

# A Revised Monitoring Model Confronts Today's Movement Toward Managerialism

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*There are many lessons to be drawn from the sweep of history. In law, the compelling story repeatedly told is the observable co-movement of law on the one hand, and economic, social, and political changes on the other hand.<sup>1</sup> Aberrations, however, do arise but generally do not persist in the long term. Contemporary corporate law seems to be on the cusp of such an abnormality as legal developments and proposed reforms for corporate law are currently conflicting with the direction in which the host environment is moving. This article identifies a series of contemporary judicial and regulatory corporate governance developments that are at odds with multiple forces unleashed by today's ownership of public companies being highly concentrated in the hands of various types of financial institutions. In particular, we focus on the appropriateness of recent regulatory impediments that have been placed in the path of the continuing evolution of the monitoring board of directors but with an eye to the past, as well as how developments over the last several decades complete the central feature of modern corporate governance, the monitoring model.*

*To address this question, we begin by travelling back in time to post-World War II America during the dominance of managerialism, when shareholders were analogous to children—seen but not heard. That model was replaced by today's monitoring model, which empowers oversight of management in the hands of outside directors, whose obeisance, at least on paper, is anchored in the firm's residual claimants, the stockholders who elect the directors. But, as we discuss, the monitoring board has something of a checkered history in serving this function. We argue that from its inception the monitoring board was incomplete and board-centric because it was formed in an era where the received model was dispersed, not concentrated, ownership. That, of course, is no longer what characterizes American public companies. Today we believe that the*

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1. See generally MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870–1960* (1992) (comparing the evolution of the common law to economic growth in the U.S). Oliver Wendell Holmes gained much of his stature by being in the vanguard as one who recognized that the law was not simply found in a set of abstract principles received from on high but was rather molded by on-the-ground practical considerations, shaped by interacting social, political, and economic forces. See, e.g., Bradley C.S. Watson, *Oliver Wendell Holmes, Jr. and the Natural Law*, NAT. LAW, NAT. RIGHTS, AND AM. CONSTITUTIONALISM (2011), <http://www.nlnrac.org/critics/oliver-wendell-holmes> [<https://perma.cc/2JWU-JXRK>].

*growth of institutional investors' voting power and the engagement of hedge fund activists have repeatedly demonstrated ways to strengthen the monitoring board and in practice remedied many of its weaknesses.<sup>2</sup> We argue that this natural progression has been disrupted by recent regulatory actions aimed at weakening the shareholders' voice.*

*We next challenge the emerging New Paradigm and its accompanying appeals to stakeholder primacy that are being advanced as the future models for corporate governance. We conclude the article with a short set of recommendations we believe will bolster the heretofore incomplete and board-centric monitoring model for corporate governance.*

### I. Managerialism—The Quiet Life of the CEO

Corporate governance is a broad term.<sup>3</sup> Today there are two schools of thought about what constitutes good corporate governance: the shareholder perspective<sup>4</sup> and the stakeholder model.<sup>5</sup> In this section, we focus on managerialism<sup>6</sup> and the stakeholder model. We trace the rise of their importance during the 1950s and '60s and their decline during the 1970s and '80s. We also show how managerialism's fortunes moved in tandem with those of the stakeholder model.

In the post-World War II period, managerialism was the dominant form of governance. Throughout the 1950s and 1960s, American public

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2. See *infra* text accompanying notes 54–85 (reviewing empirical studies and case study of effects of activist hedge funds). This Article addresses a critique of the monitoring model leveled thirty years ago, “who will monitor the monitors[?]” Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873–74 (1991) (recommending that to enhance the monitoring model, financial institutions be empowered to appoint directors chosen from a cadre of professional directors).

3. The term *corporate governance* refers to the interplay between actors with direct and indirect interests in a corporation, including management, the board of directors, shareholders, employees, creditors, suppliers, customers, local communities, government, and the general public. Brian R. Cheffins, *Corporate Governance Since the Managerial Capitalism Era*, 89 BUS. HIST. REV. 717, 717 (2015); Steve Letza, Xiuping Sun & James Kirkbride, *Shareholding Versus Stakeholding: A Critical Review of Corporate Governance*, 12 CORP. GOVERNANCE 242, 242 (2004).

4. The shareholder perspective views the corporation as a legal instrument for shareholders to maximize their investment returns and focuses on the checks and balances between shareholders, the board of directors, and executive managers to secure the shareholders' interests. Letza et al., *supra* note 3, at 243.

5. The stakeholder perspective views the corporation as an entity serving the interests of a larger group of actors—including employees, creditors, suppliers, customers, and local communities. *Id.*

6. The historical reference point for our use of the expression “managerialism” is the era immediately after World War II, when, as we describe below, managers pursued the interests of the corporation not with the single focus of shareholders but by mediating the owners' interests along with those of other stakeholders. This era and the mission pursued by corporate executives are richly developed in Harwell Wells, “*Corporation Law Is Dead*”: *Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century*, 15 U. PA. J. BUS. L. 305, 310 (2013), which used the expression “heroic managerialism” to give emphasis to the executives according non-shareholder interests great weight in their pursuit of profits.

corporations were largely run by unfettered CEOs purportedly for the benefit of their stakeholders. Stockholders were dispersed, weak, and, with few exceptions, universally ignored. Corporate directors were underlings or friends of the CEO and often rubberstamped whatever the CEO told them to approve. The American economy was booming as many of the other nations in the world were still struggling to rebuild in the aftermath of the war.

The seeds of managerialism were sown earlier. In the midst of the Great Depression, Berle and Means captured the nation's attention by bringing to light the ills of the modern public corporation, in which not only was ownership separated from management, but more importantly, management hired capital, not the other way around as most assumed. They were also prescient because they foretold the rise of stakeholder capitalism and managerial domination.<sup>7</sup> In their view, the nation's largest corporations would come to dominate American society to such an extent that the "larger interests of society" would have a claim on their wealth "at least equal to that of shareholders."<sup>8</sup> At the helm, managers would be responsible for the monumental task of "balancing a variety of claims by various groups in the community and assigning each a portion of the income stream on the basis of public policy rather than private cupidity."<sup>9</sup> Corporations were to become the modern city-state as managers served a broad group of constituencies.

Power, of course, was needed to discharge such a heavy responsibility. Hence, power accreted naturally to executives to enable officers to mediate among the divergent interests of various stakeholders in the firm. At the same time, throughout the '50s and '60s, corporate boards were dominated by inside directors, friends of the CEO, and outsiders with deep commercial relationships with the company, such as its investment bankers or lawyers, and thus they were not independent of management. And, under the stakeholder model, boards were not focused exclusively on increasing shareholder value, seeing this as just one of many objectives managers were to pursue within the broader mission of balancing the sometimes competing interests of the firm's many stakeholders.<sup>10</sup> Thus, the stakeholder model

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7. See Wells, *supra* note 6, at 314 (describing Berle and Means' work as "foundational" to "modern corporate law scholarship"). See generally James J. Park, *From Managers to Markets: Valuation and the Shareholder Wealth Paradigm*, 7–18 (UCLA Sch. of Law, Law & Econ. Research Paper No. 20–09, 2021), <https://ssrn.com/abstract=3731764> [<https://perma.cc/5SQC-Y6XY>] (reviewing the rise and fall of managerialism).

8. Wells, *supra* note 6, at 322 (quoting ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 356 (1933)).

9. Wells, *supra* note 6, at 314 (quoting BERLE, *supra* note 8).

10. See, e.g., Wells, *supra* note 6, at 322 (highlighting the prevailing thought in the 1950s and well into the '60s that corporations were something of an inanimate statesman, speaking for capitalism by pursuing social objectives beyond wealth maximization).

required and got what it needed: a dominant CEO and a docile board of directors.<sup>11</sup>

Directors were weak for several reasons. Professor Myles Mace of Harvard Business School, in his widely cited survey of practices within boardrooms of American public companies, concluded there was a serious misalignment between popular conceptions of boards and what they actually did.<sup>12</sup> Mace noted that by the nature of their role, directors regrettably did not devote substantial time to the affairs of the companies they serve.<sup>13</sup> Even though the handful of outside directors occasionally did provide useful advice and counsel when their specialized backgrounds, e.g., finance, were implicated in the affairs of the company, boards had too heavy a representation from subordinates to the CEO to be considered independent.<sup>14</sup> And while boards were sometimes tasked to replace an incapacitated CEO, only rarely did they ask one to resign.<sup>15</sup> Indeed, the few incidents reported involving an attempt to force an underperforming or incompetent CEO to step down required a combination of inside and outside directors to act without the CEO knowing; the rarity of such instances was attributed to the attendant risk of punishment for acts treated akin to treason if the ouster failed.<sup>16</sup>

The centralization of managerial power came largely at the expense of shareholders.<sup>17</sup> According to the popular book *American Business Creed*, the rise of the stakeholder perspective meant that shareholders were now “on a par with other groups who have stakes in, and just claims on, the organization.”<sup>18</sup> *Fortune* magazine stated in 1951 that the shareholder “has become a kind of contingent bondholder rather than a part owner, [one] who rarely exerts any direct influence on the affairs of the company.”<sup>19</sup> Not only had the aim of the corporation shifted away from maximum profitmaking, but shareholders’ influence on the direction of the corporation had become

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11. See Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes but Uncertain Benefits*, 25 J. CORP. L. 349, 352 (2000) (relating anecdotes of CEOs’ dominance over directors in the 1950s); MYLES L. MACE, DIRECTORS: MYTH AND REALITY 179–94 (1971) (noting that the role of directors was largely advisory rather than of a decision-making nature); RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION 94–96 (1976) (summarizing views on board impotence).

12. MACE, *supra* note 11, at 2.

13. *Id.* at 179.

14. *Id.* at 179–80.

15. See Hamilton, *supra* note 11, at 351 (“About the only situation in which the board . . . selected a new CEO was . . . serious illness or unexpected death . . .”).

16. See *id.* (comparing CEO removal to a “palace coup”).

17. Wells, *supra* note 6, at 328.

18. FRANCIS X. SUTTON, SEYMOUR E. HARRIS, CARL KAYSSEN & JAMES TOBIN, THE AMERICAN BUSINESS CREED 58 (1956).

19. Wells, *supra* note 6, at 328 (quoting THE EDITORS OF FORTUNE MAGAZINE, U.S.A. THE PERMANENT REVOLUTION 68 (1951)).

minimal. According to Professor Robert Hamilton, Berle and Means' description of the impact of the separation of ownership and control had continued salience in the 1950s.<sup>20</sup> Retail investors lacked both the appetite and aptitude to intervene in corporate affairs and did not own more than a tiny fraction of the company's stock.<sup>21</sup> Consequently, the shareholder democracy movement was small and faced "astounding obstacles."<sup>22</sup> Any possibility that an outside group could successfully solicit proxies in opposition to management was remote.<sup>23</sup> Hence, the typical pathway for shareholders to convey their dissatisfaction with the management of corporate decision-making was to follow the "Wall Street Rule": sell shares in the market rather than attempt to vote or sue to effect change in the corporation.<sup>24</sup>

The weaknesses of the managerialist governance model for the public firm manifested beginning in the 1970s with poor performance by American companies in the face of rising global competition from industrial powers in once war-torn countries, inherent inefficiencies of the conglomerate form of business organization that pervaded many sectors of American industry,<sup>25</sup> and the high-profile bribery scandals uncovered in the wake of Watergate.<sup>26</sup> Thus, by at least the late 1980s, managerialism had been mostly replaced by a monitoring model anchored in a focus on shareholder wealth maximization.<sup>27</sup>

Additionally, before that, the stakeholder model had come under pressure from shareholder friendly hostile takeovers. The omnipresent threat of a takeover bid incentivized managers to focus on shareholder returns and

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20. Hamilton, *supra* note 11, at 350.

