a less adversarial avenue for changing the board, and reduce the likelihood that they will face proxy fights.

Stockholders Who Propose Long-Lasting Corporate Governance Changes Should Have a Substantial, Long-Term Interest that Gives Them a Motive to Want the Corporation to Prosper

Stockholders of publicly traded corporations have substantial liquidity and freedom to alienate their shares. Indeed, as I will soon note, they appear to love to alienate their shares. This reality still pertains even as many institutional investors have become active in proposing the adoption of corporate governance changes and even substantive business strategies by public companies. If adopted, these corporate governance changes (e.g., changes to the corporation's

18. One model for an enhanced "Rule 14a-8E" as in "election" might involve the following: i) affording proponents 1,000 or more words to describe the election reform proposal, given the relative complexity of the subject matter involved; ii) granting proponents the ability to also hyperlink to the text of the actual election bylaw proposals; iii) requiring that any issuer who failed to implement, amended, or otherwise altered a stockholder-adopted proposal under Rule 14a-8E disclose the reasons for that action in the next 10-Q and the next 10-K.

19. In prior writings, I have outlined one possible model for a periodic system. *See* Strine, *Toward a True Corporate Republic*, *supra* note 16.

board structure or election system) and business strategies (e.g., the reduction of capital expenditures in order to fund a stock buyback program) will often have a long-term effect on the corporation's performance. Yet, many activist investors[20] hold their stock for a very short period of time and may have the potential to reap profits based on short-term trading strategies that arbitrage corporate policies.[21] Indeed, it is possible for stockholders to engage in activism while holding a net short position, in which they stand to profit if the corporation's profits decline.[22]

The rights given to stockholders to make proposals and vote on corporate business are premised on the theory that stockholders have an interest in increasing the sustainable profitability of the firm.[23] But in corporate polities, unlike nation-states, the citizenry can easily depart and not "eat their own cooking." As a result, there is a danger that activist stockholders will make proposals motivated by interests other than maximizing the long-term, sustainable profitability of the corporation.

To address this important concern in a balanced way, the following principles might usefully guide policymakers: stockholders who make substantive proposals with long-term effects, such as bylaws, precatory proposals relating to sub-

20. Charles Nathan and Parul Mehta have incisively pointed out that the term "activist investor" is commonly used to describe two different kinds of investors, who have different motives, world views, and agendas. *See* Charles Nathan & Parul Mehta, *The Parallel Universes of Institutional Investors and Institutional Voting*, Harv. L. Sch. Forum 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/#1. One type of activist investor is the "event driven" hedge fund or similar actor. Those investors tend to favor short-term strategies like leverage, big dividends, recapitalizations, sales, and similar transactions that return capital immediately to shareholders. But, there is another type of "activist investor" who may be best described as "corporate governance activists." Those are institutional investors such as CalPERS, CalSTERS, TIAA-CREF, and the AFL-CIO. It is the latter type of "governance" activists that have focused on features of the governance structures of firms. Unlike activist investors in the hedge fund sense, corporate governance activists primarily agitate only about corporate governance. These two types of activists, however, have a symbiotic relationship that tilts the direction of corporate management toward short-termism. The "governance activists" often amplify the power of the hedge funds by pushing corporate governance measures—such as the elimination of classified boards and other takeover defenses—that make boards more susceptible to immediate market pressures. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. Pa. L. Rev. 653, 684 (2010) ("The hedge funds have inspired interventions by large, mainstream investment advisors; they also have depended on and received the support of other, more passive institutional investors.").

21. For a good discussion of how this is possible, see Anabtawi & Stout, *supra* note 13, at 1258–59, 1291–92.

22. *See id.* at 1287; *see also* Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reform*, 61 Bus. Law. 1011 (2006); Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775.

23. *See* Bainbridge, *supra* note 6, at 470 ("[S]hareholders have the strongest economic incentive to care about the size of the residual claim [on returns to corporate assets], which means that they have the greatest incentive to elect directors committed to maximizing firm profitability."); Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 68 (1991) (noting that shareholders are given voting rights because "[a]s the residual claimants, shareholders have the appropriate incentives (collective action problems notwithstanding) to make discretionary decisions. The firm should invest in new products, plants, and so forth, until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives.").

stantive corporate governance, or proposals for a slate of directors to be elected, should have a substantial, positive economic interest in the corporation; and the corporate electorate should receive full disclosure of the economic interests of proponents of such action, and that disclosure should be updated regularly until stockholder action is finally taken.[24]

Confronting the Challenge of Focusing Institutional Investors on What Matters to Their Investors and Society: The Long-Term Performance of the Company

The incisive thinking of Adolf Berle about the implications of the separation of ownership and control has dominated corporate law scholarship for most of the last seventy-five years.[25] Berle's recognition that the emergence of public corporations with dispersed stockholders presented the need for regulatory measures to ensure that corporate managers act responsibly toward their investors and society remains timely.

Given the depth of Berle's intellect and his concern for the societal effects of corporate behavior, one senses that he would be deeply unsatisfied by the present failure to address new market phenomena, most notably the: 1) separation of ownership from ownership;[26] and 2) the emergence of reaggregated forms of aggressive capital, largely unconstrained by legal or equitable duties to other stockholders or society as a whole.[27]

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24. To give the corporate electorate better information about activist investors seeking to influence corporate change and issuers and regulators better information about trading in derivatives that could adversely affect issuers, section 13 of the Securities Exchange Act of 1934 could be amended to: (1) reduce the reporting threshold from 5 percent to 3 percent; (2) require reporting of any position, long or short, that meets that threshold (in either direction); (3) expand the definition of beneficial ownership to cover derivatives; and (4) give the SEC authority to require earlier disclosures and more prompt updating. This reform would follow the model of the recent reforms in the United Kingdom, which have made much more information available on a more timely basis. *See* Fin. Servs. Auth., Disclosure and Transparency Rule 5 (2009) (U.K.).

25. *See* A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931); Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 333–57 (1932).

26. As an essay by Nathan and Mehta highlights, the separation concept does not even stop at ownership itself. *See* Nathan & Mehta, *supra* note 20. This is because within many institutional investor complexes, the staff who vote shares do so based on an overall philosophy about corporate governance that has little, if anything, to do with what is best for a particular firm. Their staff are often entirely separate from the professional investors who actually decide what stocks to buy and how long to hold them. *See id*. But, at some of these complexes, these "voting" staffs are quite active in the sense of pushing corporate governance ideas at many corporations despite the non-involvement of the personnel who actually act as investors, however short term.

27. As I have noted previously:

> Most Americans invest with a rational time horizon consistent with sound corporate planning. They invest with the hope of putting a child through college or providing for themselves in retirement. But individual Americans don't wield control over who sits on the boards of public companies. The financial intermediaries who invest their capital do. These intermediaries have powerful incentives—in important instances, not of their own making—to push corporate boards to engage in risky activities that may be adverse to the interest of long-term investors and

These phenomena present a formidable new challenge to the wealth-creating potential of public corporations. The existing model of corporate law focuses solely on the duties the managers owe to stockholders. It does not address the reality that most "stockholders" are now themselves a form of agency, being institutional investors who represent end-user investors. These institutional investors now control nearly 70 percent of U.S. publicly traded equities, a figure that will continue to grow.[28]

For a variety of reasons, these institutional investors often have a myopic concern for short-term performance. Responsible commentators estimate hedge fund turnover[29] at around 300 percent annually.[30] What is even more disturbing than hedge fund turnover is the gerbil-like trading activity of the mutual fund industry which is the primary investor of Americans' 401(k) contributions. The average portfolio turnover at actively managed mutual funds,[31] for example, is approximately 100 percent a year.[32] Median turnover is in the 65 percent

> society. That is, there is now a separation of "ownership from ownership" that creates conflicts of its own that are analogous to those of the paradigmatic, but increasingly outdated, Berle-Means model for separation of ownership from control.
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> Unless these incentives and conflicts are addressed, it should be expected that corporate boards will continue to face strong pressures to manage their enterprises in a manner that emphasizes the short term over the long term, and that involves greater risk than is socially optimal.

