Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities*

In the summer of 2008, the Corporate Governance Committee of the ABA Section of Business Law established a Task Force on Delineation of Governance Roles and Responsibilities to examine whether, in the large U.S. public corporation, the decision rights and responsibilities of shareholders and boards of directors are shifting and, if so, the implications of any such shift. Seasoned lawyers representing shareholder, corporate, and academic perspectives comprise the Task Force and have engaged in a series of meetings over the past ten months to discuss shareholder and board roles—roles that are under increasing regulatory pressures in light of the financial crisis.

As one might expect given the diverse perspectives represented, not all Task Force members agree on all points in this Report. Some Task Force members favor significant adjustment in the regulation of corporate governance; others believe that very little, if any, adjustment is needed. However, recognizing that we all share a common interest in the success of the U.S. corporation, the Task Force believes that all those involved in thinking about the future of the corporation would benefit from a clear understanding of the roles played by shareholders and boards under corporate law and the rationales for those roles.

As recent events have shown, much depends on whether federal regulation (including pending proposals on which the Task Force takes no position), state corporate law, and private ordering of corporate governance support decisions that are in the long-term interests of our economy. The Task Force hopes that this Report will provide a context for policymakers, participants in the corporate governance process, and the public in considering responses to the current crisis. The Task Force believes that consideration should be given in the regulatory reform calculus to the value of the distinct shareholder and board roles and responsibilities defined in corporate law.

* August 1, 2009. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the American Bar Association.

Members of the Task Force on Delineation of Governance Roles & Responsibilities

Rhonda L. Brauer
Senior Managing Director, Corporate Governance
Georgeson Inc.

Stephen L. Brown
Director, Corporate Governance & Associate General Counsel
TIAA-CREF

Peter Clapman
President & CEO
Governance for Owners USA

Marty Dunn
Partner
O'Melveny & Myers LLP

Robert Fatovic
Executive Vice President & General Counsel
Ryder Systems, Inc.

Allen Ferrell
Greenfield Professor of Securities Law
Harvard Law School

Amy L. Goodman
Partner
Gibson, Dunn & Crutcher LLP

Carol Graebner
Deputy General Counsel
PNM Resources

Lawrence A. Hamermesh
Ruby R. Vale Professor of Corporate & Business Law
Widener University School of Law

James J. Hanks
Partner
Venable LLP

Carol Hansell
Partner
Davies Ward Phillips & Vineberg, LLP &
Chair of the Corporate Governance Committee of the ABA Section of Business Law, *ex officio*

Daniel F. Hopp
Senior Vice President, Secretary & General Counsel
Whirlpool Corporation

Catherine Jackson
Corporate Governance & Proxy Voting
Ontario Teachers'
Pension Plan

Marjorie Fine Knowles
Professor of Law
Georgia State University

Richard H. Koppes
Of Counsel
Jones Day

Henry Lesser
Senior Counsel
DLA Piper LLP (US)

Susan I. Permut
Senior Vice President, Deputy General Counsel & Assistant Secretary
EMC Corporation

Kim Rucker
Senior Vice President & General Counsel
Avon Products, Inc.

Hillary Sales
Walter D. Coles Professor of Law & Professor of Management
Washington University in St. Louis School of Law

Damon Silvers
Associate General Counsel
AFL-CIO

Dannette L. Smith
Secretary to the Board & Deputy General Counsel
UnitedHealth Group Incorporated

Lynn Stout
Paul Hastings Professor of Corporate & Securities Law
UCLA School of Law

Chair: Holly J. Gregory
Partner
Weil, Gotshal & Manges LLP

Vice Chairs: Bradley R. Aronstam
Senior Associate
Connolly Bove Lodge & Hutz LLP

Peter P. Tomczak
Senior Associate
Baker & McKenzie LLP

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I. Introduction

How the law apportions governance roles among shareholders, boards of directors, and managers is central to the success or failure of the corporate form.[1] The way in which these roles are structured in state corporate law[2] is a critical part of the legal fabric of American business, and provides the backdrop for federal regulation

1. Decision rights and responsibilities in the publicly traded corporation have been the subject of considerable discussion in academic literature. *See, e.g.*, Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (1776); Adolph A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932); William O. Douglas, *Directors Who Do Not Direct*, 47 Harv. L. Rev. 1305 (1934); R.H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937); Myles L. Mace, Directors: Myth and Reality (1971); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business (1977); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977); Ira M. Millstein & Salem M. Katsh, The Limits of Corporate Power: Existing Constraints on the Exercise of Corporate Discretion (Beard Books 2d prtg. 2003) (1981); Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991); Paul W. MacAvoy & Ira M. Millstein, The Recurrent Crisis in Corporate Governance (2003); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. Rev. 601 (2006); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 Harv. L. Rev. 1735 (2006); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675 (2007); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 Va. L. Rev. 789 (2007); Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. Corp. L. 1 (2007); Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stan. L. Rev. 1255 (2008); Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance,* 95 Va. L. Rev. 685 (2009).

2. This Report relies to a substantial degree on principles of corporate law as expressed in the General Corporation Law of the State of Delaware, Del. Code Ann. tit. 8, §§ 101 et seq. (2001 & Supp.

of public corporations.[3] Returning to solid economic growth over the long term will depend in part on the ability of policymakers to respond to concerns over corporate governance as a factor in the present crisis while avoiding reforms that are insensitive to positive aspects of the present legal ordering of decision rights and responsibilities within the corporation. Maintaining an appropriate balance between responsibilities for corporate oversight and decision-making is critical to the corporation's capacity to serve as an engine of economic growth, job creation, and innovation.

The modern corporate form is a legal construct of state law that builds upon earlier legal forms—notably the business partnership and special purpose corporation. The corporation, and in particular the publicly traded corporation, has had unprecedented success in aggregating capital from various sources and putting that capital to use in large-scale projects that benefit society. Corporations have created wealth on a scale previously unseen, but their contribution to economic well-being extends well beyond the return of profit to shareholders. Corporations deploy assets for the efficient production of goods and services that society needs or wants: they provide employment, support innovation, purchase goods and services, pay taxes, and support various social and charitable programs that benefit society at large. The corporation's ability to aggregate capital and commit it over the long term to projects with an uncertain but promising outcome is the foundation for these broad benefits.

2008), and related case law, since Delaware is the state of incorporation for over 60 percent of Fortune 500 companies (and a large number of other public and private corporations) and has a judiciary that is widely recognized for its sophistication concerning issues of corporate law. Delaware corporate law tends to exert a strong influence on the direction of corporate law throughout the United States. The Task Force believes that the principles for which Delaware law is cited reflect generally accepted principles of state corporate law, recognizing that other states, through adoption of a version of the *Model Business Corporation Act Annotated* (4th ed. 2008) or their own unique statutory provisions, may diverge from Delaware in certain respects.

3. A broad range of corporate governance-related reforms have been proposed in response to the current financial crisis. In many instances, the reform ideas predate the financial crisis, having been long-advocated by shareholder activists (for example, requiring majority voting rather than plurality voting in uncontested director elections, providing shareholders with access to the company's proxy materials for the nomination of directors, providing shareholders with an advisory vote on executive compensation, and eliminating classified boards). Reforms proposed (or adopted) include the following: (i) limiting board discretion regarding the levels and structure of executive compensation, *see* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28394 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30); Excessive Pay Shareholder Approval Act, S. 1006, 111th Cong. (2009) (introduced May 7, 2009); Excessive Pay Capped Deduction Act of 2009, S. 1007, 111th Cong. (2009) (introduced May 7, 2009); Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009) (introduced July 21, 2009) [hereinafter Proposed Compensation Fairness Act]; (ii) increasing shareholder influence in director elections through a right of shareholders to access the company's proxy for certain shareholder nominations, *see* Facilitating Shareholder Director Nominations, Exchange Act Release No. 33-9046, 74 Fed. Reg. 29024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274), *available at* http://www.sec.gov/rules/proposed/2009/33-9046.pdf [hereinafter SEC Proxy Access Rule Proposal]; Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009) (introduced May 19, 2009) [hereinafter Proposed Shareholder Bill of Rights Act]; Shareholder Empowerment Act of 2009, H.R. 2861, 111th Cong. (2009) (introduced June 12, 2009) [hereinafter Proposed Shareholder Empowerment Act]; (iii) providing shareholders with an "advisory" vote on aspects of executive compensation, *see* Proposed Shareholder Bill of Rights Act, *supra;* Investor Protection Act of 2009, http://www.treas.gov/press/releases/docs/

The corporate form, however, is not without critics. Two major grounds for concern have been expressed throughout its history:

- The corporate form provides opportunity for those who manage the corporation to act in a self-interested manner at the expense of its shareholders.
- The corporate focus on profit maximization for the benefit of shareholders may lead to undervaluing the contributions of certain other participants, including employees and the larger society.

To a degree, these concerns are in tension with each other and relate to distinct views about for whom the corporation should be governed. Those who are most concerned about protecting shareholders from the potential for self-interested action by boards and managers may be hesitant to consider the role of corporate governance in helping to balance the broader social impact of corporate behavior. This tension may be relieved somewhat through recognizing both that corporate reputation plays an increasing role in market value and that the interests of shareholders and the broader society in corporate success converge over the long term. In any event, the corporate form represents a governmental grant of power and the expectation is that corporations will be instruments of value-creation for the benefit of not only shareholders but also for the broader society.

The corporate form is defined by the way it distributes decision rights and responsibilities among shareholders, the board, and management. The corporation can attract significant capital precisely because shareholders enjoy limited liability and can share in the success of the corporation without managing the corporation. Shareholders as equity providers are neither liable for corporate conduct nor responsible for the management of the business, as they would be in a partnership. Corporate law vests in shareholders the power to elect directors, to participate in

tg_218IX.pdf (draft legislation delivered by the U.S. Department of the Treasury to the U.S. Congress on July 10, 2009) [hereinafter Proposed Investor Protection Act]; Corporate Governance Reform Act of 2009, H.R. 3272, 111th Cong. (2009) (introduced July 21, 2009) [hereinafter Proposed Corporate Governance Reform Act]; Proposed Compensation Fairness Act, *supra;* (iv) mandating majority vote standards for uncontested elections of directors, *see* Proposed Shareholder Bill of Rights Act, *supra*, § 5 (directors in uncontested elections to be elected by a majority of votes cast as to each nominee); Proposed Shareholder Empowerment Act, *supra*, § 2 (same); (v) requiring independent board leadership or enhanced disclosure regarding the structure of board leadership, *see* Proposed Shareholder Bill of Rights Act, *supra*, § 5 (requiring chairperson of the board to meet certain director independence requirements); Proposed Shareholder Empowerment Act, *supra*, § 2 (same); Proposed Corporate Governance Reform Act, *supra*, § 2 (requiring that the chairperson of the board of an issuer be independent); *see also* Millstein Ctr. for Corporate Governance & Performance, Yale Sch. of Mgmt. Policy Briefing No. 4: Chairing the Board—The Case for Independent Leadership in Corporate North America 3 (2009), *available at* http://millstein.som.yale.edu/2009%2003%2030%20Chairing%20The%20Board.pdf (recommending that public companies appoint an independent, non-executive chairman of the board or "[i]f corporate directors choose to take a different course, either by combining the two posts or naming a non-independent chair, they should explain to their corporation's shareowners why doing so represents a superior approach to optimizing long-term shareowner value"); (vi) strengthening independence requirements for compensation committee members and requiring independent compensation consultants, *see* Proposed Investor Protection Act, *supra*, § 942; Proposed Compensation Fairness Act, *supra*, § 3; Proposed Shareholder Empowerment Act, *supra*, § 3; and (vii) creating a risk committee comprised of independent directors, *see* Proposed Shareholder Bill of Rights Act, *supra*, § 5; Proposed Corporate Governance Reform Act, *supra*, § 3.

the annual meeting of shareholders, and to approve certain fundamental changes to the corporation's business. Management control of the corporation is vested in the board of directors and the executive officers to whom the board delegates authority. Directors and officers are required by law to act in the best interests of the corporation and its shareholders, thereby creating an efficient and accountable decision-making structure for entrepreneurial activity. These roles are described more fully in Part II below.

Shareholders and boards have become increasingly engaged in their roles, and generally this increased engagement has been a positive development. However, tensions over the boundaries of the roles of shareholders and boards have become more evident. Tension is heightened in the context of the global financial crisis, which has caused some to question whether the corporate governance system and the public corporation are capable of continuing to drive wealth production. The Task Force believes that constructive discussion of governance concerns requires that all parties:

- Understand the current legal framework for the corporate governance system and the rationale for that system;
- Recognize that the potential for undue short-term thinking is not limited to any single participant in the governance system;
- Embrace the common long-term interest that all parties share in corporate success and effective governance and management of the corporation; and
- Reject the rigidity in viewpoints that all too often gets in the way of thoughtful discourse on governance issues.

Effective corporate governance requires joint recognition by shareholders, boards, and managers of the common interest they share with creditors, customers, suppliers, employees, and the public in long-term sustainable corporate value-creation. It also requires an understanding and respect for the distinct roles and responsibilities of shareholders and boards, and of the executive officers to whom the board delegates authority for the day-to-day management of the business.

Almost two decades ago, a leading commentator on corporate governance posed, as a guide for reform consideration, the following question: "What do we expect of the modern corporation as the predominant legal vehicle for capital-raising and deployment?"[4] The Task Force believes this question continues as a useful reference for discussions. Reform proposals should be assessed in light of their likely impact on the capital raising and capital deployment ability of the corporate form in aid of sustainable growth and wealth creation.

The Task Force notes the significant changes in the nature of shareholders and boards that have taken place over the last twenty-five years. Public company

4. Henry Lesser, *Corporate Governance: Some Unasked Questions—A Personal Commentary*, 19 Pepp. L. Rev. 857, 858 (1992); *see also id.* at 858–59 (posing the above question seventeen years ago in a context all too familiar: "[A]s the United States enters a presidential election year with its economy in continuing recession, there are already signs that the debate over corporate governance has become increasingly politicized, with issues such as proxy reform, executive compensation, and board representation rapidly acquiring the characteristics of polemic banners.").

ownership has become more concentrated in institutions, while institutions themselves have become more diverse. For some institutions, share ownership is fleeting in nature (overall, average holding periods have shrunk dramatically). Boards have become more independent of management, a development that means boards have less specialized knowledge of the firms they oversee. Assessment of proposed reforms should take into account these changes. Consideration of reforms that might alter roles and responsibilities within the corporation should be made with a clear understanding of the rationales for the current ordering and whether the risks associated with proposed changes outweigh potential benefits. The goal of any reform effort should be to ensure that the corporation is positioned to continue its successful role in our economy, ultimately for the benefit of society at large.

Policymakers should be mindful of trends in governance practices and should seek to formulate realistic responses that take into account the roles of managers, boards, and shareholders in the corporate governance system.

II. Traditional Roles: Shareholders, Boards, and Managers

A. Overview and Note on Nomenclature

The modern corporation took shape in the 1800s with the development of corporate laws in Britain and in various U.S. states that allowed incorporation for general business purposes through the registration of articles of incorporation rather than through special "charter" legislation or grant.[5] These laws brought together a number of important concepts that had developed in various degrees over time:

- The corporation is an "artificial person" with the same capacity to own assets and enter into contracts as a natural person, and the ability to issue freely transferable shares to a large number of investors. This provides the corporation with the ability to continue as a concern independent of the continuing participation of any particular equity holder ("perpetual life").
- Equity investors are not liable for the debts and obligations of the corporation, which gives these investors the potential to share in the upside of the business without any risks beyond the value of their equity stake ("limited liability").
- Control of, and responsibility for, the business and affairs of the corporation is vested in the board of directors, rather than in the company's shareholders. The shareholders elect the directors for limited terms. As a result, equity providers elect the directors responsible for the management of the company, but are freed from management responsibilities ("passive investment"). The capital they provide can be committed to long-term investment in activities of promising but uncertain outcome, since only the

5. *See generally* John Micklethwait & Adrian Wooldridge, The Company: A Short History of a Revolutionary Idea (2003).

board has the ability to take actions that would return the corporation's capital to equity investors (capital is "locked in").[6]

The corporate form has proven to be a remarkably powerful tool for aggregating capital from various sources to increase the pool of capital available for productive investment in projects of considerable scale, scope, and duration. Issuance of freely transferable certificates of stock to passive investors—investors who would not play an active role in managing the enterprise and were not liable to the corporation, other shareholders, or third parties for its losses—enabled the corporation to tap into the resources of multiple investors while allowing investors to diversify. The allocation of decision rights as between shareholders and the board provides a mechanism for efficient decision-making regarding entrepreneurial activities. It avoids the significant difficulties of educating and bringing together thousands of equity investors to make key decisions by shareholder referendum.[7] The corporate attributes of passive equity investment and limited liability, board control, and the "lock-in" or commitment of equity capital are intertwined and central to the modern publicly traded corporation's ability to attract and deploy capital for large-scale, long-term entrepreneurial projects.

