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Preserving the Corporate Superego in a Time of Activism: An Essay on Ethics and Economics

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Abstract

This essay focuses on the impact of recent changes in corporate governance on ethical behavior within the public corporation. It argues that a style of corporate behavior—one characterized by a risk tolerant, even reckless, pursuit of short-term profits and a disregard for the interests of non-shareholder constituencies—is attributable in significant part to recent changes in corporate governance, including the rise of hedge fund activism, greater use of incentive compensation, and the appearance of blockholder directors. It then surveys feasible responses intended to strengthen the role of the boards as the corporation's conscience and superego. Given the difficulty of reform, it predicts that the problems identified are likely to get worse before they get better.

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By John C. Coffee, Jr.*

I. Introduction

Corporate governance matters—and in more ways than are immediately obvious. Most commentators stress that governance matters to corporate efficiency and the unending pursuit of reduced agency costs.[1] This article will instead focus on the impact of governance on ethical behavior and corporate social responsibility. From either perspective, when any important element in the corporate governance environment is disturbed, the impact of this disturbance radiates broadly, causing unexpected and unintended changes in corporate behavior. In particular, this article will contend that a particular style of corporate behavior—characterized by a risk tolerant, even reckless, pursuit of short-term profits and a disregard for the interests of non-shareholder constituencies—is a reaction attributable to a new influence acting on the corporate governance environment: namely, pressure from shareholder activists (mainly hedge funds) that are rationally risk tolerant and that focus on short-term share value maximization. The consequence is a shift towards heightened leverage, the acceptance of greater risk, and shortened time horizons. That frames this article's ultimate issue: What, if anything, can or should be done in response to this development?

Immediately, it is important not to overstate. No claim is here made that an epidemic of corporate irresponsibility is underway, that hedge funds are inherently amoral, or that all activists

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[1] Some commentators argue that corporate governance matters most to the new activists, who in their view are seeking to unite dispersed shareholders and serve as their natural champion. See Ronald J Gilson and Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013). In contrast, this article does not view the minimization of agency costs as the ultimate goal of corporate law, but as one that may often be in tension with ethical behavior.

consider only the short-run. Most public companies do behave responsibly (at least most of the time). Nor is it denied that boards should seek to maximize shareholder value over the long-run, even if that implies losses for other stakeholders. Rather, what is contended is that activist pressure tends to curb the board's discretion to (1) plan for the long term; (2) disdain questionable or unethical behavior; and (3) accommodate the legitimate interests of other stakeholders.

In particular, as activist pressure increases, the role of the board as the corporation's superego is gradually marginalized and possibly eclipsed. This term "superego" may seem out of place here, more appropriate to a discussion of Freudian psychology than corporate law and economics. But this article is premised on the belief that the board of the public corporation has traditionally played such a role as the corporate organ most likely to exercise restraint, to recognize ethical limits on profit maximization, and to accommodate other stakeholders. At least until recently, boards at public companies approached decision-making with a distinctive style that was deliberative, collegial, consensus-seeking and at least slightly risk-averse. If a proposed policy or course of action carried legal or reputational risk or would prejudice the interests of other stakeholders, this was a reason for many boards to disfavor it, or at least to exercise caution.[2] Yet, this risk-averse bias was probably grounded on a particular set of relationships among the board, management, and the corporation's shareholders, which relationships have now changed. As a result, not only will more risk be tolerated, but also the very idea of the board as a cohesive, collegial body may be yielding to a different conception of the board as a collection of proxies for specific groups of shareholders. Fragmented and factionalized, such a board would represent a weaker superego (if it still played that role at all).

Discussions of corporate ethics and social responsibility often tend to be more aspirational and exhortative than diagnostic. In contrast, this article seeks to provide an economic foundation for both its critique and its prescriptions. Ultimately, it will offer both a rationale and specific reforms to enhance the

[2] Although the risk of personal liability for a director is remote, this factor probably also contributed to their preference to avoid illegal or questionable acts, particularly in light of the relatively modest economic benefits historically paid to outside directors.

role of the board as the corporation's superego. First, however, we need to examine more closely the new risk-tolerant style of corporate behavior that this article asserts results from changes in the corporate governance environment. As its poster child for "poor" corporate governance, this article will focus in Part I on Valeant Pharmaceuticals International. Then, in Part II, it will attribute its deficiencies and reckless style to three basic transitions in corporate governance: (1) the rise of undiversified institutional investors (chiefly, hedge funds) as the new catalyst of shareholder activism; (2) the appearance of "blockholder" directors as the agents of specific shareholders; and (3) the shift from cash to equity compensation for both officers and directors. Collectively, these transitions are moving us from a system of corporate governance that was board-centric to one that is shareholder-centric. To be sure, other factors—the decline in staggered boards; [3] the growing importance of proxy advisors; [4] the availability of "proxy access,"[5] and SEC deregulation[6]—also explain much of the increase in shareholder activism and have contributed to the shift to a shareholder-centric system. But these developments are themselves the product of shareholder demands for movement toward a more shareholder-centric system of governance. That heightened demand caused institutional holders to resist staggered boards, seek proxy access, and hire proxy advisors as their agents. Part III will offer a short history of corporate governance that uses

[3] In 2000, 300 of the S&P 500 had staggered boards, but as of the end of 2013, only 60 did. See Stephen Davidoff Solomon, "The Case Against Staggered Boards," N.Y. Times Blogs, Dealbook (March 20, 2012); David Benoit, "Clash over Darden Board Will be Measure of Activist Clout," Wall Street Journal, May 23, 2014.

[4] See, for example, Peter Iliev and Michelle Lowry, "Are Mutual Funds Active Voters" (finding over 25% of mutual funds "to rely almost entirely on ISS recommendations")(available at http://ssrn.com/abstract=2145398)(2014). Many mutual funds may make independent decisions, but the strong influence of Institutional Shareholder Services ("ISS"), the principal proxy adviser, seems demonstrated by such data.

[5] Proxy access refers to procedures, adopted usually in response to pressure from activists, pursuant which the corporation permits a defined percentage of shareholders (usually between three to five percent) who have held their shares for a requisite period (usually three years) to place between one and three candidates on the corporation's own proxy statement, thus enabling shareholders to choose among these candidates and the corporation's own slate of nominees. Although proxy access does not enable insurgents to seize control, it does both facilitate shareholder choice and spare the insurgents the cost of mounting a proxy fight to obtain board representation. However, because hedge funds have rarely held their shares for three years at the time they seek proxy access, they are thus required to find allies among longer holding diversified investors in order to exploit this provision. Much debate has surrounded the likely impact of this reform, but it is clearly being widely adopted. EY reports that over the last two years more than a third of Standard & Poor's 500 companies have adopted a "proxy access" proposal, driven largely by shareholder proposals. See EY, "Four takeaways from proxy season 2016," at 1.

[6] For a brief overview of SEC deregulation of the proxy process, see John C. Coffee and Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 41 Journal of Corporation Law 545, 559-561 (2016).

these transitions to segment modern corporate history into three periods. Finally, Part IV turns to how a stronger corporate superego might be developed and protected.

II. Risky Business: The Valeant Story

Few firms have achieved notoriety as quickly as Valeant Pharmaceuticals International.[7] Valeant's basic business model was to buy prescription drugs (or the companies owning those drugs) and then raise the prices of those drugs astronomically—up to 600% or more.[8] Figure A shows this basic pattern:[9]

[7] Valeant came to dominate the news in the latter half of 2015. For representative stories, see Andrew Pollack and Sabrina Tavernise, "Valeant's Drug Price Strategy Enriches It, but Infuriates Patients and Lawmakers," New York Times, Oct. 4, 2015; Joe Nocera, "Is Valeant Pharmaceuticals the Next Enron?," New York Times, October 27, 2015; Jonathan Rockoff, "Valeant Pharmaceuticals Under Investigation by Federal Prosecutors," The Wall Street Journal, October 15, 2015.

[8] To give two examples uncovered by the Committee on Oversight and Governmental Reform of the U.S. House of Representatives:

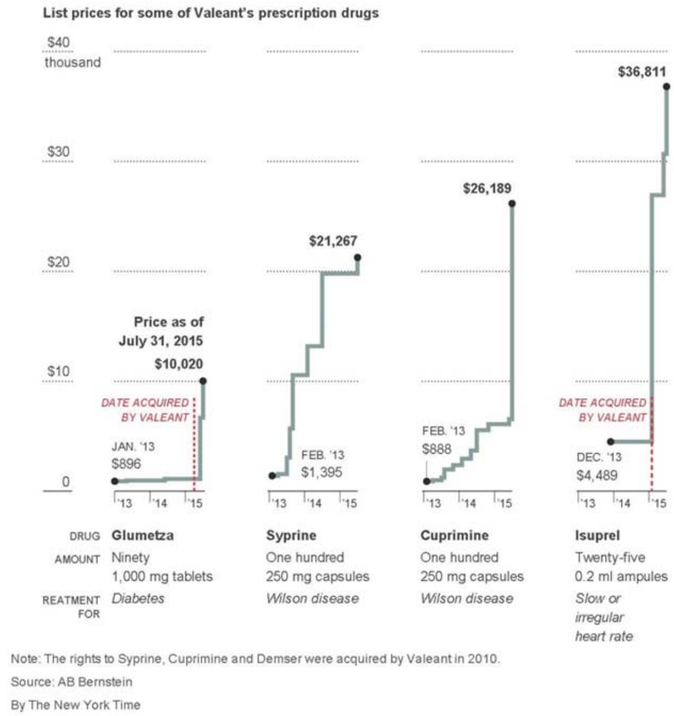
> "In February 2015, Valeant purchases Isuprel and Nitropress, which treat abnormal heart rhythms, congestive heart failure, and hypertension episodes, for $350 million, and increased their prices by 525% and 212% overnight." See Memorandum, dated February 2, 2016, to Democratic Members of the Committee, Re: Documents Obtained by Committee from Valeant Pharmaceuticals" at p. 1 (hereinafter, "House Memorandum")(copy on file with the author).

This House Memorandum went on to state:

> "The documents indicate that Mr. Pearson (Valeant's CEO) purchased Isuprel and Nitropress in order to dramatically increase their prices and drive up his company's revenues and profits…The documents obtained by the Committee demonstrate that Valeant identified goals for revenues first, and then set drug prices to reach those goals. Valeant employed this strategy for both Isuprel and Nitropress, generating gross revenues of more than $547 million and profits of approximately $315 million in 2015 alone."

For even higher percentage price spikes, see infra at note 23.

[9] See "A Drug Company's Price Tactics Pinch Insurers and Consumers," New York Times, October 5, 2015.



When Valeant acquired the entire company, it typically slashed or eliminated the acquired company's own "research and development" budget and spiked prices on its existing product line.[10] Since 2010, Valeant acquired companies with a total value of over $36 billion.[11] Even by this measure then, its "slash and burn" style was reshaping the drug industry. Symptomatically, Valeant was emulating the behavior of activist hedge funds, which characteristically seek in their "engagements" with public firms to reduce the target firm's investment in longer-term projects in favor of maximizing shareholder payout.[12]

Is there anything wrong or unethical about this behavior? If all Valeant did was to raise prices to extraordinary levels to benefit shareholders, some (and most notably, Milton Friedman) would argue that

[10] See Pollack and Tavernise, supra note 7 ("Valeant is known for buying companies and laying off employees to achieve savings, while accumulating a debt of about $30 billion"). These authors further note that Valeant "spends an amount equivalent to only 3 percent of its sales on research and development, which it views as risky and inefficient compared with buying existing drugs" while "traditional big drug companies spend 15 to 20 of sales on research on development.")

[11] See Gretchen Morgenson, "Valeant's High-Price Drug Strategy" New York Times, October 2, 2015.