21. Cheffins, *supra* note 3, at 720; Hamilton, *supra* note 11, at 350.

22. DANIEL JAY BAUM & NED B. STILES, *THE SILENT PARTNERS: INSTITUTIONAL INVESTORS AND CORPORATE CONTROL* 14–17 (Authors Guild Backinprint.com ed. 2007) (1965).

23. See NADER, *supra* note 11, at 89–90 (outlining state law obstacles to effective exercise of shareholder democracy).

24. Hamilton, *supra* note 11, at 350.

25. See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 444 (2001) (explaining that the collapse of conglomerate strategy in the 1970s and into the 1980s "largely destroyed the normative appeal of the managerialist model").

26. Cheffins, *supra* note 3, at 725–26. Through the Watergate Scandal beginning in 1972, the Special Prosecutor's Office not only unearthed political impropriety, but also corporate impropriety. *Id.* These revelations transformed the public image of corporations. Having once viewed corporations as generally law-abiding corporate citizens, the public now viewed corporations as criminal enterprises, and feared corporate misdeeds. Hamilton, *supra* note 11, at 359. As a result, corporate governance reforms that granted the board of directors additional monitoring power were put on the official agenda. *Id.* at 359–60; Cheffins, *supra* note 3, at 726. 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, 1478 (2007) (referring to the above events as evidence of a "governance crisis" that ushered in reform efforts through the monitoring model).

27. Gordon, *supra* note 26, at 1469. Gordon places this shift as concluding in the 1990s, but like any historical change, the movement most certainly began earlier.

acted as an external corporate governance mechanism.<sup>28</sup> Moreover, as we discuss more fully in the next section, the growth of institutional investors—organizations that hold large portfolios of securities under professional management—had a significant impact on shifting the balance of corporate power back towards shareholders.<sup>29</sup> This all spawned calls for reform that ultimately gave rise to the monitoring model.

## II. The Rise of the Monitoring Model

The monitoring model is premised on the belief that independent directors can act as robust monitors of corporate management in order to improve corporate performance and take extraordinary action to curb internal abuses in crucial situations by, among other things, terminating ineffective corporate management.<sup>30</sup> Beginning in the 1970s, a pronounced shift in thinking regarding the mission of the firm occurred, resulting in more and more public companies increasing the percentage of independent directors on their board. The monitoring model meant great emphasis was placed on defining relationships and processes of appointment which disqualified an individual from being independent while reducing the substantive content of fiduciary obligations.<sup>31</sup> Whereas before the monitoring model, self-dealing acquisitions were addressed through a broad inquiry into the overall financial fairness of the transaction, under the influence of the monitoring model, the inquiry shifted so that the focus was heavily anchored on the process whereby an independent body of directors approved the transaction.<sup>32</sup> This emphasis

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28. Cheffins, *supra* note 3, at 729–30. Before the era of the hostile takeovers, a wave of management-going-private transactions could also be seen as indicative failings of managerialism as insiders exploited their firm’s undervaluation by taking the firms private and changing operations to improve returns for the manager-owners.

29. Hamilton, *supra* note 11, at 353.

30. This widely adhered to view is carefully developed by Professor Melvin A. Eisenberg. See generally MELVIN A. EISENBERG, *Who Manages the Business of a Corporation?*, in THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 139 (1976) (closely analyzing alternative board structures and concluding the monitoring model holds the best opportunity for boards to achieve what they are capable of achieving).

31. Masulis conducted a recent review of the literature on boards of directors with a focus on the value of independent directors. See Ronald W. Masulis, *A Survey of Recent Evidence on Boards of Directors and CEO Incentives*, 49 ASIA-PAC. J. FIN. STUD. 7, 19 (2020) (finding, among other things, that evidence suggests “board independence leads to greater sensitivity of forced CEO turnover to performance”).

32. The overriding role that independent director approval plays in such transactions supports the view that the monitoring model exists, at least in part, to insulate transactions from close judicial scrutiny. See Lawrence E. Mitchell, *The Trouble with Boards*, in PERSPECTIVES ON CORPORATE GOVERNANCE 17, 41 (F. Scott Kieff & Troy A. Paredes eds., 2010) (arguing the monitoring model was developed primarily to insulate directors and managers from liability).

was soon extended beyond self-dealing transactions<sup>33</sup> and became the medium to address the corporation's interest served by an on-going derivative suit.<sup>34</sup> In these extensions, there was emphasis on the financial independence of the deciding directors as well as the steps they took to reach a decision.

The monitoring model also impacts how directors interact with one another. With the emphasis on process, the time demands on outsiders to meet this new standard increased with the result being that directors' roles within governance morphed into their being more specialists than generalists in monitoring management's overall stewardship. Today, the directors' monitoring role is bifurcated through tasks assigned to three or more board subcommittees so there is a threat this may balkanize oversight.

Empirical evidence on the benefits associated with the independent directors in fulfilling the objectives of the monitoring model is mixed. Studies of various financial performance measurements do not make a compelling case that the degree of board independence is associated with significant financial performance.<sup>35</sup> The clearest indication of director independence exists in studies examining whether increases in the degree of board independence impacts CEO tenure. In considering this connection, it is useful to divide the inquiry into three distinct corporate governance periods. First, there was a noticeable relationship between the percentage of outside directors and CEO turnover during the halcyon days of the 1970s when companies moved quickly to have a core group of outside directors.<sup>36</sup> The second era is the 1980s when hostile takeovers were center stage as a mechanism for addressing managerial "slack"; during this period, there was an observable relationship between the percentage of inside directors and CEO turnover, but it is not as pronounced as when boards were just evolving to being largely outsiders.<sup>37</sup> In the third, contemporary era, with the

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33. See, e.g., *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014) (conditioning the presumption of fairness of self-dealing acquisition on there being an independent negotiating committee as well as fully informed non-coerced approval by independent shareholders).

34. See, e.g., C.N.V. Krishnan, Steven Davidoff Solomon & Randall S. Thomas, *How Do Legal Standards Matter? An Empirical Study of Special Litigation Committees*, 60 J. CORP. FIN. 1, 2 (2020) (reviewing dismissal rates to conclude that judicial review of procedures followed by committees has significant impact on outcomes).

35. Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance: The Sequel*, 58 J. CORP. FIN. 142, 142–43 (2019).

36. See, e.g., Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. (THE DISTRIBUTION OF POWER AMONG CORPORATE MANAGERS, SHAREHOLDERS, AND DIRECTORS) 431, 447 (1987) (finding in a study of NYSE firms between 1974–1983 that underperforming firms with outsider dominated boards were more likely to replace their CEOs; the results were found not impacted by ownership structure, size, or industry considerations).

37. See Wayne H. Mikkelsen & M. Megan Partch, *The Decline of Takeovers and Disciplinary Managerial Turnover*, 44 J. FIN. ECON. 205, 221 (1997) (finding that percentage of independent

prevalence of boards being heavily comprised of outside directors, slight differences in the percentage of outside directors were not observed to have a significant impact on CEO tenure.<sup>38</sup>

The impact of outside directors on CEO compensation is less clear than in the case of CEO tenure. Indeed, the growing percentage of boards being made up of outside directors appears to have negligible impact on executive compensation. In addition to the clubiness of the boardroom,<sup>39</sup> there is evidence of other biasing forces, such as the directors' compensation itself<sup>40</sup> or even that the corporation makes charitable contributions to charities in which directors are affiliated.<sup>41</sup>

However, stronger linkages of pay and performance have been observed when the board has an independent director who is a blockholder (IDB); when this exists, there is lower excess pay for CEOs and lower proportions of equity-based pay.<sup>42</sup> Agrawal and Nasser's findings suggest that IDB presence is systemically connected to corporate governance and reveal that CEOs of firms with IDBs have lower excess pay and lower equity-compensation.<sup>43</sup> The authors posit that their results lend support to the monitoring model over the private-benefits model.<sup>44</sup> Their data also support our belief that independent directors are a good solution to issues in corporate governance, but they too need incentives to monitor management in the best interest of the shareholders.<sup>45</sup>

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directors was not a significant variable in CEO turnover in both the active-takeover era between 1984–1988 or low-takeover era between 1989–1993). Interestingly, the authors find that CEO turnover has no statistical relationship to performance in the low-takeover era. *Id.* at 206.

38. See Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance*, 14 J. CORP. FIN. 257, 270 (2008) (finding firms with a larger percent of independent directors were more likely to respond to poor performance by terminating the CEO); Eliezer M. Fich & Anil Shivdasani, *Are Busy Boards Effective Monitors?*, 61 J. FIN. 689, 691 (2006) (finding that CEO turnover is more sensitive to poor performance when independent directors comprise a majority of the board). *But see* Bhagat & Bolton, *supra* note 35, at 146 n.10 (supporting the view that director independence became such an overarching concern after the passage of the Sarbanes–Oxley Act of 2002 that incremental increases in percentage of outside directors were no longer significant variables in the tenure of CEOs).

39. EISENBERG, *supra* note 30, at 171.

40. David Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281, 2281 (2004).

41. Ye Cai, Jin Xu & Jun Yang, *Paying by Donating: Corporate Donations Affiliated with Independent Directors*, 34 REV. FIN. STUD. 618, 655 (2021).

42. Anup Agrawal & Tareque Nasser, *Blockholders on Boards and CEO Compensation, Turnover and Firm Valuation*, 9 Q.J. FIN., Mar. 2019, at 1950010–1, 1950010–5.

43. *Id.*

44. *Id.* at 1950010–43.

45. Liu and her coauthors find that institutional investor monitoring creates important director incentives to monitor, but distracted institutional investors weaken board oversight. Claire Liu, Angie Low, Ronald W. Masulis & Le Zhang, *Monitoring the Monitor: Distracted Institutional Investors and Board Governance*, 33 REV. FIN. STUD. 4489, 4525 (2020).