Discussions about the roles of shareholders and boards may be hampered by the use of terms that are charged with meaning from other, non-corporate contexts, and hence are evocative yet not wholly accurate:

- *Shareholder democracy:* Although the corporation's governing body—the board of directors—is elected by the shareholders, the board's governance powers are determined by law and therefore neither delegated by, nor derived from, the shareholders. Upon election to the board, each director becomes a fiduciary to the corporation and must act in the best interests of the corporation and the entire body of shareholders, no matter who nominated or what groups the director is affiliated with.[8] Therefore, analogies to democratic forms of government are imprecise.[9]

6. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 388–91 (2003); Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 732–42 (2006).

7. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1053–56 (1993) (discussing rationales for and benefits of centralized board decision-making).

8. *See* E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 774–75 (2008) ("Directors will generally be responsible for protecting the best interests of the corporation and all its stockholders, despite the directors' designation by some particular constituency, because fiduciary duties generally will trump contractual expectations in the corporate context. . . . [T]he primary basis upon which a constituency director's conduct will be measured is whether the director's decision is based upon the corporate merits of the subject before the board, rather than extraneous considerations or influences.").

9. *See* A. Gilchrist Sparks, III, *Corporate Democracy—What It Is, What It Isn't, and What It Should Be, in* WHAT ALL BUSINESS LAWYERS AND LITIGATORS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 279, 281–85 (PLI Corp. L. & Prac., Course Handbook Series No. 1543, 2006) (noting (i) shareholders are not captive in the same way that citizens are given that shareholder interest tends to be of much shorter duration; (ii) the greater lack of interest and participation by shareholders in corporate elections increases the ability of shareholders with a specific interest to exert influence; (iii) institutional investors are

- *Corporate owners:* The corporate form bifurcates the provision of equity capital and the control of the business and affairs of the corporation. This specialization of functions is famously referred to as the "separation of ownership and control,"[10] and shareholders are often referred to as the "owners" of the corporation. However, the corporation is a legal person in its own right rather than a mere asset. Once the separation of equity rights and control occurs in the formation of the corporate entity, the analogy of shareholders to "owners" of the corporate "asset" is imperfect at best.[11] The asset that shareholders own is the stock that represents their investment interest. (Shareholders may more accurately be called "shareowners" or "stockowners.") Whether individually or collectively, stock represents limited contractual and decision rights in the corporation that fall short of the full bundle of powers and responsibilities typically associated with ownership. Shareholders do not have the right to come to corporate headquarters and remove a proportionate share of the machinery or dictate how widgets will be manufactured. They do have the right to elect directors and determine certain fundamental matters as described below.
- *Principals and agents:* Contrary to the often-used analogy, directors are not "agents" in a principal-agent relationship with shareholders, since shareholders cannot dictate board actions and directors are obligated to make their own judgments based on the best interests of the corporation and

themselves intermediaries for others having the economic interest in the shares; (iv) many institutional shareholders outsource vote decisions to, or are otherwise influenced by the recommendations of, proxy advisors; and (v) votes may be otherwise "rented" or exercised by persons lacking any economic interest in the shares).

10. Berle & Means, *supra* note 1, at 5.

11. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 260–61 (1999) (citing Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 Cornell L. Rev. 856, 863 n.22 (1997); Margaret M. Blair, *Corporate "Ownership": A Misleading Word Muddies the Corporate Governance Debate*, Brookings Rev., Winter 1995, at 16); *see also* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 Iowa L. Rev. 1, 3 n.5 (2002) ("Although I follow convention in using the term 'separation of ownership and control,' ownership is not a particularly useful concept in the corporate context."); Bainbridge, *supra* note 7, at 1052 n.104 ("[I]t is more than a little misleading to speak of 'ownership' in this context. The corporation is not an entity, but an aggregate of various inputs acting together to produce goods or services. . . . [T]he firm is a legal fiction representing a complex nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm. Because shareholders are simply one of the inputs bound together by this web of voluntary agreements, ownership is not a meaningful concept under this model."); Blair & Stout, *supra* note 6, at 725 ("[T]here was at least one glaring problem with simultaneously arguing that a corporation should be regarded as a 'nexus of contracts' and that corporate law should require corporate managers to act on behalf of the shareholders who 'owned' the firm. The problem was that the nexus metaphor did not support the notion that the corporation was something that could be 'owned.'"); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 396 (1983) ("Shareholders are no more the 'owners' of the firm than are bondholders, other creditors, and employees (including managers) who devote specialized resources to the enterprise, yet bondholders and employees do not vote at all."); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189, 1192 (2002) ("From both a legal and an economic perspective, the claim that shareholders own the public corporation simply is empirically incorrect.").

bear the full liability for those judgments.[12] Moreover, directors lack the ability to bind shareholders to contracts, and the corporate assets managed by directors are not subject to claims from a shareholder's creditors.[13] Thus, the basic indicia of the principal-agent relationship are missing in the shareholder-director relationship.

B. The Role of the Shareholders

Unless otherwise stated in the corporation's organizing documents, it is generally accepted—and expected—that the objective of the corporation is "the conduct of business activities with a view to enhancing corporate profit and shareholder gain."[14] Shareholders have key but limited rights associated with their residual interest in the corporation after all of its obligations—to creditors, suppliers, employees, and the government—have been paid.[15] These rights are intertwined with the corporation's ability to attract capital through its accommodation of passive equity investment and provision of limited liability.

Shareholders have the right to convey their shares, participate in annual or special shareholder meetings (including by attending, nominating directors, proposing to amend bylaws consistent with the articles of incorporation and state corporate law, and voting), elect the board of directors, receive information about the performance of the company and related matters, approve actions by the board of directors that would work a fundamental change in the structure of

12. In a principal-agent relationship, the principal has the power to give binding instructions to the agent. *See* Restatement (Third) of Agency § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."). However, directors are generally not bound to act as shareholders wish. *See, e.g.*, Paramount Commc'ns, Inc. v. Time Inc., Nos. 10866, 10670 & 10935, 1989 WL 79880, at *30 (Del. Ch. 1989) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."), *aff'd*, 571 A.2d 1140 (Del. 1990); *see also* Deborah A. DeMott, *Shareholders as Principals* 2 (Duke Law Sch. Pub. Law & Legal Theory Working Paper Series, Working Paper No. 15, 2001), *available at* http://ssrn.com/abstract=275049 ("Contemporary corporate law does not treat directors as shareholders' agents other than in a loose or metaphorical sense. If fully applicable to directors' relationships to shareholders, the common law of agency would destabilize the legal consequences that contemporary corporate law facilitates.").

13. *See* DeMott, *supra* note 12, at 4 (citing Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387 (2000); Restatement (Third) of Agency § 3.10(1) (2006)).

14. Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations § 2.01(a) (1994).

15. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("When a corporation is *insolvent*, . . . its creditors take the place of the shareholders as the residual beneficiaries of any increase in value."); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004) ("By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers. Where the assets of the company are insufficient to pay its debts, and the remaining equity is underwater, whatever remains of the company's assets will be used to pay creditors, usually either by seniority of debt or on a pro rata basis among debtors of equal priority.").

share ownership or the nature of the corporation, and assert claims on behalf of the corporation against directors and officers.[16]

Shareholder approval is required for the corporation to consummate certain transactions, such as mergers, sales of all or substantially all of the corporation's assets, amendments to the corporation's certificate of incorporation, and voluntary dissolutions.[17] However, only the board may initiate these actions.[18] Shareholders

16. Specific shareholder rights under state law include rights to: (i) vote at stockholder meetings, including with respect to the election of directors, *see* Del. Code Ann. tit. 8, §§ 211–212 (2001 & Supp. 2008); Model Bus. Corp. Act Ann. §§ 7.21–7.28 (4th ed. 2008); (ii) inspect the corporation's books and records, *see* Del. Code Ann. tit. 8, § 220 (Supp. 2008); Model Bus. Corp. Act Ann., *supra*, § 16.02; (iii) obtain the corporation's stockholder list, *see* Del. Code Ann. tit. 8, § 219 (Supp. 2008); Model Bus. Corp. Act Ann., *supra*, § 7.20; (iv) adopt certain corporate bylaws, *see* Del. Code Ann. tit. 8, § 109(a) (2001); Model Bus. Corp. Act Ann., *supra*, § 10.20; (v) authorize persons to act by proxy, thereby enabling shareholders to wage proxy contests, *see* Del. Code Ann. tit. 8, § 212 (2001 & Supp. 2008); Model Bus. Corp. Act Ann., *supra*, § 7.22; (vi) attend annual and special meetings of shareholders, *see* Del. Code Ann. tit. 8, § 211 (2001); Model Bus. Corp. Act Ann., *supra*, §§ 7.01–7.02; and (vii) sue directors and officers for breach of fiduciary duties, *see* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1036–39 (Del. 2004); Model Bus. Corp. Act Ann., *supra*, §§ 7.40–7.47. Note that under the Delaware General Corporation Law, "[t]he bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." Del. Code Ann. tit. 8, § 109(b) (2001); *see also* Model Bus. Corp. Act Ann., *supra*, § 2.06(b) ("The bylaws of a corporation may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation."). Given the broad mandate afforded to directors to manage the business and affairs of the corporation, "the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)" of the Delaware General Corporation Law. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 232 (Del. 2008). "Rather, the shareholders' statutory power to adopt, amend or repeal bylaws under Section 109 cannot be 'inconsistent with law,' including Section 141(a)." *Id.* at 232 n.7. In *CA*, the Delaware Supreme Court addressed the proposed inclusion of a bylaw on CA, Inc.'s proxy statement that would have required CA's board to reimburse the reasonable fees of any shareholder that sought to elect less than 50 percent of the board and succeeded in electing at least one director. *See id.* at 229–30. The court held that since the underlying purpose of the bylaw related to the process of electing directors, it was in line with stockholder-adopted bylaws imposing procedural and process-related restrictions on directors that had been permitted under section 109 and, therefore, was a proper subject for stockholder action. *See id.* at 233–37. However, the court went on to hold that the proposed bylaw, if adopted, would violate state law given the mandatory nature of the proposed bylaw's language (i.e., "the board of directors shall"), which failed to "reserve to [the] directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all." *Id.* at 240.

17. *See* Del. Code Ann. tit. 8, § 251 (Supp. 2008) (mergers); Model Bus. Corp. Act Ann. § 11.04 (4th ed. 2008) (mergers and share exchanges); Del. Code Ann. tit. 8, § 271 (2001 & Supp. 2008) (sale of all or substantially all assets); Model Bus. Corp. Act Ann., *supra*, § 12.02 (sale of assets that would leave the corporation without a significant continuing business activity); Del. Code Ann. tit. 8, § 242 (2001) (amendment to certificate of incorporation); Model Bus. Corp. Act Ann., *supra*, § 10.03 (same); Del. Code Ann. tit. 8, § 275 (2001) (voluntary dissolution); Model Bus. Corp. Act Ann., *supra* § 14.02 (same).

18. *See* Del. Code Ann. tit. 8, § 251(b) (Supp. 2008) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability."); Model Bus. Corp. Act Ann. § 11.04(a–b) (4th ed. 2008) ("The plan of merger or share exchange must be adopted by the board of directors. . . . [A]fter adopting the plan of merger or share exchange the board of directors must submit the plan to the shareholders for their approval."); Del. Code Ann. tit. 8, § 271(a) (2001) ("Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property

have no rights regarding decisions whether to pay dividends or to reinvest profits; these decisions are reserved wholly to the board of directors.[19]

Shareholders of publicly traded corporations have significant information rights through the interplay of their state law inspection rights,[20] directors' fiduciary duties,[21] federal securities laws, and securities market listing rules.[22] The federal securities laws were enacted in the 1930s in an effort to protect investors and promote confidence in the wake of the market crash, largely through

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and assets, including its goodwill and its corporate franchises, upon such terms and conditions and for such consideration, which may consist in whole or in part of money or other property, including shares of stock in, and/or other securities of, any other corporation or corporations, as its board of directors or governing body deems expedient and for the best interests of the corporation . . . ."); MODEL BUS. CORP. ACT ANN., *supra*, § 12.02(b) ("A disposition that requires approval of the shareholders . . . shall be initiated by a resolution by the board of directors authorizing the disposition."); DEL. CODE ANN. tit. 8, § 275(a) (2001) ("If it should be deemed advisable in the judgment of the board of directors of any corporation that it should be dissolved, the board, after the adoption of a resolution to that effect by a majority of the whole board at any meeting called for that purpose, shall cause notice to be mailed to each stockholder entitled to vote thereon of the adoption of the resolution and of a meeting of stockholders to take action upon the resolution."); MODEL BUS. CORP. ACT ANN., *supra*, § 14.02(a) ("A corporation's board of directors may propose dissolution for submission to the shareholders."); DEL. CODE ANN. tit. 8, § 242(b)(1) (2001) ("If the corporation has capital stock, its board of directors shall adopt a resolution setting forth the amendment [of the certificate of incorporation] proposed, declaring its advisability, and either calling a special meeting of the stockholders entitled to vote in respect thereof for the consideration of such amendment or directing that the amendment proposed be considered at the next annual meeting of the stockholders."); MODEL BUS. CORP. ACT ANN., *supra*, § 10.03(a–b) ("The proposed amendment [of the articles of incorporation] must be adopted by the board of directors. . . . [A]fter adopting the proposed amendment the board of directors must submit the amendment to the shareholders for their approval.").

19. *See* Gabelli & Co. v. Liggett Group, Inc., 479 A.2d 276, 280 (Del. 1984) ("It is settled law in this State that the declaration and payment of a dividend rests in the discretion of the corporation's board of directors in the exercise of its business judgment; that, before the courts will interfere with the judgment of the board of directors in such matter, fraud or gross abuse of discretion must be shown.").

20. *See* DEL. CODE ANN. tit. 8, § 220(c) (Supp. 2008) ("Where the stockholder seeks to inspect the corporation's stock ledger or list of stockholders and establishes that such stockholder is a stockholder and has complied with this section respecting the form and manner of making demand for inspection of such documents, the burden of proof shall be upon the corporation to establish that the inspection such stockholder seeks is for an improper purpose."); MODEL BUS. CORP. ACT ANN. § 16.02(a) (4th ed. 2008) ("A shareholder of a corporation is entitled to inspect and copy, during regular business hours at the corporation's principal office, any of the records of the corporation described in section 16.01(e) if the shareholder gives the corporation written notice of the shareholder's demand at least five business days before the date on which the shareholder wishes to inspect and copy.").

21. *See* Unanue v. Unanue, No. 204-N, 2004 WL 2521292, at *8 (Del. Ch. Nov. 3, 2004) ("[D]irectors generally have a fiduciary duty to disclose all material facts when they seek stockholder action or communicate with stockholders. The fiduciary duty to disclose often overlaps the affirmative duties to disclose under the federal securities laws. Where the federal laws mandate disclosure, Delaware law requires that any disclosure made be full and fair. There need not be an affirmative disclosure requirement under federal law, however, for a fiduciary duty to disclose to arise under Delaware law." (footnotes omitted)).