[12] A major aim of hedge fund activism has recently been to reduce investment by target companies in long-term investments and particularly in "research and development" investments. See Coffee and Palia, supra note 6, at 573 to 581.

managers were under a duty to do so to maximize profits.[13] At first glance, it may seem that Valeant was such a case in which Valeant was simply maximizing shareholder value by squeezing the last penny out of patients and insurers. Yet, why had not the original owner of the drug done the same? On closer examination, Valeant's success owed much to deceptive behavior, particularly involving its undisclosed relationship with a captive online pharmacy company, Philidor Services, which Valeant held an option to buy.[14] Because Philidor would order Valeant's drugs at an inflated price and bill the insurer, the patient may never have learned of the price spike, and the insurer did not know that Philidor was only a sock puppet for Valeant. Thus, the insurer did not demand that a cheaper generic drug be substituted for Valeant's higher priced brand name drug. As a New York Times columnist concluded, Valeant used Philidor "to keep patients from getting generics instead of its high-priced drugs."[15] Although Philidor's seeming independence corroborated Valeant's pricing, it was entirely illusory, as Valeant actually consolidated Philidor's financial results with its own. The relationship between the two firms has spawned a grand jury investigation, and when that investigation was disclosed publicly in late 2015, Valeant's stock price tanked and insurers refused to deal with Philidor.[16]

The point here is that Valeant's hard-nosed, profit-maximizing behavior seems to have involved an element of fraud. Valeant did not simply negotiate a hard bargain with its customers and other stakeholders, but seems to have actually deceived them. When this deception was disclosed, Valeant was disgraced, and its stock price immediately fell by over two-thirds.

[13] Milton Friedman, of course, famously argued that the "social responsibility of business is to increase its profits." See Milton Friedman, "The Social Responsibility of Business is to Increase Its Profits," The New York Times Magazine, September 13, 1970. Many economists would agree with him, but the law's view is more qualified. See text and note infra at note 79. Note also that Mr. Friedman focused on profits and not maximizing the stock price, which goal raises other issues.

[14] See Linette Lopez, "The secret firm at the heart of Valeant's crisis has an alleged history of shady behavior with customers," Business Insider, October 23, 2015; Robert Langreth and Esme Deprez," The Tiny Pharmacy at the Center of Valeant's Money Mystery," Bloomberg, October 29, 2015.

[15] See Nocera, supra note 7. This author opens his New York Times column by observing: "Valeant Pharmaceuticals is a sleazy company." Id. That has been the standard reaction.

[16] See Rockoff, supra note 7; see also Myles Lidland, "Pharma-Giant Valeant accused of fraud, denies it—stock still craters," Business Insider, October 21, 2015. This criminal investigation has recently heated up in 2016. See Jacquie McNish and Christopher N. Matthews, "Valeant Faces Criminal Probe." Wall Street Journal, August 11, 2016 at B-1.

Now comes the two points that make Valeant's story particularly relevant: First, Valeant was the darling of the hedge funds, and was heavily owned and influenced by them.[17] The press has described Valeant as a "hedge fund hotel,"[18] because a number of prominent hedge funds held large stakes in it or even took seats on its board. This herding should not surprise us. Much like the typical "activist" fund, Valeant shunned long-term investment projects in favor of short-term returns. Nor did Valeant see any reason to accommodate the stakeholders who relied on it.

Arguably, one could defend Valeant's conduct on the ground that it was simply seeking to maximize shareholder value and thus gave no quarter to other stakeholders. But here we encounter again the basic dilemma to which this article will return: those firms that most aggressively pursue shareholder wealth maximization often utilize questionable to illegal means. Eventually, as its problems mounted, Valeant was compelled to replace its CEO and change its business model.

Second, at least equally causal of the Valeant fiasco, was its aggressive use of incentive compensation. J. Michael Pearson, Valeant's CEO, received a compensation package, designed largely by ValueAct, a hedge fund and major Valeant shareholder, that paid Pearson only $1 million in cash, but also offered him an assortment of contingent equity awards (stock and options) valued at $16 million.[19] In particular, Pearson received performance stock units that would vest only if Valeant achieved the following three-year compounded total shareholder returns:

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[17] See Julia La Roche, "It's a hedge fund horror show as Valeant gets crushed," Business Insider, October 21, 2015.

[18] As of June, 30, 2015, the following leading activist funds held the following percentages in Valeant's stock:

Pershing Square………..	5.71%
Value Act Holdings……	4.39%
Paulsen and Co………...	2.64%
Lone Pine Capital……...	1.56%
Viking Global………….	1.35%

The total is 15.56% and other activist funds have not disclosed their holdings in Valeant. See La Roche, supra note 17. As of October, 2015, Pershing Square, perhaps the most visible activist fund in the U.S., had lost over $1 billion. ValueAct, another prominent hedge fund, was reported to have lost over $2 billion (as it had held over 5.6% as of mid-2015). See Maureen Farrell and David Benoit, "It's Crunch Time for the Hedge Fund that Helped Build Valeant," The Wall Street Journal, October 26, 2015. For the view that Valeant was a "hedge fund hotel," see VRX, "Valeant Proves to Be A Hedge Fund Hotel Wrecking Ball," VALUEWALK, May 17, 2016 (noting as of this later date that the stock was now down 90% since its price peaked in 2015 and that a long list of funds had finally sold out their positions).

[19] See David F. Larcker and Brian Tayan, "CEO Pay at Valeant: Does Extreme Compensation Create Extreme Risk?" Stanford Closer Look Series, CGRP56 (April 28, 2016) at p.1.

1) 3-year Total Shareholder Return ("TSR") < 15%...0

2) 3-year TSR from 15 to 29%, 407,498 shares vested

3) 3-year TSR return of 30 to 44%, 814,996 shares vested.

4) 3-year TSR > 45 %, 1,222,494 shares vested[20]

Other senior officers received similar awards. Based on this reward structure, Pearson moved quickly to slash overhead, shrink the research and development budget, and move Valeant to Canada (and a reduced corporate tax rate). Although his tactics worked at first, he brought the company under increasing public and regulatory scrutiny, and scrutiny discovered legal and reputational issues. Eventually, the board was forced to conduct an extended review of the company's financial statements and delay their release. Ratings agencies downgraded their ratings on Valeant, and under pressure, Pearson resigned.

All this seems fully consistent with the most basic generalization about executive compensation: executives respond to equity awards (and particularly stock options) by taking increased risk.[21] Such incentive also may incline executives to engage in financial misreporting.[22] At Valeant, extreme incentives produced extreme behavior.

We will later return to these two factors: hedge fund pressure and incentive compensation. In truth, they go together, and Valeant is not a case where shareholder pressure alone pushed the company into illegality. Rather, its managers and its shareholders seem both to have been zealously committed to maximize shareholder value in the short-run, for their own reasons. That made Valeant an ideal candidate for hedge fund portfolios, and the funds herded to buy Valeant. But when, as here, managerial and shareholder incentives to take risk reinforce each other this aggressively, danger looms.

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[20] Id.

[21] See, e.g., Jeff L. Coles, Naveen D. Daniel and Lalitha Naveen, Managerial Incentives and Risk-Taking, 79(2) Journal of Financial Economics 413-468 (2006); David F. Larcker, Gaika Ormazabal, Brian Taylor, and Donald J. Taylor, "Follow the Money: Compensation, Risk and the Financial Crisis," Stanford Closer Look Series (September 8, 2014).

[22] Cristopher S. Armstrong, David F. Larcker, Gaika Ormazabal, and Daniel J. Taylor, The Relation Between Equity Incentives and Misreporting: The Role of Risk-Taking Incentives, 109(2) Journal of Financial Economics 327-350 (2013).

Of course, Valeant is only one example, but it became the role model for the rest of the industry, which, after initially criticizing Valeant, started to adopt its approach.[23] In the wake of Valeant's success and pressure from activists, the pharmaceutical industry at least marginally curbed its traditional emphasis on research and development to move towards Valeant's contrarian business model that disfavored long-term investments. The most recent and much publicized example of such a transition is Mylan, N.V., a major generic drug company. In 2016, Mylan attracted a firestorm of adverse publicity for its decision to spike the price of EpiPen, an emergency treatment for persons with life-threatening allergies.[24] Why did it announce a price spike at a time when this was certain to attract criticism? One only has to connect the dots. In 2014, the Mylan board approved a one-time stock award "that hinged on more than doubling the company's adjusted per-share earnings over a five-year period ending in 2018."[25] Because Mylan was in the mature and low-growth generic drug business, this seemed an unattainable goal. Still, for the company's top five executives, the award was "potentially worth $82 million overall."[26] So incentivized, managers spiked the price of EpiPen, their leading product, in 2016 and tolerated the criticism.

This pattern of incentive compensation producing a tolerance (or even zest) for unethical behavior is not in any way limited to the pharmaceutical industry. The clearest example of rampantly

[23] Although Valeant invented the business model of buying drugs and drug companies to mark up prices, the most aggressive practitioner of this model has been Turing Pharmaceuticals, which marked up the price of Dataprim from $13.50 per tablet to $750 per tablet. Dataprim was described by the New York Times as "the standard of care for treating a life-threatening parasitic infection." See Andrew Pollack, "Drug goes from $13.50 a Tablet to $750 Overnight," New York Times, September 20, 2015. Martin Shkreli, the founder and CEO of Turing, was formerly a hedge fund manager, and has since been indicted on a variety of charges, partly involving his allegedly fraudulent treatment of his own hedge fund investors. Testifying before Congress, the flamboyant Shkreli defended his conduct, saying that all drug companies were now following Valeant's model. Subsequent articles have agreed that he was largely correct. See Robert Longreth and Rebecca Spalding, "Shkreli was Right: Everyone's Hiking Drug Prices," Bloomberg, February 2, 2016. (reporting that a survey of 5,000 brand-name prescription drugs found that the price more than doubled for 60 and at least quadrupled for 20 since 2014). The percentage record was set by Alcortin A, a combination antibiotic and steroid, which soared 1,860 percent over that period. For similar accounts of industry-wide price increases, see "Pharmaceutical Companies Buy Rivals' Drugs, Then Jack-Up The Prices," Wall Street Journal, April 26, 2015; Carolyn Y. Jo
hnson, "As therapies for rare diseases enrich drugmakers, do they pain everyone else?" Washington Post, August 5, 2016 (noting impact of Orphan Drug Act on prices on drugs for rare diseases).

[24] Mylan increased the price of EpiPen from under $100 to $600, and this elicited a barrage of criticism, including a very hostile New York Times editorial. See "Another Drug Ripoff," N.Y Times, August 25, 2016 at A-18 (editorial).

[25] See Mark Maremont, "Mylan Tied Pay to Tough Targets," The Wall Street Journal, September 2, 2010 at B-1.

[26] Id.

fraudulent behavior induced by compensation incentives is supplied by Wells Fargo & Co., one of the nation's largest banks. At least 5,300 of its employees engaged in outright fraud over a five year period in opening an estimated two million sham accounts for customers—without the customers' knowledge or authorization.[27] The Wells Fargo executive with the seeming responsibility for monitoring Wells Fargo's aggressive cross-selling practices was Carrie Tolstedt, the divisional senior vice president for community banking, who supervised the bank's 6,000 retail branches. She announced her retirement just before the scandal broke, taking with her an estimated $124 million "golden parachute."[28] Of course, one executive cannot alone compel 5,300 employees to engage in rampant fraud, and her involvement in the actual fraud has not been established. Still, lower echelon employees apparently feared for their jobs if they did not meet ambitious quotas for cross-selling Wells Fargo's products. Hence, many cheated. But high incentives to those near the top can create unrealistic goals that induce underlings to commit fraud.

This pattern seems destined to repeat itself.

III. What Has Changed in Corporate Governance That Explains a Weakened Corporate Superego?

Many barriers to shareholder activism have recently been downsized or relaxed. For example, staggered boards are today far less common than in the past;[29] proxy advisors (most notably, Institutional Shareholder Services ("ISS")) have reduced the costs of shareholder coordination;[30] broker votes have been restricted,[31] thereby increasing the voting power of those who do vote; companies are accepting

[27] Wells Fargo charged customers at least $1.5 million in fees for these unwanted accounts and additional fees for an estimated 500,000 unauthorized credit cards. See Andrew Ross Sorkin, "The Brazen Shame No One Noticed," New York Times, September 13, 2016 at p. B-1. In 2016, Wells Fargo agreed to pay $185 million for this misconduct to various regulators. 5,300 is the estimated number of Wells Fargo employees terminated over a five year period for involvement in this misbehavior.

[28] See Matt Egan, "$124 million payday for Wells Fargo exec who led fake accounts unit," The Buzz, September 13, 2016 (available at http://money.cnn.com/2016/09/12/investing/wells-fargo-fake-account-exec-payday/). This package was a mixture of shares, options, and restricted stock, and only some of it reflects incentive compensation. But her annual salary was only $1.7 million. By any standard, this is an enormous payment to an executive who was not even near the top of the Wells Fargo hierarchy.

