Embattled CEOs

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In this Article, we argue that chief executive officers (CEOs) of publicly held corporations in the United States are losing power to their boards of directors and to their shareholders. This loss of power is recent (say, since 2000) and gradual, but nevertheless represents a significant move away from the imperial CEO who was surrounded by a hand-picked board and lethargic shareholders. After discussing the concept of power and its dimensions, we document the causes and symptoms of the decline in CEO power in several areas: share ownership composition and shareholder activism; governance rules and the board response to shareholder activism; regulatory changes related to shareholder voting; changes in the board of directors; and executive compensation. We argue that this decline in CEO power represents a long-term trend, rather than a temporary response to economic and political conditions. The decline in CEO power has several important implications, including implications with respect to the possibility of a regulatory backlash against certain newly empowered shareholder groups, future development in Delaware's corporate law, the type of persons who will serve on corporate boards in the future, the type of shareholder initiatives that will be introduced and the corporate response to them, the convergence of corporate laws across countries, the source of resistance to acquisitions and the legal regulation of target defenses, the desirability of legal reforms expanding shareholder voting rights, and the relationship between CEOs and private equity firms.

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I. Introduction

In this Article, we present a straightforward thesis. The CEOs of publicly held corporations in the United States are losing power. They are losing power to boards of directors that increasingly consist of both nominally and substantively independent directors. And, perhaps more so, they are losing power to shareholders. This loss of power is recent (say, since 2000) and gradual, but nevertheless represents a significant move away from the imperial CEO who was surrounded by a hand-picked board and lethargic shareholders.

Most significantly, we think that the recent loss of power is not some cyclical change, and the developments we discuss largely predate the "Great Recession" that started in 2008. Rather, we argue that the decline of CEO power is caused by some underlying changes in the economic and regulatory landscape that will persist, and predict that these changes will result in a further decline of CEO power, at least in the intermediate term. What we may be witnessing is the emergence of a new era of corporate governance for the early part of the twenty-first century, where power over the U.S. corporate enterprise is more evenly distributed between various participants—inside managers, outside directors, and shareholders—rather than concentrated in the hands of the CEO.

This is, to our knowledge, the first academic article to document and analyze the loss of CEO power.[1] Beyond identifying this power decline as an important element of an evolving corporate-governance structure, this Article makes a variety of contributions. First, relying on the philosophical and sociological analyses of power, we use a more sophisticated and self-conscious conceptual scheme that clarifies the various aspects of power that are relevant. Second, because CEO power is both conceptually complex and difficult to observe from outside the firm, we assemble data from a wide variety of sources that provide both direct and indirect evidence of the decline. Finally, we examine the implications of a decline of CEO power in publicly traded U.S. corporations for corporate governance and control.

1. There have been several articles in the trade press on the "decline of the imperial CEO." *See, e.g.*, David Leonhardt with Andrew Ross Sorkin, *Reining in the Imperial C.E.O.: Handshakes Are Becoming a Bit Less Golden*, N.Y. TIMES, Sept. 15, 2002, § 3, at 1 (chronicling attempts by certain boards to restrain CEOs' salaries). The focus of these articles, however, has largely been on CEO firings and compensation. *Id.* While, as we discuss below, both of these are elements of the decline of CEO power, they are only a piece of a much larger picture.

The intuition that drives this Article is nicely captured in Milo Winter's famous 1912 illustration of Gulliver tied down by the Lilliputians.[2]

"I found my arms and legs were strongly fastened on each side to the ground."

Each Lilliputian is far smaller and weaker than Gulliver, and their ropes, individually, are mere threads. Collectively, and in the aggregate, however, the threads bind Gulliver.

2. JONATHAN SWIFT, GULLIVER'S TRAVELS 4 (Milo Winter illustrator, Rand McNally & Co. 1912) (1726), *available at* http://www.jaffebros.com/lee/gulliver/winter/p1.jpeg.

The Article is organized as follows. In Part II, we discuss what we mean by "CEO power." In Parts III–VII, we analyze the causes for and symptoms of the loss of CEO power. We consider shareholder composition and activism (Part III), governance rules and the board response to shareholder activism (Part IV), regulatory changes related to shareholder voting (Part V), changes in the board of directors (Part VI), and executive compensation (Part VII). In Part VIII, we tie our analysis of the causes for and symptoms of the loss of CEO power to the aspects and dimensions of power examined in Part II. In Part IX, we discuss the implications of our analysis.

Before embarking on our analysis, it is worth recalling just how much power CEOs had before all the changes that we document here. Myles Mace's surveys of directors and officers during the 1960s provide a wonderful window into what it used to be like.[3] Consider the following quotes from top executives on the role of the CEO and directors:

> To put it bluntly, whether a board has any function or not, it must truly reflect the nature of the chief executive officer of the company more than anything else. If he wants to use the board, he will use them. And if he doesn't want to use the board, he will run over them pretty roughshod. Basically, the board can be made just about as useful as the president wishes it to be.
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> The president of a company, or the chairman of the board, or whoever runs this operation, really determines the contribution the board makes. If all he wants to do is to get up in front of them and sort of go through some motions, see that fees get distributed, give them a bit of lunch—then that's the kind of performance you will get, because the chief executive officer controls the affair. If, on the other hand, the chief executive officer seeks out where in the management areas various board members might be able to make more of a contribution than in others, and then structures his board so that emphasis is placed on such questions rather than on the rote alternative, then the chief executive is making a direct impact on the contribution the board makes. This, I suppose, is a matter of style.
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> . . . The old man [the president] has exactly the kind of a board he wants. They all live here in the city, and they just don't do a damn thing as directors. The old man thinks it is a great board, and from his point of view he is probably right. From my point of view they are a big glob of nothing. Not that there aren't some extremely able outsiders on the board—there are. But as board members, they know who is in control and they will never cross the old man.
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> . . . .

3. MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971).

> . . . What any new board member finds out very quickly in our company is that it is very difficult to do anything except go along with the recommendations of the president. Because directors who don't go along with them tend to find themselves asked to leave.[4]

These interviews led Mace to conclude the following:

> Presidents of these [widely held] companies have assumed and do exercise the de facto powers of control of the companies for which they are responsible. To them the stockholders constitute what is in effect an anonymous mass of paper faces. Thus, presidents in these situations determine what directors do or do not do.
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> . . . .
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> Most presidents, it was found, choose to exercise their powers of control in a moderate and acceptable manner with regard to their relationships with boards of directors. They communicate, though, explicitly or implicitly, that they, as presidents, control the enterprises they head, and this is generally understood and accepted by the directors. Many of them are presidents of companies themselves, and they thoroughly understand the existence and location of powers of control.[5]

II. Power and the CEO

Power is a complex concept that has generated, and continues to generate, a huge literature. Drawing on that literature, in speaking of CEO power, we are interested in three related aspects of power: decision making, second-guessing, and scope.[6]

Decision making refers to the ability of the CEO to decide key issues facing the firm either on her own or by getting the pro forma approval by other decision makers in the firm, such as shareholders, the board of directors, or lower-level managers.[7] A greater ability to decide means more

4. *Id.* at 78–79. Mace also comments: "This point of view was confirmed many times during our study." *Id.* at 79.

5. *Id.* at 84.

6. There is a huge literature on "power" in philosophy, sociology, and political science. Important contributions from which we base some of our assertions include ROBERT DAHL, WHO GOVERNS? (2d ed. 2005); STEVEN LUKES, POWER: A RADICAL VIEW (2d ed. 2005); PETER MORRISS, POWER: A PHILOSOPHICAL ANALYSIS (2d ed. 2002); and DENNIS WRONG, POWER: ITS FORMS, BASES, AND USES (Transaction ed., Transaction Publishers 1995) (1979). Because our interest is essentially practical and comparative—whether CEOs are less powerful than they used to be?—we do not need to come up with a comprehensive analysis of power. Rather, it is enough to identify a set of features that approximate the recognized scope of the term power in corporate law and governance. We assert without proving that these aspects capture the essential elements of "CEO power," including the various aspects of "power to" and "power over" as well as the related notions of "autonomy."

7. *Cf.* LUKES, *supra* note 6, at 16–19 (describing a "one-dimensional" view of political power that is best understood as the ability to make decisions affecting others).

CEO power.[8] Decision-making ability, in turn, has several facets. First, CEO power includes the CEO's ability to control whether an issue is even presented to other potential decision makers, i.e., the power of the CEO to control the agenda of these other decision-making bodies.[9] Second, it includes the ability of the CEO to determine the outcome of an issue that is presented to these other bodies, i.e., the power to determine the decision outcome.[10] Third, it includes the ability of the CEO to act if the issue is not presented to these other bodies, i.e., the power to act independently.[11] CEOs have the greatest power if they either (i) have both agenda control and the power to act independently or (ii) have the power to determine the decision outcome.

Second-guessing refers to the ability of other actors to second-guess, and penalize, the CEO for a decision.[12] A lesser ability to second-guess by other actors means more CEO power. Second-guessing, unlike decision making, thus relates not to the ability to make a decision to start with, but to the consequences if other actors, at the time or with the benefit of hindsight, disagree with a decision that has already been made.

Finally, scope relates to the type of decisions that a CEO has the power to make.[13] Scope, in turn, has three dimensions: extension, comprehensiveness, and intensity.[14] Extension relates to the scale of the firm: Given the CEO's power within a firm, a CEO of a larger firm is more powerful than a CEO of a smaller firm.[15] Comprehensiveness relates to the type of decisions over which a CEO has power.[16] For example, can the CEO

8. *See* NELSON W. POLSBY, COMMUNITY POWER AND POLITICAL THEORY 3–4 (1980) (discussing the concept of power and suggesting that the amount of power a decision maker possesses is directly related to his ability to make important decisions that affect others and change future events).

9. *Cf. id.* at 25 (noting a more developed theory of political power incorporating agenda setting as an aspect of the ability to make decisions).

10. *See* DAHL, *supra* note 6, at 66 (arguing that a decision maker's power can be measured by "the frequency with which he successfully initiates an important policy over the opposition of others, or vetoes policies initiated by others").

11. *See* WRONG, *supra* note 6, at 36–41 (exploring the concept of "authority" and explaining how powerful leaders are able to impose their decisions and judgments on others without being questioned or tested).

12. In his groundbreaking work analyzing the political power structures in New Haven, Connecticut, Robert Dahl used the frequency of second-guessing veto power used by other parties as a rough measure of their influence over the decision maker. DAHL, *supra* note 6, at 66; *see also id.* at 163–65 (arguing that decision makers who must ultimately answer to other actors—such as politicians who must win future elections to remain in office—are greatly influenced by the preferences of those other actors when deciding what policies to adopt or reject).

13. *See* LUKES, *supra* note 6, at 22 (highlighting the importance scope plays in understanding the amount of power invested in the decision maker).

14. WRONG, *supra* note 6, at 14–16 (citing Bertrand de Jouvenel, *Authority: The Efficient Imperative*, *in* THE NATURE OF POLITICS 84, 85 (Dennis Hale & Marc Landy eds., 1992)).

15. *Id.* at 14–15.

16. *Id.* at 14–16.

set the price of a product sold by the firm, the price of a division that the company wants to put up for sale, or the price at which the whole firm is to be sold to a third party? The more comprehensive the type of decisions, the more powerful is the CEO. Finally, intensity relates to how far the CEO can push others without loss of compliance.[17] A CEO may, for example, have the power to set the price for a product, a division, or the whole firm as long as the price is within the range of reasonable prices but may not be able to get away with setting a ridiculously low price.

Each of these aspects of power captures a different facet of what we take people to mean when they talk of "CEO power." As we will show in the discussion below, the CEO's power has changed over some of these dimensions more than over others. In particular, we will argue that CEOs have lost decision-making power, in terms of agenda control, outcome manipulation, and the power to make decisions independently, albeit in different degrees and to different competing decision-making bodies. CEOs have also become more subject to second-guessing by both shareholders and board members. In terms of scope, CEOs have suffered a decline of power along the dimensions of comprehensiveness and intensity, though not extension.

In addition to its conceptual complexity, power is also a complex social phenomenon that emerges at the intersection of law, norms, and personal qualities such as charisma.[18] The accumulation and exercise of power often occur below the surface, giving rise to an "iceberg" problem: what we observe is likely to be only a small part of what is taking place.[19]

Moreover, in examining changes in power, sorting out cause and effect is likewise extremely difficult both conceptually and analytically. For example, is increased shareholder power evidence of a decline in CEO power, a cause of it, or an effect of it? How about the emergence of more independent boards? The answer, in these and other situations, is often, but not always, "all of the above."

These complications make our analysis somewhat conjectural. Maybe we are completely wrong that CEO power has declined. Maybe CEOs are every bit as powerful as they once were. Maybe they were never very powerful. Or maybe it is impossible to come up with a metric for measuring CEO power or, even if one can design a metric, to collect the data to determine whether CEO power has declined. On the other hand, we think that there are lots of reasons to think that one can intelligibly discuss CEO power,

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17. *Id.*

18. For a comprehensive survey of the complexity of political power and decision making in one American city, see DAHL, *supra* note 6. Dahl himself calls the subject "among the most complex phenomena we struggle to understand." *Id.* at xi.

19. *See id.* at 89 (observing that indirect influences on decision making may be very great but difficult to see compared to direct influences).

that it has declined, and that this decline has important implications. That is the case we make in this Article.

III. Changes in Shareholder Composition and Activism

The profile and behavior of shareholders has been fundamentally transformed over the last decade. In this Part, we discuss several changes that have led to a reduction in CEO power: the continued increase in shareholdings by institutional investors and the rise of mutual funds as the most significant type of institutional investor; the emergence of hedge funds as significant shareholder activists; the change by mutual funds and public pension funds to a more confrontational mode of activism; and the increased prominence and power of proxy advisory firms.

A. The Never-Ending Rise of Institutional Investors

Commentators have long noted the change in the ownership structure of shares of publicly traded corporations. In an article published in 1990, for example, Bernie Black presented data showing that the percentage of institutional ownership in New York Stock Exchange (NYSE) companies, which tend to be the largest publicly held companies, had increased from 45.2% in 1980 to 54.4% in 1988.[20] Around the same period, several other articles noted the increase in institutional ownership and the commensurate decline in individual ownership of shares and argued that the concentrated ownership by institutions would be the dawn of a new era of shareholder power.[21] As we have remarked elsewhere, the hopes of these commentators have been largely unfulfilled—until recently, that is.[22]

Probably as a result of the spate of scholarship from the early 1990s, the fact that share ownership by institutions has increased has long been treated as yesterday's news. There are, however, two noteworthy developments about share ownership by institutions since 1990.

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20. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 570 (1990). In examining the different measures of concentration of shareholding discussed in the text, it is worth remembering that different studies examine different samples and may define terms differently. The most important results are the trends within a sample.

21. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 827, 830–49 (1991) (arguing that the increase in institutional equity ownership would improve corporate performance). *But see, e.g.*, Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452 (1991) ("[R]ecent developments, including the increased concentration of shareholdings, the emergence of new players, and the increased activism of institutional shareholders, are unlikely to bring about a fundamental change in corporate law . . . .").

22. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1024–26 (2007) (exploring activism by hedge funds, which exceeds that by traditional institutional investors, including recent examples and potential problems).

The first is that the increase in share ownership by institutions and the decline in share ownership by individuals have continued since 1990 at virtually the same rate. As shown in Table 1, according to flow of funds accounts compiled by the Federal Reserve, the percentage of stock of publicly held companies held by all institutions (pension funds, mutual funds, banks, insurance companies, and brokers/dealers) increased from 19% in 1970 to 37% in 1990, an 18 percentage-point increase. Between 1990 and 2008, that percentage increased by a further 13 percentage points to 50%.[23] Ownership by households and nonprofits[24]—a category that includes large individual blockholders as well as retail investors—has decreased from 78% in 1970 to 56% in 1990—a 22 percentage-point decrease—and then decreased by another 20 percentage points to 36% in 2008.[25] If the changes in the ownership structure between 1970 and 1990 were notable and important, the further changes between 1990 and 2008 are presumably also important.

Table 1: Percent Ownership of Equities by Types of Investor

	1965	1970	1975	1980	1985	1990	1995	2000	2002	2004	2006	2008
Households and Nonprofits	84	78	70	68	54	56	52	46	39	40	38	36
Private Pension Funds	6	8	13	16	23	17	15	11	13	12	12	11
Public Pension Funds	0	1	3	3	5	8	8	8	9	9	9	9
Mutual Funds	5	5	5	3	5	7	13	19	19	21	23	22
All Institutions	14	19	26	27	40	37	42	44	50	49	51	50

23. *See infra* tbl.1; *see also* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1985–1994, at 83 (2009), *available at* http://www.federalreserve.gov/releases/z1/current/annuals/a1985-1994.pdf [hereinafter ANNUAL FLOWS AND OUTSTANDINGS 1985–1994]; BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 2005–2008, at 83 (2009), *available at* http://www.federalreserve.gov/releases/z1/current/annuals/a2005-2008.pdf [hereinafter ANNUAL FLOWS AND OUTSTANDINGS 2005–2008] (both providing the level values from which the percentages were calculated).

24. Generally, values for the households and nonprofit organizations sector are residuals; in other words, such values equal known totals for all sectors less known values for other sectors. 1 BD. OF GOVERNORS OF THE FED. RESERVE SYS., GUIDE TO THE FLOW OF FUNDS ACCOUNTS 170 (1993). Besides pension funds, mutual funds, banks, insurance companies, brokers/dealers, and households and nonprofits, the Federal Reserve provides data for ownership by state and local governments and foreign residents, among others. *See, e.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS THIRD QUARTER 2009, at 7 (2009), *available at* http://www.federalreserve.gov/releases/z1/current/zi.pdf [hereinafter FLOWS AND OUTSTANDINGS THIRD QUARTER 2009] (listing debt growth by sector: households, business, state and local governments, federal government, domestic financial sectors, and foreign); *id.* at 18–38 (providing data by sector: households and nonprofit organizations, life insurance companies, and private pension funds).

25. *See supra* tbl.1; *see also* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1965–1974, at 83 (2009), *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1965-1974.pdf [hereinafter ANNUAL FLOWS AND OUTSTANDINGS 1965–1974]; ANNUAL FLOWS AND OUTSTANDINGS 1985–1994, *supra* note 23, at 55; ANNUAL FLOWS AND OUTSTANDINGS 2005–2008, *supra* note 23, at 55 (all providing the level values from which the percentages were calculated).

Moreover, the figures in the flow of funds accounts do not account separately for stock held by hedge funds. Rather, hedge fund stock beneficially owned by individuals and nonprofits is included in the household and nonprofit category[26] even though hedge fund assets have surged over the last few years[27] (though they have declined with the recent market downturn[28]). By the end of 2008, hedge funds had an estimated $1.5 trillion in assets under management.[29] If these assets include, say, $500 billion in stock of publicly held corporations, the percentage of such stock held by households would fall to 33% and the percentage held by institutions would rise to 53%. Given these trends, the 90%–10% ratio of retail to institutional stock ownership of the 1950s could soon become 90%–10% the other way.[30] Brian Cartwright, while the general counsel at the SEC, recently referred to this as the "deretailization" of the stock market.[31]

The second development relates to the composition of the institutional holdings. Pre-1990, the most important type of institutional owner was the private pension fund. Ownership by private pension funds had increased from 1% in 1950 to 17% in 1990.[32] By contrast, ownership by mutual funds and public pension funds had increased at a slower pace, from 3% in 1950 to 7% in 1990 for mutual funds and from less than 1% in 1950 to 8% in 1990 for public pension funds. But even in 1990, commentators recognized that

26. *See* Rochelle L. Antoniewicz, A Comparison of the Household Sector from the Flow of Funds Accounts and the Survey of Consumer Finances 10 (Oct. 2000) (unpublished manuscript, on file at http://www.federalreserve.gov/PUBS/oss/oss2/papers/antoniewicz_paper.pdf) ("Because hedge funds are not required to file any documentation on their assets or asset values, the flow of funds cannot separate these financial intermediaries from the household sector. Therefore, hedge fund assets are contained within the FFA household sector assets."); *see also* FLOWS AND OUTSTANDINGS THIRD QUARTER 2009, *supra* note 24, at 104 n.1 (indicating that the households and nonprofit organizations sector includes domestic hedge funds).

27. *See* MARKO MASLAKOVIC, INT'L FIN. SERVS., HEDGE FUNDS: CITY BUSINESS SERIES 1 (2007), http://www.ifsl.org.uk/upload/CBS_Hedge_Funds_2007.pdf (noting the hedge fund industry's recent "remarkable growth").

28. *See* INT'L FIN. SERVS. LONDON, HEDGE FUNDS 2009, at 1, (2009) available at http://www.ifsl.org.uk/upload/CBS_Hedge%20Funds%202009(1).pdf (reporting that hedge fund assets plummeted approximately 30% in 2008 and may fall a further 20% in 2009).

