Will a New Paradigm for Corporate Governance Bring Peace to the Thirty Years' War

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The decades-long conflict that is currently raging over short-termism and activist hedge funds strikes me as analogous to the Thirty Years' War of the 17th Century, albeit fought with statistics ("empirical evidence"), op-eds and journal articles rather than cannon, pike and sword. I decided, after some thirty-six years in the front line of the army defending corporations and their boards, that pursuing the thought might result in an essay more interesting (and perhaps a bit more amusing) than my usual memos and articles.

In 1618, after two centuries of religious disputation and tenuous co-existence, the ascension of the staunchly partisan Ferdinand II as Holy Roman Emperor sparked a revolt that disrupted the balance of power in Europe and began the Thirty Years' War. The War quickly involved the major powers of Europe. The conflict resulted in the Peace of Westphalia and the redrawing of the religious and political map of Europe, a new paradigm for the governance of Europe.

In 1985, a century of disputation as to the roles of professional management, boards of directors and shareholders of public companies similarly resulted in the disruption of the balance of power and general prosperity. In the two decades immediately preceding 1985, corporate raiders had perfected the front-end-loaded, two-tier, junk-bond-financed, bust-up tender offer, using tactics such as the "Highly Confident Letter" to launch a takeover without firm financing, "greenmail" (accumulating a block of stock and threatening a takeover bid unless the target company repurchases the block at a premium to the market) and litigation attacking protective state laws. Public companies did not have sufficient time or means to defend against corporate raiders. The battles culminated in two key 1985 decisions of the Delaware Supreme Court that restored the balance of power between boards of directors and opportunistic shareholders. In the Unocal case, the court upheld the power of the board of directors to reject, and take action to defeat, a hostile takeover bid, and in the Household case, it sustained the legality of the poison pill, which I had introduced three years earlier in an effort to level the playing field between corporate raiders and the companies they targeted.

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As in the religious wars of the 17th Century, the corporate governance wars of the modern era are being fought by the corporate raiders with the blessing of the academic bishops of economics and of law—with the "Chicago School of Economics" and the law school of the University of Chicago being the most prominent. In 1970, Chicago Professor Milton Friedman *ex cathedra* announced that the sole purpose of the business corporation was to maximize profits for shareholders and Chicago Professor Eugene Fama supplemented that doctrine with the Efficient Market Theory, enabling the argument that profits were to be maximized in the short term. In addition to the Chicago law professors, Harvard and Columbia law professors quickly embraced the Chicago School of Economics. To supplement the doctrinal arguments, Adolf Berle's 1932 concern about professional management's fidelity to shareholders was embraced by Harvard Professor Michael Jensen in a widely cited 1976 article enshrining the theory of agency cost as necessitating curbing the power of management and boards. See Michael Jensen and William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*. It should be noted that in 2001 Professor Jensen reformulated his thinking and proposed an "enlightened stakeholder theory," one that "accepts maximization of the long-run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders." See also Michael Jensen, *Agency Costs of Overvalued Equity*, March 2005. For an excellent review of the evolution of the doctrinal arguments, see Steven Pearlstein, *Social Capital, Corporate Purpose and the Revival of American Capitalism* Brookings, January 2014 ("In the recent history of bad ideas, few have had a more pernicious effect than the one that corporations should be managed to maximize 'shareholder value'"). For a similar view of an investment manager see James Montier, *The World's Dumbest Idea*, December 2014.

Until my 1979 article, *Takeover Bids in the Target's Boardroom*—setting forth the proposition that the board of directors has the power to exercise its business judgment to reject a hostile takeover bid—there had been scant judicial decisions or academic articles in support of this position. Immediately upon its publication, the pontification of academics led by professors at Chicago and Harvard screamed blasphemy in a five-year frenzy of articles in the leading law journals and economics journals. With the 1985 endorsement of my legal theories and poison pill, the thirty-years' corporate governance war began. It is still going strong, although a peace may be in sight.

But, I get ahead of myself. In 1985, armed with economic theories, statistics and the cry of "shareholder democracy," the prelates and armies of shareholder-centric governance took up pulpits and arms and began their campaign to defy practical experience and reject the views of the people to whom we look not just to manage our great public business corporations, but to manage them in a manner designed to achieve the kind of success that leads to growth of the value of their businesses and their shares and the concomitant growth of GDP and the Nation's economy over the long term.

