Embattled CEOs

by Marcel Kahan and Edward Rock

October 2008

We would like to thank Bill Allen, Jennifer Hill, Margaret Blair, Randall Thomas, Scott Wornow, and participants in workshops at Fordham Law School and Vanderbilt Law School for comments and Daniela Fischel and Phillip Won for research assistance.

INTRODUCTION

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

Most significantly, we think that the recent loss of power is not some cyclical change, but represents some underlying changes in the economic and regulatory landscape that will persist and result in a further decline of CEO power at least in the intermediate term. What we may be witnessing is the emergence of a new era of corporate governance for the early part of the 21st century, where power over the U.S. corporate enterprise is more evenly distributed between various participants – inside managers, outside directors, and shareholders – rather than concentrated in the hands of the CEO.

While other's have noted the CEO's loss of power,[1] this article makes a variety of contributions. First, relying on the philosophical and sociological analyses of power, we use a more sophisticated and self conscious conceptual scheme that clarifies the various aspects of power that are relevant. Second, because CEO power is both conceptually complex and difficult to observe from outside the firm, we assemble data from a wide variety of sources that provide both direct and indirect evidence of the decline. Finally, we examine the implications of a

[1] Although there have been numerous articles in the trade press on the "decline of the imperial CEO," see, e.g., David Leonhardt with Andrew Ross Sorkin, Reining in the Imperial CEO, NYTimes Sept 15, 2002, the focus has largely been on CEO firings and compensation. While, as we discuss below, both of these are elements of the decline of CEO power, they are only a piece of a much larger picture.

decline of CEO power in the large publicly traded US corporation for corporate governance and control.

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

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

The article is organized as follows. In Part I, we discuss what we mean by "CEO power." In Parts II - VI, we discuss the causes and symptoms for the loss of CEO power. We

[2] Jonathan Swift, Gulliver's Travels (Windermere series, New York, Chicago: Rand McNally & Co., 1936, c1912, illustrations by Milo Winter, available on line at http://www.jaffebros.com/lee/gulliver/winter/index.html).

consider shareholder composition and activism (Part II), the actual governance rules and the board response to shareholder activism (Part III), regulatory changes related to shareholder voting (Part IV), changes in the board of directors (Part V) and executive compensation (Part VI). In Part VII, we tie our analysis of the causes and symptoms of loss of CEO power to the aspects and dimensions of power discussed, and discuss the effects of these changes on CEO power. In Part VIII, we discuss the implications of our analysis.

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

Consider the following quotes from top executives on the role of the CEO and directors:

- "To put it bluntly, whether a board has any function or not, it must truly reflect the nature of the chief executive officer of the company more than anything else. If he wants to use the board, he will use them. And if he doesn't want to use the board, he will run over them pretty roughshod. Basically, the board can be made just about as useful as the president wishes it to be."[4]

- "The president of a company, or the chairman of the board, or whoever runs this operation, really determines the contribution the board makes. If all he wants to do is to get up in front of them and sort of go through some motions, see that fees get distributed, give them a bit of lunch – then that's the kind of performance you will get, because the

[3] Myles Mace, Directors: Myth and Reality (1971).

[4] Mace at 78.

chief executive officer controls the affair. If, on the other hand, the chief executive officer seeks out where in the management ares various board members might be able to make more of a contribution than in others, and then structures his board so that emphasis is placed on such questions rather than on the rote alternative, then chief executive is making a direct impact on the contribution the board makes. This, I suppose, is a matter of style."[5]

- "What any new board member finds out very quickly in our company is that it is very difficult to do anything except go along with the recommendations of the president. Because directors who doin't go along with them tend to find themselves asked to leave."[6]

- "The old man [the president] has exactly the kind of a board he wants. They all live here in the city, and they just don't do a damn thing as directors. The old man thinks it is a great board, and from his point of view he is porbably right. From my point of view they are a big glob of nothing. Not that there aren't some extremely able outsiders on the board – there are. But as board members, they know who is in control and they will never cross the old man."[7]

These interviews led Mace to conclude that "Presidents of these [widely held] companies have assumed and do exercise the de facto powers of control of the companies for which they are

---

[5] Mace at 78.

[6] Mace at 79.

[7] Mace at 79. Mace then comments: "This point of view was confirmed many times during our study." Id.

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

I. POWER AND THE CEO

A. What is CEO Power?

Power is a complex concept that has generated, and continues to generate, a huge literature. Drawing on that literature, in speaking of CEO power, we are interested in three related aspects of power: decision making, second-guessing, and scope.[8]

Decision making refers to the ability of the CEO to decide key issues facing the firm either on her own or by getting the pro forma approval by other decision-makers in the firm, such as shareholders, the board of directors, or lower-level managers. A greater ability to decide means more CEO power. Decision making ability, in turn, has several facets. First, CEO power includes the CEO's ability to control whether an issue is even presented to other potential

[8] There is a huge literature on "power" in Philosophy, Sociology and Political Science. Important contributions include Robert Dahl, Who Governs (2d edition 2005); Steven Lukes, Power: A Radical View (2d ed. 2005), Dennis Wrong, Power: Its Forms, Bases, and Uses (2004); and Peter Morriss, Power: A Philosophical Analysis (2d ed. 2002). Because our interest is essentially practical and comparative – are CEOs less powerful than they used to be? – we do not need to come up with a comprehensive analysis of power. Rather, it is enough to identify a set of features that approximate the recognized scope of the term "power" in corporate law and governance. We assert without proving that these aspects capture the essential elements of "CEO power" including the various aspects of "power to" and "power over" as well as the related notions of "autonomy."

decision-makers, i.e. the power of the CEO to control the agenda of these other decision-making bodies. Second, it includes the ability of the CEO to determine the outcome of an issue that is presented to these other bodies, i.e. the power to determine the decision outcome. Third, the ability of the CEO to act if the issue is not presented to these other bodies, i.e. the power to act independently. CEOs have the greatest power if they either (i) have both agenda control and the power to act independently or (ii) they have the power to determine the decision outcome.

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

Finally, scope relates to the type of decisions that a CEO has the power to make. Scope, in turn, has three dimensions: extension, comprehensiveness, and intensity. Extension relates to the scale of the firm: Given the CEO's power within a firm, a CEO of a larger firm is more powerful than a CEO of a smaller firm. Comprehensiveness relates to the type of decisions over which a CEO has power. For example, can the CEO set the price of a product sold by the firm, the price of a division that the company wants to put up for sale, or the price at which the whole firm is to be sold to a third party? The more comprehensive the type of decisions, the more powerful is the CEO. Finally, intensity relates to how far can the CEO push others without loss of compliance. A CEO may, for example, have the power to set the price for a product, a division, or the whole firm as long as the price is within the range of reasonable prices, but may not be able to get away with setting a ridiculously low price.

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

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

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

These complications make our analysis somewhat speculative. Maybe we are completely wrong that CEO power has declined. Maybe CEOs are every bit as powerful as they once were. Maybe they were never very powerful. Or maybe it is impossible to come up with a metric for measuring CEO power or, even if one can design a metric, to collect the data to determine

whether CEO power has declined. On the other hand, we think that there are lots of reasons to think that one can intelligibly discuss CEO power, that it has declined, and that this decline in CEO power has important implications. That is the case we make in this article.

II. CHANGES IN SHAREHOLDER COMPOSITION AND ACTIVISM

The profile and behavior of shareholders has been fundamentally transformed in recent decades. These changes in shareholder composition and activism have reduced CEO power.

1. The Never-Ending Rise of Institutional Investors

Commentators have long noted the change in the ownership structure of shares of publicly-traded corporations. In an article published in 1990, for example, Bernie Black presented data showing that the percentage of institutional ownership in New York Stock Exchange companies, which tend to be the largest publicly held companies, had increased from 45.2% in 1980 to 54.4% in 1988.[9] Around the same period, several other articles noted the increase in institutional ownership and the commensurate decline in individual ownership of shares and argued that the concentrated ownership by institutions would be the dawn of a new era of shareholder power.[10] As we have remarked elsewhere, although shareholder power has

---

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

[10] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991); Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Mark J. Roe, *A Political Theory on American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). *But see, e.g.* Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1990); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); see also Anat R. Admati et al., Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium. 102 J. Pol. Econ. 1097 (1994) (developing model of large shareholder monitoring).

increased somewhat over the last 20 years, the hopes of these commentators have been largely unfulfilled – until recently, that is.[11]

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

First, the increase in ownership by institutions and the decline in ownership by individuals has continued since 1990 at virtually the same rate. As shown in Table 1, the percentage of stock of publicly held companies help by all institutions (pension funds, mutual funds, banks, insurance companies, and broker/dealers) increased from 8% in 1950, to 19% in 1970, to 37% in 1990, to 60% in 2006.[12] Ownership by "households"[13] has decreased from 90% in 1950 to 78%% in 1970 to 56% in 1990 to 27% in 2006. If the increase in ownership by institutions from 19% in 1970 to 37% in 1990 was an important phenomenon to commentators from that period, the further increase to 60-70% is presumably also important. Furthermore, the fact that the rate of increase has not budged – in fact, aggregate ownership by institutions has increased every single year since 2000 – means that the day is not far when dispersed individual investors will own only a trivial fraction of equities.[14] The 90-10% ratio of retail to institutional

---

[11] Marcel Kahan & Edward Rock, Hedge Funds and Corporate Governance and Control, 155 U. Pa. L. Rev. 1021 (2007).

[12] Bd. of Governors of the Fed. Reserve System, Flow of Funds Accounts of the United States [hereinafter Flow of Funds Accounts], various years.

[13] The federal reserve treats households as the residual category which thus includes any shares not attributed to other categories. See Guide to the Flow of Funds Accounts. Besides the institutions noted above and household, the federal reserve provides data for ownership by state and local governments and foreign residents.

[14] Note that household ownership also includes holdings by individual blockholders.

stock ownership of the 1950s could soon become 90-10 the other way.[15] Brian Cartwright, the general counsel at the SEC, has recently referred to this as "deretailization" and has argued that the disappearance of individual (i.e., non-institutional) ownership "will have, and already is having, profound consequences."[16]

More important than the overall increase in institutional holdings is the composition of that ownership. Pre-1990, the most important type of institutional owners were private pension funds. Ownership by private pension funds had increased from 1% in 1950 to 8% in 1970 to 17% in 1990. By contrast, ownership by mutual funds and public pension funds had increased at a slower pace, from 3% in 1950 to 5% in 1970 to 7% in 1990 for mutual funds and from less than 1% in 1950 to 1% in 1970 to 8% in 1990.[17] But even in 1990, commentators recognized that private pension funds were among the least likely institutions to take an activist approach and private funds have indeed not been active.[18]

Since 1990, the picture has changed drastically. Holdings by private pension funds have declined from 17% in 1990 to 13% in 2006, and given the problems with defined benefit plans, they are poised for further declines. Mutual funds, by contrast, have taken off, quadrupling their percentage holdings from 7% to 28%.[19] And mutual funds, as discussed below, have recently

---

[15] Brian Cartwright, The Future of Securities Regulation, University of Pennsylvania Law School Institute for Law and Economics Distinguished Jurist Lecture, October 24, 2007, available at http://sec.gov/news/speech/2007/spch102407bgc.htm.

[16] Cartwright, supra note XX.

[17] Flow of Funds Accounts, supra note XX, various years.

[18] Black, Shareholder passivity, supra note XX, at 596-598.

[19] Flow of Funds Accounts, supra note XX, various years.

become increasingly engaged in governance activism.[20]

2. Hedge Funds: The New Player

As we have discussed in an earlier paper, activist hedge funds have recently emerged as critical new players in both corporate governance and corporate control. Hedge funds have created headaches for CEOs and corporate boards by pushing for changes in management and changes in business strategy including opposing acquisitions favored by management both as shareholders of the acquirer and as shareholders of the target, and by making unsolicited bids.[21] The list of companies that have been subjected to campaigns by hedge funds and other activist investors include McDonalds, Time-Warner, H.J. Heinz, Wendy's, Massey Energy, KT&G, infoUSA, GenCorp; Sovereign Bancorp, Deutsche Boerse; Novartis, Sears Holdings, VNU, Delphi, Calpine**,** Kerr-McGee, Blockbuster, Hollinger International[22], Target[23], Kraft[24], Home

[20] See infra XX.

[21] See Kahan & Rock, supra note XX.

[22] See Kahan & Rock, supra note XX, at 1024-42.

[23] Wall St. J., July 17, 2007, at C3.

[24] Kraft in deal with Peltz's Trian, Reuters, Nov. 8, 2007, at http://www.reuters.com/article/innovationNews/idUSN0757299320071108.

Depot,[25] WCI,[26] Motorola,[27] Biogen,[28] Comcast,[29] H&R Block,[30] Tiffany,[31] Alcoa[32], BEA Systems,[33] CSX,[34] Circuit City,[35] Zale Jewelers,[36] CSX,[37] the New York Times,[38] and Sprint-Nextel.[39] According to Wachtell, Lipton partner Patricia Vlahakis, hedge funds conducted 137 activist campaign just in the fourth quarter of 2007.[40] In many of these instances, hedge funds

---

[25] Home Depot Draws Proxy Threat from Investor, Wall St. J., Dec. 19, 2006, at A10 (Relational Investors)

[26] Icahn, WCI Management Trade Barbs at Hint of Hostile Bid; Shares Jump by: SA Editor Jonathan Liss, Seeking Alpha, Mar. 14, 2007, at http://seekingalpha.com/article/29487-icahn-wci-management-trade-barbs-at-hint-of-hostile-bid-shares-jump.

[27] Motorola Reaches Truce with Icahn, Wall St. J., April 8, 2008, at B3 (Icahn)

[28] Biogen Considers a Sale; Pressure Comes from Icahn, Wall St. J., Oct. 13, 2007, at A3.

[29] Comcast Holder Seeks CEO's Dismissal, Wall St. J., Jan. 18, 2008 at A8 (Chieftain Capital Management)

[30] Wall St. J., September 7, 2007, at C3

[31] Tiffany Will Hear Ideas of Peltz Funds, New Tork Times, Feb. 27, 2007, at http://query.nytimes.com/gst/fullpage.html?res=9503EED91E3EF934A15751C0A9619C8B63.

[32] Alcoa: JANA Partners LLC calls on Alcoa's Board to drop Alcan bid and pursue strategic alternatives including a sale of the company, Reuters, May 8, 2007at http://www.reuters.com/article/inPlayBriefing/idUSIN20070508142830AA20070508.