We believe the uneven to non-observable benefits associated with independent boards reflect the fact that the monitoring model, initially received as board-centric, was incomplete. At the time the monitoring model was initially embraced, stock ownership was highly dispersed so that stockholders were not an organized force; hence, the monitoring model was distinctly board-centric. Such a preoccupation with the board is ripe for reexamination now, both because financial institutions currently hold 70% of the shares of publicly traded companies and because there is a rich history of activist institutional investors.<sup>46</sup> We believe both of these developments can enhance the monitoring model. However, because the rise of institutional investors followed the conceptualization and adoption of the monitoring model, a role for the investors as an active part of monitoring was not incorporated into the model.

Institutional activism began in the 1990s and has since accelerated,<sup>47</sup> focusing on governance proposals that held strong intuitive appeal regarding strengthening board independence—annual elections, needing majority support of the shareholders, direct shareholder nominations of director candidates, and independence in the board’s agenda by selecting a chair that was a monitor—not the monitored.<sup>48</sup> Support across a constellation of institutional shareholders on such general governance positions posed no insurmountable collective action concerns. On the other hand, time constraints and financial burdens for most institutional investors to determine how a company held in its portfolio could materially improve its performance led to them being “rationally reticent” while being eager to receive proposals to improve the performance of a portfolio company.<sup>49</sup>

These problems created their own solution; proxy voting advisors sprang up to assist the institutions in deciding how to vote their shares in hundreds of companies.<sup>50</sup> Proxy advisors were also retained to perform a variety of other services, such as keeping track of proxy cut-off times, examining proxy materials, and promulgating vote recommendations.<sup>51</sup> Yet,

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46. U.S. GOV’T ACCOUNTABILITY OFF., GAO-17-47, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS’ ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 13 (2016).

47. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013).

48. See generally Keith L. Johnson, *Rebuilding Corporate Boards and Refocusing Shareholders for the Post-Enron Era*, 76 ST. JOHN’S L. REV. 787 (2002) (describing how shareholders can preserve and enhance the company by focusing on director value).

49. See Gilson & Gordon, *supra* note 47, at 867 (noting that many institutional investors are constrained by conflicts of interest, as well as resources, to be activists, so they are reticent to initiate; however, they nonetheless devote resources they have to considering well-crafted proposals by hedge funds and others who are neither reticent nor constrained).

50. Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 34-87457, 2019 WL 5869793 at \*7-8 (proposed Nov. 5, 2019) (to be codified at 17 C.F.R. pt. 240).

51. *Id.* at \*8.

even the advent of this new service did not fully resolve many of the corporate governance problems facing institutional investors. The deficiencies of the monitoring model—part-time directors with limited access to information, a director nomination process dominated by management, and directors with limited financial incentives in taking action to improve corporate value—persisted. This void set the stage for institutional-shareholder activism that became a force for urging independent directors to take action in ways the activists argued were better aligned with the interests of shareholders; this development bolstered the monitoring model and has enabled it to become a more vibrant part of contemporary corporate governance.<sup>52</sup> But, there was still much more that needed to be done.

The activist hedge funds entered this fertile ground as “governance intermediaries.”<sup>53</sup> This occurred as hedge fund activists provided boards with alternative business strategies backed up with investment banker analyses, top-flight management consultants, and alternative flows of information to those provided by corporate management. The appearance of an activist hedge fund with a strong track record in prior engagements generated clear short-run performance improvements and perhaps, but more controversially, long-run gains too.<sup>54</sup> These developments demonstratively stiffened the spine of directors by leading to significant operational changes in the wake of shareholder concentration and support our view that, as initially adopted, the

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52. In a fascinating study of one large U.K. institutional investor, Becht and his co-authors, found that this particular institution engaged with all of its portfolio companies at least once a year, and its dedicated Governance and Stewardship Group had 564 direct contacts with portfolio firms in 2015. Marco Becht, Julian Franks & Hannes F. Wagner, *Corporate Governance Through Voice and Exit* 11 (European Corp. Governance Inst., Finance Working Paper No. 633/2019, 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3456626](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3456626) [https://perma.cc/3JMV-RTEP]. They also found that hedge fund activist proposals received “special treatment,” resulting in extra scrutiny. *Id.* at 63.

53. Gilson & Gordon, *supra* note 47, at 867 (“[R]econcentration of ownership through institutions adds only marginally to the value of the vote . . . [T]he activist shareholder . . . increase[s] the value of the vote held by the institutions by teeing up the intervention choices at low cost to the institutional owners.”).

54. There is a serious dispute about whether hedge fund activism produces long-run value increases in targeted corporations. Compare John Armour, *Shareholder Rights*, 36 OXFORD REV. ECON. POL’Y 314, 335 (2020) (arguing that the exercise of shareholder rights focusing on market pricing leads to short termism), and Ed deHaan, David Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 24 REV. ACCT. STUD. 536 (2019) (showing post-activism long-term returns insignificantly different from zero), with Lucian Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1120 (2015) (finding no evidence that hedge fund activism has long-term negative effects).

monitoring model was incomplete; the model failed to incorporate mechanisms for shareholders to engage directly with boards of directors.<sup>55</sup>

Modest is not the adjective used to characterize the record of successful activist shareholders. Activist investors' value in the monitoring process is documented by the substantial average announcement return in the targeted company's stock price upon an activist hedge fund's announcement following notice of a position in the company.<sup>56</sup> In an important recent working paper, Vyacheslav Fos and his co-authors show that activist investors increase firm value by influencing the target firm's corporate policies. Their estimates are that an average of 4.77%, which is 75.2% of the total observed Schedule 13D filing returns, are the result of changes at the target firm.<sup>57</sup> Moreover, these activist funds have a holding period longer than the average investor.<sup>58</sup> Although the activist funds more frequently collaborate with the target company's management than pursue more confrontational alternatives, the evidence reflects that both executive compensation and the executives themselves are on the chopping block.<sup>59</sup> We see that when the monitoring model is joined by an engaged institutional holder, boards restrain executive compensation—something not observed when the only actor is the independent directors. Moreover, in an era of activist investors, boards have become even more willing to terminate poorly performing CEOs when supported by the activist investor.<sup>60</sup>

The impact of hedge fund activists is widespread. One recent study reports that from 2000 to 2013 there were 3,012 campaigns initiated by activist hedge funds.<sup>61</sup> From January to August of 2019, activists launched 205 campaigns and won 76 board seats.<sup>62</sup> This is down from a record 360

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55. Different types of shareholders will engage in different types and levels of monitoring of the firms in their portfolios. Julian Franks, *Institutional Ownership and Governance*, 36 OXFORD REV. ECON. POL'Y 258, 267–68 (2020) (comparing active asset managers, passive asset managers, and hedge fund activists and concluding that hedge fund activists spend “much greater resources” than other asset managers and concentrate on strategic issues).

56. Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755–57 (2008); Rui Albuquerque, Vyacheslav Fos & Enrique J. Schroth, *Value Creation in Shareholder Activism: A Structural Approach* 41 (European Corp. Governance Inst., Finance Working Paper No. 685/2020, 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3639636](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3639636) [<https://perma.cc/PC7J-AQW3>].

57. Albuquerque et al., *supra* note 56, at 3.

58. Brav et al., *supra* note 56, at 1731–32, 1747 tbl.2.

59. *Id.* at 1732.

60. *Id.* at 1770.

61. Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1, 5 tbl.1 (2020).

62. SULLIVAN & CROMWELL LLP, REVIEW AND ANALYSIS OF 2019 U.S. SHAREHOLDER ACTIVISM 3 (2019), [https://www.sullcrom.com/siteFiles/Publications/2019 ShareholderActivismAnnualReport.pdf](https://www.sullcrom.com/siteFiles/Publications/2019%20ShareholderActivismAnnualReport.pdf) [<https://perma.cc/Y573-DLS8>].

campaigns in 2015.<sup>63</sup> Overall, the activists' strategy is to influence the targeted board, not to dominate it.<sup>64</sup> Success for such campaigns must be assessed over time. The outcomes achieved in the campaigns reflect that activists are meeting with increasing success. For example, 0.7 board seats were won per campaign (a 35% increase from 2017).<sup>65</sup> In a very extensive study of hedge fund activism, the authors found that 13% resulted in settlements, whereas 5% were pursued to contested shareholder votes.<sup>66</sup> Settlements as a rule entail the target adding new directors to its board; this has the effect of bringing about an "increase in the number of activist-affiliated, activist-desired, and well-connected directors and [a] decrease [in] the number of old and long-tenured directors," as well as planting the seeds for serious changes in corporate strategy and leadership.<sup>67</sup> Thus, following activist campaigns, nearly half of all issuers that added activist designees to their boards in 2017 and 2018 either sold themselves or engaged in a meaningful divestiture, and the rate of CEO turnover at target companies between 2013 and 2017 increased to between 23% and 28%.<sup>68</sup>

Public perception of activist investors is also improving. Research indicates that activist strategies are increasingly focused on long-term vision and value creation rather than a short-term burst of share buybacks.<sup>69</sup> CEOs are beginning to engage with activists and, at least in one case, even solicit their involvement in major corporate reform or restructuring.<sup>70</sup> Other CEOs have adopted "internal activism" as a method of management.<sup>71</sup> The constant

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63. David Benoit, *Activism's Long Road From Corporate Raiding to Banner Year*, WALL ST. J. (Dec. 26, 2015, 12:01 AM), <https://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910> [<https://perma.cc/ZXF7-QX5W>].

64. Bebchuk et al., *supra* note 61, at 34. The modesty of the activists' actions is reflected in the observation that the activist was affiliated with barely one-half (52%) of the new directors added to the board in the months that followed their campaign. *Id.* at 14 tbl.5, panel B.

65. SULLIVAN & CROMWELL, *supra* note 62, at 2.

66. Bebchuk et al., *supra* note 61, at 5. Indeed, activists filed proxy materials as part of their steps to engage the target in only 12% of the 3,012 campaigns and ultimately pursued matters to a contested vote in only 38% of those instances. *Id.* at tbl.1.

67. *Id.* at 3.

68. See LAZARD LTD., REVIEW OF SHAREHOLDER ACTIVISM—3Q 2017 1 (2017), <https://www.lazard.com/media/450309/lazard-review-of-shareholder-activism-q3-2017-final.pdf> [<https://perma.cc/UQ63-NJD4>] (finding an average annualized CEO turnover of 23% by activist targets); Bebchuk, *supra* note 61, at 25 (finding that CEO turnover spikes at an annual 28% in the year after a settlement).

69. Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246, 1254, 1261 (2017).

70. *Id.* at 1262–63 (summarizing an engagement where the CEO of the General Electric Company invited an activist, Nelson Peltz, "to invest in the company and become active in reforming it").

71. Liz Hoffman, *More Companies Deal with Multiple Activists*, WALL ST. J. (Aug. 10, 2015, 7:08 PM), <https://www.wsj.com/articles/more-companies-deal-with-multiple-activists-1439248120> [<https://perma.cc/M7TE-9YDV>].

threat of activism continues to shape the corporate landscape, as any company of any size is a potential target.