[29] See Coffee and Palia, supra note 6, at 557.

[30] Id at 557 to 559.

[31] Id at 561 to 562. Essentially, by restricting the broker's ability to vote on behalf of retail shareholders who gave the broker no voting instructions, the changed rules reduced the votes from brokers on behalf of retail shareholders (which tend to favor management) and increased the voting power of institutional shareholders.

"proxy access" proposals that simplify the process of direct shareholder nomination of directors; [32] and the SEC has deregulated, reducing the costs of a proxy fight.[33] But these reduced costs would mean little, unless there were shareholders strongly interested in exercising voting rights. Here, there has been an even more important change, as next discussed.

A. The Rise of the Undiversified Institutional Activist

It is conventional wisdom that individual shareholders are "rationally apathetic" about voting (chiefly, because their vote will have little impact on the outcome). To the extent they have any interest, retail shareholders tend loyally to support management. In contrast, institutional investors are different. They value voting more because a relatively small number of them could constitute a voting plurality (particularly if individual shareholders do not vote). In short, the conventional wisdom says that institutions care because they have clout.

All this is true enough, but it misses something very important. Most institutional investors—in particular, mutual funds and pension funds—are diversified, for both legal and non-legal reasons.[34] Many are also "indexed," meaning that they are seeking only to earn the benchmark market return for equity.[35] In either case, they are likely to hold a large portfolio of stocks, with no more than a single digit percentage of their portfolio invested in any one stock. Typically, these institutions are also thinly staffed (either for competitive reasons or simply because an indexed investor does not need much staff to hold

[32] See text and note supra at note 5.
[33] See Coffee and Palia, supra note 6, at 559 to 561.
[34] Mutual funds are regulated by the Investment Company Act of 1940, which bars a mutual fund (with certain exceptions) from advertising itself as "diversified" if it owns more than 10% of the stock of any company. See Investment Company Act of 1990, §5(b)(1), 15 U.S.C. §80a-5(b)(1). Pension funds are regulated by the Employee Retirement Income Security Act (or "ERISA"), 29 U.S.C. §1001 et seq., which mandates diversification. See ERISA §404(c)(1), 29 U.S.C. §1104(c). Only hedge funds stand apart and are free from such an obligation. Hedge funds are also permitted to sell short, while mutual funds are not.
[35] "Index" funds invest in a broad market index and thus are "passive" in the sense that they do not attempt to "beat" the market. They have two advantages that have made them increasingly popular: (1) they charge low fees, and (2) they cannot underperform the market, whereas many "active" funds do underperform. Of course, if an index fund employs a significant staff to focus on voting decisions, it will have higher costs and may be compelled to charge higher fees than their competitors. That would be a poor business model, and so indexed funds are unlikely to invest significantly in shareholder voting, but instead delegate the task to proxy advisors.

the market).[36] These factors affect their voting behavior. Although they do vote (in part because the Department of Labor and the SEC insist that they do so[37]), they are seldom willing to invest much time or resources on specific voting issues at individual companies. Even rarer is a diversified institutional investor proposing specific changes at a specific company.

Diversified investors tend to be most interested in voting on issues of generic significance, which affect multiple companies in their portfolio. For example, they may have a generic position to vote against the poison pill or against deviations from a "one-share-one-vote" rule. Or they may favor "proxy access" or "say or pay" proposals. In general, institutional investors tend only to favor broad goals (such as independent boards or environmental policies on climate change), which apply to many firms and can be formulated in general terms. These investors are less likely to be interested in firm-specific issues that require an ad hoc analysis. For example, they would not initiate a shareholder proposal on the following topics: Should XYZ Corporation sell or spinoff its plastic division? Should it terminate its CEO? Should it elect directors opposed to further investments by XYZ in research and development? These are firm-specific issues, and even the largest institutional investors are unlikely to have a pre-existing position on them or much knowledge about the specific company. If the institution holds several hundred companies in its portfolio, researching and coming to an informed decision on all these issues would be logistically burdensome (and the payoff would be small, even if the policy change benefitted the company).

Although the diversified institutional investor will sometimes vote in favor of a firm-specific shareholder proposal raised by some other investor, it will virtually never initiate such a shareholder proposal itself. When it does vote against management, it is likely because its proxy advisor had

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[36] Little staff is needed, but equally important these firms compete based on low fees (which requires that they be thinly staffed). Professional analysts, most notably Morningstar, Inc., rate mutual funds on their ability to economize on fees and costs, and the published ratings of these analysts are influential in the marketing of mutual funds.

[37] For a brief review, see Coffee and Palia, supra note 6, at 557 to 558. Essentially, the Department of Labor, which administers the ERISA statute, took the position as early as the 1970s that failing to vote shares was a waste of a portfolio asset and implied that the fiduciary was breaching its duty of care. See 29 C.F.R. §2509.94.2 (2016). For the SEC's statement of its policies, see Investment Advisers Act Release No. 2106 "Proxy Voting by Investment Advisers," 64 Fed. Reg. 6585 (2003)(requiring written policies and procedures that are reasonably designed to assure that the adviser votes the shares in the best interests of its clients).

recommended such a vote. Put differently, mutual funds and pension funds tended to be passive owners, except when they face a recurring issue on which they had a general policy. Further, their proxy advisor probably knows that diversified institutions tended to have little interest in firm-specific proposals and thus proxy advisors have less incentive to advance such proposals to them.

Now comes the transition. Even if diversified investors prefer to support only broad, generic proposals, another class of investor has the opposite incentives. Hedge funds typically have smaller portfolios, and they are under no legal obligation to diversify.[38] Activist funds generally hold only a modest number of stocks (and they make large bets on these). Investors in hedge funds understand that they are accepting high risk in return for a hopefully high return. If a hedge fund holds a thin portfolio—say, six to ten stocks—it has every reason to formulate firm-specific proposals about those companies.

Activist funds are an important (and fairly recent) subset of hedge funds. Originally, hedge funds sold themselves to the market on the claim that, through better research and analysis, they could find "high alpha" stocks. In short, they would be better stock pickers. In reality, some lived up to this standard, but most did not. Other hedge funds marketed themselves as "quantitative" funds that sought to exploit market anomalies through the use of complex algorithms. Again, some succeeded, and others failed. Such funds generally also had limited interest in voting. Eventually, however, some hedge fund managers recognized that attempting to outperform the efficient market over the long run was not a viable strategy. Instead of seeking the best stocks (the "super-alphas"), they could much more easily identify mediocre companies, particularly those with low market value to book value ratios—and attempt to force a sale or break-up of these firms. Put simply, the goal was to realize "negative synergy" (i.e., the difference between the value of the firm's assets and its lower stock price). The key attraction of this approach was that it was relatively simple to identify mediocre companies with a high break-up value.

[38] Because a hedge fund is normally exempt from the Investment Company Act under specific statutory exemptions (most notably §§3(c)(1) and 3(c)(7) of the Investment Company Act), such a fund is neither subject to that Act's requirement of diversification or its prohibition on incentive compensation to investment managers.

Nor does this approach offend the efficient market hypothesis, because the hedge fund is not simply a stock picker; rather, it is trying to impose a change on the target firm that alters its value.

Negative synergy had also motivated "bust-up" takeovers at the end of the 1980s, but these had been largely stopped by the advent of the "poison pill" and changes in the Delaware case law on takeover defensive tactics.[39] Ironically, some contemporary activist hedge funds are run by persons who were "bust-up" bidders back in the 1980s.[40] This continuity shows that, while bust-up takeovers could be stopped, activists did not abandon their goal, but changed their tactics and resurfaced as hedge funds seeking to vote out the board and then break up the target. Essentially, these activists knew that, in contrast to a takeover, a proxy fight could not be as easily blocked by target management. When did "activist" hedge funds first seek to launch proxy fights aimed at breaking up a company? Although it is always hard to identify the first of anything, such efforts became clearly visible by 2005.[41] After that point, proxy fights aimed at forcing management to sell or spin off assets began to escalate rapidly.[42]

Hence, by 2010, a company with a low Tobin's Q or a conglomerate structure was a natural target for activist hedge funds. Once the activist fund acquired 5% or more of the target's stock and filed the legally-mandated disclosure (known as a Schedule 13D) with the SEC, this filing elicited a positive and statistically significant market reaction.[43] That, in turn, gave the activist fund the ability to reward its

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[39] In particular, the Delaware Supreme Court's decision in Paramount Communications v. Time Incorporated, 571 A.2d 1140 (Del 1989) reshaped the Delaware law on defensive tactics and suggested that the target's board could "just say no." See also Unitrin v. American General Corp., 651 A.2d 1361 (Del. 1995)(further enabling the target board to resist).

[40] Nelson Peltz, the founder of Trian Fund, a major activist fund, was a leading "bust-up" bidder in the late 1980s, as, of course, was Carl Icahn. See Jonathan Lang, "The Peltz Principle: How Nelson Peltz Gets Results," Barron's (July 4, 2015) (describing his tactics and history).

[41] For the best and fullest study of the appearance of hedge fund activists, see Thomas W. Briggs, Corporate Governance and the New Hedge Fund Activism, 32 J. Corp. L. 681, 685 (2007) (dating the appearance at around 2005). Others place the date a few years earlier, but this dispute need not be resolved here.

[42] Schedule 13D filings by "activist" hedge funds rose from 96 in 2001 to 124, 127, and 148 in 2002, 2003, and 2004, respectively, and then leaped to 237, 269, and 272 in 2005, 2006, and 2007, respectively. See Lucian A. Bebchuck, et al., Pre-Disclosure Accumulation by Activist Investors: Disclosure and Policy, 39 J. Corp. L. 1, 9 (2013).

[43] The most complete study of Schedule 13D filings (which covers some 48,902 initial filings) finds an average abnormal return of four percent on a Schedule 13D filing, but more than seven percent on initial such filings. See Ulf Von Lilienfeld-Toal and Jan Schnitzler, "What is Special About Hedge Fund Activism?: Evidence from 13-D Filings, at 2, 25 (http://ssrn.com/abstract=2506704) (2014); for another study finding a seven percent abnormal

allies, because by tipping its intent to conduct a campaign, it could give its allies a virtually riskless profit if they bought the target's shares before the Schedule 13D was filed. In return, the activist fund might expect loyalty from its allies in the ensuing proxy fight.

Activists do not need actually to break the target company up. It was enough to put the target company "in play" and raise its expected takeover premium. In the case of a bust-up takeover, if the takeover bidder were outbid by a rival, the unsuccessful first bidder could still profit handsomely. Similarly, in the case of a proxy fight, the insurgent could expect a jump in the target's stock price once it filed a Schedule 13D disclosing its ownership of a 5% block or more. The near certainty of such an abnormal gain on disclosure of its stake empowered the hedge fund contestant. Because under U.S. law the hedge fund could under most circumstances lawfully tip other institutions of its plans and anticipate that they would also profit once its stake was disclosed,[44] it held a carrot by which it could assemble a large block of allies, collectively holding a much larger share of the target's stock than it could, itself, afford to buy. This informal association—known as a "wolf pack" in the parlance—often acquires a block that dwarfs the holdings of target management,[45] and this tilted the outcome of the proxy fight in favor of the insurgents, who began to win consistently (nearly 75% of the time in contested proxy battles).[46]

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return, see Alon Brav et al., Hedge Fund Activism, Corporate Governance and Firm Performance, 63 J. Fin. 1729 (2008).

[44] Under Dirks v. S.E.C., 463 U.S. 646 (1983), a necessary precondition to insider trading liability is a fiduciary breach. An insider to the company does breach his or her duty to the corporation when the insider trades on material, nonpublic information. But a hedge fund is typically not an insider and owes no duty to the corporation in which it invests. Thus, under most circumstances, the hedge fund would not breach any duty to the target company or its shareholders by indicating in advance to other funds its intent to file a Schedule 13D or start a proxy fight.

[45] See Coffee and Palia, supra note 6, at 567-568.

[46] In 2014, "activists won a record 73% of battles for board seats in the U.S., up from 52% in 2012." See David Benoit and Kirsten Grant, "Activist Investors' Secret Ally: Big Mutual Funds," Wall Street Journal, August 10, 2015. This article finds that activists won one or more seats at a record 107 companies in 2014.