[33] Activists test Silicon Valley, Wall St. J., Oct. 20, 2007, at B1 (Icahn)

[34] En Garde, Activist hedge Funds, Wall St. J. [online?], Mar. 24, 2008 (3G Capital and TCF])

[35] Activists Circle Circuit City, Wall St. J., Mar 24, 2008, at C2 (Wattles, HBK and D.E. Shaw)

[36] Breeden continues building stake in jeweler Zale, Reuters, Jan. 7, 2008, at http://www.reuters.com/article/consumerproducts-SP/idUSN0740372120080108.

[37] Hedge Funds Propose CSX Directors, Starting proxy Battle, NYT, Dec. 20, 2007 (Children's and 3G).

[38] See, e.g., New York Times Holder protest Grows, Wall St. J., Apr. 25, 2007, at B10.

[39] Sprint Nextel Announces Appointment of Ralph Whitworth to Its Board of Directors, Reuters, Feb. 12, 2008, at http://www.reuters.com/article/pressRelease/idUS145208+12-Feb-2008+BW20080212 (appointment of head of Relational Investors to company board).

[40] Corporate Law Daily, Hedge Fund Activism, Possible Recession Will Play Roles in Upcoming Proxy Season, Feb. 1, 2008.

have been able to win outright or at least to wrest substantial concessions from the management of the companies they target.

This new activism by hedge funds has become a prime irritant for CEOs. Martin Lipton, the renowned advisor to corporate boards, last year listed attacks by activist hedge funds "as the number one key issue for directors."[41] Alan Murray from the Wall Street Journal calls hedge funds the "new leader" on the "list of bogeymen haunting the corporate boardroom"[42] and his colleague Jesse Eisinger notes that these days, hedge funds are the "shareholder activists with the most clout."[43]

What is particularly noteworthy is the degree of activist bang generated by relatively little buck. Although hedge funds manage approximately $1.7 trillion of investor money, the large majority of hedge funds do not pursue activist strategies. Rather, according to a recent estimate by J.P. Morgan, only 5% of hedge fund assets are available for shareholder activism.[44] Given these figures, the list of companies targeted by hedge funds is indeed impressive.

3. Activism by Traditional Institutions

Traditional institutional investors – specifically public pension funds and mutual funds –

---

[41] Martin Lipton, Wachtell Lipton, Rosen & Katz Client Memo, Dec. 1, 2005; see also Martin Lipton at al., Wachtell Lipton, Rosen & Katz Client Memo, Being prepared for Attacks by Activist Hedge Funds, Dec. 21, 2005 (noting "environment of increased attacks by hedge funds" and advising companies how to deal with it); Martin Lipton at al., Wachtell Lipton, Rosen & Katz Client Memo, Attacks by Activist Hedge Funds, Mar. 7, 2006 (presenting checklist for clients to deal with activist hedge funds).

[42] Alan Murray, Hedge Funds Are New Sheriffs of Boardroom, Wall St. J., Dec. 14, 2005, at A2.

[43] Jesse Eisinger, Memo to Activists: Mind CEO Pay, Wall St. J., Jan. 11, 2006, at C1 ("The shareholder activists with the most clout these days are hedge-fund managers …").

[44] Kahan & Rock, supra note XX.

have long engaged in low pressure (and low cost) "soft" forms of activism, such as voting in favor of corporate governance shareholder resolutions (and occasionally introducing them) or lobbying boards behind-the-scenes to improve their corporate governance.[45] As discuss below, the corporate governance issues "du jour" to which this activism is directed are constantly evolving and the level of support for shareholder resolutions has increased. Overall, however, there has been no major qualitative change in the nature of the soft activism by traditional institutions.

A. The Awakening of Mutual Funds

On different fronts, however, qualitative changes seem to be occurring. First, mutual funds are increasingly engaging in the hard-core activism that has until recently been the hallmark of hedge funds. For example, mutual funds have shown an increased willingness to oppose acquisition of their portfolio companies by private equity firms or large family owners.[46]

In the first half of 2007 alone, mutual funds successfully opposed a number of buy-out transactions approved by the board of directors. Most prominently, the mutual fund giant Fidelity, the largest shareholder of Clear Channel Communications, threatened to vote against an acquisition of the company by Bain Capital Partners and Thomas H. Lee Partners, two private equity firms, for $37.60 per share. The deal was strongly supported by the company's CEO (and

---

[45] Kahan & Rock, supra note XX.

[46] Research Spotlight, Investor Activism against Mergers on the Rise, March 7, 2007; OSI Buyout Down but Not Out, St. Petersburgh Times, May 9, 2007, "One reason for the trend is that hedge funds and even traditional mutual fund companies have become tougher, and more vocal, critics of deals they don't like, said Chris Young, Institutional Shareholder Services' director of mergers-and-acquisitions research.") Tom Lauricella, Oppenheimer Revolt Shows Mutual Funds' New Mood, Wall Street Journal, April 11, 2007 ("Borrowing a tactic from hedge funds and other aggressive investors, mutual funds are showing new willingness to publicly battle with companies they own."); Tom Lauricella, Mutual Funds Get Mad, Wall St. J., Oct. 2, 2007, at R1.

member of the founding family) Mark Mays – who stood to receive options on up to 2.5% of the stock of the company. But as a result of the opposition of Fidelity and other shareholders, the buyers were forced to increase the price to $39.20.[47]

Similarly, T. Rowe Price, an 8.1% stockholder, lead the opposition to the proposed acquisition of Laureate Education for $60.50. The offer was sweetened to $62.[48] Mutual fund Lord Abbett & Co., the second-largest shareholder (6.95 percent) of OSI Restaurant Partners, complained about the $40-per-share buyout price as having the "makings of a 'panic sale.'"[49] Shareholders initially failed to approve the deal, and only voted for it after Bain Capital increased the price to $41.15.[50] Investment manager Pzena Investment Management, the second-largest shareholder of Lear, opposed Carl Icahn's offer for the company, first forcing him to raise his price from $36.25 to $37.25[51] and eventually killing the deal.[52] And the public pension fund CalPERS opposed a $44 buyout of Biomet Inc. by a group of private equity firms. When it appeared that the buyout would not receive the requisite shareholder approval, the offer was

---

[47] Zachery Kouwe, Back in Play Shareholder Outcry Revives Clear Channel LBO, N.Y. Post, May 8, 2007, at http://www.nypost.com/seven/05082007/business/back_in_play_business_zachery_kouwe.htm.

[48] Laureate Education Accepts $3.82B Buyout Bid, June 5, 2007 at http://www.wtop.com/?nid=25&sid=1157803; Wall St. J., Oct. 2, 2007 at R21.

[49] OSI Buyout Down but not out, St. Petersburgh Times, May 9, 2007; see also OSI Restaurant Agrees to Bain's Higher Buyout Offer (Update7) at http://www.bloomberg.com/apps/news?pid=20601087&sid=afMhnHr6MVX8&refer=home

[50] See also Ann Carrns, *Putnam Cites Price in Plan to Vote Against WaMu's Providian Deal*, Wall St. J., Aug. 2. 2005, at C3 (quoting bank analyst as describing public opposition by a mutual fund to acquisition as "a little bit unusual")**.**

[51] Icahn's Lear Bid Not Enough, Pzena Says, Forbes.com, July 9, 2007 at http://www.forbes.com/markets/2007/07/09/lear-icahn-update-markets-equity-cx_af_0709markets20.html.

[52] Lear shareholders reject Icahn's takeover bid, Int'l Herald Tribune, July 17, 2007, at http://www.iht.com/articles/2007/07/17/business/lear.php.

raised to $46.[53] In all of these cases, the offer that the institutional investors considered too low – and that was subsequently raised – had the blessing of the respective company's board of directors and its CEO.

The new hard-core activism by traditional money managers is not confined to the buyout area. The money management arm of the investment bank Morgan Stanley has urged the New York Times Co. to dismantle its dual share structure, which assures the founding Sulzberger family of continued control of the company.[54] A campaign lead by Morgan Stanley – and supported by mutual funds T. Rowe Price and Legg Mason[55] – for shareholders to withhold their votes from nominees to the board of directors resulted in an 42% withhold vote, which amounted to a majority of the votes not controlled by the Sulzberger family.[56] Recently, Morgan Stanley hired a governance expert respected in activist circles, which fueled speculation that Morgan Stanley may itself be planning to engage in more activism.[57]

A related noteworthy – and novel – phenomenon is the cooperation between mutual funds and hedge funds in pressuring management.[58] For example, in March 2007, Oppenheimer Funds teamed up with several hedge funds to stage a coup and install new top executives at

---

[53] Wall St. J., June 8, 2007, at C3.

[54] How a Money Manager Battled the New York Times, Wall St. J., mar. 21, 2007, at A1.

[55] New York Times Holder Protest Grows, Wall St. J., Apr. 25, 2007, at B10.

[56] Shareholders Withhold Votes for Times Directors, Apr. 25, 2007, at http://www.nytimes.com/2007/04/25/business/25times.web.html?ex=1335153600&en=350cddc251fdfb59&ei=5090&partner=rssuserland&emc=rss

[57] Morgan Stanley Buffs activist Profile, Wall St. J., Dec. 13, 2006, at C15.

[58] See generally ISS, 2006 Postseason Survey at 25 (noting that asset managers who used to work behind the scenes are increasingly joining hedge funds in opposing management).

Take-Two Interactive Software Inc., the struggling maker of the popular videogame series Grand Theft Auto. According to the Wall Street Journal, this was "the first time in [Oppenheimer's] 46-year history to take such a step."[59] Other recent instances of cooperation between mutual funds and hedge funds include joint efforts to block the acquisition of the London Stock Exchange by Deutsche Bank, of Chiron by Novartis, of MONY by AXA, of Lear by Carl Icahn,[60] and of IMS Health by VNU; joint bids for Beverly Enterprises;[61] and a joint proxy fight over Time Warner.[62] Often, as in the case of Deutsche Bank, it is activist hedge funds who take the lead and mutual funds who follow. But increasingly, as in the case of Oppenheimer, mutual funds are in the forefront.[63]

B. Institutional Investor Support of Activist Hedge Funds

Even when institutional investors do not directly engage in hard core activism, their willingness to invest in activist hedge funds provides the capital that makes it possible. There are two models for this division of responsibility. The rare but most transparent approach is illustrated by Hermes, the British Telecom owned fund manager which "manages the assets of the BT Scheme and the Post Office Staff Superannuation Scheme, two of the largest four pension

---

[59] Tom Lauricella, Oppenheimer Revolt Shows Mutual Funds' New Mood, Wall Street Journal, April 11, 2007.

[60] Lear Accepts Carl Icahn's $2.8 Billion Cash Offer (Update9), Feb. 9, 2007, at http://www.bloomsberg.com/apps/news?pid=20601087&refer=home&sid=alWGZxoz9GxU (noting opposition to Icahn's offer bu Pzena (a hedge fund) and Brandes (a mutual fund).

[61] Kahan & Rock, supra note XX.

[62] ISS 2006 survey [find better cite] (Icahn, SCA, Jana and Franklin Mutual).

[63] Take-Two Dissidents Win Control, Install New Chief (Update2) at http://bloomberg.com/apps/news?pid=20601087&src=mwm&sid=agdRA1p8Epzc ("Dissident investors led by OppenheimerFunds Inc. won control of Take-Two Interactive Software Inc.").

funds in the U.K.,"[64] In 1998, Hermes established an independent fund, the Hermes UK Focus Fund, which has successfully pursued activist strategies.[65] When an activist hedge fund sits on top of, or beside, an index fund, it can be thought of as providing the activist corporate governance strike force for the associated index fund.

The more common model involves investments by institutional investors in activist hedge funds. Functionally, this is quite similar to the Hermes model: institutions who invest in independent activist funds that target underperforming companies can make money on their direct investments and may also increase the value of their portfolio overall. On the other hand, indirect investment provides the institutions with a great deal more insulation from criticism. When institutional investors invest in activist hedge funds – and they do – their identity is typically confidential. From the funds' side, this is valuable: it prevents competitors from soliciting their investors. For the institutions, it allows them to encourage and facilitate activism with plausible deniability. It is easier and cleaner for the Harvard or Yale endowments or CalPERS or NYCERS to invest in an activist hedge fund than to take the responsibility of starting and operating one themselves, on the Hermes model.[66]

4. The Role of Proxy Advisory Firms

Proxy advisory firms have arisen in parallel with the increased share ownership by

---

[64] Becht, Marco, Franks, Julian R., Mayer, Colin and Rossi, Stefano, "Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund" (April 2008). ECGI - Finance Working Paper No. 138/2006 Available at SSRN: http://ssrn.com/abstract=934712 at p. 13.

[65] Id.

[66] Jim Manzi, Is Harvard Just a Tax Free Hedge Fund? http://www.theamericanscene.com/2008/05/12/is-harvard-just-a-tax-free-hedge-fund (visited June 22, 2008)

institutional investors. Such firms make recommendation to their clients – which include most institutional investors – on how to vote their shares in the election of directors, shareholder resolutions, merger proposals, or any other matter on which shareholders vote, as well as providing services that simplify the casting of votes. Commentators describe RiskMetrics (formerly Institutional Shareholder Services and the largest advisory firm) as exercising "tremendous clout",[67] wielding "extraordinary" influence,[68] being "belligerent"[69] and to which "powerful CEOs come on bended knees."[70] Claims about its power range from swaying 18% of the votes,[71] to 20-25%[72], to 30%,[73] to affecting the vote of $25 trillion in assets,[74] to getting "whatever [it] wants."[75] Martin Lipton blames "influential proxy advisory firms", together with hedge funds and other activist shareholders, for undermining the board-centric model of governance.[76] (For the growth in similar references to RiskMetrics/ISS or Glass Lewis over time, see Figure 1).

---

[67] Advisor ISS Puts Itself on Sale Could Fetch Up to $500 Million, Wall St. J., Sep. 6, 2006, at C4.

[68] Robert D. Hershey, A Little Industry with a Lot of Sway on Proxy Votes, New York Times, Jan. 18, 2006.

[69] http://findarticles.com/p/articles/mi_m3870/is_11_20/ai_n6200661/pg_3

[70] Leo E. Strine, Jr., The Delaware Way, 30 Del. J. Corp. L. 673, 688 (2005).

[71] Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, Electing Directors, working paper 2008.