29. *Id.*

30. Brian G. Cartwright, Gen. Counsel, SEC, Speech by SEC Staff: The Future of Securities Regulation (Oct. 24, 2007) (transcript available at http://sec.gov/news/speech/2007/spch102407bgc. htm).

31. *Id.*

32. *See supra* tbl.1; *see also* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1945–1954, at 83 (2009), *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1945-1954.pdf [hereinafter ANNUAL FLOWS AND OUTSTANDINGS 1945–1954]; ANNUAL FLOWS AND OUTSTANDINGS 1985–1994, *supra* note 23, at 68 (both providing the level values from which the percentages were calculated).

private pension funds were among the least likely institutions to take an activist approach.[33]

Since 1990, the picture has changed drastically. Holdings by private pension funds have declined from 17% in 1990 to 11% in 2008;[34] and given the disadvantages of defined benefit plans,[35] they are poised for further declines. Mutual funds, by contrast, have taken off, tripling their percentage holdings from 7% to 22%.[36] And mutual funds, as discussed below, have recently become increasingly engaged in governance activism.[37]

B. Hedge Funds: The New Player

As we have shown in an earlier article, activist hedge funds have emerged as critical new players in both corporate governance and corporate control.[38] Hedge funds have created headaches for CEOs and corporate boards by pushing for changes in management and changes in business strategy, including opposing acquisitions favored by management both as shareholders of the acquirer and as shareholders of the target, and by making unsolicited bids.[39] The list of companies that have been subjected to campaigns by hedge funds and other activist investors includes McDonald's,[40] Time Warner,[41] H.J. Heinz Company,[42] Wendy's,[43] Massey Energy,[44] KT&G,[45] infoUSA,[46] GenCorp,[47] Sovereign Bancorp,[48] Deutsche Börse,[49]

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33. *See* Black, *supra* note 20, at 596–98 ("[W]e can't expect corporate pension managers to become visibly active in the best of circumstances . . . .").

34. *See* ANNUAL FLOWS AND OUTSTANDINGS 1985–1994, *supra* note 23, at 83; ANNUAL FLOWS AND OUTSTANDINGS 2005–2008, *supra* note 23, at 83 (both providing the level values from which the percentages were calculated).

35. *See* Alvin Lurie, *How a Lawsuit Almost Strangled Pensions*, POINTOFLAW.COM, Nov. 12, 2006, http://www.pointoflaw.com/columns/archives/003183.php ("For many years the design of pension plans has been shifting away from the 'defined benefit' format that was once typical. Employers came to dislike such plans because they can impose devastating new funding liabilities in certain situations, as when interest rates sink while the stock market declines. Employees do not find such plans as suitable as they once did because they no longer expect to follow the model of lifetime one-workplace employment for which the plans were originally designed.").

36. *See* ANNUAL FLOWS AND OUTSTANDINGS 1985–1994, *supra* note 23, at 83; ANNUAL FLOWS AND OUTSTANDINGS 2005–2008, *supra* note 23, at 83 (both providing the level values from which the percentages were calculated).

37. *See infra* notes 85–109 and accompanying text (highlighting increased buyout opposition and influence on corporate structure by mutual funds, sometimes in cooperation with traditionally more activist hedge funds).

38. *See* Kahan & Rock, *supra* note 22, at 1029–42 (discussing methods by which hedge funds have pressured for change in corporate governance, blocked acquisitions, and bought or bid for portfolio companies).

39. *See id.* (highlighting a number of examples of hedge fund activism).

40. *Id.* at 1024.

41. *Id.*

42. *Id.*

43. *Id.* at 1031.

44. *Id.* at 1024.

45. *Id.*

Novartis,[50] Sears Holdings,[51] VNU,[52] Delphi,[53] Calpine,[54] Kerr-McGee,[55] Blockbuster,[56] Hollinger International,[57] Target,[58] Kraft,[59] Home Depot,[60] WCI,[61] Motorola,[62] Biogen,[63] Comcast,[64] H&R Block,[65] Tiffany & Co.,[66] Alcoa,[67] BEA Systems,[68] CSX,[69] Circuit City,[70] Zale Corporation,[71] the *New*

46. *Id.*

47. *Id.* at 1025.

48. William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1392 (2007).

49. Kahan & Rock, *supra* note 22, at 1025.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.* at 1031.

56. *Id.*

57. *Id.* at 1033.

58. *See* Jared A. Favole & Mike Barris, *With 9.6% Stake in Target, Ackman Fires Value Salvo*, WALL ST. J., July 17, 2007, at C3 (reporting that a 9.6% stakeholder in Target planned to pressure the retailer to increase value).

59. *See* Brad Dorfman, *Kraft in Deal with Peltz's Trian*, REUTERS, Nov. 7, 2007, http://www.reuters.com/article/idUSN0757299320071108 (describing a deal struck between Kraft and an activist shareholder regarding the composition of the board).

60. *See* Ann Zimmerman & Mary Ellen Lloyd, *Home Depot Draws Proxy Threat from Investor*, WALL ST. J., Dec. 19, 2006, at A10 (indicating a potential conflict stemming from stakeholder Relational Development's disapproval of Home Depot's growth strategy).

61. *See* Jonathan Liss, *Icahn, WCI Management Trade Barbs at Hint of Hostile Bid; Shares Jump*, SEEKING ALPHA, Mar. 14, 2007, http://seekingalpha.com/article/29487-icahn-wci-management-trade-barbs-at-hint-of-hostile-bid-shares-jump (reporting that a 14.6% stakeholder claimed the CEO was "not qualified" to lead the company).

62. *See* Sara Silver, *Motorola Reaches Truce with Icahn*, WALL ST. J., Apr. 8, 2008, at B3 (describing a deal by which 6.4% shareholder Icahn dropped his proxy battle against the Motorola board of directors in exchange for the ability to nominate two board positions).

63. *See* Keith J. Winstein, *Biogen Considers a Sale; Pressure Comes from Icahn*, WALL ST. J., Oct. 13–14, 2007, at A3 (describing 4% shareholder Icahn's $23 billion bid to purchase Biogen).

64. *See* Merissa Marr & Dionne Searcey, *Comcast Holder Seeks CEO's Dismissal: Chieftan Targets Dual-Class Voting and Executive Pay*, WALL ST. J., Jan. 18, 2008, at A8 (describing a 2% stockholder's demands for restructuring after Comcast stock fell 40% in one year).

65. *See* Kevin Kingsbury, *H&R Block Holders Vote to Install Breeden Picks*, WALL ST. J., Sept. 7, 2007, at C3 (observing that a substantial majority of the lagging company's shareholders voted to replace three board members).

66. *See Tiffany Will Hear Ideas of Peltz Funds*, N.Y. TIMES, Feb. 2, 2007, at C4 (signaling Tiffany & Co.'s willingness to cooperate with a majority-shareholder investment firm).

67. *See Alcoa: JANA Partners LLC Calls on Alcoa's Board to Drop Alcan's Bid and Pursue Strategic Alternatives Including a Sale of the Company*, REUTERS, May 8, 2007, http://www.reuters.com/article/idUSIN20070508142830AA20070508 (highlighting a hedge fund's activist attempts to influence corporate decisions).

68. *See* Pui-Wing Tam & Vauhini Vara, *Activists Test Silicon Valley: Icahn Is Latest Investor Trying to Unlock Value in Technology Industry*, WALL ST. J., Oct. 20–21, 2007, at B1 (describing hedge fund managers' increasing willingness to influence undervalued technology firms).

69. *See* Michael J. de la Merced, *Hedge Funds Propose CSX Directors, Starting Proxy Battle*, N.Y. TIMES, Dec. 20, 2007, at C2 (describing hedge funds' proposals of five alternate directors as

York Times,[72] and Sprint Nextel.[73] According to Wachtell Lipton partner Patricia Vlahakis, hedge funds conducted 137 activist campaigns just in the fourth quarter of 2007.[74] In many of these instances, hedge funds have been able to win outright or at least to wrest substantial concessions from the management of the companies they target.[75]

This new activism by hedge funds has become a prime irritant for CEOs. Martin Lipton, the renowned advisor to corporate boards, recently listed "attacks by activist hedge funds" as a key issue for directors.[76] Alan Murray from the *Wall Street Journal* calls hedge funds the "new leader" on the "list of bogeymen haunting the corporate boardroom,"[77] and his colleague Jesse Eisinger notes that these days hedge funds are the "shareholder activists with the most clout."[78]

What is particularly noteworthy is the degree of activist bang generated by relatively little buck. Although hedge funds manage substantial amounts of investor money,[79] the large majority of hedge funds do not pursue activist strategies. Rather, according to a recent estimate by J.P. Morgan, only 5% of

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yet one more example of a hostile maneuver); Heidi N. Moore, *En Garde, Activist Hedge Funds*, WALL ST. J. DEAL J., Mar. 24, 2008, http://blogs.wsj.com/deals/2008/03/24/can-investment-banks-take-a-stand-against-activist-hedge-funds (describing a claim over swap agreements filed by CSX against two hedge funds).

70. *See* Gary McWilliams, *Activists Circle Circuit City*, WALL ST. J., Mar. 24, 2008, at C2 (forecasting changes in management due to activist hedge funds' increased control of Circuit City).

71. *See* Karey Wutkowski, *Breeden Builds Up Stake in Jeweler Zale*, REUTERS, Jan. 7, 2008, http://www.reuters.com/article/idUSN0740372120080108 (noting that activist-investor Breeden increased his holdings in Zale Corporation to 15.85%).

72. *See* Sarah Ellison, *New York Times Holder Protest Grows*, WALL ST. J., Apr. 25, 2007, at B10 (noting that a growing number of shareholders, led by money manager Morgan Stanley, withheld their votes from directors up for reelection as a sign of their dissatisfaction).

73. *See Sprint Nextel Announces Appointment of Ralph Whitworth to Its Board of Directors*, REUTERS, Feb. 12, 2008, http://www.reuters.com/article/pressRelease/idUS145208+12-Feb-2008+BW20080212 (noting the appointment of a large stakeholder to the Sprint Nextel Board as an investment advisor).

74. *Hedge Fund Activism, Possible Recession Will Play Roles in Upcoming Proxy Season*, CORP. L. DAILY, Feb. 1, 2008 (on file with authors).

75. *See supra* notes 45, 48, 49, 53, 56–57, 59 and accompanying text.

76. Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, to Clients 1 (Dec. 17, 2007) (on file with Texas Law Review).

77. Alan Murray, *Hedge Funds Are New Sheriffs of Boardroom*, WALL ST. J., Dec. 14, 2005, at A2.

78. *See* Jesse Eisinger, *Memo to Activists: Mind CEO Pay*, WALL ST. J., Jan. 11, 2006, at C1 ("The shareholder activists with the most clout these days are hedge-fund managers . . . .").

79. *See* ALEXANDER INEICHEN & KURT SILBERSTEIN, AIMA'S ROADMAP TO HEDGE FUNDS 10 (2008), http://www.aima.org/en/knowledge_centre/education/aimas-roadmap-to-hedge-funds.cfm (estimating hedge fund assets to be between $1.8 and $4 trillion); *see also supra* notes 26–28 and accompanying text.

hedge fund assets are available for shareholder activism.[80] Given these figures, the list of companies targeted by hedge funds is indeed impressive.[81]

C. *Activism by Traditional Institutions*

Traditional institutional investors—specifically public pension funds and mutual funds—have long engaged in low-pressure (and low-cost) "soft" forms of activism, such as voting in favor of corporate-governance shareholder resolutions (and occasionally introducing them) or lobbying boards behind-the-scenes to improve their corporate governance.[82] As discussed below, the corporate-governance issues "du jour" to which this activism is directed are constantly evolving, and the level of support for shareholder resolutions has increased.[83] Overall, however, there has been no major qualitative change in the nature of the soft activism by traditional institutions.[84] On different fronts, however, qualitative changes seem to be occurring.

1. The Awakening of Mutual Funds.—Mutual funds are increasingly engaging in the hard-core activism that has been the hallmark of hedge funds. For example, mutual funds have shown an increased willingness to oppose acquisition of their portfolio companies by private equity firms or large family owners.[85]

In 2007, the most recent year with significant buyout activity, mutual funds successfully opposed a number of buyout transactions approved by the board of directors. For example, mutual-fund giant Fidelity, the largest

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80. Kahan & Rock, *supra* note 22, at 1046.

81. Hedge fund activism is continuing even after the recent financial crisis. *See* David Walker, *Activist Hedge Funds Passively Rebound*, WALL ST. J. (EUR.), Sept. 29, 2009, at 19 (chronicling activist hedge funds' gain of 29.23% in 2009 after dropping 30.81% in 2008); *see also* Alistair Barr, *Pershing Square to Fight Landry's Buyout*, MARKET WATCH, Nov. 13, 2009, http://www.marketwatch.com/story/pershing-square-to-fight-landrys-buyout-2009-11-13-174800 (describing a major shareholder's successful opposition of an attempted buyout by Landry's founder).

82. *See* Kahan & Rock, *supra* note 22, at 1042–44 (describing the lower impact forms of activism traditionally favored by pension funds and mutual funds).

83. *See infra* notes 156–61 and accompanying text.

84. *See* PAUL LANGLEY, THE EVERYDAY LIFE OF GLOBAL FINANCE 122 (2008) (observing that even after a corporation becomes the target of an activist resolution, it is still common for the institutional investors to voice their concerns in private meetings with executives).

85. *See* Scott Barancik, *OSI Buyout Down but Not Out*, ST. PETERSBURG TIMES, May 9, 2007, at 1D (commenting on the trend of hedge fund managers who are also becoming more vocal critics of unfavorable deals); Tom Lauricella, *Mutual Funds Get Mad*, WALL ST. J., Oct. 2, 2007, at R1 (profiling recent instances of mutual-fund managers "rabble-rousing" and taking action against companies in which they have a stake); Tom Lauricella, *Oppenheimer Revolt Shows Mutual Funds' New Mood*, WALL ST. J., Apr. 11, 2007, at C1 [hereinafter Lauricella, *Opphenheimer*] (reporting that mutual funds are "borrowing a tactic from hedge funds . . . to publicly battle with companies they own"); John Laide, *Investor Activism Against Mergers on the Rise*, SHARKREPELLENT, Mar. 7, 2007, https://www.sharkrepellent.net/pub/rs_20070308.html (tracking major instances of activist shareholders opposing mergers in 2006).

shareholder of Clear Channel Communications, threatened to vote against an acquisition of the company by Bain Capital Partners and Thomas H. Lee Partners, two private equity firms, for $37.60 per share and thereby forced the buyers to raise the price to $39.20.[86] T. Rowe Price, an 8.1% stockholder of Laureate Education, led the opposition to the proposed acquisition of the company for $60.50; the offer was sweetened to $62.[87] Mutual fund Lord Abbett & Co., the second-largest shareholder (6.95%) of OSI Restaurant Partners, complained about the $40-per-share buyout price as having the "markings of a 'panic sale.'"[88] Shareholders approved the deal only after Bain Capital increased the price to $41.15.[89] Investment manager Pzena Investment Management, the second-largest shareholder of Lear, blocked Carl Icahn's offer for the company for $36[90] and also for the sweetened $37.25.[91] And the public pension fund CalPERS opposed a $44 buyout of Biomet Inc. by a group of private equity firms, forcing a price increase to $46.[92] In all of these cases (except for the Clear Channel acquisition), the offer that the institutional investors considered too low—and that was subsequently raised—had the blessing of the respective company's board of directors and its CEO.[93]

The new hard-core activism by traditional money managers is not confined to the buyout area. The money-management arm of the investment bank Morgan Stanley has urged the *New York Times* to dismantle its dual share structure, which assures the founding Sulzberger family of continued control of the company.[94] A campaign led by Morgan Stanley—and supported by mutual funds T. Rowe Price and Legg Mason[95]—for shareholders to withhold their votes from nominees to the board of directors resulted in a 42% withhold vote, which amounted to a majority of the votes not controlled

86. Zachery Kouwe, *Back in Play: Shareholder Outcry Revives Clear Channel LBO*, N.Y. POST, May 8, 2007, at 47; Sarah McBride & Dennis K. Berman, *Clear Channel Is Asked to Reconsider Offer*, WALL ST. J., May 7, 2007, at B12.

87. Jonathan Vuocolo, *Laureate Accepts Sweetened Buyout Bid*, WALL ST. J., June 5, 2007, at C3.

88. Barancik, *supra* note 85.

89. Richard Gibson, *OSI Holders Clear Bid to Go Private*, WALL ST. J., June 6, 2007, at C3.

90. Andrew Farrell, *Icahn's Lear Bid Not Enough, Pzena Says*, FORBES, July 9, 2007, http://www.forbes.com/2007/07/09/lear-icahn-update-markets-equity-cx_af_0709markets20.html.

91. *Lear Holders Reject Icahn's Buyout Bid*, N.Y. TIMES, July 17, 2007, at C4.

92. Jon Kamp, *New Buyout Offer for Biomet Is Now Sweeter and Tender*, WALL ST. J., June 8, 2007, at C3.

93. McBride & Berman, *supra* note 86 (Clear Channel); Susan Carey & Jonathan Vuocolo, *Biomet Agrees to Be Acquired for $10.9 Billion*, WALL ST. J., Dec. 19, 2006, at C4 (Biomet); Michael J. de la Merced, *Parent of Outback Steakhouse Is Sold in $3.2 Billion Deal*, N.Y. TIMES, Nov. 7, 2006, at C2 (OSI Restaurant Partners); Josee Valcourt, *Lear Execs in Hot Seat After Deal Dies*, DETROIT NEWS, July 17, 2007, at 1A (Lear); Vuocolo, *supra* note 87 (Laureate Education).

94. *See* Sarah Ellison, *Paper Chase: How a Money Manager Battled New York Times*, WALL ST. J., Mar. 21, 2007, at A1 (covering a Morgan Stanley portfolio manager's campaign to reform the dual-class structure of the company, among other perceived problems).

95. Ellison, *supra* note 72.

by the Sulzberger family.[96] Morgan Stanley also hired a governance expert respected in activist circles, which fueled speculation that Morgan Stanley may itself be planning to engage in more activism.[97]

A related noteworthy—and novel—phenomenon is the cooperation between mutual funds and hedge funds in pressuring management.[98] For example, in March 2007, Oppenheimer Funds teamed up with several hedge funds to stage a coup and install new top executives at Take-Two Interactive Software Inc., the struggling maker of the popular videogame series Grand Theft Auto.[99] According to the *Wall Street Journal*, this was "the first time in [Oppenheimer's] 46-year history to take such a step."[100] Other recent instances of cooperation between mutual funds and hedge funds include joint efforts to block the acquisition of the London Stock Exchange by Deutsche Börse,[101] of Chiron by Novartis,[102] of MONY by AXA,[103] of Lear by Carl Icahn,[104] and of IMS Health by VNU;[105] joint bids for Beverly Enterprises;[106]

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96. Landon Thomas Jr., *Shareholders of Times Co. Hold Out 42% of Board Vote*, N.Y. TIMES, Apr. 25, 2007, at C5.

97. *See* Kaja Whitehouse, *Morgan Stanley Buffs Activist Profile*, WALL ST. J., Dec. 13, 2006, at C15 (publicizing speculation that "the decision to hire [the expert], combined with the efforts at the New York Times, suggests the Morgan Stanley unit may be growing more interested in shareholder activism").

98. *See* Christopher Young & Qin Tuminelli, *A New World Order in M&A and Proxy Fights*, *in* INSTITUTIONAL S'HOLDER SERVS., POSTSEASON REPORT 25, 25 (2006), http://www.riskmetrics.com/system/files/private/2006PostSeasonReportFINAL.pdf (relating that asset managers recently have taken the "first tentative steps toward activism").

99. Lauricella, *Oppenheimer*, *supra* note 85.

100. *Id.*

101. *See* David Reilly, *Deutsche Boerse Drama Ends*, WALL ST. J., May 24, 2005, at C14 (reporting on the joint opposition of Atticus Capital (a hedge fund) and Fidelity Investments (a mutual-fund investor) to the takeover of the London Stock Exchange).

102. *See* David P. Hamilton, *Novartis Raises Chiron Bid, Virtually Sealing Deal*, WALL ST. J., Apr. 4, 2006, at A2 (recording that CAM North America and Legg Mason (both mutual funds) and ValueAct Capital (a hedge fund) were investors of Chiron that opposed the takeover by Novartis).

103. *See* Theo Francis, *MONY Holder, Resisting AXA, Suggests a New Chairman, CEO*, WALL ST. J., Jan. 23, 2004, at C4 (noting that MONY's four largest shareholders, composed of mutual funds and hedge funds, opposed the acquisition by AXA, though they claimed not to be working together).

104. *See* Jeff Bennett & Mike Ramsey, *Lear Accepts Carl Icahn's $2.8 Billion Cash Offer*, BLOOMBERG, Feb. 9, 2007, http://www.bloomsberg.com/apps/news?pid=20601087&refer=home&sid=alWGZxoz9GxU (noting opposition to Icahn's offer by Pzena (a hedge fund) and Brandes (a mutual fund)).