Illustrative of modern governance at work are the decade-long experiences of Dow and Dupont, as well as their merged company DowDuPont. One of the many messages from their odyssey is that no firm is too big to be the object of activist hedge funds. In 2013, DuPont was a company with \$67.5 billion market capitalization and had been a sprawling marquee company engaged in a range of product areas since its founding over 200 years ago.<sup>72</sup> After disclosing its investment in August 2013 and subsequently engaging in talks with management, Trian Fund Management, L.P. formally voiced its concerns in an open letter to the DuPont board and all shareholders in September 2014.<sup>73</sup> The letter described at length how Trian believed the conglomerate structure of DuPont was destroying shareholder value, that the board was no longer interested in holding management accountable, and that DuPont should reorganize its various lines of business into three separate companies focused on different industries.<sup>74</sup> Management, led by CEO Ellen Kullman, promptly rejected Trian's proposal, which led to Trian launching a full-scale proxy fight in January 2015.<sup>75</sup> This was one of the largest ever proxy contests led by an activist and resulted in DuPont management narrowly winning shareholder support in May 2015.<sup>76</sup> However, five months later, Ellen Kullman quietly retired as CEO of DuPont and was replaced by then-director Edward Breen.<sup>77</sup>

Meanwhile, a major DuPont competitor, Dow Chemical, was handling an activist challenge from Third Point, which was also calling for extensive corporate restructuring.<sup>78</sup> Dow was able to avoid a proxy fight, however, by

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72. David Benoit & Jacob Bunge, *Nelson Peltz Launches Proxy Fight Against DuPont*, WALL ST. J. (Jan. 8, 2015, 9:07 PM), <https://www.wsj.com/articles/nelson-peltz-launches-proxy-fight-against-dupont-1420761264> [<https://perma.cc/YX4P-4RSV>].

73. Letter from Trian Fund Mgmt. L.P., to Board of Directors, DuPont Co. (Sept. 16, 2014), <http://online.wsj.com/public/resources/documents/TrianDuPont.pdf> [<https://perma.cc/2BUE-QD8V>].

74. *Id.*

75. Benoit & Bunge, *supra* note 72.

76. Tom Hals, *DuPont Wins Board Proxy Fight Against Activist Investor Peltz*, REUTERS (May 13, 2015, 8:57 AM), <https://www.reuters.com/article/us-dupont-trian/dupont-wins-board-proxy-fight-against-activist-investor-peltz-idUSKBN0NY1JI20150513> [<https://perma.cc/2BV6-X4Z6>].

77. David Benoit, *Four Activists Challenge Plans to Carve up DowDuPont*, WALL ST. J. (July 30, 2017, 7:22 PM), <https://www.wsj.com/articles/how-to-carve-up-dowdupont-four-activists-sharpen-their-knives-1501412580> [<https://perma.cc/67S6-Z7LL>].

78. Jack Kaskey, *Dow Chemical Pact with Loeb's Third Point Avoids Proxy Fight*, GLOBE & MAIL (Nov. 21, 2014), <https://www.theglobeandmail.com/report-on-business/international-business/us-business/dow-chemical-pact-with-loebs-third-point-avoids-proxy-fight/article21703009/> [<https://perma.cc/ZXZ4-Z6L2>].

settling with Third Point and agreeing to add four new independent directors.<sup>79</sup>

With all of this as background, Dow and DuPont began discussing a potential combination in October 2015.<sup>80</sup> The plan, formally unveiled in December 2015, envisioned a merger-of-equals between the two companies followed by a breakup of the newly formed DowDuPont into three independent, publicly traded entities.<sup>81</sup> At this point even more activists joined the fray, with Jana Partners and Glenview Capital Management joining Trian and Third Point in critiquing the proposed \$150 billion deal.<sup>82</sup> This was the beginning of a multi-year struggle over the direction of the proposed breakup plan, with activists successfully pushing for the retirement of DowDuPont Executive Chairman (and former Dow Chemical CEO) Andrew Liveris and retooling various aspects of the breakup deal itself.<sup>83</sup> DowDuPont CEO Edward Breen ended up openly engaging with the activist investors while designing the deal, admitting that activists raised fair points and that having them involved and supportive of the deal was valuable to the process.<sup>84</sup> In a December 2018 interview, Mr. Breen advised CEOs to engage with activists: “[t]alk to them and understand exactly all the details of where they’re coming from. You’re not going to agree with them on everything, but they’re doing their homework also and sometimes they’re making some pretty good points.”<sup>85</sup> The engagement of DuPont, Dow and DowDuPont by activist hedge funds is neither isolated nor a cherry-picked illustration.

The lesson we emphasize from the above is that the strategies advanced in these campaigns and ultimately pursued were formulated and initiated outside the target company’s boardroom and would not have been successful if the targeted firm believed the strategy did not have substantial support among institutional holders. Thus, activist holders supplement the monitoring model by providing their independent evaluation of the firm’s performance and management’s stewardship, and by advancing alternative strategies in the shareholders’ interests. All of this information is eventually shared with the targeted firm’s board. In doing so, the hedge funds help the

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79. *Id.* Of note is that two of these directors were receiving base and incentive compensation from Third Point, a so-called “Golden Leash” arrangement.

80. David Benoit, *Dow, DuPont Deal Underscores Rise of Activists*, WALL ST. J. (Europe), Dec. 14, 2015, at B1.

81. Dan Primack, *Dow Chemical and DuPont Announce Mega-Merger*, FORTUNE (Dec. 11, 2015, 6:00 AM), <https://fortune.com/2015/12/11/dow-chemical-and-dupont-announce-mega-merger/> [<https://perma.cc/KBS9-SDBN>].

82. Benoit, *supra* note 77.

83. *Id.*

84. Jacob Bunge, *Meet the Breakup Artist Taking Apart DowDuPont*, WALL ST. J. (Dec. 26, 2018, 9:00 AM), <https://www.wsj.com/articles/meet-the-breakup-artist-taking-apart-dowdupont-11545832801> [<https://perma.cc/E56Z-YJK9>].

85. *Id.*

directors to overcome the time, information, and other talent constraints on the target board members.

Importantly for the thesis of this article, the advent of the activist investor reflects the incompleteness of the monitoring model as initially conceived and hence the inherent weakness that prevents a director-centric model from achieving its full potential. The directors, though independent, suffer acute time, information, talent, and psychological constraints<sup>86</sup> that in combination can impact their ability to undertake an impartial, penetrating, and sweeping assessment of the strategies pursued by the firm's management. The campaigns of activist hedge funds are mechanisms by which, through a credible shareholder threat, the target board initiates closer and more independent evaluation of management's stewardship. Such an impetus can be thought of as "error correction" and when it results in the true correction of course it produces shareholder value. Thus, activist campaigns demonstrate how the objectives of the monitoring model are strengthened by deep shareholder involvement and that such involvement fills a gap that persists in the contemporary board-centric model.<sup>87</sup>

In the next section, we set forth several contemporary judicial and regulatory developments whose very existence is dramatically at odds with the fact that ownership of public companies is highly concentrated in the hands of various types of financial institutions and that their power is closely connected to that of third-party proxy voting advisors and hedge fund activists.

### III. Girding Against Hedge Fund and Shareholder Activism: Chipping Away at the Legal Rules that Form Their Foundations

Unquestionably, the rise of financial institutions, the emergence of third-party voting advisors, and the concomitant appearance of hedge fund activism are the most significant developments to impact the public corporation in the last fifty years. The separation of ownership from management, captured nearly a century ago by Adolf Berle and Gardiner Means, still persists, but the problem is no longer exacerbated by the collective action problem associated with shares owned almost entirely by investors with holdings too small to justify being other than rationally

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86. Moreover, because the target board has not only been involved with the strategies challenged by the activist but also likely identifies as well with their implementing management, the board cannot be expected to quickly cast aside those connections and consider an outsider's proposals neutrally. Hence, the engagement between the targeted board and the activist is at least initially adversarial.

87. Consistent with our thesis, Professors Fisch and Sepe also suggest that a board's relationship with outside investors has become more collaborative in recent years. Jill E. Fisch & Simone M. Sepe, *Shareholder Collaboration*, 98 TEXAS L. REV. 863, 873 (2020) (reasoning that through such interactions the "partial information" problem of the cloistered directors is addressed).

apathetic. Not surprisingly, the changes that have ensued have unsettled managers. Their angst has unleashed a series of developments that confront shareholder activism.

Recently, the Securities and Exchange Commission (SEC) has turned its attention to the regulatory regime governing the proxy voting process.<sup>88</sup> In 2018, the SEC's Division of Investment Management withdrew its no-action guidance that enabled institutional investors to rely on proxy advisory recommendations.<sup>89</sup> On November 5, 2019, in response to critics of the proxy advisory industry, the SEC voted to propose amendments to the Exchange Act rules regulating proxies.<sup>90</sup> On July 22, 2020, the SEC adopted amendments to its rules governing proxy voting advice.<sup>91</sup>

The amendments to Rules 14a-1(l), 14a-2(b)(1), and 14a-2(b)(3) expand the circumstances in which proxy voting advice would constitute a solicitation and thus be regulated.<sup>92</sup> And amendments to Rules 14a-2(b)(1) and 14a-2(b)(3) require proxy advisory firms to disclose material conflicts of interest in their proxy voting advice, to provide companies an opportunity to review and provide feedback on the proxy voting advice before it is released, and to grant registrants an option to request that the proxy voting firms include in their voting advice a hyperlink to the registrants' written statement describing their views on such voting advice.<sup>93</sup> Finally, the amendment to Rule 14a-9 details examples of when the failure to disclose certain information in the proxy voting advice could be misleading within the meaning of the rule.<sup>94</sup> The net effect of these changes will be to hamstring proxy advisors' ability to provide candid, private advice to their clients.

Another area of resistance to activist shareholders is imposing early warning requirements that impede the activist. The most straightforward

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88. Michael Cappucci, *The Proxy War Against Proxy Advisors*, N.Y.U. J.L. & BUS. (forthcoming) (manuscript at 26-27), <https://www.ssrn.com/abstract=3488427> [<https://perma.cc/G8DA-SP7P>].

89. *Id.* at 26.

90. Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rule Amendments to Improve Accuracy and Transparency of Proxy Voting Advice (Nov. 5, 2019), <https://www.sec.gov/news/press-release/2019-231> [<https://perma.cc/989C-DQUM>].

91. Press Release, U.S. Securities and Exchange Commission, SEC Adopts Rule Amendments to Provide Investors Using Proxy Voting Advice More Transparent, Accurate and Complete Information (July 22, 2020), <https://www.sec.gov/news/press-release/2020-161> [<https://perma.cc/36FJ-23WX>].

92. *Id.*

93. Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55,082, 55,096-97, 55,201 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240). *See also id.* at 55,096 (listing examples of cases where "the interests of a proxy voting advice business may diverge materially from the interests of the clients who utilize their advice" and noting that circumstances in such examples "create a risk that the proxy voting advice business's voting advice could be influenced by the business's own interests, which may call into question the objectivity and independence of its advice").

