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"Patient Capital": Can Delaware Corporate Law Help Revive It?

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"Patient Capital": Can Delaware Corporate Law Help Revive It?

Justice Jack B. Jacobs*

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I. The Problem

A. Growth of the U.S. Economy During the Golden Era of "Patient Capital"

Over the past four decades, the U.S. economy has experienced major shifts. Those shifts, in turn, have resulted in seismic changes in American (and particularly Delaware) corporate statutory and fiduciary law. From the end of World War II through the 1960s, the U.S. economy remained on a steady and steep growth curve, and American corporate enterprises as a

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whole generated wealth in a stable, steep-curved way. This period, from 1945 to 1975, was the "golden era" of American economic prosperity.¹

That state of affairs was both reflected in, and supported by, the then-state of American corporate law at that time. To use a simplistic metaphor, during that post-war period, American corporations were the dog and the capital markets were the tail. That is, the focus and time horizon of both corporate managements and investors was on long-term, stable growth, with the growth of the company being primary and any increase in the value of stockholders' investments being secondary. During this period, the mindset of the business communities, managements, and investors alike reflected a tacit societal consensus and recognition that the innovation and development of new products would take time, typically five years or more, before the company would realize a profit. As a corollary, it was also recognized that the capital investment needed to develop those products also required a parallel period during which investors would have to patiently "sit still" before they would realize a return on their investment. Today, unfortunately, the exact reverse of that ethos and mindset prevails in this country. The capital markets are now the dog, and the corporations that create the wealth that, in turn, generates investment capital are the tail. This Lecture will focus, in part, upon how this came to be.

Although the term was not coined during the golden era—indeed, it was not coined until a few years ago—this tolerant mindset for raising and investing capital during this golden period is described as "patient capital."² That descriptive term is to be contrasted with the opposite metaphor that describes the world that exists today: "impatient" or "activist investor" capital.³

1. See, e.g., George Ross, *Labor Versus Globalization*, 570 ANNALS AM. ACAD. POL. & SOC. SCI. 78, 80–83 (2000).

2. That term, which I encountered for the first time in 2010, has been defined as effective control of a company by "some set of insiders" with the "incentive and capacity to monitor management's performance," but who "are not dependent on short-term, publicly available performance metrics to do so." PEPPER D. CULPEPPER, QUIET POLITICS AND BUSINESS POWER; CORPORATE CONTROL IN EUROPE AND JAPAN 26 (2011). Microsoft and Google are two examples of "companies with large shareholders whose controlling interest in the company gives its managers patient capital." *Id.* at 26–27.

3. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1276 (2008) (describing activist investors as "willing to mount public relations campaigns, initiate litigation, and launch proxy battles to pressure corporate officers . . . into following their preferred business strategy"); Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 LAW & POL'Y 363, 376 (1997) (describing impatient capital as when "funds supplied by external capital providers move rapidly from company to company, usually based on perceptions of opportunities for

During this twenty-five year post-war period, the stability of U.S. (and particularly Delaware) corporate law both reflected and supported the stability of the corporate and capital markets. During that time, unlike today, corporate shareholders were, by and large, passive retail or "end-user" investors like your parents and grandparents.⁴ Those "mom and pop" shareholders by and large left the corporation's managers alone to grow the firm over the long-term. With relatively few exceptions, no one pressured corporate managements to run their companies from quarter to quarter to meet the expectations of stock analysts or institutional shareholders,⁵ and only rarely were there efforts to pressure managers to manage for the short-term by threatening to oust them from office.

To be sure, it was possible even then to oust an incumbent board from control, but the tool for doing so was the proxy contest,⁶ which was a costly and risky process and, therefore, infrequently used. Tender offers⁷ made that job easier, but that tool did not develop until shortly before the end of the golden era. So, during the so-called golden era, there was no "market for corporate control" as that term is currently understood.⁸ As a result, during this period corporate law was largely static, quiescent, and typically management friendly. Indeed, nothing short of an outright, demonstrable

near-term appreciation" (citations omitted)).

4. See Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 12 (2010) (defining end-user investors as individuals "saving primarily for two purposes, to put their kids through college and to fund their own retirements").

5. See Robert G. Vanecko, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance*, 87 NW. U. L. REV. 376, 376 n.2 (1992) (defining institutional investors, or institutional shareholders, as "public and private pension funds, mutual funds, insurance companies, banks, foundations, and endowments," or entities in which individual investors' money is "professionally managed" (citations omitted)).

6. See Richard M. Duvall & Douglas V. Austin, *Predicting the Results of Proxy Contests*, 20 J. FIN. 464, 465 (1965) (defining proxy contests as efforts launched by shareholders for either "minority representation on the board of directors" or "control of the company in which part of the ownership attempts to place the firm under new management").