105. *See* Jason Singer, *For VNU, a Shareholder Revolt May Lead to Its Sale or Breakup*, WALL ST. J., Oct. 25, 2005, at A3 (reporting that a group of VNU shareholders including Fidelity Investments (a mutual fund) and Knight Vinke (a hedge fund) banded together to tell board members to abandon the friendly acquisition).

106. *See* Kahan & Rock, *supra* note 22, at 1045 (recounting the occasion in 2005 when Franklin Mutual Advisors (a mutual fund) and various hedge funds joined forces to bid jointly on Beverly Enterprises).

and a joint proxy fight over Time Warner.[107] Often, as in the case of Deutsche Börse, it is activist hedge funds that take the lead and mutual funds that follow.[108] But increasingly, as in the case of Oppenheimer, mutual funds are in the forefront.[109]

2. Pension Fund Support of Activist Hedge Funds.—Although pension funds predominantly do not themselves engage in hard-core activism, they often have affiliations with activist hedge funds that do. There are two models for this division of responsibility. The rare but most transparent approach is illustrated by Hermes, the British Telecom-owned fund manager that "manages the assets of the BT Scheme and the Post Office Staff Superannuation Scheme, two of the largest four pension funds in the U.K."[110] In 1998, Hermes established an independent fund, the Hermes U.K. Focus Fund,[111] which has successfully pursued activist strategies.[112] When an activist hedge fund sits on top of, or beside, an index fund, it can be thought of as providing the activist corporate-governance strike force for the associated index fund.[113]

The more common model involves investments by institutional investors in activist hedge funds.[114] Functionally, this is quite similar to the Hermes model: institutions who invest in independent activist funds that target underperforming companies can make money on their direct investments

107. *See* Young & Tuminelli, *supra* note 98, at 27 (recalling a 2006 proxy fight where Carl Icahn led a gang of mutual funds and hedge funds to ultimately pressure Time Warner into making valuable concessions).

108. In the case of the failed takeover of the London Stock Exchange by Deutsche Börse, a London-based hedge fund manager was an early shareholder to rattle sabers—mutual funds like Fidelity Investments only followed the activist hedge funds' war cries weeks later. *See* David Reilly, *Deutsche Boerse Faces Mounting Opposition to Its Bid for LSE*, WALL ST. J., Feb. 28, 2005, at C4 (reporting that Fidelity Investments and Merrill Lynch investment managers jumped onto the activist bandwagon in late February); Jason Singer et al., *Fund Chief Fights Deutsche Boerse on Buyout Plan*, WALL ST. J., Jan. 21, 2005, at C4 (profiling the crusade of Christopher Hohn of Children's Investment Fund Management to kill the ill-fated purchase since at least January of 2005).

109. *See* Don Jeffrey & Michael White, *Take-Two Dissidents Win Control, Install New Chief*, BLOOMBERG, Mar. 29, 2007, http://bloomberg.com/apps/news?pid=20601087&src=mwm&sid=agdRA1p8Epzc (last updated Mar. 29, 2007) (reporting that Oppenheimer led other investors, including hedge funds, to force a change of CEO at Take-Two).

110. Marco Becht et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund* 13 (Eur. Corporate Governance Inst., Fin. Working Paper No. 138/2006, 2008), *available at* http://ssrn.com/abstract=934712.

111. *Id.* at 14.

112. *See id.* at 41 (concluding that the Hermes U.K. Focus Fund's activism has created "substantial shareholder gains").

113. *See* Kahan & Rock, *supra* note 22, at 1043 (observing that institutional investors often engage in "passive activism" by taking heed of and supporting the proposals of co-investors).

114. *See* Marcel Kahan & Edward Rock, *Hedge Fund Activism: The Case for Non-intervention*, ADMIN. & REG. L. NEWS, Winter 2008, at 6 (stating that many public pension funds have invested in hedge funds).

and may also increase the value of their portfolio overall.[115] On the other hand, indirect investment provides the institutions with a great deal more insulation from criticism since it is the pension fund itself that selects the target for activism and devises the activist strategy. It is easier and cleaner for the Harvard or Yale endowments or CalPERS or NYCERS to invest in an activist hedge fund than to take the responsibility of starting and operating one themselves on the Hermes model.[116]

D. The Role of Proxy Advisory Firms

Proxy advisory firms have arisen in parallel with the increased share ownership by institutional investors.[117] Such firms make recommendations to their clients—which include most institutional investors[118]—on how to vote their shares in the election of directors, shareholder resolutions, merger proposals, or any other matter on which shareholders vote, as well as provide services that simplify the casting of votes.[119] Commentators have described ISS (the largest advisory firm and now a division of RiskMetrics)[120] as an entity that exercises "tremendous clout,"[121] wielding "extraordinary" influence,[122] being "belligerent,"[123] and to which "powerful CEOs come on bended knees."[124] Claims about its power range from swaying 19% of the

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115. *See* Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 312 (2008) (remarking that institutional investors have frequently supported hedge funds in their activism and noting that hedge funds generate value by being good stock pickers and by intervening in undervalued firms on behalf of shareholders).

116. Jim Manzi, *Is Harvard Just a Tax Free Hedge Fund?*, AM. SCENE, May 15, 2008, http://www.theamericanscene.com/2008/05/12/is-harvard-just-a-tax-free-hedge-fund.

117. *See* Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 393 (2009) (highlighting the sharp increase in the percentage of equity securities held by institutional investors and emphasizing that these investors are likely to receive voting advice from proxy advisors).

118. *See id.* at 385–86 (explaining that proxy advisors provide research and voting advice and citing a 2006 *New York Times* article reporting that the advice of the largest proxy advisor—Institutional Shareholder Services (ISS)—affects the decisions of professional investors controlling half the value of the world's common stock).

119. *See* THEODORE ROOSEVELT MALLOCH & SCOTT T. MASSEY, RENEWING AMERICAN CULTURE: THE PURSUIT OF HAPPINESS 170 (2006) (describing proxy advisory firms and noting that they "give advice to institutional shareholders on how to vote their stock").

120. David S. Hilzenrath, *Investor Advisor ISS Is Sold to RiskMetrics*, WASH. POST, Nov. 2, 2006, at D1.

121. Dennis K. Berman & Joann S. Lublin, *Advisor ISS Puts Itself on Sale, Could Fetch Up to $500 Million*, WALL ST. J., Sept. 6, 2006, at C4.

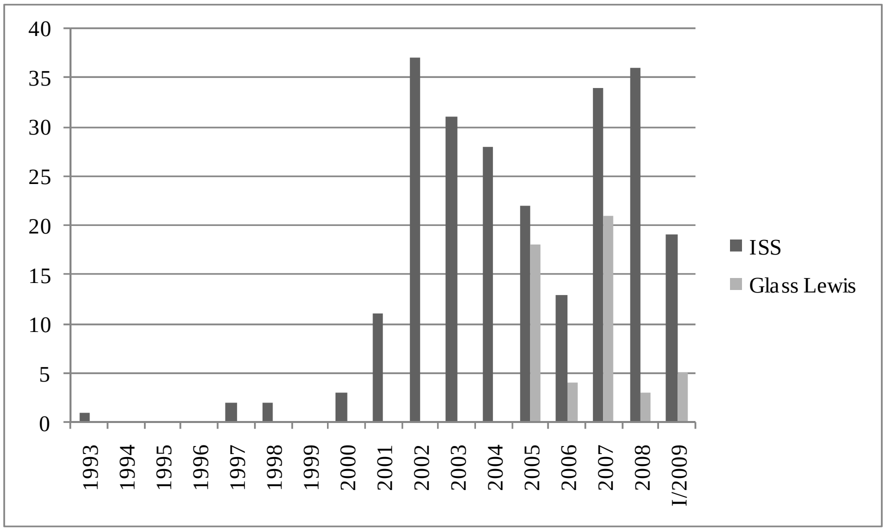
122. *See* Robert D. Hershey, *A Little Industry with a Lot of Sway on Proxy Votes*, N.Y. TIMES, Jan. 18, 2006, § 3, at 6 (describing proxy advisors generally as wielding extraordinary influence and identifying ISS as the most prominent advisory firm).

123. John Goff, *Who's the Boss?*, CFO MAG., Sept. 1, 2004, http://www.cfo.com/article.cfm/3127506?f=singlepage.

124. Leo E. Strine, Jr., *The Delaware Way*, 30 DEL. J. CORP. L. 673, 688 (2005).

votes,[125] to 21%,[126] to 30%,[127] to affecting the vote of $25 trillion in assets,[128] to getting "whatever [it] wants."[129] Martin Lipton blames "influential proxy advisory firms," together with hedge funds and other activist shareholders, for undermining the board-centric model of governance.[130]

Figure 1: Advisor References per Year[131]



As a rough metric of the increased power of proxy advisors, or at least of the public perception of such power, we collected references to ISS (or RiskMetrics) as well as to Glass Lewis (the second-largest proxy advisory firm). As reported in Figure 1, the number of times that these firms are referred to as powerful, influential, and the like has grown substantially since 2000.

While many of the more extreme claims about the power of these firms are likely to be exaggerated,[132] proxy advisors are important in at least two

125. Jie Cai et al., *Electing Directors*, 64 J. FIN. 2389, 2404 (2009).

126. Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, FIN. MGMT., Winter 2002, at 29, 30.

127. *Is ISS Too Powerful? And Whose Interests Does It Serve?*, Posting of William J. Holstein to Corner Office, http://blogs.bnet.com/ceo/?p=1100 (Feb. 7, 2008, 8:03 EST).

128. *See* Hershey, *supra* note 122 (describing ISS's influence on the governance decisions of professional investors who control $25 trillion in assets).

129. *Is ISS Too Powerful? And Whose Interests Does It Serve?*, *supra* note 127.

130. Martin Lipton, *Some Thoughts for Boards of Directors in 2008*, BRIEFLY, Jan. 2008, at 1.

131. The data reflected in this figure were gathered by conducting a search on Westlaw for articles mentioning ISS, RiskMetrics, or Glass Lewis within ten words of shareholder and either powerful, clout, or influential. The data for 2009 include results through June 10.

132. Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. (forthcoming 2010).

ways. First, they may be new and independent power centers that, to some significant degree, influence the votes of clients.[133] Second, they may function as central coordinating and information agents who help create a unified front of institutional investors, and thereby increase collective institutional shareholder influence.[134]

IV. Changes in Governance Rules and Boards' Responses to Activism

In recent years, the governance structure of large publicly held corporations has been transformed through a combination of regulatory changes and shareholder activism.[135] These changes are both a cause and a reflection of a decline in CEO power.[136] In this Part, we document and analyze trends with respect to staggered boards, the voting rules in director elections, and the adoption and implementation of shareholder proposals.

A. *The Decline of Staggered Boards*

Modern corporate law scholarship regards staggered boards as one of the most potent and controversial anti-takeover devices.[137] In companies with "effective" staggered boards, it takes two consecutive annual shareholder meetings to replace a majority of a board of directors against the opposition of incumbents.[138] While poison pills that are not coupled with staggered boards are nowadays viewed as relatively harmless,[139] several commentators have argued that staggered boards, coupled with the (virtually) universally available poison pill, serve to illegitimately entrench managers

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133. *See* James F. Cotter et al., *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 50 VILL. L. REV. (forthcoming 2010) (manuscript at 107, on file with Texas Law Review) (finding that mutual-fund votes correspond more closely to ISS recommendations than to management recommendations).

134. *See* Thuy-Nga T. Vo, *Rating Management Behavior and Ethics: A Proposal to Upgrade the Corporate Governance Rating Criteria*, 34 J. CORP. L. 1, 8 (2008) ("The increasing concentration of stock ownership in the hands of institutional investors, and the interest of these institutional investors in the governance of public companies, have also fueled the need for information about corporate governance practices.").

135. *See id.* at 11–13 (describing how public companies are now required by the Sarbanes–Oxley Act to have audit committees composed of independent directors and how the ratings systems used by major advisory services reflect generally accepted views of strong governance).

136. *See id.* at 13 (arguing that companies are increasingly assigning separate individuals to the board-chair and CEO positions despite the absence of a legal duty to do so in order to enhance the board's role as an independent monitor of management's performance).

137. *See, e.g.*, Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890 (2002) (commenting that a staggered board "offers a more powerful antitakeover defense than has previously been recognized" and suggesting that the staggered board's power as a takeover prevention tool may warrant changes in takeover regulation and in general takeover doctrine).

138. *Id.* at 912.

139. *Id.* at 899.

and that courts should find some way to render them ineffective.[140] The policy battlefront for takeover defenses, in other words, has shifted to staggered boards.

For existing companies, conventional wisdom had it that shareholders and boards are in a stalemate. Boards of companies without staggered boards may want to adopt staggered boards, but they do not propose a charter amendment because they know that shareholders will not approve it.[141] Shareholders in companies with staggered boards want to get rid of them but cannot because the board refuses to approve the requisite charter amendment.[142]

The conventional wisdom is wrong. The tide on staggered boards has turned and, at least for the largest companies, the day is not far off when staggered boards will be the rare exception. In Table 2, we present data on staggered boards in the S&P 100 companies. S&P 100 companies are among the largest and the most established companies in the U.S., representing, in aggregate, almost 45% of the market capitalization.[143]

Table 2: Staggered Boards in S&P 100 Companies

	Companies with Staggered Boards	New Adoptions	Eliminations	Eliminations as % of Companies with Staggered Boards
2003	44			
2004	41	0	3	6.80%
2005	34	0	7	17.10%
2006	25	0	8	23.50%
2007	21	0	5	24.00%
2008	16	0	1	6.30%
2009	15			

140. *See* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 561 (2002) (suggesting that courts should review staggered board terms because "[n]either the finance literature nor the norms of corporate law support vesting such unbalanced power in the hands of the board"); *see also* Bebchuk et al., *supra* note 137, at 949 (indicating that shareholders should not be permitted to adopt an anti-takeover device, such as staggered boards, that does not allow for a one-time up-or-down referendum on acquisition offers).

141. Bebchuk et al., *supra* note 137, at 900.

142. This was largely true until 2003. *See* Jennifer Levitz, *Getting the Message*, WALL ST. J., Oct. 9, 2006, at R6 (showing that virtually all shareholder resolutions that received majority support were ignored prior to 2003).

143. STANDARD & POORS, S&P 100, at 1 (2008), www2.standardandpoors.com/spf/pdf/index/SP_100_Factsheet.pdf.

As Table 2 shows, the incidence of staggered boards has declined from 44% to 16% between 2003 and 2009.[144] Put differently, over the six-year period, two-thirds of the companies that had staggered boards have dismantled them.

To be sure, the decline of staggered boards among the largest and most established companies does not necessarily mean that staggered boards are universally in decline. Arguably the managers of the largest companies are least in need of insulation against takeovers, and thus most willing to agree to destagger. Indeed, staggered boards are alive and well in companies at the time of their IPO. In a sample of twenty-six companies that went public in the first part of 2007, we found that twenty had a staggered-board provision in their charter.

That said, the largest and most established companies act as trendsetters for what is considered good corporate governance.[145] The directors of these companies sit on boards of smaller companies, and their managers are members of influential groups like the Business Roundtable.[146] With most of these companies dismantling their staggered boards over the last six years, it will become increasingly difficult for other companies to resist shareholder pressure.

In fact, smaller companies have started to go down the same path of dismantling their staggered boards that the S&P 100 companies have almost completed. Thus, according to *SharkRepellent*, the incidence of staggered boards among the (still large) S&P 500 companies declined from 57% in 2003 to 36% in 2007; among midsize S&P 400 companies, it declined from 67% in 2003 to 58% in 2007; and among small S&P 600 companies, it declined from 61% in 2003 to 55% in 2007.[147] Thus, we already see that other companies have started, and we predict that they will continue to, follow the lead of the S&P 100 companies.

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144. Of the sixteen companies that still had staggered boards in place for 2008, one had a "non-effective" staggered board (which is not regarded as a forceful anti-takeover mechanism), and the boards of two others had, since 2003, proposed charter amendments to destagger that failed to get the requisite (supermajority) shareholder approval.

145. *See* Jared A. Favole, *Big Firms Increasingly Declassify Boards*, WALL ST. J., Jan. 10, 2007, at B2 (noting that in 2006 S&P 500 companies were the first group, ahead of small and midcap companies, to surpass the 50% mark for having declassified boards).

146. *See* BusinessRoundtable.org, About Us, http://www.businessroundtable.org/about (detailing the influence CEOs from leading U.S. companies have on the association and noting that member companies "comprise nearly a third of the total value of the U.S. stock markets and pay more than 60 percent of all corporate income taxes paid to the federal government").

147. *See* SharkRepellent.net, S&P 1500 Classified Boards at Year End (2009) (on file with Texas Law Review) (reporting the number of classified boards in S&P 400, 500, and 600 companies from 1998 to 2009).

B. The Meteoric Rise of Majority Voting for Directors

Perhaps the most astonishing change in the corporate-governance environment is the meteoric rise of majority voting for directors. The traditional voting standard for director elections was plurality voting.[148] Under plurality voting, the directors who receive the most votes are elected. This means, in effect, that if the number of nominees is equal to the number of vacancies—as is the case in the overwhelming majority of director elections—every nominee is assured election since it takes only one vote to be elected.[149]

Until recently, the directors of most corporations were elected under a plurality-voting regime. Of S&P 100 companies, only ten deviated from plurality voting in 2003.[150] By 2009, that number had increased to ninety (see Table 3). Moreover, of the ten remaining companies, one had not yet filed its 2009 proxy statement, four were no longer publicly traded, and four others had some form of cumulative or dual-class voting regime in place, which complicates majority voting for directors.[151] Only a single company definitely retained a regular plurality-voting regime. As Table 3 shows, most of the change from plurality to majority voting took place in the two-year span from 2005 to 2007, where the number of S&P 100 companies with majority voting increased from nine to eighty-one. Thus, within just two years, we have moved from a regime in which majority voting was the rare exception to a regime in which it has been adopted by virtually all of the largest companies. Though the rise of majority voting among the broader set of S&P 500 companies has been somewhat slower,[152] experienced observers

148. *See* Annalisa Barrett & Beth Young, *Majority of Votes Withheld: Shareholders Say "No," Boards Say "Yes,"* 16 CORP. GOVERNANCE ADVISOR 6, 6 (2008) (discussing the shift from plurality to majority voting as it relates to withheld votes); CLAUDIA H. ALLEN, NEAL, GERBER & EISENBERG, LLP, STUDY OF MAJORITY VOTING IN DIRECTOR ELECTIONS, at ii (2007), http://www.ngelaw.com/files/upload/majoritystudy111207.pdf ("Until recently, virtually all directors of U.S. public companies were elected under a 'plurality' vote standard.").

149. *See* Allen, *supra* note 148, at ii ("A nominee in an election to be decided by a plurality could theoretically be elected with as little as one vote, thereby ensuring that, in an uncontested election, nominees slated by a board will be elected and that board seats will not be left vacant.").

150. Two as a result of state law, five due to charter or bylaw provisions, and three for unknown reasons.

151. Majority voting is not well defined for cumulative voting.

152. *See* ALLEN, *supra* note 148, at i (highlighting the increase in S&P 500 majority voting from 16% to 66% in the period from February 2006 to November 2007). Companies that have adopted majority voting differ in whether they have done so through a bylaw amendment, which usually specifies that a director who receives more "withhold" or "against" votes than "for" votes is not elected, or through corporate-governance guidelines requiring a director to tender her resignation if she receives more "withhold" or "against" votes than "for" votes. *Id.* at ii–iii, ix. Delaware law was recently changed to clarify that a resignation conditional on not receiving a specified vote can provide that it is irrevocable. DEL. CODE ANN. tit. 8, § 141(b) (2009). The distinction between these two variants, however, is not large. Even if the director is not elected, the remaining board members could, if they wanted to, fill the resulting vacancy with the very director who failed to receive the requisite shareholder vote. Directors, of course, will be reluctant to do so,

like Martin Lipton opined that "it is clear today that majority voting will become universal."[153]

Table 3: Number of S&P 100 Companies Applying Majority Voting

	2003	2004	2005	2006	2007	2008	2009
Majority Voting	10	9	9	51	81	85	90

Two further comments are in order to put this shift in perspective. First, it is important to highlight that boards simply caved in to demands for majority voting. Unlike the shift from staggered boards to annual election, the more dramatic shift from plurality to majority voting was not preceded by a long and tortured shareholder campaign; it happened over a very short time span and was more complete.[154] Second, the shift to majority voting makes the shift from staggered boards all the more important. To the extent that majority voting provides a tool for shareholders to show their disapproval for specific directors, rather than the board or management as a whole, annual voting means that shareholders have the opportunity to do so, *for each director*, on a yearly basis. Thus, while staggered boards have hitherto been viewed largely as an anti-takeover device, they now are also important as a mechanism to insulate board members from shareholder "withhold" campaigns. And the demise of staggered boards documented in the previous sections means that the ability to exert pressure via withhold campaigns is increasing.