Leo E. Strine, Jr., *Why Excessive Risk-Taking Is Not Unexpected*, N.Y. TIMES DEALBOOK (Oct. 5, 2009, 1:30 PM), http://dealbook.blogs.nytimes.com/2009/10/05/dealbook-dialogue-leo-strine/; *see also* Leo E. Strine, Jr., *Human Freedom and Two Friedmen: Musings on the Implications of Globalization for the Effective Regulation of Corporate Behaviour*, 58 U. TORONTO L.J. 241 (2008); 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 (2007) [hereinafter Strine, *Toward Common Sense*].

28. *See* John C. Bogle, *Restoring Faith in Financial Markets*, WALL ST. J., Jan. 19, 2010, at A25 (noting that institutional investors control almost 70 percent of the shares of U.S. corporations); Press Release, The Conference Bd., U.S. Institutional Investors Continue to Boost Ownership of U.S. Corporations 1 (Jan. 22, 2007) (on file with *The Business Lawyer*) (indicating that "in 2005 institutional investors held a record 61.2% of total 2005 U.S. equities, up from 51.4% in 2000").

29. Bill Barker, *Turnover and Cash Reserves*, MOTLEY FOOL, http://www.fool.com/school/mutualfunds/costs/turnover.htm (last visited Sept. 18, 2010) ("In plain[ ] English, turnover represents how much of a mutual fund's holdings are changed over the course of a year through buying and selling.").

30. *See* Anabtawi & Stout, *supra* note 13, at 1291–92 (citing Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579 (2006)); HENNESSEE GROUP LLC, COMMENTS OF HENNESSEE GROUP LLC FOR THE U.S. SECURITIES AND EXCHANGE COMMISSION ROUNDTABLE ON HEDGE FUNDS (May 14–15, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-gradante.pdf (stating that, for 2002, the average portfolio manager turns its portfolio over three times—a 30 percent increase from 1999).

31. Not surprisingly in light of the decline of defined benefit retirement plans and the tax incentives and limited investment options given to 401(k) investors, the percentage of U.S. equities controlled by mutual funds is growing rapidly. *See* Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 655 (2009) (citing BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS AND OUTSTANDINGS, FOURTH QUARTER 2006, at 90 tbl. L.213 (2007), *available at* http://www.federalreserve.gov/releases/z1/20070308/z1.pdf (showing that mutual funds went from controlling 7 percent of U.S. equities in 1990 to 32 percent by 2006; the actual data cited seems to indicate an increase to over one-third)).

32. *See* Brian Reid & Kimberlee Miller, *Mutual Funds and Portfolio Turnovers,* RES. COMMENT. (Inv. Co. Inst. Nov. 17, 2004) (on file with *The Business Lawyer*) (reporting a 117 percent average annual

range.[33] Sadly, there appears to be a basis to believe that pension funds also engage in turnover of their equity investments at a similar rate.[34] Given that institutions dominate ownership, these trends now consistently result in annualized turnover of stocks traded on the New York Stock Exchange of well over 100 percent, with turnover approaching 138 percent in 2008.[35] And, a rough calculation using transaction activity and market capitalization data from the U.S. Statistical Abstract reveals that turnover across all U.S. exchanges reached approximately 311 percent in 2008.[36]

This kind of churning renders the institutions more short-term speculators than committed, long-term investors. Not only do such trading patterns give fund managers little reason to think deeply about the effect of corporate governance proposals on long-term corporate performance, these high-speed trading

turnover and 65 percent median annual turnover in stock mutual fund portfolios); Christine Benz, Peter Di Teresa & Russel Kinnel, Morningstar Guide to Mutual Funds 11 (2004) (reporting a 114 percent average annual turnover in stock mutual fund portfolios); *see also* Barker, *supra* note 29 ("Managed mutual funds have an average turnover rate of approximately 85%, meaning that funds are turning over nearly all of their holdings every year. Many funds, in fact, have turnover rates of more than 100%, meaning their average holding period for a stock is less than one year."); Laura Bruce, *Mutual Fund Turnover and Taxes*, Bankrate.com (Nov. 6, 2003), http://www.bankrate.com/brm/news/investing/20020306a.asp ("William Harding, an analyst with Morningstar, says the average turnover rate for managed domestic stock funds is 130 percent. 'Many managers claim to be long-term investors when, in reality, the average mutual fund manager is turning the portfolio more than once a year.'"). Stock trading in general has seen an increase in volatility. For example, annualized turnover on the New York Stock Exchange for December 2008 was 138 percent, compared to 123 percent in December 2007 and 118 percent in December 2006. *NYSE Facts and Figures: NYSE Group Turnover 2000–2009*, NYXdata.com, http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=2992&category=3 (last visited Feb. 23, 2009). Even under the approach favored by the mutual fund industry, which is based on asset weighted turnover and which includes index funds, the turnover rate of stock mutual funds is nearly 60 percent. *See* Inv. Co. Inst., 2009 Investment Company Fact Book 29 fig. 2.9 (2009), *available at* http://www.icifactbook.org/pdf/2009_factbook.pdf. That means that the typical fund turns over its entire portfolio in less than two years. A turnover rate of that kind is hardly consistent with a focus on the long-run best interests of the companies in which the funds invest.

33. Reid & Miller, *supra* note 32.

34. One respected academic commentator suggests that even pension funds "typically turn over their portfolios in a year." Lawrence E. Mitchell, *The Board as a Path Toward Corporate Social Responsibility*, *in* The New Corporate Accountability: Corporate Social Responsibility and the Law 279, 303 (Doreen McBarnet, Aurora Voiculescu & Tom Campbell eds., 2007).

35. *NYSE Facts and Figures: NYSE Group Turnover 2000–2009*, NYXdata.com, http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=2992&category=3 (last visited Jan. 19, 2010); *cf*. Lawrence E. Mitchell, *Who Needs the Stock Market? Part I: The Empirical Evidence* 5 (Oct. 23, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1292403 [hereinafter Mitchell, *Stock Market*] (citing NYSE data that annualized turnover on the NYSE was 123 percent and 118 percent for December 2007 and 2006 respectively); Lawrence E. Mitchell, The Speculation Economy: How Finance Triumphed Over Industry 277–78 (2007) (citing an increase in turnover on the NYSE from 36 percent in 1980 to 88 percent in 2000); Rob Wherry, *13 Funds that Stand by Their Stock Picks*, SmartMoney.com (May 1, 2009) (citing Morningstar for the fact that the average turnover rate among domestic equity funds rose to 102.5 percent in 2009 from 97.5 percent in 2007).