Why did the target's stock price jump on this disclosure? Various reasons can be offered, but the simplest and most plausible is that the company now had a higher expected takeover premium.[47] If there once was a 10% chance of a takeover at a premium, the disclosure of the insurgent's stake raised that possibility significantly, and the market reacted. One careful study finds that further stock price gains after the Schedule 13D's filing depend on their being a follow-up transaction (either a takeover or a significant divestiture).[48] Although some argue that the insurgents can create value by improving management or supplying new ideas and vision, the evidence to date is to the contrary. A further gain in the target's stock price after the initial Schedule 13D disclosure depends on there being a follow-up transaction.

The development of the "wolf pack" tactic and its ability to enable the participants to engage in informed trading based on material non-public information helps explain the hyperbolic rise in "engagements" by activist hedge funds over the last decade. At the same time, it also shows the close association between higher risk activities and activities of dubious morality (i.e., tipping material nonpublic information). In fairness, some activist funds will not share non-public data with potential allies, but the evidence is clear that many do.

Now, we approach the central issue: If activist hedge funds are replacing traditional pension funds and mutual funds as the primary catalyst in corporate governance, why does this transition imply a shift in the direction of greater risk tolerance? Why might it also imply a greater willingness to engage in unlawful, dubious, or at least morally problematic means?

Here, we need to begin with an important contrast between diversified and undiversified investors in how they compensate their agents. Hedge fund managers are so extraordinarily well compensated that in some years the top five hedge fund managers have earned more than all S&P 500 firms' CEOs

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[47] One careful study finds that the excess returns from hedge fund activism are most closely associated with an activist strategy of forcing the target firm into a takeover. See Robin Greenwood and Michael Schor, <u>Investor Activism and Takeovers</u>, 92 J. of Fin. Econ. 362 (2009).

[48] See Marco Brecht, Julian Franks, Jeremy Grant & Hammes F. Wagner, <u>The Returns to Hedge Fund Activism: An International Study</u>, (http://ssrn.com/abstract=2376271) (2015).

combined.[49] Hedge fund managers are typically compensated under a formula that awards them annually a percentage of the assets under management (usually 1.5% to 2%) plus a percentage of the profit earned (typically 20%, but sometimes even more). This is very unlike the compensation paid to pension and mutual fund managers, which is legally restricted and is typically a fixed percentage of assets under management.[50] Only the hedge fund manager receives a large incentive bonus, and the result is to create a very large incentive to accept risk. Put differently, hedge fund managers profit on the upside but do not necessarily bear much downside risk. Thus, if I get 20% of the profits and 0% of the losses, I am incentivized to accept risk.

To be sure, many hedge funds are run by wealthy managers who have invested most of their own personal fortunes in the fund, and that provides substantial counterbalance. But that is not a universal pattern. Even more significantly, hedge fund managers have indirect incentives. If they are successful, money will flow into their funds, leading to higher future fees. Lim, Sensoy and Weisbach have computed that these lower-visibility indirect incentives are at least 1.4 times as large as the direct incentives from incentive fees and the managers' personal stakes in the funds.[51] When one combines direct and indirect incentives, they conclude that the typical hedge funds manager's wealth increases by $0.39 for a $1 increase in investor wealth—a very powerful incentive, indeed.[52]

Of course, competition is intense among hedge funds, and those who do not succeed will be forced to exit the business. But as Lim, Sensoy and Weisbach observe:

> "The exit option will lead managers to increase the risk of the fund, even if doing so comes at a cost to investors."[53]

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[49] See Jongha Lim, Berk Sensoy, and Michael Weissbach, Indirect Incentives of Hedge Fund Managers, 71 J. of Fin. 871 (2016) (estimate as of 2007).

[50] Hedge funds are unregulated, but mutual fund fees are closely regulated and incentive compensation is largely prohibited to mutual fund managers. See Section 205 of the Investment Advisers Act of 1940 ("Investment Advisers Act"). The SEC does permit a modest level of incentive compensation, known as a "fulcrum fee," but it does not approach the incentive compensation that is paid to unregulated hedge funds.

[51] See Lim, Sensoy and Weisbach, supra note 49, at 871.

[52] Id. at 906.

[53] Id.

They predict that "accounting manipulation or fraud" will occur "more frequently" in the case of younger funds, where the manager can exit with less loss if the manager is unsuccessful.[54]

The point here is not that hedge funds are evil, amoral or dangerous, but that in their "engagements" with public corporations, they will be regularly pushing the firms they engage toward higher leverage and riskier strategies. Because they are today the driving force behind shareholder activism, this implies that activism is increasingly leading to greater risk.

B. The Changing Board: The Rise of "Blockholder" Directors

Classically, nominees for the board of directors of a public company are selected by an independent nominating committee, whose decisions the shareholders usually ratify. The nominating committee of such a company understands that it owes fiduciary duties to all the shareholders, not just to some special subset of them. The style of the public company board was collegial, and consensus was generally sought. That pattern may, however, be rapidly changing.

Although the law remains that directors owe duties to all the shareholders, the new development is the appearance of the "blockholder director"—a director selected by insurgents and typically placed on the board as part of a settlement that averts a proxy fight. Between 2004 and 2012, Gow, Shin, and Srinivasan identify some 824 "activist" directors at public companies who were appointed to the board in response to demands by activists.[55] Of these, 167 were elected in actual proxy contests, and 646 were appointed to the board as the result of a settlement without a contested shareholder vote.[56] This steep ratio shows that companies have learned that it is wiser to settle than to fight. Moreover, of this 824 total, some 346 (or 42%) were "affiliated" in the sense of being a principal or an employee of the activist fund making the demand, while 478 (or 58%) were unaffiliated.[57] Thus, in the case of the 346 "affiliated"

[54] Id.
[55] Ian D. Gow, Sa-Pyung Sean Shin, and Suraj Srinivasan, "Activist Directors: Determinants and Consequences," Harvard Business School, Working Paper 14-120 (June 20, 2014) at p.2.
[56] Id at 29 (Table 2).
[57] Id at p. 3.

directors, such director is probably receiving the bulk of his or her annual compensation from the hedge fund or other institution employing that director, and that obviously makes for divided loyalties. Some of these 824 "activist" directors serve only for a short period, as the firm is being sold or merged as a result of the activists' engagements. Nonetheless, Gow, Shin, and Srinivasan find some 678 activist directors showing up on subsequent year SEC disclosure filings,[58] meaning that they are in office for a continuing period.

Even if we use this lower figure (678), that number represents nearly 97% of the 710 new directors at these firms.[59] The new route to the boardroom appears to be that of serving as the candidate of an activist fund, and the role of the nominating committee is thus being eclipsed.

What does the presence of one or more "blockholder" directors, who made it to the board as a result of pressure from activists, do to board cohesion? My own sense is that in the case of the larger public corporation, the blockholder directors will resemble the other independent directors and will have substantial business pedigrees involving high executive positions or other notable achievements. At smaller firms, however, the blockholder directors will frequently be hedge fund employees, whose loyalty will likely be to their employer. This may well change board dynamics and reduce the collegiality and cohesion of the board. But, to the extent that the board wishes to act in a consensus-seeking manner, a block of two or three such directors seems likely to have real impact and blocking position on many issues.

At least for the immediate future, hedge fund activism seems more likely to grow than to subside. The first half of 2016 saw 306 activist campaigns in the U.S., up from 278 in 2015.[60] The most frequent activist demand was for board representation, and companies generally negotiated a compromise, rather than risk the humiliation of defeat in a proxy contest.

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[58] Id at 12.
[59] Id.
[60] Shirley Wescott, 2016 Proxy Season Review, Alliance Advisors' THE ADVISOR (July 2016) at 1, 10.

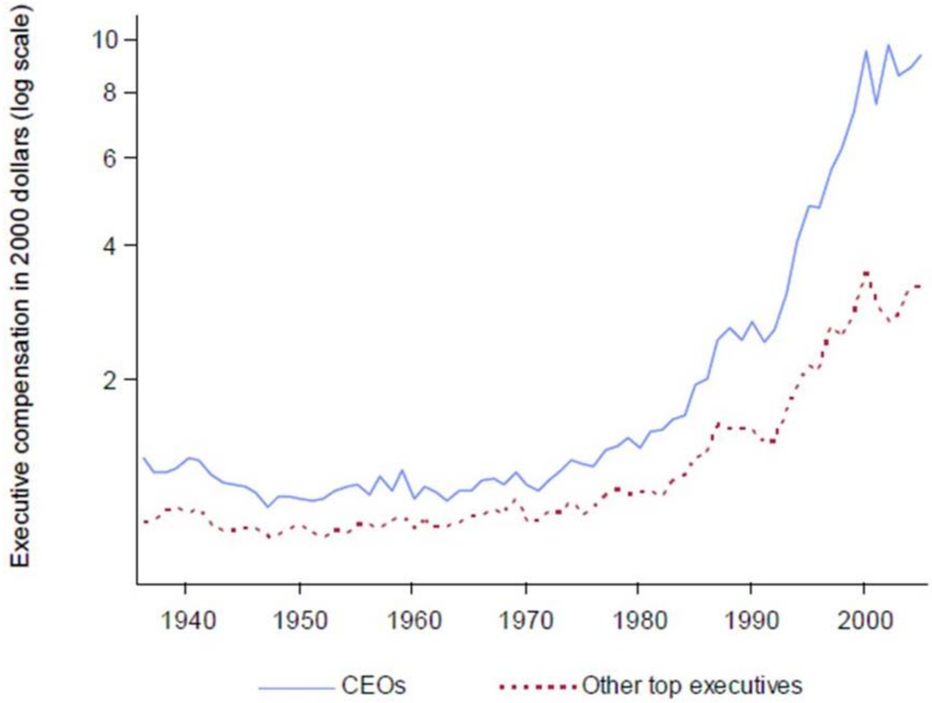
C. The Shift in Executive Compensation: From Cash to Equity

Financial economists and corporate reformers often start with an assumption: Corporate managers will pursue "empire-building" strategies that maximize firm size over profitability, because growth maximization benefits managers personally. The conventional wisdom has long been that maximizing the size of the firm benefits senior managers in at least three ways: (1) Large size usually correlates with higher executive compensation, in part because compensation committees look to compensation levels at the similarly-sized firms that constitute their corporation's peer group; (2) If larger size is obtained through acquiring firms in different industries, this reduces the risk of bankruptcy, as these firms may be co-variant (that is, as the business cycle turns sour for one firm, it picks up for another); and (3) Larger size protects the firm from a hostile takeover, as fewer bidders can afford to acquire it.

This premise that corporate managers favor size over profitability seemed accurate enough in the former era when senior management was compensated largely in cash. But that world is as remote today as "Gone With the Wind's" Tara. To understand the dramatic change in executive compensation, it is useful to start with research by Carola Frydman and Dirk Jenter, which shows that CEO compensation took off, rising astronomically from the late 1980s on.[61] Figure 2 below shows the sudden acceleration:

Figure 2: Median Compensation of CEOs and Other Top Officers from 1936 to 2005[62]

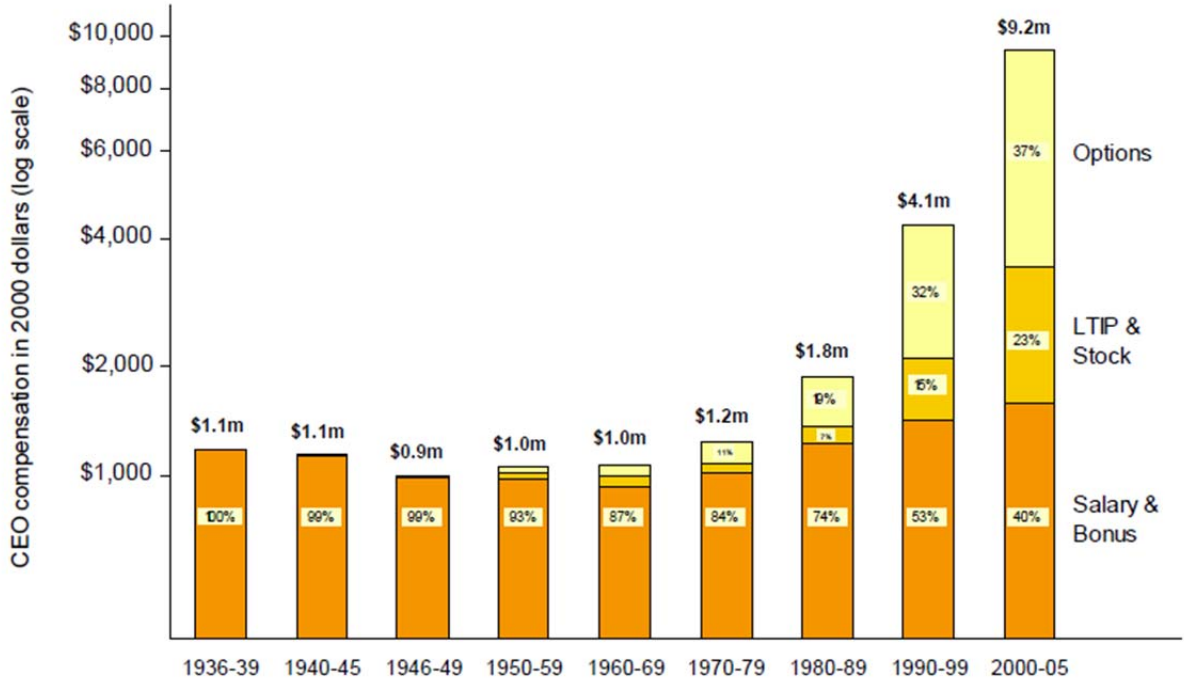
[61] See Carola Frydman and Dirk Jenter, CEO Compensation, 2 Ann. Rev. Fin. Econ. 2:75-102 (2010).
[62] Id at Figure 1.



