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TURNING A SHORT-TERM FLING INTO A LONG-TERM COMMITMENT: BOARD DUTIES IN A NEW ERA

Nadelle Grossman*

Corporate boards face significant pressure to make decisions that maximize profits in the short run. That pressure comes in part from executives who are financially rewarded for short-term profits despite the long-term risks associated with those profit-making activities. The current financial crisis, where executives at AIG and numerous other institutions ignored the long-term risks associated with their mortgage-backed securities investments, arose largely because those executives were compensated for the short-term profits generated by those investments despite their longer-term risks. Pressure on boards for short-term profits also comes from activist investors who seek to make quick money off of trading in stocks whose prices overly reflect short-term firm values.

Yet this excessive focus on producing short-term profits runs counter to the interests of non-short-termist investors, other corporate constituents, as well as our economy and society as a whole in creating corporate enterprises that are profitable on an enduring basis. Once again, the current financial crisis provides a lens through which we can see the distressing impact—both to individual businesses as well as to the entire U.S community—of an excessive focus on short-term profits.

I propose a solution to address this problem of short-termism. Under my proposal, directors would be required to make decisions that are in the long-term best interest of stockholders and the corporation under their fiduciary duties. I explain in the Article why I propose fixing the short-termism problem through fiduciary duties as well as how, practically, my proposal would be implemented.

Introduction

There is significant pressure on boards of directors, both from executives as well as from investors, to oversee businesses that generate profits in the short-term. That often leads to board decisions directed at

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producing profits over a short period of time, such as six months or a year, without regard to the ill effects of those decisions on the longer-term health of the business. This tendency to manage for the short-term, or "short-termism," in large part explains the near collapse of institutions like AIG and Merrill Lynch that seemed almost impregnable not long ago, as these institutions failed to address the long-term risks associated with their mortgage-related investments.[1]

The pressure from executives on boards is widely believed to be due in large part to executive compensation arrangements that reward executives for short-term profits. Yet executive compensation arrangements alone may not explain excessive short-termism by boards. Rather, board short-termism also seems to be due to some investors with short investment horizons who use activism to influence boards to make decisions that yield short-term returns despite the longer-term impairing effects those decisions might have on the corporate enterprise.

Yet even with these pressures on boards to create short-term value, a director is supposed to have an unyielding fiduciary duty to act in the best interest of the entire corporate enterprise of which she is a director.[2] This is reflected in the fiduciary duties every director owes to that corporation and its stockholders.[3]

Thus we must ask—are directors, by furthering the short-term interests of investors and executives, meeting their fiduciary duties? Or do—or more importantly, should—fiduciary duties *require* that they oversee a corporation's affairs with a view to furthering the corporation's sustained success? These are the positive and normative questions I address in this Article.[4]

While some scholars have focused on the problem of short-termism in the modern corporation, many have focused on the market for corporate control as the primary source for board short-termism.[5] But the wave of investor activism that has emerged over the past decade has shown that investors are able to influence boards outside of the takeover context, and even outside of the stockholder voting franchise. It has also recently become apparent that boards have been perpetuating this short-term cor-

1. *See* discussion *infra* Part II, discussing the role of short-termism in the recent economic crisis.

2. *See* discussion *infra* Part III.

3. *See* discussion *infra* Part III.

4. While this Article focuses on the fiduciary duties of directors, the principles are also applicable to executive officers, who also have fiduciary duties to the same constituencies as directors. *See* Gantler v. Stephens, 965 A.2d 695, 708 (Del. 2009) (holding that "corporate officers owe fiduciary duties that are identical to those owed by corporate directors").

5. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187, 225 (1991) (identifying, as the essence of the proposal, "to convert every fifth annual meeting of stockholders into a meaningful referendum on essential questions of corporate strategy and control, and to limit severely the ability of stockholders to effect changes in control between quinquennial meetings").

porate vision by rewarding executives for generating short-term profits without regard to the ill effects the efforts that created those profits have on the long-term. This, in turn, has created an additional source of pressure on boards to manage for the short-term. Because of these developments and the insights gained from them, this Article proposes a mechanism to keep directors more focused on long-term profitability outside of the takeover context, without requiring significant changes to the current scheme of fiduciary duties or necessitating the adoption of other significant new laws.[6]

This Article also uniquely explains how this duty of directors—to generate long-term profits outside of the takeover context—is in the interests of both shareholders and non-shareholder constituents. While communitarian scholars have for some time advocated for boards' consideration of non-shareholder interests in making business decisions, they have tended to alienate shareholder primacist scholars, who believe that the corporation should be managed for the primary benefit of stockholders. This Article bridges the gap between these two groups of scholars by explaining how directors' discharge of their reformulated fiduciary duty in the non-takeover context will be in the interest of shareholders and other corporate constituents alike.

The remainder of this Article proceeds as follows:

Part I reviews the sources of short-termism. The discussion includes an analysis of how activist investors, particularly hedge funds, influence board decisions, exacerbating the board's focus on the short-term. It also examines executive compensation as a source of pressure on boards to manage for the short-term.

Part II reveals why short-termism is bad, not just for individual businesses, but also for the health of our economy and society. This discussion looks at the economic and social costs of short-termism through the lens of the recent financial crisis, tracing the roots of that crisis to short-termism.

Part III then examines what it means under current law for directors to act "in the best interest of the corporation and its stockholders" under directors' fiduciary duties. The discussion reveals that directors have

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6. My proposal would complement the proposal recently made by Professors Iman Anabtawi and Lynn Stout. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stan. L. Rev. 1255 (2008). Under their proposal, every activist investor who has a material, pecuniary interest in any matter over which it successfully influences company action (regardless of its stock ownership percentage) would have fiduciary duties to other investors similar to those currently imposed on controlling stockholders. *See id.* at 1295. However, as they admit, Professors Anabtawi's and Stout's proposal might not be as usefully applied to address the conflict between investors in their investment horizons. *See id.* at 1290, 1301. My proposal would address this conflict by imposing on the board the duty to manage the corporation for the benefit of long-term stockholders and other corporate constituents, even where short-term activist investors attempted to influence those decisions.

discretion to decide over what time period to look in determining what amounts to the best interest of the corporation and its stockholders. As I argue in this section, this grant of broad discretion leaves directors susceptible to influence by executives and activist investors for decisions that benefit those constituents' short-term interests, even where that impairs the corporation's ability to generate profits on a sustainable basis.

Part IV examines whether it would in fact be in stockholders' and non-stockholder constituents' best interests for a corporation to be managed for the long-term, where the board is not faced with a takeover decision. As that discussion shows, each of these groups would in fact benefit from a corporation being managed with the objective of sustainable profitability.

My proposal, discussed in Part V, would impose on directors the *duty* to act in the *long-term* best interest of the corporation and its shareholders where the board is not faced with a takeover proposal. While some Delaware courts have expressed a preference for this type of long-term standard, they have generally not required it. Instead they have deferred to the board to set the time period for realization of corporate profitability. My proposal would attempt to eliminate the link between short-termism and board decisions by eliminating boards' discretion to make decisions aimed solely or even primarily at generating profits in the short-term. To comply with this reformulated duty, boards would need to consider how the relevant action would impact the corporate enterprise in the long-term and only pursue actions that were primarily aimed at generating that long-term benefit. This should also lead to decisions that are in the interests of *both* the corporation and its shareholders based on Part IV's revelation that those interests are aligned in the long-term.

Part VI then concludes.

I. Sources of Corporate Short-Termism

This section traces the sources of short-termism in the modern public corporation. It begins in Part A by assessing the sources of investor short-termism. As Subsection 1 explains, the root of investor short-termism is the rise of the public corporation and the creation of the stock market, which encourages speculative trading by investors. Yet as the discussion explains, speculative trading does not itself explain investor short-termism, for frequent trading can also mean investors are buying stock that undervalues the true value of a firm and selling stock that overvalues the true value of a firm—so that the firm's stock price ultimately reflects its true value. However, as Subsection 2 explains, the short-term bias of information that is provided to public company investors causes those investors to over-value short-term profits at the

expense of long-term profits. That means that firms' true values are overly reflective of their short-term values and under reflective of their long-term values. Subsection 2 also explains how investor behavior may also contribute to this undue focus on short-term profits.

Because investors do not manage or oversee the operation of the corporations in which they invest, this short-termism might seem to be inapposite to the time period over which corporations are managed. But as Part B explains, investor short-termism impacts board decisions both through the shareholder voting franchise (Subsection 1) as well as through investor activism (Subsection 2).

Part C assesses why executives want boards to be short-termists and how they influence boards to pursue their short-term agendas.

A. Sources of Investor Short-Termism

Any discussion of why investors are short-termists necessarily begins with an understanding of how our stock markets support the speculative nature of public company securities. Once we understand the speculative nature of public company securities, we can then understand how the stock markets cause speculative investors to unduly favor the short-term.

1. Speculative Nature of Investments in Public Companies

Use of the corporate form in the U.S. became widespread in the 19th century as a result of increasing industrialization.[7] Corporations formed during that era were largely closely-held corporations in which the stock was held by founders, their families and friends and a limited number of associates.[8] However, starting in the late 19th century and early 20th century, the size of corporations grew significantly, largely due to a wave of mergers.[9]

With this growth in corporate size came a broad expansion in the investor base.[10] As a result, investors held securities not out of an interest

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7. Lawrence E. Mitchell, The Speculation Economy: How Finance Triumphed Over Industry 8, 11–12 (2008) (describing how the Industrial Revolution led to the growth in size and number of corporations, partnerships, and proprietorships and the blossomed use of the business corporation starting in the 1840s and 1850s with the expansion of railroads).

8. *Id.* at 9.

9. *Id.* (describing the wave of mergers from 1897 to 1903 as arising due to the desire to reduce competition, create efficiencies in size and management, and generate proceeds from the issuance of stock to the public).

10. *Id.* at 4 (noting that as a result of the merger wave, middle class investors were drawn to the market for the first time and that following the panic of 1907, small investors increased their numbers, "pick[ing] among the bargains that were the leavings of the plutocrats").

to finance a particular business, but as a way to make a profit—or for speculation.[11]

That, in turn, gave rise to the need for a stock market, where investors could buy and sell securities to realize the value of their investments.[12] As Berle and Means recognized as early as 1932, investors of public companies thus became mere purveyors of capital, having relinquished the right to manage physical assets in exchange for liquidity.[13]

Where securities are traded at a higher rate than the period of time over which a firm seeks to achieve success, it reveals that investors are trading securities to generate profits rather than to finance the underlying business—in short, speculating. We can thus see the speculative nature of investments in NYSE-listed companies from data from 2006, when the turnover rate was 118%.[14] That means that on average, every share of stock of a NYSE-listed company was traded at least once during the year.[15] In contrast, the average public company's life span is more than 30 years.[16]

The rise of the derivatives market seems to have compounded the speculative nature of public company investments.[17] That is because investors typically do not hold options or other derivatives for longer than nine months.[18] Moreover, investors who hold derivative securities are typically large institutions that take large positions in those securities.[19] That fact, coupled with the sheer size of the derivatives market, means that trades by investors in derivative securities may create movement in the price of the underlying security.[20] Investors then attempt to profit off of these adjustments by increased trading, despite the fact that these ad-

11. *Id.* at 4–5 (describing the evolution of securities held by investors from bonds to preferred stock to common stock).

12. Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 5–6 (1933).

13. *Id.* at 286.

14. Mitchell, *supra* note 7, at 1 (citing John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. Acct. & Econ. 3 (2005)).

15. Undoubtedly some investors traded more than once in 2006 while others held for the entire year.

16. *See* Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 Harv. L. Rev. 1784, 1788 (2006) (finding that 63% of the Fortune 100 public companies in 2005 had gone public before 1975); *see also* Berle & Means, *supra* note 12, at 282 ("Today, the life of the investment as such is either long, or indefinite, or perhaps perpetual, and the public investor cannot accordingly count on the release of his capital through repayment."); Roger Lowenstein, *Go Long*, N.Y. Times Mag., Jan. 11, 2009, at 9, 9 ("Public-securities markets are a wondrous artifice precisely because they offer permanent capital to industry and short-term liquidity to investors.").

17. *See* Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. Rev. 137, 176–78 (1991).

18. *Id.* at 165.

19. *Id.* at 176.

20. *Id.*

justments might not reflect any actual change in the business of, or available information about, the issuer of the security.[21]

While speculation has characterized U.S. publicly traded securities since the early 1900s, the speculative nature of equity securities has become more notable with the explosion in the use of hedge funds as investment vehicles, as hedge funds often have shorter holding periods than other investors. According to one study, hedge funds hold their public company investments for an average of one and a half quarters, or approximately four and a half months.[22] This holding period is much shorter than the average seven-quarter holding period for investors on the whole.[23] One of the oft-cited reasons why hedge funds have shorter investment horizons than other investors is the structure of their managers' compensation—namely, a large component of hedge fund managers' compensation is tied to total fund profits.[24] Managers whose compensation is tied to fund profits tend to more actively manage their portfolios because they constantly seek opportunities to increase their funds' profits through speculative trading in an attempt to increase their compensation.[25] Other factors that might explain hedge funds' heightened short-termism include hedge fund managers' desire to post attractive results to raise additional funds,[26] as well as fund managers' ability to act more

21. *See id.* at 177 (arguing that these adjustments in the price of the underlying security following significant trades in the derivatives market represent a market overreaction).

22. *See* Robin Greenwood & Michael Schor, *Hedge Fund Investor Activism and Takeovers* 13 (Harvard Bus. Sch. Working Papers, Paper No. 08-004, 2007) (on file with the University of Michigan Journal of Law Reform), *available at* http://hbs.edu/research/pdf/08-004.pdf (finding that the median position at hedge funds is held for 1.5 quarters); *see also* Matteo Tonello, The Conference Bd., Inc., Hedge Fund Activism: Findings and Recommendations for Corporations and Investors 11 (2008); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. Rev. 561, 579 (2006); Sebastian Mallaby, *Hands Off Hedge Funds*, Foreign Aff., Jan.-Feb. 2007, at 91, 92. *But see* William W. Bratton, *Hedge Funds and Governance Targets*, 95 Geo. L.J. 1375, 1413 (2007) ("[T]he activists' holding record, while not pristine, shows that most commit to their targets for at least the intermediate term.").

23. *See* Greenwood & Schor, *supra* note 22, at 13 (finding that the median position at non-hedge funds is held for seven quarters). *But see* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* 4 (Eur. Corp. Governance Inst., Financial Working Paper No. 139/2006, 2008) (on file with the University of Michigan Journal of Law Reform), *available at* http://ssrn.com/abstract=948907 (finding that the median holding period for an activist hedge fund that files a Schedule 13D is one year and that analysis of other data suggests hedge funds hold on average for closer to 20 months).

24. *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1064 (2007) (stating that hedge fund managers are typically paid a percentage of profits earned).

25. *Id.* at 1064–65 (arguing that the fact that hedge fund managers are paid a percentage of profits earned means that they have a big stake in the success of their funds' investments). Because hedge fund manager compensation is not clawed back due to subsequent losses, there is no incentive to ensure those profits are sustained. *Id.* at 1064 n.208.

26. *See* Anabtawi, *supra* note 22, at 580 (noting the relationship between hedge funds' performance and their ability to raise additional funds from the capital markets, and arguing that this contributes to a preoccupation with short-term results).

nimbly than other investors,[27] as hedge funds are typically not regulated under the Investment Company Act.[28] Moreover, their managers are generally not regulated under the Investment Advisers Act.[29] This absence of regulation, including leverage restrictions and reporting requirements, allows hedge funds to take larger, less diversified positions in companies than can many other institutional investors.[30] This flexibility also allows them to hedge their risks associated with these investments to a greater extent than can other institutional investors.[31] The net result is that hedge funds can realize larger gains from short-term trades than can more heavily regulated, diversified investors.

As the foregoing discussion reveals, investors tend to hold their public company investments for speculative purposes. That means that they trade relatively frequently to try to optimize their gains from those investments. Hedge funds on average trade more frequently than other investors for reasons attributed to their unregulated structure.

Yet public companies do not use a six month, one year, or even two year period of time for the appreciation of corporate gains.[32] Rather, they typically seek to generate profits over a much longer period of time.[33] That goal is apparent from the average life span of the public company, which in 2005 exceeded 30 years for the Fortune 100 public companies.[34] It is also clear that public companies are prospectively intended to be managed for a longer period of time, for the business plans adopted by corporate executives under board oversight typically state firms' ob-

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27. SEC, Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission 33–36 (2003) [hereinafter SEC Report, Hedge Funds] (on file with the University of Michigan Journal of Law Reform), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

28. *Id.* at viii-ix, 3; Kahan & Rock, *supra* note 24, at 1062–63 (noting that while hedge funds are not subject to specific regulatory constraints, they must comply with rules applicable to investors generally, such as disclosure requirements under section 13(d) of the Securities Exchange Act and the short swing profit rules under section 16(b) of that act). The incoming administration has suggested that new regulations will be adopted, and in fact some legislation has been proposed, requiring hedge funds, private equity funds, and other presently unrelated investment vehicles to register with the SEC, maintain records, and comply with disclosure requirements. *See Modernizing the U.S. Financial Regulatory System: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 5 (2009) (statement of Paul A. Volcker, Chair, Presidential Recovery Advisory Board) (on file with the University of Michigan Journal of Law Reform), *available at* http://banking.senate.gov/
public/_files/VolckerTestimony2409.pdf.

29. SEC Report, Hedge Funds, *supra* note 27, at x, 21, 32.

30. *See* Kahan & Rock, *supra* note 24, at 1063 (noting that hedge funds can use derivatives to accumulate large economic positions without disclosure).

31. SEC Report, Hedge Funds, *supra* note 27, at 37–43; Tonello, *supra* note 22, at 20.

32. *See supra* note 16 and accompanying text.

33. *See supra* note 16 and accompanying text.

34. *See* Bebchuk, *supra* note 16, at 1788.

jectives over the subsequent five-year or longer period.[35] In any case, even if we assume that businesses seek to be successful over a five-year period, that is over twice as long as the period during which investors on average hold their shares. That alone might argue in favor of severing speculative investors from business decisions, for speculative investors would be expected to make or favor decisions that yield returns to them over their short holding periods despite the longer time horizons adopted on behalf of corporations for the achievement of corporate objectives.[36]

Still, the counter-argument is compelling: namely, despite the fact that investors have short holding periods, the value of their investments reflects not only the short-term value, but also the long-term value, of the investee corporation. That is because the stock market is efficient. Thus stock prices reflect not simply the value of firms based on anticipated returns over any particular investor's holding period, but indefinitely. That means that investors do not necessarily favor decisions that generate results in the short-term, for the values they place on their investments also reflect the profits to be generated in the long-term. I will address this argument next.