[72] Bethel, J. and S. Gillan (2002), The Impact of the Institutional and Regulatory Environment on Shareholder Voting, Financial Management, p.29-54.

[73] http://blogs.bnet.com/ceo/?p=1100

[74] Hershey, supra note XX.

[75] http://blogs.bnet.com/ceo/?p=1100

[76] Martin Lipton, Some Thoughts for Boards of Directors in 2008.

While many of the claims are likely to be exaggerated,[77] proxy advisors are important in at least two ways. First, they may be new and independent power centers that, to some significant degree, influence the votes of clients. Second, they may function as central coordinating and information agents who help create a unified front of institutional investors, and thereby increase collective institutional shareholder influence.

III. CHANGE IN GOVERNANCE RULES AND BOARD'S RESPONSE TO ACTIVISM

In recent years, the governance structure of large publicly held corporations has been transformed through a combination of regulatory changes and shareholder activism. These changes – which diminish the power of the CEO – are both a cause of, and a reflection of, a decline in CEO power.

1. The Demise of Staggered Boards

Modern corporate law scholarship regards staggered boards as one of the most potent and controversial anti-takeover devices.[78] In companies with so-called "effective" staggered boards, it takes two consecutive annual shareholder meetings to replace a majority of a board of directors against the opposition of incumbents. While poison pills that are not coupled with staggered boards are nowadays viewed as relatively harmless, several commentators have argued that staggered boards, coupled with the (virtually) universally available poison pill, illegitimately

[77] Stephen Choi, Jill Fisch, & Marcel Kahan, Director Elections and the Influence of Proxy Advisors, working paper 2008.

[78] See, e.g., Lucian Bebchuk, John Coates IV & Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," 54 Stanford Law Review 887-951 (2002);

serve to entrench managers and that courts should find some way to render them ineffective.[79] The policy battlefront for takeover defenses, in other words, has shifted to staggered boards.

For existing companies, conventional wisdom has had it that shareholders and boards are in a stalemate. Boards of companies without staggered boards may want to adopt staggered boards, but they do not propose a charter amendment because they know that shareholders will not approve it. Shareholders in companies with staggered boards want to get rid of them, but cannot because the board refuses to approve the requisite charter amendment.[80]

The conventional wisdom is wrong. The tide on staggered boards has turned and, at least for the largest companies, the day is not far off when staggered boards will be extinct. In Table 2, we present data on staggered boards in the S&P 100 companies. S&P 100 companies are the largest and among the most established companies. In aggregate, they represent almost 45% of the market capitalization in the U.S.[81] As Table 2 shows, the incidence of staggered boards has declined from 44% to 16% between 2003 and 2008.[82]

To be sure, the decline of staggered boards among the largest and most established

---

[79] Lucian Bebchuk, John Coates IV & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 Stan. L. Rev. 887, 949 (arguing that shareholders should not be permitted to adopt an antitakeover device, such as staggered boards, that does not allow for a one-time up-or-down referendum on acquisition offers); Bernard Black & Reinier Kraakman, Delaware's Takeover Law: The Uncertain Search for Hidden Value, 96 Nw. U. L. Rev. 521, 561 (2002) (arguing that courts should not respect staggered board terms because "neither the finance literature nor the norms of corporate law support vesting such unbalanced power in the hands of boards.")

[80] This was largely true up to 2003. See Getting the Message, Wall St. J., Oct. 9., 2006, at R6 (showing that virtually all shareholder resolutions that received majority support were ignored prior to 2003).

[81] Standard and Poor's, S&P 100.

[82] One the 16 companies that still had staggered boards in place for 2008, one had a "non-effective" staggered board (which is not regarded as a forceful anti-takeover mechanism) and the boards of two others had, since 2003, proposed charter amendments to destagger that failed to get the requisite (supermajority) shareholder approval.

companies does not necessarily mean that staggered boards are universally in decline. Arguably the managers of the largest companies are least in need of insulation against takeovers, and thus most willing to agree to destagger. Indeed, staggered boards are alive and well in companies at the time of their IPO. In a sample of 26 companies that went public in the first part of 2007, we found that 20 had staggered boards provisions in their charters.

That said, the largest and most established companies act as trend-setters for what is considered good corporate governance. The directors of these companies sit on boards of smaller companies, and their managers are members of influential groups like the Business Roundtable. With two-thirds of these companies dismantling their staggered boards or putting them for a shareholder vote in the last 5 years, it will become increasingly difficult for other companies to resist shareholder pressure.

In fact, smaller companies have started to go down the same path of dismantling their staggered boards that the S&P 100 companies have almost completed. Thus, according to SharkRepellent, the incidence of staggered boards among the (still large) S&P 500 companies has declined from 57% in 2003 to 47% in 2005 to 36% in 2007; among mid-size S&P 400 companies, it declined from 67% in 2003 to 64% in 2005 to 58% in 2007; and among small S&P 600 companies, it declined from 61% in 2003 to 60% in 2005 to 55% in 2007.[83] Thus, we suggest that other companies are already and will increasingly follow the lead of the S&P 100 companies.

2. The Meteoric Rise of Majority Voting for Directors

[83] See SharkRepellent.net - Library.

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

Until recently, the directors of most corporations were elected under a plurality voting regime. Of S&P 100 companies, only 10 deviated from plurality voting in 2003.[84] By 2007, that number had increased to 82. (See Table 3.) Moreover, of the 18 remaining companies, 3 had charter amendments to adopt majority voting in their 2007 proxy statements (all of which passed), 5 had some form of cumulative or dual class voting regime in place which complicates majority voting for directors,[85] and 3 had been, or were in the process of being, acquired and did not file a 2007 proxy statement. Only 7 companies retained a regular plurality voting regime. Thus, within a span of 4 years, we have moved from a regime in which majority voting was the rare exception to a regime in which it is the overwhelming norm. Though the rise of majority voting among the broader set of S&P 500 companies has been somewhat slower,[86] experienced

---

[84] Two as a result of state law, 5 due to charter or bylaw provisions, 2 unclear why, 1 unclear whether.

[85] Majority voting is not well defined for cumulative voting.

[86] See Claudia H. Allen, Study of Majority Voting in Director Elections, Neal, Gerber & Eisenberg, LLP, Nov. 2007 (from Feb. 2006 to Nov. 2007, percent of S&P 500 companies with majority voting increased from 16% to 66%).

Companies that have adopted majority voting differ in whether they have done so through a by-law amendment which usually specifies that a director who receives more "withhold" or "against" votes than "for" votes is not elected or through corporate governance guidelines requiring a director to tender her resignation is she receives more "withhold" or "against" votes than "for" votes. (Delaware law was recently changed to clarify that a resignation conditional on not receiving a specified vote can provide that it is irrevocable. See DGCL, Section 141(b).) The distinction between these two variants, however, is not large. Even if the director is not elected, the remaining board members could if they wanted to fill the resulting vacancy with the very director who failed to

observers like Martin Lipton opined that "it is clear today that majority voting will become universal."[87]

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

3. More – and More Successful – Shareholder Proposals

Another piece of evidence suggesting that the landscape is changing relates to precatory shareholder resolutions. In precatory resolutions, shareholders request the board of directors to take a certain action – such as redeem a pill or propose a charter amendment – without

---

receive the requisite shareholder vote. Directors, of course, will be reluctant to do so, but they will be equally reluctant not to accept the resignation of a director who received more "against" than "for" votes. In any case, most recent moves to majority voting are via by-law amendments and many companies that had initially adopted a corporate governance guidelines and subsequently adopted a by-law. See Allen, supra note XX.

[87] Martin Lipton, Some Thoughts ... 2008, infra.

mandating the action. Virtually all these resolutions are introduced under Rule 14a-8 of the Securities Exchange Act which permits shareholders, at little cost, to force the company to include a resolution in its own materials. Precatory resolutions thus represent a low cost and (since they are not binding) relatively low pressure form of activism.

In addition, it was long thought that precatory shareholder resolutions did not have much of an effect. This used to be true – but no longer is. First, an increasing number of shareholder resolutions are adopted by shareholders.[88] Since 2001, Georgeson, a major proxy solicitor, has prepared an annual Corporate Governance Review showing the voting results on shareholder resolutions filed with S&P 1500 companies.[89] Table 4 shows, for each year, the number of proposals receiving majority shareholder support and whether the board, in the year after passage, implemented the proposal (i.e., did what the shareholders asked it to do), ignored the proposal (i.e., refused to do what the shareholders asked it to do), or did neither (e.g., because the company was acquired or because the proposal asked the board to refrain from taking an action which the board ordinarily would not have taken anyway within that time frame).[90]

Since 2001, the number of implemented proposals has been rising steadily, from 3 to 46 proposals. This is partly due to an increase in the number of proposals receiving majority support, but to a greater degree to an increase in the percentage of implemented proposals, from 12% in 2001 to 63% in 2006. Correspondingly, the percentage of ignored proposals has

---

[88] We considered a resolution in adopted if it received more votes in favor than the combined votes against and abstentions (including broker no-votes). This appears to be the standard used by most companies.

[89] See Georgeson, Annual Corporate Governance Review, various years. Prior to 2001, Georgeson has also prepared such a report, but analyzed only corporate governance proposals made by institutional investors.

[90] Information in Table 4 about adopted resolutions is based on data in Georgeson, Annual Corporate Governance Review, various years. For each adopted resolution, we conducted research to see whether it was implemented or ignored over the next year.

declined. Thus, in 2001, few proposals were adopted and most of those that were adopted were simply ignored by the board of directors. By 2006, many more proposals were adopted and, of those, most were implemented.[91]

IV. REGULATORY CHANGES - VOTING AND SOLICITATION OF PROXIES

A generation of efforts to empower shareholders has led to a series of regulatory changes. An account of the constraints placed on CEOs is not complete with discussing them.

1. The 1992 Amendments: An Honorable Mention

The 1992 amendments to the proxy rules merit an honorable mention in this section.[92] To understand the import of this and some later reforms, it is important to give a short overview of the federal regulation of proxy solicitations.

The federal proxy rules used to prohibit *any person* from engaging in a solicitation unless that person has filed a proxy statement with the SEC and sent it to each shareholder who is being solicited or an exception applies. The definition of "solicitation" in the proxy rules, moreover, was (and still is) extraordinarily broad and includes virtually any comment about the company, management, or any proposal to be voted.[93] Preparing a proxy statement is a somewhat tedious and costly task, and printing and mailing it to each solicited shareholder further adds to the expense. If a shareholder owns only a few percent of a company's stock, if the issue involved is

---

[91] For another study on shareholder resolutions arriving at similar conclusions, see Randall S. Thomas & James F. Cotter, Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and market Reaction, 13 J. Corp. Fin. 368 (2007) (finding that, from 2002 to 2004, support for resolutions and implementation rate have increased).

[92] Securities and Exchange Commission, Release No. 34-31326 (1992).

[93] See Rule 14a-1(l) (defining solicitation to include any communication reasonably calculated to result in the procurement or withholding of a proxy).

not of critical importance, or if the shareholder is not planning to conduct a full-fledged campaign, the shareholder is not likely to engage in any solicitation unless an exception to the proxy statement filing requirement applies.[94] The natural effect of these rules was thus to stifle communication and coordination among shareholders.

The 1992 amendments added an additional important exception to the requirement to prepare and file a proxy statement. Under Rule 14a-2(b)(1), most persons who do not either "seek ... the power to act as proxy" or furnish a form of proxy need not file a proxy statement.[95] When the solicitation is oral, no filings of any sort are required.[96] This exception is useful when the solicited shareholders can vote on the form of proxy distributed *by the company* – such as votes in favor of a shareholder resolution, in opposition to a management proposal, or to withhold authority to vote for certain directors.

Rule 14a-2(b)(i) was mostly meant on encourage involvement by institutional investors. However, until recently, it does not appear that institutional investors – or anyone else, for that matter – made much use of the exceptions in the rules. Active campaigns in favor of a shareholders proposal, in opposition to a management proposal, or to withhold directors were rare until 2004.[97]

More recently, however, the exceptions in Rule 14a-2(b)(i) have become much more

---

[94] Prior to the 1992 amendments, the most important exception to these requirements related to solicitations of 10 or fewer shareholders.

[95] Rule 14a-2(b)(1).

[96] Rule 14a-6(g)(2).

[97] Prior to 2004, Georgeson did not keep track of "other activist events" where dissidents do not distribute a separate proxy card, indicating that such solicitations were rare.

important. As discussed above, institutions now commonly oppose proposed mergers endorsed by the board of directors. They also increasingly engage in campaigns in support of shareholder proposals. Finally, these provisions make it easy for hedge funds to coordinate their activities as long as they stop short of forming a 13(d) "group."[98]

Perhaps more to the point, some of the other governance changes discussed above will create even more opportunities for making use of Rule 14a-2(b)(i). Specifically, the moves[99] to majority voting and annual elections of the entire board means that the opportunities for, and the incentives to, engage in withhold campaigns increase. With annual elections, the opportunity for a withhold campaign on a specific director arises every year, rather than once every three years under staggered boards. And with majority voting, the result of sufficient withhold vote is that the director is not elected or is required to offer to resign, rather than mere embarrassment under plurality voting. Moreover, the ability of activists to threaten to engage in a withhold campaign is greatly enhanced by the fact that such a campaign would fall under the Rule 14a-2(b)(i) exceptions. This is especially true for activists that are viewed as cost-sensitive, such as mutual funds or public pension funds. Thus, whatever the use of the Rule 14a-2(b)(i) is today, we think it is likely that the use will increase significantly in the years ahead.

2. The Probable End of Broker Discretionary Voting in Director Elections

Under long-standing practice, brokers may vote shares held in their accounts according to their discretion when they do not receive specific instructions from the beneficial owners of

---

[98] CSX Corporation v. The Children's Investment Fund Management (UK) LLP (S.D.N.Y. No. 08 Civ. 2764) (2008). (discussing when hedge funds are deemed to have formed a group for Section 13(d) purposes).

[99] See infra XX.

these shares and when the matter is designated as "routine" by the New York Stock Exchange ("broker non-votes" in the jargon of the trade).[100]

These discretionary broker votes have been a reliable and significant source of pro-management votes.[101] Many individual shareholders, who tend to hold their shares in brokerage accounts, do not bother to provide voting instructions and brokers have tended to use their discretion to vote shares in accordance with the board's recommendations.