36. *See 2010 Statistical Abstract, Table 1360: U.S. and Foreign Stock Markets—Market Capitalization and Value of Shares Traded: 2000 to 2008*, U.S. Census Bureau, http://www.census.gov/compendia/statab/2010/tables/10s1360.pdf (last visited Aug. 16, 2010) (indicating that the total market value of all domestic listed companies was $11,737 billion in 2008, and that the total value of shares traded in 2008 was $36,467 billion).

strategies are also inconsistent with what corporate finance teaches about successful investing strategies.[37] The focus of many of these institutions on quarterly earnings and other short-term metrics is fundamentally inconsistent with the objectives of most of their end-user investors,[38] people saving primarily for two purposes, to put their kids through college and to fund their own retirements. These end-user investors do not care about quarterly earnings or short-term gimmicks. These end-user investors want corporations to produce sustainable wealth that will be there when they need it.[39]

Many of the wisest end-user investors do choose investment funds that do not churn: index funds. But, as a consequence, they get fiduciaries who exercise the least voice in the corporate governance debate, and who sometimes simply parrot the views of institutional shareholders with a short-term focus.[40] Indeed, it is increasingly the case that the agenda setters in corporate policy discussions are highly leveraged hedge funds, with no long-term commitment to the corporations in which they invest.[41]

That raises the other change in the Berle paradigm, which is that stockholders of public companies are no longer passive, weak, and incapable of concerted

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37. *See, e.g.*, William J. Carney, Corporate Finance: Principles and Practice 118–19 (2004) (discussing an implication of the "efficient capital markets hypothesis," which is that, because security prices efficiently reflect most of, if not all, public information about the value of a security, sophisticated investors will not trade in hope of "beating the market" based upon public announcements of new information but will simply adjust their reservation prices accordingly); Burton Malkiel, A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing (2003) (setting forth the commonly accepted corporate finance principle that an active trading strategy is unlikely to beat the performance of market averages); Bratton & Wachter, *supra* note 20, at 692–93, 707 (noting that the efficient capital markets hypothesis does not imply that a stock price necessarily equals the discounted free cash flows of a corporation, and that a stock price may differ systematically from the corporation's fundamental value because that stock price in part reflects the present owner's option to sell the stock to a more optimistic investor—i.e., stock prices reflect the speculative expectations of market participants); John F. Gaski, *Capital Market Efficiency and Its Implications for the Investor: A Case of a Superior Product Mismarketed*, *in* Innovations in Investments and Corporate Finance 105, 106 (Mark Hirschey, Kose John & Anil K. Makhija eds., 2002) (explaining that, because of market efficiency, an investment strategy of buy-and-hold will produce the highest returns).

38. *See* Bratton & Wachter, *supra* note 20, at 658–59 ("A shareholder-based agency model of the corporation sends management a simple instruction: in all circumstances, manage to maximize the market price of the stock. And that is exactly what managers of some critical financial firms did in recent years. They managed to a market that focused on their ability to increase observable earnings and, as it turned out, failed to factor in concomitant increases in risk that went largely unobserved.").

39. *See* Strine, *Toward Common Sense*, *supra* note 27, at 4–5.

40. *See* John Bogle, The Battle for the Soul of Capitalism 127 (2006) (noting weak activism on the part of indexed mutual funds, and calling for a "federation of long-term investors" that would aggregate and direct the voting power of such funds).

41. *See* Marcel Kahan & Edward B. Rock, *Embattled CEOs*, 88 Tex. L. Rev. 987, 998–999 (2010) [hereinafter Kahan & Rock, *Embattled CEOs*] (documenting the large number of corporations targeted by hedge fund activism); April Klein & Emanuel Zur, *Hedge Fund Activism* 39–40 (N.Y. Univ. Stern Sch. of Bus., Working Paper No. CLB-06-017, 2006) (showing steady increase in hedge fund activism from 1995 through 2005, the end of the period studied); Press Release, RiskMetrics Group, Hedge Funds on Track to Set New Record for Activist Campaigns (Feb. 14, 2008), *available at* http://www.riskmetrics.com/press/articles/20080214_dj (discussing increase in hedge fund activism); Bratton & Wachter, *supra* note 20, at 682 (noting that "[a]ctivist hedge funds . . . are impatient shareholders, who look for value and want it realized in the near or immediate term [and] tell managers how to realize value and challenge publicly those who resist the advice").

action.[42] With internet technology and large institutional investor holdings, it is easier, cheaper, and thus far more frequent for stockholders to demand that corporations commit to policy changes with long-term effects.[43] But many—nay, let's be honest, most—of these stockholders will not be around as investors when the consequences of the policymaking are fully felt.

Although the focus of the institutional investor community over the last twenty-five years on issues like takeover defense and encouraging executive compensation tied to stock price performance is understandable, what is less edifying is the absence of any similar weight given to issues that many end-user investors care more about, such as whether corporations are endangering their solvency by excessively leveraging themselves or skirting the law through financial gimmicks to improve the optics of the company's balance sheet.[44]

42. Berle himself predicted that capital was likely to reaggregate. In 1957, Berle estimated that pension funds would eventually own half of equity stocks and that the funds themselves would become "naked power vehicles" as a result. *See* Adolf A. Berle, Jr., Economic Power and the Free Society 10–13 (1957).

43. The number of stockholder proposals, withhold campaigns, and proxy fights that American public corporations face continues to grow. *See, e.g.*, Chris Young, The M&A and Hedge Fund Activism Landscape 12, 30, 42, 48 (Oct. 2009), *available at* http://www.law.yale.edu/documents/pdf/cbl/Chris_Young.pdf; Georgeson, Annual Corporate Governance Review 14–35 (2008). In terms of the impact of activism encouraging stock buybacks over investment in capital expenditures, Professor Mitchell estimates that for the three years ending in 3Q 2007, 279 out of the 500 corporations in the S&P 500 had spent more on stock buybacks than on capital expenditures during that period. *See* Mitchell, *Stock Market*, *supra* note 35, at 23.

44. A look at corporate governance activism in the wake of the Enron/WorldCom meltdown does not suggest that institutional investors changed their focus to concentrate more on issues of fundamental risk, fraud avoidance, and effective risk and leverage management practices. Although stockholders advanced initiatives dealing with board committees, those initiatives did not deal with the structure of the board's approach to risk management. *See* Georgeson, *supra* note 43, at 14–35 (providing a detailed examination of stockholder activism for the period 2004 to 2008, and indicating that most corporate governance activism remained focused on takeover defenses, making boards more immediately responsive to investor sentiment (e.g., through the adoption of so-called majority voting), and executive compensation). It is easy to find examples of activism designed to encourage boards to increase leverage in order to pump up immediate returns to stockholders. *See Shareholder Activism: Boon, Bane or Both?*, N.Y. Times DealBook (June 13, 2007, 2:13 PM), http://dealbook.blogs.nytimes.com/2007/06/13/shareholder-activism-boon-bane-or-both/?scp=4&sq=investor%20activism%20leverage&st=Search (discussing investor activism resulting in increasingly leveraged corporations); Young, *supra* note 43, at 29 (noting that leveraged recapitalization is one of activist hedge funds' typical strategies). But it is virtually impossible to find any institutional investor initiatives or policies directed to promoting the adoption of more effective corporate policies and procedures to reduce the possibility of firm failure. A review of the detailed corporate governance policies of two of the most experienced and respected institutional investor voices on corporate governance, the Council of Institutional Investors and TIAA-CREF, reveals an absence of attention to risk management, leverage, or other similar issues fundamental to the avoidance of financial debacles and a much greater emphasis on making sure that boards are more immediately responsive to the demands of the stock market. At best, these documents acknowledge in brief passing the need for boards to be effective monitors, while spending much greater time on other board duties. *See* TIAA-CREF, Policy Statement on Corporate Governance, *supra* note 4, at 15 (stating simply that the "Audit Committee is responsible for the adequacy of the company's internal controls and the effectiveness of management's processes to monitor and manage business risk"); CalPERS Global Principles of Accountable Corporate Governance, *supra* note 4, at 19–20 (addressing audit committee briefly without any mention of leverage or indicators of risk of firm failure); Council of Institutional Investors, Corporate Governance Policies (2009), http://www.cii.org/policies (follow "Full Council Corporate Governance Policies" hyperlink) (setting forth detailed prescriptions for public company corporate governance but never discussing risk management or leverage control).