2. Short-Term Information Bias

In a perfectly efficient stock market, stock prices would indeed fully reflect the intrinsic values of the firms whose stocks are traded on that market.[37] To capture a firm's intrinsic value, a firm's stock price must reflect not only the firm's value in the short-term, but also its value in

35. *See* L.J. Bourgeois III et al., Strategic Management: A Managerial Perspective 302 (2d ed. 1999) (stating that "[a]ll organizations of any size must plan, and planning tends to [include] . . . the development of an overarching five- and ten-year strategic plans"); Fred R. David, Strategic Management: Concepts 12–13 (12th ed. 2009) (indicating that strategies, or the means to reach objectives, are long-term oriented and typically affect a corporation's prosperity over the next five or more years); Lipton & Rosenblum, *supra* note 5, at 229 (noting that a standard business plan covers five years).

36. This is not inconsistent with the view that managers, who do make business decisions, should hold stock in a firm to have some "skin in the game," thereby reducing some of the agency costs associated with the severance of management from control. President's Council of Econ. Advisers, *Economic Organization and Competition Policy*, 19 Yale J. on Reg. 541, 548 (2002) (noting that paying managers for performance in the form of stock and stock options has become an increasingly prominent feature of corporate life, suggesting that it may prove a valuable way for shareholders to reduce agency costs). That is because while there is strong support for managers to own stock, that stock ownership is generally intended to be a long-term rather than a short-term investment. *See infra* note 141 and accompanying text (describing the current push by the federal government to indeed make managers' stock ownership "long-term" rather than drive them to manage for the short-term).

37. Peter S. Rose, Money and Capital Markets: The Financial System in an Increasingly Global Economy 542 (5th ed. 1994); Anabtawi, *supra* note 22, at 581; Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. Corp. L. 635, 639–41 (2003).

the long-term.[38] This theory of the stock market—as being perfectly efficient—is referred to as the efficient capital market hypothesis, or ECMH.[39] Under the ECMH, if a company's stock price at any time does not fully reflect a proportion of the firm's true value represented by a share of that stock, then investors will buy that firm's stock (if the stock price is lower than the firm's true value) or sell that firm's stock (if the stock price is higher than the firm's true value) until the stock price does reflect a proportionate share of the firm's true value. Thus adherents to the ECMH hail frequent trading as a mechanism to make the stock market more efficient, as each trade causes a firm's stock price to get closer to the firm's true value.[40]

One necessary predicate to the ECMH is the availability to investors of all relevant information about a firm, for that is the only way investors can know a firm's true value and determine whether its stock price undervalues or overvalues the firm.[41] However, as the Delaware courts have recognized, the stock market may not always be efficient.[42] Specifically, information about a firm—especially concerning its long-term value—may not be "perfect."[43] There are a number of reasons for this.

For one, it is not necessarily in investors' interest for information concerning a firm's long-term value to be publicly disclosed.[44] For example, if a firm were to publicly disclose what its managers believed was the most likely outcome of a lawsuit that has been—or could be—lodged against the firm, that information would serve as a cue to the plaintiffs and potential plaintiffs as to the existence of such a lawsuit, as well as

38. Anabtawi, *supra* note 22, at 581 (stating that pursuant to the efficient market theory, an investor's time horizon would not matter since stock prices would reflect long-term values).

39. Rose, *supra* note 37, at 542; *see also* Stout, *supra* note 37, at 636.

40. *See, e.g.*, Richard A. Brealey et al., Principles of Corporate Finance 355–58 (9th ed. 2008) (arguing that arbitrageurs immediately eliminate any discrepancy between stock prices and firm values by trading).

41. Rose, *supra* note 37, at 542; Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 551–52 (1984). *But see id.* at 552 (arguing that "[w]hat makes the ECMH non-trivial . . . is its prediction that, even though information is *not* immediately and costlessly available to all participants, the market will act *as if* it were").

42. *See, e.g.*, Paramount Commc'ns Inc. v. Time Inc., Nos. 10866, 10670 & 10935, 1989 WL 79880, at *19 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989) ("Directors may operate on the theory that the stock market valuation is 'wrong' in some sense, without breaching faith with shareholders. No one, after all, has access to more information concerning the corporation's present and future condition."); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1376 (Del. 1995) (citing *Paramount*, 571 A.2d at 1153).

43. Moreover, as Professor Lynn A. Stout has argued, a market that is perfect in information is not necessarily efficient in determining fundamental value because "[f]irst, arbitrage is not a costless process . . . [second, arbitrageurs] enjoy access to only finite amounts of money . . . [third, arbitrageurs] are also likely to be risk-averse, . . . [and fourth, arbitrageurs] can only hope to profit from their superior information if the rest of the market eventually becomes aware of what the arb already knows, and also comes to agree with the arb's assessment of value." Stout, *supra* note 37, at 655.

44. *See* Rose, *supra* note 37, at 542–43.

how much it may be worth.[45] Yet failing to have that information would impair investors' ability to value the firm in the long-term—when the liability may be realized.

Another example is that it is generally not in investors' interest for firms to disclose detailed information about future prospects and business strategies. For example, if managers disclosed a firm's marketing strategy and identified geographic regions or sectors for growth, that information would tip the firm's hand to its competitors, which could enable the competitors to use that information to their advantage. Yet not having that information impairs investors' ability to estimate with any accuracy the firm's future cash flows generated by future sales of those products in those regions. That, in turn, impairs their ability to calculate the firm's intrinsic value, as that is typically calculated using an estimation of future cash flows, discounted for the future.[46]

In addition, future events and circumstances are often uncertain or unknown. Because of that uncertainty, accounting rules tend to undervalue "future assets," or assets which may not be realized for some time. For example, firms may not recognize revenue in connection with the sale of a good or service until the good or service is delivered, the price for the good or service is fixed or determined, and collectability is reasonably assured.[47] That means that unless a company publicly announces

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45. This is a significant issue under proposed new Financial Accounting Standard (FAS) 5, which would require disclosure about loss contingencies (including potential lawsuits) that are more than "remote" (currently only disclosure is required for "probable" contingent losses). *See* Fin. Accounting Standards Bd., *Disclosure of Certain Loss Contingencies: An Amendment of FASB Statement No. 5 and 141(R)* ¶ 5 (Fin. Accounting Series, Exposure Draft File Reference No. 1600-100, 2008) (on file with the University of Michigan Journal of Law Reform), *available at* http://www.fasb.org/ed_contingencies.pdf. In addition, proposed FAS 5 would require firms to disclose a description of the factors that are likely to affect the ultimate outcome of that potential loss, a qualitative assessment of the most likely outcome, and significant assumptions made in estimating the amounts disclosed. *Id.* ¶ 7. The American Bar Association has written a letter to the Financial Accounting Standards Board emphatically objecting to the proposed changes to this rule on the basis that that disclosure would threaten the attorney-client privilege, that there is much uncertainty in estimating loss contingencies, and that this would create the potential for shareholder lawsuits if these estimates turn out to be wrong. *See* Letter from William H. Neukom, President, Am. Bar Ass'n, to Robert H. Herz, Chairman, Fin. Accounting Standards Bd., and David Tweedy, Chairman, Int'l Accounting Standards Bd. (Aug. 5, 2008) (on file with the University of Michigan Journal of Law Reform), *available at* http://www.abanet.org/poladv/priorities/privilegewaiver/2008aug5_privwaiv_fasb_l.pdf.

46. Tim Koller et al., Valuation: Measuring and Managing the Value of Companies 56 (4th ed. 2005). Yet another example, long-recognized by the Delaware courts, is the potential detrimental impact premature disclosure of a possible sale transaction might have on stockholders. *See* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 847 n.5 (Del. 1987) ("[T]he effect of premature disclosure of merger discussions may be substantial. The probability of completing a merger benefiting all shareholders may well hinge on secrecy during the negotiation process.").

47. SEC Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68,936 (Dec. 9, 1999) (to be codified at 17 C.F.R. pt. 211). In addition, there must be persuasive evidence that an arrangement for the sale of the good or service exists. *Id.* at 68,937. However, SAB 101 has prevented firms from including in their financial statements some expected future cash flows, which means that investors

a future sale,[48] and that information is not otherwise available, investors do not factor that information in to their determination of a firm's intrinsic value, again tending to cause that calculation to not capture the value of important future assets.

As another example, accounting rules do not permit firms to include the value of their brands or their relationships with suppliers, customers and employees in their calculation of intangible assets.[49] Moreover, accounting rules require firms to expense research and development (R&D) costs as they are incurred instead of permitting firms to capitalize those costs over the useful life of the inventions that result from the R&D.[50] This, then, leads to a reduction in profits for the period in which these expenses are incurred without any corresponding increase in assets. While the purpose of this rule may have been to encourage investments in R&D,[51] in reality this means that current investors shoulder the burden of all R&D costs, while they may (or may not) appreciate the long-term benefits of those expenditures. This likely explains some investors' reluctance for firms to make investments in R&D.[52] Yet in-

may get less information about the future cash flows of their investee firms on which to base their computations of firm values than they did before SAB 101. Jennifer Altamuro et al., *The Effects of Accelerated Revenue Recognition on Earnings Management and Earnings Informativeness: Evidence from SEC Staff Accounting Bulletin No. 101*, 80 Acct. Rev. 373, 375–76 (2005). Several trade groups, recognizing the importance of non-financial disclosure as to future expectations, have proposed increasing these types of disclosure. *See, e.g.*, Am. Inst. of Certified Public Acct., The Enhanced Business Reporting Framework (October 10, 2005), http://www.ebr360.com/downloads/ebr.framework.publicexposure.2005.10.pdf (on file with the University of Michigan Journal of Law Reform) (describing a framework to encourage companies to report extra-financial matters).

48. Firms are only required to announce future sales on a Current Report on Form 8-K where they will be made pursuant to a material contract. *See* Rule 13a-11 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.13a–11 (2008) [hereinafter Exchange Act]; SEC, Form 8-K § 1.01 (on file with the University of Michigan Journal of Law Reform), *available at* http://www.sec.gov/about/forms/form8-k.pdf.

49. Comm. for Econ. Dev., Built to Last: Focusing Corporations on Long-Term Performance 4 (2007); Matteo Tonello, The Conference Bd., Inc., Revisiting Stock Market Short-Termism 28–29 (2006).

50. *See* Tonello, *supra* note 49, at 28–29 (arguing that current financial reporting principles operate as a disincentive to invest in research, innovation, and other drivers of value because investments in intangibles are expensed, not capitalized, like those on physical and financial assets); *see also* Enzo Baglieri et al., *Evaluating Intangible Assets: The Measurement of R&D Performance* 2–3 (SDA Bocconi Sch. of Mgmt. Research Paper Series, Working Paper No. 01/49, 2001) (on file with the University of Michigan Journal of Law Reform), *available at* http://ssrn.com/abstract=278260 (noting that because of the high degree of uncertainty surrounding R&D activities, the difficulty in measuring the value of the output of R&D and the dependency on other corporate functions, R&D has always been treated as an expense center).

51. *See* Xuan-Thao Nguyen & Jeffrey A. Maine, *Acquiring Innovation*, 57 Am. U. L. Rev. 775, 793 (2008) (explaining the justification for the rule that R&D may be expensed as incurred, instead of capitalized, as the encouragement of new research and development activity and stimulation of economic growth and technological development).

52. *See* Anabtawi, *supra* note 22, at 580 (arguing that stock prices can temporarily be increased by increasing short-term earnings by, for example, cutting research and development

tangible assets may comprise a significant part of a corporation's intrinsic value.[53] That means that financial statements may not accurately capture one of the key drivers of future cash flows, which again, are typically used to calculate a firm's intrinsic value.[54]

Moreover, some commentators believe that investors tend to overly discount the value of future returns, even when they are disclosed.[55] This is undoubtedly due in large part to the unreliability of a future stream of cash flows.[56] While investors cannot be blamed for the tendency to rely on more certain historical information rather than uncertain statements as to the future, it further explains why a firm's stock price might not accurately depict the long-term value of a firm even as to information as to future assets, liabilities, and risks that is disclosed.

The fact that accounting rules, and the financial statements prepared employing those rules, fail to capture the value of firms' long-term assets and liabilities has significant implications, for a number of studies have found that investors tend to rely heavily, if not entirely, on financial statements in making their investment decisions.[57] That means that in-

expenses or capital expenditures); Lipton & Rosenblum, *supra* note 5, at 210 (arguing that managers seeking to satisfy the short-term expectations of institutional investors sacrifice investments for the future, such as research and development and capital expenditures). *But see* Koller et al., *supra* note 46, at 80–81 (arguing that stock markets reward R&D and advertising expenditures even though those expenditures may negatively affect short-term earnings); Kahan & Rock, *supra* note 24, at 1085–87 (noting the active debate as to whether the stock market undervalues long-term investments relative to short-term investments and the lack of clear empirical evidence showing that capital markets are not efficient).

53. *See* Baruch Lev, Intangibles: Management, Measurement, and Reporting 77 (2001); Baglieri et al., *supra* note 50, at 2 (arguing that intangible assets are increasingly considered the ultimate roots of a company's success).

54. *See supra* note 46 and accompanying text.

55. Anabtawi, *supra* note 22, at 581 ("Numerous studies have shown that the stock market places a disproportionately high value on a company's near-term earnings by placing an excessively high discount rate on its future expected earnings."); Hazen, *supra* note 17, at 181 ("There is considerable evidence that stock prices do not accurately discount the future."); Wayne Joerding, *Are Stock Prices Excessively Sensitive to Current Information?*, 9 J. Econ. Behav. & Org. 71, 72 (1988) (arguing that stock markets are overly sensitive to short run factors). *But see* George Loewenstein & Drazen Prelec, *Anomalies in Intertemporal Choice: Evidence and an Interpretation*, 107 Q.J. Econ. 573, 573–97 (1992) (arguing that investors use "hyperbolic discounting"; in other words, they decrease their degree of discounting with respect to pay-outs over long time horizons).

56. Berle & Means, *supra* note 12, at 320 ("[A]nd it is not easy, if indeed, it is possible at all, to disclose anything other than that which has actually occurred."). This is exemplified by the increase in stock price caused by the recognition of revenues in a current period instead of a future period. With the large number of restatements, perhaps investors are also discounting the value of past results.

57. *See* Comm. for Econ. Dev., *supra* note 49, *passim* (noting that emphasis on quarterly earnings, compensation tied to earnings per share, shortened CEO tenures, and financial reports that fail to adequately inform about company performance impede the task of building long-term value; and arguing that the false precision of financial statements feeds the focus by managers, traders, and analysts on earnings per share); Tonello, *supra* note 49, at 8 (citing a study by the U.S. National Bureau of Economic Research, Duke University, and University of Washington, finding that a ma-

vestors overly rely on short-term financial metrics in determining firms' intrinsic values. Investor determination of firm values from short-term financial metrics undoubtedly leads to a determination that is overly representative of a firm's value in the short-term.

Still, some investors, particularly professional managers, do try to adjust for some of the shortcomings of financial statement disclosures in determining a firm's intrinsic value.[58] Yet not all investors have the resources available to do so.[59] That means that different investors calculate a firm's intrinsic value differently, leading to stock trades that cause a firm's stock price to bounce around between different perceived intrinsic values. And even the investors who do adjust for financial statement shortcomings must do so extrapolating longer-term values from information that is disclosed and that has a short-term bent. That, too, would seem to impair their ability to accurately determine a firm's intrinsic value.

Moreover, even a shareholder who can "accurately" calculate a firm's intrinsic value might still prefer decisions that yield short-term profits knowing that other investors place increased weight on that in determining intrinsic value.[60]

Investors' over-reliance on short-term financial metrics in determining firms' intrinsic values is exacerbated by firms' public release of guidance as to expected earnings during the subsequent quarter. Where a corporation issues quarterly earnings guidance, management often feels pressure to meet or beat that guidance for fear of disappointing investors whose expectations were set by that guidance, as disappointed investors tend to punish a corporation through selling its stock.[61] Consequently, pressure

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jority of companies view financial indicators based on earnings (especially earnings-per-share) as a key metric of performance).

58. *See* Brealey et al., *supra* note 40, at 338 (stating that before applying any accounting measure of performance, one must make "major adjustments to the income statement and balance sheets").

59. *See* Stout, *supra* note 37, at 653 (indicating that studies suggest that where information is technical and difficult to understand, stock prices do not quickly adjust to reflect it). *But see* Gilson & Kraakman, *supra* note 41, at 565–67 (arguing that different market mechanisms operate to cause the stock market to reflect new information, even information that is only available to a few traders, though noting that information that is less available requires more time to become reflected in stock price). Even if we assume that all information eventually reaches investors, given the high turnover rate of stocks, undoubtedly many investors are trading before relevant information reaches them.

60. *See* Patrick Bolton et al., *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 Rev. Econ. Stud. 577, 578 (2006) (arguing that "overconfidence provides a source of heterogeneous beliefs among investors, which lead them to speculate against each other").

61. *See* Comm. for Econ. Dev., *supra* note 49, at 5 (revealing evidence which shows that firms that issue quarterly earnings guidance attract more transient investors and have higher trading volumes than companies that do not issue earnings guidance); John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. Acct. & Econ. 3, 67 (2005) (noting that a majority of the over 400 chief financial officers surveyed "admit[ted] to sacrificing long-term economic value to hit a target or to smooth short-term earnings"); David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 Geo.

to meet investors' expectations set through earnings guidance may cause managers to manage with the goal of keeping a firm's stock price high, notwithstanding the impairing effect that might have on long-term corporate performance.[62] For example, it might lead managers to forego incurring R&D expenses and hiring of new employees, simply to ensure projections are met.[63] It might also lead to the temptation to manage earnings to maintain consistent, positive numbers.[64] While there is support from some in the business and investment communities to curb the issuance of quarterly earnings guidance,[65] approximately half of all public corporations still provide this type of guidance.[66]

Still other market imperfections associated with investor behavior that tend to cause a short-term bias can be identified in the rubble of the cur-

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Wash. L. Rev. 890, 892 (2002) (finding that "[c]ompanies falling short [of analyst earnings targets] by even a penny per share can see an immediate plunge of 25 percent or more [in their stock price]").

62. *See, e.g.*, Comm. for Econ. Dev., *supra* note 49, at 5 ("Most observers view company forecasts of quarterly changes in earnings per share, and market reliance on those forecasts, as among the primary causes of short-term behavior—possibly including aggressive accounting by some companies to 'make their numbers,' or postponement of valuable long-term investments."); Mitchell, *supra* note 7, at 1 ("A recent survey of more than four hundred chief financial officers of major American corporations revealed that almost 80 percent of them would have at least moderately mutilated their businesses in order to meet analysts' quarterly profit estimates.").

63. *See* Mitchell, *supra* note 7, at 1 ("Cutting the budgets for research and development, advertising and maintenance and delaying hiring and new projects are some of the long-term harms they would readily inflict on their corporations."); *see also* Millon, *supra* note 61, at 893.

64. Millon, *supra* note 61, at 897. It might also lead to decisions such as layoffs to bump up a corporation's stock price in the near term. *See also* Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 Harv. L. & Pol'y Rev. 1, 12 (2008) (describing the "seven percent rule" prevalent during the wave of downsizings in the 1990s—and seemingly still applicable today—in which a firm's announcement of mass layoffs leads to a 7% jump in its stock price, and indicating that recent research shows that the long-term effect of these downsizing efforts on stock price is at least unclear and may be negative).

