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TOWARD COMMON SENSE AND COMMON GROUND? REFLECTIONS ON THE SHARED INTERESTS OF MANAGERS AND LABOR IN A MORE RATIONAL SYSTEM OF CORPORATE GOVERNANCE

Keynote Address

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Dear friends, it's a pleasure to be here in Iowa. One of my childhood heroes has been visiting you all a lot lately. In my current job, it would be improper to speak his name or of my continued high regard for him and his willingness to speak seriously, candidly, and expertly about the important issues facing our nation. But if you think of my home state and if I tell you that he inspired my hairstyle, you just might make a pretty good guess. After all, each of you made the *Journal*.

As my chronological age has caught up with my hairline, I have become more uncertain about virtually everything. This convictional plasticity is, I admit, not entirely new. I've always been suspicious of absolutism and unexamined truths.

But my distrust of dogmatism has grown deeper during my career as a lawyer, nearly all of which has been spent in public

service. In that career, I have been fortunate. During my time in the political world, I was privileged to work for an electorally courageous and policy savvy governor, Thomas R. Carper of Delaware. Governor Carper was a new democrat before the term was invented, a fiscal conservative deeply committed to economic and educational opportunities for the poor. The secret of Governor, now Senator, Carper's success is his willingness to eschew the politics of labels and to pursue progress through patient dialogue. As Governor Carper's counsel and policy director, it was my job to help him bring democrats and republicans together around an aggressive agenda to, among other things, reform Delaware's educational and welfare systems. Typical of Governor Carper, those reforms combined stringent accountability standards (which appealed to conservatives) and generous funding for new services (which appealed to liberals). The formulation and implementation of policies along those lines was challenging, as it required the affected constituencies to compromise long-held beliefs about means in order to advance common ends. But the inclusive manner in which Governor Carper proceeded earned him respect from the contending interests and enabled him to advance an agenda that addressed his most important objectives for our state.

When I was fortunate enough to join the Court of Chancery, one of my first assignments was to mediate a case pending before

Vice Chancellor Lamb. He knew that I had forged legislative policy deals for Governor Carper and thought I might have a knack for mediation. He was right to perceive that the achievement of political compromise and the successful mediation of lawsuits demand similar skills. Both require an understanding of the concept of face, the recognition that everyone must leave the process having preserved their dignity and self-respect. Likewise, both require that the person putting together the deal has a keen eye for where the concentric circles overlap and tries to build on the issues that draw the parties together rather than those that divide them.

The art of principled compromise requires thoughtful consideration of the contending arguments and a willingness to ponder new ways of doing business with an open mind. Listening is essential. Avoiding the easy use of words like “always” and “never” is crucial, lest self-drawn lines in the sand inhibit solomonic agreement.

But the political and litigation worlds are also similar in a more regrettable way. The incentives for those who deliver arguments in the political and litigation contexts often cut against these well-understood requirements for facilitating compromise. In the political context, advocates preach to the converted and shout over their adversaries. In the litigation context, advocates whose extremism in argument drives judges

crazy have lucrative practices because there are clients who believe that they are best served by rabid pit bulls. Too often, the voices that we hear the loudest are those who profit, not from solving problems through constructive engagement, but from fostering the righteous outrage of those who pay their bills.

Within the comfortably narrow ideological boundaries of our over 200-year-old republic, few of the key questions we confront today come in black or white. Yet, much of American public rhetoric is finger-painted in those colors for the pre-schoolers we citizens are assumed to be. The television talking head shows of today make the William F. Buckley John K. Gailbraith debates of the 1970s seem Aristotelian, both in substance and in age. Snarkasm from the paid talking heads, and canned bullet points from the elected officials, spew forth in a ceaseless, head ache creating cacophony. This style of argument has crept into litigation, and too many briefs eschew nouns and verbs for pages and pages of adjectival and adverbial assault.

Given these factors, it’s not surprising that the so-called corporate governance debate has many of these tired features. Exaggeration is the norm; conversation the exception. I have no intention today of characterizing the arguments of the contending forces, to summarize the relative perspectives of, for example, the Business Roundtable and the Council on Institutional Investors.

Rather, my goal is a more constructive one that will put to use some of the modest skill I have developed in identifying areas of common concern that might draw together seemingly contending interests. In particular, I intend to focus on the common corporate governance interests of those who manage American corporations and those who labor at less elevated levels for those corporations. In doing so, I accept as a reality that management and labor now derive much more of their economic wealth than they used to from the equity they own in the corporations for whom they toil and the stock market more generally. Therefore, both management and labor share an interest in the vitality of American equity markets. At the same time, I also accept the notion that most American workers obtain the bulk of their wealth from their labor and that even most top American managers can trace their wealth (including the equity they have accumulated) to their labor as executives. Therefore, both management and labor might be thought to have more concern than trust fund babies or investment bankers do for the continued ability of American corporations to support domestic employment. Likewise, both management and labor are likely to view a public corporation as something more than a nexus of contracts, as more akin to a social institution that, albeit having the ultimate goal of producing profits for stockholders, also durably serves and exemplifies other societal values. In

particular, both management and labor recoil at the notion that a corporation's worth can be summed up entirely by the current price the equity markets place on its stock, much less that the immediate demands of the stock market should thwart the long-term pursuit of corporate growth.

With this crude overview in mind, I will divide the remainder of this address into two parts. The first will address some of the major factors that are buffeting American corporations, and putting pressure on both management and labor. The second part will identify some areas of common concern, which might fruitfully serve as a focal point for a constructive conversation between management and labor on mutually advantageous corporate governance initiatives that might be in the national interest. I'm going to dive in, starting with some of the key reasons public companies are taking a rough ride on top of life's mosh pit right now.