94. *Id.* at 55,121.



reforms in this area are reflected in the repeated calls and growing support for reducing the beneficial ownership level that compels the activist investor to announce its presence and plans. This area is regulated by Section 13(d)(1) of the Securities Exchange Act, which now compels public disclosure once more than 5% of a reporting company's equity securities are acquired.<sup>95</sup> However, there is a ten-day grace period for making the filing after surpassing that level during which such beneficial holder can continue to acquire the issuer's shares<sup>96</sup> so that when the filing is ultimately made that holder may own nearly double the triggering amount.<sup>97</sup> Proposals are to reduce the triggering ownership requirement as well as shorten or eliminate the grace period.

The reforms proposed will have consequential effects for the activist hedge fund. We believe the most significant impact of the reforms is not that they erode any strategic advantage the hedge fund garners by delaying announcement of its ownership and the changes it believes its target should undertake but that they impact the activist's expected gain from its actions. Once disclosure is made, the target's stock price will on average rise. Under the current 5% trigger and ten-day grace window, the activist can purchase shares at a lower price than would be expected if public markets were aware of the activist's intentions. Thus, the reforms would reduce the financial incentives for the activist to undertake the quest. Moreover, earlier announcement would allow the target to issue a poison pill with a low ownership trigger that effectively caps the activist's ownership at a very low level, also reducing the expected benefits of undertaking the campaign.

Another early warning device is the advance notice bylaw. Most corporate statutes do not require that stockholders give advance notice in order to introduce business or nominate directors at an annual meeting. To fill this gap and thereby remove a strategic advantage of surprise from disgruntled stockholders, corporations have explicitly imposed such a requirement via an advance notice bylaw.<sup>98</sup> Advance notice bylaws have two purposes: to ensure the orderly functioning of shareholder meetings<sup>99</sup> and to

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95. 15 U.S.C. § 78m(d)(1).

96. *Id.*

97. See Alon Brav, Wei Jiang, Frank Partnoy & Randall S. Thomas, *The Returns to Hedge Fund Activism*, 64 FIN. ANALYSTS J. 45, 49 (2008) ("[T]he overwhelming majority of events involved a purchase of 5–10 percent of target shares.").

98. See, e.g., *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 344 (Del. Ch. 2008) (citing DEL. CODE ANN. tit. 8, § 222(a) (2001)) (referencing Delaware's default rules allowing stockholders to make proposals at annual meetings without advance notice); *Openwave Sys. Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 238–39 (Del. Ch. 2007) (defining advance notice bylaws and noting Delaware courts' frequent upholding of their validity). In the case of director nominations, such bylaws also often require that shareholders provide certain specified information about the nominees. *Id.*

99. *Openwave Sys. Inc.*, 924 A.2d at 239.

be used as a defensive strategy against activist shareholders.<sup>100</sup> The former is achieved by ensuring that shareholders can prepare and inform themselves prior to a vote.<sup>101</sup> The latter is achieved by allowing the incumbent board time to mount a defensive strategy against insurgents.<sup>102</sup> Advance notice bylaws have now become a standard fixture within U.S. companies<sup>103</sup> and are very much a strategic consideration in contests between managers and activists who may resort to the ballot as a means for questioning the incumbents' stewardship or a particular transaction.

The power of shareholders to propose bylaws empowering them to nominate directors is another important example of the SEC's retreat from empowering shareholders. In 2010, the SEC invoked the authority conferred on it by the Dodd–Frank legislation by adopting Rule 14a–11, which provided a mechanism for shareholders of reporting companies who individually collectively owned 3% of the issuer's shares for three years to nominate up to one-fourth of the board. Faulting the SEC for failing to engage in cost–benefit analysis sufficient to justify the rule, the Court of Appeals for the D.C. Circuit held in *Business Roundtable v. SEC*<sup>104</sup> that the rule was arbitrary and capricious.<sup>105</sup>

Surprisingly, *Business Roundtable* makes no reference whatsoever to the Dodd–Frank Act's express authorization for a rule providing proxy access or to the fact that the SEC acted pursuant to that authority.<sup>106</sup> The grant of authority to the SEC not only was unqualified but also clearly anticipated that the SEC would adopt a rule that provided terms and conditions for what the agency believed was appropriate proxy access.<sup>107</sup> The D.C. Circuit's analysis,

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100. See AARON RACHELSON, JOY M. BRYAN & PAUL W. RICHTER, CORPORATE ACQUISITIONS, MERGERS & DIVESTITURES § 1:161(2), Westlaw (database updated Dec. 2020) (suggesting that corporate management consider amending bylaws to include a notice requirement as a defensive strategy).

101. *Openwave Sys. Inc.*, 924 A.2d at 239.

102. RACHELSON ET AL., *supra* note 100.

103. See, e.g., *Openwave Sys. Inc.*, 924 A.2d at 238–39 (citing *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 43 (Del. Ch. 1998), *aff'd on other grounds sub nom. Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998)) (noting that advance notice bylaws are “commonplace” in Delaware corporations); Lawrence A. Hamermesh, *Director Nominations*, 39 DEL. J. CORP. L. 117, 136 (2014).

104. *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

105. *Id.* at 1156. For a biting critique of the court's reasoning, see generally James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEXAS L. REV. 1811 (2012).

106. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 971, 124 Stat. 1376, 1915 (2010) (codified at 15 U.S.C. § 78(n)(a)).

107. See S. REP. NO. 111–176, at 146–47 (2010) (discussing proxy access and the Section's grant of great discretion to the SEC in delineating such access). While stating that Section 972 of the Dodd–Frank Act did not require the SEC to engage in rulemaking, the committee report recognized that the provision gave the SEC “wide latitude in setting the terms” of proxy access. *Id.*

focusing exclusively on the broad policy question that Congress had taken off the table, is misdirected. By enacting Dodd–Frank, Congress embraced the broader concept of shareholder access, leaving it to the SEC to identify how that vision was to be achieved. So viewed, the D.C. Circuit’s review most appropriately should have been confined to the details of the proposal.

With Rule 14a–11 gone, activist shareholders have pursued self-help using the SEC’s shareholder proposal rule. In response, companies have exploited the grounds for omitting a proposal when it conflicts with the proposal submitted by management.<sup>108</sup> In a significant no-action letter involving Whole Foods, the SEC held that a proposal submitted by shareholders could be omitted because it conflicted with that of management.<sup>109</sup> The SEC staff reached this position even though there were several substantive differences between the shareholder’s proposal and the proposal supported by management.

Perhaps no voting-related development defies gravity more than the inability of the SEC to resist the self-preservation instincts of CEOs to its proposal for a “universal proxy” in contested elections. In 2016, the SEC proposed the use of a “universal proxy” to accommodate activist shareholders who advance a short slate of nominees.<sup>110</sup> As a practical matter, a shareholder who does not attend the stockholder meeting is unable to vote for some of management’s nominees and the nominees of the dissidents on the dissidents’ proxy. This is because, under corporate law, if a shareholder submits two different proxies the most recently executed proxy is counted on the theory it revokes the earlier proxy.<sup>111</sup> As proposed by the SEC, when there is a contested board election, the proxy used by management and the insurgent must include the names of *all* the nominees, those of management and those of the insurgent, so that shareholders can thereby choose among all the candidates rather than being forced into an all-or-nothing choice.

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at 146. The report explained that “[t]he Committee fe[lt] that it [was] proper for shareholders, as the owners of the corporation, to have the right to nominate candidates for the Board using the issuer’s proxy under limited circumstances.” *Id.*

108. 17 C.F.R. § 240.14a–8(i)(9) (2010).

109. Whole Foods Market, Inc., SEC No-Action Letter, 2014 SEC No-Act. LEXIS 414 (Dec. 1, 2014).

110. Tiffany Fobes Campion, Christopher R. Drewry & Joshua M. Dubofsky, *Universal Proxies: What Companies Need to Know*, HARV. L. SCH. F. ON CORP. GOVERNANCE 1 (Dec. 5, 2018) (citing SEC, Universal Proxy, Exchange Act Release No. 79,164 (October 16, 2018)), <https://corpgov.law.harvard.edu/2018/12/05/universal-proxies-what-companies-need-to-know> [<https://perma.cc/HVF6-9LM9>].

111. The dissident can try to overcome this feature by including on its proxy not only its nominees but also some of management’s nominees so that solicited shareholders have a sense that they are voting for the exact number of nominees as there are seats up for election. But the management nominees the dissident chooses to include may well not be the nominees the shareholder would have preferred among the larger set of management nominees. The universal proxy overcomes this problem.

Contestants, however, will have to direct shareholders to each other's proxy statements for information regarding the background of their respective candidates. In the face of strong opposition from company CEOs, who argued the universal proxy would prove disruptive, the SEC has not pursued this topic further.

The preceding are just a few of the examples we can raise of important legal developments that share a common theme: the weakening of the shareholder voice in corporate governance. Most importantly, each of these developments is critical when the shareholders are focused on the important matter of management stewardship of the firm, where shareholder action is not just a mechanism for correcting course but likely the only mechanism for doing so.

#### IV. Back to the Future: A Utopian Prescription through "Patient Capital"

##### A. *The Framework of the New Paradigm*

The tightly drawn battle lines separating the management-centric and investor-centric governance encampments have long nurtured their dispute on whether an investor focus is one that inevitably is harmful because it naturally invites the pursuit of short-term financial gains at the expense of long-term financial objectives.

A short-term mindset in managing and investing in businesses has become pervasive and is profoundly destructive to the long-term health of the economy. Short-termism erodes the foundation for future innovation, ingenuity in product enhancements and the research and development that makes possible medical breakthroughs, technological progress and scientific advances. It undercuts investments in employees, factories and equipment, expansion into new markets and the pursuit of other long-term projects that require up-front costs but have the potential for sustainable value creation and social impact.<sup>112</sup>

Furthermore, in an era of rising concerns for ESG matters and especially with a growing interest in sustainability, the advocates for a management-centric structure of corporate governance anchor their position in those concerns. In doing so, one detects more than the whiff of nostalgia to return to the halcyon days of managerialism. It is this perspective that frames the contemporary calls for a culture of patient capital as well as various governance initiatives

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112. MARTIN LIPTON, STEVEN A. ROSENBLUM, SEBASTIAN V. NILES, SARA J. LEWIS & KISHO WATANABE, INT'L BUS. COUNCIL OF THE WORLD ECON. FORUM, THE NEW PARADIGM: A ROADMAP FOR AN IMPLICIT CORPORATE GOVERNANCE PARTNERSHIP BETWEEN CORPORATIONS AND INVESTORS TO ACHIEVE SUSTAINABLE LONG-TERM INVESTMENT AND GROWTH 5 (2016), <https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25960.16.pdf> [https://perma.cc/DY99-98C6].

needed to foster that culture. The lament regarding short-termism is now embodied in a rich vision for corporate stewardship called “The New Paradigm.”<sup>113</sup>

It is not our purpose here to engage in the short-term versus long-term debate.<sup>114</sup> We believe that regardless of which is the more likely perspective pursued, neither alters our central thesis: the effectiveness of the monitoring model requires potency for the shareholders’ voice, and the prescriptions which make up the New Paradigm weaken the shareholder’s voice. As developed below, after a close review of governance proposals to establish a culture of “patient capital,” we believe these proposals are instead a prescription for “neutered capital” as the reforms now in the air ask institutional holders to forsake their power of error correction—the central justification for the shareholder vote.<sup>115</sup>

The most fully developed model for patient capital is set forth in a white paper whose lead author is the iconic Martin Lipton, a long-time advocate for the cause of long-termism and the management-centric perspective.