C. More—and More Successful—Shareholder Proposals

Another piece of evidence suggesting that the landscape is changing relates to precatory shareholder resolutions. In precatory resolutions, shareholders request the board of directors take a certain action—such as redeem a pill or propose a charter amendment—without mandating the action. Virtually all of these resolutions are introduced under Rule 14a-8 of the Securities Exchange Act, which permits shareholders, at little cost, to force the company to include a resolution in its own materials.[155] Precatory resolutions thus represent a low-cost and (since they are not binding) relatively low-pressure form of activism.

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but they will be equally reluctant to reject the resignation of a director who received more votes "against" than "for." In any case, most recent moves to majority voting are via bylaw amendments, and many companies that had initially adopted corporate-governance guidelines have subsequently adopted a bylaw. ALLEN, *supra* note 148, at ii, ix, fig.1.

153. Lipton, *supra* note 130, at 4.

154. *See* Vincent Falcone, Note, *Majority Voting in Director Elections: A Simple, Direct, and Swift Solution?*, 2007 COLUM. BUS. L. REV. 844, 853–55 (2007) (describing the widespread success of the majority-voting movement).

155. 17 C.F.R. § 240.14a-8 (2008).

It was long thought that precatory shareholder resolutions did not have much of an effect.[156] This used to be true—but no longer is. First, an increasing number of shareholder resolutions are adopted by shareholders.[157] Since 2001, Georgeson, a major proxy solicitor, has prepared an annual *Corporate Governance Review* showing the voting results on corporate-governance-related shareholder resolutions filed with S&P 1500 companies.[158] These proposals concern issues like majority voting, declassifying the board, executive compensation, or the right to call a shareholder meeting.[159] Table 4 shows, for each year, the number of proposals receiving majority shareholder support and whether the board in the year after passage implemented the proposal (i.e., did what the shareholders asked it to do), ignored the proposal (i.e., refused to do what the shareholders asked it to do), or did neither (e.g., because the company was acquired or because the proposal asked the board to refrain from taking an action which the board ordinarily would not have taken anyway within that time frame).

Table 4: Shareholder Proposals (S&P 1500)[160]

	2001	2002	2003	2004	2005	2006	2007	2008
Adopted Proposals	25	51	85	79	55	73	80	86
Implemented Proposals	3	9	21	28	34	46	39	43
Ignored Proposals	20	31	44	24	9	10	28	33
Implementation Percentage	12	18	25	35	62	63	49	50
Ignored Percentage	80	61	52	30	16	14	35	38

Since 2001, the number of implemented proposals has been rising steadily, from three in 2001 to forty-three proposals in 2008. This is due partly to an increase in the number of proposals receiving majority support but, to an even greater degree to an increase in the percentage of implemented proposals, from 12% in 2001 to 50% in 2008. Correspondingly, the percentage of ignored proposals has declined. Thus, in 2001, only twenty-five proposals were adopted and 80% of those were simply ignored by the

156. Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 177 (2001).

157. We considered a resolution adopted if it received more votes in favor than the combined votes against and abstentions (including broker no-votes). This appears to be the standard used by most companies. *See* DEL. CODE ANN. tit. 8, § 216(2) (2001 & Supp. 2008) ("In all matters other than the election of directors, the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders.").

158. Georgeson, Research, http://www.georgesonshareholder.com/emea/resources_research.php. Prior to 2001, Georgeson had also prepared such a report, but analyzed only corporate-governance proposals made by institutional investors. *Id.*

159. *Id.*

160. The data reflected in this table was gathered from Georgeson's Annual Corporate Reviews. *Id.* For each adopted resolution, we conducted research to see whether it was implemented or ignored over the next year.

board of directors. By 2008, eighty-six proposals were adopted and half of them were implemented.[161]

V. Regulatory Changes—Voting and Solicitation of Proxies

In this Part, we discuss several regulatory initiatives, some that have passed and others that are pending. As we will argue, these changes have made, and have the potential to make, shareholder activism less costly and more effective. We discuss four regulatory initiatives: the 1992 amendments to the proxy rules, the reduction in the scope of discretionary broker voting, the recently enacted notice and access rules, and the proposals for proxy access.

A. The 1992 Amendments: An Honorable Mention

Though they predate the time period that we focus on in this Article, the 1992 amendments[162] to the proxy rules merit an honorable mention. In many respects, the 1992 amendments enabled the increased levels of activism[163] that started only about a decade after the amendments were adopted.[164] To understand the import of these amendments and some later reforms, it is important to give a short overview of the federal regulation of proxy solicitations.

The federal proxy rules prohibit *any person* from engaging in a solicitation unless either that person has filed a proxy statement with the SEC and sent it to each shareholder who is being solicited or an exception applies.[165] The definition of "solicitation" in the proxy rules, moreover, is extraordinarily broad and includes virtually any comment about the company, management, or any proposal to be voted on.[166] Preparing a proxy statement is a somewhat tedious and costly task, and printing and mailing it to each solicited shareholder further adds to the expense. Thus, unless one was willing to spend a fairly substantial amount of money, one would only want to engage in a solicitation if an exception to the proxy statement filing requirement applied.

Prior to the 1992 amendments, these exceptions were highly limited.[167] The natural effect of these rules was thus to stifle communication and coor-

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161. For another study on shareholder resolutions arriving at similar conclusions, see Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 369 (2007).

162. 17 C.F.R. §§ 240, 249 (1992).

163. Catherine M. Daily et al., *Corporate Governance: Decades of Dialogue and Data*, 28 ACAD. MGMT. REV. 371, 376 (2003).

164. *See supra* Part III.

165. 17 C.F.R. § 240.14a-3 (2009).

166. *See id.* § 240.14a-1(*l*) (defining solicitation to include any communication reasonably calculated to result in the procurement or withholding of a proxy).

167. Daily et al., *supra* note 163, at 376.

dination among shareholders. The solicitations that did occur were part of full-fledged proxy contests, conducted by large shareholders who sought to obtain control over the company.[168]

The 1992 amendments added an additional important exception to the requirement to prepare and file a proxy statement. Under Rule 14a-2(b)(1), most persons who do not either seek the power to act as proxy or furnish a form of proxy need not file a proxy statement.[169] When the solicitation is oral, no filings of any sort are required.[170]

This exception is useful as long as the solicited shareholders can vote on the form of proxy distributed *by the company*. This is possible in solicitations in favor of a shareholder resolution introduced under Rule 14a-8, solicitations in opposition to a management proposal, and solicitations to withhold authority to vote for certain directors.[171]

Rule 14a-2(b)(1) was mostly meant to encourage involvement by institutional investors.[172] However, until recently, it does not appear that institutional investors—or anyone else, for that matter—made much use of the exceptions in the rules. Active campaigns in favor of a shareholder proposal or in opposition to a management proposal, or large-scale efforts to withhold votes in director elections were rare until 2004.[173]

More recently, however, the exceptions in Rule 14a-2(b)(1) have become much more important. As discussed above, institutions now commonly oppose proposed mergers endorsed by the board of directors.[174] They also increasingly engage in campaigns in support of shareholder proposals.[175] Hedge funds can also avail themselves of this exemption to coordinate their activities as long as they stop short of forming a 13(d) "group."[176] Finally, the 2004 campaign to withhold votes from Disney CEO Michael Eisner—a campaign that contributed to Eisner's resignation a year

168. *See* Lucian Ayre Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1075 (1990) (explaining that by 1990 proxy contests were becoming the takeover method of choice for large shareholders).

169. 17 C.F.R. § 240.14a-2(b)(1).

170. *Id.* § 240.14a-6(g)(2).

171. *Id.* § 240.14a-4.

172. *See* John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 840 n.17 (1994) (describing how 14a-2(b)(1)'s safe harbor was designed to encourage broad communication among shareholders, particularly institutional investors).

173. *See* Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1290 (2009) (noting that since 2004 there has been a dramatic increase in majority vote shareholder proposals to be included on corporations' proxy statements). Prior to 2004, Georgeson did not keep track of "other activist events" where dissidents did not distribute a separate proxy card, indicating that such solicitations were rare.

174. *See supra* subpart III(C).

175. *See supra* notes 155–72 and accompanying text.

176. *See* CSX Corp. v. Children's Inv. Fund Mgmt., 562 F. Supp. 2d 511, 552 (S.D.N.Y. 2008) (discussing when hedge funds are deemed to have formed a group for § 13(d) purposes).

later—showed shareholders the power of just voting no.[177] Since 2004, large-scale moves to withhold votes for directors have become increasingly common.[178] Without the 1992 amendment, such campaigns would be much more difficult.

Some of the other governance changes discussed above will create even more opportunities for making use of Rule 14a-2(b)(1). Specifically, the moves to annual elections of the entire board and majority voting[179] mean that the opportunities for, and the incentives to engage in, withhold campaigns increase. With annual elections, the opportunity to withhold a vote for a specific director arises every year, rather than once every three years under staggered boards.[180] And with majority voting, the result of a sufficient withhold vote is that the director is not elected or is required to offer to resign, rather than mere embarrassment under plurality voting.[181] Moreover, the ability of activists to threaten to engage in a withhold campaign is greatly enhanced by the fact that such a campaign would fall under the Rule 14a-2(b)(1) exceptions. This is especially true for activists that are viewed as cost sensitive, such as mutual funds or public pension funds. Thus, whatever the use of the Rule 14a-2(b)(1) is today, we think it is likely that the use will increase significantly in the years ahead.

B. The End of Brokers' Discretionary Voting in Director Elections

Under long-standing practice, brokers may vote shares held in their accounts according to their discretion when they do not receive specific instructions from the beneficial owners of these shares and when the matter is designated as "routine" by the NYSE.[182] These discretionary broker votes have been a reliable and significant source of pro-management votes.[183] Many individual shareholders, who tend to hold their shares in brokerage accounts, do not bother to provide voting instructions, and brokers have

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177. Kara Scannell, *'Broker Votes': Opponents May Win One*, WALL ST. J., June 13, 2007, at C1. The term "just vote no" goes back to Joe Grundfest, who had proposed such a strategy in a 1993 article. Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 927 (1993).

178. *See* Fairfax, *supra* note 173, at 1289 (stating that the 2004 director elections for Disney and Federated Department Stores, Inc. represent the two elections with the most withheld votes "in recent history").

179. *See supra* notes 137–63 and accompanying text.

180. *See* Bebchuk et al., *supra* note 137, at 893 ("In a company with a staggered board, directors are grouped into classes (typically three), with each class elected at successive annual meetings. . . . With three classes, directors in each class would be elected to three-year terms.").

181. *See* Fairfax, *supra* note 173, at 1288–89 (explaining the effectiveness of a withhold-the-vote campaign in both majority and plurality systems).

182. NYSE, Inc., Listed Company Manual § 452 (2003).

183. *See* Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1250 (2008) (explaining how a failure to vote has a unique impact when mediated through a broker).

tended to use their discretion to vote shares in accordance with the board's recommendations.[184]

Historically, the NYSE had regarded uncontested director elections—that is, elections where there is only one slate of nominees—as routine, even when some shareholders waged an active campaign to convince other shareholders to "withhold" their votes from certain nominees. For example, in 2004, 43% of the shares voted to withhold support from Disney's CEO Michael Eisner—a far from routine occurrence.[185] Brokers, however, were permitted to cast the votes of uninstructed shares, and, according to some, if broker votes had been ignored, Eisner would not have received majority support.[186]

The practical import of discretionary broker votes in director elections has recently declined. First, as discussed above, the percentage of shares held by individual investors—the type of investor most likely to hold their shares in brokerage accounts and not to return a ballot[187]—is steadily decreasing.[188] Second, some brokers have moved from voting uninstructed shares in accordance with the board recommendation to voting them in the same proportion as those shares in their accounts for which they received voting instructions.[189] On the other hand, voting is more important than ever. With the rise of withhold-vote campaigns and, as discussed above, majority voting for directors, an increasing number of director elections will likely become truly nonroutine.

Either way, discretionary broker votes in director elections are now gone. In October 2006, the NYSE proposed to amend Rule 452 governing broker votes to redefine all director elections as nonroutine.[190] The proposed change required SEC approval to become effective.[191] After not taking any action for over two years, the SEC last February solicited comments on the

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184. *See* Scannell, *supra* note 177 ("Brokers generally vote for management, partly, they say, because if clients wanted them to oppose management they would let them know.").

185. *Id.*

186. *Id.*

187. *See SEC Hears Testimony on Broker Votes*, Posting of Ted Allen to RiskMetrics Group, http://blog.riskmetrics.com/gov/2007/05/sec-hears-testimony-on-broker-votessubmitted-by-ted-allen-director-of-publications.html (May 24, 2007, 10:58 EST) ("While most institutions now vote their shares or give voting instructions, only 30 to 40 percent of retail investors bother to vote their shares.").

188. *See supra* subpart III(A).

189. *See* Scannell, *supra* note 177 (reporting that Goldman Sachs, Merrill Lynch, and Morgan Stanley voted proportionally in the 2007 season and that Charles Schwab has done so since 2005).

190. *See* PROXY WORKING GROUP TO THE N.Y. STOCK EXCH., REPORT AND RECOMMENDATIONS OF THE PROXY WORKING GROUP TO THE NEW YORK STOCK EXCHANGE 3–4 (2006), http://www.nyse.com/pdfs/PWG_REPORT.pdf ("[T]he election of directors can no longer be considered a 'routine' event in the life of a corporation.").

191. 15 U.S.C. § 78s(b)(1) (2006) ("No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.").

proposed changes.[192] On July 1, 2009, the SEC finally approved the amendments, effectively ending discretionary broker voting in director elections for all shareholder meetings held on or after January 1, 2010.[193]

An end of discretionary broker voting will obviously make it easier for withhold campaigns to succeed. On nonroutine shareholder proposals, it is estimated that broker nonvotes amount on average to 19% of the votes cast at an annual meeting.[194] With discretionary broker voting, a board could until recently count on brokers voting most of these shares in favor of its nominees. That would imply that, to get a majority-withhold vote, activists would have had to get over 60% of the instructed shares—a pretty steep task.[195] Without broker nonvotes, this task is much easier.

C. Notice and Access

In 2007, the SEC enacted new rules governing the electronic delivery of proxy materials.[196] Under the new rules, instead of furnishing the whole set of proxy materials, companies may mail shareholders a short notice providing some basic information about the issues to be voted on at the annual meeting and refer them to a website where the proxy statement and other solicitation materials are available.[197] The "notice and access" option is meant to reduce the cost of printing and mailing solicitation materials.[198] Importantly, the notice and access option is also made available to shareholders engaged in a solicitation opposed by the company.[199]

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192. Notice of Proposed Rule Change to Amend NYSE Rule 452 and Eliminate Broker Discretionary Voting for the Election of Directors, Exchange Act Release No. 59,464, 95 SEC Docket 744 (Feb. 26, 2009).

193. *See* Melissa Aguilar, *SEC Approves NYSE Broker Vote Ban in Director Elections*, COMPLIANCE WK., July 1, 2009, http://complianceweek.com/blog/aguilar/2009/07/01/sec-approves-nyse-broker-vote-ban-in-director-elections/ (reporting the SEC's approval of the proposed rule, its effective date, and its likely effects).

194. *See SEC Hears Testimony on Broker Votes*, *supra* note 187 (attributing this figure to Broadridge Financial).

195. The exact percentage of instructed shares is a function of both the percentage of broker no votes and the overall percentage voting. With a broker no-vote percentage of 19% and 100% voting, activists need to get 62% of the instructed shares to get a majority. With a broker no-vote percentage of 19% and 80% voting, activists need to get 66% of the instructed shares to get a majority.

196. For background and a similar point regarding notice and access as compared with issuer proxy access, see Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 487 (2008).

197. *See* 17 C.F.R. § 240.14a-16 (2009) (dictating the requirements for making proxy statements available on the Internet). Moreover, as of 2008, large accelerated filers and, as of 2009, everyone else, are required to post materials on a Web site.

198. Internet Availability of Proxy Materials, Exchange Act Release No. 52,926, 86 SEC Docket 2145 (Dec. 8, 2005).

199. *See* Fairfax, *supra* note 173, at 1285–86 (observing that e-proxy rules give individual shareholders more control since shareholders are able to "control both the content of the proxy statement and the solicitation process").

The notice and access option is especially important when shareholders cannot rely on the Rule 14a-2(b)(1) exemption discussed above. Under that exemption, shareholders can already engage in an effective proxy campaign without furnishing a proxy statement in support of a shareholder proposal, in opposition to a board proposal, or to withhold votes for board nominees to the board of directors.[200]

Rule 14a-2(b), however, has limitations. Most importantly, the exemption does not cover contests to elect a dissident slate to the board of directors.[201] Right now, such contests tend to be full-blown campaigns—such as Trian's 2006 campaign to elect some of its nominees to the board of Heinz[202]—often conducted by a hedge fund or in the context of a takeover bid. For full-fledged campaigns, the printing and mailing savings from notice and access is likely immaterial.[203] Thus, we do not expect that notice and access will lead to a significant increase in the number of such contests.

Rather, the most important impact of the notice and access rule may be to spur a new type of lower key, lower cost contest, probably for a "short slate" minority representation on the board. The campaigns in these lower key election contests are likely to resemble the campaigns currently waged in support of shareholder resolutions, in opposition to board proposals, or to withhold votes in favor of directors, which are now conducted in reliance on the Rule 14a-2(b)(1) exemption.[204] Unlike full-fledged campaigns, these campaigns are often run by cost-conscious traditional institutional investors.[205] The existence of such campaigns shows that there is some de-

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200. *See supra* notes 169–80 and accompanying text.

201. *See* 17 C.F.R. § 240.14a-2(b)(1) (stating that the exemption does not apply to nominees for the board of directors and persons acting on their behalf). Moreover, it is practically impossible to get a dissident elected without distributing one's own proxy cards. *See* Stephen Taub, *Dissidents Win Proxy Fight, Without Proxy*, COMPLIANCE WK., Apr. 10, 2007, http://www.complianceweek.com/article/3253?printable=1 (noting how rare it is for dissidents to win proxy fights without proxy materials, especially at large companies). Other campaigns that cannot be effectively conducted under Rule 14a-2(b) relate to campaigns by shareholders who must file a Schedule 13D (mostly 5% shareholders with an activist agenda), campaigns in favor of shareholder resolutions that the company excluded from its proxy statement under Rule 14a-8, or campaigns where for strategic reasons the proponents want to distribute their own proxy forms. 17 C.F.R. §§ 240.14a-2(b)(1), 240.14a-8. Note that campaigns related to mergers, which are not covered by the 14a-2(b) exemption are also not subject to the notice and access rule. *Id.* § 240.14a-16(m).

202. *See* Andrew R. Sorkin, *Enough Anger to Make Ketchup Boil: Raider in a Bruising Fight with Heinz*, N.Y. TIMES, July 27, 2006, at C1 (describing Trian's strategy in its fight for control of Heinz's board and noting that Heinz's shares had risen 20% since Trian publicly announced its campaign).

203. Trian estimated that its total expenses in conducting the proxy contest would be $7 million. THE TRIAN GROUP, PROXY STATEMENT 27 (2006). In our estimate, the printing and mailing costs of the proxy statement do not amount to a significant portion of these expenses.

204. *See* GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 48 (2007), http://www.georgesonshareholder.com/emea/research/4a)%20US%20Corp%20Gov%202007.pdf [hereinafter 2007 ANNUAL CORPORATE GOVERNANCE REVIEW] (listing thirteen other activist campaigns).

205. *See "Just Vote No" Campaigns in Uncontested Director Elections—Renewed Vitality for the 2010 Proxy Season*, Client Memorandum from Wilkie, Farr, and Gallagher 1 (Sept. 24, 2009)

mand by investors for activism that goes beyond making (or voting for) a mere shareholder proposal under Rule 14a-8 but does not go as far as a full-fledged contest. For similar campaigns to elect directors, the costs savings resulting from not having to print and mail proxy statements may well be significant.[206] Notice and access opens up a wider range of issues to these intermediate-intensity campaigns.

D. The Roller-Coaster Ride of Proxy Access

Proxy access refers to a requirement that a company include director candidates nominated by shareholders in the company's proxy statement.[207] In 2003, the SEC approved a complex proposal for rules on proxy access and solicited comments on the proposal.[208] This proposal followed earlier considerations of the issue—in 1942 and 1977—which did not result in regulatory action.[209]

Under the 2003 proposal, proxy access was subject to a number of limitations. Any shareholder proxy access was conditioned on the prior occurrence of a "triggering event"—specifically a 35% or more "withhold" vote for a director or a majority vote electing to subject the company to proxy access.[210] Such proxy access would be limited to two years after such a trigger had occurred.[211] And during these two years, only shareholders who held at least 5% of a company's stock continuously for two years could obtain proxy access and could nominate only a minority slate.[212]

The 2003 proposal was initially supported by three of the five commissioners: the Republican Chairman Donaldson and the two Democratic commissioners.[213] But the proposal elicited strong negative reactions from managerial interests, including the Business Roundtable (an association of CEOs of leading U.S. companies) and the Chamber of

(on file with authors) (hypothesizing that the low-cost "just vote no" campaigns are likely to be widely used by institutional investors, possibly even as an alternative to "short slate" proxy contests).