Forces Buffeting American Public Corporations

Forced Capitalism

Since the advent of capitalism, an ocean of ink has been spilled over the contending interests of capital and labor. In the early stages of capitalism, capital providers and the managerial class were virtually indistinguishable. As Berle and

Means most famously described, the emergence of the public corporation created a separation between the providers of capital (sometimes denominated in simple terms as owners) and those who managed public corporations. But for many decades it could be safely assumed that those at the top echelon of American corporations largely shared the interests of those who provided the capital. Neither the owners nor the managers were "labor," and relatively few Americans owned material amounts of corporate equity. Defined benefit pension plans, social security, and bank saving accounts constituted the methods by which most working Americans sought to secure themselves in retirement.

As we know, those days are long gone. For most of you who go to work in the private sector, access to a defined benefit pension plan will not be an option. More likely, you will be provided with an employer-provided supplement to contributions you make to a 401(k) plan. In order to provide for yourself in retirement, you will be required to make monthly investments. If you are acting rationally, you will make consistent contributions, in up and down markets, and do so through intermediaries, who invest your money for you. If you are acting with the most rationality, you will invest in index funds, which hold broad baskets of securities and bonds reflecting the opportunities and risks faced by the market, recognizing that it

is nearly impossible to pursue an active trading strategy that will beat the market over time.

As a result of these changing dynamics, most ordinary Americans have little choice but to invest in the market. They are in essence “forced capitalists,” even though they continue to depend for their economic security on their ability to sell their labor and to have access to quality jobs. These forced capitalists—in whose number I count myself—invest primarily for two purposes, both of which are long-term in focus: to send their children to college and to provide for themselves in retirement. This class of investors has no interest in quarter-to-quarter earnings fluctuations or gimmicks that deliver quick bursts of cash at the expense of sustainable growth. These investors want corporations to focus on fundamentally sound policies that generate durable earnings through the sale of high-quality products and services. Stock crashes and bankruptcies flowing from fraudulent and imprudent schemes to prop up stock prices cost these investors dearly, as their funds ride these issuers’ stocks down to zero, until the stocks are taken out of the relevant index.

For powerful reasons, this class of investors invests in the market primarily through intermediaries. It is these intermediaries, and not the forced capitalists, who determine how the capital of these investors is put to work and how the

mountain of shares owned for their benefit is used to influence the management of public corporations. Given the directional momentum of public policy in the United States and Europe, the inflow of funds from forced capitalists to these intermediaries is likely to continue to increase.

Shrinking Equity Returns and the Mountains Of Money in the Markets

Indeed, huge amounts of money are sloshing through the world's equity markets. This and other factors have led to diminished return expectations for equity investors in general, and a corresponding interest in investing activities that promise outsized returns.

Interestingly, some of the demand for outsized returns has come from institutional investors—such as public pension funds—facing actuarial risks because of underfunding and past investment mistakes. These investors hope that placing a portion of their portfolios in aggressive investments that promise high returns will help them close the gap. Also influential in this mix is the success some prominent investors—notably some of the Ivy League universities—have enjoyed by employing active investing strategies to produce returns that beat the overall market.

Combined with the persistent irrationality of many investors, these factors have created a fertile environment for money managers raising capital on the promise of high returns. Oddly called “hedge funds”—a term rooted in the management of risk—a good number of these funds seek to generate super-sized returns by putting pressure on public companies to change their managerial policies. These funds are under pressure to generate short-term results, in no small measure because their investors only entrust their capital for some discrete number of years and because the managers take gobs of compensation up-front from the capital they deploy for their investors. Two relatively standard pressure plays, both of which have existed for decades if not generations, are common.

The first is to see if a public company can be put into play. Amusingly, this often involves action by activist hedge funds to encourage a public company to accept an acquisition by another class of money managers seeking outsized returns, the private equity funds. We’ll come back to them again later.

The other standard play is to encourage the public company to deliver some form of immediate value to its stockholders, through increased dividends or, even better from a hedge fund’s perspective, a hefty stock buy-back program. Often, the target must take on greater leverage or decrease its capital expenditures to fund these initiatives. The impact of such

initiatives upon short-term and long-term investors can be very different, as the benefits are immediate and the risks come to roost down the road.

The Corporate Governance Industry

Another factor contributes to the potency of activist investors—an odd new business sector. It is comprised of the strange admixture of public pension fund administrators, proxy advisory and corporate governance ratings organizations, corporate law scholars, and business journalists who profit in monetary and psychic ways from corporate governance tumult. To say that these folks profit from tumult is not a normative argument; it is a positive claim.

For many of these “corporate governance” experts, the peaceful generation of profits by public corporations would be disconcerting, as it would make their reason for existence suspect. For those public pension fund administrators who view themselves as watchdogs for investors, the generation of shareholder proposals serves to justify the costs invested in their employment. And the continued generation of such proposals helps the proxy advisory organizations, by making it even more attractive for money management firms to outsource their shareholder voting decisions to these organizations in order to

reduce costs and comply with ERISA mandates for informed voting (mandates that the corporate governance industry helped to stimulate in the first place!).

Corporate law scholars dig the tumult because shareholder activism gives them an opportunity to turn their ideas of the moment into shareholder proposals with a real-world, if putatively precatory, effect. As important, the business press loves a dust-up, and often turns to academics for stentorian quotes. All in all, it's pretty heady stuff for otherwise obscure public pension fund administrators, employees at corporate governance ratings firms, and even Harvard professors to get to sound off in the *Economist*, *Business Week*, *The Wall Street Journal*, or the *New York Times* about the obstinance of a public company's CEO and board of directors.

And, in fairness, the continuous stream of shareholder proposals has generated a good deal of business for management-sided lawyers, proxy fight firms, and in-house corporate governance executives. These advisers help corporations address the proposals and, more proactively, manage their "relationship" with the corporate constituencies that generate them. Many of these management-side advisers have bought into the idea that "corporate governance" is an important end in itself, and have employed accommodationist strategies that implicitly validate

that notion and thereby the outside constituencies who advance shareholder proposals.