In essence, the New Paradigm *recalibrates* the relationship between public corporations and their major institutional investors and conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders working together to achieve long-term value and resist short-termism. In this framework, if a corporation, its board of directors and its CEO and management team are diligently pursuing well-conceived strategies that were developed with the participation of independent, competent and engaged directors, and its operations are in the hands of competent executives, investors will support the corporation and refuse to support short-term financial activists seeking to force short-term value enhancements without regard to long-term value implications. As part of their stewardship role, institutional investors will work to understand corporations’ strategies and operations and engage with them to provide corporations with opportunities to understand the investors’ opinions and to adjust strategies and operations in order to receive the investors’ support.<sup>116</sup>

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113. See Steven A. Rosenblum, *Hedge Fund Activism, Short-Termism, and a New Paradigm of Corporate Governance*, 126 YALE L.J. F. 538, 543–48 (2017) (providing a crisp summary of the New Paradigm and its dependence on agreement to long-term objectives by asset managers and their portfolio companies’ managers).

114. For such an engagement offering a close examination of the many points raised within the short-term, long-term debate, see generally Mark J. Roe, *Stock Market Short-Termism’s Impact*, 167 U. PA. L. REV. 71 (2018).

115. Randall S. Thomas & Paul H. Edelman, *The Theory and Practice of Corporate Voting at US Public Companies*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER 459, 464, 467–68 (Jennifer G. Hill & Randall S. Thomas eds., 2015).

116. LIPTON ET AL., *supra* note 112, at 1 (emphasis added).

The above is not itself controversial and surely captures, at least, the preliminary steps of even activist investors.

What is important is how the white paper recalibrates practices that institutional investors should follow. They are encouraged to “take an active *but measured* role in supporting long-term investment.”<sup>117</sup> This calls for each institutional investor not only to develop firm objectives focused on long-term performance for each of its portfolio companies but also to develop “expertise and staffing necessary to formulate its own voting guidelines, communicate with corporations and evaluate matters presented to a shareholder vote” against the so-developed objectives.<sup>118</sup> The diversified portfolio manager will most certainly see these tasks to be burdensome, especially with respect to the possibly hundreds of companies held by the fund. Recall that such concerns prompted the need for—and hence the growth of—proxy advisors whose expertise arose from repeated experiences with a range of shareholder proposals as well as executive compensation resolutions and ultimately their promulgation of extensive guidelines in considering recurring matters.

Even though resorting to proxy advisors is economically efficient, this practice is rejected by the white paper,<sup>119</sup> so that each institutional investor must incur the cost to inform itself or quietly acquiesce to the portfolio company’s managers. Since there is no evidence that funds totally defer to their proxy advisors, and there is evidence that proxy advisors’ recommendations do not dominate voting decisions, it is not clear whether this part of the New Paradigm is more than celebrating practices currently followed. More telling is that when an institution concludes that a particular portfolio company violates the fund’s objectives, the New Paradigm calls on the institution to “provide the corporation with prompt notice of its concerns and invite the corporation to engage with the investor”<sup>120</sup> and thereafter “work together toward the creation of sustainable long-term value.”<sup>121</sup> This by itself is not of concern; however, the New Paradigm does not address what

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117. *Id.* at 16 (emphasis added).

118. *Id.* at 17.

119. *Id.* (“[A]n investor should not outsource to a proxy advisory firm that uses inflexible metrics to make its recommendations . . .”). The authors’ preferred response is that embraced in Commonsense Principles 2.0, endorsed in October 2018 by numerous leading executives, whereby asset managers should disclose the extent they rely on proxy advisors and should be satisfied that the information upon which they are relying is accurate and relevant and their advisors have processes to address conflicts of interest. COMMONSENSE CORP. GOVERNANCE PRINCIPLES (October 2018), <https://www.governanceprinciples.org> [<https://perma.cc/9RS7-ZH6K>]. See also *Commonsense Principles 2.0*, COMMONSENSE CORP. GOVERNANCE PRINCIPLES 11, <https://millstein.law.columbia.edu/sites/default/files/content/images/Commonsense%20Principles/CommonsensePrinciples2.0.pdf> [<https://perma.cc/ZS6K-YHZN>]. Moreover, asset managers should also make public their proxy voting process, voting guidelines and engagement protocols. *Id.*

120. LIPTON ET AL., *supra* note 112, at 18.

121. *Id.* at 17.

should occur when the shareholder continues to disagree with the direction of the firm. The white paper eschews consideration of any leverage the institutional owner may pursue and what it does prescribe is tightly circumscribed: first talk, then more talk.<sup>122</sup>

Former Delaware Supreme Court Chief Justice Leo Strine, now a partner at the Wachtell Lipton law firm, has recently offered a series of proposals that complement those advanced by the New Paradigm.<sup>123</sup> In addition to enhanced disclosures related to the operation and incentives of the activists,<sup>124</sup> Strine proposes sweeping regulation of proxy advisory firms and institutional investors' current voting practices. For example, while observing that index funds are the quintessential long-term investor and their business is premised on extremely low operating costs, he nonetheless reasons they "should be precluded from relying on proxy advisory firms that do not provide guidance tailored to index funds' unique buy-and-hold perspective."<sup>125</sup> More broadly, he believes that index and mutual funds "should be required to have voting policies specifically tailored to the long-term purposes of those investments."<sup>126</sup> Even though the preceding practices are in large part designed to enhance the voice of the fund, Strine calls for rolling back federal requirements that funds vote on all matters submitted to them; he instead prefers that individual funds be permitted to choose from among matters calling for a vote.<sup>127</sup>

Clearly what is new under the New Paradigm and Strine's complementary arguments is driving financial institutions to committing to long-term performance objectives,<sup>128</sup> engaging management with only those objectives in mind, evaluating management's stewardship toward the objectives without the assistance of proxy advisors, and eliminating any

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122. This void should be compared to the guidelines formed by a large consortium of international asset managers. See INT'L CORP. GOVERNANCE NETWORK, ICGN GLOBAL STEWARDSHIP PRINCIPLES, 16 (setting forth Principle 4.3 Engagement Escalation that includes shareholder proposals, nomination of directors, and exiting or threatening to exit among the steps responsible stewards should consider when unhappy with the management of a portfolio company).

123. See Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1956–69 (2017) (offering policy proposals that seek to diminish the risks that hedge fund activism poses while retaining its benefits).

124. *Id.* at 1957–58.

125. *Id.* at 1965.

126. *Id.* at 1966. He further observes that this would enable funds to better enable investors to gauge if a fund advertising itself as socially responsible and pursuing sustainable investments is achieving that objective. *Id.*

127. *Id.* at 1966–67.

128. Similarly, the European Union's recent directive embraces governance-related mechanisms designed to focus companies and investors on the pursuit of long-term performance. See Directive 2017/828, of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement, 2017 O.J. (L 132) 1–9 (EU).

alternative to disciplining wayward management other than continued engagement with management. As such, the New Paradigm only partially maps existing practices by financial institutions and, more significantly, weakens the shareholders' voice in the boardroom.

Public companies regularly engage with their investors, especially financial institutions and their advisors, on an intense basis. This has been generally observed since at least the mid-1980s. Wealth managers indeed benefit greatly through such active involvement. A recent study of the multiple means by which a large money manager of actively managed mutual funds carries out its monitoring through engagement with its portfolio companies describes levels of intense systematic evaluation of each company that includes a good deal of engagement by its professionals with high-ranking company officers.<sup>129</sup> Significantly, the study links such active engagement with the manager with garnering *alpha* for the various portfolios the manager controlled. Good stewardship by money managers rewards its managers.<sup>130</sup> BlackRock's stewardship programs are designed to ensure that their personnel have direct engagement with corporate directors at the companies they invest in. Thus, the New Paradigm embraces an important ongoing practice of many financial institutions. Where the New Paradigm diverges from the status quo is that in recent years we see mutual funds more frequently vote against management proposals,<sup>131</sup> while voting in favor of hedge fund activists in their campaigns. This is not a practice considered in the New Paradigm or by Strine.

Such fund engagement, however, is deeply qualified by the recent rise of passive investment strategies, such as those practiced by index funds. Professors Bebchuk and Hirst's study of three major asset managers pours cold water on the New Paradigm.<sup>132</sup> They persuasively reason that index fund managers have weak incentives to engage in monitoring the managers of portfolio firms<sup>133</sup> and support that view with extensive data showing the Big Three do not engage managers on their operational issues but support fairly

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129. See Becht et al., *supra* note 52, at 8 (noting, for example, that fund managers base trading decisions on quarterly analyst reports that are internally circulated).

130. *Id.* at 24.

131. BRIAN CHEFFINS, *THE PUBLIC COMPANY TRANSFORMED* 313 (2019) (attributing this change, in part, to the SEC introducing in 2003 a requirement for mutual funds to disclose their voting decisions for their portfolio companies).

132. Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029, 2033–34 (2019).

133. See *id.* at 2047, 2050 (noting that in addition to the issue of non-trivial costs to monitor a portfolio company there is a free rider problem that the fruits derived will be shared proportionally by slothful competitors).



stylized guidelines they develop to identify governance practices believed to have deviated from well-received norms.<sup>134</sup>

The recent article by Professors Barzuza, Curtis, and Webber, which sets forth reasons to believe that index funds can be expected to be both strong supporters and likely even proponents of *social* issues, also argues that index fund managers lack incentives to focus non-trivial resources on *operational* issues not related to social issues that they believe are not as strongly supported by their investors.<sup>135</sup> As such, a significant portion of all publicly traded equities are controlled by passive owners who do not engage their portfolio company managers on the type of issues that are the focus of the New Paradigm. Even in a world of index fund managers being so focused, it does not seem reasonable to us to take the position that they lack a duty to vote and that they should be required to do so in an informed way. The earlier review of the positive effects of hedge fund activism is grounds alone for index managers supporting what they or their advisors believe are positive value resolutions and doing so is consistent with their obligations to their investors. To be sure, investors in the S&P 500 Index Fund expect that Caterpillar will be among the holdings and in proportion to its value of the portfolio; investors do not expect that the fund managers will ignore their advisor's recommendation to support a proposal reasonably designed to increase Caterpillar's returns. And, viewed more broadly, to reason otherwise would effectively remove the discipline of, and hence a sense of accountability to, a significant portion of a corporation's ownership. Simply stated, the fiduciary obligations of asset managers following an indexing strategy do not absolve the manager of the necessity to vote; as fund fiduciaries they have a duty when voting to do so in an informed manner and consistent with their stewardship obligations respecting the assets in the portfolio.<sup>136</sup> Mere adherence to holding proportionate interests in an

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134. *Id.* at 2090–93 (showing that the Big Three cast “no” advisory notes on CEO compensation one-third as often as a cohort of ten active fund managers). *See also* CHEFFINS, *supra* note 131, at 377 (noting that index funds focus on “keeping costs as low as possible and eliminating tracking errors”).