7. See Arthur Fleischer, Jr. & Robert H. Mundheim, *Corporate Acquisition By Tender Offer*, 115 U. PA. L. REV. 317, 317 (1966) (defining a tender offer as "the technique of acquiring control of a corporation by making a public offer to purchase a part of the corporation's stock at a fixed price—usually in cash and representing a premium above market").

8. See CULPEPPER, *supra* note 2, at 25 ("The market for corporate control refers to the way in which the effective power over companies—that is, the ability to replace a senior management team—changes hands.").

breach of a director's or officer's duty of loyalty⁹ would warrant judicial intervention.

Not until 1985 would a Delaware court impose director liability for conduct less culpable than intentional self-dealing or disloyal wrongdoing.¹⁰ Not coincidentally, it was during that same period that the greatest expansion of shareholder derivative and class action litigation took place under Section 10(b)¹¹ and Securities and Exchange Commission (SEC) Rule 10b-5.¹² That development took place in federal courts, which were far more receptive to shareholder actions than state courts, including those of Delaware. Not until 1977 was this creeping federalization of corporate law abruptly reversed by the U.S. Supreme Court's decision in *Santa Fe Industries, Inc. v. Green*.¹³ From that point forward, the development and enforcement of corporate law resided in the state courts—most notably the courts of Delaware, where America's largest public corporations were, and still are, incorporated.

The patient capital mindset had both bad and good impacts (or, as legal academics call them, "externalities").¹⁴ The bad effects were that the courts were largely ineffective in policing corporate managers and boards who took advantage of their autonomy by doing a substandard job in

9. See Dennis J. Block, Michael J. Maimone & Steven B. Ross, *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 BROOK. L. REV. 65, 65 (1993) (defining the duty of loyalty as "the obligation of corporate fiduciaries," or directors, "to act with disinterested independence and to exercise judgment unaffected by personal financial interest in making business decisions").

10. See *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (finding the directors of a company liable for breach of fiduciary duties for failing to inform themselves of all reasonably available and relevant information regarding a merger, and for failing to disclose material information that a reasonable stockholder would consider important during a merger).

11. See Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 891 (codified as amended at 15 U.S.C. § 78j (2006)) (allowing the Securities and Exchange Commission to ban any "deceptive or manipulative devices" in connection with the "purchase or sale of any security" which it deems appropriate for the "protection of investors").

12. See 17 C.F.R. § 240.10b-5 (2011) (making it "unlawful for any person . . . to employ any device, scheme, or artifice to defraud, make any untrue statement of a material fact . . . or to engage in any act . . . which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security").

13. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) ("Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations . . . where established state policies of corporate regulation would be overridden.").

14. See BLACK'S LAW DICTIONARY 520 (9th ed. 2010) (defining externality as "a consequence or side effect of one's economic activity, causing another to benefit . . . or suffer").

managing the firm. The good effects were that the same freedom from being forced to manage the firm for the short-term gave American enterprises breathing space to innovate new products, to bring those products to market, and to plan for the long-term without pressure from investors or stock analysts to produce a short-term return on their invested capital. It is precisely for that reason—because capital was "patient"—that the United States was able, for so long, to retain its post-war position as the largest and most productive economy in the world.

Unfortunately, the United States is on the brink of losing that premier position, if it has not already. Beginning in the 1970s, and with accelerating velocity from and after 2000, the economies of the United States and many Western European countries have been in a gradual decline, both internally and in relation to emerging economies such as China and India. That is attributable to a multitude of causes, which include a globalized economy; noncompetitive, high U.S. labor costs; multi-trillion dollar domestic government deficits; profligate borrowing to cover those deficits; underinvestment in research, development, and public education; export of, and failure to protect, critical technology; and dysfunctional tax and currency policies. Having no expertise in these areas, I make no pretense of being able to analyze precise causes and effects at the macroscopic level. All I can do is identify this mix of causes to frame the context for focusing on one additional—and highly significant—contributing cause: the decline (if not outright disappearance) of patient capital and the substitution, in its place, of impatient capital, driven by parallel pressures from investors and the stock analyst community to generate short-term profits. It is to this development that I devote the rest of this Lecture.

The thesis and claim of this Lecture is that the impatient capital problem needs to be fixed. To do that, changes in current U.S. corporate law are needed to allow this country to reverse the decline in its economic power in a world of global competition. The reason is that the one competitive advantage that the United States still has is the ability to innovate—to create new technologies and new industries that can be centered and grown at home, rather than being offshored to other countries with lower labor and regulatory costs. But the innovation of new ideas and their translation into products that can be sold competitively worldwide requires capital—patient capital. And for patient capital to thrive, corporate law needs to be altered to create a more nurturing environment.