65. *See, e.g.*, Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, Report and Recommendations 7 (2007) [hereinafter 21st Century] (on file with the University of Michigan Journal of Law Reform), *available at* http://www.uschamber.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5weu6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf (promoting the elimination of quarterly earnings per share guidance and the promulgation by public companies of more information about their long-term business strategies and material developments between quarterly announcements of actual earnings). *But see Disclosure Advisory Board Responds to Chamber of Commerce Recommendations on Earnings Guidance*, PR Newswire, Mar. 21, 2007, http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/03-21-2007/0004550656&EDATE= (on file with the University of Michigan Journal of Law Reform) (arguing that eliminating quarterly earnings guidance is too sweeping, and favoring a balancing of short-term and long-term guidance relative to qualitative and quantitative measures).

66. Comm. for Econ. Dev., *supra* note 49, at 5. Proponents of the practice argue that (1) the practice is necessary to keep analysts' earnings forecasts within a reasonable range, (2) successful forecasts increase stockholder confidence in management, and (3) good guidance decreases information asymmetries between management and investors. *See* Joel F. Houston et al., *To Guide or Not to Guide? Causes and Consequences of Stopping Quarterly Earnings Guidance* 2 (NYU Stern Sch. of Bus. Research Paper Series, Working Paper No. 2451/27472, 2008) (on file with the University of Michigan Journal of Law Reform), *available at* http://ssrn.com/abstract=1280693.

rent financial crisis, where investors seemed to all but ignore the risks—even those that were disclosed—about the potential collapse of the housing market.[67] For example, it is arguable that investors were caught up in the euphoria of the housing bubble, leading them to ignore, or choose to not understand, what they were buying.[68] Under this premise, information as to long-term risks, while disclosed, was simply ignored.[69] Another explanation is that investors were simply following the herd, buying securities that everyone else was buying.[70] Thus investors got caught up in the stampede to buy securities notwithstanding the disclosed long-term risks of those securities.[71] Still another explanation for investors' failure to perceive the risks of a financial collapse can be attributed to investors' tendency to over-identify with events that they were familiar with (increases in the prices of mortgage-related securities) and believed them likely to continue.[72] Each of these types of investor behavior can explain why investors choose to ignore, or fail to appreciate, long-term risks, even when they are disclosed.[73] Thus these, too, might explain why investors focus on short-term profits generated by their investments notwithstanding the longer-term risks associated with the business strategies of those firms.

3. Summary

As the foregoing discussion reveals, the lack of public disclosure as to the value of future assets and future sources of cash flows, as well as future risks and liabilities, leads investors to undervalue those long-term assets, liabilities, and risks in determining the intrinsic values of public firms. While some investors can more accurately determine the intrinsic value of a firm due to their sophistication and resources, their ability to do so is undoubtedly impaired by the lack of information they receive as to long-term values. And even investors who can more accurately compute a firm's intrinsic (including long-term) value may place a higher

67. *See* Andrei Shleifer, Inefficient Markets 2–5, 10–16 (2000) (arguing that behavioral finance shows that many investors act irrationally and this is not corrected through arbitrage activity).

68. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 Minn. L. Rev. 373, 382 (2008).

69. Yet some investors may have rationally decided to ignore information as to long-term risks, believing that they could ride out the bubble and sell their securities before the housing market crashed.

70. Schwarcz, *supra* note 68, at 382.

71. Still some investors may have rationally decided to get caught up in the herd, again on the assumption that they could sell their securities before the housing market crashed.

72. Schwarcz, *supra* note 68, at 382–83.

73. Investors might also ignore disclosure where they can defer to more easily interpreted investment signals such as rating agencies' securities ratings. *Id.* at 382.

value on short-term performance indicators, knowing that is how other investors value a firm. In any case, their trades would not necessarily cause a firm's stock price to approach a true value which appropriately includes the long-term value of that firm. Other investors also trading in that firm's securities who do not have the sophistication and resources needed to calculate a firm's long-term value would be trading using a value that gives priority to the shorter-term value of the firm. Moreover, as behavioral economics instructs, some investors may fail to appreciate, or may choose to ignore, the long-term risks of their investments. That, again, can cause a short-term bias in investor behavior, altering the longer-term focus that might prevail in a perfect market.

Still, even with these market imperfections favoring short-term investment profits, many investors' investment strategy is to hold stock for a long period of time.[74] Moreover, some large institutions are long-term investors by necessity, for due to their sheer size, they will inevitably end up holding positions in the same firms in the future.[75] Yet the existence of investor short-termism argues in favor of exercising caution when considering whether to implement investors' recommendations and demands in relation to how to manage the corporation, particularly where those demands are made by investors who are known to have short investment horizons.

B. Investor Short-Termism Impacts Board Decisions

The fact that investors desire short-term results does not necessarily translate into firms that are managed for the short-term. That is because directors oversee the business and affairs of the corporations on whose boards they serve.[76] On that basis alone it would seem that boards should be impervious to investors' demands for short-term results. Yet there are a number of reasons why boards are short-termists as a result of this investor short-termism. Subsection 1 examines how investors affect board decisions through the shareholder franchise. Subsection 2 then explores how investors have started to influence board decisions through targeted activism.

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74. *See* Charles Luftig, Note, *Considered Action, Unconsidered Result: Why the Tax Relief Act of 2003 Could Put Retirement Savings at Greater Risk*, 23 Va. Tax Rev. 701, 711 (2004) (noting that 96% of the equity investors surveyed described themselves as adhering to long-term investment strategies).

75. *See* Lipton & Rosenblum, *supra* note 5, at 216–17 ("[T]he large institutional stockholder is a long-term investor in the market as a whole. Unless it divests itself of equities altogether, it will have an equity stake in a substantial portfolio of corporations regardless of how long it maintains a stake in any one corporation.").

76. *See* discussion *infra* Part III.

1. Short-Term Investors Influence Board Decisions Through the Voting Franchise

Investors elect directors, typically on an annual basis.[77] The right to elect directors gives investors significant power over boards, for it means that ultimately, boards must be accountable to investors for their actions. That, in turn, means that directors must to an extent oblige investors' wishes, including their wishes for short-term profits, if the directors want to be reelected.

Yet there are many who challenge the effectiveness of this accountability mechanism, not only because the board, typically through a nominating committee, decides which candidates to nominate on behalf of the company, but also because it is typically only those candidates who are included in the company's proxy statement.[78] Thus the solicitation of proxies for any competing slate of directors must generally be paid for by the investor putting forth the competing slate.[79]

Still, the risk of non-reelection is becoming much more of a reality as investors increasingly use the *threat* of a proxy contest to get their director nominees on the company's slate of directors.[80] This threat increasingly has teeth as investors have started to propose bylaws requiring the reimbursement by a company of its stockholders' expenses in successfully soliciting proxies in favor of a competing slate of directors.[81] Under a new rule proposed by the SEC, which many expect to

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77. While the default rule is that directors must be elected every year, in a corporation that has a staggered board, directors only stand for election every two or three years, depending on whether the corporations' board is staggered in two or three tiers. *See* Del. Code Ann. tit. 8, § 141(d) (2001). However, the staggered board structure is disappearing, in large part due to investor pressure to avoid director entrenchment. Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 Ohio St. L.J. 53, 71 (2008) (citing studies that show that by the end of 2006, a majority of the S&P 500 companies' directors were to have been elected every year); Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 Del. J. Corp. L. 149, 155–56, 185, 187 (2008).

78. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 680, 688–95 (2007) (noting the importance of the shareholder franchise and arguing that legal and practical impediments impair shareholders' ability to exercise that franchise to replace the board).

79. *Id.* at 688–91.

80. *See* discussion *infra* Part I.B.2.

81. *See, e.g.*, CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 229–30 (Del. 2008) (describing a stockholder-proposed bylaw amendment that would require the company to reimburse the proxy solicitation expenses of a stockholder who has at least one of its directors elected to the board in a contested election). According to the Delaware Supreme Court in *AFSCME*, these types of bylaws are permissible so long as they preserve for the board the discretion to deny reimbursement where doing so is necessary for the board to comply with its fiduciary duties. *Id.* at 239–40. The new e-proxy rules and 1990 proxy rule amendments also make it easier, and less expensive, for shareholders to solicit proxies for competing slates of directors. Richard Morrisey, Sullivan & Cromwell L.L.P., *Proxy Solicitation Through the Internet*, *in* Seventh Annual Institute on Securities Regulation in Europe: A Contrast in EU and U.S. Provisions 583, 585 (PLI Corp. Law & Practice, Course Handbook Series No. 1643, 2008); *see also* Rule 14a-1(*l*)(2) under

pass in some form,[82] companies will not be able to exclude these types of proposals from their proxy statements.[83] Stockholders will undoubtedly propose more competing slates where their costs in doing so are covered by the company. In addition, under the SEC's proposed rule, stockholders holding a specified number of shares for the specified period of time will be able to include one or more director nominees on the company's proxy statement, also making a contested election more likely.[84] Investors have also been increasing their say over board composition through provisions of the bylaws or corporate policies, adopted by many companies at the behest of stockholders, which call for the resignation of any director not receiving the support of a majority of stockholders.[85] This, too, has heightened the level of accountability of directors to stockholders as directors face a greater likelihood of being forced to resign.

Outside of the director election context, stockholders have been including "say on pay" proposals—or proposals requesting that the board obtain an advisory vote from the stockholders indicating whether they approve or disapprove of management's compensation packages—on company proxy statements.[86] These types of proposals are useful in that they afford stockholders a way to collectively make recommendations to management without forcing them to pay for the solicitation of proxies in support of the proposal. However, because management may exclude from the company's proxy statement any proposal that would be impro-

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the Exchange Act, 17 C.F.R. § 240.14a-1(*l*)(2) (2008); Rule 14a-2(b)(1) under the Exchange Act, *id.* § 240.14a-2(b)(1); Rule 14a-16 under the Exchange Act, *id.* § 240.14a-16.

82. *See, e.g.*, Jeffrey McCracken & Kara Scannell, *Fight Brews as Proxy-Access Nears*, Wall St. J., Aug. 26, 2009, at C1.

83. *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274).

84. *See id.*

85. *See* Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 Colum. L. Rev. 1321, 1386 (2007) ("At the start of 2005, fewer than thirty of the Standard & Poor's 500 had bylaws or policies requiring a majority voting standard. By early 2006, this figure had increased to roughly 145."); *see also* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 Conn. L. Rev. 459, 473 (2007); Vincent Falcone, Note, *Majority Voting in Director Elections: A Simple, Direct, and Swift Solution?*, 2007 Colum. Bus. L. Rev. 844, 860 (2007).

86. *See* SEC, Division of Corporation Finance: Staff Legal Bulletin No. 14A (2002) (on file with the University of Michigan Journal of Law Reform), *available at* http://www.sec.gov/interps/legal/cfslb14a.htm (indicating the SEC's position as to which "say on pay" proposals are excludable and which are not under Rule 14a-8); Sandeep Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation*, 35 Pepp. L. Rev. 207, 219 (2008). Congress has recently passed legislation that will give investors of public companies that receive funds under the Troubled Asset Relief Program (TARP)—established under the Emergency Economic Stabilization Act of 2008—a say on pay, and the Securities and Exchange Commission has recently passed a rule implementing this legislative mandate. *See* American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, § 7001, 123 Stat. 115, 516–20 (2009); Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007); Rule 14a-20 under the Exchange Act, 17 C.F.R. § 240.14a-20 (2010).

per under state law or that relates to a company's "ordinary business operations,"[87] shareholder proposals under Rule 14a-8 have historically been limited to matters of corporate governance or social responsibility proposals that do not affect the corporation as a profit-making institution, and have often taken the form of precatory—or non-binding—proposals.[88] Again, Rule 14a-8 is likely to become much more important to stockholders with respect to the election of directors if the SEC's proposed rule described above passes.

Investors also have the right to vote on certain significant transactions. These transactions include mergers, sales of all or substantially all of firms' assets and dissolutions.[89] That means that boards may not pursue these types of transactions without shareholder support, and in that way, are held accountable to stockholders. Perhaps more importantly, any board decision to implement defenses to a takeover offer must meet higher-than-normal fiduciary duty standards.[90]

Yet these voting rights do not give shareholders the power to *initiate* these types of takeover transactions. Rather, they must be approved by the board, who then must submit the transaction to the stockholders for approval.[91] Stockholders do, however, have the right to initiate a sale of their stock, either in a stand-alone transaction or to an acquirer through a collective tender offer. This is undoubtedly one of the most important tools stockholders have traditionally used to keep boards in line with their interests, for it allows stockholders to vote against the board by using their feet.[92] Still, boards have traditionally employed any number of defenses to either prevent or make more difficult takeovers via tender offers. These defenses include the poison pill,[93] golden parachute pay-

87. 17 C.F.R. § 240.14a-8(i)(1), (7) (2008).

88. *See* SEC, Division of Corporation Finance: Staff Legal Bulletin No. 14, at 27 (2001) (on file with the University of Michigan Journal of Law Reform), *available at* http://www.sec.gov/pdf/cfslb14.pdf ("In our experience, we have found that proposals that are binding on the company face a much greater likelihood of being improper under state law and, therefore, excludable under rule 14a-8(i)(1)."); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 541 (1990).

89. *See* Del. Code Ann. tit. 8, §§ 251, 271, 275 (2001).

90. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) (setting forth an "enhanced duty" before the business judgment rule is applied to a board's decision to adopt defensive measures in response to a takeover offer "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests").

91. *See* Del. Code Ann. tit. 8, §§ 251, 271, 275.

92. *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. Davis L. Rev. 407, 409, 425 (2006) (arguing that the right to sell shares is one of the most fundamental rights of shareholders because it allows shareholders to obtain the economic benefits from their investments and allows shareholders to exit if they become dissatisfied with management).

93. A poison pill is a device through which current stockholders, excluding the attempting acquirer, receive the right to convert a security into additional shares of stock at an extreme discount, thereby making the takeover significantly more expensive for the acquirer. *See* 1 Dennis J.

ments to executives,[94] and a staggered board structure.[95] Moreover, Delaware, like many other states, has an anti-takeover statute that deters takeovers structured as tender offers.[96] Still, many of these board-adopted defensive measures are in decline as these measures are perceived as simply ways to entrench boards, rather than mechanisms boards may use to protect investors from coercive and inadequate takeover offers.[97] Golden parachutes have been especially susceptible to challenge as pressure mounts on boards to tie manager compensation to long-term performance.[98] In any event, it would be unduly simplistic to assume that directors always seek to avoid a takeover due to their self-interest in remaining as directors. In fact, with the current wave of pressure on directors to hold stock and have some "skin in the game," it may be in directors' interests to consummate a takeover to realize the value of their stock holdings.

Even without an actual takeover offer, the mere possibility that a potential acquirer will make an unwanted offer undoubtedly keeps boards accountable to stockholders.[99] This is typically manifested through board actions aimed at maintaining a high stock price, thereby making it less likely that an acquirer can offer an attractive control premium to the shareholders.[100]

Block et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors 1085–91 (5th ed. 1998). The Delaware courts more highly scrutinize these types of defensive measures, particularly when they are taken in the face of a pending takeover offer, than they do other business decisions. *See, e.g.*, *Unocal*, 493 A.2d at 954. Recently a number of stockholders have proposed bylaw amendments which require stockholder approval before the board can renew a poison pill. *See* Victor Lewkow & Sarah ten Siethoff, *The Embattled Poison Pill*, *in* Contests for Corporate Control 2007: Current Offensive & Defensive Strategies in M&A Transactions 403, 405 (PLI Corporate Law & Practice, Course Handbook Series No. B-1584, 2007).

94. This defense triggers a large balloon payment to certain executive officers upon a change in control, thus making the acquisition more expensive. 1 Block et al., *supra* note 93, at 1296–98.

95. This type of "shark repellant" makes it impossible to replace the entire board at a single annual stockholders meeting. *Id.* at 1246, 1249, 1278–83. See *supra* note 77 and accompanying text for a discussion of the decline in popularity of the staggered board structure.

96. *See* Del. Code Ann. tit. 8, § 203.

97. *See* Jim Mallea, *M&A Year End Review*, FactSet Mergers, Jan. 23, 2009, https://www.factsetmergers.com/marequest?an=dt.getPage&st=1&pg=/pub/rs_20090122.html&rnd=970861 (on file with the University of Michigan Journal of Law Reform) (noting the six-year trend towards decreasing takeover defenses). *But see id.* (noting the surge in pill adoptions late in 2008 leading to the highest annual rate of pill adoptions since 2002, and arguing that this is likely related to the precipitous drop in valuations and increased risk of takeovers rather than a sea change in the current thinking on poison pills).

98. *See* 1 Block et al., *supra* note 93, at 1298 (explaining the many grounds on which golden parachutes have been criticized and noting they are often *de minimus* in comparison to the deal size); *see also* discussion *infra* note 142 and accompanying text (explaining how recent laws restrict the payment of golden parachutes by companies receiving funds from the U.S. Treasury).

99. *See* Hazen, *supra* note 17, at 182.

100. *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. Fin. Econ. 409, 410–11 (2005); Hazen, *supra* note 17, at 182.

Finally, stockholders have the right to approve amendments to a firm's charter submitted to them by the board, as well as the right to amend the bylaws without director action.[101] Stockholders have actually been increasingly using the right to amend the bylaws to give themselves a more effective voice in the election of directors.[102] While bylaws only define the processes and procedures by which board decisions are made,[103] it is clear that regulating those processes and procedures can have a significant impact on the substance of the decisions made using them.[104]

As the foregoing discussion reveals, shareholders may hold directors accountable to their interests through their statutory voting rights. Most importantly, shareholders have the right to elect directors, which is becoming increasingly effective as a result of majority vote bylaws as well as reforms aimed at increasing the likelihood of a contested director election. Shareholders also have the right to approve many significant transactions. These accountability mechanisms allow stockholders to influence board decisions. Still, these accountability mechanisms typically require the vote of a majority of shareholders for success. That means that they are less useful to minority investors seeking to individually influence board actions. That, perhaps, explains the rise of the non-voting channels of influence discussed next.

2. Short-Term Investors Influence Board Decisions Outside of the Voting Franchise—Modern Trends in Activism

The foregoing discussion does not reveal the true extent of investor influence on boards, for it depicts investors who are limited in their mode of influence to the stockholder voting franchise. But this is no longer true, particularly in the wave of activism that has emerged following the numerous collapses of the early 21st century, where many boards

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101. *See* Del. Code Ann. tit. 8, § 109(a); *see also* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 232 (Del. 2008) (holding that the stockholders' power to amend the bylaws cannot be non-consensually eliminated or limited by anyone other than the legislature).

102. *See, e.g.*, *AFSCME*, 953 A.2d at 229–30; *supra* notes 81–85 and accompanying text.

103. *See id.* at 234–35 ("It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.").