In addition, historically, the NYSE has regarded uncontested director elections – that is, elections where there is only one slate of nominees – as routine, even when some shareholders waged an active campaign to convince other shareholders to "withhold" their votes from certain nominees. For example, in 2004, 43% of the shares voted to withhold support from Disney's CEO Michael Eisner – a far from routine vote that may have forced him to resign. Brokers, however, were permitted to cast the votes of uninstructed shares, and, according to some, if broker votes had been ignored, Eisner would not have received majority support.[102]

The significance of discretionary broker votes has recently declined. First, as discussed above, the percentage of shares held by individual investors – the type of investor most likely to hold their shares in brokerage accounts and not to return a ballot[103] – is steadily decreasing.

---

[100] NYSE, Inc., Rule 452 (Mar. 6, 2003).

[101] Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Voting, 96 Georgetown L. J. 1227, 1250 (2008).

[102] See 'Broker Votes': Opponents May Win One, Wall St. J., June 13, 2007, at C1 (ascribing this to the Council of Institutional Investors).

[103] SEC Hears Testimony on Broker Votes, at http://blog.issproxy.com/2007/05/sec_hears_testimony_on_broker.html ("While most institutions now vote their shares or give voting instructions, only 30 to 40 percent of retail investors bother to vote their shares.")

Second, several brokers have recently moved from voting uninstructed shares in accordance with the board recommendation to voting them in the same proportion as those shares in their accounts for which they received voting instructions.[104] On the other hand, voting is more important than ever. With the rise of withhold-vote campaigns and, as discussed above, majority voting for directors, an increasing number of director elections will likely become truly non-routine, making the ability of brokers to vote more important.

Either way, however, discretionary broker votes in director elections may soon be gone. In October 2006, the NYSE proposed to amend Rule 452 governing broker votes to redefine all director elections as non-routine.[105] The proposed change requires SEC approval to become effective, but one wonders why the SEC would deny approval to a rule proposed by the NYSE that would take away voting rights from persons who no one argues have any legitimate interest in the outcome of the vote. If and when approved, brokers will lose their discretionary voting authority for any director election.

An end of discretionary broker voting will obviously make it easier for withhold campaigns to succeed. On non-routine shareholder proposals, broker non-votes amount on average to 19% of the votes cast at an annual meeting.[106] Until recently, a board could count on brokers voting these shares in favor of its nominees. That would imply that, to get a majority withhold vote, activists would have to get 62% of the instructed shares - a pretty steep task.

---

[104] See 'Broker Votes': Opponents May Win One, Wall St. J., June 13, 2007, at C1 (reporting that Goldman Sachs, Merrill Lynch, and Morgan Stanley have done so in the 2007 season and that Charles Schwan has done so since 2005).

[105] Report and Recommendations of the Proxy Working Group to the New York Stock Exchange 3 (2006), *available at* http://www.nyse.com/pdfs/PWG_REPORT.pdf.

[106] See SEC Hears Testimony on Broker Votes, May 25, 2007, at http://blog.riskmetrics.com/2007/05/ (attributing this figure to Broadridge Financial).

Without broker non-votes, this task is much easier.

3. Notice and Access

Last year, the SEC enacted new rules governing the electronic delivery of proxy materials.[107] Under the rules, companies soliciting proxies may mail shareholders a short notice providing some basic information about the issues to be voted on the annual meeting and referring them to a website where the proxy statement and other solicitation materials are available instead of furnishing the whole set of proxy materials.[108] The "notice and access"option is meant to reduce the cost of printing and mailing solicitation materials. Importantly, the "notice and access" option is also made available to shareholders engaged in a solicitation opposed by the company.

The "notice and access" option is especially important when shareholders cannot rely on the Rule 14a-2(b)(i) exemption discussed above. Under that exemption, shareholders can already engage in an effective proxy campaign without furnishing a proxy statement in support of a shareholder proposal, in opposition to a board proposal, or to withhold votes for board nominees to the board of directors. On these issues, the option to shareholders of making a proxy statement available electronically is largely irrelevant.

Rule 14a-2(b), however, has its limitations. Most importantly, the exemption does not

---

[107] For background and a similar point re: notice and access as compared with issuer proxy access, see Jeffrey Gordon, Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy, – Vand. L. Rev. – (forthcoming 2008).

[108] See Rule 14a-16. Morever, as of 2008, large accelerated filers, and, as of 2009, everyone else, is required to post materials on a web-site.

cover contests to elect a dissident slate to the board of directors.[109] Right now, many such contests tend to be full-blown campaigns – such as the Trian's campaign against Heinz – often conducted by a hedge fund or in the context of takeover bid. For full-fledged campaigns, the printing and mailing savings from "notice and access" is likely immaterial.[110] Thus, we do not expect that "notice and access" will lead to a significant increase in the number of such contests.

Rather, the largest impact of the "notice and access" rule will likely lie in lower-key, lower-cost, contests, probably for a "short slate" minority representation on the aboard. In such contests, the costs savings resulting from not having to print and mail proxy statements may well be significant.[111]

The campaigns in these lower-key election contests are likely to resemble the campaigns currently waged in support of shareholder resolutions, in opposition to a board proposals, or to withhold votes in favor of directors, which are now conducted in reliance on the Rule 14a-2(b)(i) exemption.[112] Unlike full-fledged campaigns, these campaigns are often run by cost-conscious traditional institutional investors. The existence of such campaigns shows that there is some demand by investors for activism that goes beyond making (or voting for) a mere shareholder proposal under Rule 14a-8, but does not go as far as a full-fledged contest. "Notice and access"

---

[109] See Rule 14a-2(b)(1)(iv) and (x) (exemption does not apply to nominees for the board of directors and persons acting on their behalf). Moreover, it is practically impossible to get a dissident elected without distributing ones own proxy cards.

[110] Trian estimated that its expenses will be $7 million. Proxy Statement, July 12, 2006.

[111] David A. Katz & Laura A. McIntosh, *Corporate Governance: A Seismic Shift in the Mechanics of Electing Directors*, Wachtell, Lipton, Rosen & Katz client memo, July 27, 2006, fn. 20.

[112] See Georgeson 2006 Annual Corporate Governance Review, Figure 20, Other Activist Campaigns (listing 13 other activist campaigns).

opens up a wider range of issues to these intermediate-intensity campaigns.[113]

4. The Uncertain – and Irrelevant – Fate of Proxy Access

One of the regulatory issues that seems never to go away is "proxy access." Proxy access refers to a requirement that a company include director candidates nominated by shareholders in the company's proxy statement. In 2003, the SEC approved a complex proposal for rules on proxy access and solicited comments on the proposal. This proposal followed earlier considerations of the issue – in 1942 and 1977 – which did not result in regulatory action.[114]

Under the proposal, proxy access was subject to a number of limitations. First, any shareholder proxy access was conditioned on the prior occurrence of a "triggering event" – specifically a 35% or more "withhold" vote for a person nominated as director by the board or a majority vote in favor of a shareholder proposal (made by a shareholder holding at least 1% of the company's stock) electing to subject the company to proxy access. Second, any such proxy access would be limited to two years after such a trigger had occurred. Third, in the two years after a triggering event, only shareholders who held at least 5% of company's stock continuously for two years could obtain proxy access. Fourth, that shareholder could only nominate a minority slate (1 to 3 directors, depending on the total board size).[115]

---

[113] Other campaigns that cannot be effectively conducted under Rule 14a-2(b) relate to campaigns by shareholders who must file a Schedule 13D (mostly 5% shareholders with an activist agenda), campaigns in favor of shareholder resolutions that the company excluded from its proxy statement under Rule 14a-8, or campaign were for strategic reasons the proponents wants to distribute its own proxy forms. Note that campaigns related to mergers, which not covered by the 14a-2(b) exemption, are also not subject to the "notice and access" rule.

[114] Staff Report, Review of the Proxy Process Regarding the Nomination and Election of Directors, July 15, 2003.

[115] Id. at XX.

When initially made, the proxy access proposal was supported by three of the five commissioners: the Republican Chairman Donaldson and two Democratic commissioners.[116] But the proposal elicited strong negative reactions from managerial interests, including the Business Roundtable (an association of chief executive officers of leading U.S. companies) and the Chamber of Commerce,[117] and Donaldson's support waned. When Donaldson resigned as chairman in 2005,[118] the practical effect was that the proposal, which has been lingering in limbo for some time, was considered dead.

A hard battle had been fought between proponents and opponents of greater shareholder rights, and the Business Roundtable had won – or so it seemed. Curiously, however, majority voting for directors – which started spreading at about the time of Donaldson's resignation and is now in place in most S&P 100 companies[119] – gives shareholders many of the same powers in a more useful form.[120] Most importantly, majority voting (like proxy access) gives shareholders the power to "diselect" – and embarrass – a director from the board and the ability to do so without having to file a proxy statement with the SEC. The credible threat of "diselecting" a director gives shareholders leverage. With the pending change in NYSE rules on discretionary

---

[116] Id.

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

[118] Donaldson Announces Resignation as S.E.C. Chairman, New York Times, June 1, 2005, at http://www.nytimes.com/2005/06/01/business/01wire-sec.html?ex=1275278400&en=d89d9d8be5440394&ei=5090&partner=rssuserland&emc=rss.

[119] See infra XX.

[120] For a similar opinion, see Joseph Grundfest, Proxy Access Unnecessary in View of Issuers' Shift to Majority Voting, Corporate Law Daily, Nov. 13. 2007.

broker votes, shareholders can diselect a director with fewer votes than would have been required under the proxy access proposals. Furthermore, while the proxy access proposal was subject to limitations – a triggering event must have occurred in the prior two years, the nominating shareholder must have owned 5% of the stock for two years, and only one to three incumbents could be challenged – majority voting is not so constrained.

To be sure, majority voting differs from proxy access in that shareholders cannot pick the director to replace the one they diselect. But we do not think that this is a major deficit. First and foremost, shareholders will have a much easier time agreeing on diselecting a director than agreeing both on rejecting a director candidate *and* on replacing her with a specific person. As a result, majority voting gives shareholders a much more useful tool than proxy access. Moreover, it is often the ability to remove an offensive director (and the ability to threaten such a removal), rather than the ability to pick a replacement, that shareholders are really after. This is all the more so because any shareholder nominees would have to have broad appeal to maximize their chances of getting elected and would thus likely be drawn from the same pool of candidates as regular directors.

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

In any case, there is an aftermath. Like the Sorcerer's Apprentice, the SEC could not

control the forces it set in motion. The American Federation of State, County and Municipal Employees (AFSCME) submitted its own home-made proposal for proxy access for inclusion in the 2005 proxy statement of the American International Group under Rule 14a-8. The SEC's Division of Corporate Finance issued a no-action letter permitting AIG not to include the proposal under Rule 14a-8(i)(8) because it related to an election. In a stinging opinion issued in September 2006, the Court of Appeals for the Second Circuit rejected the SEC's reasoning as inconsistent with the SEC's own prior interpretations of election exclusion and ruled that the proposal could not be excluded.[121] The SEC immediately announced that it would consider amending Rule 14a-8 and that revisions to the rule would be finalized in time for the 2007 proxy season. Despite this promise of speed, the SEC delayed action several times.[122] On July 25, 2007, the SEC finally approved two separate proposals for public comments, each by a 3-2 vote with the new chairman Cox once siding with the two other Republican commissioners and once with the two Democrats. The first proposal would restate (and put on a firmer regulatory footing) the SEC's position rejected by the Second Circuit that shareholder proposals on proxy access can be excluded under Rule 14a-8c). The second resembles the 2003 proposal that never gained traction and would thus establish a form of proxy access for all companies.[123] In

---

[121] AFSCME v. AIG, 462 F.3d 121 (2d Cir. 2006).

[122] Since October 2006, the SEC has delayed scheduled consideration of proxy access at least twice. See Atkins Says SEC Roundtable Likely on Proxy Access Issue; Time Not Yet Set, BNA Sec. Reg. & Law, Mar. 12, 2007, at 379.

In the meantime, there has been no groundswell of shareholder proposals resembling AFSCME's in the 2007 season – a fact quiet consistent with our view that majority voting (and, to a lesser extent, notice and access) have made the fate of the proxy access rule largely irrelevant.

[123] See Nicholas Rummell, SEC splits proxy access votes as Cox says 'yea' to two proposals, July 25, 2007, at http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070725/REG/70725013/1036.

November 2007, the SEC adopted the first position by a party-line 3-1 vote, one of the Democratic commissioners having resigned in the interim.[124] But lest this vote be mistaken as closing the issue, SEC Chairman Cox announced that he hoped that the SEC would revisit proxy access in 2008 and adopt a rule permitting some access.[125]

V. CHANGES IN THE BOARD OF DIRECTORS

1. Listing Standards

In 2003, in the wake on the Enron scandal and the Sarbanes-Oxley Act of 2002, the New York Stock Exchange ('NYSE') and the NASDAQ Stock Market adopted new governance rules for listed companies.[126] Both sets of rules now require boards of most companies[127] to have a majority of "independent" directors (albeit with somewhat varying definitions of "independence"),[128] to have an audit committee consisting entirely of independent directors[129] and that the independent directors have regular separate meetings ("executive sessions").[130] The NYSE rules further require that each board have a nominating/corporate governance and a

---

[124] See http://blog.riskmetrics.com/2007/11/the_sec_denies_proxy_accesssub.html

[125] Id. (quoting Cox as saying "Today is not the end ... [W]e can act on a new rule proposal next year that does more than just perpetuate the status quo."

[126] See Goodwin Procter LLP, SEC Approves Final NYSE and Nasdaq Corporate Governance Standards (2003), at http://library.findlaw.com/2003/Nov/11/133156.html.

[127] Boards of certain controlled companies are exempt.

[128] N.Y.S.E. Listed Company Manual, Section 303A.0; NASDAQ Rule 4350(c)(1).

[129] N.Y.S.E. Listed Company Manual, Section 303A.07(b); NASDAQ Rule 4350(d)(2).