B. Decline of the U.S. Economy in the Post-1970 Era of Increasingly Impatient Capital

1. Changes in the Macroscopic Economic Environment

The decades from and after the 1970s have witnessed a radical transformation of the value systems and the processes by which public corporations are managed. Several elements have combined to cause that transformation. One major element is the "deretailization" of the American securities market, which has changed the character and mindset of public company shareholders and their willingness to invest for the long-term.¹⁵ A second is securities market and compensation practices that incentivize both corporate and institutional investor managers to manage their firms for the short-term.

To understand deretailization, an important background fact is that, in 1960, most stockholders were individual, end-user, retail investors. In 1951, individual retail investors owned over 75% of all outstanding corporate equities in the United States.¹⁶ By 1979, institutional investors as a group owned over 36%.¹⁷ Today, institutional investors, including public and private pension and retirement funds, mutual funds, and hedge funds, control nearly 70%.¹⁸ Those institutional investors are managed by persons or firms whose compensation depends on generating short-term returns from the portfolio company shares under fund management. Those arrangements motivate these institutional investors to exert significant pressure on corporate managements and boards to deploy corporate assets and develop business strategies that will yield short-term profits, often at the expense of the long-term.

That, however, is not the only reason for the short-term perspective of these powerful institutions, acting in their capacity as significant

15. Brian G. Cartwright, Gen. Counsel, Sec. & Exch. Comm'n, Speech at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation (Oct. 24, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch102407bgc.htm> (defining "deretailization" as "the dwindling percentage of retail investors," or "those who lack the sophistication or net worth to gain access to institutional markets," from both "key existing markets" and "dynamic new trading markets and new asset classes").

16. John Armour, Jack B. Jacobs & Curtis J. Milhaupt, *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT'L L.J. 219, 240 (2011).

17. *Id.*

18. Strine, *supra* note 4, at 10.

shareholders of their portfolio companies. Another reason is that they hold their shares only for a short period of time. Today, the rate of turnover, or "churning," of invested portfolio stock is extremely high. The annual turnover of investments made by hedge funds is about 300% annually.¹⁹ At actively managed mutual funds, which constitute the primary investor of American 401(k) retirement funds, the annual turnover is about 100%.²⁰ Viewing it from an even broader standpoint, in 2008, the average turnover of all stocks traded on the New York Stock Exchange (NYSE) was 138% per year.²¹ Exacerbating this trend is the strategy employed by many activist hedge funds—to hold their stock for a short period of time and create pressure on boards to adopt short-term policies that will yield an immediate profit. It is increasingly the case that the "agenda setters in corporate policy discussions are highly leveraged hedge funds that have no long-term commitment to the corporations in which they invest."²²

To paraphrase an observation made by Chancellor Leo E. Strine, Jr. in a recent article, the blue chip institutional investors, which control 70% of our publicly traded companies, are "more short-term speculators" than "committed, long-term investors."²³ Professor Lawrence Mitchell's characterization is even more pungent. Mitchell argues that this trend has transformed the stock market from "a place for investment to a highly sophisticated gambling den."²⁴ One thing is clear—stockholders of public companies are no longer passive, patient investors, as was the case during the so-called "golden era."

The short-termism of corporate shareholders is not the only force causing corporate managements to govern for the short-term. There are other contributing forces including, quite notably, executive compensation arrangements and pressures exerted by the stock analyst community. It is no secret that most corporate executives are compensated with a package of cash and stock, weighted (for tax reasons) most heavily in favor of stock and stock options. That creates a clear and direct pocketbook financial incentive for corporate executives to manage their companies in a way designed to increase the stock price, or at least do nothing that will cause the stock price to go down. That incentive is amplified by stock analysts

19. *Id.*

20. *Id.*

21. *Id.* at 11.

22. *Id.* at 12.

23. *Id.* at 11.

24. Lawrence E. Mitchell, *The Morals of the Marketplace: A Cautionary Essay for Our Time*, 20 STAN. L. & POL'Y REV. 171, 180 (2009).

who microscopically scrutinize reported quarterly earnings statements to see whether the quarterly results meet management projections. If they do not, the result is an adverse analyst report (the moral equivalent of a bad grade) that is usually followed by a sell recommendation that sends the stock price downward.

There is an old saw called the Harvard Law of Animal Behavior, which is: under perfectly controlled conditions, animals do as they damn well please.²⁵ There is another, which applies more broadly, known as the Texas A&M Law of Human Behavior, and goes something like this: under any conditions, people, including corporate managers, do whatever they are paid to do. If they are not paid to manage their companies for the long-term, then they will not. In today's environment, corporate managers and boards have little incentive to manage for the long-term. They are not rewarded financially for doing so. Moreover, they continually operate under the shadow (i.e., the implied threat) of a proxy contest—of being ousted at the next annual meeting if they deviate from the short-term agendas of their large institutional stockholders. Even without any threat of a proxy contest, for companies that have a majority vote requirement, there is the threat of a campaign to deny board incumbents the majority vote needed for their reelection.