What caused this sudden rise after decades of stability? The simplest answer is the shift from cash compensation to equity compensation. Frydman and Jenter again chart the change:

Panel A: The structure of CEO compensation from 1936 to 2005[63]

[63] Id at at Figure 2.



As of 2015, Equilar reports that the share of total CEO compensation deriving from equity was 60% (with cash accounting only for 36%) for companies in the S&P 500.[64]

If senior managers are compensated primarily in stock and have much of their wealth invested in their company, they will rationally seek to maximize the firm's stock price. Earlier, we considered the cases of Valeant, Mylan and Wells Fargo, where unethical or even obviously fraudulent behavior seemed linked to incentive compensation. Of course, most executives who receive incentive compensation do not commit fraud. But the likelihood of fraud increases as the amount of incentive compensation at stake grows larger.

Other impacts of this change in compensation are less obvious. Inefficient mergers or mergers in which the acquirer overpays are no longer attractive to managers, because they reduce the stock price.

[64] See Equilar, "2015 CEO Pay Strategies" at p. 9. The remaining 4% of compensation fell into the category of "other." Equally important at S&P 500 companies, the 36% cash component divided into 13% salary and 23% bonus compensation. Id at 10. Bonuses are also a form of incentive compensation that increases the likelihood of risk-taking. This study reports strong trend lines toward greater use of both performance-based stock compensation and bonus compensation. From 2010 to 2014, the median value of performance-based stock compensation at firms in the S&P 1500 index increased 38.1% and bonus compensation rose 12.4%; in sharp contrast, median salaries rose over this same period only by 2.2%. Id at 8.

More importantly, the CEO's interests are now well aligned with those of the hedge fund activist; both want to maximize the stock prize. Given this alignment, the board's ability or willingness to pay its traditional role as the corporate superego may be compromised.

IV. A Short History of U.S. Corporate Governance

The corporate history of the public company in the United States during the 20th century can be grouped into three stages. Of course, not all firms fit this pattern, and we are talking about the largest firms, not start-ups.

A. Stage One: The Managerial Corporation (1920 to 1985)

Dispersed ownership arose first in the United States and later in the United Kingdom. Elsewhere, it has appeared, but it is not the norm. In the U.S., the three most plausible explanations for dispersed ownership are:

(1) A merger wave from 1890 to 1910 combined large corporations into giant firms in response to the Sherman Antitrust Act, which outlawed price-fixing and collusion, but not mergers that created market power. Investment bankers and others saw the advantages (for shareholders) in forming firms that dominated their industry and spared shareholders from "cutthroat competition" between rival firms.[65] The formation of U.S. Steel by J.P. Morgan is one of the clearest examples, as are numerous railroad mergers.

(2) Seeking to encourage retail ownership (and increased business for its brokers), the New York Stock Exchange began a campaign around 1900 to assure investors that firms listed on it were safer and sounder than firms traded elsewhere.[66] To this end, it mandated financial disclosures (such as audited financial statements) that no other exchange had required. Later in the 1920s, some large commercial

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[65] For an overview of this and other theories, see John C. Coffee, Jr. "Dispersed Ownership: The Theories, The Evidence, And The Enduring Tension Between 'Lumpers' and 'Splitters,' in Dennis C. Mueller (ed.), THE OXFORD HANDBOOK OF CAPITALISM (2012) at 463-507.

[66] On the role of the NYSE, see John C. Coffee, Jr., The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. 1 (2001).

banks aggressively marketed stock to their individual clients, particularly focusing on middle class individuals. Eventually, this produced a stock bubble at the end of the 1920s, but before then dispersed ownership had arrived.

(3) The size of the North American continent required immense amounts of capital to build continent-spanning railroads and telegraph and telephone systems. Later, the infant auto industry had similarly large capital needs. Although (as Mark Roe has argued[67]) it is conceivable that banks could have financed these companies' capital needs (as German banks did on a lesser scale), the U.S. banking system was fragmented by the U.S.'s federal structure and possibly also by an aversion in the U.S. to large financial institutions. As a result, U.S. banks remained relatively smaller and more fragmented than their U.K or German equivalents, and it was necessary for growing firms to finance with equity.

Whichever theory is preferred (and all may apply), Adolf Berle and Gardinier Means discovered in 1932 that dispersed ownership had arrived in the U.S.[68] Historically, it developed in various industries sometime between 1890 and 1920. Once share ownership became dispersed, relatively few firms had a majority shareholder. Their absence effectively left management in control by default, and management came to populate a majority of board seats.

How did management use their control? Many have argued that management displayed strong risk aversion during this era. Their careers and fortunes were invested in their firms, and thus they avoided leverage, maximized size (often through inefficient mergers), and, beginning in the 1950s, pursued diversification through conglomerate acquisitions.[69] Such an "empire-building" policy protected managers, and acquisitions created new positions that senior and mid-level managers could assume at the

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[67] Mark J. Roe, STRONG MANAGERS, WEAK OWNERS: The Political Roots of American Corporate Finance (1994).

[68] Adolf A. Berle, Jr. and Gardinier C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[69] For representative studies, all suggesting a tendency towards "empire building," see Oliver E. Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. 323 (1986); Sanford J. Grossman and Oliver D. Hart, "Corporate Financial Structures and Managerial Incentives," in The Economics of Information and Uncertainty, 107-140 (John J. McCall ed., 1982).

new acquisitions. Later, when takeovers appeared, maximizing corporate size also promised relative safety from hostile transactions.

During this era, compensation was mainly in cash. Compensation levels also remained fairly low, possibly because of confiscatory tax rates in mid-Century America and possibly because of the political embarrassment that might result from high CEO salaries during the Depression Era and World War II eras.

Critics of "managerialism" argued that management in this era did not profit-maximize, but only "profit-satisficed."[70] Partly, such a policy reduced risk, but even more, it balanced the interests of various constituencies. Because dispersed shareholders held little power, management was equally responsive to the interests of creditors, employees and local communities—all of whom were likely in closer personal contact with management. Payout to shareholders remained a secondary concern, at least so long as some "satisfactory" increase in revenues could be reported. Late in this era, as stock options came into use, management became more attentive to their company's stock price, but it was only a relative change. Not until 1990 did a majority of the board at U.S. public corporations come to be composed of independent outside directors.[71] Until then, board oversight was probably more nominal than real.

The era of the managerial corporation came to an end in the 1980s, as the result of four interrelated trends:

(1) The rise of institutional investors, who rose from holding only 5% of the shares in the early 1950s to a majority by the end of the 1980s;

(2) The advent of the hostile takeover, which arose in the 1980s and came to focus on dismantling conglomerate firms, largely to realize negative synergy;

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[70] Under the "behavioral model" of the firm, which was first developed by Nobel Laureate Herbert Simon, managers did not "profit maximize," but rather "profit satisficed"—that is, they earned the level of profits that would satisfy their investors and keep them in office. See Herbert A. Simon, A Behavioral Model of Rational Choice, 69 Q. J. Econ. 99 (1955).

[71] See Jeffrey Gordon, The Rise of Independent Directors in the United States, 59 Stan. L. Rev. 1465, 1474 (2007).

(3) Accountability crises in the 1970s, involving foreign and domestic bribery and illegal political contributions, which led to new legislation and demands for majority independent boards; and

(4) The rise of global competition, which in particular challenged the American auto industry, as foreign manufacturers began to produce lower cost vehicles.

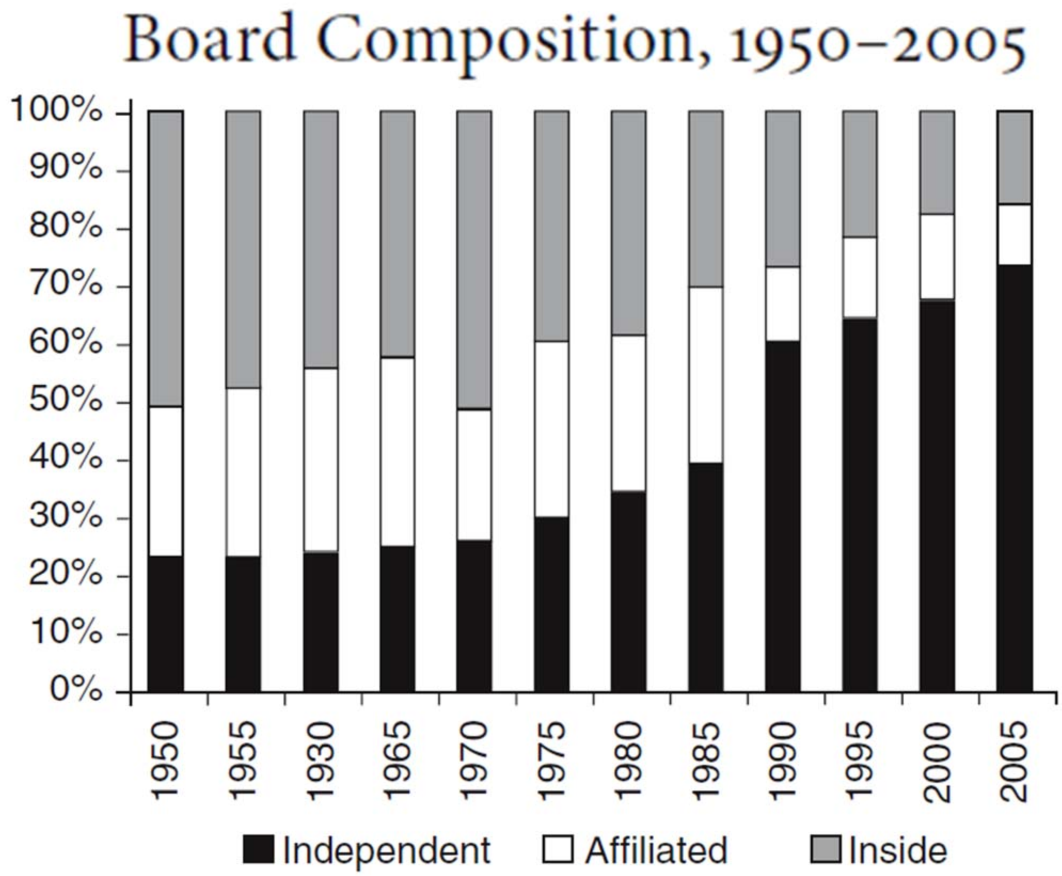
The upshot of increased global competition was to end the cozy alliance between management and other stakeholders, as management realized that it could no longer agree with unions on annual wage increases and pass this cost onto consumers in annual price increases. Instead, it was forced to export plants and jobs extraterritorially. Balancing shareholder and stakeholder interests became more difficult, as profit margins fell and institutional investors began to assert themselves.

B. Stage Two: Passive Shareholder Capitalism (1985 to 2005)

By the mid-1980s, the dominant players in the corporate governance environment were pension funds and mutual funds. Not only did they own the majority of the stock of public firms, but their desire for high liquidity led them to concentrate their investments on the largest firms where they owned even higher percentages (usually 70% or more). Thus, their influence was greatest at the Fortune 500 level.