Academic and Journalistic Laziness

As any American law student who has taken corporations knows, American corporate law scholarship since the New Deal has been preoccupied with addressing the agency costs that arise from the separation of ownership and control exemplified by public corporations. The laboratory rats for this aspect of social science continue to be operating corporations that make money by selling products and services. The inertial direction of this scholarship has, as a general matter, always been toward greater constraints on the discretion of corporate management and more direct influence by stockholders. As a normative matter, it is often argued that the stockholders, as the residual claimants of the corporation, are the group best able to keep management honest and focused on increasing the value of the corporation. Therefore, for many influential scholars, the more tools and the more opportunities stockholders have to influence corporate policies, the better. Restrictions on takeover defenses are not enough; there must be the opportunity to unseat directors without even nominating opposing candidates. Unseating directors is not enough; stockholders need to be able to adopt specific policies that management must implement. Even the many scholars who debate the utility of this approach to corporate governance share something critical with their rivals: the home field for the debate.

As much as corporate law scholars fetishize the agency costs that flow from the separation of ownership and control in operating companies, they have been amazingly quiet about the "separation of ownership from ownership." What I mean by that is that the equity of public corporations is often owned, not by the end-user investors, but by another form of agency, a mutual fund, or other institutional investor. It is these intermediaries who vote corporate stock and apply pressure to public company operating boards. I daresay that more American stockholders own equity in Fidelity- and Vanguard-controlled mutual funds than own stock in Microsoft or GE. But corporate law scholarship does not reflect that reality.

The same corporate law scholars who would belittle the argument that the Wall Street rule is a sufficient protection for public company stockholders accept that argument as a good one when it comes to mutual fund investors. Admittedly, the scholars would say that the ability of mutual fund investors to get their money out at net asset value whenever they want gives them a protection that the stockholders of operating companies do not have. But that retort seems hollow. The net asset value of my mutual fund simply reflects the market value of its investments, most of which are in the stock of publicly traded operating corporations. As important, the idea that investors have more real choice in mutual fund investments than they have

in operating company investments is hardly self-evident. Likewise, it would be passing strange if corporate law scholars truly believed that professional money managers would, as a class, be less likely to exploit their agency than the managers of corporations that make products and deliver services.

Nonetheless, the corporate law scholarship of the last 25 years obsesses over the agency costs of operating company boards, particularly in the mergers and acquisitions context. Little of it considers that the “empowerment” of stockholders does not empower end-user investors so much as it empowers intermediaries. Even less of it considers the political science of empowerment and the divisions that exist within the institutional investor community. Most corporate law scholars have not burdened their minds with the fact that undifferentiated empowerment of these so-called stockholders may disproportionately strengthen the hand of activist institutions that have short-term or non-financial objectives that are at odds with the interests of individual index fund investors. That proxy fights and derivative suits against money management boards are virtually unheard of under the “Business Trust” statutes that are prevalent in the governance of mutual funds is accepted by corporate law scholars with equanimity. But these same scholars claim the much greater number of such fights and suits against the board of operating companies is grossly

insufficient and a justification for reforms in the corporation law governing operating corporations.

The dearth of academic interest also flows from the relative difficulty of writing about institutional investors. Because public companies must disclose huge amounts of information about themselves, they are easy to study. Institutional investors are much harder to probe.

And let’s face it, mutual and pension funds are simply not as interesting as operating companies. Operating companies actually make things. They employ a lot of Americans. They have public faces. We are used to them being the focus of the key questions.

Compounding these problems is the reality that they affect the financial press even more than they affect academics. Tenured professors have the freedom to pursue projects that take years of tedious spadework. Financial journalists do not and often look to the academic community for inspiration.

There has probably never been a time when academic corporate lawyers have been more influential than they are now with the financial press. Ironically, that influence remains directed at the management of operating corporations, precisely when the traditional Berle-Means paradigm has fundamentally changed in favor of stockholders. No longer are the equity holders of public corporations diffuse and weak. Instead, the

equity holders of public corporations represent a new and powerful form of agency, which presents its own risks to both individual investors and more generally to the best interests of our nation. Academic and journalistic inertia are weakening the power of centralized management and ignoring the dangers of this new form of agency.

“Professional” Independent Directors

For much of the last 40 years, corporate law reformers have sought to increase the independence of corporate directors from top corporate managers, and to constitute corporate boards that are more accountable to stockholders. These “monitoring directors” are often idealized as platonic trustees, who are well-positioned to protect the best interests of the stockholders and corporate constituencies without worrying about their own personal self-interest.

Many of the reforms adopted in the wake of the Enron and Worldcom scandals involved mandates for corporate boards to undertake certain duties only through directors who meet newly strengthened definitions of independence. As a practical matter, these time-intensive functions and new definitions have influenced the typical composition of a public company’s board of directors. In order to meet all the functional mandates,

corporate boards need a large number of independent directors. Because of tightened, non-contextual independence standards, executives affiliated with industry partners or management have to take on a federally endorsed label of “non-independent” in order to serve, regardless of the expertise they might bring to bear on the ordinary decisions that regularly occupy top management. Increasingly, boards are comprised of one person who knows everything about the company and who has an intense interest in its future—the CEO—and nine or ten other people selected precisely because they have no possible interest in or connection to the company that might cause them to be perceived as conflicted—or that might cause them to have any genuine concern for the corporation’s future.

Many of these independent directors derive important elements of their net worth from board service. Because they have no real ties to any particular company, but a great deal of interest in their own futures, these directors are not anxious to incur the wrath of institutional investors and those who advise them. They fear that if they oppose an initiative to get rid of a takeover defense at company *X*, they will face withhold campaigns at companies *Y* and *Z*. With power dynamics changing toward activist institutional investors, independent directors who wish to remain in the game will seek to avoid the ire of ISS, the business op-ed commentators at the *New York Times*, and

so forth. Even active CEOs who serve on other corporate boards are subject to these pressures. The worst thing that a public company CEO can do is find himself the subject of bad press because of his resistance to a stockholder proposal directed at another company on whose board he sits. That unwanted attention could result in proposals directed at the company he manages on a daily basis, upsetting his board and distracting from his pursuit of the company's business strategy.