2. *Changes in the Legal Environment*

Just as state and federal corporate law mirrored and supported the larger macroscopic economic structure that encouraged patient capital during the first twenty-five years after World War II, those bodies of law now mirror and support the structural changes that have led to the opposite state of affairs—our current world of impatient capital. Those structural changes are numerous. They include the advent of the hostile tender offer and defenses thereto; developments at the state and federal levels requiring boards to be independent of, and sometimes adversarial to, corporate managements; and legal developments that empower shareholders to force corporate boards and managements to be more responsive to their immediate agendas. A few examples will suffice to illustrate the point.

Just as the past four decades have witnessed the evolution to a world of activist shareholders, so too have they witnessed a parallel evolution to a

25. See STEVEN PINKER, *THE BLANK SLATE: THE MODERN DENIAL OF HUMAN NATURE* 177 (2002) ("Under controlled experimental conditions of temperature, time, lighting, feeding, and training, the organism will behave as it damned well pleases.").

world of activist boards that are now required to be independent of their managements. That evolution began gradually and then swiftly accelerated, at both the state and federal levels, after 2000.

These changes began in the mid-1980s, initially in the context of hostile takeovers. In the mid-1980s, the Delaware Supreme Court decided *Smith v. Van Gorkom*,²⁶ *Unocal Corp. v. Mesa Petroleum Co.*,²⁷ and *Mills Acquisition Co. v. MacMillan, Inc.*²⁸ All three cases demanded independent, active director involvement with, and oversight of, the merger and acquisition process. In *Van Gorkom*, an independent board was held financially liable for approving a merger of their company without having obtained a valuation of the company, and for relying solely on the advice of the CEO—who negotiated the deal without the board's involvement—that the merger terms were fair.²⁹ In *Unocal*, the court held that a target company board has both the power and the duty to take defensive measures against hostile takeover bids that it reasonably believes will threaten the welfare of the enterprise and the shareholders.³⁰ Finally, in *MacMillan*, the Delaware Supreme Court invalidated a merger agreement approved by a board that passively delegated the entire competitive bidding process, with no independent board oversight, to the senior management group that was one of two bidders competing to acquire the company.³¹

At this early stage, the director independence theme of these and other Delaware decisions was narrowly focused. The central message was simply that directors whose company was being sold must not be subservient to management, and, in that specific context, a court will give far more deference to decisions made by a board controlled by independent

26. See *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (finding the directors of a company liable for breach of fiduciary duties for failing to inform themselves of all reasonably available and relevant information regarding a merger, and for failing to disclose material information that a reasonable stockholder would consider important during a merger).

27. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–55 (Del. 1985) (finding that a corporation's board of directors may undertake defensive measures to a pending takeover bid if the board feels the offer is not in the best interests of the corporation and its shareholders, and if such measures are reasonable in relation to the threat posed).

28. See *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988) (finding the provisions of a merger agreement invalid because a lack of oversight by the board of directors "tainted the design and execution of the transaction").

29. *Van Gorkom*, 488 A.2d at 877–81.

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

31. See *MacMillan*, 559 A.2d at 1282 (finding that "legal complications" to a transaction are necessarily "intensified" without "board planning and oversight to insulate the self-interested management from the bidding process").

directors than to one dominated by insiders. After 2000, however, that bounded view of director independence became subsumed by a far broader and overriding mandate, legislated by the U.S. Congress in the wake of Enron and other related scandals. That new law created a world that requires activist, independent directors to dominate public company boards. The 2002 Sarbanes-Oxley Act,³² and the implementing Rules of the SEC and the stock exchanges, now mandate director independence for all companies required to register with the SEC, which means almost all U.S. public companies. Under the NYSE and NASDAQ listing rules, publicly held company boards must have a majority of independent directors, and their audit and compensation committees must consist entirely of independent directors.³³

To be clear, my claim is not that this development is bad. This talk is not intended as a screed against director independence. Many of those reforms have helped to reduce the evils caused by CEO-dominated boards. But, there has also come an unforeseen cost. The Exchange Rules' strict definition of who does and does not constitute an "independent" director has become a centripetal force—it has made boards less cohesive and has disqualified from board service many persons who are knowledgeable of the firm's business, the relevant industry, and who would otherwise be an available resource to help companies plan for the long-term.³⁴

The most significant structural changes, in my view, have been legal developments that empower shareholders to force corporate boards and managements to be more responsive to their immediate agendas, however short-term those agendas may be. Ironically, these developments, if viewed by themselves, are reforms that have significant merit and have been welcomed by the shareholder and academic communities. Two of these

32. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C. (2006)) (attempting to protect investors by "improving the accuracy and reliability of corporate disclosures made pursuant to securities laws").