One impact of their rise was a concomitant shift toward majority independent boards at public companies. This was the type of generalized goal that diversified investors could support because it applied universally and did not require ad hoc analysis. As the diagram below shows, sometime between 1985 and 1990, independent directors came to compose a majority of the board at public corporations:[72]

[72] Id.



Still, by law and by choice, both mutual and pension funds were diversified, and their large portfolios implied little interest on their part in true firm-specific issues. To understand this, imagine that the cost of a proxy fight might be several million dollars and that both mutual and pension funds rarely held more than 2% of the stock of a portfolio firm. Even if that company pursued a highly inadvisable policy, the multi-million dollar costs of such a proxy campaign were likely to exceed 2% of the projected benefits of the campaign. Nor was there any established mechanism for sharing the costs of activism among all shareholders (or even among all institutional holders). To be sure, it was virtually costless to vote "no" on a management proposal or to vote in favor of a proposal brought by some other shareholder (for example, a possible takeover bidder). As a result, activism was largely confined to resisting management proposals and voting with those insurgent proposals that were brought.

Some important developments did occur during this period. The rise of proxy advisors (most notably, ISS) did reduce the costs of shareholder coordination. Also, institutions learned to use SEC Rule 14a-8 to make low-cost shareholder proposals,[73] but these proposals were largely precatory, rather than binding. Thus, institutions could coordinate at low cost to support a shareholder proposal, but these usually related to a broader public policy issue (such as climate change or discrimination) or to broader procedural governance issues (such as separating the CEO and board chair positions). Also, the Delaware Supreme Court ruled at the end of this period that shareholders could not amend the bylaws so as to limit the board's power where the board was itself acting in pursuit of its fiduciary obligations.[74] This effectively seemed to mean that shareholders were largely confined to non-binding, precatory votes on shareholder proposals.

The barrier to greater shareholder activism was not just the high cost of a proxy campaign, but also the thin staffs at both mutual funds and pension funds. Mutual funds competed in terms of their ability to minimize costs (which Morningstar publicly rated), and firm-specific activism required serious and expensive staff work. Private pension funds had little interest in supporting shareholder activism (because it might someday disrupt their own company), and public pension funds, while interested, were chronically underfunded. As a result, shareholder activism that would propose firm-specific changes at individual firms had to await a different champion.

C. Stage Three: Hedge Funds Emerge As The New Catalyst of Shareholder Activism

[73] Under SEC Rule 14a-8, 17 C.F.R. §240.14a-8, a shareholder may place a proposal on the corporation's proxy statement (thus sparing the shareholder the cost of preparing and distributing its own proxy statement), but only if the proposal is considered a "proper subject" for shareholder action under state law. Generally, precatory proposals and certain proposals to amend the corporation's bylaws are considered proper subjects for shareholder action. But see text and note infra at note 74.

[74] See C.A., Inc. v. AFSCME Employees Pension Plan, 953 A. 2d 227 (Del. 2008) (finding that a shareholder adopted bylaw was invalid because it sought to restrict the board's discretion where the board asserted an obligation to act in pursuit of its fiduciary duties).

The phenomena of "activist" hedge funds buying stock in target companies specifically to propose changes in business policies and/or management first became clearly visible around 2005.[75] With this transition, shareholder activism moved from being essentially defensive (i.e., resisting management proposals or compensation) to offensive (i.e., seeking specific actions, such as sales of the company, restructurings, divestitures, major buybacks or, at the least, board representation for the activist). Over a 20-month period from 2005-2006, the first study of hedge fund activism counted some 52 activist campaigns.[76]

The pace soon increased, and the period from 2010 to early 2014 witnessed 1,115 "activist" campaigns.[77] Despite substantial setbacks for some of the best-known activist funds in 2015, the first six months of 2016 still saw a record level of activist campaigns.[78]

Behind this accelerating curve lie some basic institutional differences between mutual funds and hedge funds: (1) Hedge funds are basically undiversified, and most hold relatively small portfolios in terms of the number of stocks held; (2) Unlike mutual funds, hedge funds typically have significant staffs; originally, they focused on finding undervalued stocks, but they are equally capable of identifying firms where management changes might unlock negative synergy or provoke a sale to a new bidder; and (3) Hedge funds employ compensation formulas that incentivize their managers to accept high risk.

These differences quickly surfaced in activist campaigns. Using their larger staffs, activist hedge funds quickly developed a protocol under which they would prepare a lengthy "White Paper," assessing the target company and offering a recommended strategy. Often this paper would be several hundred pages (and supplemented by PowerPoint slides). This both placed the burden on management to respond and allowed the activist to convince diversified institutions that its plans at least justified giving it some minority representation on the board. Because they were not required to contribute to the costs of the

[75] See text and notes supra at notes 38 to 47.
[76] See Briggs, supra note 41, at 685-696.
[77] See Coffee and Palia, supra note 6, at 554-555 (citing various studies).
[78] See Wescott, supra note 60.

campaign, diversified investors were generally happy to free ride on the activist's efforts. Also, to the extent that the target had underperformed the market, diversified investors were sympathetic to some change at the target. "What's the harm?" was their standard question of management.[79] But the presence of even a handful of minority directors did change board dynamics.

The darker side of this new activism involves its reliance on tipping.[80] Either by tipping favored funds of their intentions or by allowing other funds to observe them and infer their intentions, some activists learned to attract pre-announcement allies—some open and some hidden—, which enabled them to assemble larger coalitions of shareholders. Once the "wolf pack" tactic was perfected, hedge funds became far more potent insurgents than any other class of insurgent (other than the hostile bidder) had ever been. Other activists do not tip allies in advance of public disclosure, but the practice seems widespread.

The bottom line then is that the world looks bright for hedge fund activists; as they have many advantages. Activists can economize on their costs, and they use a proxy fight only as their weapon of last resort. Negotiations are conducted in the shadow of such a hostile option. Unlike the hostile bidder, who could be halted (at least for a time) by the poison pill, the activist hedge fund can outflank that defensive stratagem. By assembling a de facto coalition that could not be described as a "group" under the SEC's definition of that term, they escaped the reach of the poison pill, which usually limited how much stock a "group" could acquire.

Further, the activist fund could profit in ways that the hostile bidder could not. It did not need to seek control; rather it could seek only to put the target "in play" for another bidder to acquire. Acquiring itself a far smaller stake than a hostile bidder, it needed less capital, and it could also bail out more

[79] The author has been so advised by multiple investment bankers active in this field who have been so advised by institutional investors that they lobbied.

[80] See Yu Ting Forester Wong, "Wolves at the Door: A Closer Look at Hedge Fund Activism," (http://ssrn.com/abstract=2721413)(2016). This author finds that lead activists do appear to tip their favorite trading partners prior to the public disclosure of the filing of the Schedule 13D and that this practice accounts for a sizable "wolf pack" that owns a substantial percentage of the target's stock and thus increases the lead activist's probability of success.

quickly (and at a profit) if it saw little hope of the target being acquired. Finally, by seeking board representation, it could seek to itself run (or at least influence) the auction for the target, turning the acquisition from a hostile bid into a much safer "friendly" one.

In short, given these advantages, it should be little surprise then that activist campaigns continue to increase.

V. Activism and Social Responsibility

Much (but not all) of the academic literature on hedge fund activism applauds its rise, because many academics see the underlying corporate governance issues as involving only the familiar tensions between managers and shareholders.[81] To be sure, their interests do conflict, and arguably activism has reduced agency costs. But it is myopic to stop there. Other stakeholders have interests that are also placed at risk by hedge fund activism. The clearest example is probably creditors. Much evidence shows that creditors do foreseeably lose when activists begin to gain control, because hedge fund activism typically results in greater leverage and thus an uncompensated increase in risk for existing creditors.[82] Accordingly, creditors have incentives to adopt measures that protect themselves and even to pay concessions to shareholders for such protections (as we will see shortly). In the case of employees, the evidence is a little less clear, but some studies show that activism does result in reductions in the firm's total number of employees.[83] More speculative is the impact of activism on other, more inchoate constituencies, such as customers and local communities, but Valeant certainly provides one illustration of a case where those interests were also injured. Ultimately, the real difference between these latter

[81] See e.g., Gilson and Gordon, supra note 1; Lucian Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005). But see William W. Bratton and Michael L. Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653 (2016).
[82] See April Klein and Emanuel Zur, The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders, 24 Rev. Fin. Stud. 1735 (2011); April Klein and Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187 (2009).
[83] See Yvan Allaire and Francois Dauphin, The Game of Activist Hedge Funds: Cui Bono? (2015)(available at http://ssrn.com/abstract=2657553) (finding a 2.5% average reduction in employees after an engagement).

constituencies and creditors is that non-creditor stakeholders have less ability than creditors to contract with the corporation and embed protections in their agreements.

Some will reply: "So what? It is management's duty to pursue the interests of shareholders only and maximize share value!" Actually, that overstates by a wide margin. Both Delaware cases and other authoritative commentaries recognize that the board can make reasonable provisions for the interests of other stakeholders.[84] No case or statute has ever insisted the board is under a duty to maximize share value (at least in the short run). Still, even if the board can consider the interests of other constituencies, boards under the pressure of activist funds may be less able or willing to do so.

In this light, what principled positions exist that explain why the board should be able to protect other stakeholders when their interests conflict with those of shareholders? Even more importantly, how can such a principled position be reflected in realistic policies that can be effectively implemented? This section will consider two possibilities.

A. Efficient Contracting: How the Board and Stakeholders Might Contract

Imagine that some creditors negotiate a contractual protection with the corporation that protects them from what they see as opportunistic behavior by hedge fund activists and that the result is to increase corporate cash flow without reducing the value of the firm. This outcome is exactly contrary to

[84] Even in the face of a lucrative takeover bid, the Delaware Supreme Court has ruled in its famous Unocal decision that a target board may take defensive measures based on a concern for "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees and perhaps even the community generally)." Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 955 (1985). This is a clear recognition that the interests of stakeholders may be considered, even when it may cost shareholders a significant gain.

The American Law Institute has generalized this position in Section 2.01 ("The objective and conduct of the corporation") of its PRINCIPLES OF CORPORATE GOVERNANCE (1994), which is its restatement-like effort to codify the law of fiduciary duties. Initially, its states in Section 2.01(a) that "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain." But then it adds the important qualification in §2.01(b) that:

> "(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation in the conduct of its businesses… may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business;"

In short the board of Valeant could decide, consistent with its fiduciary duties to shareholders, that it was irresponsible to spike the price of a life-saving drug by 500%.

what academics with a tunnel vision focused on manager/shareholder conflicts predict will happen. In their view, any such contractual protection is simply a disguised takeover defense, which entrenches management and therefore must reduce the value of the firm.

But the latest evidence seemingly contradicts the standard academic view. In two recent papers, Professors Griffith and Reisel study a recent contractual innovation in corporate debt securities known as "Dead Hand Proxy Puts" that has clearly been designed to deter hedge fund activism.[85] Technically, the Dead Hand Proxy Put updates a standard "change of control" provision in loan agreements and bond indentures that provided for acceleration of corporate indebtedness upon certain defined "changes in control" to include a new triggering event: the election of nominees of hedge fund activists to a majority of the positions on the corporation's board. Further, in order to cover the now typical scenario of directors being added to the board as the result of a settlement with these activists, the provision expressly provides that this acceleration provision cannot be waived by the board (and this makes the put a "dead hand" provision in the parlance because it is beyond the power of the board to modify).

At first glance, this sounds like an anti-takeover defense. But now add a key fact: creditors reduce the cost of credit to corporations that adopt Dead Hand Poison Puts. In their study, Griffith and Reiser examine a sample of bank loans from 1994 through 2014 and find that the reduction in loan spreads was statistically significant.[86] The cost of debt was reduced by approximately 60 basis points, and the authors estimate that the average annual saving in interest costs for the corporation was $22 million per year.[87] Moreover, not only does the Dead Hand Poison Put reduce the cost of borrowing to the corporation, but the adoption of such a provision did not result in any reduction in the firm's stock

[85] See Sean J. Griffith and Natalia Reisel, "Dead Hand Proxy Puts, Hedge Fund Activism, and the Cost of Capital," (http://ssrn.com/abstract=______(June 2016)(hereinafter, "Griffith and Reisel I"); Sean J. Griffith and Natalia Reisel, "Dead Hand Proxy Puts and Firm Value: Efficient Contracting in the Shadow of Hedge Fund Activism" (Working Paper, July 2016)(hereinafter, "Griffith and Reisel II").
[86] See Griffith and Reisel I at 26-27.
[87] Id at 27. The authors acknowledge that this $22 million estimate involves a "rough calculation."

price, thereby demonstrating that shareholders suffered no loss.[88] Thus, this seems a win/win bargain for both creditors and shareholders, as the former receive needed protections against a possible future danger and shareholders get cheaper credit.