104. For example, as the Delaware Supreme Court noted in *AFSCME*, stockholders may adopt a bylaw requiring the reimbursement of any stockholder for its proxy expenses incurred in conducting a successful competing proxy solicitation, as that primarily relates to the process for the election of directors; provided that, as was not the case with the AFSCME-proposed bylaw, the board retains the authority to deny such reimbursement where to do so would be required by their fiduciary duties. *Id.* at 234–40.

were perceived as having failed to actively oversee the corporations under their charge.[105]

In this new era of activism, investors influence boards directly, without involving other stockholders. Some of the mechanisms employed by investors to influence boards include demand letters sent to the board,[106] often made public through the filing of the letter on a Schedule 13D,[107] and publicity campaigns.[108] Investors have also been using the threat of a proxy contest to obtain board concessions, often leading the board to include the threatening investor's candidates in the slate of directors nominated by the board.[109]

Through these informal channels, some investors have been expanding their scope of influence beyond matters on which they have a voting right. These investors, especially hedge funds, now commonly seek to influence boards on ordinary business decisions, such as the sale of dormant assets or lines of business,[110] the decrease of capital expenditures,[111] and the payment of dividends or repurchase of shares.[112]

105. *But see* April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* 10 (NYU Law and Econ. Research Paper Series, Paper No. 06-41, 2006) (on file with the University of Michigan Journal of Law Reform), *available at* http://ssrn.com/abstract=913362 (noting that institutional investors began to seek changes using informal communications starting in the 1980s, but these efforts had little impact on firm performance or stock price).

106. *See e.g.*, *The Children's Investment Master Fund Urges CSX to Take Immediate Action to Improve Corporate Governance and Business Performance*, Bus. Wire, Oct. 16, 2007, http://www.businesswire.com/news/home/20071016005752/en/Childrens-Investment-Master-Fund-Urges-CSX-Action (on file with the University of Michigan Journal of Law Reform) (including a letter from The Children's Investment Master Fund to the CSX board calling for the CSX board to separate the chairman and CEO roles and align management compensation with shareholder interests, among other things).

107. *See, e.g.*, CNET Networks, Inc., Beneficial Ownership Report (Schedule 13D), at 7–9 (Dec. 26, 2007) (filed by JANA Partners LLC) (disclosing a letter revealing JANA's intention to increase CNET's board size and to solicit proxies in favor of JANA's nominees).

108. *See, e.g.*, Press Release, Pershing Square Capital Mgmt., L.P., Pershing Square Capital Management Announces Public Presentation on Target Corporation on Wednesday, October 29, 2008 (Oct. 28, 2009) (on file with the University of Michigan Journal of Law Reform), *available at* http://www.smartbrief.com/news/aaaa/industryPR-detail.jsp?id=88A02468-EFC6-4FC9-A425-E2D675E9154A; *see also* Kahan & Rock, *supra* note 24, at 1029.

109. *See* Kahan & Rock, *supra* note 24, at 1029; *see also* Klein & Zur, *supra* note 105, at 67.

110. *See e.g.*, Kerr McGee Corp., Beneficial Ownership Report (Schedule 13D), at sched. A (Mar. 3, 2005) (filed by Icahn Partners L.P.) (describing Icahn's demand that the Kerr McGee board repurchase stock, sell the chemical unit and lock in oil prices on future production).

111. *See, e.g.*, Applebee's Int'l, Inc., Beneficial Ownership Report (Schedule 13D/A, Amend. No.1), at exhibit B (Dec. 11, 2006) (filed by Breeden Capital Mgmt. LLC) (describing Breeden Capital's demands on Applebee's board that they decrease capital expenditures).

112. *See, e.g.*, Brooks Automation, Inc., Beneficial Ownership Report (Schedule 13D/A, Amend. No.7), at exhibit 1 (Sep. 26, 2007) (filed by The D3 Family Fund, L.P.) (disclosing a letter from investor David Nierenberg to Robert Lepofsky, the chief executive officer of Brooks Automation, demanding that Brooks Automation repurchase shares of its stock over the next 3–4 years).

They also seek to influence board decisions as to potential takeovers before stockholders have the right to vote on the transaction.[113]

Based on the impact they have had on firms, some of these activist efforts appear designed to deliver a short-term spike in stock price. This is supported by the results of a study conducted by April Klein and Emanuel Zur in which they found that while the stock prices of the targets of hedge fund activism were abnormally high throughout the year following activism,[114] there was no evidence that those targets in fact became more profitable one year following the activism.[115] On the contrary, they found a deterioration in those firms' profitability one year following the activism.[116] Other studies and reports have found similar, deleterious long-term effects of this type of activism on public corporations.[117] Even if we cannot conclusively establish that any particular case of activism is designed to generate short-term returns for investors, the empirical evidence of the effects of activism does suggest the truth of this conclusion in many cases. This conclusion also seems consistent with the conclusion in Section A that many investors, particularly hedge funds, are short-termists who desire short-term results. We should indeed expect investors who are short-termists and who use a strategy of activism to

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113. *See, e.g.*, Lexar Media, Inc., Beneficial Ownership Report (Schedule 13D), at exhibit B (Mar. 20, 2006) (filed by Elliott Assocs., L.P.); Lexar Media, Inc., Beneficial Ownership Report (Schedule 13D/A, Amend. No.1), at 2 (Apr. 6, 2006) (filed by Icahn Partners Master Fund LP) (describing Elliott Associates' and Icahn's pressure on the Micron board to oppose the acquisition of Lexar).

114. Klein & Zur, *supra* note 105, at 38, 40.

115. *Id.* at 40.

116. *Id.* at 43 (finding that there is no immediate increase in the firm's accounting profitability or other firm performance indicators either pre- or post-activism, and finding, on the contrary, evidence that earnings-per-share ratios (EPS) may decline in the year following the investment that triggers 13D filing requirements). Klein and Zur also found that hedge fund targets were not particularly poor performers. *See id.* at 24 (finding that the targets of hedge funds have higher earnings, are financially healthier, and have more cash on their balance sheets than targets of other entrepreneurial activists). *But see* Greenwood & Schor, *supra* note 22, at 24 (finding that the targets of hedge funds underperformed relative to other firms in their industry). While the Klein/Zur study does not look at the impact of this activism over a period of longer than one year, the data does suggest that returns, while initially positive, decrease over time. *See* Klein & Zur, *supra* note 105, at 40.

117. *See, e.g.*, Jonathan Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. Fin. Econ. 365, 365–69 (1996) (finding shareholder proposals targeting corporate governance issues ineffective at increasing shareholder value or improving firm's longer-term operating performance). *But see* Brav et al., *supra* note 23, at 3 (finding a statistically meaningless reaction from the market for capital structure-related activism and governance-related activism but a positive abnormal reaction where hedge funds are active in changing a company's business strategy or a sale of the company); Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 Yale J. on Reg. 174, 177 (2001) (noting that the empirical evidence suggests that shareholder activism has an insignificant effect on targeted firms' performance, and that while a few studies find evidence of a positive impact, other studies find a significant negative stock price effect from activism).

use their sway to bring about short-term results, regardless of the adverse impact that might have on a firm in the long-term.

Many of the reasons discussed in Section A as to why hedge funds are often shorter-term investors than other investors also explain why many hedge funds are more active than other types of investors.[118] Namely, because hedge funds are not subject to the diversification requirement under the Investment Company Act, they can take larger stakes in public companies than can other institutional investors that are subject to that act.[119] That, in turn, enables hedge funds to receive a larger proportionate share of the benefits generated by their activism than they otherwise would with a smaller ownership percentage.[120] Moreover, because they generally earn a percentage of fund profits, fund managers have an incentive to use activism to bring about corporate decisions that generate profits in the short-term.[121] This incentive exists notwithstanding any longer-term downside to the firm from those decisions.[122] The fact that hedge funds can reduce or eliminate the economic risk associated with their investments[123] might also explain their disproportionate activism, for it creates an incentive for them to influence decisions to create stock price spikes, but also to cause stock prices to drop, allowing them to profit off of those downward adjustments.[124]

As the foregoing discussion reveals, investors are becoming increasingly influential in corporate decision-making through non-voting channels. Empirical evidence suggests that some of those activist efforts, particularly those by hedge funds, may impair firm profitability in the long-term. Yet even on a theoretical level, investor short-termism coupled with the rise of activism is worrisome, for it leads intuitively to

118. In their study, Robin Greenwood and Michael Schor found that hedge funds engaged in activism using 13D filings more than four times as often as other institutional investors. *See* Greenwood & Schor, *supra* note 22, at 10.

119. *See supra* notes 28–30.

120. *See* Kahan & Rock, *supra* note 24, at 1062 (arguing that evidence suggests that hedge funds enjoy significant economies of scale).

121. *See supra* note 24 and accompanying text.

122. This is the same phenomenon that causes officers to be short-termists that is discussed *infra* in Part I.C.

123. *See supra* note 31 and accompanying text.

124. The King Pharmaceuticals-Mylan Laboratories merger is one of the primary examples of a hedge fund hedging away its economic risk associated with a firm's stock and then supporting a merger of that firm with another in which the hedge fund owned a substantial interest at a price that stockholders generally viewed as inadequate. *See* Kahan & Rock, *supra* note 24, at 1075 (describing the Mylan Laboratories transaction as "[a] particularly extreme form of a hedging-related conflict"). While the hedge fund did not use activism to influence the Mylan Laboratories board to seek a merger, it is not difficult to imagine a situation where a hedge fund would seek to influence that decision through activism. *See* Anabtawi & Stout, *supra* note 6, at 1286–87 (indicating that conflicts between activists and other shareholders can exist when activist shareholders take "adverse positions" in derivatives or in securities offered by other companies, and citing as an example a hedge fund that takes a net short position in a company, which allows the hedge fund to profit from its status as a shareholder, and pushes for corporate strategies that drive share price down).

the conclusion that investors will, on occasion, use activism to bring about decisions that create short-term value, even where that might impair the long-term well-being of a firm.

Advocates of shareholder voice have justified shareholders' ability to influence the board on the basis that shareholders as a class would never vote to adopt measures that did not benefit shareholders collectively—as represented by approval by a majority of shareholders.[125] This was supported by the number of shareholder proposals that addressed social concerns of pension funds that did not receive majority vote approval.[126] But now that shareholders are affecting corporate decisions outside of the shareholder franchise, it once again raises the concern that shareholders are influencing board decisions in their own self-interest, without any "cleansing" majority shareholder vote to ensure their actions benefit the majority of shareholders. The fact that many activist investors have shorter investment horizons than other investors only contributes to the long-term risk to corporations of this type of activism.

C. Executive Officer Short-Termism Affects Board Decisions

Investors are not the only class of corporate constituent that has reasons to pressure the board for decisions that yield short-term results. Executive officers also have reasons to want a corporation to be profitable in the short-term.

The primary rationale for executives' short-term focus is the prevalence of the executive compensation practice of tying executive compensation to short-term financial metrics such as stock price and earnings per share.[127] This creates an incentive for officers to manage with the goal of maximizing short-term profits, thereby increasing the amount of their compensation.[128] This short-termism

125. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 Case W. Res. L. Rev. 557, 564 (2005) ("Indeed, past voting patterns clearly indicate that shareholder resolutions that are brought because of their appeal to shareholders with special interests generally do not pass.").

126. *See* discussion *supra* notes 87–88 and accompanying text.

127. *See* Comm. for Econ. Dev., *supra* note 49, at 3 ("Performance triggers for incentive payments, when used, are often tied to short-term financial indicators such as annual earnings per share or share-price performance. Such targets encourage executives to adopt too short a time horizon and to focus too much on short-term share price and accounting measures and not enough on long-term strategic development."); Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. Pa. J. Lab. & Emp. L. 227, 234 (1999).

128. *See* Comm. for Econ. Dev., *supra* note 49, at 3. One might ask why shareholders tolerate such lavish pay practices, as that likely means there are fewer assets available to shareholders. One likely reason is that this practice does not constitute a breach of any duty owed to shareholders so long as there is a rational business purpose associated with the compensation decision, and the decision is not made in bad faith. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006). Moreover, short-termists likely tolerate this practice as it means that managers are generating

by officers impacts boards, for boards rely heavily on officers to provide the information the board needs to make business decisions.[129] Thus officers have an incentive—and the means—to provide information favoring short-term business decisions. Boards also rely heavily on officers in forming strategy, for boards are effectively overseers of the strategic-planning process.[130] Again, to the extent officers control strategy-setting and related information flows to the board, that process is undoubtedly imbued by officers' short-term agendas. This is particularly true as boards become more independent per SEC and stock exchange rules, placing them more at the mercy of corporate insiders for information and strategic ideas.[131]

There is a strong movement afoot to tie officer compensation to long-term performance targets.[132] This is exemplified by the large number of proposals made by shareholders since 2006 requesting that shareholders be given an advisory vote on executives' compensation, or a "say on pay."[133] While those proposals generally do not identify as their goal a desire to tie management compensation to *long-term* performance, boards seems to interpret that as their implicit purpose, as they generally respond by identifying how their compensation arrangements already award managers for long-term profitability.[134]

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short-term profits for their benefit as well. *See* discussion *supra* Part I.A; *see also* Daniel J.H. Greenwood, *The Dividend Puzzle: Are Shares Entitled to the Residual?*, 32 J. Corp. L. 103, 151–52 (2006) (arguing that while shareholders do not have the right to receive dividends, they have the good fortune of receiving them as a side-effect of managerial self-enrichment).

129. Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 Hofstra L. Rev. 89, 105 (2004) ("As a practical matter, the outside directors must rely on information presented to them by the corporation's officers when making decisions. . . . Given these constraints of time and information, the board can hardly initiate much of any corporate strategy or decisions. Instead, the board's role largely falls to approval of such strategies and decisions as officers bring before the board.").

130. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. Pa. L. Rev. 1399, 1415 (2005) ("[T]he board of directors will actually *direct* and monitor the management of the company, including strategic business plans . . . .").

131. *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921, 951 (1999) (citing Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 Acad. Mgmt. Rev. 72 (1990)) (arguing that insiders may be better at making strategic planning decisions). *But see* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 Geo. L.J. 797, 803 (2001) (arguing that objective outsiders also serve a useful purpose in strategic planning as they can expose insiders' biases).

132. *See* Lucian A. Bebchuk & Jesse M. Fried, Pay Without Performance*: Overview of the Issues*, 30 J. Corp. L. 647, 670 (2005).

133. *See supra* note 86 and accompanying text.

134. *See, e.g.*, Exxon Mobil Corp., Definitive Additional Proxy Soliciting Materials and Rule 14(a)(12) Materials (Schedule 14A), at 2 (May 12, 2008) ("The Board works diligently to ensure that the Company's compensation philosophy and elements drive behavior that is aligned with long-term shareholder value creation."); UnitedHealth Group Inc., Definitive Proxy Statement (Schedule

The federal government, too, has immersed itself in this movement towards coupling manager compensation and long-term corporate performance. While the world awaited a quick Congressional response to the financial crisis that threatened the survival of insurance giant AIG and banks Bank of America and Citigroup, among others, Congress debated how to limit the profit-based compensation of the executives whose institutions were ailing and needed financial assistance.[135] The result was a host of restrictions in the law setting forth the U.S. Treasury's initial effort at a bail-out—the Emergency Economic Stabilization Act of 2008, or EESA—aimed at de-coupling executive compensation and short-term performance at companies that receive meaningful financial assistance from the U.S. Treasury.[136] These restrictions include a prohibition on senior executives' compensation for "unnecessary and excessive risks that threaten the value of the financial institution."[137] Moreover, those executives must repay any income awarded to them due to financial performance that later turns out to be materially erroneous.[138] And none of those executives may receive a severance bonus upon a change in control while the Treasury holds its investment.[139]

Congress passed a second bail-out law—the American Recovery and Reinvestment Act of 2009, or ARRA—on the heels of the EESA, with the goal of stimulating the U.S. economy primarily through federal tax cuts, job creation, and domestic spending initiatives.[140] The ARRA greatly expands on the EESA's compensation restrictions by capping the amount of incentive compensation that may be paid to senior executives of companies that receive financial assistance under the EESA to one third of the amount of their salaries.[141] Yet the ARRA goes further, capping the salaries, not only of top executives, but also of the next 20 most highly paid employees, at companies that receive exceptional assistance

14A), at 21 (Apr. 29, 2008) ("We endeavor to closely align these goals [the achievement of enterprise, business unit, and individual goals] with shareholder interests by defining expected business, customer and employee outcomes that create shareholder value over the longer term.").

135. *See* 110 Cong. Rec. H10,702–10, H10,712–06 (daily ed. Oct. 3, 2008); 110 Cong. Rec. S10,220–83, S10,291–95 (daily ed. Oct. 1, 2008); 110 Cong. Rec. H10,337–11 (daily ed. Sept. 29, 2008).

136. *See* Emergency Economic Stabilization Act of 2008, 12 U.S.C.A. §§ 5201–5261 (West Supp. 2009), *amended by* American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, § 7001, 123 Stat. 115, 516–20 (2009).

137. *Id.* § 5221(b)(2)(A).

138. *Id.* § 5221(b)(2)(B). This requirement is similar to the claw-back provision of the Sarbanes-Oxley Act of 2002, though SOX requires misconduct for the claw-back requirement to kick in. *See* 15 U.S.C.A. § 7243(a) (West 2009).

139. 12 U.S.C.A. § 5221(b)(2)(C).

140. American Recovery and Reinvestment Act § 3, 123 Stat. at 115–16.

141. *Id.* § 7001, 123 Stat. at 517–18. Moreover, this incentive compensation may only be paid in the form of long-term restricted stock. *Id.*

from the U.S. Treasury.[142] While these restrictions follow on the heels of the EESA's efforts to curb the mis-match between executive compensation and true long-term performance, they clearly go further by limiting the total compensation (regardless of long-term profitability) that may be paid to the most highly compensated employees at all companies that receive funds from the U.S. Treasury.[143]

These new bail-out laws are clearly targeted at limiting the incentives for executives to manage in a way that benefits themselves financially in the short-term, notwithstanding the future risks those decisions pose, including the disappearance of those profits over the long-term. Still, the EESA and ARRA only apply to firms that receive financial assistance from the U.S. Treasury—and many of the restrictions only apply to the senior executives at firms that receive significant financial assistance. Yet it should be obvious that the compensation problems that these laws seek to address are not limited to the few institutions that obtain financial assistance from the U.S. Treasury. Nevertheless, through these laws Congress likely sought to set new standards in the area of executive compensation, to be followed by boards of firms that do not receive the U.S. Treasury's financial assistance.[144] This is consistent with the mes-

142. *Id.* This restriction applies to officers and employees at companies that receive more than $500 million in funding under the TARP established under the EESA. *Id.* The act also expands the ban on golden parachutes under the EESA so that it applies to all companies that receive funds from the U.S. Treasury under the TARP. *Id.* This act more broadly implements some of the guidelines that had previously been promulgated by the U.S. Treasury, also aimed at limiting the compensation of top executives. *See* Press Release, U.S. Dep't of Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009) [hereinafter Press Release, U.S. Dep't of Treasury] (on file with the University of Michigan Journal of Law Reform), *available at* http://www.ustreas.gov/press/releases/
tg15.htm. In these guidelines, the Treasury also called for the SEC's cooperation to pass regulations that require compensation committees of all public financial institutions to review and disclose executive and certain employee compensation arrangements and explain how these compensation arrangements are consistent with promoting sound risk management and long-term value creation for their companies and their shareholders. *Id.* The Federal Reserve is also in the process of proposing new rules that would give it an effective approval right over all bankers' pay with the goal of restricting pay plans that encourage reckless behavior by rewarding only short-term gains. Damian Paletta & Jon Hilsenrath, *Bankers Face Sweeping Curbs on Pay*, Wall St. J., Sept. 18, 2009, at A1.