[130] N.Y.S.E. Listed Company Manual, Section 303A.03; NASDAQ Rule 4350(c)(2).

compensation committee consisting entirely of independent directors.[131] The NASDAQ rules do not require boards to establish such committees, but if a company does establish a nominating or a compensation committee, it must consist entirely of independent directors.[132] The NASDAQ rules do not address the composition of any separate corporate governance committee. Both set of rules became effective in January 2004 for some companies, and later for others. And the Sarbanes-Oxley Act of 2002 itself requires, as of 2003, that each listed company have an audit committee consisting entirely of independent directors.[133]

2. Nominal Board Independence

As Jeff Gordon as recently shown, the nominal independence of board members has increased dramatically since the 1950s. Gordon estimates that the percentage of inside directors has steadily decreased from 50% in 1950 to around 10% in 2005 and that the percentage of independent directors has correspondingly increased from around 20% to around 80%.[134]

What is less clear, however, is whether there has been a significant change in board make-up over the last 5 and 10 years and, if so, whether any change is attributable to the changed listing requirements. Korn/Ferry, which conducts annual reviews of proxy statements of Fortune 1000 companies, reports that the average number of insiders on boards remained steady at 2

---

[131] N.Y.S.E. Listed Company Manual, Section 303A.04 and .05.

[132] NASDAQ Rule 4350(c)(3) and (4).

[133] Sarbanes-Oxley Act of 2002, Section 301 (amending section 10A of Securities Exchange Act).

[134] Jeffrey N. Gordon, The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices, 59 Stan. L. Rev. 1465, 1473-78 (2007).

between 1997 and 2006, while the average number of outsiders has declined from 9 to 8.[135] It is, of course, possible that these outsiders include fewer "grey" directors (who, albeit not employees of the company, have a relationship that renders them non-independent). But we consider it unlikely that any significant decline in the number of grey directors would not also be reflected in the changed numbers of inside and outside directors.

Similarly, there appears to have been no change in the make-up of the key committees. According to Korn/Ferry data, in each year between 1997 and 2006, neither audit, nor compensation, nor nominating, nor corporate governance committees have had (on average) *any* insider directors (the average number of outside directors on each committee varied between 3 and 4).[136] Thus, both in terms of overall board composition and in terms of the composition of key committees, there have been no recent changes and most companies have fulfilled the requirements of the new 2004 listing standards for several years prior to their adoption.

3. Substantive Board Independence I: What do Boards Do?

One way to get a handle on whether boards have become more substantively independent of the CEO is to examine what boards spend their time on. Specifically, boards that spend relatively more time on monitoring the CEO are likely to be more substantively independent, and the CEOs of companies with such boards are likely to be less powerful.

There are several useful metrics of what boards spent their time on. One important measure is whether a board has established a committee devoted to certain tasks and how

---

[135] Korn/Ferry International, Annual Board of Directors Study (various years).

[136] Korn/Ferry International, Annual Board of Directors Study (various years).

frequently that committee meets. Virtually all companies have had audit and compensation committees for a significant period of time.[137] But the number of companies with nominating and corporate governance committees has increased significantly. According to Korn/Ferry, the percentage of companies with nominating committees hovered in the low to mid-70s until 2002, increased to 87% in 2003, and further increased to over 95% from 2004 on. The percentage of companies with corporate governance committees (which are not regulated by NASDAQ standards) gradually increased from 39% in 1997 to 48% in 2001, and then increased at a more rapid rate to 54% in 2002, 72% in 2003, 90% in 2004, and 94% in 2005 and 2006.[138] (See Figure 2). The changed NYSE and NASDAQ listing requirements presumably account for at least a portion of this increase. Many companies, however, added these committees before they were required to do so. The trend in corporate governance committees, not required by Sarbanes Oxley or NASDAQ listing standards, and increasing even pre-SOX, suggests that a significant portion of the increase may be unrelated to the changed standards.

Another interesting trend can be observed by looking at some other committees. The three committees included in the Korn/Ferry data that relate to "management" – the executive committee, the finance committee, and the investment committee – experienced a steady decline in significance.[139] (See Figure 3) By contrast, the one committee charged with monitoring functions that is not affected by the changed listing standards – the succession committee –

---

[137] Of companies participating in the Korn/Ferry survey, 100% had audit and 99% had compensation committees by 1995. Korn/Ferry International, 22nd Annual Board of Directors Study (1995).

[138] Korn/Ferry International, Annual Board of Directors Study (various years).

[139] Korn/Ferry International, Annual Board of Directors Study (various years).

experienced a steady (if slow) increase from 31% in 1997 to 39% in 2006.[140]

Another indicator of whether these committees serve as window dressing or whether they perform important functions is the number of times they meet. As Table 5 indicates, the number of meetings of committees with monitoring functions – the audit, compensation, nominating, corporate governance, and succession committees – has generally increased.[141] With the exception of the audit committees, this increase does not seem to be due to an increased burden placed on these committees by the Sarbanes-Oxley Act. Rather, the number of meetings increased at approximately the same rate in the pre-Sarbanes Oxley period (1997 - 2001) as in the post-Sarbanes-Oxley period (2001 - 2006). The numbers of meetings of the committees with management functions – executive, finance and investment – have remained steady.[142]

We also examined the compensation received by board members for serving on various committees. As a measure of compensation, we used the retainer received by the committee chair because cash compensation levels for that measure were available for each committee in most years.[143] Between 1996 and 2001, compensation for committee service adjusted for inflation barely budged. (See Figure 4). Average compensation (adjusted for inflation) changed by less than 1% per year for all committees combined, all committees but the audit committee, the audit committee, the four other monitoring committees, and the three management

---

[140] The only other committees included in the Korn/Ferry data are the "Corporate Responsibility" committee, which experiences a slight decline, and the director compensation committee, which experiences a major increase.

[141] Korn/Ferry International, Annual Board of Directors Study (various years).

[142] Korn/Ferry International, Annual Board of Directors Study (various years).

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

committees. But between 2001 and 2006, the picture is starkly different. Compensation for the chair of the audit committee increased on average by 18% a year – unsurprising given the additional responsibilities resulting from the Sarbanes-Oxley Act. But compensation for the four other monitoring committees also increased, by a respectable average of 11% a year; while compensation for the three management committees increased by only 5% a year.[144]

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

Some other data in the Korn/Ferry survey provide additional evidence that outside directors work harder. Survey responses indicate that, between 1997 and 2003, the monthly numbers of hours worked increased from 13 to 19. In 2004 and 2005, when Korn/Ferry instead asked whether the board had more meetings than in the prior year, 29% and 34%, respectively, responded yes.[145]

4. Substantive Board Independence II: Changed Board Dynamics

Over the last few years, boardroom dynamics have changed, with outside directors emerging as a power center independent of CEOs. Until recently, outside directors never met without the CEO present and received most of their information from management. This insider control of the information flow to and among outside directors has ceased. Nowadays, it is not

---

[144] Korn/Ferry International, Annual Board of Directors Study (various years). Another fact of perhaps symbolic significance: between 1996 and 2002, the highest average retainer (usually by a large margin) was paid to the chair of the executive committee, traditionally the CEO. By 2005, the average retainer of the chair of the executive committee was less than the retainer for the chair of each of the five committees with monitoring tasks.

[145] Korn/Ferry International, Annual Board of Directors Study (various years).

unusual for directors to meet with significant shareholders and even with employees.[146] In some instances, they even hire outside consultants to review business plans presented by management.[147] In addition, since 2004, outside directors are required by stock exchange rules to meet in "executive sessions" outside the presence of the CEO. According to reports, directors who fear the company is heading off course use these meetings to reinforce each others' concern and settle on a plan of action – including, on occasion, a plan to fire the CEO.[148]

Responses in the Korn/Ferry survey confirm this change in board dynamics. Thus, the percentage of boards with a formal process for evaluating CEOs increased from the high 60s in 1997 and 2001 to around 90% in 2006. In addition, the percentage of boards with a lead outside director (if the CEO is also the chairman) increased from around 30% up to 2002 to around 80% in 2006. According to another annual survey conducted by the Business Roundtable, 90% of companies had an independent chairman, lead director or presiding director in 2007 (up from 83% in 2005 and 71% in 2004).[149]

The latter increase could be attributable to the requirement that independent directors meet in executive sessions. Though there is no requirement for a lead director, a board may find it useful to appoint a lead director to run these meetings. But we think more is going on. For one, the percentage of respondents who said that companies *should have* lead outside director

---

[146] Move Over CEO: Here Come the Directors, Wall St. J., Oct. 9, 2006, at R1. See also Lipton, 2008, at 7 (increased demand by public pension funds and other activists to meet independent directors.

[147] Id.

[148] Private Time, Wall St. J., Oct. 9, 2006, at R4.

[149] Korn/Ferry International, Annual Board of Directors Study (various years).

increased from 55% in 2001 to 84% in 2006.[150] Second, the percentage of companies with a lead director *out of those that conduct executive sessions* increased from 34% in 1997 to 78% in 2001 to 83% in 2006.[151] This indicates that the increase in lead directors is not merely a pragmatic adjustment to the regulatory change, but reflects a change in the board attitude that a greater dispersion of power – away from the CEO and towards the independent directors – is desirable or at least required.

Finally, the standard US practice of having the CEO also serve as Chairman of the Board seems to be eroding. According to the Business Roundtable Survey, the percentage of companies that had split the CEO and Chairman position increased from 4% in 2004, to 9% in 2005, to 11% in 2006, to 13% in 2007.[152] And our own review of S&P 100 companies indicates that the percentage of companies with split positions increased from 18% in 2003 to 26% in 2006.

Perhaps the most telling indicator that boardroom dynamics have changed is the annual list of "Key Issues for Directors" prepared by Martin Lipton. In 2006, the number one item on the list was "Anticipating Attacks by activist hedge funds ..."[153] In 2007, attacks by activist hedge fund had dropped to number seven (of nine) and a new entry headed the list: "Maintaining

---

[150] Id.

[151] Id.

[152] Business Roundtable, Business Roundtable Corporate Governance Survey Key Findings, Oct. 2007.

[153] Client Memorandum from martin Lipton, Wachtell, Lipton, Rosen & Katz, Key Issues for Directors (Dec. 6, 2006).

collegiality and the culture of common enterprise with the CEO and senior management ..."[154]

5. Substantive Board Independence III: CEO Turnover

As another indicator for the greater substantive independence of the board of directors, CEO tenure is declining. According to a recent report prepared by Booz Allen Hamilton, directors are "becoming more critical ... and are far more likely to insist that CEOs deliver acceptable shareholder returns."[155] Importantly, Booz Allen finds that boards are increasingly prepared to replace CEOs *in anticipation of disappointing future performance,* rather than in response to poor past performance. For 2006, total turnover (which includes turnover due to retirement, dismissal and acquisition) was 14.3%. Among the other specific finding, Booz Allen reports that, between 1995 and 2006, annual turnover of CEOs had increased by 59% and performance-related turnover by 318%. Correspondingly, the fraction of CEOs who were forced from office increased from 1/8 to nearly 1/3.

A study by Steve Kaplan and Bernadette Minton arrives at similar conclusions.[156] Kaplan and Minton find a total takeover rate (including both external (take-over related) and internal (non takeover-related) turnover) of 16.45% and an internal takeover rate of 12.83% for 1998 - 2005, which corresponds to an average CEO tenure period of as low as six years. This period, the authors say, is substantially shorter than the ones reported in previous work for the 1970s,

---

[154] Client Memorandum from martin Lipton, Wachtell, Lipton, Rosen & Katz, Key Issues for Directors (Dec. 17, 2007).

[155] Chuck Lucier et al., The Era of the Inclusive Leader, Special Report, 47 Strategy + Business 2 (Summer 2007).

[156] Steven N. Kaplan & Bernadette A. Minton, How has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs.

1980s, and 1990s. They conclude that boards respond more broadly to poor performance than they had in the past and monitor more frequently and aggressively.

In our analysis of S&P 100 companies, we found that, of 96 companies that had not been acquired between March 2006 and March 2008, 19 had a turnover in CEOs. (This corresponds to a somewhat lower internal takeover rate than reported in the study above, which may be due to the fact that CEOs of S&P 100 companies are less inclined than CEOs of smaller companies to leave for a different position.) Of these 19 changes, one can be classified as a promotion (Goldman Sachs' CEO became Secretary of the Treasury), and 9 (based on press reports) as involuntary. The remainder are claimed to be retirements. Using the academic convention of and treating a "retirement" of a CEO who is 60 or older as voluntary and a "retirement" of a CEO under 60 as forced (unless the reported reason is health), a total of 12 changes can be classified as involuntary. Thus, our sample yields a somewhat higher estimate for involuntary turnover, both absolutely and as a fraction of total turnover, than the Booz Allen study.

VI. Executive Compensation: The Final Frontier

1. Enhanced Disclosure

In July 2006, the SEC adopted new and enhanced disclosure requirements for executive compensation.[157] The new rules expand the previous disclosure regime in several ways. First, proxy statement must contain a new section "Compensation Discussion and Analysis" with a narrative discussion of objectives, design of compensation program, and how the company

[157] S.E.C. Release Nos. 33-8732A (2006).

determines the amount of various compensation elements.[158] Second, more information is required for stock options and retirement benefits, including the fair value of these options on the date of the grant.[159] Third, an enhanced summary compensation table must provide a dollar value for each compensation item as well as elements for total compensation.[160] The last requirement, in particular, makes it harder to camouflage compensation by shifting it into categories that need not be quantified.[161] Prior to the 2006 reforms, the reported figure for "total compensation" did not include the value of stock awards, option grants and retirement benefits. And although some information on these items was disclosed elsewhere in the proxy statement, it was hard to decipher their dollar value. Thus, for example, GE reported that its CEO Jeffrey Immelt received "total compensation" of $3.4 million in 2005, that he was also granted 430,000 performance stock units (PSUs) in 2005, and that he held PSUs and restricted stock with a value of $45.7 million as of December 31, 2005; but it did not disclose either the fair value of the PSUs granted in 2005 nor the total compensation including these PSUs for 2005.[162] For 2006 (post-reform), GE disclosed that Immelt received total compensation of $17.9 million, a figure that includes stock and option awards valued at $8 million and increases in pension value of $1 million.[163]

---

[158] Reg. S-K, Item 402(b).

[159] Reg. S-K, Item 402(d)(2)(ii) and Item 402(a)(6)(iv).

[160] Reg. S-K, Item 402(c).

[161] Bebchuk, Lucian Arye & Fried, Jesse & Walker, David I, Managerial Power and Rent Extraction in the Design of Executive Compensation, 2002.

[162] General Electric Corp., Proxy Statement, 2006.

[163] General Electric Corp., Proxy Statement, 2006.