Griffith and Reisel view the use of this innovation as an example of efficient contracting.[89] Creditors and managers have struck a good deal for both shareholders and creditors that mitigates the possibility of future opportunistic behavior by activists. Nonetheless, the Delaware courts have been skeptical and have suggested (but not yet held) that the adoption of such a provision may amount to a breach of the board's fiduciary duty.[90] As a result, Dead Hand Proxy Puts are more used outside of Delaware. Griffith and Reisel report that during 2015, 103 corporations incorporated outside of Delaware adopted such provisions, while Delaware companies adopted 48 such provisions over the same period—a more than 2:1 margin.[91]

Delaware's skepticism may reflect the same myopic obsession with protecting shareholders from management entrenchment that characterizes much of the academic literature on corporate governance. Both miss the possibility that the board can play an umpire-like role, protecting stakeholders without damaging shareholders by reducing firm value.

But only some stakeholders can contract efficiently with the corporation. In the case of creditors, Griffith and Reisel find that although loan agreements contained Dead Hand Proxy Puts, bond indentures seldom did—even though bondholders also benefitted when such a provision was inserted into the

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[88] See Griffith and Reisel II at 37-38. In fact, they find that "shareholders react positively to the filing of loan contracts with Dead Hand Proxy Puts" and that "this reaction is statistically significant at the 5% level and, in the case of median raw equity returns, at the 1% level." Id at 38.

[89] Griffith and Reisel II at 42 to 49.

[90] In at least three recent decisions, the Delaware Court of Chancery has suggested that Dead Hand Proxy Puts may breach the fiduciary duties of the management that adopts them. None of these decisions has, however, so held on the merits. See San Antonio Fire & Police Pension Fund v. Amylin Pharm, Inc., 983 A. 2d 304, 307-08 (Del. Ch.), aff'd, 981 A. 3d 1173 (Del. 2009); Kallick v. Sandridge Energy, Inc., 68 A. 3d 242, 261 (Del. Ch. 2013); Pontiac General Employees Retirement System v. Ballantine, C.A. No. 9789-VCL (Del Ch. Oct. 14, 2014).

[91] Griffith and Reisel find that, during 2015, Delaware-incorporated companies adopted 48 Dead Hand Proxy Puts while companies incorporated elsewhere adopted the provision 103 times. See Griffith and Reisel II at p. 57.

corporation's loan agreements.[92] They explain that bond indentures lack such a provision because there was no feasible way for the bondholders to waive them (while the banks in loan syndicates could easily waive them and often did so in return for an appropriate fee).[93]

This difference frames a key question: if the board can mitigate conflicts between stakeholders and shareholders in a way that deters activists but does not reduce firm value, should the board be more broadly authorized to do so, even when the compromise cannot be embedded in a formal contract? To move beyond the simpler case of creditors, should the board also be able to make a commitment to its employees that may benefit the corporation (by assuring labor tranquility or cheaper wages) and that does not reduce firm value, but does deter activists. In principle, the answer should be yes, and the answer should not turn on whether the deal can be set forth in a formal contract. But such an answer does require enhanced judicial review to make certain that stakeholders have a legitimate interest and that both sides actually benefit (or at least that the intent was to achieve such an outcome). A mere business judgment standard of review would not be adequate to this task. Still, Delaware has long followed the Unocal standard, which requires the board in adopting an antitakeover measure to show both a "threat" to corporate interests and a response that was "reasonable" in relation to that threat.[94] Under such a standard, Dead Hand Proxy Puts should regularly survive judicial scrutiny.

To sum up, this section has argued that if some stakeholders can legitimately contract with the corporation to protect themselves from the adverse consequences to them of an activist takeover, the board should be able to act on behalf of those other stakeholders not in a position to contract. But the test should look to whether the board is mediating a conflict between stakeholders and shareholders in a way that can be expected to benefit the corporation.

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[92] Griffith and Reisel I at 16-17.

[93] Id at 6 (explaining that dispersed bondholders cannot feasibly waive defaults under an indenture, while creditors under loan agreements can because they do not face coordination or legal problems in waiving defaults). Thus, because loan creditors can and do waive defaults in returns for a fee, both sides can benefit.

[94] See Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946 (Del 1985). For the suggestion that Unocal's "intermediate" standard of reviews should apply to Dead Hand Proxy Puts, see Griffith and Reisel II at 50-53.

B. Looking for the Beneficial Owners' Voice

Let's return to the Valeant fact pattern and assume that a hypothetical drug company has purchased an established drug for $10 million and can mark up its price by 500% so that it earns a $20 million return on its investment within two years.[95] Assume further that no fraud or deception is involved, and, on these facts, this clearly is not a case where efficient contracting could enable both sides to realize reciprocal benefits. Here, our hypothetical firm expects to make a bonanza, but only if it spikes the drug's price.

To ethicists, such behavior is amoral at the least. But what is the appropriate answer to those, who, like Milton Friedman, insist that the corporation is under a duty to maximize its profits for shareholders?[96] Technically, there may in fact be no such legal duty to maximize profits (at least over the short run[97]), but that response does not answer how the board can justify not favoring its shareholders' interests.

How can the board justify foregoing this profit? The best answer may be that the board believes that its own shareholders on normative grounds would not want the firm to deal this harshly with its customers. But how can we say this when institutional investors are buying the stock of our hypothetical firm precisely because this strategy is so profitable? Here, we come to the key point: these intermediaries (pension funds and mutual funds mainly) are themselves agents, and not the ultimate investor. Do these intermediaries adequately represent the true interests of these funds' beneficial owners? All that can be fairly said is that we do not know. Our contemporary system of corporate governance relies on agents to implement the investors' right of franchise. Agents monitor agents: the board monitors management, and institutional shareholders monitor the company's board. But who monitors the agents at institutional shareholders who make voting decisions on behalf of their beneficial owners? The short answer is that no

[95] Why is this possible? Various reasons can be given, including that the seller may have been a corporation with a strong corporate superego that would not mark up the drug's price 500%, but would sell the drug to other firms. Or the selling firm may just have simply feared the adverse publicity that Valeant received.
[96] See Friedman, supra note 11.
[97] See text and note supra at note 84.

independent outsider does this. In that light, one can question whether these agents' decisions truly reflect the views and values of the ultimate beneficial owners.

Even if this question cannot be answered with confidence, some evidence points to a likelihood that the two groups (agents and ultimate owners) have very different attitudes. Although there is relatively little research on values and social attitudes in corporate governance, one important study surveyed all the directors and CEOs of public companies in one country (Sweden).[98] It found strong differences in the values and beliefs between directors committed to "shareholderism" and directors favoring "stakeholderist" stances, but it further observed that even directors personally favoring "stakeholders" found themselves under strong role pressure to vote instead in favor of shareholders.[99] Other studies have similarly reported that directors often feel trapped by their traditional legal responsibility to the shareholders.[100] The fact that directors favor shareholders over stakeholders (even with misgivings) will surprise few. At the pension fund level, however, it seems more anomalous that those who vote on behalf of pension funds favor shareholders over stakeholders because the actual beneficiaries of pension funds (i.e., employees) may be logically more stakeholder-oriented than shareholder-oriented.

Should the pension fund's trustees and agents, representing employees, behave differently than other institutional shareholders and show greater loyalty to stakeholders? Legally, this is a complicated issue. Traditionally, trustees are not required to follow instructions from beneficiaries (at least where the beneficiaries are not unanimous), and trustees must act in the "best interests" of their beneficiaries.[101]

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[98] See Renee B. Adams, Amir Licht, and Lilach Sagin, "Shareholderism: Board Members's Values and the Shareholder-Stakeholder Dilemma" (http://ssrn.com/abstract=1118664)(2009).
[99] Id at 18-19 (when faced with specific cases, both stakeholder-oriented and shareholder-oriented directors tended to side with shareholders, believing it was their legal duty to do so).
[100] Based on an extensive survey of directors at S&P 400 firms, Lorsch and MacIver find that directors often feel trapped by their assumed legal responsibility to shareholders and therefore subordinate stakeholder interests to shareholder interests. See Jay Lorsch and E. MacIver, PAWNS OR POTENTATES: The Reality of America's Corporate Boards (1989) at 49.
[101] For a thorough review of the fiduciary duties applicable to trustees in connection with institutional investors' adoption of "socially responsible investing," see Benjamin J. Richardson, Fiduciary Relationships for Socially Responsible Investing: A Multinational Perspective, 48 American Business L. J. 397 (2011); see also, Cynthia A.

Still, in determining the "best interests" of the beneficiaries, commentators agree that trustees may consult with their beneficiaries, may consider prevailing social customs and values, and, based on them, may decide to avoid "socially controversial activities posing financial risks to their portfolios."[102] This has provided the justification for trustees to engage in "socially responsible investing" and to disdain investing in certain industries. It is but a small step to move from trustees investing in a "socially responsible" fashion to directors running the company in the same fashion, giving at least some weight to the preferences of the beneficiaries. On this basis, the directors of a Valeant are certainly authorized to deviate from the goal of shareholder wealth maximization in their conduct of the business when they sense reputational or legal risk.

Nonetheless, the fact remains that the agents throughout our corporate governance system favor shareholders over stakeholders, particularly in the United States.[103] Many tend to vote exactly as ISS or other proxy advisors recommend,[104] and ISS's commitment is clearly to "shareholderism," and not the stakeholders. In fairness, ISS does not make the rules; rather, it responds to its constituents' preferences. Behind these preferences lies a professional culture, shared by both pension fund trustees and proxy advisors, that demands loyalty to shareholders.

This article, therefore, submits that those controlling the voting behavior of large institutional investors have preferences and values that probably are not well aligned with those of their beneficial

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Williams and John M. Conley, Corporate Social Responsibility in the International Context: Is there an Emerging Fiduciary Duty to Consider Human Rights?, 74 U. of Conn. L. Review 74 (2005).

[102] See Richardson, supra note 101, at 639.

[103] Although research has been limited, some empirical research finds that pension fund advisers and trustees place "little weight" on the views of the fund's beneficial owners. See Richardson, supra note 101, at 630. Here, U.S. firms may be particularly conservative. Corporate boards at public companies in the U.S. tend to be far older, more male-dominated, and have been in office much longer than in Europe. See Stephen Foley, Jenifer Bissel and David Oakley, "Male, Stale, and Frail," Financial Times, August 16, 2016, at p. 7 (finding the average U.S. board to be 85% male and its members to be twice as likely to be over 65 and to have been in office longer than their European counterparts). The implication of such data is that U.S. boards are likely more conservative and more shareholder-oriented than boards at corresponding companies in Europe. Interestingly, a major effort is now underway in the U.S. to purge boards of aging directors and to establish term limits. See Jennifer Bissel and Stephen Foley, "Alphabet and Berkshire boards targeted over veteran directors," Financial Times, August 22, 2016 at A-1. Whether such a shift would imply greater empathy for stakeholders is speculative, but seems likely.

[104] See sources cited supra at note 4.

holders (particularly in the case of pension funds). Put differently, it seems unreasonable to believe that the ultimate beneficial holders lack any normative views and would impose no limitation on the pursuit of profit maximization (even if that is how their agents vote). The behavior of a Valeant would shock most (but probably not all) beneficial owners. Still, even if this premise is correct, where does it lead us in policy terms? In theory, one could pass the voting rights at the pension fund through to the beneficial owners, but as a practical matter, such a "pass through" is entirely infeasible and would be a radical change. Not only would it be costly, but most beneficial owners will have even less interest in voting on most issues than the retail shareholder (who is generally assumed to be rationally apathetic).

Possibly, less drastic measures may be feasible. Directors could attempt to learn the preferences of beneficial owners and use it as a justification for resisting pressures from activists. For example, the target corporation might attempt to reach the beneficial owners in an attempt to influence the actual pension fund directors. To give an illustration, assume that the board and management of a large corporation that is being challenged by activist funds attempts to reach (through the media) the beneficial owners of CalPERS in order that their protests might deter CalPERS directors from voting for the funds' nominees. Would that work? Or would it backfire? No one really knows today, but this is the one leverage point that has not yet been exploited. Conceivably, pension funds could form advisory committees of their beneficial owners to review and monitor their voting behavior. This would, however, require recognition of this misalignment, which is still a tension more repressed than recognized.