Even after the market debacle involving WorldCom and Enron, the institutional investor community remained preoccupied with issues like takeovers and executive compensation. And before the more recent market crash, important segments of the institutional investor community were demanding to know why more public companies could not operate with the high degree of leverage employed by those owned by private equity firms.[45]

The potency of the institutional investor community is easy to see. When they want something, they tend to get it.[46] Institutional investors demanded and largely got changes to CEO compensation so that it was primarily based on components—such as options—that were tied to raising the corporation's stock price.[47] Institutional investors wanted a reduction in takeover defenses and have

45. *See, e.g.*, *Are Heavyweight Investors Turning on Private Equity?*, N.Y. Times DealBook (May 8, 2007, 7:28 AM), http://dealbook.blogs.nytimes.com/2007/05/08/are-heavyweight-investors-turning-on-private-equity/ (discussing the power shift between institutional investors and buyout dealmakers, because shareholders including institutional investors grew tired of watching private equity firms make drastically higher profits); *The Incredible Shrinking Stock Market?*, N.Y. Times DealBook (May 17, 2007, 2:56 PM), http://dealbook.blogs.nytimes.com/2007/05/17/the-incredible-shrinking-stock-market/ (noting the recent trend of institutional investors to shift allocations toward private equity funds to procure higher returns); *see also* Bratton & Wachter, *supra* note 20, at 716–17, 720 (stating that "evidence suggests that shareholders first fell in love, and then fell out of love [during the financial crisis], with the financial companies that were taking on the most risk and the most leverage," that the "relative weight of the financial sector within the S&P 500 grew from 13.0% in 1999 to 22.3% in 2006" due to the "stock market favor[ing] the banks between 2000 and 2007 because of rising earnings that resulted from wide spreads between expected returns on lending and the costs of increasing leverage in a stable economic environment," and that this led to a clear "instruction manual" for management: "get with the program by generating more risky loans and doing so with more leverage").

46. Kahan & Rock, *Embattled CEOs*, *supra* note 41, at 1051 (concluding "that the balance of power between CEOs, boards, and shareholders has shifted dramatically in the last decade in favor of shareholders").

47. Executive compensation based on more direct measures of corporate performance became a goal of many institutional investors in the early 1990s. *See, e.g.*, Robert A.G. Monks & Nell Minow, Power and Accountability 174 (1991) (discussing instances where "increasing pressure by the public and institutional investors" led to "many corporations . . . tying pay to performance"); *The SEC and the Issue of Runaway Executive Pay: Hearing Before the S. Subcomm. on Oversight of Government Management*, 102d Cong. 99 (1991) (statement of Robert Monks, President, Institutional Shareholders Partners); Geraldine Fabrikant, *Market Place; Pension Funds Tell Paramount It's Time to Take Some Action*, N.Y. Times, Mar. 5, 1993, at D6 (reporting that Wisconsin's state pension fund informed Paramount Communications Inc. that the fund would withhold its vote for four board members on the company's compensation committee because "management's annual and long-term bonuses are not tied to the company's return to shareholders," and that the Council of Institutional Investors said it would support the fund's plan); Richard Stevenson, *Large Foot in the Board-Room Door*, N.Y. Times, June 6, 1991, at D1 (quoting CalPERS' chief executive officer as saying that "CalPERS was likely to take on more companies over the issue of executive compensation. [CalPERS'] objection was not to huge paychecks in and of themselves. Rather, [the CEO] said, directors have no place approving pay packages that enrich chief executives who preside over falling stock prices and eroding business prospects. 'This is going to be one of the big issues of the 90's,' [the CEO] said."); Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, Contemp. Fin. Digest, Autumn 1998, at 10, 19 (noting that "in 1993, Fidelity Investments announced that it would vote against directors if executive compensation were not sufficiently linked to corporate performance"). For the intellectual underpinnings of this movement, see, for example, Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. Pol. Econ. 225 (1990); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, but How*, Harv. Bus. Rev., May–June 1990, at 138.

been highly successful in achieving that objective.[48] In the wake of Delaware's passage of a so-called majority voting statute in 2006, over 70 percent of the largest public companies have adopted that approach in response to stockholder demands.[49] In response to investor sentiment, corporations levered up, took more risks, and engaged in huge stock buyback programs.[50]

Institutional investors have pressed boards to replace managers who do not deliver high returns promptly, and CEO tenure has decreased markedly.[51] And, of

48. *See, e.g.*, Martin Lipton, David A. Katz & Laura A. McIntosh, *The System Isn't Broken: A Legislative Parade of Horribles*, *in* 1 The Altman Group, Governance Compendium Series 34, 43 (2009) (citing www.SharkRepellent.net to indicate that the percentage of the S&P 500 with staggered boards has declined from 61 percent in 1999 to 34 percent at the end of 2008); Bratton & Wachter, *supra* note 20, at 679 ("Staggered boards (which together with poison pills afford the maximum available protection) among S&P 100 companies declined from 44 percent to 16 percent between 2003 and 2008; the decline among S&P 500 companies is from 57 percent in 2003 to 36 percent in 2007."); Frank Aquila & Samantha Lipton, *In the Face of an Unsolicited Bid*, Practical Law: The Journal, May 2010, at 78, 79 ("Today US public companies have far weaker anti-takeover defenses than in previous years: [o]nly 17% of companies in the S&P 500 had shareholder rights plans by the end of 2009, down from 60% of companies as recently as 2002; [o]nly 32% of the companies in the S&P 500 had a staggered board by the end of 2009, down from 60% in 2002." (citation omitted)); *Poison Pill Usage Continues to Decline*, DealLawyers.com (Oct. 29, 2009, 6:45 AM), http://www.deallawyers.com/Blog/2009/10/poison-pill-usage-continues-to-decline.html (citing proprietary RiskMetrics report).

49. *Protecting Shareholders and Restoring Public Confidence by Improving Corporate Governance: Hearing Before the Subcomm. on Securities, Insurance & Investment of the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 8 (2009) (statement of John J. Castellani, President, Business Roundtable) (noting that "more than 70% of S&P 500 companies" have adopted a majority voting statute as of October 2008).

50. *See* Press Release, Standard & Poor's, S&P 500 Stock Buybacks Retreat 66% in Fourth Quarter; Off 42% in 2008 (Mar. 26, 2009), *available at* https://www.sp-indexdata.com/idpfiles/indexalert/prc/active/pressreleases/032609_buyback-pr.pdf (reporting that, in 2008, "S&P 500 buybacks reached $339.6 billion—a 42.3% drop from the record setting $589.1 billion spent during 2007"); Bratton & Wachter, *supra* note 20, at 686 ("In 1987, repurchases amounted to 1.6% of average market capitalization, and total payout amounted to 3.8%; in 2007, repurchases amounted to 4.6%, and total payout amounted to 6.3%."); Ben Steverman, *The Incredible Shrinking Stock Buyback*, Bloomberg Bus. Wk. (June 18, 2009, 9:36 PM), http://www.businessweek.com/investor/content/jun2009/pi20090618_506017.htm?chan=top+news_top+news+index+-+temp_news+%2B+analysis ("[I]n the third quarter of 2007, when stocks were near their all-time peak, S&P 500 firms bought back a record $172 billion in shares. Buybacks had become a wildly popular way for firms to reward shareholders. By buying shares and taking them off the market, firms can bolster their earnings per share."); Elizabeth Douglass, *Stock Buybacks Earn Oil Firms a Gusher of Criticism*, L.A. Times, Aug. 1, 2007, at A1 (noting that "buybacks across all industries hit a record-high $117.7 billion in the first quarter of 2007" and that, in particular, "[t]he top four oil companies booked a combined $57.5 billion in profits in the first half of the year and devoted $22.9 billion—40% of their total earnings—to share repurchasing"); *Shareholder Activism: Boon, Bane or Both?*, N.Y. Times DealBook (June 13, 2007, 2:13 PM), http://dealbook.blogs.nytimes.com/2007/06/13/shareholder-activism-boon-bane-or-both/?scp=4&sq=investor%20activism%20leverage&st=Search (discussing investor activism resulting in increasingly leveraged corporations).

51. Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. Chi. L. Rev. 871, 883 n.58 (2002) (detailing the evidence of shorter CEO tenure and increased terminations of CEOs); Kahan & Rock, *Embattled CEOs*, *supra* note 41, at 45–46 (documenting the huge increase in CEO turnover and CEO performance-related turnover at public companies); Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs* (NBER Working Paper No. 12465, 2006), *available at* http://www.law.yale.edu/documents/pdf/cbl/kaplanminton0806.pdf (finding a material uptick in CEO turnover beginning in the 1990s, and evidence that boards are increasingly sensitive to firm performance when deciding whether to retain a CEO).

course, the American M&A markets have been robust, giving American investors the world's largest diet of sell side premia.[52]

As a whole, institutional investors have pushed for corporate managers to be highly responsive to the immediate pressures and incentives of the capital markets. The upside of this is that the boards of public corporations have never been more sensitive to what the corporate electorate wants at any given moment. The downside of this, however, is that if the electorate itself does not have the correct incentives and does not push an agenda that appropriately focuses on the long term, the responsiveness of managers to the incentives they face can result in business strategies that involve excessive risk and, perhaps most worrying, underinvestment in future growth.[53]

52. *See, e.g.*, John C. Coates, IV, *M&A Break Fees: US Litigation vs. UK Regulation* 23–24 (Harvard Law Sch. Public Law & Legal Theory Working Paper No. 09-57, 2009), *available at* http://ssrn.com/abstract=1475354 (showing that the incidence of successful bids for control and M&A activity in the United States was higher than in the United Kingdom in the period 1990 to 2008 "usually by a significant margin"). Although on paper the UK system arguably fosters a more open market for corporate control, the American system has generated a huge amount of M&A activity that has put premiums regularly in the pockets of sell-side stockholders. *See id.* at 30 (showing that from 1989 to 2008, the incidence of premium-generating bids was higher in the United States than in the United Kingdom). Moreover, the American requirement for annual elections and the Rule 14a-8 process has resulted in far more frequent exercises of stockholder voting than elsewhere in the developed world. *See* Georgeson, *supra* note 43, at 14 (indicating that, in 2007, 665 corporate governance proposals were submitted in the United States). In most other systems, boards are not subject to reelection on an annual basis and the overall incidence of stockholder activism is far lower than in the United States. In 2007, for example, there were only sixty-eight stockholder proposals made among the companies listed on the major exchanges found in the European Union. Georgeson, Proxy Voting Season Review 2007: UK & Europe 31 (2007).

53. Professor Mitchell has noted the increasing lack of linkage between the interests of active equity investors and the long-term fate of corporations:

> [M]odern investment theory effectively detaches the stock from the corporation. Stock picking, portfolio selection, and portfolio rebalancing, typically occur within these boundaries, relying far less on the fundamental factors that make a given corporation unique than on the statistical behavior of its stock price. This is not, by any means, to say that the corporation's performance is irrelevant. Obviously its stock price variance will be importantly dependent upon factors like its financial performance. But it is to say that the corporation itself as a unique, economically productive entity, as an actor in the real economy, has become a significantly unimportant factor in the typical investor's buy and sell decisions.

Lawrence E. Mitchell, *The Morals of the Marketplace: A Cautionary Essay for Our Time*, 20 Stan. L. & Pol'y Rev. 171, 179 (2009). Mitchell argues that this trend has transformed the stock market from "a place for investment to a highly sophisticated gambling den," pointing to the following turnover statistics as evidence:

> Turnover on the New York Stock Exchange in 2007 was 123%. This compares to 88% in 2000, the year in which the dot.com bubble collapsed, and 36% as recently as 1980. Indeed one has to go back to 1928 and '29 (and before that, to the mid-teens, and then to 1910) in order to observe turnover ratios as high or higher than have been seen in recent years.

Id. at 180 (citing Robert Sobel, The Big Board: A History of the New York Stock Market 159 (1965); Robert J. Shiller, Irrational Exuberance 52 (2d ed. 2005)). Most disturbingly, Professor Mitchell cites evidence that corporate managers have sacrificed attractive long-term strategies to please a short-term stock market:

> [T]he corporation itself as a unique, economically productive entity, as an actor in the real economy, has become a significantly unimportant factor in the typical investor's buy and sell decisions.

It is jejune to demand that CEOs and boards manage for the long term when the stockholders who can replace them buy and sell based on short-term stock price movements, rather than the long-term prospects of firms.[54] It is contradictory to demand managerial responsiveness to stockholder sentiment, and then criticize managers for failing to resist stockholder demands for riskier business strategies and more highly levered balance sheets.

To be concrete about the realities faced by corporate managers, the trading activity statistics I cite translate into this disturbing reality: the stockholder base of public companies turns over nearly completely on an annual basis.[55] The agenda of this electorate has not involved a keen focus on the avoidance of excessive risk, the avoidance of firm failure, and an emphasis on long-term growth. It has been on increasing stock prices as fast and as much as possible, even if that requires financial gimmickry and risk.

The problem of short-termism is also illustrated by the policies of proxy advisory firms whose growth was fueled by the Labor Department's informed voting requirements for regulated investment funds. The leading firm, RiskMetrics, bases its voting recommendation on what would be best for a stockholder who will own the company's shares for two years.[56] In one way, that is uplifting because it exceeds the holding period for typical institutional investors. But it reveals the

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> At the same time, those buy and sell decisions can have a profound effect on managerial behavior because of the manner in which market movements affect not only the individual corporation's stock price but its cost of capital and public perceptions of its solidity. Recent evidence has made this clear. For example, a 2005 survey of the chief financial officers of 400 major corporations found that they would have been willing to take action that harmed their corporations in the long-term in order to meet analysts' quarterly stock price projections. These included laying-off workers, cutting research and development budgets, delaying necessary capital investment, and the like. Several recent studies have also demonstrated an increasing short-termism in managerial behavior, encouraged, if not created, by the need to satisfy the stock market.

Id. at 179–80.

54. *See* Leo E. Strine, Jr., *Why Excessive Risk-Taking Is Not Unexpected*, N.Y. Times DealBook (Oct. 5, 2009, 1:30 PM), http://dealbook.blogs.nytimes.com/2009/10/05/dealbook-dialogue-leo-strine/ ("Ideally, we want a system where corporate boards are highly accountable and responsive to their stockholders for the generation of sustainable profits. But for that policy objective to be achieved, stockholders themselves must act like genuine investors, who are interested in the creation and preservation of long-term wealth, not short-term movements in stock prices. So long as many of the most influential and active investors continue to think short term, it is unrealistic to expect the corporate boards they elect to strike the proper balance between the pursuit of profits through risky endeavors and the prudent preservation of value."); *see also* Bratton & Wachter, *supra* note 20, at 688–715 (arguing that, because of information asymmetries between management and stockholders and because of speculative pricing that results from heterogenous expectations, there is an inevitable "gulf between managing to maximize long-term fundamental value and managing to maximize the market price of the stock").

55. Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 Geo. L.J. 1227, 1232 (2008) ("With annual turnover of shares in a public company around 99%, the shareholder base is constantly in flux." (citing NYSE Overview Statistics, http://www.nysedata.com/factbook (follow "NYSE Historical Statistics" hyperlink, then follow "NYSE Overview Statistics" hyperlink) (last visited Mar. 12, 2008))).

56. Institutional S'holder Servs., Today's Dynamic M&A Landscape: The Interplay of M&A and Activism 19 (June 27, 2007) (unpublished slides, on file with *The Business Lawyer*) (voting recommendations are directed at a hypothetical two-year holder).

deeper problem of short-termism. So, too, perhaps does the federal capital gains tax policy, which gives investors a lower, "long-term" rate if they hold an entire calendar year![57]

Most of the policies that influence the behavior of institutional investors rest outside the corporate law itself. The incentives of institutional investors are set by federal rules under the Investment Company Act of 1940, the tax code, and the very weak-to-non-existent constraints of the business trust statutes under which many investment funds act.