2. Say on Pay

The latest shareholder rights initiative goes by the poetic label "say on pay."[164] "Say on pay" would require a company to give its shareholders a non-binding, advisory vote on the compensation of its executives. This could have serious ramifications. The combination of traditional institutional investors with various performance or governance gripes, union-affiliated pension funds that may be willing to campaign for a "say NO on pay" vote, and populist sentiments against executives whose pay, as a multiple of average worker salary, has risen steadily – together with the disclosure requirements that make it harder to "camouflage" executive compensation – means that many CEOs could find their packages disapproved by shareholders. Moreover, given the recent trend of boards to heed shareholders requests,[165] even an advisory vote could be a significant threat to CEO pocketbooks. Unsurprisingly, management lawyers like Martin Lipton recommend that such votes be "strongly resisted."[166]

A bill mandating "say on pay" for all public companies was passed by the House of Representatives in April 2008,[167] but has so far not progressed in the Senate. Perhaps more importantly, the SEC has ruled that shareholder proposals requesting boards to adopt "say on pay" are not excludable under Rule 14a-8.[168] According to ISS, the number of such proposals

---

[164] BNA Corp. Gov. Rpt., Annual Meeting Voting Compels More Accountability, Mar. 3, 2008 (listing "say on pay" as one of top 3 issues on corporate ballots for 2008).

[165] See supra XX.

[166] Martin Lipton, Some Thoughts for Boards of Directors in 2008, Dec. 6, 2007, at 8.

[167] Wall St. J., Apr. 21, 2007, at A3.

[168] Proposals on Policy for 'Advisory' Votes Regarding Executive Pay Not Excludable, BNA Sec. Reg. & L. Rpt., March 5, 2007.

has sky-rocketed from 0 in 2005, 7 in 2006, 41 in 2007, to at least 76 in 2008[169] – the single most numerous category of proposals for that year.[170]

Shareholder support for these proposal is high – the average proposal received 41.7% in 2007 – but not nearly as high as support for proposals to destagger (63.9% support) or to adopt majority voting (50.3% support).[171] Of 38 such proposal for which results were reported by Georgeson, only 2 (at Ingersoll-Rand and Motorola) garnered a majority of the votes cast.[172] This partly explains why these proposals are so numerous. When proposals to destagger a board or to adopt majority voting, which shareholders regularly adopt, are introduced, companies often agree to make the requested changes without a shareholder vote and thus remove the proposal from the ballot. But because boards have a high chance of defeating a "say on pay" proposal, they have less of an incentive to adopt "say on pay" on their own.

So far. The problem for boards – and CEOs, who would presumably be most affected by "say on pay" votes – is that for new types of shareholder proposals, the percentage of shares voted in favor and the number of proposals introduced tends to increase over time. Thus, for example, support for majority vote proposals, also of relatively recent vintage, increased from 11% (on 12 proposals) in 2004, to 44% (on 54) in 2005, to 48% (on 84) in 2006, to 50% (on 37) in 2007. For shareholder proposals for "say on pay," the number of proposals and, to a lesser extent, the support they garner (no proposal in 2005, 40% on 7 proposals in 2006, 41% on 41

---

[169] See http://www.directorship.com/no-say-on-pay, July 23, 2008 (76 proposals so far that year).

[170] RiskMetrics Group, 2007 Postseason Report, October 2007, at 6.

[171] RiskMetrics Group, 2007 Postseason Report, October 2007, at 6.

[172] Georgeson, 2007 Annual Corporate Governance Review.

proposals in 2007, 42% on 76 proposals in 2008), seems to follow a similar pattern.[173] Morever, signs are that the board front against "say on pay" is starting to break. In 2008, Aflac Inc. became the first company to hold an advisory "say on pay" vote, apparently without any shareholder pressure.[174] Verizon Communications, where a 2007 proposal received slightly more "for" than "against" votes (but less than majority support), and Blockbuster, where the proposal received majority support, decided to adopt "say on pay" for 2009.[175] And Pfizer and several other large companies have formed a working group with union officials to discuss adoption of say on pay.[176]

3. Actual Compensation

Actual executive compensation may present the final frontier in the erosion of CEO dominance. Many commentators believe that CEOs, through their influence over the board, essentially set their own pay.[177] Even if one does not subscribe to the more extreme versions of the theory, which accords a minimal role to market forces in setting CEO pay, compensation is surely important for CEOs and CEOs can be expected to use the levers of power they have to notch up the amount they earn. Thus, if we are right and CEOs have lost power, we may expect that the decline in power has, or will soon have, an adverse impact on their compensation.

---

[173] http://www.directorship.com/no-say-on-pay, July 23, 2008 (2008 data); RiskMetrics Group, 2007 Postseason Report, October 2007, at 6 (other years); RiskMetrics Group, 2006 Postseason Report, 2006 (2004 data).

[174] Wall St. J., Mar. 7, 2008, at B1.

[175] Wall St. J., Feb. 27, 2008, at A2. So did Par Pharmaceuticals.

[176] Martin Lipton, Some Thoughts for Boards of Directors in 2008, Dec. 6, 2007, at 8.

[177] See Bebchuk et al., supra note XX.

However, as discussed below, other factors may push it in the opposite direction and make it difficult to predict the effect of a loss on power on compensation.

VII. THE EFFECTS OF THESE CHANGES ON CEO POWER

In the previous pages, we've summarized a large number of changes in the relationships between CEOs, boards and shareholders. In this section, we analyze how these changes affect CEO power, using our earlier taxonomy.

a. Decision-making : Decisions and Agenda Control

Consider the single most important decision in the life of a company: whether to sell control. In a world of dispersed shareholdings – think back to the 1950s and 1960s – this was a decision in the first instance for the CEO, possibly with the advice of the board of directors.[178] A CEO who determined that it was a good time to sell the company or to buy another company would reasonably expect that decision to carry the day, even if the particular form of corporate combination required board and shareholder approval. Likewise, a CEO who decided that it was not a good time to sell had reasonable grounds for assuming that the decision would end discussion.

In today's world of activist hedge funds, more independent directors and assertive shareholders, that is clearly no longer true. How does it play out today? First, the changes in shareholder composition and activism means that shareholding is far more concentrated, and concentrated in the hands of shareholders – hedge funds and more traditional institutional shareholders – who are more willing to challenge a CEO's decision than ever before. Such

[178] See, generally, Myles Mace, Directors: Myth & Reality (1971).

challenges are becoming easier than ever to mount because the decline of staggered boards, the rise of majority voting for directors, and the ever increasing success of shareholder proposals, means that shareholders have far more opportunities to hold directors accountable for their deference to the CEO. Moreover, the 1992 partial deregulation of the proxy rules, combined with the probable end of broker non-votes, and the adopting of e-proxy means that the costs of challenging the CEO's decision have been markedly reduced. All this takes place against the backdrop of directors who, as a result of Sarbanes-Oxley driven stock exchange reforms in listing standards, are both formally and substantively more independent than ever before.

A decision by the CEO to sell or not to sell the company – as, say, PeopleSoft CEO Craig Conway learned – is therefore but the beginning of the conversation.[179] And, because all the players know that the rules of the game have changed, some conversations do not even start. In today's environment, a decision by the CEO to sell the company to a favored bidder over a competing bidder offering more is doomed from the outset.

Equally dramatically, the CEO has largely lost control over the agenda to the shareholders. The changes summarized above combine to eliminate the CEO's ability to keep matters off the corporate agenda. With hedge funds and more traditional institutional shareholders willing to agitate in favor of proposals on the issuer's proxy under 14a-8, or pursue matters directly in their own proxy solicitations, with the costs of such solicitations declining because of regulation and technology, and with increasing success in passing and implementing such proposals, CEO agenda control has been limited if not eliminated. In case after case,

---

[179] Against Conway's opposition, PeopleSoft was eventually acquired by Oracle. Finally, Oracle Nails PeopleSoft, BusinessWeek,, Dec. 13 2004, at http://www.businessweek.com/technology/content/dec2004/tc20041213_8884_tc024.htm.

shareholders have proved themselves capable of forcing unwanted topics onto the front burner.

These examples of loss of CEO decision-making powers are the most visible tips of an iceberg. In several other areas, our analysis suggest, CEO decision-making power has also declined. These include, in particular, the areas delegated to the responsibility of wholly independent board committee: audit, compensation, and nomination. How much else of the iceberg is hidden under water is hard to tell. Presumably, board members still generally defer to the CEO when it comes to operational decisions (or else decide to fire the CEO). By the same token, CEOs probably involve board members more in major strategic decisions (if only to make sure that they are on board if the decision does not work out as planed). And anecdotal evidence suggests that "friendly" hedge funds – who do not engage in adversarial activism – share their views about major business decisions with the CEO. Thus, it is likely that CEO decision-making power has declined significantly with respect to some key issues and more moderately over a wider set of issues, with both large shareholders and independent directors gaining power at the expense of CEOs.

b. Second Guessing

Though CEOs have some power to make decisions, it is in the aspect of second-guessing where their loss of power is most notable. In matters that to not constitute major strategic or governance decisions, the rise of active shareholders and independent directors does not seem to have affected the CEO's ability to direct action within the firm. Here, CEOs still reign supreme. But CEOs who become entangled in scandals, who consume excessive perks,[180] or who are not

[180] Personal use of corporate jets must be disclosed under 17 CFR 229.402, "Executive Compensation," and the regulations for perk disclosure in §229.402(b)(2)(iii)(C). Under these disclosure rules, the total value of perks must be disclosed based upon their "aggregate incremental cost" to the company, but only if the total exceeds the lesser of $50,000 or 10 percent of the executive's salary plus bonus. A further requirement is that the company must

responsive to shareholders or boards, are more likely to face repercussions.

What has changed, then, more than anything else, is the ability and incentives for other players to second guess the CEO's actions. Consider first a CEO who acts imperiously in regard to selling the company. If this decision was once considered the final word, it no longer is. In today's environment, one would expect hedge funds to buy shares in order to challenge the decision. Thus, when Yahoo's CEO Jerry Yang cold-shouldered an offer by Microsoft to acquire the company, it did not take long for Carl Icahn to commence a proxy contest and place three nominees on Yahoo's board.[181] More generally, the evidence we presented indicates that if a CEO makes mistakes (or perhaps just has bad luck), both shareholders and directors will voice their criticism sooner and more strongly and in the days of yore, be it informally, through a proxy challenge or another activist campaign, or through a board-induced CEO resignation.

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

As noted earlier, CEO power can also be divided along the dimensions of extension, comprehensiveness, and intensity. Extension essentially relates to the scale of the firm. Since firms have not gotten smaller, and since CEOs remain to be on top of the firm, CEO power has not declined along that dimension. In terms of comprehensiveness – the number of topics over which power is exercised – and intensity – the degree to which the holder of power can impose his or her will – CEO power has declined. As noted before, the decline is most pronounced (that is, the decline is sharpest along the dimension of intensity) in areas which require board or

---

itemize the cost of any individual perk, such as personal aircraft use, if it exceeds 25 percent of the overall perk total, assuming that the total exceeds the $50,000 threshold. David Yermack, Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns, working paper 2005 (ssrn).

[181] See Icahn-Yahoo declare a truce, Fortune, July 21, 2008, at http://dailybriefing.blogs.fortune.cnn.com/2008/07/21/icahn-joining-yahoo-board/.

shareholder approval, such as decisions to sell the firm, audit matters, compensation, corporate governance, and board nominations. In other areas, we believe CEO power has declined as well, but due to the lack of transparency over how these decisions are made and whether they are second-guessed, it is harder to document the decline. Morever, since independent directors and even activist shareholders have limited capacity to micro-manage a company, it is likely that CEOs still have substantial decision-making power over most non-strategic business matters, as long as their decisions produce acceptable results.

VIII. IMPLICATIONS

1. Fundamental Shift or Perfect Storm?

Some observers, noting some of the issues we discussed in the preceding part, have characterized the current state of affairs as a "perfect storm."[182] The perfect storm metaphor evokes a temporary and accidental alignment of forces that creates a special situation or opportunity.[183] But like other storms, perfect ones ultimately pass and the situation returns to normal.

We do not think this captures what is happening. The changes we discuss are not temporary and their simultaneous occurrence is not accidental. Any changes in the regulatory environment – including the changes in proxy rules, the revised listing standards in the stock exchange rules, and (if it happens) the elimination of broker voting in uncontested director

[182] Allen, supra note __, at __. IR Guide, A Perfect Proxy Storm.

[183] See, e.g., www.aacsb.edu/publications/Archives/JanFeb06/p34-37.pdf ("A perfect storm, by definition, is a convergence of independent events ...").

elections – are likely to persist. The shift in equity ownership from individuals to institutions reflects fundamental long-term change forces[184] and will continue. Companies who have agreed to destagger the board are unlikely to receive shareholder approval to reintroduce a staggered board.[185] And while most companies that have adopted majority voting could return to plurality voting without shareholder approval,[186] we think this is both unlikely and ultimately ineffective: even under a plurality vote regime, a director who receives a majority "withhold" votes faces enormous pressures to resign.

These changes, in turn, have caused some of the other changes we observe. To be successful, activist hedge funds need allies, and institutional investors with their increased holdings are likely candidates. Successful hedge fund activism has led traditional institutions first to lend their active support to hedge funds, and then to lead the charge themselves. The rise in institutional holdings has generated demand for voting advice by proxy advisors. The destaggering of boards and majority voting has increased the meaningfulness and the frequency of director elections. That directors are up for election more frequently, that they are worried about a large "withhold" vote, and that ignoring shareholder proposals is a sure way to increase the withhold vote,[187] is at least part of reason why boards have become more responsive to shareholder resolutions. This, in turn, means that more companies will destagger, adopt majority

---

[184] Specifically, the way retirement benefits are financed.

[185] Marcel Kahan & Edward Rock, Corporate Constitutionalism: Anti-Takeover Provisions as Precommitment, 152 *University of Pennsylvania Law Review* 473 (2003).

[186] Companies require shareholder approval only if majority voting in embedded in the charter, if a majority voting by-law was adopted by shareholders, or if a board-adopted by-law provided that it can be amended only by shareholders.

[187] See Choi et al. supra note XX.

voting, or even give shareholders a "say on pay." Independent nominating and governance committees reduce the ability of CEOs to stop this. Increased holdings by institutions and fear of hedge funds increases both the demand by shareholders to meet with outside directors and the willingness of directors to do so. Directors meeting in executive session creates the opportunity to discuss company developments unmonitored by the CEOs. As more boards question their CEOs, it becomes more acceptable for directors in other companies to do so. Greater substantive independence and greater pressure from shareholders, in turn, increases CEO turnover. Increased turnover means that, at any point of time, there will be more members of the board who have picked the CEO than members who were picked for the board during the CEO's tenure. Thus, even if CEOs continue to influence the selection of board members, despite the requirement for wholly independent nominating committees, shorter tenure implies less CEO influence over board membership. And we could go on.