For public company CEOs, these dynamics often mean that one has a board that is less equipped than it used to be to provide strategic advice, is pre-occupied with the completion of a long list of legal mandates, and is motivated and empowered to employ advisers who often urge and procure acceptance of the most cautious and costly method of addressing any risk, however trifling. Perhaps as important, these boards are anxious to compromise whenever the institutional investor community rattles toy sabers. Rather than trustees willing to sacrifice their offices over matters of principle, independent directors increasingly look more like elected officials, who rationalize away compromises in conviction on the basis that the good produced by their continued service justifies the accommodation of sub-optimal proposals when that is necessary to avoid electoral defeat. Better to get rid of the classified board, the poison pill, the plurality vote, and so on and so forth, than to

face a withhold campaign or proxy fight that could really do harm.

The Globalization of Capital and Product Markets Without The Globalization of Externality Regulation

It now seems quaint that workers in the Midwest and the northeastern United States used to fear wage competition from non-union labor in the South. Political scientists once fretted over the incentives individual American states had to compete with each other by lowering the standards expected of corporations in order to attract jobs, fearing that the self-interest of states acting in isolation would undermine the greater good of the overall republic. Nearly as quaint are fears over competition from workers in Japan, which from any global perspective, is a progressive, wealthy nation with well-paid workers.

Now, the doors of the United States and Europe have been opened wide to products and capital from every corner of the world. The hurly-burly of capitalism has been globalized. But something else has not.

In the United States, Europe, Japan, and other developed nations, it was long ago realized that the unrestrained operation of private sector commercial activity was

unacceptable. Businesses did not internalize all their costs; to the contrary, disregard for the environment and the mistreatment of labor were as much the market rule, as the exception. The developed world therefore developed requirements for the responsible conduct of business, which restricted environmental degradation, protected the safety and dignity of labor, and ensured minimum wages and maximum hours. Along with those requirements, governments implemented social safety nets, designed to make sure that decent levels of housing, health care, education, and nutrition were available to all their citizens. Put in simple terms, there was a recognition that although market competition was a powerful force for the creation of societal wealth, its excesses and limitations had to be addressed if the optimal social outcomes were to result.

For what now seems to be a fleeting moment, it seemed that the West had hit upon an ideal balance, which left sufficient room for capitalistic dynamism while creating enviable standards of living for ordinary working people and historically unprecedented protections for the poor. Although the balance struck was not identical in each nation, the similarities in approach far exceeded the differences.

As we move deeper into the 21st century, this balanced approach is under extreme pressure. American corporations now face competition from nations whose economic and social

conditions are far different than our own. Within these nations, it is possible to engage in business conduct that violates widely accepted legal standards in the West, and that sinks even deeper beneath the normative floor the West sets for the ethically and socially responsible conduct of corporate affairs. That reality confronts American managers with ethically complex challenges.

It is frustrating enough to confront domestic competitors who employ “full-time part-time” workers and off-load the costs of their employees’ health care needs onto others. It is even more difficult to compete with businesses who locate operations in nations without functioning environmental standards, without protections for labor, and where the prevailing wages for skilled labor make the American minimum wage look generous. Although possible to rationalize as giving opportunities to the very poor in the developing world, the decision to confront such competition by off-shoring also frequently involves the knowing decision by a manager to hire labor under terms and conditions he would not want his children to endure.

The increased potency of institutional investors and their desire for measures to enhance stock price have put intense pressure on corporate managers to take cost-cutting measures. These measures—e.g., downsizing, off-shoring existing jobs, concentrating new job growth in low wage labor markets, or

limiting domestic wage and benefit growth—drive a wedge between labor and management. Indeed, as CEOs strive to and are rewarded for pleasing the equity markets through cost-cutting measures, they may face the most withering outrage from middle managers, who are expected to do more with less at the workplace and who face greater insecurity in employment, at the same time as they've seen CEO pay soaring to unprecedented levels. Who wants to bet whether most of Lou Dobbs's audience wears a white collar?

Despite High Wages, CEOs Are Not Enjoying Their Jobs

But middle managers are not the only ones feeling insecure. CEOs themselves face greater prospects of termination.

Not only that, CEOs don't seem to be having fun. Having to explain to employees why the corporation is off-shoring jobs and increasing the employees' share of health insurance costs, having to be lectured by a twenty-something analyst about a penny miss in the quarterly earnings, and having to consider at board meetings cosmetic measures to improve the corporation's corporate governance ratings lest the corporation be subject to an array of shareholder proposals—these are really fun things to do. Add to that the increased focus on regulatory compliance arising out of the scandals of the turn of the century. Then top

it off with a high level of public cynicism about CEO pay and integrity. Put it all together and being a public company CEO isn’t what it used to be.

For that reason, it should not be surprising to see CEOs seeking solace in high pay or, more recently, in the loving arms of private equity buyers. Ironic though it is, private equity investors are now viewed as the nurturing providers of patient capital compared to the public equity markets. Through an alliance with private equity, top managers can give the public stockholders an exit premium, avoid the quarter-to-quarter earnings madness, make a boatload of money for themselves upfront, off load the need to deal with professional independent directors who constantly fret about ISS and the business press, lower their own public profile, and hope to at least chart a course for the enterprise by which progress is measured over years rather than months. Hence, the current wave of MBOs, which take large public companies private.

These and other ingredients have cooked up a volatile stew of discontent. Workers and ordinary investors feel that CEOs are selfish and taking outrageous pay at a time when other Americans are economically insecure. Independent directors are scared and weary, bending under the pressure of being the fulcrum between management and stockholder activists and under the weight of their post-Sarbanes-Oxley regulatory workload. CEOs feel

embattled, disrespected, and subject to the short-term whims of the stock market, institutional investors, regulators, and even their own now more politically independent directors.