22. Publicly traded corporations are subject to the disclosure requirements of the Securities Act of 1933 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)) [hereinafter Securities Act], the Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. §§ 78a–78mm (2006)) [hereinafter Exchange Act], and the rules promulgated under the Securities Act and the Exchange Act. Among other things, issuers must furnish quarterly and annual reports disclosing an ever broadening

mandated disclosures and regulation of proxy solicitations. These laws regulate the content and disclosure of information provided to shareholders, as set forth in annual and quarterly reports, proxy statements, and the provision of other financial information to investors and the public.[23] Federal securities regulations also provide shareholders of publicly traded companies with the right to include in the company's proxy materials certain shareholder proposals, subject to both procedural and substantive restrictions.[24] Shareholders may present in the proxy statement certain types of binding and non-binding shareholder proposals. Binding proposals are those that seek bylaw amendments consistent with shareholder powers to amend the bylaws or other areas of shareholder decision rights.[25] Non-binding shareholder proposals may be used to request

amount of information, including all material information concerning the company's financial condition and operations. *See* Exchange Act § 13, 15 U.S.C. § 78m (2006) (mandating that all companies with equity securities subject to registration requirements set forth in section 12 of the Securities Act disclose material information on a periodic basis). In addition, the rules of stock exchanges on which the shares of public companies are traded also provide for disclosure obligations. *See* NYSE Euronext, Listed Company Manual §§ 202.00–204.00 (2009), *available at* http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1101074746736.html&displayPage=/lcm/lcm_subsection.html; NASDAQ Listing R. 5250, *available at* http://nasdaq.cchwallstreet.com/main (last visited Sept. 5, 2009).

23. The Exchange Act, the Securities Act, and other federal laws regulating securities and the securities industry were enacted in the wake of the stock market crash of 1929. In addition to imposing disclosure obligations on issuers, the federal securities laws regulate the activities of brokers and dealers and the trading of securities on national exchanges. They also created the U.S. Securities and Exchange Commission ("SEC") to enforce the federal securities laws, promulgate rules thereunder, and protect investors. *See supra* note 22; *see also infra* note 29; Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2009) (making it unlawful to employ deceptive or manipulative devices "in connection with the purchase or sale of any security").

24. *See* Exchange Act Rule 14a-8, 17 C.F.R. § 240.14a-8 (2009) (providing that shareholder who has continuously held, for at least one year, the lesser of (i) $2,000 in market value or (ii) 1 percent of the company's securities entitled to be voted on the matter may include in the company's proxy materials a shareholder proposal containing a "recommendation or requirement that the Company and/or its board of directors take action"). In addition to procedural requirements, Rule 14a-8 imposes substantive limitations on the subject matter of shareholder proposals, including that a proposal must not: (i) be an improper subject for action by shareholders under state law; (ii) if implemented, cause the company to violate any applicable state, federal, or foreign law; (iii) contain in the proposal or supporting statement any materially false or misleading statements or otherwise violate the proxy rules; (iv) relate to the redress of a personal claim or grievance or further a personal interest or benefit not shared by shareholders at large; (v) relate to operations that account for less than 5 percent of the company's total assets and for less than 5 percent of its net earnings and gross sales, and is not otherwise significantly related to the business; (vi) seek an action that the company would lack the power or authority to implement; (vii) relate to the company's ordinary business operations; (viii) relate to a director nomination or election; (ix) directly conflict with one of the company's own proposals to be submitted to shareholders at the same meeting; (x) have been substantially implemented already; (xi) be substantially duplicative of another proposal previously submitted by another proponent for consideration at the same meeting; (xii) address substantially the same subject matter as a prior proposal that did not receive a certain threshold of votes (depending on the number of times submitted within the past five years); or (xiii) relate to specific amounts of cash or stock dividends. *See id.*

25. *See* Amy L. Goodman & John F. Olson, A Practical Guide to SEC Proxy and Compensation Rules § 1404[c], at 14-30 (4th ed. 2009) ("Unlike proposals that direct a board or a company to take action, binding bylaw amendments require no further action by a board or company to take effect. Once approved by shareholders, such amendments automatically amend the bylaws in the manner proposed by the proposal.").

that the board take action on certain matters on which shareholders do not have decisional rights under state law.[26] In 2007, according to the SEC, approximately 98 percent of the shareholder proposals that went to a vote were non-binding.[27]

Shareholders' limited authority to influence the business and affairs of the corporation is matched by their limited obligations. (Limited control is essential to lock in capital and also can be thought of as the quid pro quo for limited liability in the deal that shareholders have struck.) Shareholders who own less than a controlling interest in the corporation owe no legal duties to the corporation or to fellow shareholders, while controlling shareholders owe certain fiduciary obligations.[28] In addition, enhanced federal securities law obligations are imposed on holdings of 5 percent and 10 percent of a corporation's stock.[29]

While shareholders enjoy limited liability, shareholding entails risk that the company will not succeed and the value of the shareholder's investment will be lost in whole or in part. Unlike creditors, shareholders (unless they hold preferred stock) generally have no right to insist on a particular return on their investment, and are last in line for payment, including in a liquidation. Shareholders' chief protections for the inadequate performance of an investment lie in their abilities to "sell, vote, and sue." Specifically, shareholders may:

26. *See* Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 Bus. Law. 1079, 1088–89 (2008) (discussing SEC Rule 14a-8, which resulted in "stockholders ha[ving], by federal mandate, the option to require a stockholder referendum on a non-binding resolution when state law gives stockholders no right to demand such a show of hands," but often operated to exclude binding bylaws); *see also supra* note 16 (discussing the Delaware Supreme Court's recent *CA, Inc.* decision).

27. "Although stockholders are allowed to make mandatory proposals, '[a]fter more than four [now six] decades of experience and modification, the consensus understanding of the typical rule 14a-8 proposal is that it is advisory or precatory in nature.'" Strine, *supra* note 26, at 1088 n.31 (quoting Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 Ga. L. Rev. 97, 101 (1988)); *see also id.* (citing Riskmetrics Group, 2007 Postseason Report: A Closer Look at Accountability and Engagement 5 (2007) (observing that "only 2 percent of the shareholder proposals that appeared on proxy statements during the 2007 proxy season were binding")); Joao Dos Santos & Chen Song, Analysis of the Wealth Effects of Shareholder Proposals ii (2008), *available at* http://www.uschamber.com/publications/reports/080722wfi_shareholder.htm ("Overall, we find little conclusive evidence that shareholder proposals tangibly improve firm value. Given the costs associated with the proxy process and the unproven impact on company value, some consideration should be given to the net benefits of such initiatives.").

28. "Controlling" shareholders of publicly traded corporations—i.e., shareholders who "'own[] a majority interest in or exercise[] control over the business affairs of the corporation'"—owe duties similar to the ones owed by directors. Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1113–14 (Del. 1994) (emphasis omitted) (quoting Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987)); *see generally* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785 (2003) (discussing the fiduciary duties of controlling shareholders).

29. *See* Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1) (2006); Exchange Act Rule 13d-1, 17 C.F.R. § 240.13d-1 (2009) (requiring any person or group of persons agreeing to act together who acquire beneficial ownership of more than 5 percent of a class of registered equity securities to disclose, within ten days of the acquisition, specific information—including the identity of the stockholder, the amount of the stockholder's interest in the security, and the purpose of the transaction—by filing a Schedule 13D with the SEC); *see also* Exchange Act § 16(b), 15 U.S.C. § 78p(b) (2006) (imposing strict "short swing profit" liability on 10 percent beneficial owners who profit by engaging in a "purchase and sale" or "sale and purchase" of a given security within a six-month period).

- Exit at any time by selling their interest in the corporation;
- Vote in the election of the corporation's board of directors, to amend the bylaws as described above, and on certain other fundamental matters; and
- Seek judicial enforcement of fiduciary duties.[30]

Much of the current discussion of shareholder rights and tensions regarding shareholder efforts to influence corporate behavior result from perceived inadequacies of these devices in protecting shareholders from board failures to provide effective oversight.

Shareholder protections are not failsafe. By exiting, the shareholder may lock in any gain on the investment or prevent further decrease in value and, if shareholders sell in sufficient numbers, the decrease in stock value may create an incentive for changes in board and management performance. However, this is of little benefit to those who have already exited. Given the traditional practice of plurality voting, shareholder votes in the election of directors have had little influence on board composition, since typically the incumbent board nominated the board slate and there was no competing slate. Shareholders may suggest nominees and try to negotiate with the incumbent board, and may also undertake the expense of a proxy contest.[31] However, undertaking a proxy contest in an attempt to replace incumbent board members is both expensive and risky. Not only is the outcome of the proxy contest (and hence the investment in it) uncertain, there are no guarantees that replacement directors will perform any better than the ousted incumbents. Contested elections also impose costs and disruption on the corporation. Some observers view the relative infrequency of contested director elections as evidence of failure of the accountability mechanism in the U.S. governance

30. According to the SEC's shareholder proxy access rule proposal:

> If shareholders are dissatisfied with their company's performance and believe that the problem lies with the ineffectiveness of the company's board of directors, the existing proxy process provides shareholders with three principal options to attempt to effect change. First, shareholders can mount a proxy contest in accordance with our proxy rules. Second, shareholders can use the shareholder proposal procedure in Rule 14a-8 to submit proposals and have a vote on topics that are important to them. Third, shareholders can conduct a "withhold vote" or "vote no" campaign against one or more directors.
>
> Shareholders also can use options that exist outside of the proxy process. For example, shareholders can sell their shares (sometimes referred to as the "Wall Street Walk"); they can engage in a dialogue with management (including recommending a candidate to the nominating committee); or they can propose a board nominee at a shareholder meeting. Each of these options has drawbacks that limit its effectiveness.

SEC Proxy Access Rule Proposal, *supra* note 3, at 29027 (footnotes omitted).

31. *See supra* note 16; *see also* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members. . . . [W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.").

system.[32] Other observers emphasize that contested elections should not be the norm in an efficient governance system, going so far as to suggest that "shareholder voting is properly understood not as a primary component of the corporate decisionmaking structure, but rather as an accountability device of last resort, to be used sparingly, at most."[33]

C. The Role of the Board and through Delegation, Management

The board of directors is vested under state law with managing or directing the business and affairs of the corporation,[34] and therefore is recognized in law as the primary corporate decision-making body. The board in turn typically delegates significant authority for the day-to-day operations to a professional CEO and other executive officers,[35] who in turn derive their management authority from the board of directors.[36] To the extent that a board delegates to management,

32. *See* Bebchuk, *The Myth of the Shareholder Franchise, supra* note 1, at 688 ("[E]ven when shareholder dissatisfaction with board actions and decisions is substantial, challengers face considerable impediments to replacing boards.").

33. Bainbridge, *Director Primacy and Shareholder Disempowerment, supra* note 1, at 1750; *see also* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 Bus. Law. 67, 69 (2003) ("Typically an election contest is a last resort, as it should be in light of the extraordinary disruption that an election contest brings to bear on the entire organization."); *id.* at 83–84 (noting that an election contest "diverts large amounts of management time and attention from the operation of the business, as well as potentially imposing significant monetary costs for the printing and mailing of proxy materials and supplements and the assistance of outside advisors").

34. *See* Del. Code Ann. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."); Model Bus. Corp. Act Ann. § 8.01(b) (4th ed. 2008) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . . ."); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998) ("One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation."); Spiegel v. Buntrock, 571 A.2d 767, 772–73 (Del. 1990) ("A basic principle of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").

35. "'It is generally recognized that the board of directors is not expected to operate the business. Even under statutes providing that the business and affairs shall be 'managed' by the board of directors, it is recognized that actual operation is a function of management. The responsibility of the board is limited to overseeing such operation.'" Am. Law Inst., *supra* note 14, § 3.01 cmt. a (citation omitted); *see also* Grimes v. Donald, No. 13358, 1995 WL 54441, at *8 (Del. Ch. Jan. 11, 1995) ("[G]iven the large, complex organizations through which modern multi-function business corporations often operate, the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance. . . . Thus Section 141(a) of [the] DGCL expressly permits a board of directors to delegate managerial duties to officers of the corporation, except to the extent that the corporation's certificate of incorporation or bylaws may limit or prohibit such a delegation."), *aff'd*, 673 A.2d 1207 (Del. 1996).

36. Delaware corporations are required to have officers to sign instruments and stock certificates on behalf of the corporation. *See* Del. Code Ann. tit. 8, § 142(a) (2001). Subject to the corporation's governing documents and private contracts, officers are appointed and removed by the board of directors.

it must exercise reasonable oversight and supervision over management.[37] Additionally, certain board functions may not be delegated.[38] Board functions that generally are retained by the board and are central to its focus include the following:

- Selecting, monitoring, evaluating, motivating, and compensating, and, when necessary, replacing the CEO and other key members of senior management;
- Monitoring corporate performance and assessing whether the corporation is being appropriately managed by the senior management team;
- Providing strategic guidance to the senior management team and reviewing and approving financial objectives and major corporate plans and actions;
- Developing corporate policy;
- Reviewing and approving major changes in auditing and accounting principles and practices;
- Overseeing audit, internal controls, risk management and ethics, and compliance;
- In a public company, overseeing financial reporting and related disclosures;
- Declaring dividends and approving share repurchase programs;
- Making decisions on major transactions and other material events concerning the corporation for submission to the shareholders for approval; and
- Performing any other functions prescribed by law, regulation or listing rule, or the corporation's certificate of incorporation or bylaws.[39]

In contrast to the limited powers of shareholders, the board has broad powers to initiate and adopt corporate plans, commitments, and actions.[40] However, certain director powers are limited by the need for shareholder approval,[41] and, in all cases, director powers are subject to the board's fiduciary duties to the corporation and its shareholders.

In fulfilling their mandate, directors are required to act under the high standards imposed on fiduciaries, including the duties to act with due care (focusing appropriate attention and making decisions on an informed basis), in good faith, and in the best interests of the corporation and its shareholders. Directors owe

See id. § 142(b) (appointment and removal); Model Bus. Corp. Act Ann. § 8.40(b) (4th ed. 2008) (election and appointment); *id.* § 8.43(b) (removal). Like directors, officers owe fiduciary duties to the corporation and its shareholders. *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009).

37. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68, 971 (Del. Ch. 1996) (holding that failure to implement a corporate information and reporting system such that the board would be able to reach informed judgments concerning both the corporation's compliance with the law and its business performance would result in a breach of the duty of care); *see also* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) (affirming *Caremark* as the appropriate standard for evaluating director oversight claims); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 121–31 (Del. Ch. 2009) (applying the *Caremark* doctrine to directors' monitoring of business risk).

38. *See infra* text accompanying notes 55–57.

39. *See generally* Am. Law Inst., *supra* note 14, § 3.02(a).

40. *See id.* § 3.02(b); *see also supra* note 18.

41. *See supra* Part II.B.

duties of care and loyalty both to the corporation and to the shareholder body as a whole. The duty of care requires that directors inform themselves of "all material information reasonably available to them" concerning a given decision prior to acting on that decision.[42] "[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director . . . and not shared by the stockholders generally."[43] Individual directors breach their duty of loyalty by placing the interests of anyone—whether themselves, management, a third party, or a subset of shareholders—over the corporation or the shareholders generally.[44]

Directors are also obligated to act in a deliberative and fully informed manner, which requires access to relevant and timely information.[45] One of the very practical challenges in corporate governance relates to the difference between managers and directors in their access to information about the corporation and the implications of this difference on the ability of part-time outside directors to hold managers accountable for the responsibilities that have been delegated to them. Increased reliance on independent directors in publicly traded companies—directors who by definition lack their own sources of information about internal corporate matters due to their lack of employment and business ties to the company—may in fact increase director dependency on management for the information that directors need to provide appropriate oversight.[46] Nonetheless, directors must make

42. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

43. Cede & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993); *see also* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."). Note, however, that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty." Stone *ex rel*. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006).