We are not so bold to claim that all the trends we described will continue unabated. But we think that it is much more likely that CEOs, in the intermediate term (over the next 10 years or so) will lose more power than that they will regain some of the power they have lost.

2. Backlash

If we are correct and the changes we discuss presage a continuing decline in the power of CEOs, rather than a cyclical and self-reversing shift, there is the possibility of a political backlash. Such a backlash, in the form of state anti-takeover statutes and Delaware's sanctioning of the poison pill, helped stop the hostile takeover wave of the 1980s, the last significant threat to managerial power. These days, advocates of managerialism already argue that the increased

power of shareholders and decreased board collegiality induces an excessive short-term orientation that harms US competitiveness.

While the possibility of backlash cannot be excluded, we believe that its likelihood is remote. Unlike in the 1980s, the threat to managers derives from multiple sources – traditional institutions, hedge funds, proxy advisors, technology, and their fellow directors – rather than from a small group of raiders. And compared to raiders of the 1980s, who were in many respects outsiders,[188] even hedge funds (a fortiori institutional investors and board members) are part of (or well connected to) the establishment and have significant political power. The threat to managers is more gradual and broad-based than in the 1980s, and thus less likely to result in a strong response. Finally, there is little reason to expect populist support for pro-management changes: organized labor, who supported anti-takeover legislation in the 1980s, is lined up against management in this round.[189]

3. Board Composition

The shift of power from CEOs to outside board members also has implications for the type of persons who will serve on corporate boards. Compared to outside directors 10 years ago, outside directors today are likely to have more power, to enjoy a less collegial relationship to the insiders, to have a greater workload, to earn a greater pay, to have occasional need to become confrontational, and to deal with vocal and restive shareholders. Accordingly, board

---

[188] For example, many prominent investment banks and law firms refused to work for hostile bidders. See, e.g., Ron Chernow, The House of Morgan (2001) at 707 (until the late 1980s, J.P. Morgan did not do work for hostile bidders).

[189] For example, union affiliated pension funds sponsor some of the anti-management resolutions discussed above. See TAN XX.

composition will shift to persons who are good at these new tasks, who derive greater enjoyment for them, and who have the needed time and energy to devote to the job.

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

4. Shareholder "Flavor of the Year" Initiatives

Shareholder resolutions often come in waves, with every year or so witnessing the emergence of a new "flavor of the year" type of precatory resolution and the decline of some prior types. For 2008, professionals predict a significant rise in "say on pay" resolutions. In prior years, we saw a wave on resolutions on confidential voting, poison pill rescissions, performance-based options, etc.

Management's response has largely been to duck and hope for the storm to pass before the topic gained sufficient traction to generate real pressure for change. This tactics looks increasingly untenable. First, with the rise of institutional investors, it takes less time for a new proposal to gain significant shareholder support. Second, once a proposal has received (or is expected to receive) support, boards are increasingly willing to adopt the recommendation. We would thus predict more success of shareholder initiatives, which in turn will lead to more initiatives. The vote and company response on "say on pay" resolutions over the next few proxy cycles will be an early test for our prediction.

5. Convergence

Much ink has been spilled on the question of whether corporate law and governance systems in different countries are converging.[190] Our evidence suggest that we may be witnessing the end of a particular exceptionalism in U.S. corporate governance: the imperial CEO. In many respects, the changes we discussed in this article, while new from the U.S. perspective, have long been part of the corporate governance regime in other Anglo-American countries, such as the UK, Canada and Australia. Thus, for example, most UK companies have a non-executive chairman of the board and UK law gives shareholders a non-binding "say on pay."[191] Poison pills are not permitted under Australian law.[192] Under Canadian law, directors of a company with a classified board can be removed without cause, making this device an ineffective takeover defense. As US practice moves closer to the practice of these other countries, both with regard to specific issues and with regard to the overall power of the CEO, the corporate law regimes are converging.

6. Resistance to Acquisition

If we are right, being CEO of a public company has become less fun. You get to call fewer shots, you are being second-guessed by boards and shareholders, and your job security has

---

[190] See, e.g., Jennifer G. Hill, The Persistent Debate about Convergence in Comparative Corporate Governance, 27 Sydney Law Review 743 (2005).

[191] See The Future of Say on Pay: Current Status and Possible Impact, Aug. 12, 2008, at http://www.boardmember.com/boardroom-committee-interactive/compensation-committee/articles/?C=1985&i=4700.

[192] Jennifer G. Hill, The Shifting Balance of Power between Shareholders and the Board: News Corp's Exodus to Delaware and Other Antipodean Tales, working paper 2008.

decreased. All of this will make CEOs more willing to let their company be acquired and cash in on appreciated stock options or severance payments. CEO resistance to acquisitions should thus decline.

On the other hand, boards and shareholders may be the ones to offer roadblocks. Boards may get more involved in the negotiations of acquisition terms, and may reject offers that the CEO may want to accept. And we have already witnessed instances of shareholders trying to renegotiate a deal struck by management.[193] Board and shareholder resistance to acquisitions – which, until recently, was negligible – should thus increase.

In related work, we document the divergence in financial incentives to engage in control transactions between the CEO and independent directors.[194] While today's CEOs have strong monetary incentives to support a change in control, especially as they approach the end of their tenure,[195] for outside directors it is a losing proposition. While outside directors are able to sell any shares they have for a premium, these gains are dwarfed by the loss of the very substantial director fees. Moreover, such directors are typically not able to replace their lost directorship with another of comparable status.

These changes, in turn, may impact Delaware law on acquisitions. First, Delaware law on hostile takeovers and, in particular, the "just say no" defense, will become less important. By the same token, Delaware law on the ability of boards to "lock up" deals in the absence of a

---

[193] See supra TAN.

[194] Kahan & Rock, Outside Directors as the Brakes of Corporate Control.

[195] Coates & Kraakman, working paper.

bidding contest could become more important.[196] More profoundly, Delaware law rests to some extent on the premise that shareholders want to sell the company at a premium, and management wants to block the sale and stay independent.[197] If this premise becomes increasingly incorrect, Delaware law will have to adapt the substantive standard by which it evaluates transactions.

7. The Need for Greater Shareholder Voting Rights

Recently, our colleague Lucian Bebchuk has argued that shareholder voting rights should be expanded to include the power, without board approval, to change the company's governance structure (including the power to change the charter and to reincorporate into a different state) and to make certain specific business decisions (such as the power to instruct the board to auction the company to the highest bidder).[198] The premise of Bebchuk's argument is that, even though shareholders elect the board of directors, and thus indirectly already control all of these decision, this indirect control is not enough because directors do not heed shareholder wishes. Predictably, other commentators have ridden to the defense of the current system where the board retain greater control.[199]

The evidence we present in this article suggests that, whatever the merits of Bebchuk's proposal when it was conceived, the need for (and desirability of) any reform suggested by

---

[196] In practice, Delaware law addresses lock ups only in the context of competing bids.

[197] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)..

[198] See Lucian A. Bebchuk, Letting Shareholders Set the Rules 119 *Harv L Rev* 1784 (2006); Lucian A. Bebchuk, The Case for Increasing Shareholder Power 118 *Harv L Rev* 833 (2005).

[199] Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 *Harv L Rev* 1735 (2006); Leo E. Strine, Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America, 119 *Harv L Rev* 1759 (2006).

Bebchuk has declined. Bebchuk and his detractors fundamentally differ with respect to one major issue: when shareholders and the board of director take different position with respect to a matter – such as whether the charter should be amended in a certain way or the company should be auctioned off – who is more likely to be right? Both sides to the debate, however, would presumably agree that boards are more likely to heed shareholder wishes if they believe that what shareholders want is good, or at least is not bad, (or at least not very bad), for the company. That is, the merits of what shareholders want and the likelihood of boards following a non-binding shareholder vote, are correlated.

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

As we have shown in this article, however, even though the formal powers of the board have not changed, boards have become much more receptive to shareholders. For example, boards have become more likely to implement non-binding resolutions that receive majority shareholder support. Thus, boards voluntarily, albeit selectively, implement more shareholder-proposed governance changes. This obviously reduces the need for removing board veto power over governance changes, as proposed by Bebchuk. But if, as is likely, from among all the governance changes desired by a majority of shareholders, the governance changes implemented by boards are better than those rejected by boards, it may also mean that the time for Bebchuk's

proposal has passed. Even if we would be better off with letting shareholders set the rules than with giving veto right to boards when boards regularly ignored what shareholders want, we may be better off with board veto than with unfettered shareholder rights to set the rules when boards implement a significant portion of non-binding proposals passed by shareholders.

8. Private Equity to the Rescue?: the trade off between power and wealth

As remarkable as the growth in hedge funds may have been, it is not unparalleled. The funds raised by private equity firms in the U.S. have experienced a growth rate – 23%, annually compounded, from 1999 to 2006 – as high as the hedge fund assets under a management (19% during that period).[200] The total dollar volume of private equity M&A transactions in 2006 was $900 billion, a magnitude comparable to the total hedge fund assets ($1,427 billion), especially considering that a significant portion of hedge fund assets are not invested in equity securities.[201]

Moreover, at least until the recent credit crunch, private equity funds played an increasingly large role in M&A. As a percentage of total M&A dollar volume, private equity M&A has grown from less than 5% in 1999 to more than 25% in 2006. In 2006, there were 151 going-private transactions sponsored by private equity funds, up from only 67 in 2000.[202]

Private equity, like hedge funds, are significant new players. On the one hand, private equity, which rarely if ever engages in hostile transactions, empower CEOs by offering a safe harbor in a storm, by expanding CEO's options and opportunities, and, when taking companies

---

[200] The Blackstone Group, Amendment Number 9 to Form S-1, filed June 21, 2007, at 148, 151.

[201] Id. at 149, 151.

[202] Id. at 149.

private, by offering the possibility of great wealth. On the other hand, private equity, as an institution, weakens CEOs by increasing the likelihood of a change of control, by closely monitoring their investments in public companies, and by tightly controlling portfolio companies (setting and monitoring goals; firing underperfoming CEOs).

So, while having one's company acquired by a private equity firm may make an CEO rich, his power is reduced. When a company is acquired, the CEO either leaves the firm or stays on to manage the firm, which is now a portfolio company in a private equity fund. In the former case, the CEO gives up any power that comes with the job. In the latter case, the CEO now has a boss – the management of the private equity firm – which has the ability and the incentives to monitor him and to fire him if they are dissatisfied. Whatever financial rewards the CEO may obtain in his new position, one thing is clear: the power of a CEO of a company owned by a private equity fund is much less than the power of a CEO of a comparable company that is publicly traded.

CEOs, like other people, have complex motivations. Money is nice but so is power and prestige. Successful lawyers give up substantial income to become (poorly paid) judges. Successful businessmen spend vast sums to achieve (unremunerative) elective office.[203] But the substitution effect can run the other way as well: CEOs who have lost power may find the possibility of great wealth offered by private equity relatively more attractive.

Moreover, to the extent that we are right that the changes in CEO power are here to stay,

---

[203] Corzine, ex-CEO of Goldman Sachs, spent $60 million to become a US Senator (see What Makes Jon Corzine Run , Business Week, Sep. 27, 2004 at http://www.businessweek.com/magazine/content/04_39/b3901098.htm), and then another $43 million to become governor of New Jersey (http://www.washingtonpost.com/wp-dyn/content/article/2005/11/08/AR2005110802108.html). Michael Bloomberg spent $65 million to become New York mayor. Id.

we predict that public companies, to keep successful CEOs who have the option to move to private companies, will have to pay more. To the extent that power and money are substitutes, the decline in power predicts an increase in monetary compensation.

CONCLUSION: SEARCHING FOR THE SWEET SPOT

The story we tell above is a story of declining CEO power, a decline that has occurred across almost all of the relevant dimensions. Is this a good thing?

One of the great virtues of the corporate form is centralized management.[204] Much of corporate law can be interpreted as establishing and protecting that centralized management because of the benefits that it provides to the participants in the firm. At the same time, the centralization of management in the hands of paid managers creates the shareholder-manager agency costs, the prevention of which forms such an important part of corporate law.

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

In this article, we argue that the balance of power between CEOs, boards and shareholders has shifted dramatically in the last decade in favor of shareholders. We expect that the shift will continue in the same direction, leaving CEOs ever more embattled, at least in comparison to their predecessors a generation ago. But we cannot claim, and do not know, whether the balance has shifted too far, whether under current conditions the CEO is not powerful enough. On the other hand, those arguing to strip the CEO of even more power also

[204] Rock & Wachter, Islands of Conscious Power

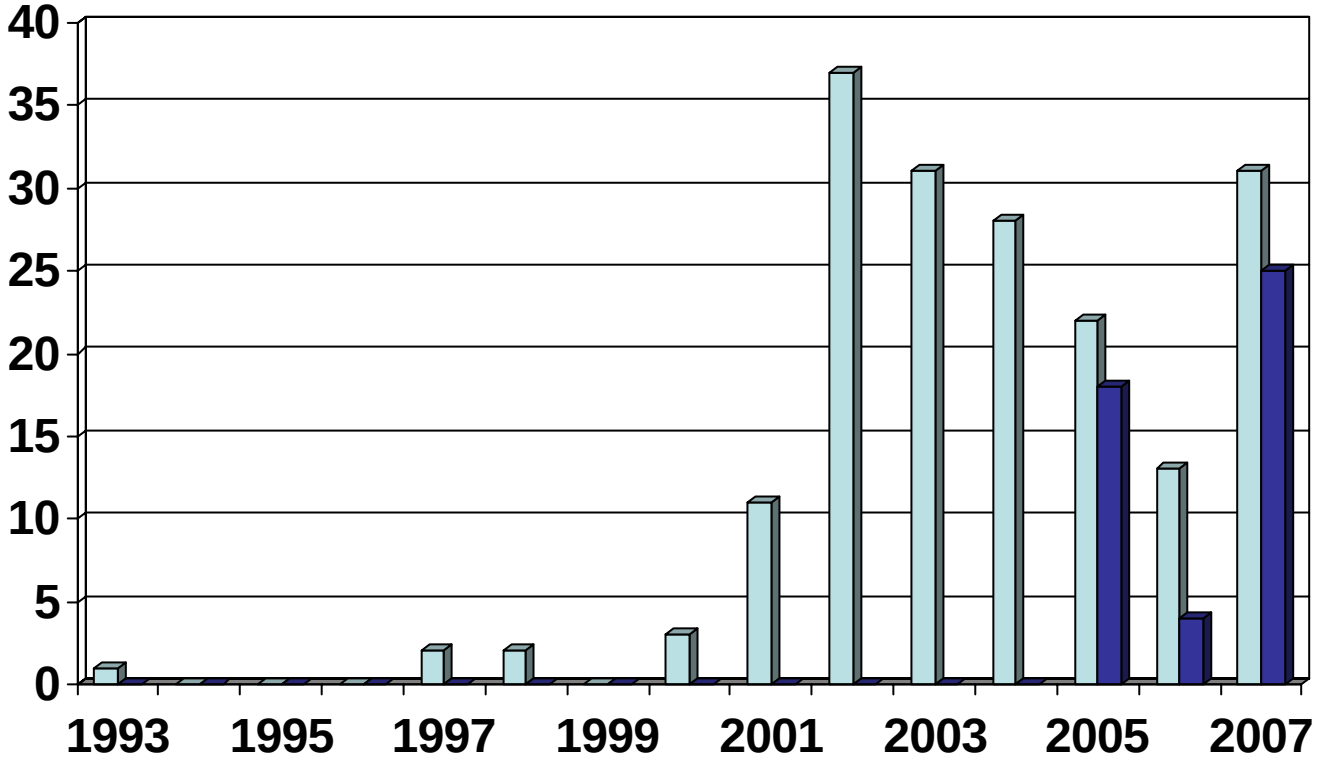
cannot show that the CEO of today is too powerful.