I'm not naïve enough to believe that there is any corporate governance agenda that will eliminate these feelings; many of them arise out of larger economic trends well beyond the influence of corporate law and, as important, out of the natural clash of interests among labor, management, and investors. But I do perceive that there are important areas of common concern where management and labor could come together to create a corporate governance structure that better fosters mutual interest in sustainable economic growth.

In the remaining minutes, I will outline a few of those areas. I do so not so much to advocate specific solutions, but to identify what seem to me to be common complaints and goals of these corporate constituencies. In identifying these areas, I will risk noting where one constituency or the other must give a bit in order to get something it desires.

Common Ground for Management and Labor?

Settling the Continued Takeover/Corporate Election Hoo-ha

I confess to being amazed at the energy that is still poured into the subject of whether American corporations are

subject to a vigorous enough market for corporate control. Isolated anecdotes of market failure of course exist, but the history of the last quarter century reflects the dynamism of the American mergers and acquisitions market, with corporate law acting as an effective goad to corporate boards to be open to combinations and sales proposals attractive to stockholders. Though there may be deficiencies in the American system of corporate governance, the absence of opportunities for sell-side stockholders to receive acquisition premia hardly seems one of them. Yet, for a variety of reasons, not the least of which is how fun hostile takeover activity is to observers and how comparatively easy it is for corporate law scholars to write about takeover defenses than deeper problems of corporate performance, the issue of takeover defenses still preoccupies the corporate governance debate.

Into this mix throw the proposals to create greater accountability over the boards of corporations that, because of their size or because of regulatory issues, were not subject to the market for corporate control. The shareholder access proposal still being bandied about at the SEC was most convincingly supported by the argument that indexed investors should have a tool to influence the composition of large corporations that perform poorly over an extended period of time because selling wasn’t a real option for indexed investors.

Notably, the shareholder access proposal as originally conceived required the actual nomination of rival candidates by stockholders who had held corporate stock for at least a year.

As we now know, shareholder access has gone nowhere. But that does not mean that management won. To the contrary, institutional investors used their influence to obtain a less responsible and arguably more potent weapon to change the composition of the board, the conversion of a decision to "withhold authority" from a member of the management slate into an effective no vote. With this weapon in hand, institutional investors can pit the incumbent board against a platform of generalized outrage, with the very real threat that generalized outrage will win. This weapon does not require institutional investors to name actual candidates who will assume the fiduciary duties that come with board service; it simply requires them to advocate that the bums should be tossed out. Independent directors are now running scared of withhold campaigns, and increasingly ready to make the bargains necessary to avoid being targeted. This fear permeates the system as professional independent directors wish to avoid controversy on all their boards.

For long-term investors, labor, and management, the ad hoc and constantly changing arrangements being worked out by the call and shout of the stockholder proposal process are less than

ideal. A more durable and rational system of accountability might be attractive.

That could be built around the following elements:

1. Abandon Classified Boards But Keep Traditional Poison Pills

As current trends show, boards are—for better or worse—increasingly giving up their classified structures, and once given up, those structures will not return. Given the receptivity of independent directors to attractive takeover bids, classified boards have almost never kept a corporation independent in the face of a premium bid. On the other hand, it is crazy from an investor's perspective for a target board not to have a traditional pill in place to stimulate a value-enhancing auction and to deter structurally coercive bids. An M & A pact where management would support the elimination of classified boards and long-term investors would accept traditional poison pills might settle this question in a stable way.

2. Create a Rational Corporate Election and Accountability System

Management must accept the reality that investors will continue to demand a greater ability to hold boards accountable. The current corporate election system remains difficult for outsiders to use, in the absence of a takeover bid. At the same time, institutional investors slight the disruptive effect that electoral contests and withhold campaigns have on corporations. Corporate elections are a means to an end, not ends in themselves. Current trends are toward the implementation of a Rube Goldberg system of accountability, whereby activist institutional investors can use the threat of a withhold campaign to bargain for concessions and the seating of some of their favorites by action of the incumbent slate. This arguably smacks of green mail and a hidden form of cumulative voting, the benefits of which arguably flow largely to short-term activist investors.

For long-term investors and management, there might be gains to be made by reforming the corporate election process to provide for greater access periodically, say every three years. This access could be made available only to investors who have held their shares for at least a year and who are not bidders for control, and could involve the reimbursement of solicitation expenses for any rival slate that gains a material percentage of the votes. By this means, corporate boards would be subject to the greater possibility of electoral defeat on a regular, but

not annual, basis.[2] In exchange for this access, management could demand a restoration of the plurality voting system, on the reasonable ground that stockholders now have a means to influence board composition by using the responsible means of naming a rival slate of actual people willing to serve on the board.

3. No More Pizza on the Wall

Consistent with the objective of implementing a responsible and efficient system of accountability, the costly precatory proposal process could be brought to a long-overdue halt. Instead of a pretend polity, stockholders would do real things. If they have a proposal to make, it would be in the form of a bylaw with real effect. In the case where the validity of a bylaw is doubtful, stockholders would be granted access to the corporation's proxy by the SEC and the SEC would leave it to state adjudicators to answer the underlying question. In a real corporate republic with a vibrant election process, proxy access for stockholders seeking to propose bylaws, and strong voting power for stockholders over important transactions, where management is also disciplined by an active market for corporate

[2] In other writings, I have explained that the enhanced process could be used annually at corporations with classified boards.

control, there would be little justification for the continued cost of throwing pizzas at corporate boards every year.

4. Quiet The CEO Pay Furor

There is a great deal that can be said about CEO pay. I'm not going there today.