33. N.Y. Stock Exch. Euronext, *Listed Company Manual*, §§ 303.A04, A05, A07, <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F> (last visited Nov. 23, 2011) [hereinafter *NYSE Manual*] (on file with the Washington and Lee Law Review); THE NASDAQ STOCK MARKET, INC., CORPORATE GOVERNANCE §§ 4350(c)–(d) (2004), available at <http://www.nasdaq.com/about/CorporateGovernance.pdf>.

34. See William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 967 (2003) (observing that "the tighter standards of independence . . . may well render directors currently categorized as independent unable to serve on key board committees").

reforms are particularly important: the increased use of the shareholder bylaw process to limit the power of boards to adopt governance rules, including takeover defenses; and the new rules governing proxy access and proxy reimbursement.

For several years, the activist shareholder community has sought to influence the governance of publicly held corporations through the bylaw amendment process. The Delaware General Corporation Law³⁵ expressly confers upon the shareholders the power to adopt and amend bylaws, while providing that the board cannot eliminate or limit that power.³⁶ For the last decade, institutional shareholders have used that authority to limit the board's power to adopt poison pills.³⁷ Usually, this is done by adopting a bylaw which provides that any board-adopted pill will have a fixed duration and will require a shareholder vote to adopt any new pill or revive an expired one.³⁸

The same process has been utilized to reform the proxy election system to require the corporation to reimburse the expenses of any shareholder group that nominates a "short slate"³⁹ of candidates that are then successfully elected to the board. The Delaware Supreme Court

35. See DEL. CODE ANN. tit. 8, §§ 101–398 (2010) (establishing corporation law in Delaware).

36. See *id.* § 109(a) ("After a corporation other than a nonstock corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote."). Furthermore, the "directors or governing body . . . shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws." *Id.*

37. See Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 205 (2005) ("[O]ver the last decade shareholders have sought to use bylaws to limit poison pills and to grant shareholders access to the corporate proxy materials to nominate directors."). Poison pills are

the most potent of antitakeover defenses. If a corporation has a poison pill and a hostile bidder acquires enough of the corporation's shares to trigger the pill, other shareholders will have the right to buy more shares at below-market prices, meaning that the bidder must buy those shares as well. Alternatively, the pill could trigger the right to purchase more shares of the bidder at low prices after a merger has occurred, diluting the value of the bidder's current shareholdings.

Id. at 209.

38. See *id.* at 210 (noting that shareholders have used bylaws to limit poison pills by requiring "boards to redeem existing pills under certain circumstances, while others required shareholder approval for putting new pills in place").

39. See J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 J. CORP. L. 391, 430 (2011) (explaining that dissident shareholders often seek a minority representation on a board of directors by running a short slate).

recently held that any bylaw that defines the process or procedure by which substantive board decisions are made is a proper subject for shareholder action; and those bylaws will not impermissibly infringe the board's power to manage the affairs of the corporation, so long as the bylaw does not limit the board's exercise of its fiduciary duties.⁴⁰ That decision legitimized the shareholder bylaw process as a tool in the arsenal of activist shareholders to alter the composition of the board and, thus, to exert leverage to influence business decisions.

Those proxy reform tools have now been enacted into legislation at both the state and federal levels. In 2009, the Delaware Legislature adopted Sections 112⁴¹ and 113⁴² of the General Corporation Law. Section 112 creates proxy access for shareholder groups urging the election of their nominated, dissident slate. This statute allows bylaws to prescribe the conditions and procedures for when these shareholder groups' proxy materials can be included in the company's solicitation materials that are sent to shareholders in support of the board's director nominee slate.⁴³ For dissident shareholder groups that want to conduct their own proxy solicitation, Section 113 permits the adoption of bylaws that authorize the corporation to reimburse the dissident group's proxy solicitation expenses, under prescribed conditions.⁴⁴ These statutes further provide that, where shareholders adopt such bylaws, the directors cannot repeal them.⁴⁵

What Delaware law made merely optional, the U.S. Congress has now made mandatory in the Dodd-Frank Act.⁴⁶ Section 971 of Dodd-Frank authorizes the SEC to adopt proxy access rules.⁴⁷ In September 2010, the SEC adopted proposed Rule 14a-11 by a 3-2 vote.⁴⁸ If and when Rule 14a-

40. See *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 238 (Del. 2008).

41. See DEL. CODE ANN. tit. 8, § 112 (2009) ("The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required . . . to include in its proxy solicitation materials . . . 1 or more individuals nominated by a stockholder.").

42. See *id.* § 113 (allowing shareholders to adopt bylaws that reimburse "expenses incurred by a stockholder in soliciting proxies in connection with an election of directors").

43. *Id.* § 112.

44. *Id.* § 113.

45. See *id.* § 109 ("After a corporation other than a nonstock corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote.").

46. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (establishing financial regulatory reform).

47. *Id.* § 971, 124 Stat. at 1915.