If, however, the corporate law is to give institutional investors even more clout, it is vital that these institutions be accountable to their end-user investors and society as a whole for basing their investing and corporate governance activism on what will produce sustainable, long-term growth. Similarly, we must also address the business realities that lead even those institutional investors managing retirement moneys to compete on the basis of quarterly performance. Nothing could be more absurd, of course, than 401(k) funds worrying about short-term metrics, but if their investors irrationally can trade out for free based on the past quarter's results, fund managers cannot ignore those results.

Although the challenge of addressing the misalignment between the interests of end-user investors and society in the long run and the incentives of the institutional investor community to think and act myopically is considerable, it is past time to begin.

Areas that would be productive for examination include 1) pricing and tax strategies to encourage investing and discourage churning by institutional investors and "fund hopping" by end-user investors; 2) enhanced requirements for institutional investors to factor concern about fundamental risk, leverage, and legal compliance into their investing and corporate governance decisions; 3) requirements that investment manager compensation be aligned with the investment horizons of end-user investors; 4) considering a mandated separation of funds managing 401(k) and college savings investments from more liquid investments, and requiring investing practices consistent with retirement and college investment objectives; 5) requirements that index funds vote shares and engage in activism in a manner consistent with the funds' commitment to hold the entire benchmark index; 6) leverage limitations, broader disclosure, and other regulations for hedge funds that decrease the ability and incentive of these funds to effectively push public corporations into risky business decisions; 7) mandating that institutional investors disclose fuller and more timely information about their economic interests (including their ownership of derivatives and short positions) and about their voting and share lending policies; 8) restoring the sophisticated investor exception[58] to allowing Thurston Howell to lose his fortune, and requiring pension, charitable, and governmental investment funds to invest only

57. *See* 26 U.S.C. § 1222(3) (2006). Typically, short-term capital gains are taxed at 35 percent, while so-called "long-term" gains are taxed at either 5 percent or 15 percent, depending upon the individual's tax bracket. *See* 26 U.S.C.A. § 1 (West 2002 & Supp. 2010).

58. 15 U.S.C. § 77d(6) (2006).

through investment advisors covered by the 1940 Act; and 9) prohibiting pension, charitable, and governmental investment funds from relying on the advice of proxy advisory services unless those services give voting advice based on the economic perspective and goals of an investor intending to hold her stock for at least five years.

Berle feared, as most perceptive American economic and political thinkers have, power without accountability. Equity capital, in the form of institutional investors, now wields substantial power, power that affects all Americans. The maturation of the institutional investor community creates the need to harness its potential and ensure that its focus is where it should be: promoting the sustainable long-term growth of its investors' wealth through the corporate form.

A Durable Solution to the Legitimate Concerns About Executive Compensation Would Be Useful for Investors and Society

During the last quarter century, the compensation of top executives, particularly CEOs, has grown enormously. There is a heated argument about why that is the case and whether, on balance, that increase is largely attributable to demands by the institutional investor community that the takeover market operate with great vibrancy, that underperforming management be replaced, that executive compensation take the form of stock options, and that top executives engage in measures (such as job cutting and outsourcing) that they may find distasteful but which increase corporate bottom lines.[59] Arguably, these pressures to manage to an avaricious market, greatly decreased job security, and a change in the public perception of CEOs of public companies from being community leaders running important societal institutions into being ruthless sharpies willing to do whatever it takes to increase the corporation's stock price, have led CEOs to seek much greater compensation.[60] Ironically, some say, the one corporate constituency that has little to complain about executive compensation are stockholders, whose returns have largely tracked the increases in CEO pay, while returns to ordinary corporate workers in the form of wages and returns to society in the form of increases in median family income have stagnated.[61] On the other hand, even institutional investors, such as labor pension funds, who do invest for the long term are concerned about executive compensation, believing that it is excessive and often tied to counterproductive ends, such as short-term stock price movements, rather than the sound generation of corporate wealth over the long

59. *Compare* Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, 22 Acad. Mgmt. Persp. 1 (2008), *with* Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: An Overview of the Issues*, 30 J. Corp. L. 647 (2005).

60. *See* Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 Duke L.J. 1013, 1022 (2009) ("Because business executives, as distinct from entrepreneurs, do not like risk, they will demand a higher wage if the wage has a substantial risky component; and stock options are risky.").

61. *See* Robert B. Reich, *Don't Count on Shareholders*, Am. Prospect, Apr. 2007, at 52.

run.[62] And, many corporate advisors and mid-level executives privately admit that many CEOs have grabbed for and gotten compensation packages that are far in excess of what market forces would generate.

More pragmatically, executive compensation is unlikely to return to levels where it is not politically salient. As a result, the current approach to executive compensation that is prevalent in the United States, which involves the board unilaterally determining executive compensation, is likely to be the source of continued controversy. Admittedly, there is an argument that this should not be so, especially given the mandates for compensation committees comprised entirely of independent directors[63] and the increasing prevalence of boards with virtually no insiders other than the CEO.[64] But, the continuation of practices such as the use of compensation consultants rather than the employment of real negotiators by compensation committees, and the eyebrow-raising nature of the overall level of CEO compensation in the United States, has led to concerns that executive compensation continues to be determined in a cozy, non-businesslike way and has fueled demands for more stockholder involvement in this aspect of managing the corporation.

To this mix one should also add a reality about the ability of a traditional tool of American corporate law to deal with conflict transactions. This reality is that fiduciary duty litigation is unlikely to become a useful or efficient tool to police the overpayment of top executives. To have courts second guess independent boards about the amount and methods in which they chose to contract with top management would involve a serious conflict with the traditional principles that undergird the business judgment rule. And, it would be difficult to imagine a more sensitive area of director discretion than decisions about who to employ as CEO and what incentives to give the CEO.

One traditional tool that American corporate law has used to address the fairness of conflict transactions and the transformational nature of some board decisions (such as the decision to merge) has been to give the stockholders a chance to express their views at the ballot box.[65] And, federal law has, for more than a

62. *See, e.g.*, Damon Silvers, *Commentary on "Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance" by Leo E. Strine, Jr.*, 33 J. Corp. L. 85 (2007).

63. *See, e.g.*, N.Y. Stock Exch., Listed Company Manual § 303.A05(a) (2009) ("Listed companies must have a compensation committee composed entirely of independent directors."); Nasdaq Stock Mkt., Inc., Corporate Governance § 4350(c)(3) (2004), *available at* http://www.nasdaq.com/about/CorporateGovernance.pdf (requiring that compensation for executives be set by "a majority of independent directors" or "a compensation committee comprised solely of independent directors").

64. *See* Shearman & Sterling LLP, 2009 Trends in the Corporate Governance of the Largest US Public Companies: General Governance Practices 11 (2009) (reporting that, out of 100 large U.S. publicly traded companies surveyed, "[t]he CEO is the only non-independent director at 49 of the Top 100 Companies" and "[i]ndependent directors constitute 75% or more of the boards of 88 of the Top 100 Companies surveyed this year"); *see also* 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, 1473–76 (2007) (canvassing a number of studies to show that the percentage of independent directors sitting on the boards of U.S. public companies increased from 20 percent in 1950 to approximately 70 percent in 2005).