What I do venture is that management and labor are both poorly served by the lack of a more durable resolution of this controversy. Right now, some individual corporations in concert with certain institutional investors are toying with allowing their stockholders to cast advisory votes on executive pay, à la the English system. That would be a steroid–fueled growth in the muscle of stockholders. Traditional corporate lawyers, most notably Martin Lipton, rightly fear that this might be a near fatal slice toward the "death by a thousand cuts" corporate boards seem to be accepting. Mr. Lipton is also correct to fear the more general phenomenon of eroding board authority. But the question is whether corporations can stop the nicks without more collective action by groups like the Business Roundtable, so that corporate managers as a class get something substantial in exchange for the concessions they are now constantly making individually.

In the context of a larger reform to create a rationally balanced system of corporate accountability, it might be worth considering the admittedly large step of permitting stockholders to adopt non-repealable bylaws requiring that the employment contracts of top executives be subject to stockholder approval. When this means is combined with an enhanced corporate election system, stockholders would have a more potent ability to check any employment practices they perceive as overreaching. To improve the informational base stockholders would have to consider whether to use that new tool, additional disclosure requirements might be implemented to place top executive pay in fuller context—for example, by comparing that pay in present and historical terms to the median pay provided to the corporation's workers and to the returns received by the corporation's stockholders.

The government is poorly positioned to set CEO pay. If stockholders are granted the practical ability to balance cost and morale concerns against the need for top-flight executive talent, they will not only have more ability to hold compensation committees accountable, but will also themselves bear accountability for the incentives they approve. As a

result, one might hope that CEO pay would lose much of its enervating salience as a political issue.[3]

But if corporate boards accede on major ideas like these in isolation, these ideas will do little to calm the waters for management. The business community is playing a prevent defense in a game without a clock. At some point, the mantra of "more, more, more" reform has to stop. If executive pay, takeovers, and elections have all been addressed in a way that creates greater accountability, will institutional investors back off on precatory proposals? On the withhold vote?

To stop the slide and push the debate toward more rationality, management needs labor. For its part, labor needs to remember that as much cheap momentary pleasure as continued stories of CEO discomfort brings, labor ultimately loses if American corporations become bad replicas of high school Model U.N. convocations.

5. Give Managers and Directors More Time to Focus on Business

[3] As a social issue, however, it is absurd to think that capital—in the form of stockholders—will address the concerns over CEO pay of those who see top executive pay as a symptom of a larger problem of growing income inequality. I suspect much of the sentiment for congressional legislation has more to do with that issue of wage inequality, rather than with a concern that stockholders are suffering from excessive CEO pay.

The major scandals that drove the adoption of Sarbanes-Oxley and the exchange rule reforms of 2002 were all characterized by a common factor—top manager greed exploited a stock market that fixated on accounting earnings, however odd the source of their generation. Unlike some, I concede that there were valuable aspects to the 2002 reforms.

But taken in their entirety, those reforms have put enormous time pressures on corporate boards and managers. Although the scandals that gave rise to the reforms all were caused by misconduct by top managers, the 404 process has caused countless hours of work at the lowest managerial levels of public companies, with the accounting industry becoming the ironic beneficiaries of its own prior failure and, according to much lore, encouraging (nay, nearly demanding) that its issuer clients implement onerous internal control processes to address any and all risks.

At the same time, the exchange rules have created a large laundry list of tasks that only committees comprised entirely of independent directors must accomplish. These tasks are time-consuming and detract from the ability of public corporations to maintain small, cohesive boards that spend quality time in plenary session discussing big-picture strategic issues. Tightened, across-the-board, labels of non-independence discourage service by those with affiliations to the company,

even if they would be extremely useful in helping the corporation establish and implement a sound strategy for long-term profitability.

Trimming back anything called reform is always politically risky. But with labor's support for a constructive, fresh look, the political environment for a tailoring of some mandates would be more hospitable. Although labor has a strong interest in preventing a future spate of governance meltdowns, it also has an interest in ensuring that corporate boards and managers can spend most of their time in the constructive effort of trying to make their companies' business strategies succeed, rather than on the completion of a mind-numbing checklist of regulatory mandates. Having smart people with useful industry experience serve on boards would seem to be of value to workers dependent on the competitiveness of American corporations.[4]

For its part, the Business Roundtable could ground its request for 404 relief in an important confession. By admitting that its members were at the center of the scandals that gave

[4] Similarly, Section 11 of the federal securities laws deters persons of independent wealth from serving as independent directors on public boards, because those persons may be subjected to costly proceedings and potential liability even when they have not acted with an illicit state of mind. Bringing Section 11 into line with other federal statutes and allowing independent directors to be dismissed as defendants unless the plaintiffs plead scienter on their part would address this problem in a responsible way, consistent with labor's interests.

rise to 404 and that middle managers had nothing to do with those scandals, the Roundtable could stimulate a restructuring of 404 to focus it more discretely and cost-effectively on the need to have tight internal controls to prevent fraud by the top management of corporations and to relieve burdens at lower levels of corporations. A way to do this could be to mandate the adequacy of internal controls designed to: 1) prevent fraud by top officers; and 2) address risks meeting a rational materiality threshold like 5% of firm value, thereby freeing up directors to use their business judgment regarding the utility and intensity of lower-level internal control processes.

6. Temper the Influence of Short-term Stockholders

Management and labor have legitimate reasons to distrust activist short-term investors who seek to influence corporate policy. When a bidder for control wins, it owns the company and becomes responsible for its fate. When investors run a proxy fight and elect a new board, the new directors become fiduciaries accountable to the stockholders for their conduct. But when an activist investor uses the influence of a withhold campaign to get a corporate board to change its strategy, succeeds in that endeavor, and then sells out its position, that investor is accountable to no one if the corporation later

falters because of the change in strategy it advanced. The company's long-term investors, management, and labor are left eating the activists' cooking.