In 1985, Jesse Unruh, Treasurer of the State of California, and Jay Goldin, Comptroller of the City of New York, both consummate politicians, gathered a group of public and union pension funds to create the Council of Institutional Investors (CII). Their council sought to strengthen the hand of pension funds and other institutional investors in curbing use of the poison pill and other methods of defeating hostile tender offers and to increase the role of shareholders in determining the strategy and the management of business corporations. Concurrently, a brigade of mercenaries—Institutional Shareholder Services (ISS)—was formed to sell advice to institutional shareholders as to how to vote on corporate governance practices and corporate transactions. Ever since, ISS has been allied with CII and has routinely supported corporate governance proposals approved by CII and designed to promote shareholder-centric governance.

Also in 1985, the Securities and Exchange Commission galloped to the aid of the corporate raiders, arguing in an *amicus curiae* brief in the <u>*Household*</u> case that the poison pill was contrary to the principles underlying the Williams Act because it would, according to the SEC, deprive shareholders of the opportunity to consider "virtually all" tender offers. While unsuccessful in its attempt to nullify the poison pill, the brief foretold the SEC's central role in increasing federal interference in corporate governance during the next thirty years. In large measure, the fundamental battle of the war has been resistance to the fast-marching federalization of corporate governance at the expense of traditional state law.

In 1992, the SEC shifted the battlefront to the proxy rules, adopting amendments to permit a dissident's proxy card to include a short slate of director candidates, thus removing what was previously a major impediment to gaining minority representation on a company's board. The 1992 amendments also newly permitted the private solicitation of an unlimited number of shareholders without making any public disclosure, so long as the person making the solicitation does not ask for a proxy. By permitting shareholders to privately lobby other shareholders, the SEC made it possible for the outcome of matters presented to a shareholder vote to be effectively decided in private, out of view of both the corporation and other shareholders.

In the wake of the Enron and WorldCom corporate scandals in 2001 and 2002, Congress and the SEC again increased federal regulation of corporate governance. Passage of the Sarbanes-Oxley Act in 2002 imposed new standards of director independence, management accountability and governance. At the same time, the SEC used the national stock exchanges as instruments to further regulate corporate governance. At the behest of the SEC, in 2002-2003, the New York Stock Exchange and NASDAQ approved corporate governance standards regarding director independence, audit committee expertise requirements and a mandate that each listed company establish and disclose corporate governance principles and a code of business conduct and ethics.

Just as Congress, the SEC and the national stock exchanges were changing corporate governance to increase the power of shareholders, it was also becoming easier and more attractive for ERISA plan investment managers and other institutional investors to outsource proxy voting to outside firms such as ISS. The Department of Labor in 1994 ordered that ERISA plan investment managers with voting authority must vote on proxy issues—and, in doing so, must vote in the economic interests of the plan participants. However, regulatory guidance was unclear as to whether these investment managers could vote in the long-term economic interests of plan participants, leaving the managers unsure as to whether they retained discretion to reject an immediate premium in a takeover or activist situation in favor of management's plan for long-term growth. Faced with this uncertainty and the economic burden of voting small holdings in a large number of companies, many ERISA plan investment managers began outsourcing their proxy voting decisions to proxy advisory firms. The watershed was reached in 2003, when the SEC took the position that institutional investors may discharge their duty to vote in their clients' best interests by voting in accordance with predetermined policies and the recommendations of independent third parties such as proxy advisors. At the same time, the SEC began requiring institutional investors to disclose how they vote on proxy issues. Taken together, these actions increased the pressure on institutional investors to follow the recommendations of proxy advisory firms.

While the SEC has been active during the past thirty years in creating new regulations aimed at managing corporate governance, it has been reluctant to act in areas that facilitate activist attacks on companies. In 2011, my firm submitted a rulemaking petition to shorten the reporting deadline and expand the definition of beneficial ownership. We believe that the 10-day reporting lag after crossing the 5% ownership reporting threshold and the current narrow definition of beneficial ownership facilitate market manipulation and abusive tactics. The SEC has never responded to this rulemaking petition, despite having previously acknowledged the shortcomings of the current reporting regime.

The SEC's reluctance to act to restrain the questionable tactics of activists and the ability of activist hedge funds to marshal the voting power of institutional investors is consistent with its long-held view that the involvement of activists is not a trend to guard against. Thus, in 2013, Mary Jo White, Chair of the SEC, commented that the negative perception of activists was not shared by the SEC. Last year, the SEC remained silent in the face of allegations that an activist investor had violated insider trading laws. In the midst of the 2014 hostile bid launched by Valeant Pharmaceuticals and Pershing Square Capital Management to acquire Allergan, Allergan filed a lawsuit alleging that Valeant and Pershing Square violated insider trading laws by acquiring Allergan shares just before Valeant launched a tender offer. A federal judge decided that Allergan had raised "serious questions" about whether insider trading had been committed in connection with the hostile bid. Nonetheless, the SEC did not take any action in response to the allegations or the court's decision.