135. Michael Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1248, 1257 (2020).

136. Funds, especially index funds, generally delegate “voting authority to an investment advisor . . . [with] a fiduciary duty ‘to vote proxies of portfolio securities in the best interest of fund shareholders.’” Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, 79 MD. L. REV. 954, 1004 (2020). The SEC, however, has made it clear that funds do not need to “cast votes in every election on every issue proposed by portfolio companies . . . [and] should perform a cost–benefit analysis to determine whether the effort involved in researching the issue exceeds the potential value to the fund of casting an informed vote.” Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175, 186 (2017).

identifiable cohort of companies is not the sole requirement of responsible asset stewardship.

Even though actively managed mutual funds do not suffer from the same baked-in weak incentive structure discussed by Bebchuk and Hirst, they nonetheless are at best followers in activist campaigns. Picking and choosing investments, not changing the performance of portfolio companies, is their trade. Nonetheless, they do pile on when they believe supporting the activist agenda will increase the value of a portfolio company.<sup>137</sup> The observed support that actively managed mutual funds provide activist hedge funds reflects the incompleteness of the New Paradigm; the force that is communicated to a portfolio company's management through engagement is proportional to the steps that might follow if engagement does not lead to

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The SEC focuses its regulation on investment advisors. It requires all registered investment advisors to “adopt written policies and procedures . . . to ensure that [advisors] vote client securities in the best interest of clients.” Maurice M. Lefkort, *SEC Examines Passive Voting by Investors*, WHARTON MAG. (Oct. 15, 2018), <https://magazine.wharton.upenn.edu/digital/sec-examines-passive-voting-by-investors/> [<https://perma.cc/MQX3-MHQE>]. It also allows investment advisors to rely on an “independent third party (such as a proxy advisory firm)” to meet their obligations. *Id.* See also Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 817 n.77 (2018) (noting that “SEC material explicitly recognized that votes based upon the recommendations of an independent third party can serve investment advisers to fulfill their fiduciary obligations under Rule 206(4)-6”).

Under the Investment Company Act of 1940 and Investment Advisers Act of 1940, index fund directors and advisors have the fiduciary duties of loyalty and care to the funds they administer. Lipton, *supra*, at 180. As part of both duties of care and loyalty, fund directors and boards of funds have “a responsibility to oversee their fund’s affairs, including the voting of the fund’s proxies.” MUT. FUND DIR’S FORUM, PRACTICAL GUIDANCE FOR FUND DIRECTORS ON OVERSIGHT OF PROXY VOTING 1 (2012), [https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/mergersweb.pdf?sfvrsn=e050f954\\_6](https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/mergersweb.pdf?sfvrsn=e050f954_6) [<https://perma.cc/PX2J-9RSH>]. The SEC has stated its view that the duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. *See id.* at 1–2.

In the past decade, the operative expression that has grown in usage is the “duty of prudence.” Keith Johnson, Susan Gary & Cynthia Williams, *Comment Letter: Fiduciary Duty Guidance for Proxy Voting Reform*, HARV. L. SCH. F. ON CORP. GOVERNANCE 2 (Nov. 27, 2018), <https://corpgov.law.harvard.edu/wp-content/uploads/2018/11/Harvard-CG-Blog-w-endnotes-Proxy-voting-fiduciary-duty-Nov-2018.pdf> [<https://perma.cc/92HM-7JA9>]. *See also* Richard H. Koppes & Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing*, 20 J. CORP. L. 413, 426 (1995) (noting the first use of the “prudent person” investment standard was from an 1830 ruling, *Harvard College v. Amory*). The duty of prudence “requires that fiduciaries have a reasonable process in place to investigate and verify facts relevant to investment decisions.” Johnson et al., *supra*, at 2. Other authorities have merely used the standard of prudence as part of the duty of care, requiring a fiduciary to “exercise the judgment and care that a prudent person would exercise in the management of his or her own affairs.” Lipton, *supra*, at 180. Either way, prudence appears to be a leading keyword regarding funds’ fiduciary obligations. *See generally* Bernard S. Sharfman, *The Conflict Between BlackRock’s Shareholder Activism and ERISA’s Fiduciary Duty*, CASE W. RES. L. REV. (forthcoming 2021) (closely examining the obligation of institutional investors whose assets in part are managed by advisors whose voting decisions are guided by their controlling shareholder).

137. Gilson & Gordon, *supra* note 47, at 891–92.

change. More than talk must be in the institutional investor's arsenal. Indeed, it would appear inconsistent to champion dialogue between board and shareholders around long-term goals and at the same time ask those same shareholders not to act when their collective views are at odds with management. Thus, we can see that repeated institutional engagement regarding the same concerns can be expected to attract an even more bellicose form of investor activism.

We therefore ask, what is added by the New Paradigm aside from managers and their investors adhering to the nebulous north star of whether a given initiative supports the pursuit of long-term value? As seen, evidence reflects that passive investors adhere to a low-operating-cost strategy that rejects meaningful sustained engagement to increase shareholder value. Evidence also reflects that other investors do pursue *alpha* through engagement, and their success, discussed earlier, reflects that they are followed by investors who, though reticent to lead, are nonetheless eager to embrace strategies believed to increase their returns. But in the next section we suggest it harbors a more important mission.

#### B. *Stakeholder Primacy*

The New Paradigm of corporate governance urges public corporations to focus on broader *stakeholder* interests rather than exclusively focusing on *shareholder* interests and investment returns.<sup>138</sup> Inherent in the New Paradigm is the growing chorus in favor of environmental, social, and governance (ESG) initiatives, which provides that corporations should “incorporate relevant sustainability, ESG (environmental, social and governance) and CSR (corporate social responsibility) considerations in developing their long-term strategies and operations planning.”<sup>139</sup> The commitment not just to ESG but to the stakeholder model was crisply embraced in the summer of 2019 by members of the Business Roundtable; the statement is an important development in light of the fact that the organization is made up of hundreds of leading CEOs and other leaders of public companies. The statement unqualifiedly embraced the view that “each of our stakeholders is essential” and the companies embraced a “fundamental

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138. Legally, in jurisdictions such as Delaware, it seems undisputed that managers are required “to promote the value of the corporation for the benefit of its stockholders.” Edward Rock, *For Whom Is the Corporation Managed in 2020?: The Debate Over Corporate Purpose* 8 (European Corp. Governance Inst., Finance Working Paper No. 515/2020, 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3589951#](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3589951#) [<https://perma.cc/9TTN-SU5Q>] (quoting C. William Chandler of the Delaware Chancery Court).

139. LIPTON ET AL., *supra* note 112, at 2. *See also id.* at 18–19 (calling on institutional investors to similarly take account of sustainability and ESG in their investment strategies and to engage management of portfolio companies in a “robust dialogue” on the importance of ESG factors).

commitment to *all* of our stakeholders.”<sup>140</sup> They committed to “lead their companies for the benefit of all stakeholders,” and to deliver value not just to shareholders but also to the benefit of “customers, employees, suppliers, [and] communities.”<sup>141</sup> The statement further observes that “[f]inancial metrics such as total shareholder return and earnings targets will be balanced against a more holistic understanding of firm value.”<sup>142</sup>

When such non-specific statements are made, however, there is a natural concern that they are mere puffery. Consider that in the wake of the COVID-19 pandemic many “key signatories are furloughing employees, paying dividends to shareholders and provoking complaints from workers that they aren’t adequately protected from danger.”<sup>143</sup> Moreover, “[w]hen the pandemic prompted companies to furlough or lay off thousands of employees,” CEO pay cuts were minimal or non-existent.<sup>144</sup>

Nonetheless, in advocating this perspective, the New Paradigm complements an important shareholder movement that has with increasing frequency pressured boards and management to incorporate ESG initiatives into long-term corporate strategies and business models,<sup>145</sup> arguing that “sustainability factors are critical to long-term business viability.”<sup>146</sup> Indeed,

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140. *Business Roundtable Redefines the Purpose of a Corporation to Promote ‘An Economy that Serves All Americans’*, BUS. ROUNDTABLE (Aug. 19, 2019), <https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans> [<https://perma.cc/NNG9-ZUTH>] (emphasis added).

141. *Id.* “The Business Roundtable did not provide specifics on how it would carry out its newly stated ideals, offering more of a mission statement than a plan of action.” David Gelles & David Yaffe-Bellany, *Shareholder Value Is No Longer Everything, Top C.E.O.s Say*, N.Y. TIMES (Aug. 19, 2019), <https://www.nytimes.com/2019/08/19/business/business-roundtable-ceo-corporations.html> [<https://perma.cc/KNW2-YX33>]. In December of 2019, the World Economic Forum published a manifesto urging companies to move from shareholder primacy to “stakeholder capitalism,” thereby marking a worldwide push for the adoption of the New Paradigm. Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 95 (2020).

142. LIPTON ET AL., *supra* note 112, at 6.

143. Peter S. Goodman, *Big Business Pledged Gentler Capitalism. It’s Not Happening in a Pandemic*, N.Y. TIMES (Apr. 13, 2020), <https://www.nytimes.com/2020/04/13/business/business-roundtable-coronavirus.html> [<https://perma.cc/862H-7KUW>] (“Their actions expose the reality that the rhetoric of the Business Roundtable did not alter the decisive question of American capitalism—where the money goes.”).

144. Peter Eavis, *As the Pandemic Forced Layoffs, C.E.O.s Gave up Little*, N.Y. TIMES (July 29, 2020), <https://www.nytimes.com/2020/07/29/business/economy/ceo-pay-pandemic-layoffs.html> [<https://perma.cc/K7CC-7A6J>] (citing empirical study of CEO pay changes after the COVID-19 outbreak).

145. Many core ESG issues have come from technological advancements and large-scale societal changes, but they still implicate individual company decisions. Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1408–09 (2020).

146. David M. Silk, Sabastian V. Niles & Carmen X.W. Lu, *Accelerating ESG Disclosure—WEF Task Force Releases Preliminary Framework Centered on Mainstream Reporting Aligned with UN Sustainable Development Goals*, WACHTELL, LIPTON, ROSEN & KATZ 1 (Feb. 3, 2020),

investors are increasingly introducing ESG initiatives during board engagements and through shareholder proposals.<sup>147</sup> The movement is clearly international; for example, between 2015 and 2018, a U.K.-based institutional investor conducted 353 ESG engagements in the United States.<sup>148</sup> It is in this rising interest among the millennials that Professors Barzuza, Curtis, and Webber rest their case that index funds will not be passive with respect to ESG issues believed important to the wave of future millennial-fund investors.