To address some of the legitimate concerns arising from the activism of short-term investors, management and labor might consider ideas along these lines: i) reforming the disclosure laws to require the disclosure of short positions on a basis at least on par with the requirements for the disclosure of long positions and, in general, to make clearer the directional interest large investors have in an issuer; and ii) conditioning the right to file stockholder proposals or seek books and records on a sworn certification that the stockholder has held a net long position in the issuer for some reasonable prior period. Requirements like these would be based on the premise that only stockholders with some demonstrated commitment to the best interests of the corporation should be able to use these potent rights. Moreover, by giving the market better information about short and hedged positions, pure long investors could better assess the economic motives for the proposals of activist investors and the judiciary could more accurately determine how much cleansing effect should be given to particular stockholder votes.

7. Reduce the Focus on Quarterly Earnings Estimates

No rational person believes that corporations can deliver consistent, quarter-to-quarter earnings growth nor that corporations should be managed with that objective in mind. The concept that all information materially enhances the ability of the marketplace to make rational judgments has never been accepted as the basis for American legal doctrine; rather, judgments about reliability permeate the federal securities laws.

Management and labor might therefore usefully press for a requirement that quarterly earnings estimates be deemed misleading and therefore prohibited unless they come in the context of a fully disclosed long-term plan for the growth of corporate earnings. Absent their placement in that more disciplined, rational context, quarterly earnings estimates provide little that is of value to investors but continue to contribute to managing to the market. Managing to the market was characteristic of Enron, Worldcom, HealthSouth, and other companies that contributed to market meltdown. Isolated issuer restraint is of little utility as competitive realities lead to collective idiocy, as CEOs fear the loss of analyst coverage if they refuse to feed the market beast and their competitors continue to do so. Less drastic means to get at this would be initiatives within the Business Roundtable to encourage

industry-wide decisions to move away from quarterly earnings estimates to annual estimates of a range of possible results. Whatever their precise form, the goal would be clear: to enable managers to focus more on sustainable, long-term corporate growth and less on meeting the market's short-term expectations.

8. Confront The Agency Problem Of Institutional Investors

Although the economic power of institutional investors has grown enormously, corporate and securities laws continue to focus obsessively on operating companies. This ignores the reality that most Americans invest in funds controlled by institutional investors, rather than in operating companies. Even more important, it ignores that institutional investors are regularly seeking to and succeeding in influencing the policies of operating companies. Therefore, these intermediaries are exercising economic clout in a manner that affects the tens of millions of Americans who work for and invest (directly or indirectly) in those corporations.

Problematically, those institutional investors whose goals are most in line with ordinary Americans—those that manage index funds—have rational reasons to be as inert as possible when it comes to voting shares and influencing issuer behavior. Meanwhile, those institutions with short-term or political

objectives often have the loudest voice. And many traditional money managers, such as mutual funds, would just as soon dispense with their votes altogether. They therefore look to proxy advisory firms, such as ISS and Glass Lewis, in order to give them a rational basis for explaining their voting decisions if questioned about their compliance with ERISA standards.

Oddly, some mutual fund companies even brag about the fact that the folks who make their voting decisions are different from the ones who invest the money. Strange indeed. So too is the fact that huge amounts of time and not insignificant dollars are now spent by institutional investors in determining how to vote on the blizzard of precatory proposals now on the ballots at public company annual meetings. Much of this cost flows from the legal requirement that institutional investors vote shares in an informed manner.

But that does not mean that the voting is done in a way that rationally advances the interest of long-term investors. For example, a large index fund complex told me that it voted on a huge corporate merger on a single-issuer basis—voting its shares of the target for the merger and its shares of the (larger) market-cap acquirer against the deal — without considering whether the merger was in the best interests of investors in the fund as a whole, taking into account that the fund owned both of the issuers that were proposing to merge.

Likewise, another mutual fund complex told me that it takes into account the potential for financial fraud (think Enron) by short-weighting fishy stocks in its actively managed funds. When I asked whether the information was shared with the managers of their index funds and whether that triggered activism against the issuers whose disclosures generated concerns about fraud or managed earnings, the complex basically said no, nothing was done to protect the indexed investors.

Of similar concern is the reality that the entities that provide proxy voting advice and corporate governance ratings are not subject to the same disclosure requirements as public operating companies. At least one of the major firms that advises institutional investors on how to vote also sells its services to issuers. These firms also do not make clear how their corporate governance ratings actually work. Perhaps there has been some recent change, but in the recent past, it was true that for issuers to determine how a particular change in corporate governance would affect their ratings from one service, they had to pay the firm that doled out the ratings. It was impossible for them to tell from the publicly available information because the firm’s rating criteria was not made public in a clear way.

This issue is undoubtedly complex. But one can rationally question a system where it appears that the institutional

investors most active in pressuring issuers are pursuing investment strategies at odds with the core principle of the efficient capital markets hypothesis and those who are pursuing the most rational strategy are the most silent. As disturbing is the idea that the practical power to influence a large percentage of the corporate vote has been outsourced to entities that have no accountability to the public.

Although management interests are chary about admitting it, the American business establishment has long ago realized that regulation of economic power was inevitable and that such regulation must be even-handed. Right now, the managers of public operating companies are tightly regulated, yet those who govern institutional investors are comparatively free from public scrutiny.

For both managers and labor, it might be useful to control this form of agency as well and to ensure that institutional investors' conduct is better aligned with the best interests of long-term investors. Given the mountains of 401(k) money that American workers, as a practical matter, will entrust to these firms for generations, the utility of considering measures to guarantee greater alignment seems self-evident to anyone who has listened to corporate law scholars beat the agency cost drum. Avenues for exploration could include requirements for institutional investors (in particular, index funds) to: focus

on indicators of possible fraud or firm failure in making investment and voting decisions, align the compensation incentives of their management personnel with the investment horizons of long-term investors, and vote on mergers in a manner that takes into account whether the fund owns shares of both parties to the merger. In tandem with this could be the consideration of requirements prohibiting mutual and pension funds from utilizing proxy voting recommendations services unless those services publicly disclose: i) the revenues they receive from public companies and institutional investors, and the nature of the work that generates those revenues; and ii) the process used by them to develop their corporate governance ratings for corporations and directors, including the specific criteria and weighting they use to calculate the specific ratings given to corporations and directors.