206. *See* Corporate Governance: A Seismic Shift in the Mechanics of Electing Directors, Client Memorandum from David A. Katz & Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz n.20 (July 27, 2006) (noting that, in the authors' experience, mailing costs are a substantial part of the dissidents' cost in a proxy fight).

207. DIV. OF CORP. FIN., SEC, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 1–2 (2003).

208. *Id.* at 1, 5.

209. *Id.* at 2–3, 5.

210. Security Holder Director Nominations, 68 Fed. Reg. 60,790 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

211. *Id.* at 60,794.

212. *Id.*

213. *See* Jonathan Peterson, *SEC Offers Conflicting Shareholder Proposals*, L.A. TIMES, July 26, 2007, at 3 (stating that Chairman Donaldson and the SEC's Democratic commissioners supported the SEC's 2003 proposal).

Commerce,[214] and Donaldson's support waned.[215] When Donaldson resigned as chairman in 2005,[216] the practical effect was that the proposal, which had been lingering in limbo for some time, was considered dead.[217]

A hard battle had been fought between proponents and opponents of greater shareholder rights, and the Business Roundtable had won—or so it seemed. Curiously, however, majority voting for directors—which started spreading at about the time of Donaldson's resignation and is now in place in most large companies[218]—gives shareholders many of the same powers and in a more useful form.[219] Most importantly, majority voting (like proxy access) gives shareholders the power to "diselect" a director from the board without having to file a proxy statement with the SEC.[220] Furthermore, while the proxy-access proposal was subject to limitations, majority voting is not so constrained.

To be sure, majority voting differs from proxy access in that shareholders cannot pick the director to replace the one they diselect. But this may be a net advantage. First and foremost, shareholders will have a much easier time agreeing on diselecting a director than agreeing both on

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214. *See* Bill Baue, *Opening Up Pandora's Box: SEC Proxy Roundtable Questions Role of Non-binding Resolutions*, SOCIALFUNDS, May 15, 2007, http://www.socialfunds.com/news/article.cgi/2293.html ("The SEC allowed the rule it proposed in October 2003, allowing shareowners proxy access to nominate directors in certain circumstance, to die on the vine due to opposition by the Business Roundtable and the US Chamber of Commerce, which threatened a lawsuit.").

215. *See* Stephen Labaton, *S.E.C. Rebuffs Investors on Board Votes*, N.Y. TIMES, Feb. 8, 2005, at C2 (explaining that Donaldson "no longer supported the proposal put forward by the commission in 2003").

216. Stephen Labaton, *Donaldson Announces Resignation as S.E.C. Chairman*, N.Y. TIMES, June 1, 2005, *available at* http://www.nytimes.com/2005/06/01/business/01wiresec.html?ex=1275278400&en=d89d9d8be5440394&ei=5090&partner=rssuserland&emc=rs.

217. *Id.*

218. *See supra* notes 148–63 and accompanying text.

219. For a similar opinion, see Rachel McTague, *Grundfest: Proxy Access Unnecessary in View of Issuers' Shift to Majority Voting*, CORP. L. DAILY, Nov. 19, 2007, http://corplawcenter.bna.com/ pic2/clb.nsf/id/BNAP-78ZV9X?OpenDocument.

220. *See* Louis M. Thompson, Jr., *Shareholder Democracy to March On in '07*, COMPLIANCE WK., Nov. 21, 2006, http://www.complianceweek.com/article/2935/shareholder-democracy-to-march-on-in-07 (comparing the power to remove directors under the "majority-voting concept" with proxy access for director nominations). With the change in NYSE rules eliminating discretionary broker votes in director elections, another distinction between proxy access and majority voting will be eliminated. With proxy access, a vote of directors where shareholders nominated a competing slate would not have been viewed as routine, and brokers would not have discretionary voting power. *See* David A. Cifrino et al., *SEC Eliminates Broker Discretionary Voting in Director Elections, Proposes Changes to Disclosure & Other Requirements Regarding Corporate Governance & Compensation*, MCDERMOTT NEWLS., July 6, 2009, http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/a89585fc-a483-4fed-9358-7cccf7b00616.cfm (explaining that, in the current system, "elections are already considered 'non-routine' matters on which discretionary voting is not allowed"). With the new NYSE rules, brokers do not have discretionary voting power in regular elections either. *See id.* (explaining that the change "eliminates 'discretionary voting' for all director elections").

rejecting the board's nominee *and* on replacing her with a specific person. As a result, majority voting gives shareholders a much more useful tool than proxy access. Moreover, it is often the ability to remove an offensive director (and the ability to threaten such a removal), rather than the ability to pick a replacement, that shareholders are really after. This is all the more so because any shareholder nominees would have to have broad appeal to maximize their chances of getting elected and would thus likely be drawn from the same pool of candidates as regular directors.

And even if what shareholders really want is to elect someone of their choice to the board, they have won half the battle. The proxy-access proposal would have spared shareholders who wanted to conduct a proxy contest the costs of preparing, printing, and mailing a proxy statement. Notice and access similarly saves shareholders printing and mailing costs (albeit not preparation costs) and does so without any of the limitations that were part of the proxy-access proposal.

In any case, there is an aftermath. Like the Sorcerer's Apprentice, the SEC could not control the forces it set in motion. In 2005, the American Federation of State, County and Municipal Employees (AFSCME) submitted its own homemade proposal for proxy access under Rule 14a-8 to American International Group (AIG).[221] The SEC's Division of Corporate Finance issued a no-action letter permitting AIG to omit the proposal under Rule 14a-8(i)(8).[222] In a stinging opinion issued in September 2006, the Court of Appeals for the Second Circuit rejected the SEC's reasoning as inconsistent with the SEC's own prior interpretations of its rules and held that the proposal could not be excluded.[223] The SEC immediately announced that it would consider amending Rule 14a-8.[224] After several delays,[225] in July 2007, the SEC finally approved two alternative proposals for public comments, each by a 3–2 vote with the new chairman Cox once siding with the two other Republican commissioners and once with the two Democrats.[226] The first proposal would have put on a firmer regulatory

221. AFSCME v. AIG, 462 F.3d 121, 123–24 (2d Cir. 2006).

222. *Id.* at 124.

223. *See id.* at 129 (upbraiding the SEC for failing to acknowledge its changed position regarding the excludability of proxy-access bylaw proposals and for failing to offer a reasoned basis for the change).

224. Press Release, SEC, Commission Calendars Proposed Amendment to Rule 14a-8 Governing Director Nominations by Shareholders (Sept. 7, 2006), *available at* http://www.sec.gov/news/press/2006/2006-150.htm) (last modified Sept. 7, 2006.

225. Since October 2006, the SEC has delayed scheduled consideration of proxy access at least twice. *See Atkins Says SEC Roundtable Likely on Proxy Access Issue; Time Not Yet Set*, 39 Sec. Reg. & L. Rep. (BNA) No. 11, at 379 (Mar. 12, 2007). In the meantime, there has been no groundswell of shareholder proposals resembling AFSCME's in the 2007 season—a fact quite consistent with our view that majority voting (and, to a lesser extent, notice and access) has made the fate of the proxy-access rule largely irrelevant.

226. Stephen Labaton, *A Public Airing for Proposals on Shareholders*, N.Y. TIMES, July 26, 2007, at C3.

footing the SEC's position rejected by the Second Circuit that shareholder proposals on proxy access can be excluded under Rule 14a-8(i)(8); the second resembled the 2003 proposal for proxy access.[227] In November 2007, the SEC adopted the first proposal by a party-line 3–1 vote.[228]

But with the 2008 election of President Obama, tables—and the party makeup of the SEC—turned again. Now with a majority of Democrats, the SEC on June 10, 2009, voted 3–2 (again along party lines) to approve for public comment another proxy-access proposal (with somewhat fewer limitations than the 2003 proposal) and for good measure a proposal to reverse the November 2007 amendments to Rule 14a-8(i)(8).[229] Because of the number of comments it received, the SEC has indicated that it will not act until spring of 2010.[230]

VI. Changes in the Board of Directors

Up to now, our analysis has focused on developments related to CEOs losing power to shareholders. In this Part, we discuss several developments related to CEOs losing power to corporate boards. Specifically, we will examine the 2003 amendments to the NYSE and NASDAQ listing standards, changes in nominal director independence, and changes in substantive director independence.

A. Listing Standards

In 2003, in the wake of the Enron scandal and the Sarbanes–Oxley Act of 2002, the NYSE and the NASDAQ Stock Market adopted new governance rules for listed companies.[231] Both sets of rules now require

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227. *See* Nicholas Rummell, *SEC Splits Proxy Access Votes as Cox Says 'Yea' to Two Proposals*, FIN. WK., July 25, 2007, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070725/REG/70725013/1036 (describing how the first proposal would allow shareholders to put forth proxy proposals calling for bylaw changes to allow shareholder-approved directors during corporate elections and how the second would restate the SEC's position prior to the Second Circuit's invalidation).

228. *The SEC Denies Proxy Access*, Posting of L. Reed Walton to RiskMetrics Group, http://blog.riskmetrics.com/gov/2007/11/the-sec-denies-proxy-accesssubmitted-by-l-reed-walton-publications.html (Nov. 30, 2007, 10:33 EST).

229. Georgeson Inc. & Latham & Watkins LLP, *Proxy Access Proposed Rules Published by SEC*, CORP. GOVERNANCE COMMENT., June 15, 2009, http://www.georgeson.com/usa/download/corp_gov_commentary.html.

230. Mary Schapiro, Chairman, SEC, Address to the Practising Law Institute's 41st Annual Institute on Securities Regulation (Nov. 4, 2009) (on file at http://sec.gov/news/speech/2009/spch110409mls.htm).

231. Goodwin Procter, *SEC Approves Final NYSE and Nasdaq Corporate Governance Standards*, PUB. CO. ADVISORY, Nov. 11, 2003, at 1, http://www.goodwinprocter.com/~/media/Files/Publications/Newsletters/Public Company Advisory/2003/SEC_Approves_Final_NYSE_and_Nasdaq_Corporate_Governance_Standards.ashx.

boards of most companies[232] to consist of a majority of "independent" directors (albeit with somewhat varying definitions of "independence"[233]), to establish an audit committee consisting entirely of independent directors,[234] and to conduct regular separate meetings ("executive sessions") of the independent directors.[235] The NYSE rules further require that each board have nominating/corporate-governance and compensation committees consisting entirely of independent directors.[236] The NASDAQ rules do not require boards to establish such committees, but if a company does establish a nominating or a compensation committee, it must consist entirely of independent directors.[237] Both sets of rules became effective in January 2004 for some companies, and later for others.[238] And the Sarbanes–Oxley Act itself requires that each listed company have an audit committee consisting entirely of independent directors.[239]

B. *Nominal Board Independence*

As Jeff Gordon has recently shown, the nominal independence of board members has increased dramatically since the 1950s.[240] Gordon estimates that the percentage of inside directors has steadily decreased from 50% in 1950 to around 10% in 2005 and that the percentage of independent directors has correspondingly increased from around 20% to around 80%.[241]

What is less clear, however, is whether there has been a significant change in board makeup over the last ten years and, if so, whether any change is attributable to the changed listing requirements. Korn/Ferry, which conducts annual reviews of proxy statements of Fortune 1000 companies, reports that the average number of insiders on boards remained steady at two between 1997 and 2007, while the average number of outsiders has declined

232. Boards of certain controlled companies are exempt. NYSE, Inc., Listed Company Manual § 303A.0 (2003) ("A listed company of which more than 50% of the voting power is held by an individual, a group or another company need not comply.").

233. NASDAQ, Inc., Rule 5605(b)(1); NYSE, Inc., Listed Company Manual § 303A.01–.02.

234. NASDAQ, Inc., Rule 5605(c)(2)(A); NYSE, Inc., Listed Company Manual § 303A.07(b).

235. NASDAQ, Inc., Rule 5605(b)(2); NYSE, Inc., Listed Company Manual § 303A.03.

236. NYSE, Inc., Listed Company Manual § 303A.04–.05.

237. NASDAQ, Inc., Rule 5605(d)–(e). The NASDAQ rules do not address the composition of any separate corporate-governance committee.

238. Goodwin Procter, *SEC Expected to Approve Final Nasdaq Corporate Governance Standards*, PUB. CO. ADVISORY, Oct. 21, 2003, http://www.goodwinprocter.com/~/media/Files/Publications/Newsletters/Public Company Advisory/2003/SEC_Expected_to_Approve_Final_Nasdaq_Corporate_Governance_Standards.ashx.

239. 15 U.S.C. § 78j-1 (2006).

240. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1468 (2007).

241. *See id.* at 1473–75 (presenting a methodology and graphical data demonstrating the trend from insider to independent directors).

from nine to eight.[242] Another source of data is the Investor Responsibility Research Center (IRRC) (now part of RiskMetrics), which categorizes each director as an employee of the company, a linked director (a former employee, family member of an employee, or a director who provides, or whose employer provides, services to the company, or is a significant customer), or an independent director.[243] We collected information of these categorizations for the years 2000 and 2007 for companies in the S&P 500 Index, for the Midcap (S&P 400) Index, and for the SmallCap (S&P 600) Index. The IRRC data shows a decline of average total board size for S&P 500 companies (but not for companies in the other indices), as well as a decline in the number of employee directors from about 2.1 to 1.5. Depending on the index, the average percentage of employee directors declined from 18% to 24% in 2000 to 14% and 18% in 2007. Linked directors experience a steeper decline, from around 1.3 to 1.6 in 2000 to 0.6 in 2007, while the number of directors categorized as independent increased. For all companies combined, the percentage of linked directors declined from 14.5% to 6.4% over this seven-year period.

Table 5: Nominal Director Independence

	Employee	Independent	Linked	Total
	2007	2007	2007	2007
SP 500	1.5	8.5	0.6	10.6
SP 400	1.5	7.2	0.6	9.3
SP 600	1.5	6.2	0.6	8.3
	2000	2000	2000	2000
SP 500	2.1	7.9	1.6	11.5
SP 400	2.0	5.9	1.4	9.3
SP 600	2.0	5.0	1.3	8.4

Compared to the longer period investigated by Gordon, it thus appears that the move away from employee directors largely preceded 2000. However, post-2000, there was a significant drop in linked directors.

There appears to have been no change in the makeup of the key committees. According to Korn/Ferry data, in each year between 1997 and 2006, neither audit, nor compensation, nor nominating, nor corporate-governance committees have had (on average) *any* insider directors (the average number of outside directors on each committee varied between three

242. KORN/FERRY INT'L, 32ND ANNUAL BOARD OF DIRECTORS STUDY 36 (2007) [hereinafter 32ND ANNUAL BOARD OF DIRECTORS STUDY], *available at* http://www.kornferry.com/Library/ViewGallery.asp?CID=1573&LanguageID=1&RegionID=23.

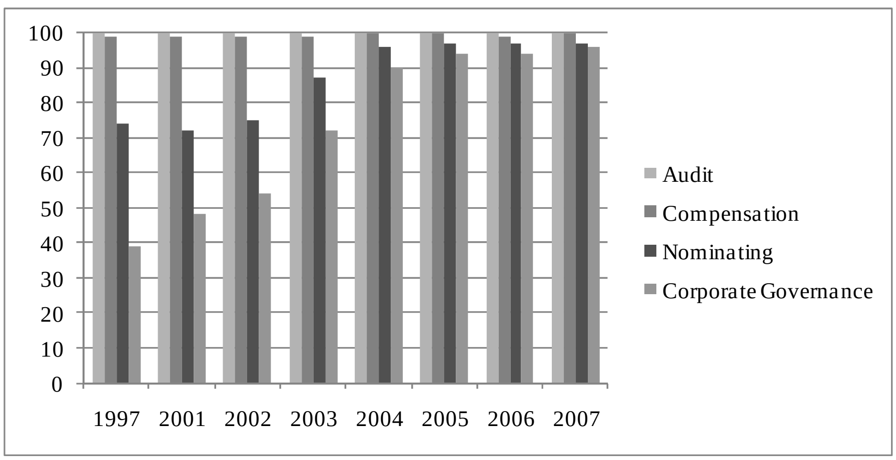
243. IRRC Legacy Directors Database, Overview of IRRC Directors in WRDS, http://wrds-web.wharton.upenn.edu/wrds/support/Data/_001Manuals%20and%20Overviews/_115RiskMetrics/Overview%20of%20IRRC%20Legacy%20Directors%20Database%20on%20WRDS.cfm.

and four).[244] Moreover, according to IRRC data, even in 2000, 60% of directors in S&P 600 companies, 64% of directors in S&P 400 companies, and 69% of directors in S&P 500 companies were independent.[245] Thus, it is likely that most companies fulfilled the requirements of the new 2004 listing standards for committee and board composition several years prior to their adoption.

C. Substantive Board Independence I: What Do Boards Do?

More important than nominal board independence, however, is whether boards are substantively independent: whether directors act as independent decision makers, rather than as yes-men for the CEO. One way to get a handle on whether boards have become more substantively independent of the CEO is to examine what boards spend their time on. Specifically, boards that spend relatively more time monitoring the CEO are likely to be more substantively independent, and the CEOs of companies with such boards are likely to be less powerful.

Figure 2: Percentage of Companies with Board Committees: Audit, Compensation, Nominating, and Corporate Governance



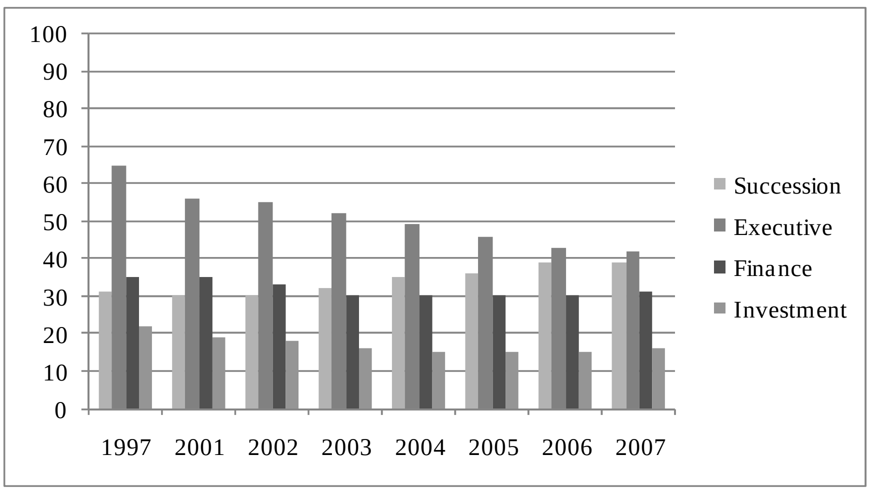
There are several useful metrics for determining what boards spend their time on. One important measure is whether a board has established a committee devoted to certain tasks and how frequently that committee meets. Virtually all larger companies have had audit and compensation committees

244. KORN/FERRY INT'L, 33RD ANNUAL BOARD OF DIRECTORS STUDY 13 tbl.D (2006) [hereinafter 33RD ANNUAL BOARD OF DIRECTORS STUDY], *available at* http://www.kornferry.com/Publication/3322.

245. IRRC Legacy Directors Database, *supra* note 243.

for a significant period of time.[246] But the number of companies with nominating and corporate-governance committees has increased significantly. According to Korn/Ferry, the percentage of companies with nominating committees hovered in the low- to mid-seventies until 2002, increased to 87% in 2003, and further increased to over 95% from 2004 on.[247] The percentage of companies with corporate-governance committees (which are not regulated by NASDAQ standards) gradually increased from 39% in 1997 to 48% in 2001, and then increased at a more rapid rate to 96% in 2007.[248] The changed NYSE and NASDAQ listing requirements presumably account for at least a portion of this increase. Many companies, however, had added these committees before they were required to do so.[249] The trend in corporate-governance committees, not required by Sarbanes–Oxley or NASDAQ listing standards, showing an increase even in the pre-Sarbanes–Oxley period, suggests that a significant portion of the increase may be unrelated to the changed standards.

Figure 3: Percentage of Companies with Board Committees: Succession, Executive, Finance, and Investment



246. Of companies participating in the Korn/Ferry survey, 100% had audit and 99% had compensation committees by 1995. 33RD ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 244, at 12 tbl.C.

247. *Id.*

248. KORN/FERRY INT'L, 34TH ANNUAL BOARD OF DIRECTORS STUDY 18 tbl.C (2007) [hereinafter 34TH ANNUAL BOARD OF DIRECTORS STUDY], *available at* http://www.kornferryinstitute.com/leadership/board_of_directors/publication/1225/34th_Annual_Board_of_Directors_Study.