At a minimum, however, corporate boards can justify acting as a corporate superego on the ground that they believe their company's ultimate investors want them to behave in this fashion. The premise here is only that beneficial owners share the values of their society. Although this is a sound normative argument, the problem is that it does not protect such directors from ouster by activist funds that disagree.

To sum up, the great anomaly in corporate governance today is that institutional investors (and particularly pension funds) vote and behave as if they (1) had little or no interest in normative issues about the behavior of their portfolio companies, and (2) were systematically pro-shareholder and anti-stakeholder. Yet, their beneficial owners likely have very different preferences. This tension is softened and ameliorated to the extent that corporate boards can act as the firm's superego, but the survival of that role is in question.

C. Strengthening the Corporate Superego

Public corporations are required to have adequate internal controls, but this idea has not been taken very far in terms of implementation. What more could be done? Consider the following measures:

1. The corporation's chief legal officer could be made to report directly to the board (or its audit committee).[105] The outside auditor already does so by virtue of the Sarbanes-Oxley Act, and the idea here would be to insulate the chief legal officer from managerial pressure (either to ignore evidence of illegal or fraudulent conduct or to fail to report it to the audit committee). So insulated, the chief legal officer could not be terminated by the CEO, but only by the board.

2. All corporate officers and employees could be subjected by a corporate bylaw or policy statement to an obligation that they report credible evidence of misconduct, illegality or fraud to the audit committee. Today, Federal law only prohibits retaliation against whistle-blowers, but nothing typically compels the employee to be an internal whistleblower and report misconduct upward within the company.[106]

[105] For a fuller discussion of this and related proposals, see John C. Coffee, Jr., The Attorney as Gatekeeper: An Agenda for the SEC, 103 Colum. L. Rev. 1293 (2003).

[106] One modest qualification is needed here. SEC's rules do require an attorney "appearing and practicing before the Commission" "who becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of issuer" to "report such evidence to the issuer's chief legal officer" (and, if necessary, to its audit committee). See Rule 3 ("Issuer as Client") of the SEC's "Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer," 17 C.F.R. 205.3. Adopted shortly after the time that Sarbanes-Oxley was enacted, these rules appear to have been rarely, if ever, enforced by the SEC.

3. The corporation could even offer financial rewards to the employee who reports to the audit committee. From a practical and hard-nosed perspective, the corporation might be willing to do so because it prefers that a whistle-blower goes to it, rather than to the Government. Records would need to be kept internally as to the information received and the responses made to it.

4. Periodic legal audits could be required to review the company's legal exposure. Such audits would report to the audit committee not just whether the law had been violated, but where the company had the greatest exposure to future legal problems. Again, this would be costly, but here the Bar, eager for the business, would probably be supportive.

The net effect of these measures is hard to estimate and could be modest, but it would change the functional activity of the audit committee, moving it from simply a monitor of financial performance to a more investigative body. To be sure, it would be costly, but involvement in crime is ultimately even more so.

D. Corporate Governance and Structure: Possible Reforms

A number of commentators have announced their diagnoses that hedge fund activism has pressured public companies into an excessive focus on the short-run, and they have then proposed a variety of reforms.[107] A notable example is Colin Mayer, who would recognize a new specialized "trust corporation" that would limit liquidity and effectively require long-term holding.[108] Although this approach might well work, it comes at a high price for institutional investors in terms of the necessary sacrifice of liquidity. Probably, the closest "real world" equivalent to Colin Mayer's "trust corporation" is the new "public benefit corporation," which expressly identifies the purposes other than shareholder gain for which the corporation is founded and authorizes the board to balance between the interests of

[107] For representative examples, see Iman Anabtawi and Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255 (2008); Lynne Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 J. of Corporation Law 264 (2011); William Bratton and Michael Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653 (2010).

[108] See Colin Mayer, FIRM COMMITMENT: Why the corporation is failing us and how to restore trust in it (2013). Colin Mayer coins the term, the "trust firm," for an entity that would limit its voting rights to longer term shareholders in order to create "a degree of insulation from excessive influence of short-term shareholders." Id at 211. He does not suggest that all firms would or should adopt this model.

stakeholders and shareholders.[109] Currently, over 4,000 such "public benefit" corporations exist in the U.S., but none are publicly traded at this point.[110] Thus, although some firms would opt into the model that Colin Mayer has proposed, they will likely represent only a relatively small fraction of all U.S. corporations.

In this light, it makes sense to ask: what are the less drastic means of encouraging longer term holding by institutional investors, thereby discouraging brief in-and-out "raids" by activists who hold for only a short period? Two means merit consideration: One is to amend the tax laws to raise the marginal rate applicable to the short-term holding of securities.[111] This involves a host of issues concerning tax law that are beyond the scope of this brief article. A second route (and one that does not require legislation) is to adopt some form of tenured voting under which short-term holders receive lesser voting rights per share than longer-term holders.[112] This is a more palatable alternative to dual class capital structures (which give absolute control to the senior class), but it is probably also unlikely to win support today from contemporary institutional investors. It would work, however, to the advantage of diversified institutional investors (who often are indexed and tend to be longer-term holders). Activists could still win control, but first they would have to convince the diversified (and longer-term) investors to vote for them: Also, under tenured voting systems, the wolf-pack would no longer be an effective weapon for activists.

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[109] A "public benefit" corporation can, for example, specify that it has been created to help cure a specific disease and plans to devote 50% of its earnings to that purpose. Since 2010, some thirty states and the District of Columbia have passed legislation authorizing for-profit "public benefit corporations." The board of directors is typically directed to consider specified "stakeholders" on an equal basis with shareholders (or otherwise to determine the relative weight to place on their interests). See Stephen Glover, Lisa A. Fontenot, and Harrison A. Korn, "Gibson Dunn identifies a Corporate Paradigm Shift: Public Benefit Corporations," The CLS Blue Sky Blog, August 22, 2016; see also Note, Sustaining the Sustainable Corporation: Benefit Corporations and the Viability of Going Public, 104 Geo. L.J 171 (2015) (analyzing Delaware public benefit corporations).

[110] See Glover, Fontenot, and Korn, supra note 109, at 1.

[111] For example, capital gains taxation could be conditioned on a two or three year holder period. In truth, many hedge funds already pay taxes at ordinary income rates on their securities transactions, because they do not hold for even six months. But even the ordinary income rate could be raised for certain types of income.

[112] Tenured voting involves the award of additional votes to shareholders based on the duration of their share ownership. See David J. Berger, Steven Davidoff Solomon, and Aaron Jedidiah Benjamin, "Tenure Voting and the U.S. Public Company" (available at http://ssrn.com/abstract=27040538 (2016)) (analyzing legality of such systems under U.S. law.) Others would simply deny voting rights to short-term holders. Arguing that "tourists don't vote," Yvan Allaire has advocated for a minimum holding period of at least one year before shareholders should be allowed to vote. See Yvan Allaire, "Good Versus Bad Capitalism: A Call for a Governance Revolution" (2003) (available at http://ssrn.com/abstract=2274412). A number of Japanese companies give additional votes to longer holding shareholders.

The bottom line is that, although numerous governance changes could deter short-term activists, few are likely to be adopted today. The search for remedies needs to look elsewhere.

E. Compensation Reforms

Earlier, it was argued that incentive compensation leads to increased risk-taking and reduced law compliance.[113] Much theory supports this, and Congress recognized it in principle in the Dodd-Frank Act by restricting risky incentive compensation at "too big to fail" banks.[114] But what can be done outside that limited context? Congress is unlikely to regulate compensation, as corporate governance has traditionally been seen as a matter for state regulation. Possibly more disclosure and comparative analysis could be required. Credit rating agencies could also be compelled or induced to consider this factor in rating the firm's debt securities. Optimists may believe that other companies will also learn from Valeant's example and avoid creating compensation formulas that invite disaster. Nonetheless, one must be skeptical here about the likelihood of significant reform.

VI. Conclusion

We have moved, or are at least moving, from a board-centric system of corporate governance to a shareholder-centric system. For our purposes, this recognition has two major implications: (1) Corporations may be less law compliant and more risk-tolerant in this brave new world; and (2) Stakeholders are increasingly exposed to loss from short-term activism.

This new reality that constituencies other than shareholders may desire (and need) judicial protection poses a considerable challenge for courts, which have long focused almost exclusively on shareholder protection.[115] The traditional judicial rationale for this attitude of shareholder primacy was

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[113] See text and notes supra at notes 19 to 22 and 51 to 54.
[114] See Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (restricting "unsafe and unsound compensation practices" at financial institutions above a specified size).
[115] Others have made this point before me that courts should be more sensitive to shareholder/creditor agency problems in the new shareholder-centric world. See Edward B. Rock, Adapting to the New Shareholder-Centric Reality, 161 U. Pa. L. Rev. 1907 (2013).

that only the dispersed and largely powerless shareholders truly depended on the board, while other constituencies could protect themselves by contract or other protections. That rationale was always overstated, but today it makes even less sense. Fearing real injury, stakeholders will today offer improved terms if they can be protected from prospective opportunism. Dead Hand Proxy Puts provide an example of such bilateral negotiations that improve the positions of both sides. Yet, many other stakeholders cannot similarly so contract. Here, it still may be in the corporation's long-term interests to protect such exposed stakeholders from opportunistic behavior. Thus, when courts view new devices skeptically (such as the proxy put[116]) because they believe their first obligation is to protect shareholders from managerial entrenchment, these courts may be revealing an outdated understanding of contemporary corporate governance.

In the last analysis, can ethicists and economists agree on much? Certainly, agreement should be possible on two points: First, ethical failures are often the product of perverse incentives embodied in compensation formulas that overly reward risk-taking. Second, from an ex ante perspective, it is wiser for the board to engage in efficient long-term contracting with other stakeholders than to permit shareholders to exploit ex post every opportunity on which stakeholder interests can be subordinated to shareholder interests. But, even assuming agreement on these two points, neither takes us that far toward a satisfactory resolution. Also, a third area where agreement should be possible has more pessimistic implications: In the absence of structural or governance reforms that today seem unlikely, collisions between the ethical course and the economically value-maximizing course are increasingly predictable.

If that is true and if we wish the board to play the role of corporate superego, how do we justify the board assuming such a role and rejecting Milton Friedman's edict that boards should maximize profits for shareholders? Phrased differently, how does one answer the claim that it is anti-democratic and elitist for the board to substitute its own moral values for those of its shareholders? The short answer is that no one knows the actual preferences of the ultimate beneficiaries because our existing system of agents

[116] The Delaware courts have to date been skeptical of these proxy puts. See text and note supra at note 90.

keeps them hidden. We live today in an age of "Intermediary Capitalism," in which beneficial ownership is divorced from any voice in the firm.[117] In response, the board can and should be able to act on its believe that it is representing the views of a "silent majority"—i.e., the company's ultimate beneficial holders at pension and mutual funds.

Once one postulates that there is such a silent majority (or, more simply, that short-term activists do not truly represent all the shareholders), the more the board becomes entitled to define its role as a counterbalancing force and to take a normative perspective. The real issue is not whether the board should play such a superego role, but whether it can effectively do so in a world where the shareholders can today more easily remove the board than in the past. The answer here is in doubt and may ultimately depend on whether diversified investors come to recognize that their interests are not always well aligned with those of activist investors. That will be a continuing story.

The bottom line is that ethics and the economic goal of shareholder wealth maximization will remain in tension, with activist hedge funds exacerbating the friction. But, there are ways—limited to be sure—of mediating this conflict if courts will view their role from a wider perspective that sees more than shareholder interests at stake. For the long-run, however, governance reforms (such as tenured voting and restrictions on incentive compensation) may be the better answer.

Realists will answer that most of the reforms discussed above are not feasible in at least the short-run. Perhaps they are not, but, if so, the problem of the diminished corporate superego seems likely to get worse, before it gets better.

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[117] I borrow this term "Intermediary Capitalism" from Paul H. Edelman, Randall S. Thomas, and Robert B. Thompson, Shareholder Voting in an Age of Intermediary Capitalism, 87 S. Cal. L. Rev 1359 (2014) (approving recent developments in voting by institutional investors).