9. Encourage Investment and Discourage Churning

One of the primary arguments made by mutual fund complexes against activism by their index funds is based on cost. If index funds spend resources to be active, informed stockholders, that makes it harder for the funds to match the market return. Because investors are paying for a market return and giving up prospects for outsized returns, index funds worry about being undercut by competitors. I realize that the patron saint of index investing, John Bogle, believes that the mutual fund industry's cost excuses for failing to be more informed, active stockholders, are largely unconvincing. But doubtless there are real competitive pressures that do cut against any particular mutual fund complex acting in isolation. It is for that very reason that regulation to require all index funds to make a baseline effort might be useful, as it addresses this factor.

Given the gaping federal deficit and a variety of social needs that management and long-term investors would acknowledge as requiring attention, an additional leveling strategy might well be considered. That would involve ideas to raise revenue by addressing short-term trading strategies. These could involve higher capital gains taxes on stock held for less than two years or a very small percentage tax on securities trades. By these means, the budget and social investment chasm that threatens our

long-term economic vitality could be narrowed in a livable way that also has the utility of providing a comparative advantage to institutional investors who act like investors, rather than gamblers.

I'll finish with two issues—health insurance and globalization—that might strike some of you as a bit beyond the traditional domain of so-called corporate governance. Perhaps that is true. But it is also unrealistic to think that the frustrations and fear of working Americans facing these issues will not influence how their labor and pension funds act as stockholders. A present and future where good jobs are available in the United States is vital to labor. If management is not perceived as caring about that objective, it should not be surprised to see discontent come out sideways, through nettlesome stockholder proposals that tweak CEOs where it hurts.

10. Eliminate the Connection Between Health Insurance Access and Employment at a Particular Corporation

Managers and labor want American corporations to be competitive and to provide quality employment opportunities for generations to come. To these ends, both realize that many workers currently depend on employer-sponsored health insurance to protect themselves and their families. Likewise, both

recognize that workers cannot rationally expect to work for only one corporation for an entire career. Both also realize that responsible corporations that provide health insurance face competitive pressures from corporations that don't provide those benefits and from corporations domiciled in nations where the costs of providing health coverage are socialized. Consequently, management and labor have a shared interest in pursuing long overdue action on this front.

As a starting point, the Business Roundtable and AFL-CIO could declare a mutual pox on anyone who uses tired nostrums like "socialized medicine" in order to stifle reform to provide Americans with affordable access to a choice of health insurance plans through a means not tied to employment at any particular firm. There is room for a healthy debate, but advocacy that distorts and misrepresents the issues simply delays sorely needed progress. By deciding what level of access we, as a decent people, expect all our citizens to have, and implementing that commitment in a more rational way that is not employer-specific, our nation can both free up American corporations to compete more effectively and relieve American workers of the worry that a change in employment will put their families' health at risk. Not only that, progress on this front could provide a foundation for action to address related issues, such as the question of how our corporations, and nation, manage to

remain competitive and provide for the needs of working Americans and their families when we have to bear the full burden of addressing the retirement obligations owed to the baby boomers. Common to many other looming issues is the extent to which employer-specific means of meeting important safety net objectives should persist or whether more portable means of access can be developed, which provide workers with economic security but don’t reduce the competitiveness of specific corporations.

A Management-Labor Commitment to Globalizing Enlightened Externality Regulation

There was a time in the not too distant past when American management and labor took great pride in the American approach to economic affairs, as providing a model that, in contrast to communism, delivered real benefits to labor through a system that balanced the dynamism of market behavior with important protections for labor, communities, and the environment. As developing nations become huge players in world capital and product markets, the United States, and the West writ large, have a compelling interest in helping those nations implement the shared lessons of our capitalist history. To support the globalization of enlightened standards of labor and

environmental protection, for example, is not to be against the amorphous concept of “free trade”; it is to acknowledge that there was good reason for the Western world to temper market behavior with regulation to protect vulnerable workers and the environment. Human ingenuity ought to be sufficient for the West—with strong, joint United States and European leadership—to figure out how to foster globalized trade without compromising the core aspects of our enlightened approach to capitalism. It is doubtful social progress for American managers to find themselves unable to match competitors whose production facilities are free to engage in grotesque pollution and whose workers have no right to organize and no genuine political freedom. And only the most hubristic and selfish American managers can pretend that only low-skilled American and European workers are at risk from the globalization of trade without the globalization of externality regulation. If they care about job opportunities for their children, which I assume they do, top executives should care about guaranteeing that all competitors in trade have to meet decent standards of responsible behavior toward workers and the environment.

In pursuing the global implementation of an enlightened capitalism and in honoring its principles in their daily management decisions, American CEOs would also begin to rebuild some of the public regard they have lost during the past few

decades. The more they are viewed as genuinely striving to generate profits in a manner that reflects a genuine concern for the well-being of the nation that charters their corporations, the communities in which their corporations operate, and the workers who toil for them, the more the public will respect them.

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This menu of areas for joint management-labor cooperation is half-baked at best, I admit. But that is not so important. What is important is that a more serious endeavor to reach common ground regarding corporate governance be undertaken between those who purport to speak for American managers and those who speak for labor. Unless management and labor recognize their common interests, both may see trivial corporate governance turmoil and short-term market pressures detract from the long-term pursuit of corporate profit and job growth.

America’s public corporations are not playthings. They are societally chartered institutions of enormous importance and value. Those who govern them ought to be accountable for the generation of durable wealth for stockholders. But the system of accountability must be a rational one that supports wealth creation within a system of enlightened capitalism. The management of public corporations should be given the space to implement sound long-term plans to make money by selling useful

products and services without the distraction of constant tumult from transient stockholders with short-term interests and a corporate governance industry that reaps profits from the perpetuation of strife.