249. *See* James S. Linck et al., *The Effects and Unintended Consequences of the Sarbanes–Oxley Act on the Supply and Demand for Directors*, 22 REV. FIN. STUD. 3287, 3288 (2009), *available at* http://rfs.oxfordjournals.org/cgi/reprint/22/8/3287.pdf ("[C]hanges in boards and directors have been occurring for some time."); *see also id.* at 3292 (enumerating the recently mandated "major governance provisions").

Another interesting trend can be observed by looking at some other committees. The three committees included in the Korn/Ferry data that relate to "management"—the executive committee, the finance committee, and the investment committee—experienced a steady decline.[250] By contrast, the one committee charged with monitoring functions that is not affected by the changed listing standards—the succession committee—experienced a steady (if slow) increase from 31% in 1995 to 39% in 2007.[251]

A further indicator of whether these committees serve as window dressing or whether they perform important functions is the number of times they meet. As Table 6 indicates, the number of meetings of committees with monitoring functions—the audit, compensation, nominating, corporate-governance, and succession committees—has generally increased.[252] With the exception of the audit committees, this increase does not seem to be due to an increased burden placed on these committees by the Sarbanes–Oxley Act. Rather, the number of meetings increased at approximately the same rate in the pre-Sarbanes–Oxley period (1997–2001) as in the post-Sarbanes–Oxley period (2002–2006). By contrast, the number of meetings of the committees with management functions—executive, finance, and investment—has largely remained steady.[253]

Table 6: Committee Meetings per Year

	1997	2001	2007
Audit	3	4	9
Compensation	4	5	6
Nominating	2	3	4
Corporate Governance	3	3	4
Succession	5	5	6
Executive	4	4	4
Finance	5	4	5
Investment	4	4	5

250. 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 18 tbl.C.

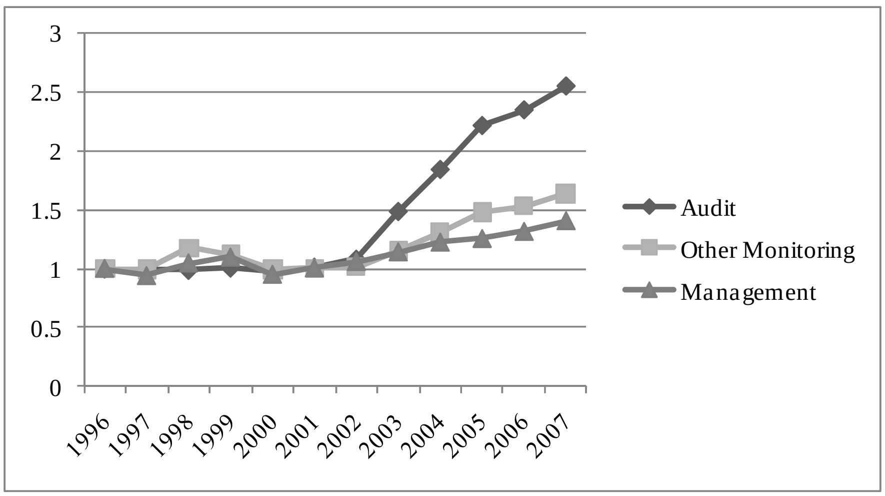
251. The only other committees included in the Korn/Ferry data but not included in Figure 2 or 3 are the "Corporate Responsibility" committee, which experienced a slight decline, and the "Director Compensation" committee, which experienced a major increase. *Id.*

252. KORN/FERRY INT'L, 30TH ANNUAL BOARD OF DIRECTORS STUDY 13 tbl.F (2003) [hereinafter 30TH ANNUAL BOARD OF DIRECTORS STUDY], *available at* http://www.kornferryinstitute.com/about_us/thought_leadership_library/publication/1492/30th_Annual_Board_of_Directors_Study; 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 19 tbl.E.

253. 30TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 252, at 13 tbl.F; 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 19 tbl.E.

We also examined the compensation received by board members for serving on various committees. As a measure of compensation, we used the retainer received by the committee chair because cash compensation levels for that measure were available for each committee in most years.[254] Between 1996 and 2001, compensation for committee service adjusted for inflation barely budged. Average compensation (adjusted for inflation) changed by less than 1% per year for all committees combined, all committees but the audit committee, the four other monitoring committees, and the three management committees.[255] But between 2001 and 2007, the picture is starkly different. Compensation for the chair of the audit committee increased on average by 17% a year over the six years, and by 11% a year since 2004.[256] Compensation for the four other monitoring committees also increased by an average total of 64% over the six-year period. In contrast, compensation for the three management committees increased by only 40%.[257]

Figure 4: Committee Compensation Trends[258]



254. Because information for 2001 was not available for some committees, we interpolated the figures for 2000 and 2002.

255. 30TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 252, at 15 tbl.1; 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 21 tbl.H.

256. 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 21 tbl.H.

257. *Id.* at tbls.H–I. Another fact of perhaps symbolic significance: between 1996 and 2002, the highest average retainer (usually by a large margin) was paid to the chair of the executive committee, traditionally the CEO. By 2005, the average retainer of the chair of the executive committee was less than the retainer for the chair of each of the five committees with monitoring tasks. *Id.* at tbl.I.

258. The figure is based on cash retainer for committee chair. All amounts are adjusted for inflation. Other monitoring committees are compensation, nominating, corporate governance, and succession. Management committees are executive, finance, and investment.

These changes indicate a shift in what the board is doing. Rather than help the corporate insider with managing the business of the corporation, boards are now increasingly engaged in monitoring management and planning for management changes.

Some other data in the Korn/Ferry survey provide additional evidence that outside directors work harder. Survey responses indicate that between 1997 and 2007 the number of hours worked per month increased from thirteen to sixteen.[259] In 2004 and 2005, when Korn/Ferry instead asked whether the board had more meetings than in the prior year, 29% and 34%, respectively, responded yes.[260]

D. Substantive Board Independence II: Changed Board Dynamics

Over the last few years, boardroom dynamics have changed, with outside directors emerging as a power center independent of CEOs. Until recently, outside directors never met without the CEO present and received most of their information from management. This insider control of the information flow, both to and among outside directors, has diminished. Nowadays, it is not unusual for directors to meet with significant shareholders and even with employees.[261] In some instances, they even hire outside consultants to review business plans presented by management.[262] In addition, since 2004, outside directors are required by stock-exchange rules to meet in "executive sessions" outside the presence of the CEO.[263] According to reports, "directors who fear a company is heading off course can use executive session meetings to reinforce each others' concerns and settle on a plan of action"—including, on occasion, a plan to fire the CEO.[264]

Responses in the Korn/Ferry survey confirm this change in board dynamics. The percentage of boards with a formal process for evaluating CEOs increased from the high sixties in 1997 and 2001 to around 92% in 2007.[265] The percentage of boards with a lead outside director (if the CEO is

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259. *See* 30TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 252, at 24; 32ND ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 242, at 53; 33RD ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 244, at 23; 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 34.

260. 32ND ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 242, at 53.

261. Kaja Whitehouse, *Move Over CEO: Here Come the Directors*, WALL ST. J., Oct. 9, 2006, at R1; *see also* Lipton, *supra* note 130, at 7 (discussing increased demand by public pension funds and other activists to meet with independent directors).

262. Whitehouse, *supra* note 261.

263. NASDAQ, Inc., Rule 5605(b)(2); NYSE, Inc., Listed Company Manual § 303A.03 (2003).

264. George Anders, *Private Time*, WALL ST. J., Oct. 9, 2006, at R4.

265. 30TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 252, at 22; 32ND ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 242, at 22, 63; 33RD ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 244, at 9; 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 12 chart D.

also the chairman) increased from around 30% in 2002 to 84% in 2007.[266] And according to an annual survey conducted by the Business Roundtable, 90% of companies had an independent chairman, lead director, or presiding director in 2007 (up from 83% in 2005 and 71% in 2004).[267]

The latter increase could be attributable to the requirement that independent directors meet in executive sessions.[268] Though there is no requirement for a lead director, a board may find it useful to appoint a lead director to run these meetings. But we think more is going on. For one, the percentage of respondents who said that companies *should have* a lead outside director increased from 55% in 2001 to 84% in 2006.[269] Second, the percentage of companies with a lead director *out of those that conduct executive sessions* increased from 34% in 1997 to 78% in 2001 to 85% in 2007. This indicates that the increase in lead directors is not merely a pragmatic adjustment to the requirement to hold executive sessions but also reflects a change in the board attitude that a greater dispersion of power—away from the CEO and towards the independent directors—is desirable.

Finally, the long-standard U.S. practice of having the CEO also serve as Chairman of the Board seems to be eroding.[270] According to the Business Roundtable Survey, the percentage of companies that had split the CEO and Chairman positions increased from 4% in 2004 to 13% in 2007.[271] And our own review of S&P 100 companies indicates that the percentage of companies with split positions increased from 18% in 2003 to 26% in 2006.

Perhaps the most telling indicator that boardroom dynamics have changed is the annual list of "Key Issues for Directors" prepared by Martin Lipton. In 2007, the number one item on the list was "Anticipating attacks by activist hedge funds."[272] For 2008, attacks by activist hedge funds had dropped to number seven (of nine) and a new entry headed the list: "Maintaining collegiality and the culture of common enterprise with the CEO and senior management."[273]

E. Substantive Board Independence III: CEO Turnover

As another indicator of the greater substantive independence of the board of directors, CEO tenure is declining. According to a 2007 report pre-

266. 32ND ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 242, at 54; 34TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 248, at 7.

267. BUS. ROUNDTABLE, BUSINESS ROUNDTABLE CORPORATE GOVERNANCE SURVEY KEY FINDINGS (2007).

268. *See supra* note 235 and accompanying text.

269. 30TH ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 252, at 20; 33RD ANNUAL BOARD OF DIRECTORS STUDY, *supra* note 244, at 24.

270. Lipton, *supra* note 130, at 17.

271. BUS. ROUNDTABLE, *supra* note 267.

272. Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, to Clients 1 (Dec. 6, 2006) (on file with Texas Law Review).

273. Memorandum from Martin Lipton, *supra* note 76, at 1.

pared by Booz Allen Hamilton, directors are "becoming more critical . . . and are far more likely to insist that CEOs deliver acceptable shareholder returns."[274] Importantly, Booz Allen finds that boards are increasingly prepared to replace CEOs *in anticipation of disappointing future performance*, rather than in response to poor past performance.[275] For 2006, total turnover (which includes turnover due to retirement, dismissal, and acquisition) was 14.3%.[276] Among the other specific findings, Booz Allen reports that, between 1995 and 2006, annual turnover of CEOs had increased by 59% and performance-related turnover by 318%.[277] Correspondingly, the fraction of CEOs who were forced from office increased from one out of eight to nearly one out of three.[278]

A study by Steve Kaplan and Bernadette Minton arrives at similar conclusions.[279] Kaplan and Minton find a total turnover rate, including both external (takeover related) and internal (nontakeover related) turnover, of 17.4% and an internal turnover rate of 12.6% for 1998–2005, which corresponds to an average CEO tenure period of as low as six years.[280] This tenure, the authors say, is substantially shorter than the ones reported in previous work for the 1970s, 1980s, and 1990s.[281] They conclude that boards respond more broadly to poor performance than they have in the past and monitor more frequently and aggressively.[282]

In our analysis of S&P 100 companies, we found that of the ninety-six companies that had not been acquired between March 2006 and March 2008, nineteen had a turnover in CEOs. This corresponds to a somewhat higher internal takeover rate than reported in the study above.[283] Of these nineteen changes, one can be classified as a promotion (Goldman Sachs's CEO became Secretary of the Treasury), and nine (based on press reports) as

274. Chuck Lucier et al., *The Era of the Inclusive Leader*, STRATEGY + BUS., Summer 2007, at 2.

275. *Id.*

276. *Id.* at 3.

277. *Id.*

278. *Id.*

279. Steven N. Kaplan & Bernadette A. Minton, How Has CEO Turnover Changed? 1 (Aug. 2008) (unpublished manuscript, on file at http://faculty.chicagobooth.edu/steven.kaplan/research/km.pdf).

280. *Id.* at 2.

281. *Id.* at 4.

282. *See id.* at 4 (explaining boards' broader and more immediate responses to poor market performance as well as poor industry performance).

283. Kaplan & Minton, *supra* note 279, at 1. Our analysis results in a 19.8% internal takeover rate for this period, as opposed to the 12.6% rate found from 1998–2005. Our study's rate covers two years, meaning that the rate per year is about half—less than Kaplan and Minton's reported annualized rate.

involuntary.[284] The remainder were claimed to be retirements. Using the academic convention of treating a "retirement" of a CEO who is sixty or older as voluntary and a "retirement" of a CEO under sixty as forced (unless the reported reason is health), a total of twelve changes can be classified as involuntary. Thus, our sample yields a somewhat higher estimate for involuntary turnover, both absolutely and as a fraction of total turnover, than the Booz Allen study.[285]

Increased CEO turnover is not only a symptom of increased substantive independence.[286] It is also a cause for further independence. As CEO turnover increases, the tenure of outside directors relative to the CEO increases. As Table 7 below shows, an increasing percentage of S&P 500 companies have significant fractions of outside directors whose tenure on the board precedes the CEO.

Table 7: CEO and Outside Director Tenure in S&P 500 Firms

	2000	2001	2002	2003	2004	2005	2006	2007
At least 25% of outsiders have tenure greater than CEO's (% of cos.)	47	50	50	52	53	58	58	54
At least 50% of outsiders have tenure greater than CEO's (% of cos.)	23	26	23	24	25	30	30	28
At least 75% of outsiders have tenure greater than CEO's (% of cos.)	5	6	5	4	5	8	8	8
Mean CEO tenure (years)	10.2	9.5	9.7	9.1	9.1	9	8	8.3
Mean Outside Director tenure (years)	8	8.1	7.9	7.8	7.8	7.9	7.8	7.7

Such relative tenure contributes to substantive independence in two respects. First, outside directors who became board members before the CEO should in no way feel that they owe their board seat to the CEO. Second, such outside board members will often have been involved in the selection of the CEO.[287] Thus, rather than viewing themselves as having been hired by the CEO, they are more likely to view themselves as having hired the CEO, and are thus in a stronger position to contradict the CEO or even fire him.

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284. *See* Michael Mandel, *Mr. Risk Goes to Washington*, BUS. WEEK, June 12, 2006, http://www.businessweek.com/magazine/content/06_24/b3988001.htm (describing Henry Paulson's resignation as CEO of Goldman Sachs Group in order to serve as Secretary of the Treasury).

285. *See* Lucier et al., *supra* note 274, at 3 (stating that nearly one in three CEOs left involuntarily in 2006).

286. It is possible that the increased turnover is exclusively due to other factors, such as more attractive severance packages for CEOs.

287. *See generally* Kenneth A. Borokhovich et al., *Outside Directors and CEO Selection*, 31 J. FIN. & QUANTITATIVE ANALYSIS 337 (discussing the role of outsiders in the selection of a new CEO).

VII. Executive Compensation: The Final Frontier

As another metric of changes in CEO power, we examine executive compensation. We discuss three developments: the disclosure rules adopted in 2006, the recent initiatives to give shareholders a "say on pay," and recent trends in CEO compensation.

A. Enhanced Disclosure

In July 2006, the SEC adopted new and enhanced disclosure requirements for executive compensation.[288] The new rules expand the previous disclosure regime in several ways. First, a proxy statement must contain a new section, "Compensation Discussion and Analysis," with a narrative discussion of objectives, design of compensation program, and how the company determines the amount of various compensation elements.[289] Second, more information is required for stock options and retirement benefits, including the fair value of these options on the date of grant.[290] Third, an enhanced summary-compensation table must provide a dollar value for each compensation item as well as elements for total compensation.[291] The last requirement, in particular, makes it harder to camouflage compensation by shifting it into categories that need not be quantified.[292] Prior to the 2006 reforms, the reported figure for "total compensation" did not include the value of stock awards, option grants, and retirement benefits.[293] And although some information on these items was disclosed elsewhere in the proxy statement, it was hard to decipher their dollar value.

Thus, for example, in 2005, GE reported that its CEO Jeffrey Immelt received "total compensation" of $3.4 million, that he was also granted 430,000 performance stock units (PSUs), and that he held PSUs and restricted stock with a value of $45.7 million as of December 31, 2005; but it did not disclose either the fair value of the PSUs granted in 2005 nor the total compensation including these PSUs for 2005.[294] In 2006 (postreform), GE disclosed that Immelt received total compensation of $17.9 million, a figure

288. Executive Compensation and Related Person Disclosure, Exchange Act Release No. 8,732A, 71 Fed. Reg. 53,158 (Sept. 8, 2006).

289. 17 C.F.R. § 229.402(b) (2009).

290. *Id.* § 229.402(a)(6)(iv), (d)(2)(ii).

291. *Id.* § 229.402(c)(2).

292. *See* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation* 39–42 (Nat'l Bureau of Econ. Research, Working Paper No. 9068, 2002) (arguing that companies are trying to camouflage compensation paid to executives as options).

293. Kathryn Yeaton, *The SEC's New Rules on Executive Compensation*, CPA J., July 2007, at 26, 29.

294. Gen. Elec. Corp., Notice of 2006 Annual Meeting and Proxy Statement (Schedule 14A), at 28–29, 34–35 (Mar. 3, 2006).

that includes stock and option awards valued at $8 million and an increase in pension value of $1 million.[295]

B. "Say on Pay"

One of the latest shareholder-rights initiatives goes by the poetic label "say on pay."[296] Say on pay requires a company to give its shareholders a nonbinding, advisory vote on the compensation of its executives.[297] This could have serious ramifications. The combination of traditional institutional investors with various performance or governance gripes, union-affiliated pension funds that may be willing to campaign for a "say NO on pay" vote, and populist sentiments against executives and their high salaries—together with the disclosure requirements that make it harder to camouflage executive compensation[298]—means that CEOs could find their packages disapproved by shareholders. Moreover, given the recent trend of boards to heed shareholders requests,[299] even an advisory vote could be a significant threat to CEO pocketbooks. Unsurprisingly, management lawyers like Martin Lipton recommend that such votes be "strongly resisted."[300]

In 2007, the SEC ruled that shareholder proposals requesting boards to adopt say on pay are not excludable under Rule 14a-8.[301] According to ISS, the number of such proposals has skyrocketed from 0 in 2005, to 7 in 2006, 41 in the first half of 2007, and at least 67 in 2008[302]—the single most

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295. Gen. Elec. Corp., Notice of 2007 Annual Meeting and Proxy Statement (Schedule 14A), at 21 (Feb. 27, 2007).

296. *See* Malini Manickavasagam, *Shareholder Proposals: Annual Meeting Voting Compels More Accountability*, 11 BNA CORP. GOV. REP. 30 (2008) (listing "say on pay" as one of top three issues on corporate ballots for 2008).

297. Sandeep Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation,* 35 PEPP. L. REV. 207, 220–21 (2008).

298. *See* 7 C.F.R. § 229.402(c)(2) (2009) (requiring corporations to report dollar amounts in a number of categories); Bebchuk et al., *supra* note 292, at 39–42 (discussing the use of options as a means of camouflaging executive compensation).

299. *See* Whitehouse, *supra* note 261 (observing that if shareholders make enough of an impact, directors will respond).

300. Lipton, *supra* note 130, at 8.

301. *See Proposals on Policy for 'Advisory' Votes Regarding Executive Pay Not Excludable*, 39 Sec. Reg. & L. Rep. (BNA) No. 9, at 370 (Mar. 5, 2007) (reviewing three separate no-action responses in which the staff of the Division of Corporate Finance advised AT&T Inc., Qwest Communications International Inc., and Clear Channel Communications Inc. respectively that they may not exclude proposals that the board adopt policies allowing shareholders to cast "advisory" votes on executive compensation from proxy materials for upcoming shareholder meetings).