65. *See, e.g.*, Del. Code Ann. tit. 8, § 144 (2001); Criden v. Steinberg, No. 17082, 2000 WL 354390, at *3 (Del. Ch. Mar. 23, 2000); Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 895–902 (Del. Ch. 1999).

decade, required publicly listed corporations to obtain stockholder approval for certain corporate stock option plans.[66] Indeed, use of the stockholder franchise in a flexible and company-specific way would be a principled way to reduce the distracting controversy surrounding executive compensation.[67]

But, to be consistent with the private ordering approach that has served to create so much wealth from the corporate form, stockholder input on executive compensation should proceed only if the stockholders of a particular corporation have decided that such input is good for their specific corporation.[68] Private ordering will avoid the costs of an overbroad and rigid mandate, and allow the marketplace to innovate and develop approaches that, with experience, move toward the right balance.[69] A possible method that would facilitate such a private ordering solution to the executive compensation controversy would permit stockholders to establish, by a bylaw that could not be repealed by the board: 1) a process that the board must use to negotiate and contract with the top managers of the corporations; or 2) a procedure for stockholders to approve, in a non-binding or binding way, the compensation arrangements of the top managers of public corporations.

By such means, stockholders would have the ability to check excessive executive compensation and to express their views about the appropriate objectives

66. *See* Omnibus Budget Reconciliation Act of 1993, § 13211, Pub. L. No. 103-66, 107 Stat. 312, 469–71 (codified at 26 U.S.C.A. § 162(m) (West 2002 & Supp. 2010)); *see also* N.Y. Stock Exch., NYSE Listed Company Manual § 303A.08 (2009) (requiring NYSE-listed companies to obtain shareholder approval for stock option plans and material revisions to stock option plans).

67. I do not wish to exaggerate the promise of this use of the franchise. One of the proposals the institutional investor community has pursued in the wake of the financial sector meltdown has been "say on pay." But, as a respected scholar, Professor Brian Cheffins, has noted, "say on pay" has been in place in the United Kingdom since 2002. From the time of its introduction to the market debacle, UK stockholders overwhelmingly endorsed banker compensation packages. Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 Bus. Law. 1, 57 (2009). Although a 2009 report from the UK government indicated that the past banker compensation policies had created incentives for excessive risk taking, the stockholder vote requirement apparently did not result in any check or even modest complaint about those incentives. *Id.* Thus, Professor Cheffins concludes that "to the extent that policymakers in the United States are inclined to rely on 'say on pay' as a check against the adoption of the sort of counter-productive incentives that helped to precipitate the recent financial crisis, their expectations are unlikely to be fulfilled." *Id.*

68. And, even in the current environment, many stockholder majorities have decided that "say on pay" is not advisable for their corporations. *See* David A. Katz & Laura A. McIntosh, *Corporate Governance Update: 2009 Proxy Season Review and a Look Ahead to 2010*, Harv. L. Sch. Forum on Corp. Governance & Fin. Reg. (Nov. 29, 2009, 2:30 PM) (noting that there were seventy-nine "say on pay" resolutions in 2009, which only garnered support from an average of 46 percent of shareholders (citing RiskMetrics Group, Postseason Report 5–6 (Oct. 2009))); Georgeson, Annual Corporate Governance Review 4 (2009) (stating that, in 2007, shareholder-sponsored "say on pay" resolutions averaged 39 percent of votes in favor; in 2008, 39 percent of shareholders voted in favor; and in 2009, 44 percent of shareholders voted in favor).

69. One such example is Microsoft's recent adoption of a "say on pay" policy that will allow shareholders to cast a non-binding, advisory vote every three years on the compensation plans for the company's senior executives. *See* Brad Smith & John Seethoff, *Microsoft's Board Adopts New "Say-on-Pay" Policy*, Microsoft on the Issues (Sept. 17, 2009, 4:50 PM), http://blogs.technet.com/b/microsoft_on_the_issues/archive/2009/09/18/microsoft-s-board-adopts-new-say-on-pay-policy.aspx. That policy was adopted after conversations between Microsoft and one of the nation's most thoughtful corporate governance experts, Edward Durkin, of the Carpenters' Union Pension Trust.

that should drive that compensation. Possessing such influence, stockholders would also share up-front responsibility for the decisions made and therefore be poorly positioned to complain if those decisions do not work out as well as was anticipated.

If Stockholders Can Implement a More Competitive Election System and Have More Say on Executive Compensation and Incentives, There Is Less Justification for Stockholder Input on Specific Aspects of Corporate Management and Strategy

To the extent that stockholders are granted the power to adopt bylaws creating a more competitive election system and providing greater stockholder input into executive compensation arrangements, stockholders will have a substantially more potent ability to shape boards to their liking and to ensure that managerial incentives accord with investor sentiment. Given that reality, if measures of this kind that increase stockholder clout are adopted, additional incursions on the republican model of corporate democracy must be strenuously resisted. Otherwise, American public corporations will run the risk of becoming a Model U.N., where the principal purpose is not the successful pursuit of long-run profit, but the provision of a forum for certain stockholders with specific agendas to give voice to their pet concerns.[70]

As Americans, we might consider the wisdom of our founding fathers when looking at just how much of a direct democracy we want our public corporations to become. Even though the electorate of our republic as a whole, and of individual states, is far more stable and actually invested than the transitory electorates of corporations, the constitutions of our nation and state governments include a variety of provisions to promote stability, ensure that deeper changes are supported by more than a momentary majority, and encourage a sound long-term direction.[71] Heck, the United States Senate may be the nation's oldest classified

70. *See* Grundfest, *supra* note 12, at 365.

71. For example, to amend the Constitution requires a very strong consensus. U.S. Const. art. V (providing that "[t]he Congress, whenever two thirds of both houses shall deem it necessary, shall propose amendments to this Constitution, or, on the application of the legislatures of two thirds of the several states, shall call a convention for proposing amendments, which, in either case, shall be valid to all intents and purposes, as part of this Constitution, when ratified by the legislatures of three fourths of the several states, or by conventions in three fourths thereof"). Likewise, many state constitutions can only be amended if two successive legislatures support an amendment by a two-thirds vote. *See, e.g.*, Del. Const. art. XVI, § 1 ("Any amendment or amendments to this Constitution may be proposed in the Senate or House of Representatives; and if the same shall be agreed to by two-thirds of all the members elected to each House, such proposed amendment or amendments shall be entered . . . if in the General Assembly next . . . such proposed amendment or amendments shall upon yea and nay vote be agreed to by two-thirds of all the members elected to each House, the same shall thereupon become part of the Constitution."); *see also id*. art. IX, § 1 ("No general incorporation law, nor any special act of incorporation, shall be enacted without the concurrence of two-thirds of all the members elected to each House of the General Assembly.").

board and they get six-year terms![72] When the electorate has a fleeting interest in the fate of the polity, one would think that it would be more, not less, important to ensure that changes with long-lasting effect be designed and motivated by a desire to promote the best long-run, not short-term, outcome.

Relatedly, it is clear that stockholders have more tools than ever to hold boards accountable and the election process is more vibrant than ever. The election of more accountable boards should come with less tumult, not more. More accountable boards should be given more, not less, leeway to make decisions during their term. This does not mean that corporation law should strip stockholders of their substantive rights to vote on mergers or major asset sales. But it does mean that the costs of further distracting corporate managers from focusing on managing the business to generate profit would outweigh the benefits that come from more corporate referendums.