143. As Professor Lucian Bebchuk has argued, the restriction in the ARRA "[m]andating that at least two-thirds of an executive's total pay be decoupled from performance, as the stimulus bill does, is a step in the wrong direction," as it constrains boards' ability to reward executives for long-term performance. Lucian Bebchuk, *Congress Gets Punitive on Executive Pay*, Wall St. J., Feb. 17, 2009, at A15.

144. This seems to be yet another example of Congress treading on state corporate law's domain of regulating internal affairs of corporations incorporated in those states. *See* Thomas Lee Hazen, The Law of Securities Regulation 809 (5th ed. 2006) (noting a departure after the Sarbanes-Oxley Act of 2002 from the dichotomy where states define officers' and directors' duties and federal securities laws regulate information provided to investors). On that basis, I question whether a federal, one-size fits all legislation in the area of executive compensation is the best way to address the problem of excessive short-termism, especially given the myriad of different reasons why investors and boards are short-termists, as discussed in this Article. My recommendation for addressing the short-termism problem in a more general way is discussed in Part V *infra*.

sage that has been repeatedly delivered by President Obama's administration that the administration is placing at the top of its agenda curbing the mis-match between executive compensation and corporate performance.[145]

Still, these acts only address one source of short-termism—that created by executive compensation practices. They do not, however, provide a comprehensive approach to the problem of short-termism, nor do they offer a coherent strategy to re-orient boards and managers on the long-term.

D. Summary

While the stock market would, in an ideal world, cause investors to price a corporation's stock at its true value, we do not live in an ideal world. Stock prices seem to overly reflect firms' short-term values. That largely stems from investors' over-reliance on financial statements that fail to capture firms' long-term values. While not every investor is a "short-termist," these information biases would tend to make investors more short-termist than they might otherwise be. Investor short-termism also emerges from investors' irrational behavior, exemplified by the current financial crisis in which investors got caught up in the housing bubble and herded to the same financial securities despite the long-term risks of those investments.

Investors whose investment strategies include activism tend to have shorter investment horizons than the average investor. These investors have been using techniques outside of the shareholder franchise to compel boards to make decisions that benefit these investors in the short-term, while having a potential value-destroying impact on the corporation in the long-term. Directors are not impervious to these short-term pressures, not only because they risk not being reelected if they appear to be unresponsive to shareholder demands, but also because they are exposed to the risk of ouster in connection with a takeover transaction if they do not maintain a high stock price. Directors likely also focus on

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145. *See, e.g.*, Pres. Barack Obama, Remarks by President Barack Obama on Executive Compensation with Secretary Geithner (Feb. 4, 2009) (transcript available at http://www.whitehouse.gov/the_press_office/RemarksbyPresidentBarackObamaOnExecutiveCompensationSecretaryGeithner) (on file with the University of Michigan Journal of Law Reform) ("[I]n order to restore our financial system, we've got to restore trust. And in order to restore trust, we've got to make certain that taxpayer funds are not subsidizing excessive compensation packages on Wall Street."); Press Release, U.S. Dep't of Treasury, *supra* note 142 ("[T]he standards [referring to the new Treasury guidelines on executive pay] . . . mark the beginning of a long-term effort to examine both the degree that executive compensation structures at financial institutions contributed to our current financial crisis and how corporate governance and compensation rules can be reformed to better promote long-term value and growth for shareholders, companies, workers and the economy at large and to prevent such financial crises from occurring again.").

short-term performance because that is the time period as to which executives are concerned, due to the nature of their compensation. That impacts the board because the executive officers are the board's primary source for information about the corporation's operations as well as areas for growth. Moreover, the executive officers actually develop and implement the corporation's strategy while the board merely oversees that from its independence perch.

But is short-termism necessarily a bad thing? In other words, might it not be a good thing to allow investors and managers to profit off of short-term stock price movements, even if that impairs a corporation's long-term success? That is the question that I turn to next.

II. Is Short-Termism Bad?

We need to look no further than the current financial meltdown to get a sense of the ill effects of corporate short-termism, not just on individual business enterprises, but on the entire U.S. economy and community. To set the stage, we must first understand the role of short-termism in causing the recent crisis.

Leading up to the current financial crisis, financial institutions took large positions in mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs).[146] MBSs are securities whose payment derives principally or entirely from mortgage loans, while CDOs are securities whose payment derives from a mixed pool of mortgage loans and other receivables.[147] When home prices plummeted in 2008, many borrowers defaulted on their loans, including loans that backed MBSs and CDOs.[148] The result was either the impairment, or total loss, in value of MBSs and CDOs, particularly those that were more junior in priority of payment.[149]

One of the primary reasons why financial institutions invested so heavily in these securities is that they failed to appreciate the longer-term risks associated with these investments—particularly the risk of a hous-

146. According to Federal Reserve Chairman Ben Bernanke, subprime lending grew from $35 billion in 1994 to $600 billion in 2006. Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve, Remarks at the National Community Reinvestment Coalition Annual Meeting (Mar. 14, 2008) (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm) (on file with the University of Michigan Journal of Law Reform). These sub-prime loans were loans that backed MBSs and CDOs. *See* Schwarcz, *supra* note 68, at 375–76 (explaining how the subprime mortgage meltdown infected the markets for MBSs and CDOs).

147. Schwarcz, *supra* note 68, at 376. There is a separate class of securities that is backed by a mixed pool of MBSs and other asset-backed securities (ABSs), referred to as ABS CDOs. *Id.* To the extent those pools contain MBSs, they, too, derive their payments from mortgage loans. *Id.*

148. *Id.* at 378–79.

149. *Id.*

ing market collapse.[150] This may have resulted from the euphoria of the moment (i.e., a bubble), where investors failed to pay close attention to what they were buying,[151] or the herding phenomenon, meaning investors simply followed the pack to invest in MBSs and CDOs.[152] Or it may have resulted from factors similar to those that impel executives to manage for the short-term—namely, compensation for originators and investment bankers that was tied to short-term success (i.e., security placement) notwithstanding the longer-term risks of an investment in the securities they originated and sold.[153] As a consequence, many firms had large exposures to MBSs and CDOs that, once the longer-term risks materialized, generated tremendous firm losses, reversing previously realized profits.[154]

These losses have had a significant impact not only on the firms that invested in the MBSs and CDOs, but also on the entire U.S. economy. Due to the failure of so many financial institutions, the credit markets have seized up, making it very difficult for U.S. businesses to get the debt financing they have needed to operate.[155] This has, in turn, led to a dramatic decline in capital spending and R&D.[156]

This is alarming, for capital investments and R&D are the lifeblood of corporate growth.[157] Without these types of investments and expenditures, there would be no new income-producing assets, and no new

150. *Id.* at 379 (arguing that the failure of investors to envision a worst-case scenario that would result from the fall of the housing market reflected to some extent a failure to take a sufficiently long-term view of risk); *see also* Lowenstein, *supra* note 16, at 10 ("Nobody [who invested in MBSs and in the banks that own them] was thinking about what these companies were worth, only about the next quotation on the screen."). *But see* Schwarcz, *supra* note 68, at 380 (arguing that the failure to have forecasted a worst-case possibility such as the experience of the Great Depression is inevitable since that is assessed *ex ante*).

151. Schwarcz, *supra* note 68, at 382. Some investors undoubtedly decided, rationally, to invest in these securities with the hope of benefiting from the housing market bubble before it burst.

152. *Id.* This phenomenon, again, could have been the product of rational choice by some investors who believed they could break from the herd before the market collapsed.

153. *See id.* at 384–85.

154. Though not for the originators and fund managers whose compensation was not clawed back following these losses. *Id.*

155. *See* Craig K. Elwell, Financial Market Turmoil and U.S. Macroeconomic Performance 1 (2008) (on file with the University of Michigan Journal of Law Reform), *available at* http://assets.opencrs.com/rpts/R40007_20081203.pdf ("The move toward short-term lending diminishes the flow of long-term credit to the non-financial economy and dampens the economic activities of households and businesses that are dependent on borrowing.").

156. *See id.* at 5 ("After advancing 7.5% in 2006, the pace of spending by businesses on new plant and equipment slowed to 5.0% in 2007, and through the second quarter of 2008 that pace had slowed to about 2.3%.").

157. *See* Michael E. Porter, *Why America Needs an Economic Strategy*, Bus. Wk., Nov. 10, 2008, at 39, 40 ("An inadequate rate of reinvestment in science and technology is hampering America's feeder system for entrepreneurship.").

innovations, to steam corporate growth.[158] A firm creates wealth through capital investments or R&D by investing in new products and new ways to produce or commercialize existing products and services.[159] But it takes time for these investments to materialize, since they necessarily involve something new and unknown.[160]

The seizing up of the credit markets post-crisis does not alone explain the decline in capital investments and R&D expenditures. This is likely also due in part to pressure placed on managers to forego R&D and capital expenditures as a way to boost corporate profits.[161] Unless this pressure is alleviated, the trend towards decreasing levels of capital investments and R&D may continue, leading to a decline in innovation and entrepreneurism in the U.S.

The financial crisis also shows the significant social cost of the failure of numerous large U.S. public companies. Since the start of the 2008 economic crisis, the U.S. unemployment rate has soared to 10% (in December 2009) from 5% (in December 2007).[162] And the trend of an unemployment rate close to 10% seems to be continuing.[163]

All of these and other adverse consequences of the financial crisis reaffirm the view of the corporation—specifically the public corporation—as not simply an autonomous, self-contained economic unit, but instead as a key member of the economic and social fabric of the U.S. economy.[164] Recognizing the impact of the crisis on U.S. businesses, the

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158. *See* William T. Allen & Leo E. Strine, Jr., *When the Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton's Vision of the Corporate Law*, 60 Bus. Law. 1383, 1388 (2005) ("For [Martin Lipton], social wealth is actually created, not in financial markets, but within corporations—where research scientists invent products, engineers plan, and marketing and production people at all levels of the corporation develop and execute strategies to deliver attractive goods and services efficiently."); Porter, *supra* note 157.

159. *See* Houman B. Shadab, *Innovation and Corporate Governance: The Impact of Sarbanes-Oxley*, 10 U. Pa. J. Bus. & Emp. L. 955, 962 (2008) ("The capability of a firm to create change through innovation . . . is a source of value to the business and its shareholders. For this reason, successful innovation results in better economic performance . . . .").

160. *See id.* at 963.

161. *See* discussion *supra* Part I.A.2.

162. Bureau of Labor Statistics, The Employment Situation: December 2008 (2009) (on file with the University of Michigan Journal of Law Reform), *available at* http://www.bls.gov/news.release/archives/empsit_01092009.htm; Bureau of Labor Statistics, Labor Force Statistics From the Current Population Survey, http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000 [hereinafter Bureau of Labor Statistics, Labor Force Statistics] (on file with the University of Michigan Journal of Law Reform). From December 2005 to December 2007, the rate had fluctuated between 4.4% and 5.0%. *Id.*

163. U.S. Department of Labor statistics show that the unemployment rate since December 2009 has fluctuated between 9.7 and 9.9. Bureau of Labor Statistics, Labor Force Statistics, *supra* note 162.

164. Berle and Means recognized this to be true over 75 years ago. *See* Berle & Means, *supra* note 12, at 1 (describing the public corporation as a "major social institution"); *see also* Kent Greenfield, *Proposition: Saving the World with Corporate Law*, 57 Emory L.J. 948, 963 (2008) (arguing that the ultimate goal of corporate law should be to create societal wealth, broadly defined).

economy, and the citizenry, the federal government has staged the largest cumulative financial assistance package ever conceived, providing over $2.1 trillion in capital to U.S. businesses.[165] The terms of the financial assistance clearly show a policy in favor of U.S. businesses creating *sustainable* business models. This is reflected in the compensation provisions of the EESA and ARRA,[166] as well as in the conditions placed on the funds made available to GM and Chrysler.[167] It is also apparent from repeated messages delivered by the Obama administration that U.S. businesses need to be successful in the long-term.[168]

In summary, the current financial crisis has shown the ills of corporate short-termism on U.S. businesses as well as on our national economy and citizenry. Not only did businesses fail to appreciate, or choose to ignore, risks associated with their investments due to their short-term profit-induced stupor, but they also failed to protect themselves from those risks. The collective impact has been numerous corporate failures, a serious contraction in credit markets, an alarming decline in employment, and an overall skepticism as to the strength of the U.S. economy.

That is not to say that corporations, and corporate law, should be designed to enhance social wealth without regard to financial returns to investors. In fact, if directors ignored or placed a second priority on stockholders' financial interests, investors would undoubtedly be reluctant to part with their money for fear that their investments would simply be used to create wealth for others in society. But corporate law, as with other law, reflects a series of policy choices.[169] Thus the policies that

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165. *Adding Up the Government's Total Bailout Tab*, N.Y. Times, Feb. 4, 2009, http://www.nytimes.com/interactive/2009/02/04/business/20090205-bailout-totals-graphic.html (on file with the University of Michigan Journal of Law Reform) (stating that the government has spent $528 billion lending to businesses and $1.6 trillion investing in businesses). The above amount does not include financial assistance in the form of government insurance or tax benefits.

166. *See* discussion *supra* notes 136–43 and accompanying text.

167. Both Congress and the administration set as a condition to financial assistance to GM and Chrysler that they each present a business plan showing how they could be profitable on a sustainable basis. *See* U.S. Dep't of Treasury, Program Descriptions: Automotive Industry Financing Program (July 6, 2009), http://financialstability.gov/roadtostability/programs.htm (on file with the University of Michigan Journal of Law Reform) (stating that the Automotive Industry Financing Program "will require steps be taken by participating firms to implement plans that achieve long-term viability"). For more detailed information concerning the Automotive Industry Financing Program, see U.S. Dep't of Treasury, Automotive Industry Financing Program, http://financialstability.gov/roadtostability/autoprogram.html (on file with the University of Michigan Journal of Law Reform).

168. *See, e.g.*, Pres. Barack Obama, Weekly Address of President-elect Barack Obama (Jan. 3, 2009) (transcript available at http://change.gov/newsroom/entry/american_recovery_and_reinvestment/) (on file with the University of Michigan Journal of Law Reform) ("We need an American Recovery and Reinvestment Plan that not only creates jobs in the short-term but spurs economic growth and competitiveness in the long-term.").

169. *See* Lipton & Rosenblum, *supra* note 5, at 193 ("Given the corporation's origins as a historical and legal construct created for specific public policy reasons, the state naturally may choose

serve as the foundation for our corporate laws should reflect the reality that the purpose of corporations is not simply to generate quick wealth for shareholders, but to generate *sustained* wealth for shareholders, as well as for our society as a whole. As William Allen, former Chancellor of the Delaware Chancery Court, and Vice Chancellor Strine have keenly observed on this point, "corporation law itself, in this view [referring to Martin Lipton's institutionalist view], is seen as but a part of a larger economic and social policy that sought and seeks to promote wealth creation, not simply for the benefit of stockholders and managers, but more generally for the benefit of a nation."[170]

As a vital component to the creation of durable societal wealth, corporations must look to being successful in the long-term, to give their capital investments and innovative projects time to germinate and yield returns. It is counterproductive to this goal for corporations to focus primarily on generating profits for their investors on a quarter-to-quarter or even year-to-year basis.[171] Because long-term wealth creation is a substantial policy concern, corporate laws should be designed to further that interest and to dissuade corporate players from pursing counterproductive goals.

The obvious question then becomes: how do we fix our system so that it achieves the goal of long-term value creation? In my view, the most sensible place to start is at the board level, as directors are the hubs that keep the corporate spokes together. More specifically, directors are charged with overseeing a corporation's business and affairs.[172] In that capacity, they have the duty to make business decisions and oversee the corporation with the objective of the corporation achieving its business purpose.[173] Therefore, it makes sense to

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to condition the use of the corporate form upon compliance with rules that advance societal goals, even if those goals clash with stockholder interests.").

170. Allen & Strine, *supra* note 158, at 1385; *see also* Leo E. Strine, Jr., Response, *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 Harv. L. Rev. 1759, 1764 (2006) ("The primary goal of corporate law [under the traditionalist perspective], therefore, is not to prevent failure at each and every firm to the fullest extent possible, but to facilitate the maximum creation of durable societal wealth by all firms."). For an explanation of how business decisions can be made in the interest of both shareholders and society, see discussion *infra* Part IV.

171. The many business and investment leaders who met at the Conference Board's Corporate/Investment summit echoed this sentiment. As their report states, "Undoubtedly, the health of an economic system depends on its ability to perform well year after year—not only during the next quarter." Tonello, *supra* note 49, at 5; *see also* Lipton & Rosenblum, *supra* note 5, at 192 ("The health and stability of these economies [referring to the economies of the U.S. and U.K.] depends on the ability of corporations to maintain healthy and stable business operations over the long term and to compete in world markets.").

172. *See* discussion *infra* Part III.A.

173. *See* discussion *infra* Part III.A. This is true even though the business judgment rule generally shields directors from liability for decisions that have a rational business purpose and are made in good faith.

implement the corporate objective of long-term value creation through the board, the primary overseer of corporate operations and strategy. It is thus to the board that I turn to next.

III. What it Means for Directors to Act in the Best Interest of the Corporation and its Stockholders

As I discuss in Part I, investors in public companies as well as some executives have reasons to want corporations to generate profits in the short-term. Part I also explains how those investors and executives can influence boards to make decisions that are responsive to their short-term interests. However as I explain in Part II, managing a corporation for the benefit of those short-term interests is antithetical to the goal of creating sustainable wealth for individual businesses and for our economy.

This section explains why directors have the freedom to be responsive to investors' and executives' short-term interests under their fiduciary duties, even though that runs counter to the interests of long-term minded investors, other corporate constituents, and our economy. This discussion focuses on Delaware law, not only because it is the jurisdiction where the majority of public corporations are incorporated,[174] but also because Delaware law is followed, or looked to for guidance by, courts in other jurisdictions.[175]

A. Introduction

Directors oversee the management of the business and affairs of the corporation on whose board they serve.[176] In this capacity, they are described as fiduciaries of the corporation and its shareholders.[177] That means that in exercising their powers, directors must comply with their fiduciary duties.[178]

174. *See* 1 Block et al., *supra* note 93, at 2–3 (finding that a majority of public corporations are incorporated in Delaware).

175. Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 Fordham J. Corp. & Fin. L. 393, 397 (2007); *see also* Dennis J. Connolly & Bess M. Parrish, *Current Issues Involving the Application of Exculpation and the Business Judgment Rule to Creditors' Suits Against Directors of Insolvent Corporations*, 2006 Ann. Surv. Bankr. L. 1, 4.

176. Del. Code Ann. tit. 8, § 141(a) (2001).

177. Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).

178. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993).