48. See Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,674 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, and 249) (announcing the

11 becomes effective, it would require public companies, in certain circumstances, to include shareholders' board nominees in the company's proxy solicitation, and would amend SEC Rule 14a-8 to require companies, in specified circumstances, to include shareholder proposals regarding director nomination procedures in their proxy materials.⁴⁹ No opt out from these rules is allowed.⁵⁰ Moreover, Rule 14a-11 preempts state law to the extent that state law would "prohibit inclusion of shareholder director nominees in company proxy materials or set share ownership or other terms that are more restrictive than Rule 14a-11 under which shareholder director nominees will be included in company proxy materials."⁵¹ Currently, proposed Rule 14a-11 is not effective because it was recently challenged by the Business Roundtable and vacated in federal court on procedural grounds.⁵² Regardless, the Rule will be resurrected at some future point in one form or another.

In today's world, the shareholders of public companies are highly motivated to influence the company's board and executives to govern for the short-term. The current American corporation law, at both the state and federal level, gives those shareholders powerful tools to exert that influence. The boards and executives that wish to manage their businesses for the long-term have little power to resist. In my view, this has created a national problem that needs to be fixed.

C. The Problem

In a world of global competition, this country (and much of Western Europe) is losing out to countries with lower labor costs. The question is how the United States can meet that competition. It will not be done by lowering our labor costs because it is unlikely that the American labor force, whether blue or white collar, would be willing, voluntarily, to lower its standard of living to compete head-on with workers in lower-standard-of-living societies, such as China, India, and other developing economies. To compete successfully, the United States needs to develop new products

adoption of Rule 14a-11).

49. *Id.* at 56,668.

50. *See id.* at 56,674.

51. *Id.* at 56,678.

52. *See* Bus. Roundtable v. Sec. & Exch. Comm., 647 F.3d 1144, 1148 (D.C. Cir. 2011) (finding that the SEC acted "arbitrarily and capriciously" in "fail[ing] once again . . . to assess the economic effects of [Rule 14a-11].").

and services that the world's consumers will buy, regardless of high price, because those products are needed and no one else has yet developed them. Stated differently, the United States needs to exploit its competitive advantage, and the most important (perhaps only) advantage we have is our ability to innovate. The problem is that innovation takes time. It takes time to develop an idea from the drawing board to a marketable product. And, it takes invested capital that is willing to stand still for that time before realizing a return. Thus, the problem is that the United States needs to find a way to encourage and nurture patient capital in an investment environment that is structurally unreceptive to being patient. The question then becomes, how can we do that?

One can imagine an entire spectrum of possible approaches. The most extreme approach would be for Congress to federalize this entire subject area by enacting, wholesale, an array of new laws that would discourage, if not prevent, investors from pressuring managements to govern for the short-term. This would effectively convert most, if not all, invested capital into patient capital. The problem with that approach, however, is that it would require preempting most state corporate law, radically amending existing federal securities law, and completely disrupting the capital markets and the legitimate expectations of investors who have invested in reliance on the existing set of institutions and rules. The resulting dislocation would be not only undesirable, but also politically impossible. This radical approach would also raise serious constitutional issues, such as abrogation of contract rights. Thus, a comprehensive and preemptive federal solution is neither realistic nor beneficial; however, this is far from saying that the federal government should not play a role. In fact, no reform of any kind will be possible without federal cooperation. But the solution will have to be more modest and less far reaching to be workable.

The solution I propose would start at the state law level. It would amend the corporate statutes of Delaware and of other states (including the Model Business Corporation Act states) to give existing corporations the authority to adopt a charter provision abolishing yearly elections of directors. In place thereof, the board would be elected to serve for a longer period, such as five years. During that period, the board could not be removed by shareholders except for cause. Moreover, the directors would be authorized to adopt defenses against any takeover bids they view, reasonably and in good faith, as being contrary to the best interests of the corporation. The objective would be to liberate the directors to manage the firm for the longer term required to create and develop the innovative

products and services that would enable the American economy to become competitive again.

In all candor, this idea is not original. The key concept was proposed ten years ago, in an article that I co-authored with former Delaware Chancellor William T. Allen and current Chancellor Leo E. Strine, Jr.⁵³ That article was written with a far narrower context and purpose. At that time, the issue we were confronting was: on what principled basis should corporate boards be allowed to defend against a hostile bid—even one that is non-coercive, at a significant premium, and would prevent their own shareholders from realizing a short-term profit.⁵⁴ In *Paramount Communications, Inc. v. Time Inc. (Time Warner)*,⁵⁵ the Delaware Supreme Court permitted the Time Warner board to do just that, on the ground that where a corporate board has a long-term strategy for generating corporate wealth, it is not required to forgo that strategy in favor of an unsolicited takeover bid merely because it would generate a short-term profit.⁵⁶

As discussed in that now dated article, *Time Warner* and other Delaware takeover decisions were merely a surface manifestation of a more fundamental debate taking place in the academy and the corporate community. The fundamental issue was what is the purpose of the corporation. Specifically, whose interests is the corporation intended to advance—the interests of shareholders that have committed their capital to the firm for a long period of time or the interests of the shareholders at the specific time the takeover bid occurs?⁵⁷ The answer depends (we concluded) on which of two competing conceptions of the corporation the law should embrace: the entity conception,⁵⁸ which posits that the purpose of the corporation is long-term wealth maximization for all corporate

53. See generally William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002).

54. See *id.* at 1067.

55. See *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990) (establishing that "a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover").