44. *See generally* Veasey & Di Guglielmo, *supra* note 8.

45. "The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'" *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812); *see also* Del. Code Ann. tit. 8, § 220(d) (Supp. 2008) (director's right to corporate information); Intrieri v. Avatex, No. 16335-NC, 1998 WL 326608 (Del. Ch. June 12, 1998) (addressing same).

46. Listing standards mandate that a majority of a public company's board of directors be "independent," i.e., have no material relationships to the company and its management, as determined by the board of directors, within certain parameters set forth in the listing rules. *See* NYSE Euronext, Listed Company Manual, *supra* note 22, § 303A.01 ("Listed companies must have a majority of independent directors."); NASDAQ Listing R. 5605(b)(1) ("A majority of the board of directors must be comprised of independent directors as defined in Rule 5605(a)(2)."). Further, all members of a public company's audit committee are required to be independent under heightened standards of independence. *See* Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(3) (2006) ("Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent."); Exchange Act Rule 10a-3, 17 C.F.R. § 240.10a-3 (2009) (establishing heightened independence requirements for audit committee members); *see also* NYSE Euronext, Listed Company Manual, *supra* note 22, § 303A.06 ("Listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act."); NASDAQ Listing R. 5605(c)(2)(A) (similar). In addition to audit oversight, certain key functions—executive compensation and director nomination and governance generally—are reserved by the listing rules to independent directors. *See* NYSE Euronext, Listed Company Manual, *supra* note 22,

reasonable effort to ensure that they are being kept appropriately apprised of the company's compliance with the law and its business performance.[47]

Directors and officers are subject to liability for their actions—and inactions.[48] Unlike shareholders, whose liability is limited to the value of their investment in the corporation, directors and officers are exposed to broad potential liability as fiduciaries (and under other laws including, but not limited to, the federal securities laws and employment laws). Directors are shielded from liability for most business decisions by the strong judicial deference accorded under the "business judgment rule."[49] This judicial deference recognizes both the primacy of the board's role in corporate decision-making and the significant risks that are inherent in making entrepreneurial decisions.[50] Directors also are protected against liability by shareholder-approved exculpatory charter provisions that eliminate (or,

§ 303A.05 (compensation committee "must . . . have direct responsibility to: (A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation"); NASDAQ Listing R. 5605(d)(1) ("Compensation of the chief executive officer of the Company must be determined, or recommended to the Board for determination, either by: (A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or (B) a compensation committee comprised solely of Independent Directors."); NYSE Euronext, Listed Company Manual, *supra* note 22, § 303A.04(a) ("Listed companies must have a nominating/corporate governance committee composed entirely of independent directors."); NASDAQ Listing R. 5605(e)(1) ("Director nominees must either be selected, or recommended for the Board's selection, either by: (A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate, or (B) a nominations committee comprised solely of Independent Directors.").

47. *See Stone*, 911 A.2d at 370; *see also supra* note 37 and accompanying text (discussing the oversight duties of directors as embodied in the *Caremark* doctrine).

48. *See supra* notes 37, 42–44 and accompanying text.

49. The business judgment rule "presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'" *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting *Aronson*, 473 A.2d at 812); *see also* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287, 1298 (2001) ("[A] standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process.").

50. Courts generally apply the "business judgment rule" in assessing the actions of directors. The rule protects and promotes the role of the board as the primary corporate decision-maker by preventing second-guessing of the decisions of independent and disinterested directors who "'acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'" *Disney*, 906 A.2d at 52 (quoting *Aronson*, 473 A.2d at 812). "The business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors." MM Cos., Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003). When a court invokes the business judgment rule presumption, director conduct is assessed not by looking at the outcome of a given decision, but instead by focusing on the board's process in reaching the decision. *See* Paramount Comm'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 45 n.17 (Del. 1994). The business judgment rule thus encourages good-faith decision-making on matters that by their very nature entail risk taking. *See* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052–53 (Del. Ch. 1996). "Where the party challenging the board's decision does allege

in some states, the corporation statute may directly eliminate) monetary liability for breaches of the fiduciary duty of care.[51]

Directors of public companies also face potential liability under the federal securities laws. Indemnification provisions and D&O insurance reduce the likelihood that claims will result in out-of-pocket payments by directors.[52] However, the liability potential remains. While outside directors of public companies rarely pay legal expenses or damages pursuant to a judgment or settlement agreement out of their own pockets, in recent years, claims under federal securities laws have resulted in a number of instances where directors have settled out of their own funds. In the Enron and WorldCom suits, pension fund plaintiffs demanded such out-of-pocket payments as a condition of settlement.[53]

"The principal threats to outside directors who perform poorly are the time, aggravation, and potential harm to reputation that a lawsuit can entail, not direct financial loss."[54] In an environment of increasing media scrutiny and coordinated

and prove facts sufficient to overcome the business judgment rule presumption, 'the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders,'" I Stephen A. Radin, The Business Judgment Rule: Fiduciary Duties of Directors 62 (6th ed. 2009) (quoting *Disney*, 906 A. 2d at 52). Delaware courts also have crafted other standards of review in different contexts that displace the business judgment rule. *See generally* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (1985) (enhanced scrutiny for defensive measures); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (duties attendant to a sale of control).

51. *See* Del. Code Ann. tit. 8, § 102(b)(7) (2001) (empowering, but not requiring, shareholders to adopt charter "provision[s] eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages" except for breaches of the duty of loyalty, acts and omission not in good faith, acts that involve violations of law, or in regard to any transaction from which the director derived an improper personal benefit); Model Bus. Corp. Act Ann. § 2.02(b)(4) (4th ed. 2008) (permitting the articles of incorporation to include "a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which the director is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law"); *see also* Fla. Stat. Ann. § 607.0831 (West 2007) (shielding directors from liability for any act or failure to act, unless the director engaged in a violation of criminal law, derived an improper personal benefit from a transaction, carelessly approved an unlawful dividend or other distribution, or (in a derivative or direct action by a shareholder) acted in "conscious disregard for the best interest of the corporation, or [engaged in] willful misconduct"). Delaware's General Assembly enacted section 102(b)(7) in response to the threat of unlimited liability for breaches of the duty of care arising from the Delaware Supreme Court's decision in *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). *See* Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffery M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law* 39, 42 (Widener Law Sch. Legal Studies Research Paper No. 09-13, Harvard Law & Econ. Discussion Paper No. 630, 2009), *available at* http://ssrn.com/abstract=1349971 (acknowledging same and discussing the drafting process surrounding that section).

52. *See* Del. Code Ann. tit. 8, § 145 (2001) (indemnification and advancement); Model Bus. Corp. Act Ann. §§ 8.50–8.59 (4th ed. 2008) (same); Del. Code Ann. tit. 8, § 145(g) (2001) (director and officer insurance); Model Bus. Corp. Act Ann., *supra*, § 8.57 (same).

53. *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 Stan. L. Rev. 1055, 1057–58, 1062–74 (2006) (describing Enron and WorldCom settlements and finding thirteen cases of out-of-pocket payments by outside directors in a 25-year period).

54. *Id*. at 1056.

shareholder activity, directors' reputational interests, including their interests in being associated with well-regarded and successful corporations, provide significant motivations that may be at least as, if not more, powerful than concerns about personal financial liability.

Directors cannot escape liability by deferring to the viewpoints of some or even all of their shareholders. For example, in deciding whether to approve a merger agreement, a board of directors must act in an informed and deliberate manner, and "may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement."[55] This stems from the principle that "directors may not delegate to others those duties that are 'at the heart of the management of the corporation.'"[56] This underscores that directors are not agents of the shareholders; they cannot take instruction from shareholders with respect to matters that are within their decision-making responsibilities. The corporate form entrusts the corporate enterprise to the board of directors, and this is a trust that cannot be renounced by deference to even a majority of shareholders.[57] Shareholders who are displeased with director decisions regarding corporate affairs can seek to try and convince directors to take a different course, elect different directors, or sell their stock.

III. Board Accountability

A. The Accountability Issue and the Influence of the CEO

Concerns about the apportionment of decision rights and responsibilities in the corporation date back several hundred years to Adam Smith, with the recognition that those charged with managing the joint stock corporation for the equity providers may have interests that cause them to neglect their duties or otherwise deviate from acting in the best interests of shareholders.[58] However, it was in the aftermath of the economic crisis of the Great Depression that the modern problem of corporate accountability to shareholders of the large publicly traded U.S. corporations was emphasized by Adolph Berle and Gardiner Means.[59] The accountability problem results from a combination of diffuse share ownership, economic disincentive for individual shareholders to bear the cost of engaging in actions

55. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1142 n.2 (Del. 1990) (citing Beard v. Elster, 160 A.2d 731, 737 (Del. Ch. 1960)); *see also* Paramount Commc'ns, Inc. v. Time Inc., Nos. 10866, 10670 & 10935, 1989 WL 79880, at *30 (Del. Ch. 1989) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage to firm."), *aff'd*, 571 A.2d 1140 (Del. 1990).

56. Canal Capital Corp. v. French, No. 11,764, 1992 WL 159008, at *2 (Del. Ch. July 2, 1992) (quoting Chapin v. Benwood Found., Inc., 402 A.2d 1205, 1210 (Del. Ch. 1979)); *see also* Lehrman v. Cohen, 222 A.2d 800, 808 (Del. 1966) ("It is settled, of course, as a general principle, that directors may not delegate their duty to manage the corporate enterprise.").

57. *See supra* notes 55–56 and accompanying text.

58. *See* Smith, *supra* note 1, at 264–65.

59. *See* Berle & Means, *supra* note 1, at 76 (recognizing that as a consequence of unconcentrated share ownership, shareholders had relatively little incentive or power to hold the board and management accountable for their stewardship of the corporation).

with benefits that would be widely shared, the limited nature of shareholder rights, and the failure of the board of directors to engage in active, informed, and objective oversight of the managers to whom they delegated authority. Considerable scholarly discussion and debate in the fields of economics, law, and organizational behavior have grappled with the issue of how the governance system can best protect relatively diffuse, disparate, and historically powerless shareholders from the potential for the self-interest of autonomous managers in light of the lack of independence and active oversight by directors.[60]

A legitimate criticism of corporate governance for much of the last century was that boards were unduly passive and deferential to the professional managers to whom they had delegated authority for the daily operations of the company.[61] Corporate managers obtain their powers largely by way of delegation from the board. Throughout much of the last century, the professional managers hired to run public companies have wielded significant power in relation to both the board of directors and shareholders. This dominance resulted from the legitimate recognition that CEOs need latitude to lead the company, cultural deference that had been traditionally accorded CEOs including with respect to board leadership, and management's information advantage as to the corporation's business and affairs given managers' full-time attention to the business involvement and control of the daily operations of the firm. As a general matter, independent directors do not have their own sources of information about the company's performance, its strategic opportunities, and the risks associated with those opportunities. While they can access analyst and press reports and other broadly available public information about the company, they must rely on management for internal nonpublic information about company performance and strategy. In addition, they face very real time constraints given the inherent part-time nature of their role.

B. Board Engagement

While director deference to CEOs continues to be cited by some as a concern,[62] in the past decade public company boards have become more engaged and active in providing oversight and guidance. In the 1990s, as institutional investors and others advocated greater board engagement and objectivity, a number of boards

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60. *See id.* at 66, 78, 82; *see also* Lucian A. Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 15 (2004) ("This diffuse ownership structure is the norm in the United States, though not in other countries." (citing Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999))).

61. *See generally* Mace, *supra* note 1; Douglas, *supra* note 1; Myles L. Mace, *Directors: Myth and Reality—Ten Years Later*, 32 Rutgers L. Rev. 293 (1979).

62. *See* Harvard Bus. Sch., Summit Report 2008: Global Governance 2 (2008), *available at* http://www.hbs.edu/centennial/businesssummit/business-society/global-governance.pdf ("While Sarbanes-Oxley mandates a certain level of board independence, true independence is often lacking. Boards often feel a certain sense of 'deference and protectiveness' toward senior executives, said Mr. [Damon A.] Silvers, clouding objective analysis of troubling situations and fostering denial."); *see also* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 Nw. U. L. Rev. 898, 913–17 (1996) (discussing how chief executive officers may dominate independent directors).

responded by relying more heavily on outside directors who lacked material relationships to the company and its management, and also by restructuring board processes to encourage greater independent analysis by the board. Board engagement and independence accelerated with the governance reforms mandated by the Sarbanes-Oxley Act and related SEC and securities market listing regulations in reaction to highly public governance failures at Enron and WorldCom. The continuing emphasis in jurisprudence, especially in case law from Delaware, of the importance of director oversight[63] also has helped to improve director appreciation of the accountability paradigm in corporate decision-making.

Federal laws, regulations, and listing rules adopted in the wake of the WorldCom and Enron governance failures built upon recommendations that had long appeared in the growing body of "best practice" recommendations to provide a framework for more engaged and objective board oversight.[64] In addition to mandating that public company boards be comprised of a majority of directors who lack material relationships to the company, to its senior managers, and to its independent auditor, the key audit, compensation, and nominating governance functions were tasked to committees comprised of independent directors. Regular "executive sessions" of the independent and non-management directors without members of management present were mandated by listing rules to provide outside directors with significant opportunity to discuss matters of importance

63. *See supra* note 37 and accompanying text.

64. *See* Am. Bar Ass'n Comm. on Corporate Laws, The Corporate Director's Guidebook (5th ed. 2007) (originally published 1994), *available at* 62 Bus. Law. 1482 (2007) (identifying boardroom practices and procedures that support and promote effective director involvement); Gen. Motors Bd. of Directors, Corporate Governance Guidelines (2008) (originally adopted 1994) (on file with *The Business Lawyer*) (board policy regarding governance practices relating to board and committee independence, independence standards, executive sessions, and board evaluation); Nat'l Ass'n of Corporate Directors (NACD), Report of the NACD Blue Ribbon Commission on Director Professionalism (2005) (originally published 1996) (advocating that boards "establish[] a governance committee, creat[e] independent leadership roles, influenc[e] board and committee agendas, determine[] effective independent selection and compensation methods, require[] stock ownership, establish[] an evaluation process, hold[] 'executive sessions' of the independent directors, and access[] independent advice"); Teachers Ins. & Annuity Ass'n—Coll. Ret. Equities Fund, TIAA-CREF Policy Statement on Corporate Governance (2007) (originally released 1997), *available at* http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf; Bus. Roundtable, Principles of Corporate Governance (2005) (originally published in 1997 as *Statement on Corporate Governance*), *available at* http://www.businessroundtable.org/initiatives/leadership/governance (similar); Cal. Pub. Employees' Ret. Sys., Global Principles of Accountable Corporate Governance (2009) (originally adopted in 1998 as *Corporate Governance Principles and Guidelines—United States*), *available at* http://www.calpers-governance.org/docs-sof/marketinitiatives/2009-04-01-corp-governance-pub20-final-glossy.pdf (similar); Council of Institutional Investors, Corporate Governance Policies (2009) (originally adopted 1998), *available at* http://www.cii.org/UserFiles/file/council%20policies/CII%20Full%20Corp%20Gov%20Policies%205-7-09.pdf (similar); *see generally* Am. Bar Ass'n, Report of the American Bar Association Task Force on Corporate Responsibility 31 (2003) (the "Cheek Report"), *available at* http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf ("The board of directors of a public corporation must engage in active, independent and informed oversight of the corporation's business and affairs, including its senior management. . . . In order to improve the effectiveness of such oversight, the board of directors of a public corporation should adopt governance principles [that, among other things,] establish and preserve the independence and objectivity of directors by eliminating disabling conflicts of interest and undue influence or control by the senior management of the corporation . . . .").

that may involve management conflicts, thereby supporting objective oversight. Governance guidelines setting forth the board's policies relating to its own structure and processes—including board and committee self-evaluations—were mandated or encouraged by listing rules and, in the case of audit committees, by the Sarbanes-Oxley Act, underscoring the role of the board and its committees in determining how best to govern.[65]

Board composition and practices for S&P 500 companies have changed significantly over the past ten years[66]:

- The percentage of independent directors has grown from 78 percent in 1998 to 82 percent in 2008.[67] (These statistics understate the magnitude of this change, given enhanced rigor in the definition of "independence.")
- The nomination process is now run by independent directors (pursuant to listing rule requirements), often with the assistance of a director search consultant,[68] leading to increased reliance on external sources for recruiting directors. In 2008, 60 percent of new director nominations came through a search firm, 21 percent came from independent directors, and 9 percent were recommended by the CEO, down from 14 percent in 2005.[69]
- Fewer active CEOs and other similarly senior executives now serve on boards, with only 31 percent of new independent directors also holding positions as active CEOs, COOs, chairmen, presidents, or vice chairmen, down from 49 percent in 1998.[70]
- Boards are gradually improving their racial and gender diversity. In 2007, 85 percent of Fortune 1000 companies had one or more female director (up from 78 percent in 2001), and 78 percent had one or more director from an ethnic minority (up from 68 percent in 2001).[71] In 2008, approximately one in five new directors came from a diverse ethnic background, and women accounted for 18 percent of new directors.[72]
- Directors spend considerable time preparing for and participating in board and committee meetings: the NACD estimates that on average a director spends approximately 223 hours per year on board and committee

65. For a discussion of a principles-based approach to governance best practices, see NAT'L ASS'N OF CORPORATE DIRECTORS (NACD), KEY AGREED PRINCIPLES TO STRENGTHEN CORPORATE GOVERNANCE FOR U.S. PUBLICLY TRADED COMPANIES (2009), *available at* https://secure.nacdonline.org/StaticContent/StaticPages/DM/NACDKeyAgreedPrinciples.pdf.