The reality is that state corporate law does not contemplate non-binding stockholder votes on particular business or corporate governance matters. But, since the early 1940s, Rule 14a-8 has, by federal mandate, given stockholders of a publicly traded corporation the ability to force a non-binding stockholder plebiscite on discrete policy questions.[73] In recent years, Rule 14a-8 proposals have become much more frequent.[74]

In that regard, there is a sensible basis to consider the outdated thresholds used by the SEC in implementing Rule 14a-8 to make sure that stockholders who make proposals about issues like takeover defenses and corporate strategy have a substantial, long-term ownership stake and pay a reasonable filing fee for making proposals. The current thresholds—which only require a stockholder to own $2,000 of stock and to pay no filing fee—are outdated and let stockholders with interests that are not necessarily aligned with most long-term investors advance their own agenda, with the costs borne by the corporation and all of its investors.[75] When a proposal involves an issue of corporate profit, and not—I stress for my friends in the labor community—a so-called social proposal, it is sensible that the proponent have sufficient skin in the game to ensure that its motivations are genuinely aligned with those of stockholders seeking long-term corporate profitability.[76]

72. *Cf*. Thomas Wentworth Higginson, *The Birth of a Nation*, Harper's New Monthly Mag., Jan. 1884, at 242, *available at* http://cdl.library.cornell.edu/cgi-bin/moa/moa-cgi?notisid=ABK4014-0068&byte=124245405 (describing a fabled discussion between George Washington and Thomas Jefferson, where Jefferson poured his coffee into a saucer to cool it, and Washington noted that legislation is similarly "poured into the Senatorial saucer to cool it").

73. *See* Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 Bus. Law. 1079, 1088 (2008) [hereinafter Strine, *Breaking the Logjam*].

74. Georgeson, *supra* note 43, at 22.

75. Strine, *Breaking the Logjam*, *supra* note 73, at 1100.

76. As to social proposals, I accept the reality that 14a-8 has long created a low-cost forum for social activists to raise issues of concern with public corporations. How effective it has been for social activism is debatable—social concerns not being traditionally regarded as a deep concern of capital—but I advocate no reduction in voice of this kind.

Running a corporation requires making a large number of decisions all the time, many of which must be made under time pressure. To have stockholders intrude on a decision-by-decision basis, or nitpick over procedural items, is inefficient and unnecessary if the stockholders have the ability, through an accessible and affordable election system, to replace the directors. The focus of stockholder input ought to be on whether the board, as an overall matter, is skillfully, diligently, lawfully, and loyally implementing a sound strategy to generate sustainable corporate profitability.

The "More, More, More" Approach to Corporate Governance Reform Needs to End

"More, More, More" was a horrible disco song[77] and is an even worse approach to corporate governance reform. But, over time, that is the approach that has been taken. Whenever a crisis occurs or a new issue captures the attention of institutional investors, the impulse has been to add more mandates for corporate boards.

Undoubtedly, some of these mandates have been sensible, and there is little doubt that corporate boards are working harder than ever and are comprised more than ever of individuals whose independence cannot be doubted.

But these mandates come at a cost. Because the stock exchanges mandate that several committees be comprised entirely of independent directors—audit, nominating, corporate governance, and compensation[78]—and boards are subject to an ever-growing number of checklist items the law requires them to address, several problems have arisen. These range from the disincentive that the label "non-independent director" has on the willingness to serve of so-called "grey directors" who might bring tremendous business acumen to the board—to the problems in reconciling the need for time for various committee meetings and the value of having the entire board deliberate on larger matters of company strategy and risk—to the very real danger that certain committees—most particularly, the audit committee—will be given an impossibly difficult and broad area of responsibility. In this regard, it is notable that most corporations continue to entrust all responsibility for accounting, financial, and legal compliance and risk management in the audit committee[79] despite the diversity of compliance chal-

77. Andrea True, *More, More, More, on* More, More, More (Buddah Records 1975).

78. *See, e.g.*, N.Y. Stock Exch., Listed Company Manual §§ 303A.04, 303A.05, 303A.07 (2009) (requiring independent directors to comprise nominating/corporate governance, compensation, and audit committees); Nasdaq Stock Mkt., Inc., Corporate Governance § 4350(c), (d) (2004), *available at* http://www.nasdaq.com/about/CorporateGovernance.pdf (requiring independent directors to comprise nominating, compensation, and audit committees).

79. *See* KPMG, Fall 2009 Audit Committee Roundtable Report 3 (2010), *available at* http://www.kpmginstitutes.com/aci/insights/2010/pdf/fall-2009-roundttable-report.pdf (indicating that, of the audit committees surveyed, 70 percent were responsible for financial risk management, 63 percent were responsible for compliance risk management, and 58 percent were responsible for IT security risk management).

lenges that exist, the complexity of current financial markets and products, and the importance of these tasks to the corporation's very survival.[80] One reason for the continuation of this imprudent approach is the difficulty of adding a separate risk or legal compliance committee to coordinate with the audit committee and better cover the full range of corporate risk on top of the host of the other stock exchange-mandated committees and board duties.

To the extent that stockholders have a greater chance to replace the board if they wish and to have a say on the form and extent of executive compensation, measures to reduce some of the mandates for board action in areas that are not critical to corporate profitability, law compliance, and survival would seem to be in order. Perhaps most importantly, the current financial crisis suggests that from a societal standpoint it would be best to focus mandatory board committees and tasks on those areas vital to corporate health and to the protection of society. Most fundamentally, that means ensuring that boards have adequate time to focus on whether the corporation has the right strategy, whether that strategy is being implemented effectively and by the right management team, whether the corporation is taking prudent steps to comply with the law, and whether the corporation is operating with a prudent level of financial leverage.

And, put more bluntly, it is time for corporate governance reform advocates to recognize a basic fact known to Catholics like me: humans are fallible and we are neither omnipotent nor omniscient. We make mistakes, we miss things, particularly when we are given too much to do. There is a limit to the ability to add more to the managerial agenda without compromising management's ability to effectively perform its most important duties. With the proposal of "more" things to

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80. In this regard, consider that the New York Stock Exchange's Listed Company Manual sets forth the audit committee's "duties and responsibilities," which include "at a minimum" the following:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;
(B) meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the listed company's specific disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations";
(C) discuss the listed company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;
(D) discuss policies with respect to risk assessment and risk management;
(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;
(F) review with the independent auditor any audit problems or difficulties and management's response;
(G) set clear hiring policies for employees or former employees of the independent auditors; and
(H) report regularly to the board of directors.

N.Y. Stock Exch., Listed Company Manual § 303A.07(b)(iii) (2009).

do should come the responsibility to identify those preexisting functions that are "less" important and should be dispensed with. Absent this sort of mature discipline, the proposal of more mandates will actually harm stockholders and society as a whole, by making it impossible for directors to effectively carry out their responsibilities, giving investors and the public unrealistic expectations about what can be asked of corporate managers, and dissuading qualified candidates from serving on corporate boards.

* * *

The kind of mature, hard thinking required to help boards and managers perform better is not easy to accomplish. It requires, though, that the agenda setters of corporate governance spend far less time tracking quarterly performance or pushing their latest product or idea de jour,[81] and more time acting as old-fashioned investors.

Investors eschew buying the stock of corporations that rely on gimmicks and put their money in corporations that generate real cash flows through product and service sales. Investors do not care to pump up stock prices in the short term if that endangers the firm's solvency and long-term growth prospects. Investors want boards and managers to avoid excessive leverage, to comply with the law, and to make sound, long-term capital investments. Investors want boards and managers to spend their time developing, perfecting, and implementing the firm's business strategy and addressing the major risks to the success of that strategy, and not plowing through a huge checklist of particular mandates.

In sum, real investors want what we as a society want and we as end-user, individual investors want; which is for corporations to create sustainable wealth. Until, however, the institutions who control and churn American stocks actually act and think like investors themselves, it is unrealistic to think that the corporations they influence will be well-positioned to advance that widely shared objective. So long as many of the most influential and active investors continue to think short term, it is unrealistic to expect the corporate boards they elect to strike the proper balance between the pursuit of profits through risky endeavors and the prudent preservation of value. Rather, to foster sustainable economic growth, stockholders themselves must act like genuine investors, who are interested in the creation and preservation of long-term wealth, not short-term movements in stock prices.

81. Kahan & Rock, *Embattled CEOs*, *supra* note 41, at 59 ("Shareholder resolutions often come in waves, with every year or so witnessing the emergence of a new 'flavor of the year' type precatory resolution and the decline of some prior types.").