56. See *id.* at 1154 ("Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.").

57. Allen et al., *supra* note 53, at 1071.

58. See *id.* at 1076 (stating that the entity approach "views the corporation as a societal institution whose purpose is broader than simply serving the ends of those who own stock").

constituencies; or the property model,⁵⁹ under which the board's only mandate is to advance the interests of the stockholders. Those two models are at war with each other, and Delaware's corporate jurisprudence has embraced neither model in its entirety. Because that debate was so laden with policy implications, as to be unavoidably legislative in character, we predicted that the courts were not likely to resolve that debate.⁶⁰ Thus, we proposed a solution to help bridge the gap between these models.

The solution we proposed was that corporate boards would be elected every three years, rather than annually, and during that period the board would not be subject to removal without cause.⁶¹ This solution would give boards the space to think and plan for the long-term, while furthering the interests of the subset of investors who think and plan for the long-term.⁶² In exchange for that greater insulation from the yearly electoral process, the director election process would be made fairer by affording access to the company's proxy machinery to all nominees having the support of a significant block of stock (we suggested from 5% to 8%).⁶³ This reform would give shareholders a meaningful opportunity to decide who should be on the board and thereby ensure board accountability to both long-term and short-term shareholders.

The proposal for which I argue today is a variation of that 2001 proposal, but its context and purpose are entirely different. Ten years ago the focus was more academic than pragmatic. At that point in time there was no broader macroeconomic focus because the United States was not yet a loser in a globalized, competitive economy. Today, the environment has radically changed because we have (or will have) mandatory proxy access and optional proxy reimbursement. Yet, we still continue to have annual elections, with their adverse impact on the incentives of corporate managements and boards to plan and innovate for the long-term. Today, we are losing out in the globalized economy, and therefore need patient capital to enable us to compete effectively. Accordingly, my proposal—

59. *See id.* at 1074–75 ("The property school strongly believes that capital markets, while not perfect, are generally efficient, and that the overall wealth of society will be enhanced in the long term if corporate control can be transferred relatively freely between buyers and sellers.").

60. *Id.* at 1073–74.

61. *See id.* at 1073 ("[O]nce elected, [directors] would serve guaranteed three-year terms, and would be subject to removal without cause only at the next shareholders' meeting.").

62. *Id.* at 1100.

63. *Id.* at 1072.

giving corporations the authority to provide for board elections every five years—borrows from our 2001 proposal, but for a totally different purpose.

I submit that this proposal would be politically feasible because it is modest. I make no claim, however, that it would be perfect or free from obstacles. Objections would be raised that will need to be addressed.

II. The Solution

There are three major obstacles to this proposal. The first is whether investors will be willing to invest in companies that elect directors every five years. There are two scenarios where this problem will arise: the start-up company that has not yet gone public, and the corporation that is already publicly held. This question has both legal and economic aspects. The legal issue is whether the stock of the company, under either scenario, can even be listed on a national securities exchange. Under the current Exchange Listing Rules, it could not, because both the NYSE and NASDAQ Listing Rules require listed companies to have an annual stockholders meeting.⁶⁴ Consequently, the Exchange Listing Rules would have to be changed to permit the stock of those companies that opt into this system to be listed. That, in turn, will require the approval of the SEC, which regulates the Exchanges, and most likely will require the SEC to adopt a Rule addressing that subject.

The economic question is whether investors would be willing to make an investment where they would risk having to forgo a return for possibly up to five years. To that question I suggest two answers. The first is that they would be willing to invest if the upside gain exceeds the risk—that is, if the innovation is sufficiently promising (think Microsoft, Apple, Oracle, or Intel). A second response is that, in cases where the risk-reward calculus is too unclear to predict, the federal government can reduce the risk (and perhaps state governments as well) by creating appropriate tax incentives. For decades, American tax policy has been deployed to encourage investment in specific new economic areas. What has been done before can, and should, be done again.

64. See *NYSE Manual*, *supra* note 33, § 302.00 ("Listed companies are required to hold an annual shareholders' meeting during each fiscal year."); THE NASDAQ STOCK MARKET, INC., MEETINGS OF SHAREHOLDERS § 5620(a) (2009), available at http://www.nasdaq.com/about/Listing_Rules_041309.pdf ("Each Company listing common stock or voting preferred stock, and their equivalents, shall hold an annual meeting of Shareholders no later than one year after the end of the Company's fiscal year-end.").