66. *See generally* SPENCER STUART, SPENCER STUART BOARD INDEX (2008), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_08.pdf; NAT'L ASS'N OF CORP. DIRECTORS ("NACD"), NACD PUBLIC COMPANY GOVERNANCE SURVEY (2008); KORN/FERRY INT'L, 34TH ANNUAL BOARD OF DIRECTORS STUDY (2008), *available at* http://www.kornferry.com/Publication/9955.

67. *See* SPENCER STUART, *supra* note 66, at 8.

68. *See* NACD, *supra* note 66, at 24 (reporting that 49.2 percent of respondent boards had retained a search firm to seek qualified board candidates and finding that a larger proportion of those boards who hired search firms rated their director recruitment to be effective (80.6 percent vs. 59.1 percent)).

69. *See* SPENCER STUART, *supra* note 66, at 15.

70. *See id.* at 11.

71. *See* KORN/FERRY INT'L, *supra* note 66, at 7.

72. *See* SPENCER STUART, *supra* note 66, at 12.

matters.[73] The average number of board meetings per year has increased from seven in 1998 to almost nine in 2008.[74] While nearly half of S&P 500 boards meet between six and eight times per year, more than 40 percent meet more frequently.[75]

- Independent board leadership in the form of an independent chair or a lead or presiding director has increased. Approximately 16 percent of S&P 500 companies now have an independent chair;[76] among S&P Mid and Small Cap companies the figure is higher (23 percent and 27 percent, respectively).[77] In 2008, 95 percent of S&P 500 boards had an independent lead or presiding director, compared with only 36 percent in 2003.[78]
- Some form of board evaluation is now performed by 90 percent of S&P 500 boards.[79]
- Boards are increasingly aware of the key role that they play. According to NACD data, boards rate as among the top issues for their focus matters of succession planning, strategic planning, and oversight of risk management.[80]

These changes are in addition to the enhanced rigor of board oversight of the audit, financial reporting, and internal controls mandated by the Sarbanes-Oxley Act.

Boards have also become less tolerant of poor performance. In 1995, one in eight departing CEOs resigned under board pressure or were fired, while in 2006 almost one in three departing CEOs left involuntarily.[81] Boards also have become more responsive to shareholder concerns. For example, within a relatively short time span, a significant majority of S&P 500 companies (66 percent) adopted some form of a majority voting standard for uncontested director elections.[82] Boards

73. *See* NACD, *supra* note 66, at 32.

74. *See* Spencer Stuart, *supra* note 66, at 24 ("On average, boards meet 8.7 times per year, up from 7.8 in 2003 and 7.0 in 1998.").

75. *See id.*

76. *See id.* at 20.

77. *See* Millstein Ctr. for Corporate Governance & Performance, *supra* note 3, at 5 ("A RiskMetrics study, expanded to include S&P Mid and SmallCap companies, shows the appointment of independent non-executive chairmen to be slightly higher at 23% and 27% respectively for 2008, a cumulative increase of 17% from 2006 for the S&P 1500." (citing RiskMetrics Group, Board Practices: Trends in Board Structure at S&P 1500 Companies (2008))).

78. *See* Spencer Stuart, *supra* note 66, at 21.

79. *See id.* at 24.

80. *See* NACD, *supra* note 66, at 47–51.

81. *See* Chuck Lucier, Steven Wheeler & Rolf Habbel, *The Era of the Inclusive Leader*, Strategy + Bus., Summer 2007, at 3, *available at* http://www.boozallen.com/media/file/Era_of_the_Inclusive_Leader_.pdf.

82. *See* Claudia H. Allen, Study of Majority Voting in Director Elections i (2007), *available at* http://www.ngelaw.com/files/upload/majoritystudy111207.pdf; *see also* Annalisa Barrett & Beth Young, *Majority Voting for Director Elections—It Is Not Yet Standard Practice*, Analyst Alert, Dec. 2008 (on file with *The Business Lawyer*) (noting that as of December 2008, 67.9 percent of S&P 500 companies had either changed to an actual majority vote standard (49.5 percent) or, while retaining plurality voting, had adopted board polices requiring directors to resign if they did not receive a majority of votes in support of election (18.4 percent)).

also have shown an increasing tendency to respond to shareholder proposals and other expressions of shareholder viewpoints on issues such as poison pills, classified boards, supermajority provisions, and performance-based stock options. Overall, the number of shareholder proposals brought to a vote declined for the sixth consecutive year in 2008, down 10 percent from 2007 and 21 percent from the record high set in 2004.[83] This reduction is based in significant degree on "the fact that many companies have adopted a more proactive approach to discussing governance issues with their shareholders and third-party opinion-makers."[84]

Boards also are more actively engaging in discussions with shareholders on a variety of governance related topics outside of the proxy proposal context, including nomination of directors, compensation matters, social and environmental issues, and the range of matters raised by shareholders during proxy season. Pfizer, UnitedHealth, and Home Depot, for example, initiated meetings with large institutional investors to discuss issues ranging from executive compensation to board composition.[85] In addition, many corporate boards and executives participate in private meetings with investors about similar corporate governance topics, and this "quiet diplomacy" is increasing. Companies also are experimenting with shareholder surveys and web-based communications as a means of obtaining insights on shareholders' concerns.[86]

Despite these changes in board governance over the past decade, continuing problems with option timing and accounting and risk management—problems that often have been associated with financial restatements and failed business strategies—have resulted in continued criticisms of the quality of board oversight. Most recently, instances of collapse or near collapse of financial services firms—due to what some observers now view as reliance on risky strategies coupled with handsome incentives for the executives undertaking such strategies—has been cited by observers as evidence of ineffective boards still caught in a culture of undue deference to chief executive officers and their teams.[87] Some counter that apparent governance failure in the financial services industry should not be widely interpreted to indicate governance failures in the myriad of other industries that were not connected to the market meltdown. Others question whether boards

83. Georgeson, 2008 Annual Corporate Governance Review 4 (2008), *available at* http://www.georgeson.com/usa/flash_viewer.html.

84. *Id.*

85. *See* Press Release, Pfizer Inc., Pfizer Board of Directors to Initiate Face-to-Face Meetings with Company's Institutional Investors on Corporate Governance Policies and Practices (June 28, 2007), http://mediaroom.pfizer.com/portal/site/pfizer/?ndmViewId=news_view&newsId=20070628005559&newsLang=en; United Health Group, Inc., Board of Directors Communication Policy (2009), *available at* http://www.unitedhealthgroup.com/about/2009/BoardShareholderCommunicationPolicy0209.pdf; Elizabeth Judd, *The Lost Art of Communication*, Corp. Sec'y, Apr. 2008, http://www.shareholderforum.com/Reference/20080400_CorporateSecretary.htm (discussing, among other corporations, Home Depot).

86. *See, e.g.*, Posting of Carol Bowie to RiskMetrics Group Risk & Governance Blog, http://blog.riskmetrics.com/2008/10/scheringplough_will_survey_sha.html (Oct. 29, 2008) ("Schering-Plough Will Survey Shareholders on Pay").

87. *See supra* note 62; *see also* Proposed Shareholder Bill of Rights Act, *supra* note 3, § 2(2) ("[W]ithin too many of the Nation's most important businesses and financial institutions, both executive

comprised of outside part-time directors, who, by definition of independence, lack strong inside knowledge about the company, should be expected to identify risks that not only corporate managers, but also ratings agencies and regulators—and investors—failed to see. The Task Force recognizes that the issues associated with the financial crisis are complex.[88] Whether one views board failure as one of the causes of the current crisis or not, ultimately the board of directors is the primary decision-making body in the corporation and is responsible for the enterprise entrusted to it. Current political and regulatory focus is on the board, and adjustments to governance regulation are more than likely in response.

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management and boards of directors have failed in their most basic duties, including to enact compensation policies that are linked to the long-term profitability of their institutions, to appropriately analyze and oversee enterprise risk, and most importantly, to prioritize the long-term health of their firms and their shareholders."); *id.* § 2(4) ("a key contributing factor to such failure was the lack of accountability of boards to their ultimate owners, the shareholders").

88. *See, e.g.*, *Addressing the Need for Comprehensive Regulatory Reform: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 3 (2009) (statement of Timothy F. Geithner, Secretary, U.S. Department of the Treasury), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf ("The current crisis had many causes. Two decades of sustained economic growth bred widespread complacency among financial intermediaries and investors. . . . The rising market hid Ponzi schemes and other flagrant abuses that should have been detected and eliminated. In that environment, institutions and investors looked for higher returns by taking on greater exposure to the risk of infrequent but severe losses. A long period of home price appreciation encouraged borrowers, lenders, and investors to make choices that could only succeed if home prices continued to appreciate. We had a system under which firms encouraged people to take unwise risks on complicated products, with ruinous results for them and for our financial system. Market discipline failed to constrain dangerous levels of risk-taking throughout the financial system. New financial products were created to meet demand from investors, and the complexity outmatched the risk-management capabilities of even the most sophisticated financial institutions. Financial activity migrated outside the banking system, relying on the assumption that liquidity would always be available. Regulated institutions held too little capital relative to the risks to which they were exposed. And the combined effects of the requirements for capital, reserves and liquidity amplified rather than dampened financial cycles. This worked to intensify the boom and magnify the bust. Supervision and regulation failed to prevent these problems. There were failures where regulation was extensive and failures where it was absent. Regulators were aware that a large share of loans made by banks and other lenders were being originated for distribution to investors through securitizations, but they did not identify the risks caused by explosive growth in complex products based on these products. Investment banks, large insurance companies, finance companies, and the GSEs were subject to only limited oversight on a consolidated basis, despite the fact that many of those companies owned federally insured depository institutions or had other access to explicit or implicit forms of support from the government. Federal law allowed many institutions to choose among regulatory regimes for consolidated supervision and, not surprisingly, they avoided the stronger regulatory authority applicable to bank holding companies. Those companies and others were highly leveraged or used short-term borrowing to buy long-term assets, yet lacked strong federal prudential regulation and routine access to central bank liquidity. And while supervision and regulation failed to constrain the build up of leverage and risk, the United States came into this crisis without adequate tools to manage it effectively."); Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression (2009); Joseph E. Stiglitz, *Capitalist Fools*, Vanity Fair, Jan. 2009, at 48; Ben Steverman & David Bogoslaw, *The Financial Crisis Blame Game*, Bus. Wk. Online, Oct. 20, 2008, http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm?chan=investing_investing+index+page_top+stories. Congress has established a commission to explore the underlying causes of the financial crisis. *See* Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-1, § 5(a), 123 Stat. 1617, 1625–31 (to be codified at 31 U.S.C. § 3729) (creating Financial Crisis Inquiry Commission "to examine the causes, domestic and global, of the current financial and economic crisis in the United States"); *see also* John D. McKinnon & Corey Boles, *Panel Set for Probe into Crisis*, Wall St. J., July 16, 2009, at A5 (reporting on the appointment of members to Financial Crisis Inquiry Commission).

IV. The Changing Nature and Influence of Shareholders

Over the past twenty-five years, shareholder identity, concentration of share ownership, and shareholder influence have changed dramatically, as institutions have replaced individuals as the predominant shareholders of U.S. corporations.[89] Concentrated share ownership in institutional hands and regulations that emphasize that pension funds and mutual funds must treat voting rights as assets to be managed on behalf of the beneficiaries have provided institutional investors with greater incentives to exercise their shareholder rights. Some institutional investors—most notably public and union pension funds—have focused their attention on board composition and practices and have sought changes in governance that they view as important. The highly successful campaign to institute majority voting in place of plurality voting for uncontested director elections is one example. More recently, hedge funds have become engaged in shareholder activism, as a means of pushing for a particular strategy or outcome consistent with their economic interests, which—some observers argue—may diverge from other longer-term shareholders. The growth of institutional investors and the emergence of new types of institutional investors highlight increasing diversity of interests among the shareholding base.

Shareholder activism efforts have been assisted by the removal of regulatory and technological barriers to communication and coordination between shareholders. Large institutional shareholders have developed with the will and capacity to use their voice and vote actively. In addition, the emergence of influential proxy advisory firms has assisted in the coordination of shareholder activism. Overall, shareholder engagement provides the opportunity for overcoming collective choice problems and "rational apathy" in favor of meaningful shareholder oversight. Meaningful shareholder oversight—as with board oversight of management—requires, however, the application of company-specific judgment and consideration of the interests of the corporation and its entire shareholding body.

A. Growth of Institutional Investor Equity Ownership

A shareholder of a public company today is far more likely to be an institutional investor than an individual. In 1950, more than 93 percent of U.S. equities were

89. A number of factors have contributed to the shift in shareholding from individuals to institutions, including the growth in pension plans and the adoption in 1974 of a requirement that private defined-benefit pension plans fund their obligations with a diversified securities portfolio, the growth of defined contribution plans, and the final repeal in 1999 of the Glass Steagall Act by the Gramm-Leach-Bliley Financial Modernization Act that ended the restrictions on direct ownership of equity by banks and insurance companies. *See* Employees Retirement Income Security Act of 1974 § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (2006) (imposing on trustees of covered plans a duty of diversification "so as to minimize the risk of large losses"); *see also* Shlomo Benartzi, Richard H. Thaler, Stephen P. Utkus & Cass R. Sunstein, *The Law and Economics of Company Stock in 401(k) Plans*, 50 J.L. & Econ. 45, 47 (2007); Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 Ala. L. Rev. 1385, 1433–34 (2008); Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 Colum. L. Rev. 1519, 1528 (1997); Strine, *supra* note 26, at 1081–82 ("[M]ost Americans have become what I call forced capitalists, people who earn most of their wealth through their labor,

directly owned by individuals.[90] By 2006, however, it is estimated that individual stock ownership had fallen to approximately 33 percent of U.S. equities.[91] (Some estimates have individuals currently accounting for approximately 25 percent of equity investment.[92]) Mutual funds alone are estimated to hold approximately 27 percent of U.S. equities,[93] and public pension funds are estimated to account for 10 percent or more of the total U.S. equity market.[94]

The data is even more dramatic for equity ownership in the largest (based on market cap) publicly traded U.S. companies. According to a Conference Board study:

- In 2007, institutional investors owned 76.9 percent of the largest 1000 companies.[95]
- The largest twenty-five companies had total institutional investor holdings ranging from 85.35 percent (AIG) to 52.9 percent (ExxonMobil). And almost a quarter of the companies on this list—AIG, WalMart, Google, ConocoPhillips, Hewlett-Packard, and Microsoft—all had institutional ownership in excess of 75 percent.[96]
- Concentration of share ownership in the largest twenty-five companies is significant. Just ten institutional investors account for between approximately 56 percent (WalMart) and 18 percent (ExxonMobil and Procter & Gamble) of the equity ownership in the top twenty-five companies; and just twenty institutional investors account for between approximately 61 percent (WalMart) and 24 percent (ExxonMobil and Procter & Gamble).[97]

By virtue of the size and concentration of their holdings, institutional investors are the antithesis of the small, dispersed, relatively powerless, and rationally apathetic shareholders described by Berle and Means in 1932.[98] To the extent that shareholdings are concentrated among a smaller group of shareholders, the col-

but who are required to provide for their retirement by giving substantial portions of their income to financial intermediaries for investment in the stock market."); Strine, *supra* note 1, at 4 ("For powerful reasons, this class of investors invests in the market primarily through intermediaries.").