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

Table 1: Percent Ownership of Equities by Types of Investor

	1965	1970	1975	1980	1985	1990	1995	2000	2001	2002	2003	2004	2005	2006
Households	84	78	70	68	54	56	52	46	42	38	36	33	30	27
Private Pension Funds	6	8	13	16	23	17	15	11	12	13	13	13	13	13
Public Pension Funds	0	1	3	3	5	8	8	8	9	9	10	10	10	10
Mutual Funds	5	5	5	3	5	7	13	19	19	19	21	23	25	28
All Institutions	14	19	26	27	40	37	42	45	48	50	52	54	57	60

Figure 1: Advisor References per Year



Based on Westlaw search in allnews database with the following search term:
[(ISS “Glass Lewis”) /10 (powerful clout influential) & shareholder]

Table 2: Staggered Boards in S&P 100 Companies

	Companies with Staggered Boards	New Adoptions	Eliminations	Eliminated as % of Companies having SB
2003	44			
2004	41	0	3	6.8%
2005	34	0	7	17.1%
2006	25	0	8	23.5%
2007	21	0	5	24.0%
2008	16			

Table 3: Majority Voting in S&P 100 Companies

	2003	2004	2005	2006	2007	2008
Majority Voting	10	9	9	51	81	84

Table 4: Shareholder Proposals (S&P 1500)

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

Percentage							

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

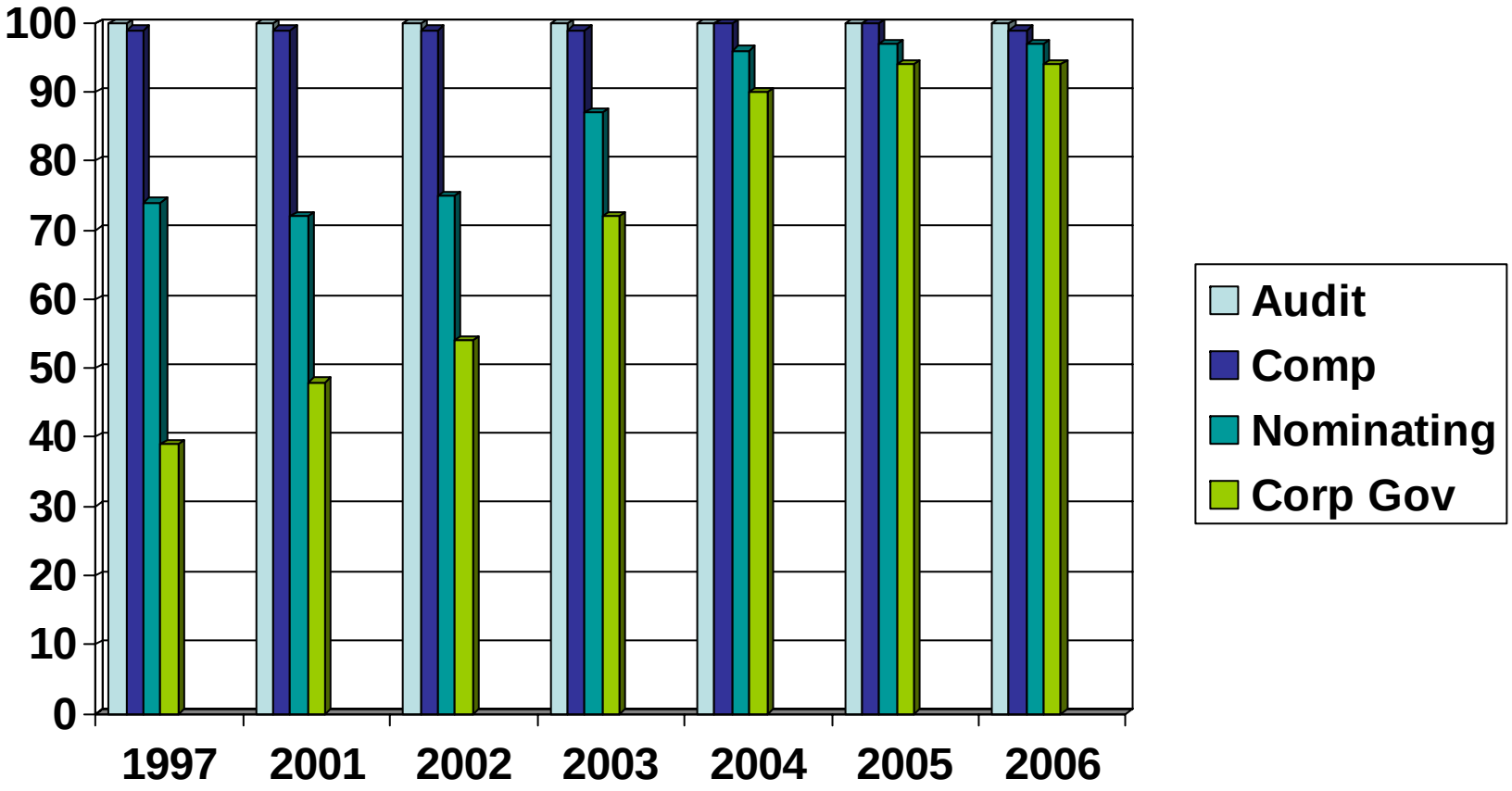


Figure 3: Percentage of Companies with Board Committee Succession, Executive, Finance, and Investment

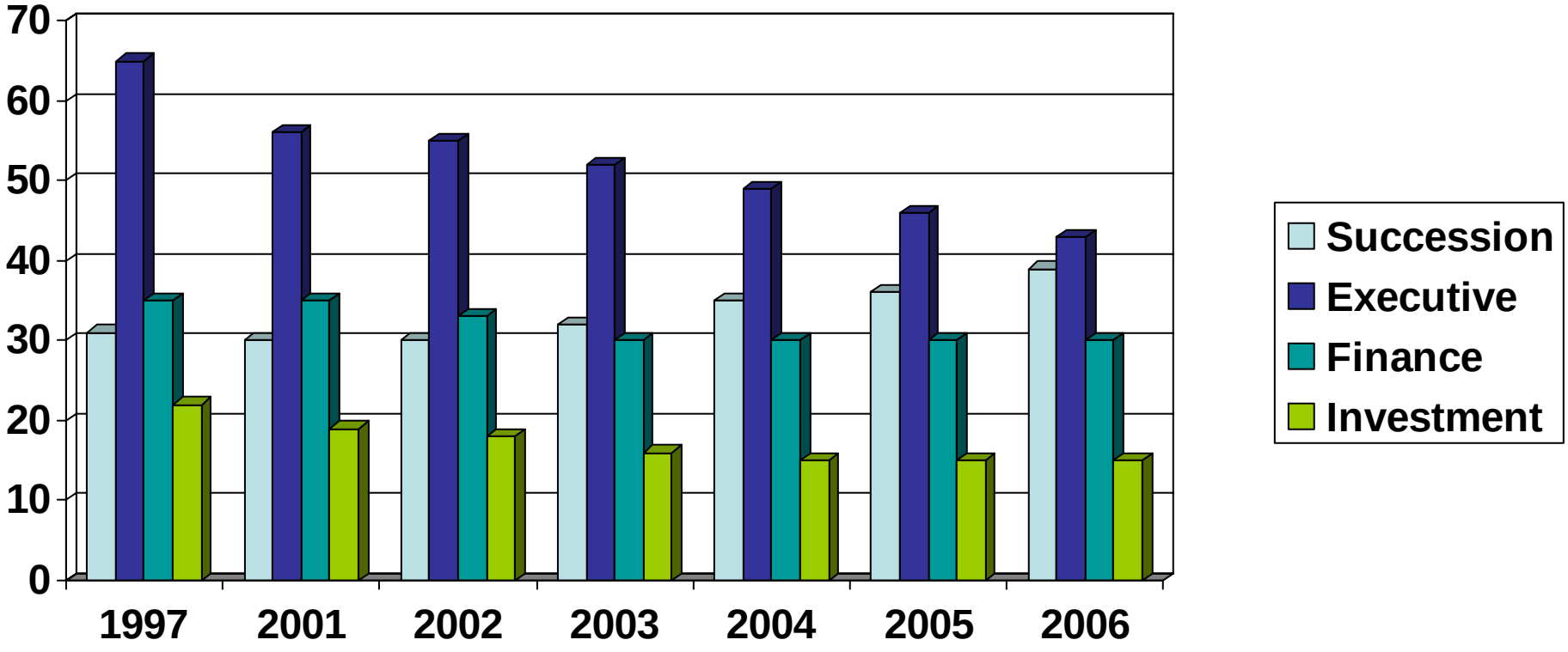
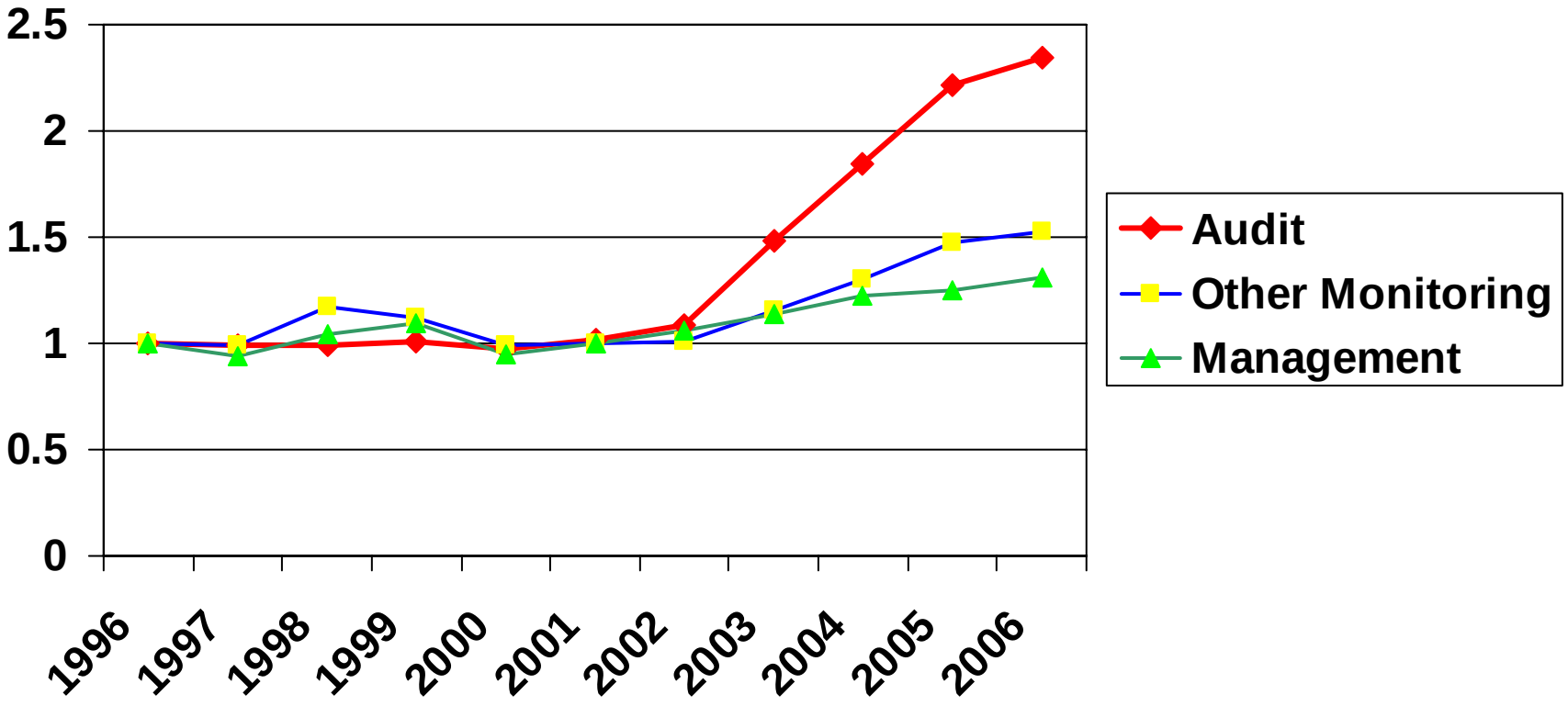


Table 5: Committee Meetings per Year

	1997	2001	2006
Audit	3	4	9
Compensation	4	5	6
Nominating	2	3	4
Corp. Gov.	3	3	4
Succession	5	5	5
Executive	4	4	3
Finance	5	4	4
Investment	4	4	4

Figure 4: Committee Compensation Trends



Based on cash retainer for committee chair. 1996 = 1. All amounts adjusted for inflation. Other monitoring committees are Compensation, Nominating, Corporate Governance, and Succession. Management committees are Executive, Finance and Investment.