A second major objection will be that existing institutional investors would have a strong interest in voting down any proposals to amend corporate charters to change the board election system from a one to a five-year regime. Again, I suggest two responses. First, if the boards proposing the charter amendment can articulate innovative lines of business that promise a significant return in five years or less, they may be able to persuade their institutional stockholders to support the proposal on purely economic grounds. A second inducement might be an agreement to do away with a staggered board (for companies that have one), because in a world where directors are elected every five years, a three-year staggered election system becomes superfluous. For those companies that are not far along in their innovative thinking, but would like the breathing space to go further down that road, a solution would be to create a wholly owned subsidiary whose charter provides for a five-year board election. Then, have the subsidiary conduct an Initial Public Offering (IPO) of a minority block of the subsidiary's stock. A board has the power to form a subsidiary and then "take it public" without shareholder approval.⁶⁵

The third principal objection would run like this: the proposed solution is unlikely to work satisfactorily because it merely chips away at the problem without addressing it head-on. The fundamental problem is that the institutional investor community no longer thinks like the end-user investors that they serve. The end-user investors (i.e., you and I) want our investments to grow for the long-term to fund our childrens' college educations and our retirement. But, the institutional investors who manage our retirement plans and other investments are interested mainly in the short-term. Unless the proposal includes some way to change the mindset of the institutional investors, it is basically swimming upstream against a very strong current.

There is force to that objection. It is correct that the major problem is the short-term mindset of the American institutional investor community. And I agree that if there were some way to wave a magic wand and proselytize those institutions into a new religion of long-term patient capitalists, that would be the optimal approach, but there is no magic wand. In a recent article published in *The Business Lawyer*, Chancellor Strine

65. See DEL. CODE ANN. tit. 8, § 141(a) (2009) (establishing the default rule that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors"). Thus, unless a corporation's certificate of incorporation or Delaware law say otherwise, the board has the power to execute and enforce decisions that affect the business and affairs of the corporation without the shareholder's approval. *Id.*

made the excellent point that it is past time to begin "addressing the misalignment between the interests of end-user investors . . . and the incentives of the institutional investor community to think and act myopically."⁶⁶ He then identified nine different regulatory reforms for consideration.⁶⁷ Chancellor Strine's proposed reforms would go a considerable way towards solving this fundamental problem, if there were a realistic prospect of their adoption. The problem, however, is that his proposals would require new top-down federal legislation that would amend the Investment Company Act of 1940 (1940 Act)⁶⁸ and change the current implementing SEC Rules along with new federal securities legislation and new SEC Rules to cover institutional investors not subject to the 1940 Act. In the current environment, this seems highly unlikely. To accomplish that, political pressure from the ground up would be needed to persuade the political branches to make those changes from the top down. In short, it would be a mistake to allow the perfect to be the enemy of the good. My proposal is far from perfect, but because it is feasible, it is (at least) good.

66. Strine, *supra* note 4, at 18.

67. The nine reforms include: (1) pricing and tax strategies to encourage investing and discourage churning by institutional investors and "fund hopping" by end-user investors; (2) enhanced requirements for institutional investors to factor concern about fundamental risk, leverage, and legal compliance into their investing and corporate governance decisions; (3) requirements that investment manager compensation be aligned with the investment horizons of end-user investors; (4) considering a mandated separation of funds managing 401(k) and college savings investments from more liquid investments, and requiring investing practices consistent with retirement and college investment objectives; (5) requirements that index funds vote shares and engage in activism in a manner consistent with the funds' commitment to hold the entire benchmark index; (6) leverage limitations, broader disclosure, and other regulations for hedge funds that decrease the ability and incentive of those funds to effectively push public corporations into risky business decisions; (7) mandating that institutional investors disclose fuller and more timely information about their economic interests (including their ownership of derivatives and short positions) and about their voting and lending policies; (8) restoring the sophisticated investor exception, and requiring pension, charitable, and governmental investment funds to invest only through investment advisors covered by the 1940 Act; and (9) prohibiting pension, charitable, and governmental investment funds from relying on the advice of proxy advisory services unless those services give voting advice based on the economic perspective and goals of an investor intending to hold her stock for at least five years. *Id.* at 18–19.

68. See Investment Company Act of 1940, 15 U.S.C. §§ 80a-51 to 80a-64 (2006) (creating comprehensive financial regulation primarily regarding investment companies and security exchanges).

III. Conclusion

We can no longer afford to allow the capital markets to be the dog that wags our portfolio corporations as the tail. Although this proposal will not solve the institutional investor short-term mindset problem, it would be a modest, bottom-up step towards generating the consensus needed to persuade the political branches of our national government to initiate the top-down changes that will be needed for a long-term solution.