90. *See* Carolyn Kay Brancato & Stephan Rabimov, Conference Bd., The 2008 Institutional Investment Report: Trends in Institutional Investor Assets and Equity Ownership of U.S. Corporations 20 (2008) (Table 10) (noting, based on values of total outstanding equity from The Board of Governors of the Federal Reserve System, that institutional investors accounted for just 6.1 percent of equity ownership in 1950).

91. *See id.* (noting that institutional investors accounted for 66.3 percent of equity ownership in 2006).

92. *See* John C. Bogle, *Reflections on "Toward Common Sense and Common Ground?*," 33 J. Corp. L. 31, 31 (2007).

93. *See* Inv. Co. Inst., 2009 Investment Company Factbook 11 (49th ed. 2009), *available at* http://www.icifactbook.org/pdf/2009_factbook.pdf.

94. *See* Brancato & Rabimov, *supra* note 90, at 22 (Table 13). This number is up dramatically from 2.9 percent in 1980. *See id.* "[N]ot only are the 'activist' state and local [pension] investors increasing their relative share of total institutional and pension fund assets, but they are also devoting a relatively larger share of their assets to equities, which can be used as a basis for proxy voting to further their corporate governance agendas." *Id.* at 4.

95. *See id.* at 27 (Table 19).

96. *See id.* at 28 (Table 21).

97. *See id.*

98. *See* Bearle & Means, *supra* note 1, at 277–87; *see also supra* note 59 and accompanying text; Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate*

lective action element of the classic accountability problem can be overcome by institutional investors.[99] Over the last twenty years, institutional investors—and in particular public, private, and union pension funds that are by nature long-term investors—have had a powerful influence on corporate governance. This is in part because many of these institutional investors recognize that they are too large simply to exit from large public companies without themselves moving the market. They also may need to remain invested to maintain adequate diversification in their portfolios or to mirror the equity holdings of a particular index. They additionally may believe that they lack the information necessary to "beat the market." For funds in this position, governance advocacy has been viewed as an important tool to improve portfolio performance.[100]

B. Shareholder Influence

In addition to the growth of institutional investors and the concentration of share ownership in their portfolios, a number of factors have given rise to the greater influence of shareholders, and in particular, institutional investors, including the following:

- The growth of pension funds with inherent long-term obligations and investment horizons, which led them to focus on the governance of companies in their portfolios;

Litigation, 61 Vand. L. Rev. 299, 300 (2008) ("Beginning in the early 1990s, institutional investor shareholder activism was praised as a promising means of reducing managerial agency costs. The theory was simple: if shareholder monitoring could limit managers' divergence from the goal of shareholder wealth maximization, then institutional shareholders were well positioned to act as effective monitors. Institutions held larger blocks of stock than most other investors and collectively held well over fifty percent of the stock of most large public companies. Acting together, these shareholders would have the power and the incentives to push for good corporate governance and to nudge managers to pursue wealth-maximizing strategies." (footnote omitted)); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811, 815 (1992) ("The case for institutional oversight, broadly speaking, is that product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available.").

99. *See generally* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 Am. U. L. Rev. 225 (2007); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277, 1336 (1991); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. Mich. J.L. Reform 117, 175–76 (1988); Black, *supra* note 98, at 815; *but see* Bainbridge, *The Case for Limited Shareholder Voting Rights, supra* note 1, at 630 (collecting sources and opining that this conclusion was erroneous "[b]ecause institutional investors generally are profit maximizers, they will not engage in an activity whose costs exceed its benefits. Even ardent proponents of institutional investor activism concede that institutions are unlikely to be involved in day-to-day corporate matters. Instead, they are likely to step in only where there are serious long-term problems.").

100. *See* Anabtawi & Stout, *Fiduciary Duties for Activist Shareholders, supra* note 1, at 1276 ("Institutional investors are in a much more favorable position to play an activist role in corporate governance than dispersed individual investors are. Although many pension and mutual funds rely on relatively passive stock-picking strategies, especially when they hold highly diversified portfolios, a number of prominent institutional investors—including both mutual funds like Fidelity and Vanguard and pension funds like CalPERS—have emerged as activist investors willing to mount public relations campaigns, initiate litigation, and launch proxy battles to pressure corporate officers and directors into following their preferred business strategy.").

- Changes in SEC regulation in 1992, coupled with technological innovation (internet) that, respectively, removed legal barriers and eased the ability of institutional investors to communicate with one another and coordinate efforts;[101]
- Clarification by regulators that pension fund and mutual fund fiduciaries have a fiduciary duty with respect to the voting rights associated with the portfolio;[102]
- Regulations that require mutual funds and investment advisors to disclose voting policies;[103]
- Increasing reliance by mutual and pension funds on proxy advisors (who have business incentives to support a broadening of the matters on which shareholders vote);[104]

101. *See* Electronic Shareholder Forums, Exchange Act Release No. 34-7172, 73 Fed. Reg. 4450 (Jan. 25, 2008) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/final/2008/34-7172.pdf. The internet is a particularly powerful tool for shareholders to coordinate efforts and also for the delivery of information about corporate performance and governance. U.S. public corporations must file their proxy statements electronically with the SEC, post filings on a public web site, and provide shareholders with the option of "paper delivery" or "notice and access." *See* Shareholder Choice Regarding Proxy Materials, Exchange Act Release No. 34-6135, 72 Fed. Reg. 42222 (July 26, 2007) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/final/2007/34-6135.pdf; *see also* Raymond A. Be, Special Counsel, Office of Rulemaking, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Statement by SEC Staff: Opening Statement of the Division of Corporation Finance at the SEC Open Meeting (June 20, 2007), *available at* http://sec.gov/news/speech/2007/spch062007rab.htm (discussing same). By lowering the costs associated with corporate monitoring and the adoption of certain activist strategies, particularly proxy fights, advances in information technology enable shareholders to take a more active role in matters of corporate governance. *See* Douglas R. Cole, *E-Proxies for Sale? Corporate Vote-Buying in the Internet Age*, 76 Wash. L. Rev. 793, 812–13 (2001); Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 Vand. L. Rev. 475, 487–90 (2008); Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 Colum. L. Rev. 1321, 1387 n.242 (2007); Ethan G. Stone, *Business Strategists and Election Commissioners: How the Meaning of Loyalty Varies with the Board's Distinct Fiduciary Roles*, 31 J. Corp. L. 893, 917 n.106 (2006); *see generally* Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 Harv. L. Rev. 747 (1985).

102. Regulations adopted in 2003 obligate certain funds to disclose publicly how they vote in corporate elections and also require funds to adopt written policies and procedures to help ensure that proxies are voted in the best interests of clients. *See* 17 C.F.R. § 270.30b1-4 (2009) (requiring registered management investment companies to file an annual report "containing the registrant's proxy voting record for the most recent twelve-month period ended June 30"); *id.* § 275.206(4)-6 (requiring investment advisors to "[a]dopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the best interest of clients," "[d]isclose to clients how they may obtain information . . . about how you voted with respect to their securities," and "[d]escribe to clients your proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client"). In addition, ERISA long has been interpreted to impose fiduciary obligations on ERISA trustees to vote proxies for stocks held by ERISA retirement and pension plans. *See* Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, U.S. Dep't of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988), *reprinted in* 15 Pension Rep. (BNA) 391, 391 (1988).

103. *See* 17 C.F.R. § 275.206(4)-6(c) (2009) ("[d]escribe to clients your proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client").

104. Many institutional investors purchase advice from proxy advisory services, such as RiskMetrics/ISS, Glass Lewis, and Proxy Governance. *See* Lucian Arye Bebchuk, *The Case for*

- Revision of the SEC's position on executive pay issues related to ordinary business and the resulting focus of shareholder proposals on compensation issues[105] and expanded executive compensation reporting requirements, which require greater pay disclosure and explanation;[106]
- Moves by an increasing number of companies (especially large cap companies) to replace plurality voting with majority voting for uncontested director elections, putting teeth into shareholder campaigns (often recommended by proxy advisors) to withhold votes from or vote against reelecting directors[107] (and, with the recent abolition of broker discretionary

Shareholder Access: A Response to the Business Roundtable, 55 CASE W. RES. L. REV. 557, 564 (2005) ("Confronting the need to make voting decisions in numerous companies, such institutional investors do not make case-by-case decisions. Rather, they largely follow voting guidelines that they develop either on their own or by using the guidelines of Institutional Shareholder Services (ISS) or some other proxy advisory service."). Proxy advisory services are perceived as having significant influence over the voting practices of institutional investors. *See id.* ("ISS, the currently leading proxy advisory service, is viewed as having pervasive influence on the voting decisions of many institutional investors."); *see also* Letter from Henry A. McKinnell, Chairman, Bus. Roundtable, to Jonathan Katz, Sec'y, U.S. Sec. & Exch. Comm'n 29 (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/s71903-81.pdf ("Benefit plans and other institutional investors rely heavily on these proxy voting guidelines, often refusing even to *discuss* the merits of particular proposals with management. These investors typically do not review individual shareholder proposals on a company-by-company basis and do not consider the effectiveness or ineffectiveness of a company's proxy process when casting their vote. In fact, they seldom deviate from ISS or other voting guidelines regardless of a company's position, circumstances, or responsiveness to shareholders.").

105. *See supra* notes 24 & 26.

106. *See generally* Executive Compensation Disclosure, Exchange Act Release No. 33-962, 57 Fed. Reg. 48126 (Oct. 16, 1992) (to be codified at 17 C.F.R. pts. 228, 229, 240 & 249), *available at* http://content.lawyerlinks.com/default.htm#http://content.lawyerlinks.com/library/sec/sec_releases/33-962.htm.

107. Delaware and many other states provide that directors shall be elected by a plurality of the vote unless otherwise provided in a corporation's certificate of incorporation or bylaws. *See* DEL. CODE ANN. tit. 8, § 216(1) (Supp. 2008) ("Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors."); MODEL BUS. CORP. ACT ANN. § 7.28(a) (4th ed. 2008) ("Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present."). Under a plurality system, a candidate is elected to a board seat if he or she receives the largest number of votes cast for that seat. In uncontested elections in which the only candidates on the ballot are those proposed by the corporation, a director can be elected even if only a small percentage of the shares are voted in his or her favor. In recent years, a number of shareholder groups have persuaded corporations to amend their certificates of incorporation or bylaws and/or to adopt policies to require that individuals must receive a majority of the votes cast in order to be elected as directors. A number of shareholder groups also recently have persuaded corporations and state legislatures to adopt provisions that would require director nominees to receive a majority of the votes cast (or a majority of all the votes that could be cast by all outstanding voting securities) in order to be elected. *See* Proposed Shareholder Empowerment Act, *supra* note 3, § 2; E. Norman Veasey, *The Stockholder Franchise Is Not a Myth: A Response to Professor Bebchuk*, 93 VA. L. REV. 811, 814 (2007) (citing, inter alia, ALLEN, *supra* note 82, at i–x); Posting of Rosanna Landis Weaver to RiskMetrics Group Risk & Governance Blog, http://blog.riskmetrics.com/2007/01/2007_preview_board_electionssu.html#more (Jan. 17, 2007) ("2007 Preview: Board Elections") (citing as examples from the 2007 proxy season Bank of America, Deere, General Electric, Kimberly-Clark, Lehman Brothers Holdings, Textron, Walt Disney, First Data, Schering-Plough, Zimmer Holdings, Chubb, Pitney Bowes, Humana, Qwest Communications, AT&T, Bristol-Myers Squibb, Lexmark, Cummins, and McKesson); ALLEN, *supra* note 82, at i (observing that states that have

voting in uncontested elections, these shareholder campaigns may achieve greater success);[108]

- Increased sophistication and organization of shareholders in voicing their concerns, positioning for negotiation and engaging media attention through focus lists, campaigns against directors, shareholder proposals, and proxy contests;[109]
- Increased media and public attention to governance issues due to a number of high-profile governance failures and scandals, and increased legislative and regulatory receptivity to the imposition of reforms;
- The trend in removing classified boards and other anti-takeover devices (as evidenced, for example, by the reduced rate of poison pill adoption and renewal);[110] and
- Lowered participation of individual shareholders in proxy voting due to e-proxies, which enhances the influence of institutional shareholders.[111]

Active shareholder engagement in governance issues by institutional investors—initially led by pension funds such as CalPERS, CalSTRS, TIAA-CREF, and the AF-SCME and AFL-CIO pension funds—has played a significant role in urging boards to become more active, engaged, and objective. Notorious corporate governance failures (Enron, Global Crossing, and WorldCom are a few widely cited examples) and the resulting legislative and regulatory response also has influenced boards in important respects. While the data is not definitive, there is evidence that focus by large, long-term shareholders and greater activation by independent boards is associated with better corporate performance.[112] The influence of large active and

addressed majority voting include California, Delaware, Nevada, North Dakota, Ohio, Utah, Virginia, and Washington, and noting that states that permit such contingent, irrevocable resignations include Delaware, Maine, Texas, Utah, and Virginia).

108. *See* Self-Regulatory Organizations, Exchange Act Release No. 34-0215, 74 Fed. Reg. 33293 (July 1, 2009), *available at* http://www.sec.gov/rules/sro/nyse/2009/34-0215.pdf.

109. *See* David J. Berger & Kenneth M. Murray, *As the Market Turns: Corporate Governance Litigation in an Age of Stockholder Activism*, 5 N.Y.U. J.L. & Bus. 207, 211 (2009) ("[H]edge funds and stockholder activists have also developed sophisticated public relations strategies to express their views to stockholders and to challenge boards. For example, Carl Icahn maintains a blog, and many of the most active hedge fund managers have developed relationships with the media, earning well-deserved reputations for giving colorful, newsworthy quotes." (footnote omitted)).

110. *See* Daniel A. Neff, Takeover Law and Practice 2008, at 15 (Fifth Annual Inst. on Corporate, Sec. & Related Aspects of Mergers & Acquisitions, New York, N.Y., 2008) ("[S]hareholder proposals to repeal staggered boards have become common in recent years, and the vast majority receive the support of a majority of the votes cast. . . . Currently only 35% of S&P 500 companies have a staggered board, according to SharkRepellent.net figures, down from almost 60% earlier this decade."); *see also id.* at 70 ("[R]ecent trends in shareholder activism, as well as the ability of a board to adopt a rights plan on short notice in response to a specific threat, have led to a marked decrease in the prevalence of [shareholder rights] plans. Today, perhaps 1,400 companies, including less than one-third of the S&P 500, have shareholder rights plans in effect.").

111. *See generally* Internet Availability of Proxy Materials, Exchange Act Release No. 34-5146, 72 Fed. Reg. 4148 (Jan. 29, 2007) (to be codified at 17 C.F.R. pts. 240, 249 & 274), *available at* http://www.sec.gov/rules/final/2007/34-5146fr.pdf.