The impact of these developments is reflected in the growth of "wolf packs." Wolf packs are loose networks of activist shareholders who act alongside one another, but not in such close coordination that they would be viewed as a "group" for purposes of SEC disclosure rules. By skirting "group" status, these wolves can secretly join together to bring down big prey, subtly (or not so subtly) signaling their portfolio positions to one another. Together, they can quietly accumulate significant blocks of a company's stock much more cheaply than if earlier disclosure were required, and can do so without the targeted company learning of the accumulation in time to effectively mitigate the impact through defensive action. Equally significant from a policy standpoint is that these tactics permit accumulation of commanding blocks of stock from unsuspecting shareholders who sell at uninformed market prices.

Over the past thirty years, the net effect of legislative and regulatory actions has been to create an environment in which the corporate governance of public companies is highly regulated and there is little or no restraint on the tactics employed by activist hedge funds. Institutional investors are encouraged to outsource oversight of the corporations in their portfolios to activist hedge funds and proxy advisory firms such as ISS. This has weakened the ability of boards and managers to defend the corporation against activist attacks. Indeed, in order to lower their profile to activists trolling for targets, many public corporations have reduced capital expenditures, research and development, employee training and steady employment—the true drivers of long-term growth.

What has this thirty-years' corporate governance war wrought? A long-term oriented, well-functioning and responsible private sector is the country's core engine for economic growth, national competitiveness, real innovation and sustained employment. Prudent reinvestment of corporate profits into research and development, capital projects, steady employment and employee training and other value-creating initiatives furthers these goals. Yet U.S. companies, including well-run, high-performing companies, increasingly face (1) pressure to deliver short-term results at the expense of long-term value, whether through excessive risk-taking (for example, subprime mortgages), avoiding investments that have long-term horizons or taking on substantial leverage to fund buybacks and special payouts to shareholders; (2) challenges in trying to balance competing interests due to excessively empowered special interest and activist shareholders; and (3) significant strain from the misallocation of corporate resources and energy into mandated activist or governance initiatives that provide no meaningful benefit to investors or other critical stakeholders. Much of what is wrong with America today—slow growth, wide-spread corporate scandals, inadequate investment in long-term projects, low wages that have not kept pace with inflation, wide swings in the economy accompanied by uncertain employment and rising inequality—is attributable to short-termism and attacks, and threats of attacks, by activist hedge funds.

Although there is no single solution to these problems, the following perspectives and actions may help to restore a more reasonable balance: (1) recognition that the proper goal of good corporate governance is creating sustainable value for the benefit of all stakeholders, rather than reflexively placing more power in the hands of activist hedge funds or often-transient institutional shareholders who are themselves measured and compensated by short-term, quarterly portfolio performance, and are themselves generally agents and subject to misaligned incentives; (2) resistance to the push for legislation, regulations or agency staff interpretations that place more power in the hands of activist hedge funds and other investors with short-term perspectives that weaken the ability of corporate boards to resist short-term pressures; and (3) inclusion in any new legislation or regulation of appropriate protections to companies, as opposed to focusing only on new rights for shareholders who already have excessive leverage with which they are pressuring companies.

Finally, in the thirtieth year of the corporate governance war, two developments give hope that we may be seeing a means for shareholders to deal with poorly performing corporations without outsourcing oversight to activist hedge funds and ISS.

First, there have been two important studies by prominent economists and law professors, each of which points out serious flaws in the so-called empirical evidence used to justify short-termism, attacks by activist hedge funds and shareholder-centric corporate governance: Yvan Allaire and Francois Dauphin, *The Game of 'Activist' Hedge Funds: Cui bono?*, August 2015, and John C. Coffee, Jr. and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, September 2015. These new studies show that the so-called empirical evidence omits important control variables, uses improper specifications, contains errors and methodological flaws, suffers from selection bias and lacks real evidence of causality. In addition, these new studies show that the so-called empirical evidence ignores real-world practical experience and other significant empirical studies that reach contrary conclusions. These deficiencies were earlier noted in *The Bebchuk Syllogism*, August 2013.