In Delaware, directors owe the fiduciary duties of care and loyalty.[179] Under the duty of care, every director must become informed of all material information reasonably available before making a business decision.[180] However, due to operation of the business judgment rule, directors are only liable for failing to comply with that duty where their failure amounts to gross negligence.[181] And even then they might not be liable if the corporation has an exculpation charter provision or otherwise agrees to exculpate the directors for breaches of the duty of care.[182]

The duty of loyalty mandates that every director act in good faith in a manner she reasonably believes to be in the best interest of the corporation and its shareholders.[183] Courts typically analyze the duty of loyalty by explaining how a director violates that duty.[184] As such, a director breaches her duty of loyalty where she acts in a way that works injury to the corporation, or she deprives the corporation of a profit or advantage either that her skills and ability might bring to the corporation, or that the corporation would make in the exercise of its powers.[185]

Moreover, a director violates her duty of loyalty where she acts in bad faith.[186] The Delaware Supreme Court has identified at least three ways in which a director can be found to have acted in bad faith.[187] One way is to consciously disregard her duties.[188] Bad faith also exists where a director acts with a subjective intent to harm a corporation.[189] A third type of bad faith involves a director who acts carelessly with a higher state of culpability than gross negligence, though it is not entirely clear exactly what level of culpability is required.[190]

179. *Id.* at 367 ("Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders.").

180. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

181. *Id.* Under the business judgment rule, business decisions are presumed to have been made in good faith, on an informed basis, and in an honest belief that the action taken is in the best interest of the corporation. *Id.* To rebut that presumption, a stockholder must prove that the board failed to so inform itself, and that failure amounted to gross negligence. *Id.*

182. *See* Del. Code Ann. tit. 8, § 102(b)(7) (2001); Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) ("Our jurisprudence since the adoption of the statute has consistently stood for the proposition that a Section 102(b)(7) charter provision bars a claim that is found to state only a due care violation."). Corporations can also indemnify directors for breaches of their duty of care. *See* Del. Code Ann. tit. 8, § 145.

183. *Cede & Co.*, 634 A.2d at 361 (citing Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984)).

184. *See, e.g.*, *id.* at 362 ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.").

185. *Id.* at 361; Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

186. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) (clarifying that the failure to act in good faith results in liability because it is a necessary condition to compliance with the duty of loyalty).

187. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006).

188. *Id.* at 66–67.

189. *Id.* at 64.

190. *See id.* at 64–66.

But fiduciary duties are not merely proscriptive, indicating what conduct a director may not engage in. They also require directors to *affirmatively* protect the interests of the corporation committed to her charge.[191] This affirmative aspect of fiduciary duties is important, for it instructs directors that their business decisions and oversight responsibilities must be implemented not merely to avoid breaching a duty of trust to the corporation, but to affirmatively advance the corporation's purpose.

Delaware court decisions have focused much less on this positive aspect of fiduciary duties than on their proscriptive aspects. That is undoubtedly due to the fact that the cases that appear before the Delaware courts involve sub-par director conduct, where the courts are asked to determine whether that conduct meets the applicable standard of liability. Yet it is important to understand exactly what the affirmative aspect of fiduciary duties requires, for that establishes what purpose, and for whose benefit, directors must manage and oversee corporate affairs.[192]

It seems particularly important to determine how directors affirmatively act in the best interest of the corporation and its stockholders in the current environment, as investors are increasingly placing pressure on boards to make decisions that yield short-term results and executive compensation arrangements are driving managers to present information and strategic options to the board that are unduly focused on short-term profits. By determining what the corporation's and its stockholders' true interests are that directors must

191. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("Not only do these principles demand that corporate fiduciaries absolutely refrain from any act which breaches the trust reposed in them, *but also to affirmatively protect and defend those interests entrusted to them*." (emphasis added)); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("[T]he board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source."); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

192. Not undertaking sufficient processes to make informed decisions that further the corporation's purpose, or perhaps not understanding what the corporation's purpose is, would seem to be a conscious disregard of a duty, and thus amount to bad faith under the duty of loyalty. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749–50 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests." (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996))); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L.J. 1, 41–42 (2005) ("The duty of care, in other words, contains within itself an assumption that the decision-maker is motivated by the corporation's business purpose."). While the duty of care largely lacks teeth, as directors can be exculpated for liability arising out of breaches of that duty, directors' failure to exercise sufficient care may create liability where that failure amounts to bad faith. *See supra* notes 182, 186–88 and accompanying text.

advance, directors should be able to more clearly determine whether their decisions and oversight duties are truly being performed in the best interest of the constituents who they must protect under their fiduciary duties.

The remaining portion of this Part IV explores how the Delaware courts have interpreted and applied the positive duty to act in the "best interest of the corporation and its stockholders."

B. Acting in the Best Interest of the Corporation and its Stockholders

In Delaware, courts generally interpret the affirmative duty to act in the best interest of the corporation and its stockholders as imposing on directors the duty to advance corporate wealth through profitability.[193] While courts generally state this guiding principle to be true, they do not provide any consistent explanation as to the basis for it.[194] Yet two lines of cases suggest two distinct rationales for this corporate purpose.

In one line of cases, the Delaware courts have suggested that directors must make decisions with the *sole objective* of maximizing profits because that is what stockholders, the sole residual beneficiaries of the corporation, want.[195] Presumably the stream of logic flows as follows: common shareholders are the residual beneficiaries of a corporation because when a shareholder invests in a corporation's common stock, that stock entitles the holder to a proportionate share in the assets of the enterprise after all claims of debtors and other claimants are satisfied.[196] That means that on dissolution, shareholders receive the value of a corporation's assets in excess of its debts. Not surprisingly, the difference between the value of assets and debts on a corporation's balance sheet (after taking into account stated capital) is called

193. *See, e.g.*, Paramount Commc'ns Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) ("This broad mandate [referring to the board's duty to manage the business and affairs of a corporation under the Delaware General Corporation Law § 141(a)] includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability.").

194. *See* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 Va. L. & Bus. Rev. 163, 171 (2008) (noting that dicta in some cases suggest directors ought to attempt to maximize shareholder wealth in the long run while dicta in other cases take a broader view of corporate purpose).

195. *See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("The directors of Delaware corporations have the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners. . . . [The shareholders] are the ultimate beneficiaries of the corporation's growth and increased value." (internal quotation marks omitted)); *see also* Applebaum v. Avaya, Inc., 812 A.2d 880, 886 n.7 (Del. 2002).

196. *See* Del. Code Ann. tit. 8, § 281 (2001) (requiring, in dissolution, that all non-shareholder claimants' claims be paid first, and thereafter "[a]ny remaining assets shall be distributed to the stockholders of the dissolved corporation"); *see also* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. Rev. 601, 613 (2006).

"shareholders' equity."[197] Shareholders' equity grows when the value of assets increases (without a corresponding increase in debts), which occurs as profits accumulate.[198] Thus the more profits a corporation earns, the higher its shareholders' equity will be (unless/until those profits are distributed to shareholders or used in operations).

Yet by indicating the corporate purpose in terms *only* of what shareholders want (profits), some courts have effectively ignored what the interest of the "corporation" is. The flaw in this construction, of course, is that Delaware courts consistently pronounce fiduciary duties as being owed to both shareholders *and the corporation*.[199] We must therefore assume that both are intended to be covered by fiduciary duties. The fact that the inclusion of both the "corporation" and "stockholders" in fiduciary duties has persisted for so long and been referred to so pervasively in Delaware court opinions lends further support to the fact that these bodies are both intended to be included.[200]

Perhaps these courts only look at the interest of stockholders in assessing to whom fiduciary duties are owed as only stockholders have the right to enforce fiduciary duties against directors.[201] Yet that does not mean that directors do not owe the corporation these duties. Rather, it may mean that stockholders generally represent the interests of all constituents in the context of derivative suits against directors—thus there is no need for other constituents to also have standing to bring derivative suits.[202] This may be particularly true considering the potential cost of empowering all constituents to bring derivative suits. Or it may reveal an

197. *See* John G. Helmkamp et al., Principles of Accounting 15–16, 659 (3rd ed. 1989); Roger H. Hermanson et al., Financial Accounting: A Business Perspective 19 (8th ed. 2002). Though the balance sheet only shows assets' book values, not fair market values. Helmkamp et al., *supra*, at 119; Hermanson et al., *supra*, at 109.

198. Hermanson et al., *supra* note 197, at 16–17. Shareholders' equity also grows with the increase in value of existing assets.

199. *See supra* note 183 and accompanying text.

200. Delaware statutory law also supports the distinction between the corporation and its stockholders. *See, e.g.*, Del. Code Ann. tit. 8, § 121 (describing a corporation's general powers and distinguishing the corporation from its officers, directors, and stockholders). The fact that the corporation is distinct from its shareholders also necessarily follows from the fact that key characteristics of the corporation—including its legal personality, permanent existence, limited liability, entity-level taxation, and centralized management—all flow from its separateness. Greenwood, *supra* note 128, at 126. This distinction is also apparent from the corporate veil that exists between the corporation and its shareholders, freeing shareholders from corporate liabilities in most circumstances. *See id.*

201. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007). Though upon a corporation becoming insolvent, its creditors, too, may enforce the directors' fiduciary duties. *Id.*

202. *See* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L.Q. 403, 427 (2001) ("[C]areful inspection of the substantive nature of directors' fiduciary duties reveals that shareholders can only bring a successful derivative suit in circumstances where directors act in a fashion that hurts not just shareholders, but other residual claimants as well.").

aspirational aspect of fiduciary duties, where the standard of conduct that courts want boards to achieve (that directors act in the best interest of the corporation, including all of its constituents) varies from the standard of review (that directors will only be held liable for breaches where their conduct adversely impacts stockholders).[203] Yet perhaps courts in this line of cases do not separately analyze (or mention) the duty owed to the corporation because they believe the interests of the corporation and its stockholders are exactly the same.

In the other line of cases, the Delaware courts have recognized that the corporation's interest is a unique component of fiduciary duties and have authorized the board to consider that interest separately from the interest of stockholders.[204] In those cases, the courts have typically presumed that the corporation's interest, like stockholders' interest, is in corporate profitability.[205] Yet they generally have made this assumption without any analysis as to what the corporation's interest is or why it is in profitability. Thus the presumption underlying these decisions, like the cases discussed above, seems to be that board decisions designed to enhance corporate profitability are in the interests of both the corporation and its stockholders.[206]

Still, the Delaware courts have on occasion suggested that the interest of the corporation may differ from the interest of stockholders, at least in the takeover context.[207] *Unocal*, decided in 1985, involved a challenged Unocal board decision to offer to repurchase Unocal stock for cash as a defensive measure, to prevent Unocal stockholders from tendering

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203. *See* Veasey & Di Guglielmo, *supra* note 130, at 1416 (explaining the difference between a standard of conduct, which is an aspirational standard for what is expected of directors, and a standard of review, which governs whether a director will be held liable). The classic example of the aspirational aspect of fiduciary duties is the duty of care, where directors aspire to become informed of all information reasonably available before making decisions yet are not liable unless their failure to do so amounts to gross negligence.

204. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–56 (Del. 1985) (authorizing the board to consider shareholder and non-shareholder interests at stake in considering whether the best interest of the corporation and its shareholders requires directors to pursue a takeover bid).

205. *See, e.g.*, Paramount Commc'ns Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) ("This broad mandate [referring to the board's authority to manage a corporation's business and affairs under title 8, section 141(a) of the Delaware Code] includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability."); TW Services, Inc. v. SWT Acquisition Corp., Nos. 10427 & 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) (indicating that the board, outside of *Revlon* mode, has a duty to the corporation and its shareholders to seek long-term values).

206. Still, some of these decisions suggest that the corporation's and stockholders' interests in profitability are only aligned in the long-term. *See, e.g.*, *TW Services*, 1989 WL 20290, at *7 ("I take it as non-controversial that, under established and conventional conceptions, directors owe duties of loyalty to the corporation and to the shareholders; that this conjunctive expression is not usually problematic because the interests of shareholders as a class are seen as congruent with those of the corporation in the long run . . . .").

207. *See, e.g.*, *Unocal*, 493 A.2d at 946, 949–51.

shares to Mesa pursuant to its two-tiered coercive tender offer.[208] In that case, the Delaware Supreme Court held that the Unocal board had a "fundamental duty and obligation to protect the corporate enterprise, which *includes* stockholders, from harm reasonably perceived."[209] This language, as well as other consistent language in this opinion, shows that the court viewed the interest of stockholders as simply one component of the interest of the corporation. Moreover, the court authorized the board, in evaluating Unocal's interest, to consider the interests of its constituencies other than shareholders and referred specifically to the interests of creditors, customers, employees, and the community for this purpose.[210] This suggests that the interests of non-stockholder constituents might differ from the interests of stockholders, for if they were the same, there would be no need to authorize the board to consider them independently. Still, the court did not indicate what the interests of these constituencies were and instead deferred to the board to make that determination.[211]

Moreover, the court in *Unocal* did not indicate that the board could place the interests of non-shareholder constituents *above*—or even on equal footing to—the interests of stockholders. And in fact the court subsequently indicated in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* that the board can only consider the interests of non-stockholder constituents so long as they are "rationally related" to the interests of stockholders in profit maximization.[212] While this statement in *Revlon* was likely dicta,[213] subsequent cases citing to this proposition from *Revlon* indicates judicial support for it, even where a corporation is not in "*Revlon*" mode.[214]

208. *See id.* at 949–51.

209. *Id.* at 954 (emphasis added); *see* Stout, *supra* note 194, at 170 (arguing that this language shows that the corporation and stockholders are not the same under the duty of loyalty).

210. *Unocal*, 493 A.2d at 955.

211. *See id.*

212. 506 A.2d 173, 182 (Del. 1986) (referring to *Unocal* for the proposition that a board may have regard for various constituencies in discharging its responsibilities under *Unocal*, provided there are "rationally related benefits accruing to the stockholders").

213. The statement was likely dicta as the holding in *Revlon* applies only where the sale of control of a corporation is inevitable (and thus the board may not consider the interests of non-stockholders).

214. *See, e.g.*, *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 999 n.32 (Del. Ch. 2005) (indicating that the portion of the Delaware Supreme Court's holding in *Revlon* restricting directors to consider non-shareholder constituencies' interests only where those interests are rationally related to some benefit to stockholders tempered language in *Unocal*, but also suggesting that this limitation only applies in the context of a decision to sell a company under *Revlon*). The notion that the interests of the stockholders are primary, and the interests of other constituents secondary, can be traced back to as early as 1919, when the Michigan Supreme Court decided *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). In that case, the Michigan Supreme Court held that "[a] business corporation is organized and carried on *primarily* for the *profit of the stockholders*." *Id.* at 684 (emphasis added); *see* Stout, *supra* note 194, at 165 (arguing that *Dodge v. Ford* is routinely employed as the only legal authority for the proposition that corporate law requires corporations to have a legal duty to put shareholders' interests above all others). *But see* Jonathan R. Macey, *A Close Read*

Nor was the board in *Unocal* or in the other discussed cases *required* to consider non-shareholders' interests. At most, the courts simply *permitted* the boards to consider those interests. While the courts have not explained why this consideration is only permissive despite the fact that fiduciary duties seemingly require a consideration of the corporation's interest as well as stockholders' interest, logic and intuition suggest that it is due to the fact that the discussed cases were decided in the takeover context. In that context, the interest of stockholders is most likely to diverge from the interest of other corporate constituents, for the former would be expected to favor any takeover proposal that promised proceeds in excess of investors' perceived intrinsic values, while the latter would likely disfavor any proposal that meant discontinuance of the firm.[215] Perhaps for similar reasons, the courts in the discussed takeover cases did not require that the boards fix any particular time period for achievement of the corporate purpose.[216] Again, this is likely due to the fact that in the takeover context, the board is faced with the decision of whether or not to abandon the corporation's long-term strategy in favor of a short-term sale. Thus the takeover context seems to necessitate a broad conferral of discretion on the board as to the interests to be considered and corporate purpose to be achieved.

If this is indeed the rationale for this broad conferral of discretion on the board, then we might expect to see judicial guidance indicating that outside of the takeover context, boards *must* consider the best interest of the corporation and its stockholders in the long-term in discharging its fiduciary duties, for there would be no competing short-term option. Indeed a number of courts have suggested a judicial preference for directors to manage for the long-term.[217] Yet they generally do not re-

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of an Excellent Commentary on Dodge v. Ford, 3 Va. L. & Bus. Rev. 177, 178–79 (2008) (noting that the American Law Institute's *Principles of Corporate Governance* are consistent with *Dodge v. Ford*'s core lesson that corporate officers and directors have a duty to manage the corporation for the purpose of maximizing profits for the benefit of shareholders, and arguing that profit maximization is only a default rule).

215. *See* discussion *infra* Part IV.

216. *See, e.g.*, Paramount Commc'ns Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) ("[T]he question of 'long-term' versus 'short-term' values is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon.").

217. *See, e.g.*, TW Services, Inc. v. SWT Acquisition Corp., Nos. 10427 & 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) ("[D]irectors, in managing the business and affairs of the corporation, may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected . . . ."). Other academics have also observed that the Delaware courts seem to favor the long-term. *See, e.g.*, Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 Nw. U. L. Rev. 521, 527 (2002) (inferring from *Revlon* that directors should seek to maximize long-term shareholder value where a corporation is not in *Revlon* mode).

quire it.[218] Thus absent a takeover, courts still defer to the board to decide the time period over which the goal of profitability is to be achieved.[219] That means that the board must decide whether to achieve the goal of profitability over a six-month period, year period, five year period, or some other time period, so long as that time period is justifiable under the corporation's business plan.[220]

But this lack of judicial guidance absent a takeover proposal would seem to permit directors to make decisions that are primarily aimed at generating short-term profits, even where that comes at the expense of long-term profitability to the detriment of long-term shareholders and other corporate constituents. Normatively, then, we must ask—*should* directors have this absolute discretion where no takeover proposal is pending, or should fiduciary duty law *require* directors to manage corporations in that context for the long-term? For some, the answer to this question depends on whether the interests of shareholders and the corporation are in fact aligned in the long-term, as so often is presumed to be true. For if they are indeed aligned in the long-term, then the board could discharge this duty to both stockholders and non-stockholders simultaneously. It is to this point that I turn to next.

IV. The Interests of the Corporation and its Stockholders are Aligned in the Long-Term

As Part III reveals, under existing fiduciary duty law, directors may make business decisions that are designed to yield short-term profits, even if that comes at the expense of long-term profitability. That is because Delaware fiduciary duty confers on directors discretion to decide the time horizon for achievement of the corporate purpose of profitability. Yet some Delaware jurists have indicated that directors *should* manage for the long-term.[221] As is discussed in Part III, this seems to be based, at least in part, on their assumption that in the long-term, stockholders' and non-stockholders' interests are aligned.[222] In this Part IV, I analyze whether the interests of stockholders and non-stockholders are

218. *But see* Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders . . . .").

219. *See, e.g.*, Hahn v. Carter-Wallace, Inc., 1987 WL 18429, at *2 (Del. Ch. Oct. 9, 1987) ("While reasonable men may disagree as to whether long-term growth objectives should prevail over short-term profit considerations, the decision to pursue a long range objective is a business decision subject to a presumption of propriety under the business judgment rule.").