112. *See* Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 Colum. L. Rev. 1283, 1297–98 (1998) (opining that "ambivalent results from empirical studies to date concerning the link between structural aspects of governance

long-term institutional investors has potential benefits for corporations, including through the development of closer board and shareholder relationships, and the potential for enhanced shareholder support during troubled times.

C. Potential for Divergent Interests Among Shareholders

U.S. institutional investors are not a homogenous or monolithic group. In addition to pension funds, which themselves are divided into public, union, and private funds, institutional investors include mutual funds, private investment funds (including hedge funds), insurance companies, banks, endowments, sovereign wealth funds, and other types of institutions, subject to regulation in varying degrees. Institutional investors are usually intermediaries who hold shares for the benefit of someone else. The insertion of financial intermediaries between the beneficiaries and stock ownership has been termed "separation of ownership from

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and corporate performance do not disprove a link between board activism and increased investor returns. Even in the face of ambiguous studies, we would conclude, without more, that Darwin's logic still carries—the performing board is the grain in the balance of survival in the long run, but significant quantitative effects have not yet been experienced. . . . [Our] hypothesis [is] that independent board activities are now working to enhance corporate performance."); Andrew Junkin & Thomas Toth, Wilshire Assocs. Inc., The "CalPERS Effect" on Targeted Company Share Prices 1 (2008), *available at* http://www.calpers-governance.org/docs-sof/focuslist/wilshire-rpt.pdf ("For the five years prior to the 'initiative date,' the Focus List companies produced returns that averaged 84.2% below their respective benchmarks on a cumulative basis, which is equivalent to an excess return of −30.9% per year on an annualized basis. For the first five years after the 'initiative date,' the average targeted company produced excess returns of 15.4% above their respective benchmark return on a cumulative basis, or about 3% per year on an annualized basis. The five year cumulative excess return of 15.4% is impressive, and is roughly the same as since-inception results presented last year. The data strongly show that CalPERS' involvement has generally stopped the rapid erosion of performance results."); *see also* Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach*, 10 U. Pa. J. Bus. & Emp. L. 833, 870 (2008) ("One study indicated that hedge fund activism may help the target company's operating performance in the long run, rather than hurt it; Brave [sic] et al., found that on average target companies experienced a 7% increase in stock price during the four weeks around the announcement that a hedge fund acquired a 5% stake, that the stock kept pace with the market for the next year, and that the stock's operating performance improved over the next two years." (citing Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. Fin. 1729, 1730 (2008)); *see also* Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. Chi. L. Rev. 289, 301 n.54 (2009) (collecting studies analyzing impact of activist shareholders on returns). *But see* Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 Colum. L. Rev. 1803, 1814–15 (2008) ("There have been innumerable studies examining the impact of board composition on performance, and the decisive balance of studies has found no relation between director independence and performance, whether measured by accounting or stock return measures. Similarly, most studies seeking to measure the impact on performance of shareholder activism through shareholder proposals find no significant stock price effect from that activity." (footnote omitted)); John F. Olson, *Reflections on a Visit to Leo Strine's Peaceable Kingdom*, 33 J. Corp. L. 73, 76 (2007) ("'Notwithstanding commentators' generally positive assessment of the development of such shareholder activism, the empirical studies suggest that it has an insignificant effect on targeted firms' performance. Very few studies find evidence of positive impact, and some even find a significant negative stock price effect from activism.'" (quoting Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 Yale J. on Reg. 174, 177 (2001)).

ownership,"[113] with managers and trustees of these funds facing potential conflicts of interest in managing fund assets that are similar to those that corporate executives and directors face. Aside from their common position as investment intermediaries, however, the various types of institutions have significant differences. They are subject to varying levels of regulation, often have different investment horizons and distinct investment strategies, and as a result have different levels of interest in the governance of the companies in their portfolios.[114]

Greater diversity among shareholders and their interests leads to heightened potential for divergent interests.[115] However, with certain specific exceptions, neither state corporate law nor the federal proxy rules distinguish between shareholders on the basis of their investment horizon, size of their shareholdings, or other idiosyncratic preferences.[116] Nor do state corporate laws or federal laws mandate a uniform set of goals, such as a long-term investment strategy, for shareholders.[117] "Discussions of shareholder voting often treat the 'shareholder' as a simple entity that maximizes return on investment. The real story is far more complex. Institutional investors, like the companies whose shares they own, are managed by managers who need watching and appropriate incentives. Moreover, the single phrase 'institutional investor' obscures important differences between institutions."[118]

An area of considerable difference among shareholders relates to variations in the time horizons of their investments:

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113. Strine, *supra* note 1, at 6–7 ("What I mean by this is that the equity of public corporations is often owned, not by the end-user investors, but by another form of agency, a mutual fund, or other institutional investor. It is these intermediaries who vote corporate stock and apply pressure to public company operating boards. I daresay that more American stockholders own equity in Fidelity- and Vanguard-controlled mutual funds than own stock in Microsoft or GE. But corporate law scholarship does not reflect that reality.").

114. *See infra* notes 119–35 and accompanying text.

115. *See* Anabtawi & Stout, *Fiduciary Duties for Activist Shareholders, supra* note 1, at 1258 ("Increasingly, the economic interests of one shareholder or shareholder group conflict with the economic interests of others. The result is that activist shareholders are using their growing influence not to improve overall firm performance, as has generally been assumed, but to profit at other shareholders' expense."); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. Rev. 561, 564–65 (2006) ("Once we recognize that shareholders have significant private interests, it becomes apparent that they may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class. As a result, transferring power from boards to shareholders will not necessarily benefit all shareholders. Indeed, it could reduce overall shareholder welfare. This outcome, of course, is the opposite of that predicted by proponents of increasing shareholder power.").

116. *See* Del. Code Ann. tit. 8, § 203 (2001 & Supp. 2008) (precluding would-be acquirors absent approval from the target's board from entering into business combinations with the target unless the acquirer obtains 85 percent or more of the target's stock in a first-step transaction); Coaxial Commc'ns, Inc. v. CNA Fin. Corp., 367 A.2d 994, 998 (Del. 1976) ("The statute does not distinguish between large and small stockholders, nor between those in accord with and those in opposition to existing management."); Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 814 (Del. Ch. 2007) ("I am reluctant to premise an injunction on the notion that some stockholders are 'good' and others are 'bad short-termers.'").

117. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 595–604 (1990) (describing conflicts of interests among various institutional shareholders).

118. *Id.* at 595–96.

- Insurance companies and public, private, and union pension funds tend to maintain a relatively long-term focus in their investment activities.[119] They recognize that their obligations to their beneficiaries, who rely on the funds for college educations and retirements, have a time frame that is often measured in decades.[120] They often invest significant portions of their portfolios to track market indexes, and the pension funds in particular tend to participate actively in analyzing governance issues on a company-by-company basis and in voting the shares of portfolio companies.
- Mutual funds tend to invest on a much shorter-term basis, with an average holding period of significantly less than two years.[121] Actively managed mutual funds turn their portfolios over on a much shorter basis. Mutual fund and money market performance is measured on a quarter-by-quarter basis. With significant market competition and readily available information on relative performance, mutual fund and money market managers tend to focus on straightforward "buy low and sell high" strategies and quarterly performance metrics in an effort to attract and retain investors.[122] With some exceptions, mutual funds tend not to invest significant monies in their analysis of corporate governance issues, but must disclose voting policies.[123] The result is that some mutual funds defer to proxy advisors to

119. *See* Anabtawi, *supra* note 115, at 580.

120. *See* Strine, *supra* note 1, at 4 ("These forced capitalists—in whose number I count myself—invest primarily for two purposes, both of which are long-term in focus: to send their children to college and to provide for themselves in retirement. This class of investors has no interest in quarter-to-quarter earnings fluctuations or gimmicks that deliver quick bursts of cash at the expense of sustainable growth.").

121. "In 'Flying With The Fundamentals,' which appeared in Better Investing Magazine in January 2006, [John C.] Bogle is quoted as saying that when he got into finance in 1951, mutual fund turnover hardly varied from 16% per year, representing an average holding period of six years. However, Bogle noted that in more recent years, the average holding period has fallen to between 11 and 13 months, representing a 92% turnover rate." Richard Loth, *Portfolio Turnover*, INVESTOPEDIA, http://www.investopedia.com/university/quality-mutual-fund/chp7-fund-activity/portfolio-turnover.asp (last visited Sept. 5, 2009); Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1232 (2008) (average annual share turnover for a public company is approaching 100%).

122. *See* Anabtawi, *supra* note 115, at 580 ("Investors in mutual funds can readily liquidate their shares at the market price of the funds' holdings. This liquidity, coupled with widespread availability of information on fund performance, has led to pressure on mutual fund managers to maximize short-term returns at the expense of any longer-term focus in order to attract and retain investors." (footnote omitted)); *see also* William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1093 (1999) (noting competition among mutual fund managers based on short-term ratings).

123. *See* Bainbridge, *The Case for Limited Shareholder Voting Rights, supra* note 1, at 629–30 (noting that "[e]ven the most active institutional investors spent only trifling amounts on corporate governance activism" and that "[b]ecause institutional investors generally are profit maximizers, they will not engage in an activity whose costs exceed its benefits"); *see also* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 33-188, 68 Fed. Reg. 6564, 6574 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270 & 274), *available at* http://www.sec.gov/rules/final/33-188.htm (adopting rules requiring a mutual fund "to disclose in its registration statement . . . the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities").

determine how to vote their shares and focus their resources on determining when to buy, hold, and exit (the "Wall Street Walk").[124]

- Hedge funds also tend toward short-term strategies,[125] with "a time horizon potentially measured in minutes."[126] Hedge funds often employ investment strategies that seek to unlock capital and increase immediate returns to shareholders by pressing boards to pay more frequent, larger, or special dividends, to undertake stock repurchases, or to pursue other strategies for a near-term liquidity event due to investment criteria that differ from the longer-term interests of other shareholders.[127] Such pressures are perceived by some commentators to have caused some companies to have taken on undue leverage—leverage that they are unable to support in the current financial slowdown.[128] Note, however, that not all private unregulated investment funds should be labeled "hedge funds" insofar as their investment horizon may be measured in years, not months, even though they may be more willing than other kinds of long-term investors to pursue activist strategies.

Focus on short-term stock market returns is perceived to pressure corporations to forego corporate investment in the long-term strategies that are critical to sustainable performance. Many large public companies, institutional investors (including the California Public Employees' Retirement System, TIAA-CREF, and the AFL-CIO), industry groups (such as the Council of Institutional Investors and the Business Roundtable), and corporate governance professionals have subscribed to the Aspen Principles, which call for investors and corporations to focus on

124. Shortly after Berle and Means wrote their treatise, mutual funds turned their portfolios over at an approximate annual turnover rate of 15 percent. Recently, however, the annual turnover rate has reached 100 percent. *See* Bogle, *supra* note 92, at 33; Loth, *supra* note 121.

125. *See* Anabtawi, *supra* note 115, at 579–80 (exploring short-term perspective and strategies of hedge funds); Strine, *supra* note 1, at 5 (same).

126. Damon Silvers, *Commentary on "Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance" by Leo E. Strine, Jr.*, 33 J. Corp. L. 85, 87 (2007).

127. *See* Anabtawi, *supra* note 115, at 581–83 (describing specific investment strategies employed by hedge funds); William W. Bratton, *Hedge Funds and Governance Targets*, 95 Geo. L.J. 1375, 1379 (2007) (same); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1092 (2007) ("The interests of hedge funds sometimes diverge from those of their fellow shareholders, and activism creates stress fractures for the regulatory system. The most serious accusation leveled against activist funds, however, is that activism is designed to achieve a short-term payoff at the expense of long-term profitability."); Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 Va. L. Rev. 733, 746–47 (2007) (noting short-term perspective of hedge funds, and resulting conflict with longer-term growth and perspective of the corporation); *see also* Letter from Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, to Hon. Edward E. Kaufman 1 (Sept. 2009), *available at* http://kaufman.senate.gov/imo/media/doc/9-10-09%20Schapiro%20Response.pdf ("The interests of long-term investors and professional short-term traders in fair and efficient markets will often coincide. Indeed vigorous competition among professional short-term traders can itself lead to very important benefits for long-term investors, including narrower spreads and greater depth. If, however, the interests of long-term investors and professional short-term traders conflict, the . . . Commission's focus must be on the protection of long-term investors.").

128. *See generally supra* note 88.

long-term wealth creation and avoid the short-term pressures that result from an emphasis on quarterly results and minute-by-minute stock price movements.[129]

Aside from the potential differences related to investment time frames and investment strategies, most shareholders have other divergent interests: Hedge funds and derivative holders may vote primarily to promote their specific investment strategies.[130] Corporate pension funds may vote in support of other corporate boards and managers.[131] Some equity holders may also be debt holders, and may seek to influence portfolio companies to take actions favorable to the debt they hold. Union pension funds may have incentives to use their shareholder power to press for their members' interests.[132] Public pension funds may be influenced by

129. *See* Aspen Inst., Long-Term Valuation Creation: Guiding Principles for Corporations and Investors §§ 1–3 (2007), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/business%20and%20society%20program/FINALPRINCIPLES.pdf. *Accord* Aspen Inst., Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management 3–5 (2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf (advocating (1) changes in tax policy to encourage longer-term share ownership; (2) enhanced fiduciary duties for financial intermediaries and investment advisers to encourage longer-term investments consistent with the interests of beneficiaries and clients; and (3) greater transparency regarding the positions and plans of investors).

130. The assumption that all shareholders will exercise their voting rights to enhance corporate value is under question. *See* Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 815 (Del. Ch. 2007) (addressing possibility that special committee may have put shares in the hands of short sellers, and potential consequences of same upon an evaluation of whether fiduciary duties were fulfilled); Anabtawi, *supra* note 115, at 590–91 (describing differences in hedged versus unhedged shareholders, and citing the example of Mylan Laboratories' acquisition of King Pharmaceuticals); Kahan & Rock, *supra* note 127, at 1070–71 ("Although hedge funds hold great promise as active shareholders, their intense involvement in corporate governance and control also raises some concerns. Hedge funds are set up to make money for their investors without regard to whether the strategies they follow benefit shareholders generally."); Stout, *The Mythical Benefits of Shareholder Control, supra* note 1, at 794 (describing the "especially troubling situation" of an "investor who takes a position in a stock and uses his voting power to push for business strategies that increase the value of another security the investor also holds," and citing the example of Perry Capital's pressuring of the board of directors of Mylan Laboratories to acquire King Pharmaceuticals).

131. *See* K.A.D. Camara, *Classifying Institutional Investors*, 30 J. Corp. L. 219, 241 (2005) ("Corporate pension funds are concerned not only with maximizing shareholder value, but also with all those things with which corporate management is concerned. For example, corporate pension funds can be expected to prefer managerial insulation from the market for corporate control, large managerial compensation packages, costly acquisitions over which managers will then enjoy control, and so forth. Sympathy, understanding, and reciprocal voting encourage this concern when the shares a corporate pension fund votes are those of an unrelated corporation. Senior management feels enough of a connection and has enough hope of reciprocation to look out for other members of the group."); Black, *supra* note 117, at 596–98 (describing pressure on corporate pension funds and their managers to vote pro-manager).

132. *See* Anabtawi, *supra* note 115, at 590 ("Union pension funds, however, often also have an interest in furthering the special labor interests of union members, even at the expense of shareholder wealth. For example, a union pension fund might be seeking union recognition or desire concessions in collective-bargaining negotiations." (citing Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 Comp. Lab. L. & Pol'y J. 97, 114 (2000))); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 Harv. L. Rev. 1759, 1765 (2006) ("Those institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest.").

the politics of their jurisdiction.[133] Sovereign wealth funds also may be subject to broader political, social, or national security concerns.[134]

Diversity in shareholder interests is not new. However, shareholders are no longer primarily diffuse and powerless individuals, and a common interest in the long-term performance of the corporation can no longer be assumed to override other interests so as necessarily to result in decisions congruent with the objectives of corporate long-term value creation. Shareholders may also lend or rent their shares to others, and the rise in recent years of unregulated securities lending and derivatives markets[135] that can mimic both long and short positions makes it difficult to assume that a shareholder is acting out of an interest shared broadly by other shareholders. Shareholders' motives and even identities are often opaque to both the investing public and the corporation's fiduciaries.