Because ESG metrics are not per se financial, social activists doubt that corporate boards and management would independently pursue sustainable strategies, as their fiduciary duties require them to maximize corporate profit and shareholder financial returns. Thus, it is necessary for corporate leaders to consider the preferences of non-shareholder stakeholders, including employees, the community, supply-chain entities, and lenders—each of whom somewhat supports the transition to sustainable and equitable corporate decisions. And, a cornerstone of the New Paradigm is that investors should not only similarly support this perspective, but also in their engagement with management weigh these considerations with due deference to management’s judgments regarding ESG considerations.<sup>149</sup> This perspective is, as seen above, embraced fully in the New Paradigm.

We see these embraces of the stakeholder model, especially in the dark shadow of the New Paradigm’s overt weakening of shareholder activism, as a déjà vu moment for corporate governance. We truly have been here before. The New Paradigm aligns well with the discarded managerialism model in that shareholders are weak and management is thus free to mediate among competing constituent stakeholders. In the mid-1980s, corporate law flirted with managerialism when numerous states enacted “other constituency” statutes that broadened the protection afforded by the business judgment rule

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<https://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.26775.20.pdf> [https://perma.cc/Q2VY-3B84].

147. *ESG: Understanding the Issues, the Perspectives and the Path Forward*, PWC, <https://www.pwc.com/us/en/services/governance-insights-center/library/esg-environmental-social-governance-reporting.html> [https://perma.cc/7Y5B-AME4].

148. Andreas G.F. Hoepner, Ioannis Oikonomou, Zacharias Sautner, Laura T. Starks & Xiao Y. Zhou, *ESG Shareholder Engagement and Downside Risk* 9 (European Corp. Governance Inst., Finance Working Paper No. 671/2020, 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2874252](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2874252) [https://perma.cc/LG33-S8DP].

149. As of today, the U.S. government has failed to adopt substantive federal regulations requiring ESG disclosures. In fact, the Labor Department is “seeking a new federal regulation that could discourage retirement funds from making investments based on environmental, social and governance considerations.” Noam Scheiber & Ron Lieber, *Labor Dept. Seeks to Restrict Social Goals in Retirement Investing*, N.Y. TIMES (June 24, 2020), <https://www.nytimes.com/2020/06/24/business/labor-retirement-investing.html> [https://perma.cc/TLH4-R5CU] (“[T]he practical effect of the new framing could be to deter plan administrators from adding E.S.G. options to 401(k) plans for fear of violating the law.”). Thus, as discussed below, private parties have taken control of expanding the New Paradigm and ESG initiatives across the corporate sector.

by expressly empowering boards to consider non-shareholder interests in decision-making.<sup>150</sup> The impetus for other constituency statutes was the frequency of hostile takeovers, many directed—as discussed earlier—at lethargic companies still languishing in the practices of managerialism. It is of note that the Committee on Corporate Laws of the American Bar Association rejected including an “other constituency” provision in its highly influential Model Business Corporation Act, explaining that the provision is inconsistent with managers being accountable essentially to anyone.<sup>151</sup>

Because so much of the New Paradigm rests on the earlier move to adopt other constituency statutes, it is useful in evaluating the New Paradigm to consider the analysis of Bebchuk and Tallarita, who closely examine the differences among 32 state constituency statutes to highlight the difficulty in adopting a one-size-fits-all definition of stakeholders.<sup>152</sup> Their analysis found that employees and customers were always included, but the definitions took different forms when it came to suppliers, creditors, local communities, society, economy of the state or nation, and the environment.<sup>153</sup> Ironically, proponents of stakeholderism have delegated the responsibility of defining stakeholders to the board of directors, who have broad discretion in identifying those who are affected by corporations’ decisions.<sup>154</sup> The difficulty in defining stakeholders implicitly makes any boardroom decision-making process more complex. It also likely makes the board decisions impossible to evaluate so that the board can be held accountable.

Bebchuk and Tallarita identify three concrete critiques of stakeholderism.<sup>155</sup> The first criticism is that corporate directors’ and management’s interests fail to align with those of corporate stakeholders because officer and director compensation packages are typically equity-

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150. See Cynthia A. Williams, *Corporate Social Responsibility and Corporate Governance*, in OXFORD HANDBOOK OF CORP. L. & GOVERNANCE 1, 13 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2016), available at <https://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780198743682.001.0001/oxfordhb-9780198743682-e-31> [https://perma.cc/DP6L-XHYR]. Williams notes that:

[O]ther constituency statutes . . . give directors the statutory discretion to consider constituents other than shareholders in making decisions, particularly decisions to resist takeovers, have generally been interpreted to be relatively unimportant, and underutilized, albeit with the potential to create ambiguity regarding directors’ duties . . . allow[ing] for greater experimentation within the firm . . . .

*Id.*

151. ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2253 (1990).

152. Bebchuk & Tallarita, *supra* note 141, at 116–19.

153. For ESG purposes, Arizona and Texas are the only two states whose statutes explicitly mention the environment as a stakeholder. *Id.* at 117.

154. *Id.* at 119. There are also consequences for which stakeholder preferences are prioritized by board decisions, as “companies will commonly face many opportunities to provide some stakeholders with benefits that will come at the expense of shareholders.” *Id.* at 120.

155. *Id.* at 164.

based,<sup>156</sup> so their interests are aligned with shareholders but not with other stakeholders.<sup>157</sup> The CEO's link to shareholders was strengthened by Dodd–Frank's mandate of say-on-pay requirements, which requires shareholders to approve (via vote) executive compensation packages.<sup>158</sup> Managerial pay packages thus can be expected to diminish the influence of non-shareholder stakeholders, as poor stock performance and shareholder returns increase the likelihood that CEOs will not be re-elected to their positions.<sup>159</sup>

The second critique they identify is that because stakeholderism actually expands the freedoms associated with corporate leaders' decision-making processes,<sup>160</sup> directors and management would be further insulated from stakeholder accountability because it (1) causes institutional investors to be deferential to corporate leaders, less willing to support hedge fund activists, and more willing to support shields to market pressures; and (2) induces policymakers to support legal reforms that reduce accountability.<sup>161</sup> This would harm not only stakeholders but also shareholders via increased managerial slack, worsened corporate performance, and reduced economic efficiency and value creation.<sup>162</sup>

Their third critique is that the illusory promises of stakeholderism such as those discussed above can be used to “deflect the demand for legal, regulatory, and policy reforms.”<sup>163</sup> If proponents of the New Paradigm

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156. According to the authors, 56% of non-executive directors' compensation packages are tied to equity. *Id.* at 162.

157. Bebchuk & Tallarita do note three instances where CEO bonuses are linked to a stakeholder metric, but that link is limited. Eastman links the annual bonus based on employee safety, but specific weighting is not provided, so the compensation committee has broad discretion in awarding the bonus. Marriott links their CEO's bonus to the satisfaction of employees and guests as measured by external surveys, but those are each given less than 2% of weight. Duke Energy links their annual CEO bonus to environmental impact and customer satisfaction, but, as with Marriott, those measures maintain a weight of 0.5% and 1.6% respectively. *Id.* at 150–51.

158. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 951, 124 Stat. 1376, 1899 (2010) (requiring shareholder vote on executive compensation (a.k.a. “Say on Pay”).

159. Bebchuk & Tallarita, *supra* note 141, at 145.

160. *Id.* at 165. Professor Bainbridge reaches a similar conclusion about the Business Roundtable's embrace of ESG. Stephen M. Bainbridge, *Making Sense of the Business Roundtable's Reversal on Corporate Purpose* 54 (UCLA Sch. of Law, Law and Economics Research Working Paper No. 20–03, 2020) (“It seems reasonable to suspect that at least some BRT leaders look back fondly on the days of imperial CEOs and see embracing ESG issues as a way of restoring that sort of unfettered power.”).

161. Bebchuk, *supra* note 141, at 165 (“Recall that during the era of hostile stakeholders, stakeholderism provided a basis for and facilitated the passage of antitakeover constituency statutes that helped management fend off unwanted bidders.”).

162. *See id.* at 167 (citing Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1673–86 (2013)) (“[T]here is a substantial body of empirical evidence that increased insulation and reduced accountability are associated with worse managerial decisions and worse corporate performance.”).

163. *Id.* at 173.

blindly place their faith in the stakeholder-centric governance structure, then they may unintentionally thwart their entire movement for a more sustainable corporate future.<sup>164</sup>

## V. Synthesis

The combination of the call for patient capital and stakeholderism move public corporations down the path toward unaccountable corporate management, and perhaps toward the era of managerialism—a culture that unraveled in the face of rising global competition and scandals bred by a marked lack of accountability. Moreover, we should question the motivations for each of these proposed paradigmatic shifts. To be sure, the current era of activist investors necessarily invites questions regarding long-term versus short-term visions and related sustainability considerations. Moreover, as discussed above, ESG is very much in the air as it is a dominant consideration for a rising number of investors. But these explanations mesh poorly with the details of The New Paradigm and certainly with the multiple anti-shareholder legal developments discussed in Part III. Calls for corporate reform, such as those described here—that quiet the shareholder voice and thus weaken management accountability—naturally breed skepticism and more so in an environment in which the rise of financial institutions is positioned to complement the monitoring model.

## VI. Recommendations and Conclusion

We conclude our article where it began with a nod to history; we see current events seeking to complete history and believe we should allow that to occur. The monitoring model was sensible when adopted, but the rise of financial institutions and activist hedge funds was needed to complete the model. Today's markets are institutional markets and repeatedly institutions have demonstrated their impact in supporting financial and social proposals and strategies advanced by activist shareholders.

We therefore believe the path forward is to nurture, not impede, this trend. Regulations and developments that retard the owners' voice bear the heavy burden of changing the well-received meaning of ownership. To that end, efforts such as those described in Part III should be upheld only upon convincing evidence that shareholder activism is harmful or more likely than not is driven solely by pursuit of short-term objectives (accepting for the sake of argument that short-term is less desirable than long-term objectives). The empirical data summarized earlier reject the latter and the evidence is at best (for the managerialist's perspective) divided with respect to the latter. As such, it is hardly a draw and in any case owners with substantial financial

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164. *Id.*



investments should be allowed to consider potential wealth-maximizing proposals. And, the manner in which they so consider the proposals should be transparent and of their choice. Hence, institutions who wholly or partially rely on the recommendations of proxy solicitors should be able to do so, albeit with disclosure of the process by which they consider proxy requests. We also recommend that the rewards for activism be increased not reduced. Thus, we oppose lowering the Section 13(d)(1) beneficial ownership below 5% and eliminating the 10-day window. Indeed, in addition to retaining the 10-day window, we would increase the ownership level to 10%—thereby increasing the prospective gains for successful activist investors.