302. *See Companies Ignore 'Say on Pay' Votes*, DIRECTORSHIP, July 23, 2008, http://www.directorship.com/companies-ignore-say-on-pay-votes (reporting seventy-six proposals so far in 2008); RISKMETRICS GROUP, POSTSEASON REPORT 8 (2007), http://www.riskmetrics.com/system/files/private/2007PostSeasonReportFINAL.pdf [hereinafter 2007 POSTSEASON REPORT] (comparing the forty "say on pay" proposals that were voted on between January 1, 2007, and June 30, 2007, with the seven proposals voted on in 2006); *id*. at 6 (illustrating in chart one the fact that in 2005 there were zero votes on proposals to give shareholders an advisory vote on executive compensation).

numerous category of proposals for that year.[303] Georgeson, which tracks proposals at a smaller set of companies, found 1 say on pay proposal in 2004, 39 in 2007, and 67 in 2008.[304]

Shareholder support for these proposals is high—the average proposal received 41.7% support in 2007—but not nearly as high as support for proposals to destagger the board (63.9% support) or to adopt majority voting (50.3% support).[305] Of 39 such proposals for which results were reported by Georgeson in 2007, only 4 (at Blockbuster, Ingersoll-Rand, Motorola, and Verizon) garnered a majority of the votes cast.[306] In 2008, 6 of 67 for which results were reported received a majority.[307] The fact that many proposals receive significant, but not majority, support partly explains why these proposals are so numerous. When proposals to destagger a board or to adopt majority voting are introduced, proposals shareholders regularly adopt, companies often agree to make the requested changes without a shareholder vote and thus remove the proposal from the ballot.[308] But because boards have a high chance of defeating a say on pay proposal, they have less of an incentive to adopt say on pay before a vote. At the same time, the level of support is sufficiently high for shareholders to keep introducing these proposals in order to put pressure on the board and gather momentum for an eventual passage.

The problem for boards—and CEOs, who would presumably be most affected by say on pay votes—is that for new types of shareholder proposals, the percentage of shares voted in favor and the number of proposals introduced tends to increase over time. Thus, for example, support for majority-voting proposals, also of relatively recent vintage, increased from 12% (on 12 proposals) in 2004, to 44% (on 54) in 2005, to 48% (on 84) in 2006, to 50% (on 37) in 2007.[309] For say on pay proposals, the number of proposals and the support they garner (no proposal in 2005, 40% on 7 proposals in 2006, 42% on 41 proposals in 2007, 42% on 62 proposals in 2008) seem to

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303. *See* 2007 POSTSEASON REPORT, *supra* note 302, at 6 (observing that shareholders' say on pay proposals outnumbered eleven other types of proposals in 2007).

304. *See* GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 18 (2004), http://www.georgesonshareholder.com/usa/download/acgr/acgr2004.pdf [hereinafter 2004 ANNUAL CORPORATE GOVERNANCE REVIEW] (listing a single proposal to "approve executive compensation" in 2004); GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 5 (2008), http://www.georgesonshareholder.com/usa/download/acgr/acgr2008.pdf [hereinafter 2008 ANNUAL CORPORATE GOVERNANCE REVIEW] (comparing the number and success of say on pay proposals in 2007 with proposals in 2006).

305. 2007 POSTSEASON REPORT, *supra* note 302, at 6.

306. 2007 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 204, at 4.

307. 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 304, at 5.

308. *See* 2007 POSTSEASON REPORT, *supra* note 302, at 3 (observing that these proposals are frequently withdrawn as companies become more willing to negotiate directly with shareholders on these issues).

309. 2004 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 304, at 6; 2007 POSTSEASON REPORT, *supra* note 302, at 4.

follow a similar pattern.[310] For January 1 to June 30, 2009, RiskMetrics estimates that say on pay proposals received 46% support on 71 proposals.[311]

Moreover, signs are that the board front against say on pay is starting to break. In 2008, Aflac Inc. became the first company to hold an advisory say on pay vote.[312] Verizon Communications, where a 2007 proposal received slightly more "for" than "against" votes (but less than majority support), and Blockbuster, where the proposal received majority support, decided to adopt say on pay for 2009,[313] as did Occidental Petroleum, Intel, Hewlett-Packard, MBIA, Motorola, and Ingersoll-Rand.[314]

The current economic crisis provides further impetus for say on pay. In times of declining stock prices and rising unemployment, high compensation for CEOs is an easy target, both for activist shareholders and politicians. Shareholder proposals submitted in 2009 have gathered unprecedented support, with ten of twenty-nine receiving a majority of the votes cast.[315] Under federal regulations, companies that receive federal TARP funds must hold say on pay votes if they want to pay their executives more than $500,000.[316] And under legislation proposed by Senator Schumer, all publicly traded companies would have to hold say on pay votes.[317]

C. Actual Compensation

Actual executive compensation may present the final frontier in the erosion of CEO dominance. Many commentators believe that CEOs, through their influence over the board, essentially set their own pay.[318] Even if one does not subscribe to the more extreme versions of the theory, which accords a minimal role to market forces in setting CEO pay, compensation is surely

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310. 2007 POSTSEASON REPORT, *supra* note 302, at 6; RISKMETRICS GROUP, POSTSEASON REPORT 5 (2009), http://www.riskmetrics.com/system/files/private/2009_PSR_Public_final.pdf [hereinafter 2009 POSTSEASON REPORT].

311. 2009 POSTSEASON REPORT, *supra* note 310, at 5.

312. Joann S. Lublin, *Say on the Boss's Pay: Aflac CEO Amos Bets on His Track Record as Insurer Becomes First U.S. Company to Hold Vote on Executive Compensation*, WALL ST. J., Mar. 7, 2008, at B1.

313. George Anders, *'Say-on-Pay' Gets a Push, but Will Boards Listen?*, WALL ST. J., Feb. 27, 2008, at A2.

314. *Say-on-Pay Is on the Way*, SMARTPROS, Mar. 2, 2009, http://accounting.smartpros.com/x65641.xml.

315. Press Release, Am. Fed'n of State, County and Mun. Employees, Say on Pay Shareholder Proposals Garner Record Support During Tumultuous Shareholder Season (May 4, 2009), *available at* http://www.afscme.org/press/26145.cfm.

316. *See Obama Imposes Limits on Executive Pay*, MSNBC, Feb. 4, 2009, http://www.msnbc.msn.com/id/29003620 (noting that future recipients of TARP funds will be required to hold a nonbinding shareholder vote in order to pay executives more than $500,000).

317. DealBook, http://dealbook.blogs.nytimes.com/2009/05/19/schumer-seeks-shareholder-vote-on-executive-pay (May 19, 2009, 14:27 EDT).

318. *See generally* Bebchuk et al., *supra* note 292, at 2–4 (arguing that the influence executives have over boards exerts substantial pressure on compensation decisions, which in cases of great influence leads to compensation that is constrained only by fear of public outrage).

important for CEOs, and CEOs can be expected to use the levers of power they have to notch up the amount they earn. Thus, if we are right and CEOs have lost power, we may expect that the decline in power has, or will soon have, an adverse impact on their compensation.

Executive compensation, of course, may also respond to macroeconomic factors. As such, one should be careful not to over interpret short-term changes in executive compensation. Moreover, other things being equal, a loss of power would make the CEO job less attractive. Thus, to the extent that CEO compensation is determined by supply-and-demand forces, a loss of CEO power could result in higher monetary compensation.

Table 8: Executive Compensation

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Median Total Compensation	2.1	2.5	2.6	3	3.8	4.3	4.9	5.4	6.4	5.8	5.8	6.2	6.1	6.9	6.6	5.9
Average Total Compensation	3.1	3.7	4	5.6	7.4	9.5	9.5	12.3	11.1	8.5	7.8	8.6	8.8	9.2	8.8	7.3

All this being said, it appears that the rise in CEO compensation has come to a halt. In Table 8, we present data (in millions of 2007 dollars) of the total amount of executive compensation (salary, bonus, stock options valued at grant time, other incentive compensation, and other compensation) for the CEOs of S&P 500 companies. The table provides both the average and median compensation in that group. The table shows a steep rise in compensation during the 1990s until around 2001. Since then, median compensation has flattened and average compensation has declined. Thus, for the most recent five-year period of 2004 to 2008, median total compensation was $6.3 million and average total compensation was $8.5 million, respectively about the same and 25% below their 2000 levels. Moreover, these data fail to take account of the enhanced disclosure rules,[319] which may have resulted in higher levels of reported compensation from 2006 onwards (and thus make comparisons between pre-2005 compensation and post-2006 compensation more difficult). If one were to assume, for example, that the difference in reported 2005 and 2006 compensation is due entirely to changes in disclosure rules (and that reported 2007 and 2008 compensation under the pre-2005 rules would be lower by a like amount), then even median compensation in the 2004 to 2008 period dropped by around 10% from its 2000 level. Thus, for those who believe that CEO power is positively correlated with compensation, recent compensation trends are consistent with shrinking CEO power.

VIII. The Effects of These Changes on CEO Power

In the previous pages, we have analyzed a large number of changes in the relationships between CEOs, boards, and shareholders. In this Part, we

319. *See supra* notes 288–93 and accompanying text.

analyze how these changes affect CEO power, using the taxonomy developed in Part II.

A. Decision Making: Decisions and Agenda Control

Consider the single most important decision in the life of a company: whether to sell control. In a world of dispersed shareholdings—think back to the 1950s and 1960s—this was a decision in the first instance for the CEO, possibly with the advice of the board of directors.[320] A CEO who determined it was a good time to sell the company or to buy another company would reasonably expect that decision to carry the day, even if the particular form of corporate combination required board and shareholder approval.[321] Likewise, a CEO who decided it was not a good time to sell had reasonable grounds for assuming that the decision would end discussion.

In today's world of activist hedge funds, more independent directors, and assertive shareholders, that is clearly no longer true. How does it play out today? First, the changes in shareholder composition and activism mean that shareholding is far more concentrated, and concentrated in the hands of shareholders—hedge funds and more traditional institutional shareholders—who are more willing to challenge a CEO's decisions than ever before.[322] Such challenges are becoming easier to mount because the decline of staggered boards, the rise of majority voting for directors, and the ever-increasing success of shareholder proposals give shareholders far more opportunities to hold directors accountable for any excessive deference to the CEO.

Moreover, the 1992 partial deregulation of the proxy rules, combined with the end of discretionary broker voting and the adoption of notice and access, means that the costs of challenging the CEO's decision have markedly declined, and the chances of success have increased. The emergence of proxy advisors can further contribute to the success of such challenges. All this takes place against the backdrop of directors who show more substantive independence than ever before: they spend more time monitoring management; exercise greater control over auditing, governance, and compensation decisions; meet regularly in executive sessions; have more control over the information presented to them; and fire the CEO more frequently and more readily.[323]

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320. *See generally* MACE, *supra* note 3, at 73–85 (discussing the use of the power of control by company presidents and the interplay between presidents and boards in corporate decision making).

321. *See id.* at 186 ("In most companies the allocation of capital resources, including the acquisition of other enterprises, is accomplished through a management process of analysis resulting in recommendations to the board and in requests for approval by the board . . . . Approval by boards in most companies is perfunctory, automatic, and routine.").

322. *See* Kahan & Rock, *supra* note 22, at 1029–33 (providing examples of institutional-investor shareholders challenging CEOs).

323. *See id.* at 1029–42 (discussing various cases of activist shareholders exercising control over corporate governance).

A decision by the CEO to sell or not to sell the company—as, say, PeopleSoft CEO Craig Conway learned—is therefore but the beginning of the conversation.[324] And, because all the players know that the rules of the game have changed, some conversations do not even start. In today's environment, a decision by the CEO to sell the company to a favored bidder over a competing bidder offering more would be doomed from the outset.

Equally as dramatic, the CEO has lost significant control over the agenda to the shareholders. The changes summarized above combine to eliminate the CEO's ability to keep matters off the corporate agenda. With hedge funds and more traditional institutional shareholders willing to agitate in favor of proposals on the issuer's proxy under 14a-8 or pursue matters directly in their own proxy solicitations, with the costs of such solicitations declining because of regulation and technology, and with increasing success in passing and implementing such proposals, CEO agenda control has declined. In case after case, shareholders have proved themselves capable of forcing unwanted topics onto the front burner.[325]

These examples of the loss of CEO decision-making powers are the most visible tips of an iceberg. In several other areas, our analysis suggests CEO decision-making power has also declined. These include, in particular, the areas delegated to the responsibility of wholly independent board committees: audit, compensation, and nomination. How much more of the iceberg is hidden under water is harder to tell. Presumably, board members still generally defer to the CEO when it comes to operational decisions (or else decide to fire the CEO). By the same token, we believe that CEOs involve board members more in major strategic decisions and that board members have become more willing to share any concerns over operations with their CEOs outside the boardroom. Anecdotal evidence also suggests that "friendly" hedge funds—who do not engage in adversarial activism—share their views about major business decisions with the CEO. Thus, it is likely that CEO decision-making power has declined notably with respect to some key issues and more moderately over a wider set of issues, with both large shareholders and independent directors gaining power at the expense of CEOs.

B. Second-Guessing

What has changed more than anything else is the ability and incentives for other players to second-guess the CEO's actions. Consider first a CEO who acts imperiously with regard to selling the company.[326] If this decision

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324. Jim Kerstetter, *Finally, Oracle Nails PeopleSoft*, BUS. WK., Dec. 13, 2004, *available at* http://www.businessweek.com/technology/content/dec2004/tc20041213_8884_tc024.htm.

325. *See* Kahan & Rock, *supra* note 22, at 1029–46 (examining how a variety of shareholders, including hedge funds and mutual funds, leverage their voting powers against corporate boards).

326. CEOs who consume excessive perks may also face criticism. Personal use of corporate jets must be disclosed under 17 C.F.R. § 229.402(c)(2)(ix)(A) (2009). Under these disclosure rules,

was once considered the final word, it no longer is. In today's environment, one would expect hedge funds to buy shares in order to challenge the decision. Thus, when Yahoo's CEO Jerry Yang cold-shouldered an offer by Microsoft to acquire the company, it did not take long for Carl Icahn to commence a proxy contest and place three nominees on Yahoo's board.[327] More generally, the evidence we presented—the emergence of hedge funds, the greater power of institutional investors and their greater proclivity to activism, the regulatory changes making it easier for shareholders to challenge managements, the increased monitoring of management by outside directors, and last but not least the reduced tenure of CEOs—suggests that if a CEO makes mistakes (or perhaps just has bad luck), both shareholders and directors will voice their criticism sooner and more strongly than in the days of yore, be it informally, through a proxy challenge or other activist campaign, or through a board-induced CEO resignation.

C. The Scope of CEO Power: Extension, Comprehensiveness, and Intensity

As noted earlier, CEO power can also be divided along the dimensions of extension, comprehensiveness, and intensity. Extension essentially relates to the scale of the firm. Since firms have not gotten smaller, and since CEOs remain on top of the firm, CEO power has not declined along that dimension. In terms of comprehensiveness—the number of topics over which power is exercised—and intensity—the degree to which the holder of power can impose his or her will—CEO power has declined. As noted before, the decline is most pronounced (that is, sharpest along the dimension of intensity) in areas that require board or shareholder approval, such as decisions to sell the firm, audit matters, compensation, corporate governance, and board nominations. In other areas, we believe CEO power has declined as well, but due to the lack of transparency over how these decisions are made and whether they are second-guessed, it is harder to document the decline. Moreover, since independent directors and even activist shareholders have limited capacity to micromanage a company, it is likely that CEOs still have substantial decision-making power over most nonstrategic business matters, as long as their decisions produce acceptable results.

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the total value of perks must be disclosed "unless the aggregate amount of such compensation is less than $10,000." *Id.* A further requirement is that the company must identify by type each individual perk and must quantify and disclose each perk that exceeds the greater of $25,000 or 10% of the total amount of individual perks. *Id.* § 229.402(c)(2)(ix), instruction 4.

327. *See* Aaron Smith, *Yahoo Puts Icahn on Board, Settling Spat*, FORTUNE, July 21, 2008, *available at* http://money.cnn.com/2008/07/21/news/companies/yahoo_icahn/index.htm (noting that Yahoo agreed to place Icahn on its board and allowed him to appoint two additional board members while at the same time thwarting his efforts to take over control of the board).

IX. Implications

Our thesis that CEO power has declined notably over the last several years has important implications for corporate law and corporate governance. In this Part, we discuss these implications. First, we argue that the changes we describe reflect a long-term trend that is likely to continue and intensify, rather than some short-term cyclical movement that will reverse itself. Second, because of the nature of these changes and their underlying causes, we do not think that the loss of CEO power will generate a political backlash. Third, the new role of the board will lead to the appointment of board members having different backgrounds and competencies than before. Fourth, we predict increased velocity in the types of shareholder initiatives introduced via Rule 14a-8. Fifth, we discuss the implications of our thesis for the debate over the extent to which the corporate law of various countries is converging. Sixth, we analyze the implications of the loss of CEO power on Delaware law and the state-competition debate. Seventh, we argue that the loss of CEO power may reduce CEOs' resistance to having their company acquired. Eighth, it weakens the case for new corporate law rules that grant shareholders greater voting rights. And ninth, we examine the relationship between CEO power and private equity. Finally, in the conclusion, we comment on whether the loss of CEO power is a positive or a negative development.

A. Fundamental Shift or Perfect Storm?

Some observers, noting some of the issues we discussed in this Article, have characterized the current state of affairs as a "perfect storm."[328] The perfect-storm metaphor evokes a temporary and accidental alignment of forces that creates a special situation or opportunity.[329] But like other storms, perfect ones ultimately pass and the situation returns to normal.

We do not think this captures what is happening. The changes we discuss are not temporary and their simultaneous occurrence is not accidental. Any changes in the regulatory environment—including the changes in proxy rules, the revised listing standards in the stock exchange rules, or the elimination of broker voting in uncontested director elections—are likely to persist. The shift in equity ownership from individuals to institutions reflects fundamental long-term change forces[330] that will continue. Companies that have agreed to destagger the board are unlikely to receive shareholder approval to reintroduce a staggered board.[331] And while most

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328. ALLEN, *supra* note 148, at iv; IR MAG. GUIDE, A PERFECT PROXY STORM 2 (2007), http://www.altmangroup.com/pubs/IRMag/IR Magazine - US Guide March (2).pdf.

329. *See, e.g.*, D. Michael Fields, *Perfect Storm*, BIZED MAG., Jan./Feb. 2006, at 34, http://www.aacsb.edu/publications/Archives/JanFeb06/p34-37.pdf ("A perfect storm, by definition, is a convergence of independent events . . . .").

330. Specifically, the way retirement benefits are financed.

331. Marcel Kahan & Edward Rock, *Corporate Constitutionalism: Anti-takeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 495–96 (2003).

companies that have adopted majority voting could return to plurality voting without shareholder approval,[332] we think this is both unlikely and ultimately ineffective: even under a plurality-vote regime, a director who receives a majority of withhold votes faces enormous pressures to resign.[333]

These changes, in turn, have caused some of the other changes we observe. To be successful, activist hedge funds need allies, and institutional investors with their increased holdings are likely candidates. Successful hedge fund activism has led traditional institutions first to lend their active support to hedge funds, and then to lead the charge themselves. The rise in institutional holdings has generated demand for voting advice by proxy advisors. The destaggering of boards and majority voting has increased the meaningfulness and the frequency of director elections. That directors are up for election more frequently, that they are worried about a large withhold vote, and that proxy advisors are more likely to recommend a withhold vote if the board ignored a shareholder resolution are all at least part of the reason why boards have become more responsive to shareholder resolutions. This, in turn, means that more companies will destagger, adopt majority voting, or even give shareholders a say on pay. Independent nominating and governance committees reduce the ability of CEOs to stop this. Increased holdings by institutions and fear of hedge funds increase both the demand by shareholders to meet with outside directors and the willingness of directors to do so. Directors meeting in executive session create the opportunity to discuss company developments unmonitored by the CEOs. As more boards question their CEOs, it becomes more acceptable for directors in other companies to do so. Greater director independence and greater pressure from shareholders, in turn, increase CEO turnover. Increased turnover means that, at any point in time, there will be more members of the board who have picked the CEO and fewer who were picked during the CEO's tenure. Thus, even if CEOs continue to influence the selection of board members, despite the requirement of wholly independent nominating committees, shorter tenure implies less CEO influence over board membership. And we could go on.

We are not so bold to claim that all the trends we described will continue unabated. But we think that it is much more likely that CEOs, in the intermediate term (over the next ten years or so), will lose more power than that they will regain some of the power they have lost.

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332. Companies require shareholder approval only if majority voting is embedded in the charter, a majority voting bylaw is adopted by shareholders, or a board-adopted bylaw provides that it can be amended only by shareholders. DEL. CODE ANN. tit. 8, §§ 216, 242 (2001 & Supp. 2008).

333. *See supra* note 152.

B. Backlash

If we are correct and the changes we discuss presage a continuing decline in the power of CEOs, rather than a cyclical and self-reversing shift, there is the possibility of a political or regulatory backlash. Such a backlash, in the form of state anti-takeover statutes and Delaware's sanctioning of the poison pill, helped stop the hostile takeover wave of the 1980s, the last significant threat to managerial power.[334] These days, advocates of managerialism already argue that the increased power of shareholders and decreased board collegiality induce an excessive short-term orientation that harms U.S. competitiveness.[335]

While the possibility of backlash cannot be excluded, we believe that its likelihood is remote. Unlike in the 1980s, the threat to managers derives from multiple sources—traditional institutions, hedge funds, proxy advisors, technology, and their fellow directors—rather than from a small group of raiders. And compared to raiders of the 1980s, who were in many respects outsiders,[336] even hedge funds (and, a fortiori, institutional investors and board members) are part of (or well connected to) the establishment and have significant political power.[337] The threat to managers is more gradual and broad based than in the 1980s and thus less likely to result in a strong response. Finally, there is little reason to expect populist support for pro-management changes; organized labor, who supported anti-takeover legislation in the 1980s, is lined up against management in this round;[338] and, for the moment at least, populist anger is directed against highly compensated CEOs, rather than at shareholder activists.