220. *See Paramount Commc'ns Inc.*, 571 A.2d at 1154 ("Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.").

221. *See supra* note 217 and accompanying text.

222. *See supra* note 206 and accompanying text.

indeed aligned in the long-term. I begin by analyzing the interests of stockholders (Section A) and then turn to the interests of the corporation, represented, in addition to stockholders, by its non-stockholder constituents (Section B).

A. Stockholders' Interest In Long-Term Profitability

As is discussed in Part III, stockholders are considered to be residual beneficiaries.[223] That means that on dissolution, they receive the value of a corporation's assets in excess of its liabilities.[224] A corporation's assets grow with the accumulation of corporate profits.[225] Thus shareholders clearly have an interest in a corporation's profitability.[226] Stockholders' receipt of periodic dividends also explains their interest in profitability, for dividends are generally paid out of a corporation's profits.[227] The more profits a corporation generates, the greater the likelihood that those profits will be in excess of what the company needs to operate and will be distributed to stockholders.[228]

But do investors have an interest in a firm's *long-term* profitability? If the efficient capital market hypothesis were true, then certainly investors would want a corporation to generate profits on a sustained basis, for that would mean the corporation would be generating cash flows into the future, thereby leading to a high intrinsic value calculated from those cash flows.[229] But as I argue in Part I.A., investors have reasons to want profits to be generated in the short-term even where that might impair long-term profitability, given the short-term bias inherent in stock prices resulting from information imperfections, as well as investor behavioral

223. *See supra* notes 196–98 and accompanying text.

224. *See supra* notes 196–98 and accompanying text.

225. *See supra* notes 196–98 and accompanying text.

226. This may not be true for investors who have hedged away their economic interest. The interests of those investors will be ignored for purposes of this analysis, not because they do not exist, but because there are clear policy reasons why corporations should not be managed with their interests in mind.

227. 18 C.J.S. *Corporations* § 362 (2007) ("As a general rule, dividends can be declared and paid out of net profits only . . . ."). While dividends are typically declared and paid out of profits, in Delaware they may be declared even where a corporation does not have profits out of a corporation's surplus. *See* Del. Code Ann. tit. 8, § 170 (2001). Surplus generally refers to the amount by which a corporation's net assets (its assets minus its liabilities) exceed the amount determined by the board to constitute "capital." *See id.* at § 154. Generally "capital" is at least equal to the number of shares issued in all subscriptions multiplied by those shares' par values. *See id.*

228. While the fact that a corporation has generated a high level of profits increases the chances that the board will pay those profits out as dividends, it does not mean that a board is obligated to do so. In fact, boards are not required to pay dividends except where the failure to do so amounts to an abuse of discretion. Gabelli & Co. v. Liggett Group Inc., 479 A.2d 276, 280 (Del. 1984) (citing Eshleman v. Keenan, 194 A. 40, 43 (Del. Ch. 1937)).

229. *See* discussion *supra* Part I.A.

deviations from rationality.[230] Still, some investors—particularly those who hold their shares for a longer period of time—are less interested in short-term spikes in stock prices, for they do not trade their shares in the short-term to capitalize on those price fluctuations.[231] Those investors, in contrast, likely calculate firms' intrinsic values in a way that is more reflective of the long-term. Moreover, significant institutional investors often take a long-term view to their investments out of necessity, for they inevitably will, on repeated occasions, hold stock in the same firms.[232] Thus it seems investors may diverge in the period over which they seek corporate profitability.[233]

Delaware courts recognize that not all shareholders have the same interests.[234] And they have authorized the board to favor the interests of long-term shareholders over short-term, speculative shareholders where a corporation is not "for sale" under *Revlon*.[235] Perhaps that is because they believe long-term investors' interests are more reflective of "shareholders' interests" under the fiduciary duty analysis, given that those investors' investment decisions more truly reflect corporations' intrinsic values.[236] Consistent with that view, "shareholders' interest" would be in the generation of sustainable profits, for that would lead to the highest potential pay-out to shareholders.

B. The Corporation's Interest in Long-Term Profitability

We must first identify who the corporation is before we can determine whether the "corporation" has an interest in long-term profitability. Guidance on this emerges from *Unocal*, where the Delaware Supreme

230. *See* discussion *supra* Part I.A.

231. *See* discussion *supra* Part I.A.

232. *See* discussion *supra* Part I.A.

233. *See* Anabtawi & Stout, *supra* note 6, at 1283–92 (arguing that investors have disparate interests, including as to investment horizon).

234. *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386 (Del. 1995) (citing Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45–46 (Del. 1994)); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) ("It is well established in our jurisprudence that stockholders need not always be treated equally for all purposes."). In fact, this aspect of fiduciary duty law also seems to have been accepted by the Delaware legislature through its passage of an anti-takeover statute which limits certain rights only of a tender offerors but not other stockholders. *See* Del. Code Ann. tit. 8, § 203 (2001).

235. *See, e.g.*, TW Services, Inc. v. SWT Acquisition Corp., Nos. 10427 & 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989). A number of academics also support managing for the long-term. *See, e.g.*, Velasco, *supra* note 92, at 454 (arguing that social responsibility theory has persuaded much of society that many conflicts between shareholder and non-shareholders arise only from a short-term perspective and their interests may merge in a long-term perspective because of the benefits of harmonious and productive relationships).

236. *See supra* note 42 and accompanying text (indicating that Delaware courts understand that the stock market may be inefficient in failing to reflect the long-term value of a corporation).

Court appears to have held that the corporation's interest is represented by the interests of its various constituents.[237] The court in that case also identified the types of constituents (in addition to shareholders) that boards may consider when assessing the interest of the corporation, specifying creditors, customers, employees, and the community.[238] While the Court indicated that this was a non-exclusive listing, these seem to be the most commonly identified non-shareholder corporate constituents.[239] Thus the following analysis will look to these constituents to identify whether they are interested in long-term profitability.

1. Creditors

Creditors of a corporation are persons to whom the corporation owes money or other property.[240] Creditors are typically thought of as being either trade creditors, to whom the corporation owes money in connection with its purchase of goods and services, or borrowed money creditors, from whom the corporation borrows money for its operations.[241]

It seems clear that a creditor's primary interest is for a corporation to be able to repay its debts to the creditor as they become due.[242] That means that every creditor wants the corporation to be financially successful, at least over the term of the debt, to be able to repay the debt according to its terms. In fact the more profitable a corporation is, the less any creditor has to worry about a potential risk of the corporation not being able to repay its debts to the creditor and other potentially senior and *pari passu* creditors. Moreover, both types of creditors would likely also want a corporation to grow so that it would either need to buy larger amounts of goods and services on credit, in the case of trade creditors, or borrow larger sums, thereby generating higher interest income, in

237. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (noting, as the second element of the standard of proof for board adoption of defensive measures to a takeover offer, a balancing of the takeover bid and its effect on the corporate enterprise, and for purposes of weighing the interest of the corporate enterprise, authorizing the board to consider the impact on constituencies other than shareholders).

238. *Unocal*, 493 A.2d at 955.

239. *See, e.g.*, Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 287 (Del. Ch. 1989) (adopting the listing of non-shareholder constituents set forth in *Unocal*); *see also* Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 Geo. Wash. L. Rev. 14, 16 (1992) (noting these as the constituents typically identified by state constituency statutes).

240. Black's Law Dictionary 424 (9th ed. 2009).

241. *See* Irving A. Breitowitz, *New Developments in Consumer Bankruptcies: Chapter 7 Dismissal on the Basis of "Substantial Abuse,"* 5 J.L. & Com. 1, 87 (1984) ("Businesses, whether in the form of sole proprietorships, partnerships, or corporations, generally contemplate and depend on sustained relationships with trade creditors and commercial lenders . . . .").

242. *See* Adam Feibelman, *Commercial Lending and the Separation of Banking and Commerce*, 75 U. Cin. L. Rev. 943, 948 (2007).

the case of borrowed money creditors.[243] Thus creditors indeed seem to be primarily interested in sustained corporate profitability.[244]

2. Customers

Customers are primarily interested in obtaining quality products and services at low prices. Repeat customers, or customers who tend to buy the same products and services from the same suppliers, undoubtedly want a corporation that they buy those goods and services from to continue to exist so that it continues to supply them with quality goods and services.[245] That means that they inherently want a corporation to be profitable so that its continued existence is justified. A corporation that is profitable is also more likely to reinvest those profits in new and improved products and services, which also runs to the benefit of repeat as well as single-time customers.

Moreover, to the extent that a corporation's products come with a warranty, customers undoubtedly want the corporation to remain in business and have profits, at least so that the corporation has assets beyond its senior liabilities to satisfy its warranty obligations to the customers.

Thus all customers would seem to desire a corporation that to some extent is profitable on a sustainable basis. Still, customers are not necessarily interested in a corporation *maximizing* its profits, as that likely means that the profits came at their expense through high prices paid on consumed products and services. Thus customers, like creditors, would likely favor a corporation to be profitable on a sustained basis, but would likely favor a lower level of profitability than creditors, at least to the extent profits came at their expense.

3. Employees

Employees are primarily concerned with maintaining their jobs and getting good compensation and other benefits over the course of that employment. In addition, employees undoubtedly seek to obtain intangible benefits from their jobs, such as praise and enhanced knowledge.

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243. *Id.* at 948–49 (noting that a creditor, like an equity investor, may expect indirect gains from its investment, including the benefit of future investment relationships).

244. This is true despite the fact that creditor and stockholders likely have different tolerances for risk, particularly in the zone of insolvency. *See* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 790 n.57 (Del. Ch. 2004). Yet as the Delaware Chancery Court has pointed out, even in that context, both stockholders and creditors are interested in increasing the economic value of the firm. *Id.* at 792.

245. This reduces transaction costs of having to repeatedly research new suppliers.

This, in turn, means that employees generally want a corporation to be financially successful and to continue in existence, so that it may continue to serve as an employer and provider of those benefits. In fact, employees would be expected to want a corporation to be highly profitable, as some portion of those profits would likely trickle down to them. That would be especially true for employees who have a portion of their compensation tied to the corporation's success, whether through a cash bonus plan, stock option plan, or other plan tied to the firm's success. Moreover, to the extent that a corporation views itself as a value-creating enterprise in the long-term, it would be expected to treat its employees better, investing more resources in their education, health, and safety to yield returns over the long-term.[246] That is not to say that just because an employer is successful on a continuing basis, every employee will retain her job and receive good benefits—there are a number of other reasons, such as job performance, that factor into an employee's compensation and retention. However it seems intuitive that an employer is much more likely to pay better benefits and retain employees when it is continuing on a long-term path of profitability. Thus it seems clear that employees would also seem to want a corporation to be profitable on a sustainable basis.[247]

Still, some employees who receive a high level of compensation based on short-term profits would likely be willing to forego some level of future profits, and risk corporate longevity, in exchange for short-term profits.[248] That is not to say that they are not interested in future profits—but simply that they would likely support decisions that lead to profits in the near term rather than sustained profits over the long-term given the large size of their pay package, the time value of money, and the uncertainty of future profits and continued employment.[249] Yet it seems unreasonable for any employee to expect to be compensated for short-term profits that either derive from accounting manipulations or from decisions that do not properly reflect the risks inherent in them.

246. *See* Sanford M. Jacoby, *The Future of Labor and Finance*, 30 Comp. Lab. L. & Pol'y J. 111, 116 (2008) ("When shareholders and business strategies are guided by long-term considerations, they will, allegedly, encourage the treatment of employees not a [sic] cost but as an asset deserving of training, job security, and fair treatment that promotes low turnover and high productivity. A focus on the long-term also encourages companies to pay attention to future liabilities in areas such as employment regulation . . . .").

247. This proposition may not be as true for independent contractors, which are increasingly used by firms to avoid having to pay unemployment and other benefits. *See* Stephen F. Befort, *The Regulatory Void of Contingent Work*, 10 Emp. Rts. & Emp. Pol'y J. 235, 246 (2006). Still, even independent contractors would likely be able to obtain more attractive compensation packages and other benefits from, and be retained on a more consistent basis by, a firm that was profitable on a sustainable basis.

248. *See* discussion *supra* Part I.C.

249. This is similar to the conflict between long-term stockholders and short-term stockholders.

This is apparent from the many public tongue-lashings received by executives in the midst of the financial crisis whose compensation was high despite large firm losses,[250] as well as from the number of investor and policy-maker calls for reform of this pay practice.[251] Thus while we cannot conclude that this entire class of constituent favors long-term profitability, the executive compensation movement suggests that we discount those interests created by inflated, short-term compensation arrangements.

4. Community

Identifying who makes up the community where a corporation operates is no simple task, for that undoubtedly depends on the nature of the business and where it is located.[252] But as a general matter, individuals who live where a corporation conducts its operations presumably want a corporation to contribute as much economically to the community as possible. This includes, perhaps first and foremost, paying taxes year after year so that the community can consistently count on, and use, those tax revenues for local services and civic projects.[253] It also means consistently supplying good jobs so that local individuals can make a living and communities can consistently maintain their citizenry and tax-paying base.[254] Both of these occur where a corporation is profitable on a sustained basis, for only then will it be able to continue to supply local jobs. Obviously the more profitable a corporation is, the higher the amount of taxes it pays, thereby contributing more resources to the community for local services and civic projects.

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250. *See e.g.*, Louise Story, *Wall St. Profits Were a Mirage, but Huge Bonuses Were Real*, N.Y. Times, Dec. 18, 2008, at A1 (noting the enormous size of the 2006 bonuses Merrill Lynch paid to its CEO and traders, even though Merrill's earnings for that year turned out to be a mirage and noting criticism of pay practices which awarded large bonuses based on ephemeral earnings).

251. *See* discussion *supra* Part I.C.

252. State constituency statutes, as well as academic commentary, suggest that the relevant community to consider is that where the corporation operates. *See, e.g.*, N.J. Stat. Ann. § 14A:6-1(2)(b) (West 2003) (indicating that in making business decisions, the board may consider "the effects of the action on the community *in which the corporation operates*" (emphasis added)); N.Y. Bus. Corp. Law § 717(b)(2) (McKinney 2003) (indicating that in making business decisions, the board may consider, among other things, the communities in which the corporation does business); Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 Geo. Wash. L. Rev. 1156, 1172 (1993) (analyzing what the community's interest is by reference to the community where the corporation's plant or office is located).

253. *See* Ryan J. York, Comment, *Visages of Janus: The Heavy Burden of Other Constituency Anti-Takeover Statutes on Shareholders and the Efficient Market for Corporate Control*, 38 Willamette L. Rev. 187, 197 (2002) (identifying as the community's only identifiable interests the payment of taxes and the supply of local jobs).

254. *Id.*

To be sure, some "community" constituents might not be interested in a corporation's profitability. For instance, environmental groups would want a corporation to shut down its operations that have an adverse impact on the environment, regardless of the impact of that move on the corporation's profits.[255] But it would seem to undermine the exercise of determining the community's interest if we focused on the interests of the few exceptional interest groups rather than the larger community of interests who fit within this constituency class. Moreover, by focusing on those who live where the corporation operates, it seems legislatures that have adopted constituency statutes have decided to focus on the community interests identified above rather than on more general or global interests.

C. Summary

As the foregoing discussion shows, shareholders want a corporation to be profitable. While some shareholders would prefer that those profits be realized in the short-term, shareholders who are less influenced by market imperfections causing a short-term bias undoubtedly seek a corporation to generate profits on a sustainable basis. It is this class of shareholders that courts expressly authorize boards to prefer when analyzing whether board decisions were in fact in the best interest of shareholders. In any case, even for short-term shareholders, it would certainly be *in their interest* for a corporation to be profitable in the long-term, even if they have specious reasons to favor short-term profits.

Moreover, non-shareholders generally also want corporations to be profitable in the long-term, for those corporations are most able and apt to compensate their employees well over time and provide other employee benefits. They can also satisfy their warranty obligations owed to customers and continue to supply customers with new and improved products and services. Profitable corporations have more resources with which to repay creditors, and if they are profitable on a sustainable basis, may provide creditors with additional lending opportunities. Needless to say, corporations with sustainable profits continuously pay higher taxes and employ more local people, which benefits the citizens who live in the communities where those taxes are paid and jobs are made available.

255. Yet they, too, might want a corporation to generate profits, if the corporation would use those profits to not only remediate the corporation's adverse impacts on the environment, but to actually improve the condition of the environment.

V. Reformulating Fiduciary Duties So That They Require Directors to Act in the Long-Term Best Interest of the Stockholders and the Corporation

As is discussed in Part IV, by and large all of a corporation's constituencies—shareholders and non-shareholders alike—seem to share some commonality of interest—they all seek a corporation that is profitable on a sustained basis. In fact a number of Delaware courts have recognized this coincidence of interests on profitability over the long-term. Moreover, Section II provides a strong policy argument in favor of supporting corporations that are managed to generate wealth for the good of investors and society in the long-term. Yet as the discussion in Part III reveals, Delaware courts give boards wide discretion to decide over what time period a corporation should be managed for the purpose of generating profits. Consistently, outside of the *Revlon* sale context, they also give boards wide discretion to decide whether to consider non-stockholders' interests in making business decisions. However, because of this discretion, directors are more susceptible to influence by interest groups such as short-term investors and executives, who benefit from decisions that yield short-term profits.

Given what seems to be a strong policy in favor of managing for the long-term, and the fact that corporate law reflects policy,[256] I believe corporate law should implement that policy through fiduciary duties. My proposal for doing so is set out in Section A. Section A also explains why I propose implementing this long-term agenda through fiduciary duties as well as how this proposal would effectively be implemented. Then in Section B I set out and respond to a number of likely critiques.

A. My Proposal

To implement the strong public policy in favor of corporations that are managed for the long-term, as well as the general coincidence of corporate interest in the long-term, I propose that directors be *required* to make decisions *primarily* for the purpose of advancing the long-term best interest of the corporation and its stockholders. That means that every time the board is faced with a business decision, it would need to consider how that would benefit the corporation and the stockholders in the long-term, and make decisions that are aimed at achieving that objective. In effect that would mean that directors would need to determine how every business decision implemented the corporation's business plan, for the business plan sets out the corporation's long-term objectives

256. *See supra* note 169 and accompanying text.

as well as strategies to achieve those objectives.[257] That would not mean that the board must shape corporate strategy such that a corporation foregoes all opportunities to make current profits—but it would mean that realizing on current profits could not undermine the corporation's ability to generate profits in the future in accordance with its business plan.

Under my proposal, board decisions would continue to be protected by the business judgment rule.[258] That would mean that directors would continue to be protected in deciding how to achieve long-term profitability under the business plan, as well as how to allocate profits among the various corporate constituents. But clarifying that fiduciary duties are mandatorily long-term in nature outside of the takeover context would force directors to conduct analyses (in compliance with their duty of care) that would enable them to decide whether each business decision would be primarily beneficial to the corporation and the stockholders in the long-term—and their failure to do so could amount to a conscious disregard of their duties and thus an act in bad faith. This, then, could lead to a breach of the duty of loyalty.[259] That would likely mean that directors would have to increasingly consider non-financial factors in making decisions, for the long-term often cannot be summed up in a neat financial calculation.[260] But the challenge of valuing the long-term effects of corporate decisions should not preclude their primary importance.