Second, several major institutional investors have realized that while an activist attack on a company might produce an increase in the market price of one portfolio investment, the defensive reaction of the other hundreds or thousands of companies in the portfolio, that have been advised to "manage like an activist," has the potential of causing not only a large percentage of those companies to have lower current trading prices, but a large net decrease in the total value of the portfolio over the long term. Laurence Fink, CEO of BlackRock, the world's largest money manager, in a recent letter to S&P 500 CEOs said, "More and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth." Similarly, in a recent speech, William McNabb, CEO of Vanguard, said, "And, remember, when it comes to our indexed offerings, we are permanent shareholders. To borrow a phrase from Warren Buffett: 'Our favorite holding period is forever.' We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits. In other words, we're big, we don't make a lot of noise, and we're focused on the long term. That is *precisely* why we care so much about good governance. Vanguard funds hold companies in perpetuity. We want to see our investments grow over the long term. We're not interested in managing the companies that we invest in. But we do want to provide oversight and input to the board of directors. And we count on boards to oversee management."

BlackRock, Vanguard, and State Street, as well as a number of other major institutional investors, are saying that their support for the long-term plans of a company and their support of its management against activist attacks are conditioned on their satisfaction (1) that the long-term plans have been carefully considered and are understood by the directors, (2) with the company's corporate governance, (3) with the expertise and independence of the directors, (4) with their ability to engage directly with the directors, (5) with the frequency and quality of regular evaluation of the performance of the directors, and (6) that executive compensation is tied to performance and total shareholder return.

Taking them at face value, these institutions recognize that by not confining their support to only those situations where a change in strategy or management is clearly and appropriately warranted, they are forcing all companies to manage as an activist would and thereby reduce capital investment, research and development, employee training, marketing, new product introduction and—most damaging—steady employment. While they have not been explicit, hopefully the institutions recognize that they are the last hope in taming the activists and reversing short-termism short of federal legislation that is unlikely to pass and is by no means desirable—that cure often being worse than the illness. However, when it is recognized that short-termism is having a major adverse impact on long-term growth of companies and serious retardation of growth of GDP with a major contribution to inequality, there is a likelihood that serious legislation could be enacted, or at least as is being proposed by the European Union, legislation encouraging institutional investors to focus on long-term investment. For an excellent discussion applicable to the short-termism crisis in the U.S. as well as in Europe, see Therese Strand, *Re-Thinking Short-Termism and the Role of Patient Capital in Europe*, March 2015. See also *Activist Interventions and the Destruction of Long-Term Value*, January 2015.

That such action, hopefully by institutional investors, but if not, by legislation, is urgently needed is made clear by a current study by FTI Consulting and Activist Insight that shows 300 companies worldwide being the targets of activist attacks in the first half of 2015. Fueling this frenzy is an activist war chest of $342 billion; $169 billion in the hands of activist hedge funds and $173 billion in partially activist focused funds.

If activism moves in-house and the new paradigm becomes pervasive, the influence of the hedge fund activists and ISS will shrink. It will be replaced by the policies, evaluations and decisions of the major institutions. See *Is Activism Moving In-House*, August 2015. While this will be a welcome relief from the short-termism imposed by the hedge fund activists, it raises a new fundamental question—how will the institutions use their power? In a recent article in *Fortune*, Ram Charan posed the cogent issue: "As the biggest asset managers gain more power and exercise it more freely, they bear a heavy responsibility. They may influence employment, national competiveness, and economic policy for better or for worse. They can ensure a balance between short-term and long-term corporate goals, and between value creation and societal needs. They can keep succession planning near the top of every company's agenda. How they will discharge their responsibility remains to be seen. . . ."

We can all be more confident that if the major institutional investors do embrace this new paradigm of corporate governance, and adhere to it, their influence will be more favorable to the Nation's economy and society than the self-seeking personal greed of the hedge-fund activists. We may well be approaching a peaceful end of the corporate governance war, imposed not by government but the recognition by institutional investors that what is in the best interests of the Nation is in their best interests. If so, much is owed to Chief Justice Leo Strine of the Supreme Court of Delaware, see, e.g., *Can we do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*.

To conclude with another analogy to the Thirty Years' War, the great armies of the indexers are poised on the field of battle in the center and on the flanks, ready to renew support for the marauders and the mercenaries who continue to be anointed and blessed by the priests of empirical studies and cheered by the cult of shareholder democracy. But the revelations of Yale Professor and Nobel Laureate Robert Shiller and the "Behavioral School" of economics, other serious academic works, and the growing ranks of business pragmatists who realize that the only real beneficiaries of activism are the hedge funds that profit from their predations, have given pause to the indexers and their cohorts. Hopefully, the imposition, by major institutional investors, of the new paradigm of corporate governance will result in a new balance of power.