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334. *See* Kenneth W. Hollman, *Merger Mania: Human and Economic Effects*, REV. BUS., June 22, 1991, *available at* http://www.allbusiness.com/buying-exiting-businesses/mergers-acquisitions/268232-1.html ("Over 30 states (including Delaware) passed laws in the latter half of the 1980s to thwart the takeover effects of corporate raiders.").

335. *Has Shareholder Influence Gone Too Far? Or Not Far Enough?*, Posting of Heidi N. Moore to Deal Journal, http://blogs.wsj.com/deals/2008/05/23/has-shareholder-influence-gone-too-far-or-not-far-enough/ (May 23, 2008, 12:06 EST).

336. For example, many prominent investment banks and law firms refused to work for hostile bidders. *See, e.g.*, RON CHERNOW, THE HOUSE OF MORGAN 707 (2001) (acknowledging that until the late 1980s, J.P. Morgan did not do work for hostile bidders).

337. During the 2008 election cycle, hedge-fund-associated individuals and PACs made over $16 million in political contributions to federal candidates and parties. *See* Hedge Funds: Long-Term Contribution Trends, http://www.opensecrets.org/industries/indus.php?cycle=2010&ind=f2700 (showing amount of political contributions made by hedge funds). For six funds, the contributions exceeded $500,000. *See* Hedge Funds: Top Contributors to Federal Candidates and Parties, http://www.opensecrets.org/industries/contrib.php?ind=f2700&cycle=2008 (showing top hedge fund political contributors and detailing their contributions). Presidential candidate John Edwards worked with hedge fund Fortress Investment. Emily Thornton, *John Edwards Hits the Streets*, BUS. WK., Oct. 13, 2005, http://www.businessweek.com/bwdaily/dnflash/oct2005/nf20051013_3314_db016.htm. Chelsea Clinton has also worked with hedge funds. *Chelsea Clinton Joins New York Hedge Fund*, MSNBC, Nov. 3, 2006, http://www.msnbc.msn.com/id/15549672/.

338. For example, union-affiliated pension funds sponsor some of the anti-management resolutions discussed above. *See supra* notes 295–99 and accompanying text.

C. Board Composition

The shift of power from CEOs to outside board members also has implications for the type of persons who will serve on corporate boards. Compared to outside directors fifteen years ago, outside directors today are likely to have more power, to enjoy a less collegial relationship to the insiders, to have a greater workload, to earn greater pay, to have occasional need to become confrontational, and to deal more often with vocal and restive shareholders.[339] Accordingly, board composition will shift to persons who are good at these new tasks, who derive greater enjoyment from them, and who have the needed time and energy to devote to the job.

One category of persons who may be particularly well qualified for board service in the current environment are retired CEOs and other retired high-level executives, bankers, accountants, consultants, or investment professionals. They tend to have the time, the background, the independence, and the interest to perform the tasks set to them. We would predict that, over time, the percentage of board members from these categories will increase.

D. Shareholder "Flavor of the Year" Initiatives

Shareholder resolutions often come in waves, with every year or so witnessing the emergence of a new "flavor of the year" type of precatory resolution and the decline of some prior types. The last two proxy seasons (2007 and 2008), for example, saw the rise of proposals asking the board to grant shareholders the right to call a special meeting.[340] These proposals, virtually unheard of until 2006,[341] were proposed in twenty-three companies in 2008, were on average supported by 47% of the votes cast, and passed in eleven of the companies.[342] By contrast, proposals to redeem or get a shareholder vote on poison pills went from fifty in 2004 to three in 2008.[343]

In the past, management's response has largely been to duck and cover: to hope for the storm to pass before the topic gained sufficient traction to generate real pressure for change.[344] This tactic looks increasingly untenable.

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339. MICHAEL J. STAHL & DAVID W. GRIGSBY, STRATEGIC MANAGEMENT: TOTAL QUALITY AND GLOBAL COMPETITION 8–9 (1997).

340. 2007 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 204, at 33; 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 304, at 33–34.

341. GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 32 (2005), http://www.georgesonshareholder.com/emea/resources_research.php [hereinafter 2005 ANNUAL CORPORATE GOVERNANCE REVIEW]; GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 31 (2006), http://www.georgesonshareholder.com/emea/resources_research.php [hereinafter 2006 ANNUAL CORPORATE GOVERNANCE REVIEW].

342. 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 304, at 33–34.

343. 2004 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 304, at 21–22; 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 304, at 32–33.

344. *See* Neil O'Hara, *Prepare for Attack: What to Do When Hedge Funds Move In*, COMPLIANCE WK., Mar. 28, 2006, http://www.complianceweek.com/article/2404/defensive-moves-

First, with the rise of institutional investors, it takes less time for a new proposal to gain significant shareholder support.[345] Second, once a proposal has received (or is expected to receive) support, boards are increasingly willing to adopt the recommendation. Thus, in 2007, eleven of the seventeen shareholder right-to-call-a-special-meeting proposals passed, and eight were implemented by the following year.[346] In 2008, eleven passed, and five were implemented.[347] As for new types of shareholder initiatives, we generally predict proposals to gain more traction than in the past and to do so more quickly, which in turn will lead to more and more types of initiatives.

E. Convergence

There is a long running debate among corporate scholars over whether the corporate law and governance systems in different countries are converging.[348] Our evidence suggests that we may be witnessing the end of a particular exceptionalism in U.S. corporate governance: the imperial CEO. In many respects, the changes we discussed in this Article, while new from the U.S. perspective, have long been part of the corporate-governance regime in other Anglo-American countries, such as the U.K., Canada, and Australia. Thus, for example, most U.K. companies have a non-executive chairman of the board, and U.K. law gives shareholders a nonbinding say on pay.[349] Poison pills are not permitted under Australian law.[350] Under Canadian law, directors of a company with a classified board can be removed without cause,[351] making this device an ineffective takeover defense. As U.S. practice moves closer to the practice of these other countries, both with

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when-hedge-funds-attack (noting that before the rise in activist shareholders companies used to be able to simply ignore the investors); *see also* Kirsten Grind, *WaMu Likely to Ignore Ire of Shareholders at Meeting*, PUGET SOUND BUS. J., Apr. 11, 2008, http://seattle.bizjournals.com/seattle/stories/2008/04/14/story2.html ("Boards usually don't listen to the messages sent by shareholders when they withhold votes . . . .").

345. *See supra* notes 156–68 and accompanying text.

346. 2007 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 204, at 33.

347. 2008 ANNUAL CORPORATE GOVERNANCE REVIEW, *supra* note 304, at 33–34.

348. *See, e.g.*, CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 4–5 (Jeffrey N. Gordon & Mark J. Roe eds., 2004) (chronicling arguments about convergence and ways in which convergence could prevail); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 92 NW. U. L. REV. 641, 645–48 (1999) (describing several alternative positions that have emerged in the convergence debate); Jennifer G. Hill, *The Persistent Debate About Convergence in Comparative Corporate Governance*, 27 SYDNEY L. REV. 743, 743–44 (2005) (book review) (analyzing the "convergence–divergence" corporate governance debate over the last few decades).

349. Donald Kalfen et al., *The Future of Say on Pay: Current Status and Possible Impact*, BOARDMEMBER, http://www.boardmember.com/Article_Details.aspx?id=2076.

350. Jennifer G. Hill, *The Shifting Balance of Power Between Shareholders and the Board: New Corp's Exodus to Delaware and Other Antipodean Tales* 33 (Vanderbilt Univ. Law Sch., Law & Econ. Research Paper No. 08-06, 2008), *available at* http://ssrn.com/abstract=1086477.

351. Canada Business Corporations Act, R.S.C. § 109 (1985).

regard to specific issues and with regard to the overall power of the CEO, the corporate law regimes are converging.

F. Delaware Law

There is long standing debate in corporate law as to the tilt of Delaware law. Delaware, of course, is the jurisdiction in which most publicly traded companies are incorporated and is thus generally acknowledged as the most "attractive" corporate law jurisdiction.[352] But attractive to whom? According to "race to the bottom" commentators, the incorporation decision is largely made by managers, and Delaware succeeds in attracting corporations because it has pro-management rules.[353] According to "race to the top" commentators, the incorporation decision is driven by market forces, and Delaware succeeds in attracting corporations because it has rules that maximize the value of the corporation.[354] According to a third set, both management and shareholders have power over the incorporation decision, and Delaware succeeds because it generally has both a better corporate law than most other states and, in areas where shareholder and manager interests conflict, adopts rules that are acceptable to both sides.[355]

Some of the developments we have described pose substantial challenges for race to the bottom and race to the top commentators. Race to the bottom commentators, who believe that managerial power is predominant, may have a hard time explaining why so many companies have destaggered their boards, adopted majority voting, and implemented precatory shareholder resolutions—all developments that, on their face, reflect shareholders exercising power over governance decisions at the expense of the board. Race to the top commentators would have a somewhat easier time explaining the same developments but would still need to explain why it was optimal for a majority of large companies to have staggered boards and plu-

352. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1563 (2002) ("Delaware has a nearly 70% share of IPO firms and 95% share of firms incorporating outside their home state. Delaware's share is growing over time.").

353. *E.g.*, Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1438 (1992); *see also* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974) (arguing for federal rules as a solution to the "race for the bottom" situation created by Delaware and other states' management "enabling" acts).

354. *See, e.g.*, Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2383 (1998) (asserting that investors benefit from competition and changes in corporate domicile to states such as Delaware); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 257–58 (1977) (arguing that the fact that other states have had to change their laws in response to Delaware indicates that investors do not believe the race to the bottom theory and instead believe that they do better under Delaware law).

355. *E.g.*, Michael Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 126, 135–36 (2004); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 739–40 (2002).

rality voting several years ago, and yet it is now optimal for most of these companies to destagger their boards and adopt majority voting.

As to the third set of commentators, the loss of CEO power suggests that the optimal compromise between shareholder and manager interests that Delaware strives to adopt has moved towards the shareholder side. As shareholder power over incorporation decisions increases and management power shrinks, the Delaware law that, at the margin, appeals to the greatest set of relevant decision makers has become more shareholder friendly.

Indeed, several recent changes in Delaware law are consistent with this prediction. Thus, in 2006, Delaware adopted legislation that a shareholder-adopted bylaw mandating majority voting for directors cannot (unlike most other bylaws) be repealed by the board of directors.[356] And in 2009, Delaware adopted legislation expressly permitting the adoption of bylaws to provide for proxy access or to require reimbursement for expenses incurred in soliciting proxies for director elections in opposition to the board's nominees.[357]

G. Changing Dynamics of Resistance to Acquisition

Being CEO of a public company has become less fun. You get to call fewer shots, you are being second-guessed by boards and shareholders, your compensation has plateaued, and your job security has decreased. All of this will make CEOs more willing to let their company be acquired and cash in on appreciated stock options or severance payments. CEO resistance to acquisitions should thus decline.

On the other hand, boards and shareholders may now be the ones to offer roadblocks. Boards may get more involved in the negotiations of acquisition terms and may reject offers that the CEO may want to accept. And we have already witnessed instances of shareholders trying to renegotiate a deal struck by management.[358] Board and shareholder resistance to acquisitions—which, until recently, was negligible—has thus increased.

We are working on documenting the divergence in financial incentives to engage in control transactions between the CEO and independent directors. While today's CEOs have strong monetary incentives to support a

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356. DEL. CODE ANN. tit. 8, § 216 (2009).

357. *Id.* § 112. There have also been some recent judicial decisions favoring shareholders. In *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008), the court held that governance rules—specifically, rules on reimbursement of proxy expenses—are proper subjects of bylaws and need not be included in the corporate charter, as long as they do not require violations of Delaware law (including fiduciary duty law). *Id.* at 240. And in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), the court made it more difficult for boards to obtain shareholder ratification of breaches of fiduciary duties by holding that "the scope of the shareholder ratification doctrine must be limited to . . . circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective." *Id.* at 713.

358. *See supra* notes 320–27 and accompanying text.

change in control, especially as they approach the end of their tenure,[359] for outside directors such control changes are a losing proposition. While outside directors are able to sell any shares they have for a premium, these gains are dwarfed by the loss of the very substantial director fees.[360] Moreover, such directors are typically not able to replace their lost directorship with another of comparable status.

These changes, in turn, may impact Delaware law on acquisitions. First, Delaware law on hostile takeovers and, in particular, the "just say no" defense, will become less important. By the same token, Delaware law on the ability of boards to "lock up" deals in the absence of a bidding contest could become more important.[361] More profoundly, Delaware law rests to some extent on the premise that shareholders want to sell the company at a premium but that management may want to block the sale and stay independent.[362] To the extent that this premise is no longer correct, Delaware law will have to adapt the substantive standard by which it evaluates transactions.

H. The Need for Greater Shareholder Voting Rights

In a series of articles published in 2005 and 2006, Lucian Bebchuk argued that shareholder voting rights should be expanded to include the power, without board approval, to change the company's governance structure (including the power to change the charter and to reincorporate into a different state) and to make certain specific business decisions (such as the power to instruct the board to auction the company to the highest bidder).[363] The premise of Bebchuk's argument is that, even though shareholders elect the board of directors (and thus indirectly already control all of these decisions), directors do not heed shareholder wishes. Predictably, other

359. *See* John C. Coates, IV & Reinier Kraakman, *CEO Tenure, Performance and Turnover in S&P 500 Companies* 5 (European Corporate Governance Inst., ECGI-Finance Working Paper No. 191/2007, 2010), *available at* http://ssrn.com/abstract=925532 ("CEOs on the cusp of retirement or discharge might opt to sell their companies instead, in order to trigger option plans and liquidate equity holdings.").

360. Charles M. Elson, *Corporate Law Symposium: The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 694 (1995).

361. In practice, Delaware law addresses lock-ups only in the context of competing bids. *See* Hastings-Murtagh v. Tex. Air Corp., 649 F. Supp. 479, 484 (S.D. Fla. 1986) (determining that Delaware law allows lock-up provisions "where there is a live auction with competing bidders").

362. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (setting the standard used by courts to determine whether a board's defensive measures to a perceived threat of hostile takeover, which interfere with the exercise of shareholder voting, are reasonable).

363. *See* Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1787–95 (2006) (responding to criticism of his recommendation to give shareholders control over "rules-of-the-game" decisions); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850–75 (2005) (arguing for giving shareholders the power to initiate and adopt "rules-of-the-game" decisions such as amending corporate charters and reincorporation in another jurisdiction).

commentators have ridden to the defense of the current system where the board retains greater control.[364]

The evidence we present in this Article suggests that, whatever the merits of Bebchuk's proposal may have been when it was conceived, the need for (and desirability of) any reform suggested by Bebchuk has declined. Bebchuk and his detractors fundamentally differ with respect to one major issue: when shareholders and the board of directors disagree—e.g., over whether the company should be auctioned off—who is more likely to be right? Both sides to the debate, however, would presumably agree that boards are more likely to heed shareholder wishes if they believe that what shareholders want is good for the company. That is, the merits of what shareholders want and the likelihood of boards following a nonbinding shareholder vote are correlated.

In the ideal corporate-governance world, boards would retain just that modicum of power that permits them to block, at the margin, more bad ideas than good ideas. In the real world, of course, board power cannot be fine-tuned in that manner. As a formal matter, a board can either block certain types of decisions or it cannot. Bebchuk, in effect, argues that we would be better off if boards could not block governance changes and certain business decisions. His detractors argue that we are better off if they can.

As we have shown in this Article, however, even though the formal powers of the board have not changed, boards have become much more receptive to shareholders. Thus, boards voluntarily, albeit selectively, implement more shareholder-proposed governance changes.[365] This obviously reduces the need for removing board veto power over governance changes, as advocated by Bebchuk.

But if, as is likely, from among all the governance changes desired by a majority of shareholders, the governance changes implemented by boards are better than those rejected by boards, it may also mean that the time for Bebchuk's proposal has passed. Even if we would be better off with letting shareholders set the rules than with giving the veto right to boards when boards regularly ignored what shareholders want, we may be better off with board veto when boards implement a significant portion of nonbinding proposals passed by shareholders.

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364. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736–44 (2006) (arguing that the current regime offers substantial efficiency benefits); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1769–75 (2006) (arguing that the capital markets have not indicated a need for substantial change in corporate governance).

365. *See supra* notes 158–72 and accompanying text.

I. Private Equity to the Rescue? The Trade-Off Between Power and Wealth

As remarkable as the growth in hedge funds may have been, it is not unparalleled. The funds raised by private equity firms in the U.S. have experienced a growth rate—23%, annually compounded, from 1999 to 2006—as high as the hedge fund assets under management (19% during that period).[366] The total dollar volume of private equity M&A transactions in 2006 was $900 billion, a magnitude comparable to the total hedge fund assets ($1.427 trillion), especially considering that a significant portion of hedge fund assets are not invested in equity securities.[367]

Until the recent credit crunch, private equity funds played an increasingly large role in M&A.[368] As a percentage of total M&A dollar volume, private equity M&A had grown from less than 5% in 1999 to more than 25% in 2006.[369] In 2006, there were 151 going-private transactions sponsored by private equity funds, up from only sixty-seven in 2000.[370]

Private equity funds, like hedge funds, are significant new players. But unlike hedge funds, private equity is considered management friendly.[371] Private equity funds rarely if ever engage in hostile transactions.[372] Instead, they offer CEOs a safe harbor in a storm, by expanding CEOs' options and opportunities, and, when taking companies private, by offering the possibility of great wealth.

However, even if CEOs, on the whole, view private equity funds favorably, these funds contribute to the decline in CEO power. As an institution, private equity weakens CEOs by increasing the likelihood of a change of control, closely monitoring their investments in public companies, and tightly controlling portfolio companies (setting and monitoring goals, and firing underperforming CEOs). While having one's company acquired by a private equity firm may make a CEO rich, his power is reduced. When a company is acquired, the CEO either leaves the firm or stays on to manage

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366. The Blackstone Group L.P., Amendment Number 9 to Form S-1, at 148, 151 (June 21, 2007).

367. *Id.* at 149, 151.

368. *See* Chris Snow, *Impact of Credit Crisis on Private Equity Markets*, 28 REV. BANKING & FIN. L. 71, 79 (2009) (emphasizing the future opportunities in the private equity industry due to significant uncommitted capital from the recent "boom" despite the fact that "[b]ecause of recent financial instability and frozen credit markets, traditional private equity buyout activity has essentially stopped").

369. The Blackstone Group, *supra* note 366, at 149.

370. *Id.*

371. *See* Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 13 (2008) (contending that when a private equity fund buys a company "management can become very rich" and avoid the "adverse publicity associated with generous executive pay in public companies").

372. *See id.* at 12 (explaining that when private equity firms carry out buyouts they usually "opt to negotiate a 'friendly' deal with the target").

the firm, which is now a portfolio company in a private equity fund. In the former case, the CEO gives up any power that comes with the job. In the latter case, the CEO now has a boss—the management of the private equity firm—that has the ability and the incentives to monitor him and to fire him if they are dissatisfied. Whatever financial rewards the CEO may obtain in his new position, one thing is clear: the power of a CEO of a company owned by a private equity fund is much less than the power of a CEO of a comparable company that is publicly traded.

X. Conclusion: Searching for the Sweet Spot

The story we tell above is a story of declining CEO power over the last several years, a decline that has occurred across almost all of the relevant dimensions and that we believe will last and continue. Is this a good thing?

One of the great virtues of the corporate form is centralized management.[373] Much of corporate law can be interpreted as establishing and protecting that centralized management because of the benefits that it provides to the participants in the firm. At the same time, the centralization of management in the hands of paid managers creates agency costs for the shareholder–manager, the prevention of which forms such an important part of corporate law.

There is, for a given firm operating in a specific environment, a point at which the net benefits of delegation are maximized. The difficulty is that it is very tough to know whether we are at that point.

In this Article, we argue that the balance of power between CEOs, boards, and shareholders has shifted notably in the last decade away from CEOs towards outside directors and shareholders. If, as we expect, that shift will continue in the same direction, CEOs are left ever more embattled, at least in comparison to their predecessors a generation ago. But we cannot claim, and do not know, whether the balance has shifted too far, or whether under current conditions the CEO is not powerful enough. On the other hand, those arguing to strip the CEO of even more power also cannot show that the CEO of today is too powerful.

As we search for the sweet spot, it is worth keeping in mind that for every story about a domineering CEO who should have been replaced long ago, there is an Andrew Grove or a Jack Welch who used the power of the position to make billions of dollars for their shareholders.

373. *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-governing Corporation*, 149 U. PA. L. REV. 1619, 1698 (2001) (anchoring centralized management within the theory of the firm).