Because this reformulated duty would only require directors to *primarily* act in the long-term best interest of stockholders and the corporation, directors could, in compliance with this duty, *consider* the interests of short-term stockholders in making business decisions. This would give directors some flexibility in making business decisions that are intended to deliver short-term profits. However, it would not permit them to place those short-term interests above, or even on par with, the interests of stockholders and other corporate constituents in sustained corporate profitability. Because stockholder and non-stockholder constituents' interests converge in the long-term, this interpretation would also seem to more faithfully implement the long-standing construction of directors' fiduciary duties, which require that directors consider the interests of stockholders as well as the interest of the corporation.

One may ask why the board—rather than some other constituent—should as an initial matter be charged with implementing the corporate

257. This proposal is similar to one component of a proposal made by Professor John Matheson and Brent Olson over 15 years ago. *See infra* notes 269–71 and accompanying text.

258. See *supra* note 181 and accompanying text for a discussion of the business judgment rule.

259. See *supra* Part III for a discussion of how a conscious disregard of duties can lead to liability for a breach of the duty of loyalty.

260. See *supra* Part I.A.2 for a discussion of the limits of financial statements to capture a firm's performance.

purpose of long-term profitability. For one, the board is the body that oversees adoption and implementation of a corporation's business plan. The business plan is the source of the corporation's long-term profit-making strategy. Thus it makes sense for the board to be charged with implementing the corporate purpose through its oversight of the business planning process. The fact that boards are generally comprised of highly respected and knowledgeable businessmen and women would only make discussions about long-term profit-making strategies more meaningful.[261] Moreover, the board is already charged with the duty to act in the best interest of the corporation and its stockholders under its fiduciary duties. To the extent that any constraints are imposed on what amounts to the best interest of the corporation and stockholders, they would necessarily need to be reflected through a modification to those fiduciary duties. And this proposal would be consistent with the notion from *Revlon* that any temporal limit on directors' discretion in making business decisions should be imposed on directors through their fiduciary duties.

A related question pertains to why the common law of fiduciary duties—rather than legislation—is the appropriate means to implement a long-term corporate agenda. Initially it is important to note that my proposal does not purport to "fix" in its entirety the "problem" of short-termism. There are undoubtedly complementary steps that could—and should—be taken to shift the focus of corporations towards long-term profitability. But my proposal is intended to be the first guiding step down that path, for it would seem backwards to implement a long-term policy objective through specific legislative or regulatory changes before that policy objective is manifested through corporate governance standards.[262] Moreover, given the limitless ways in which corporations can

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261. *See also* Greenfield, *supra* note 164, at 957 (referring to literature which finds that the benefits of group decision-making are significant and that groups in many cases outperform individuals, and noting that the corporate structure takes advantage of this through placing the board as decision-maker at the top).

262. To some extent, this is already happening with respect to compensation. In that context, the federal government and regulatory agencies are issuing a patchwork of rules and regulations designed to curb compensation practices that reward executives and others for short-term profit-making activities that compromise long-term profitability. *See supra* notes 135–43 and accompanying text. In my view, it would make much more sense if these efforts *followed* a shift in corporate governance standards reflecting the corporate policy of long-term profitability, such that these regulations were simply implementing a corporate mandate pertaining to corporations' internal affairs. That would not only provide a more coherent framework by which corporations would be operated (rather than specific legislation targeted at one aspect of short-termism), but it would also guide legislators in designing legislation aimed at furthering that purpose. Understandably, in the current environment, legislators felt compelled to do something to curb lavish pay packages at financial institutions despite poor long-term results. However, in my view, before Congress and regulatory agencies head too far in the direction of detailed regulation to address specific manifestations of short-termism, Delaware courts should take the opportunity to clarify what is the object of each director's fiduciary's duties—of producing *sustainable* profits for the benefit of the corporation and its shareholders. That, then, can serve as a guide not only to shareholders in enforcing directors'

achieve long-term profitability in light of their unique business structures and strategies, it seems to make sense to use, at least as an initial matter, the standards-based approach offered by fiduciary duties to implement the long-term mandate rather than a narrower, rules-based approach typically associated with legislation.[263] This change would also ensure that state law regulating internal affairs remains relevant in the current environment of short-term investor activism. However, once my proposal is implemented, in my view it would then make sense to consider targeted ways—for example through tax incentives or penalties, new disclosure rules, or changes to the corporate voting mechanism—to implement the then clear corporate objective of generating sustainable profits, at all times being sensitive to the welcome differences between corporations and the ways in which they may achieve that objective.

This reinterpretation of the corporate purpose would also provide directors with much-needed guidance as to how to discharge their fiduciary duties, particularly in an era where they are faced with pressures from executives as well as from investors to make decisions that generate short-term profits. As the Delaware Supreme Court has acknowledged, one of the objectives of Delaware fiduciary duty law is to provide directors with "clear signal beacons and brightly lined-channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders."[264] This proposal would in fact provide some clarity as to what corporate purposes directors must seek to achieve. This, in turn, should enhance accountability of directors to shareholders, for removing an element of discretion from the board gives shareholders a more clearly defined standard to which to hold directors accountable. And since the reformulated duty would lead directors to act in the interest of both shareholders and the corporation, shareholders (at least long-term shareholders) would indeed serve as a proxy for the corporation in enforcing this duty, for doing so would be in the interest of both.

Still, this reformulation of fiduciary duties would not apply in all contexts. Specifically, because the reformulated duty would require directors to consider how to maximize profits under the corporation's long-term strategy, it would not apply in the context where the board was faced with a potential takeover or other similar sale transaction in which the future of the corporation was being questioned.[265] Indeed it is in that context that the board is deciding the very question of whether or not to

fiduciary duties, but also to legislators and regulators in developing necessary laws and regulations that seek to further that purpose.

263. In addition, in Delaware, fiduciary duties are a matter of common law, so it would not make sense to impose a limit on directors' duties through state legislation.

264. Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998).

265. This would also be true with respect to the corporation's dissolution.

scrap the corporation's long-term strategy in favor of a sale.[266] Thus in that context it makes sense to continue to permit directors to consider not only the long-term interests of stockholders and the corporation, but also their short-term interests. Again, this might explain why the cases discussed in Part III give directors such broad discretion as to the temporal element of their fiduciary duties.

That is not to turn a blind eye to the fact that the market for corporate control plays a large role in the problem of short-termism that I have identified. But it is rather to acknowledge that different aspects of the short-termism problem may require different fixes, and that my proposed fix addressed one source (though not the only source) of the short-termism problem. It also has the added benefit of approaching the short-termism problem in an incremental way, with the goal both of increasing the chances of adoption as well as providing an opportunity to reflect on the impact of the proposal without too many major shifts in the law at once.[267] Thus again, my proposal might complement other legal changes that would implement a policy promoting sustainable wealth-creation.

Perhaps the best way to see how my recommendation would be implemented is by example. Let us suppose that the business plan (determined by management subject to board oversight) of a widget manufacturing corporation called Widget Co., with operations in the western United States, includes expanding its operations into the Midwest in the subsequent five year period. Let us also suppose that an activist investor of Widget Co., Active Investor, sends a demand letter to the board of Widget Co. demanding the sale of dormant manufacturing assets and the distribution of the proceeds from that sale to shareholders. Under existing law, Widget Co.'s board could make the decision to comply with Activist Investor's demands simply on the basis that it would benefit investors in the short-term. In fact the board might follow this course of action to avoid seeming uncooperative with Activist Investor. Moreover, officers might support (and push for) this sale if their compensation was tied in any way to profits generated by this transaction. However, suppose that the assets requested to be sold would be

266. This would generally include mergers, asset sales, exchange offers, and tender offers, where shareholders would receive cash or other property in consideration for their equity interests, resulting either in a significant change in the capital structure of the corporation or in the disappearance of the corporation. *See* Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 Stan. J.L. Bus. & Fin. 31, 35–36 (2005) (identifying as the paradigmatic situations in which stockholders' and other constituencies' interests diverge as the hostile takeover context and financial distress); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 Tex. L. Rev. 579, 605–06 (1992) (describing transactions involving substantial distributions of wealth to stockholders as one class of transaction in which conflicts between stockholders and non-stockholder constituents most commonly arise).

267. Though arguably all of the new executive compensation rules might impair our ability to assess and measure independently the impact of this proposal on the problem of short-termism.

perfect for Widget Co.'s expansion into the Midwest, and that buying equivalent assets in the future would be very costly. Thus perhaps the board's decision to sell them would not be in the best interest of Widget Co. and its stockholders, at least in the long-term. Under my proposal, to comply with its fiduciary duties, the board would need to determine whether selling those assets would lead to enhanced profitability in the long-term (as compared to not selling those assets and retaining them for future use). To do that, the board would need to look at Widget Co.'s business plan as well as at how selling the assets would impact that business plan in the future.[268] If, after this analysis, the board decided that Widget Co's business plan and long-term profit-making strategy would be more effectively implemented by selling off the assets and buying different assets in the Midwest, and that Widget Co. did not need those proceeds for other projected expenditures under the business plan, then it should proceed with the course of action requested by Activist Investor. If, however, the board decided that Widget Co.'s business plan and long-term profit-making strategy would be more effectively implemented by keeping the dormant assets until they were needed for the expansion, then it should proceed in that fashion. In either case, under my proposal, the board would need to consider Widget Co.'s long-term business plan and how each course of action would have implemented that plan and Widget Co.'s ability to generate profits over time to comply with its fiduciary duties.

My proposal is similar to one component of a proposal made by Professor John Matheson and Brent Olson over 15 years ago.[269] However, the goal of Matheson's and Olson's proposal appears to have been to provide long-term shareholders with the incentive and ability to monitor the board with respect to conflict-of-interest and fundamental transactions.[270] According to Matheson and Olson, by giving institutional investors—seen as the quintessential long-term shareholder—a more meaningful voice in governance, those investors will have a greater incentive to view their holding as long-term, as they will no longer feel locked out of the governance process.[271] My proposal also seeks to focus directors on the long-term. However, my proposal places the impetus on the board, as the fulcrum of the corporate business lever, to reflect the long-term interests of stockholders and the corporation. The board is

268. Obviously the board, in making this determination, would need to consider the likelihood of the expansion actually occurring and of cheaper, equivalent (or better) assets becoming available in the future, among other things.

269. *See* John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 Minn. L. Rev. 1313, 1376–77 (1992) (proposing that the corporate purpose be to advance the interest of the corporation and its long-term shareholders).

270. *See id.* at 1315, 1376–81.

271. *Id.* at 1322.

already obligated to act as a fiduciary to all stockholders—thus in my view it makes sense to charge them with implementing the long-term corporate agenda that is developed under their oversight rather than individual investors who generally do not owe one another fiduciary duties and who may have divergent interests. Moreover, my proposal attempts to give effect to the long-standing formulation of directors' fiduciary duties as being owed both to the corporation as well as its stockholders, while also implementing the policy of creating long-term profitability for the benefit of our economy and society. Recent developments pertaining to executive compensation practices as well as investor activism would also seem to make my proposal propitious.

B. Responses to Anticipated Critique

Let me address a number of criticisms that I anticipate will be made to my proposal.

First, opponents will undoubtedly argue that my proposal removes from stockholders an ability to influence certain board decisions that they favor. The proposal would in fact do that, for it would strip from the board the discretion to make decisions that are primarily aimed at generating short-term profits, including where that is due to a request from a stockholder. That, in turn, would mean that some stockholders would effectively have less power to influence the board. But that is one of the primary purposes of the proposal—to remove from directors the discretion to manage for the short-term, whether that be due to stockholder influence, officer influence or other reasons. Moreover, the proposal would give some stockholders—particularly long-term stockholders, *more* power, for it would give them a more clearly defined standard to which to hold director conduct.

This leads to the second potential challenge—that this proposal could cause an increase in suits against boards. While it is possible that shareholders will commence more suits against directors to enforce this more clearly defined standard, directors would still be protected from needless suits under the business judgment rule.[272] Moreover, the other procedural protections that shield directors from needless fiduciary duty suits—such as the requirement that stockholders first make demand on the board unless demand would be excused as being futile[273] and that stockholder plaintiffs state their claims with particularity[274]—would continue to ap-

272. See *supra* note 181 and accompanying text for a discussion of the business judgment rule.

273. *See* Del. Ch. Ct. R. 23.1 (on file with the University of Michigan Journal of Law Reform), *available at* http://courts.delaware.gov/forms/download.aspx?id=39138; Aronson v. Lewis, 473 A.2d 805, 814–15 (Del. 1984).

274. *See* Del. Ch. Ct. R. 23.1.

ply. Thus directors would realistically only face liability for failing to meet this new aspect of fiduciary duties where they consciously disregarded their charge of advancing long-term profitability, which would amount to bad faith and thus a breach of the duty of loyalty. Yet it is precisely in those circumstances where the board should face liability, for if a board is not considering how a non-takeover decision will allow a corporation to implement its strategy in the long-term, the board should be held accountable for that failure.

A third potential criticism is that by requiring directors to consider the interests of non-shareholders in making business decisions, directors may act contrary to the interests of shareholders. This is one of the primary concerns raised by shareholder primacists, who believe that the corporation should be managed solely for the benefit of shareholders. However, as I showed in Part IV, long-term profitability is in the interest of both shareholders and the corporation's other stakeholders. Thus directors would not be acting to shareholders' detriment by focusing on long-term profitability. Moreover, directors would continue to have the discretion to decide, as between the different corporate constituents, how to allocate those profits.

Fourth, critics might argue that stockholders can simply defeat the long-term mandate under my proposal by replacing the board with directors who are sympathetic to their short-term demands. While shareholders would have the same right to remove and elect directors under my proposal that they currently have, they would not be able to elect directors simply as a means of obtaining favorable short-term action, for every director would be obligated to manage the corporation for the purpose of long-term profitability. While it is true that new directors might persuade management to change the corporate strategy to one that involves removal of certain business lines (thus leading to, for example, the sale of assets and distribution of cash to investors), even in those contexts the board's decisions would need to be part of a larger, coherent business strategy aimed at creating long-term wealth rather than being the result of an investor or officer push for short-term returns.

Fifth, one might question whether implementing this proposal would lead managers to decide to reincorporate in other jurisdictions as a way to avoid its application.[275] This argument would generally track the "race to the bottom" line of reasoning in that corporations would be expected to incorporate or reincorporate in jurisdictions with more lenient corpo-

275. Generally reincorporating in a different jurisdiction requires approval by the board and stockholders. *See, e.g.*, Del. Code Ann. tit. 8, § 390(b) (2001); *see also* Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 Fordham L. Rev. 843, 849 (1993) (noting that reincorporating requires approval of stockholders).

rate governance standards.[276] However, as many commentators have noted, there is no longer a race among states for incorporations, as Delaware has clearly won that race.[277] And in fact many commentators believe that there is not a race to the bottom at all, but rather a "race to the top" such that states with the most value-maximizing systems of corporate governance are more likely to attract incorporations.[278] Under that line of thinking, Delaware, if it implemented my proposal, might attract more incorporations (or at least would not be at risk of losing them), for as I argue above, it would cause directors to make decisions that are more reflective of a firm's "true value" than does existing law. Moreover, if Delaware courts would implement my proposal, I would expect that other states would follow suit, as they often look to Delaware law for guidance in developing their corporate laws.[279] That, in turn, would reduce or eliminate the prospect of reincorporating outside of Delaware simply to avoid application of my proposal.

Sixth, critics might challenge whether this proposal would in fact change the substance of any board decision, as directors could always find a way to rationalize how any decision would benefit the corporation and stockholders in the long-term. But one of the benefits of this proposal is that it will force the board, under its duty of care, to become informed in a way that allows it to determine whether a given action will in fact produce long-term profits. Failing to become informed in this way could amount to a conscious disregard of duty and, again, an act in bad faith. Even ignoring the prospect of liability, most directors will undoubtedly opt to become informed about whether their decisions truly advance the goal of long-term profitability once they understand that this is their required objective. Thus even if the substance of board decisions remains difficult to regulate under the reformulated duty, the processes that must be undertaken for the board to decide whether an action meets the reformulated duty should afford much protection to long-term stockholders and other constituents. Moreover, even ignoring the potential for

276. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L.J. 663, 663–68 (1974) (arguing that states' reliance on incorporation fees leads them to adopt laws that are favorable to managers over shareholders).

277. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679, 724 (2002) (noting that no state competes with Delaware for corporate charters); Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev. 588, 590 (2003).

278. *See* Romano, *supra* note 275, at 848–49 (arguing that the race to the top theory is supported by event studies); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251, 255–56 (1977) (arguing that firms that operate under a legal regime that does not maximize firm value would be outperformed by firms operating under a legal regime that did, and would therefore have lower stock prices, which would lead to the ouster of those managers or a takeover coupled with reincorporation in a regime that would maximize value). *But see* Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 Cal. L. Rev. 1775 (2002) (challenging the findings of these event studies).

279. *See supra* note 175 and accompanying text.

liability, the proposal would serve an expressive purpose, instructing directors how they *should* perform their duties.

Finally, critics will argue that the proposal ignores the problem of short-termism caused by the market for corporate control. Numerous academics have identified the takeover market as one of the primary reasons why directors manage for the short-term.[280] But it does not seem to be appropriate to adopt a one-size-fits-all solution to the short-term problem, particularly as takeover decisions involve a challenge to a corporation's long-term business objectives that are not present for non-takeover decisions. Yet there are many pressures on boards to be short-termists outside of the takeover context that should be addressed, particularly given the rise of the hedge fund and investor activism. That fact, however, should not mean that we only approach the problem through a single, comprehensive fix. In fact, as I argue above, there are many reasons to adopt an incremental approach to the short-termism problem.

Conclusion

While directors are not required under their fiduciary duties to make decisions that yield short-term profits, the pressures on them to do just that are substantial and real. They are increasingly being pressured by individual shareholders, who claim to simply be seeking value for all shareholders, to make decisions that do in fact deliver value to shareholders—but only in the short-term. They are also influenced by the short-term agendas of executives, who receive lavish bonuses upon the generation of short-term profits. The effect of many of these decisions has been to cut off a firm's source of long-term cash flows and to ignore long-term risks. The current economic crisis reveals not only the devastating impact on specific businesses of this excessive focus on the short-term, but also the disastrous impact on the entire U.S. economy and citizenry of this short-termism plague. While no single measure can be expected to fix the short-termism problem, we certainly should not sit idly by while companies continue to collapse, employees continue to lose jobs, and investors continue to lose their investments due to prior short-sighted decisions. As the new administration starts to consider how to fix the problem of short-termism, so, too, should the Delaware courts, which enforce directors' oversight and management responsibilities. They should, in my view, lead the charge, not by implementing a sweeping reform, but by simply eliminating unnecessary discretion as to the time period over which corporations should seek to achieve profitability.

280. *See supra* note 5 and accompanying text.