Diversity in shareholder interests, combined with the lack of transparency about motives, ownership, and voting exercise, presents significant challenges to boards of directors of the modern U.S. public corporation. At the same time, however, diversity of shareholder interests also helps keep markets liquid.

V. Observations and Recommendations

A. Observations

Significant governance reforms are currently under consideration by Congress and the SEC, spurred by events leading to the financial crisis. Renewed concern that our society is deeply dependent on the continued health and viability of corporations for economic growth has heightened the scrutiny of current corporate

133. See Anabtawi, *supra* note 115, at 588–89 ("The combination of the broad investment discretion accorded to, and the composition of, their boards of trustees, makes public pension funds vulnerable to pressure by other state officials. As Roberta Romano has argued, there is widespread political pressure on public funds to engage in 'social investing'—investments that foster in-state economic development." (quoting Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum. L. Rev. 795, 801, 803 (1993))).

134. *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 Stan. L. Rev. 1345, 1351 (2008) ("The other face of foreign sovereign equity investments is the source of the controversy. Viewed from this side, national security concerns anchor one end of a continuum of issues concerning when the interests of a foreign government may differ from those of an ordinary shareholder."); *see also* Bob Davis, *U.S. Pushes Sovereign Funds to Open to Outside Scrutiny—Treasury Has Talks with Abu Dhabi, Seeks Set of Rules*, Wall St. J., Feb. 26, 2008, at A1 (discussing U.S. Treasury Assistant Secretary Clay Lowery's suggestion that "sovereign-wealth funds that choose to vote their shares when they take noncontrolling stakes in U.S. companies should disclose how they voted"). *But see* Matthew A. Melone, *Should the United States Tax Sovereign Wealth Funds?*, 26 B.U. Int'l L.J. 143, 169–70 (2008) (noting that "there is little evidence to date that would suggest sovereign wealth funds have actively sought to pursue a political agenda").

135. *See* American Clean Energy and Security Act, H.R. 2454, 111th Cong. (2009); *Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks: Hearing Before the Subcomm. on Securities, Insurance & Investment of the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. (2009) (statement of Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n), *available at* http://www.sec.gov/news/testimony/2009/ts062209mls.htm (discussing regulation of over-the-counter derivatives); Letter from Timothy F. Geithner, Sec'y, U.S. Dep't of the Treasury, to Hon. Harry Reid, U.S. Senator (May 13, 2009) (same), *available at* http://www.financialstability.gov/docs/OTCletter.pdf.

governance practices. The Task Force believes that the following observations are relevant to current and potential reform discussions:

- The traditional delineation of distinct roles and responsibilities of shareholders and boards of directors in the modern public corporation, as developed primarily through state corporate law, has helped position the U.S. public corporation as a powerful economic engine for the creation of wealth over the long term.
- Shareholders and boards of U.S. public companies have become increasingly active and engaged in their roles. Generally, this increased engagement has been a positive development, and is consistent with the traditional distinction in roles and responsibilities.
- While tensions between the roles and, in particular, the decision rights of shareholders and boards are apparent, to date the roles and responsibilities have not shifted to any significant degree.
- Effective corporate governance requires responsible conduct and informed judgments from shareholders and boards.
- Effective corporate governance also requires respect for the distinct roles of shareholders and boards in corporate decision-making.

We note that many reforms proposed to date do not appear, by their own terms, to involve a direct shift of decision-making authority between shareholders and boards of directors. (However, some might say that proposals that impose new governance rules in areas that have long been discretionary work a shift of authority from shareholders and boards to legislators and regulators.)[136] We also note that direct shifts of decision-making authority from boards to shareholders would need to be reconciled with the board's responsibility for the management and direction of the corporation and any implications for fiduciary obligations associated with such decision-making. Even for reforms that fall short of working a direct shift in decision-making authority, policymakers should be sensitive to how reforms will work in practice.

Overall, shareholder power and influence has increased with the growth of institutional investors and increased interest and involvement by institutional investors. More communication and negotiation is taking place between shareholders and boards, and boards are developing greater sensitivity to the interests and concerns of shareholders. It is critical that policymakers, boards, managers, and investors work together to understand one another's interests and challenges, with a goal of channeling enhanced shareholder communication to promote the long-term best interests of the corporation. Taking hardened positions and demonizing other viewpoints should be eschewed in the governance dialogue.

Shareholders' interests in the enhancement of corporate value deserve protection—whether from board and management deviation from fiduciary obligations or

136. *See* Proposed Shareholder Bill of Rights Act, *supra* note 3, § 5 (requiring each issuer to "provide in its governing documents that each member of the board of directors of the issuer shall be subject to annual election by the shareholders"); *see also supra* note 3 (discussing other recently proposed reforms).

from the self-interested actions of fellow shareholders. Shareholder rights to elect the board and make other fundamental decisions should be meaningful. Given the increased power of shareholders and the successful negotiations that many shareholders and boards have undertaken, reform efforts should be aimed at encouraging communication and negotiation between boards and shareholders on key issues, while also ensuring boards retain the authority and ability to carry out their responsibilities.

The current state law framework that gives the board authority for the business and affairs of the corporation within a framework of fiduciary duties owed to shareholders creates an efficient decision-making structure for engaging in entrepreneurial actions for the benefit of the equity providers and ultimately our economy at large. Boards play a key role in balancing a variety of interests to determine what actions are in the best interests of the corporation and its shareholders, through their authority to manage and direct the affairs of the corporation. That authority includes determining:

- How short-term considerations (such as dividend payments and other efforts to return immediate value to shareholders) are best balanced with the long-term investments (such as R&D and brand development) necessary for sustainable wealth creation;
- What strategies and courses of action are in the best interests of the company and its shareholders;
- Which managers are suited to implement these tasks and how best to incentivize them;
- How to balance the interests of employees, suppliers, customers, and other constituents who are critical to long-term corporate success; and
- How to manage competing interests and viewpoints of various shareholders.

If the board is to perform its role, board flexibility and discretion to hire, motivate, guide, and oversee the managers to whom they delegate deserve protection.

Divergent shareholder interests complicate the board's task. Boards face challenges in addressing a variety of shareholder interests, often under pressures from a vocal subset of shareholders, and yet directors as fiduciaries must apply their own judgment based on their unique vantage point to act in what they believe to be the best interests of the corporation and the entire body of shareholders. As to this latter point, the board of directors must assess whether the views of one or a subset of shareholders are widely shared and even when views appear widely shared, as when a majority of shareholders votes in a similar way, whether the views underlying the votes are indeed similar. For example, some shareholders may vote to support a particular non-binding shareholder proposal because they have assessed the matter and believe it is in their and the company's interests. Others may be following, by rote, a set of voting recommendations that are based on views of governance practices generally rather than on company-specific considerations.

The board is required to apply its own business judgment as a fiduciary to issues that—as a matter of law—it and not the shareholders must decide. Applying fiduciary judgment in the face of apparently strong shareholder opinions is a particular challenge, given that failure to abide by majority shareholder wishes on non-binding shareholder proposals may lead powerful proxy advisors to recommend votes against directors the following year. (Some proxy advisors will change vote recommendations if the board takes action to reverse or amend a policy, often within days of the annual meeting and after many shareholders have voted.) From a practical standpoint, the power of proxy advisor recommendations in this respect—a power that is linked to the large number of mutual fund and other clients that have little incentive to invest in forming their own judgments on a company-specific basis—has the potential to change non-binding "advisory" shareholder proposals into mandates for which the board continues to bear responsibility.

Boards should be especially sensitive to the promotion of special interests not shared by the entire shareholder body (for example, pressures by short-term speculators to take actions that might return cash in the near term but leverage the company to the detriment of shareholders in the long term). Boards also need to consider the range of potential governance practices and structures and the rationales underlying such practices and structures, adopting improvements that are appropriate for the company given its circumstances but resisting those that, though popular, are not appropriate in the board's judgment.[137]

The growth of proxy advisory firms—like that of institutional shareholders—is neither inherently good nor bad.[138] Certain institutional shareholders owe a duty to their beneficiaries that requires that they exercise the vote associated with the shares they hold and that reliance on outside advisors be reasonable.[139] These

137. *See* NACD, *supra* note 66, at 8 ("A variety of structures and practices may support and further effective governance. Boards should tailor governance structures and practices to the needs of the company in a pragmatic search for what is most effective and efficient. Governance best practices should be adopted thoughtfully, and not by rote reliance on the recommendations posited by any entity or group.").

138. "Critics of proxy advisory firms, including certain industry associations and academics, contend that the proxy advisory industry suffers from significant conflicts of interest and a lack of competition and that these firms have a disproportionate influence on proxy voting. Others counter that the firms provide a valuable service for institutional investors and note that such clients are sophisticated market participants that are free to choose whether and how to employ the services of proxy advisory firms." U.S. Gov't Accountability Office, Corporate Shareholder Meetings—Issues Relating to Firms that Advise Institutional Investors on Proxy Voting 2 (2007), *available at* http://www.gao.gov/new.items/d07765.pdf; *see also* Strine, *supra* note 1, at 5–6 (discussing the business model of the proxy advisory industry including economic pressures for continued governance reforms).

139. *See* 29 U.S.C. § 1104(a) (2006) (imposing fiduciary duties, including those of loyalty and prudence, on fiduciaries of employee benefit plans subject to ERISA); *supra* note 89; Proxy Voting by Investment Advisers, Securities Act Release No. 33-188, 68 Fed. Reg. 6585, 6586 (Jan. 31, 2003) (to be codified at 17 C.F.R. pt. 275), *available at* http://www.sec.gov/rules/final/ia-2106.htm#P44_4185 ("The federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients. Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own." (footnotes omitted)); Aspen Inst., Overcoming Short-Termism, *supra* note 129, at 5 ("greater shareholder power as encapsulated in legislative proposals under consideration in the 2009 legislative session . . . should be accompanied by greater investor and intermediary responsibility").

institutions should use diligence in selecting proxy advisors, including assessing whether such advisors have appropriate capacity to undertake case-by-case analysis rather than rely on set prescriptions in providing voting advice.

Finally, the Task Force recognizes that policymakers and regulators are under pressure to provide an effective regulatory framework as a backstop against the next potential crisis and to renew investor confidence. Reforms designed to strengthen the long-term orientation of shareholders, boards, and managers and to provide greater transparency should be imposed without shifting the fundamental balance of rights and obligations between shareholders and boards in ways that might alter the long-term viability of the U.S. corporation as the preferred vehicle for investment.

B. Recommendations

Shareholders, boards, and the executives to whom they delegate management authority and those involved in legislative and regulatory reform initiatives should give special consideration to the long-term nature of corporate wealth-generating activity and strive to avoid undue short-term focus and pressures that may impede the capacity of the corporation for long-term investments and decisions necessary for sustainable wealth creation.[140] All parties also are encouraged to recognize both the challenges posed and the values contributed by the current ordering of governance relationships in the U.S. publicly traded corporation under state law.

1. *We recommend that shareholders:*

- *Act on an informed basis with respect to their governance-related rights in the corporation, and form company-specific judgments regarding such matters while taking into account their own investment goals*. This should include avoiding reliance on rigid "check the box" approaches to governance issues. Institutional investors who rely on others to advise them on governance matters should critically assess advisors' analytic capabilities, resources, and potential conflicts of interest.
- *Apply company-specific judgment when considering the use of voting rights and contested elections to change board composition*. Director elections, particularly in the context of a majority vote regime, are powerful tools for holding boards accountable and should be used with consideration for the fiduciary obligations of the board. Shareholders should consider carefully the circumstances in which a board decision not to implement an advisory (or precatory) shareholder resolution—or to follow a particular governance practice—should give rise to a campaign to withhold votes or vote against directors.

140. *See* Aspen Inst., *supra* note 129, § 1.2 ("In pursuit of long-term value creation, companies and investors should . . . [r]ecognize that firms have multiple constituencies and many types of investors, and seek to balance these interests for long-term success.").

- *Consider the long-term strategy of the corporation as communicated by the board in determining whether to initiate or support shareholder proposals.* Investors should favor a tailored governance approach that is tied to the individual corporation's long-term goals and objectives.

2. *We recommend that boards:*

- *Embrace their role as the body elected by the shareholders to manage and direct the corporation by: (a) affirmatively engaging with shareholders to seek their views; (b) considering shareholder concerns as an important data point in the development and pursuit of long-term corporate strategy; and (c) facilitating transparency by ensuring that shareholders are informed of the company's efforts toward achieving its identified long-term goals and objectives.* Boards (and managers) should recognize that promoting a high level of transparency and communication about long-term strategies should support the near-term value of the corporation to the benefit of both short-term and long-term investors. Boards may need to become more active in working with and encouraging corporate management to revamp shareholder communication efforts.
- *Acknowledge that, at times, the company's long-term goals and objectives may not conform to the desires of some shareholders, and be prepared nevertheless to explain board decisions to pursue such goals and objectives to shareholders and the market.* Boards should take seriously their responsibility to act in the long-term best interests of the corporation and the shareholding body as a whole—no matter how challenging it may sometimes be to balance divergent interests—and be prepared to explain their decisions on a principled basis.
- *Disclose with greater clarity how incentive packages are designed to encourage long-term outlook and to reward steps toward achieving long-term strategies while discouraging unduly risky behavior.* Boards should assess their compensation approach in connection with the company's strategic objectives and risk appetite.

3. *We recommend that policymakers and regulators:*

- *In the context of reform initiatives, understand the rationale for the current ordering of roles and responsibilities in the corporation and assess the impact of proposed reforms on such ordering.* Reform discussions should include an assessment of how the distinct interests of long-term and short-term shareholders will likely be affected, with special care taken to ensure that short-term shareholders are not unduly enabled to take actions that could undermine the long-term interests of the corporation and other shareholders. Consideration should also be given to whether a proposed reform is likely to change decision rights to a degree that the accountability mechanisms associated with such decisions would also need adjustment.
- *Carefully consider how best to encourage the responsible exercise of power by key participants in the governance of corporations so as to promote long-term value creation.* Boards, managers, institutional shareholders, and proxy ad-

visors all need to be encouraged to act responsibly. We note in this regard the work of the OECD and investor groups such as ICGN on shareholder responsibility.[141] Encouraging shareholder interest in long-term investment, for example by rewarding long-term holding through tax incentives and potentially enhanced voting rights, is worth exploring. The focus of the Aspen Principles on metrics, communications, and compensation for sustainable long-term value creation provides a foundation for consideration. (Also, we note that while it is difficult to set absolute parameters for what constitutes long-term investing, it should be longer than a quarter, a year, or even eighteen months.)

- *Ensure that there is equal transparency of long and short, and direct and synthetic, equity positions of shareholders.* Consideration should be given to expanding the coverage of disclosure obligations of securities holders, including disclosure of security lending.

We all have a keen interest in finding ways to restore investor confidence while positioning the corporation to undertake the actions that will create sustainable long-term value creation. While the pressures for regulatory solutions are considerable and understandable given the circumstances, caution is prudent with respect to the corporate institution around which so much of our economy is organized.

141. *See* Org. for Econ. Co-operation & Dev., OECD Principles of Corporate Governance 37 (2004), *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf (advocating disclosure of corporate governance and voting policies of institutional investors acting in a fiduciary capacity); Int'l Corporate Governance Network, ICGN Statement of Principles on Institutional Shareholder Responsibilities 4 (2007), *available at* http://www.icgn.org/files/icgn_main/pdfs/best_practice/inst_share_responsibilities/2007_principles_on_institutional_shareholder_responsibilities.pdf (setting forth ICGN's "view of the responsibilities of institutional shareholders both in relation to their external role as owners of company equity, and also in relation to their internal governance").