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A Crisis Is a Terrible Thing to Waste:
The Proposed "Shareholder Bill of Rights Act of 2009" Is a Serious Mistake

By Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis [1]

A few weeks ago, Senator Schumer announced his intention to introduce the Shareholder Bill of Rights Act of 2009. The central stated goal of the Act — "to prioritize the long-term health of firms and their shareholders" and create "more long-term stability and profitability within the corporations that are so vital to the health, well-being, and prosperity of the American people and our economy" — is commendable. That goal represents a significant break from the agendas of many self-proclaimed governance experts who, in actuality, have sometimes hijacked the banner of "good governance" to amp up stockholder power in a campaign to press Corporate America away from attention to and investment in the long term.

Short-termism is a disease that infects American business and distorts management and boardroom judgment. But it does not originate in the boardroom. It is bred in the trading rooms of the hedge funds and professional institutional investment managers who control more than 75% of the shares of most major companies. Short-termist pressure bred by stockholder power demanded unsustainable ever-increasing (quarterly) earnings growth, possible only via the shortcut of over-leverage and reduced investment, and the dangerous route of excessive risk. Stability and financial strength to weather economic cycles were sacrificed for immediate satisfaction. That short-termist pressure, in the view of many observers, contributed significantly to the financial and economic crises we face today.

Thus, the legislation's purpose — to restore the long-term stability of the firm as the ultimate goal of corporate governance — is a salutary and important guidepost.

But the suggested provisions of the Act threaten to encourage the opposite of its stated goal. The Act proposes to enhance stockholder power and thereby would fuel the very stockholder-generated short-termist pressure that, in the view of many observers, contributed significantly to the financial and economic crises we face today. The Act would implement, by federal mandate, a series of yet further empowerments of stockholders: it would require annual stockholder advisory votes on executive compensation, facilitate a federal requirement that stockholders be granted access to every corporation's proxy to nominate their own candidates to boards of directors, end staggered boards at all companies, require that all directors receive a majority of votes cast to be elected, and order that all public companies split the CEO and board chair positions.

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Increased stockholder power is directly responsible for the short-termist fixation that led to the current crises. The bulk of the specific provisions suggested would increase stockholder power. Stockholder power has already substantially increased over the last twenty years. Concomitantly, our stock markets have become ever-increasingly institutionalized. The undeniable fact is that the true "investors" are now professional money managers who are inherently short-term (even quarterly) focused. That "stockholder" pressure pushed companies to generate high financial returns at levels that were not sustainable, with management's compensation being tied to producing such returns (at stockholder urging). The increase in stockholder power and stockholder pressure to produce unrealistic profits fueled the pressure to take on increased risk. As the government arguably relaxed regulatory checks on excessive risk taking (or, at minimum, did not respond with increased prudential regulation), the increased stockholder power and pressure for ever higher returns contributed significantly to the current financial and economic crises. That pressure became all the more irresistible as it combined with increased stockholder power to oust or discipline managers and directors — power available to enforce the stockholder and activist investor agenda of ever higher short-term returns.

Furthermore, substantial concerns arise as to whether it is sound to seek to address corporate governance at the federal level in a "one size fits all" mandate, and whether the subjects proposed to be addressed in the Act would, in fact, advance or detract from the goal of re-establishing the long-term outlook necessary for sustained economic health and growth. In particular, the Act raises significant issues for all constituencies concerned with realigning proper corporate governance to facilitate long-term focus and avoiding counterproductive federal intrusion into corporate law traditionally reserved for the states.

1. The corporate governance subjects proposed to be addressed by the Act have traditionally been the province of state law. That model allows for the exploration of a variety of mechanisms, careful evolution, and the development of considerable state legislative and judicial expertise. It is not apparent that replacement of the Brandeisian state "laboratories" with federally mandated rules is sound. Indeed, it seems fair to say that moving corporate governance issues like executive compensation onto the national legislative agenda has not produced thoughtful consideration, but rather has promoted divisive and counterproductive controversy.

2. Beyond that, the federal mandate suggested by the Act is a "one size fits all" fiat that does not respond to the differing needs of different firms or industries. One model of governance for all companies is no more possible than one management structure or one organizational culture. Working out the optimal mix of power allocation between corporate management, boards, stockholders, employees and other relevant stakeholders requires nuanced balance that is inconsistent with federal dictates on a handful of subjects. Good corporate governance requires a holistic approach. It is not readily achievable by picking out and addressing a few topics. Getting corporate governance correct requires attention to all its aspects, and is ill-served by hard and fast rules imposed on certain points (*e.g.*, ending *all* classified board structures, separating CEO-Chairman positions at *all* public firms, mandating the creation of yet another committee at *all* public companies).

3. Importantly, the states have proven themselves responsive to legitimate calls for reform. Delaware has recently amended its corporate statute to permit corporate boards or stockholders to provide for stockholder access to the company's proxy materials for director elections. Delaware, New York and other states have recently amended their laws to facilitate the adoption of majority voting policies for director elections. These state-based initiatives have proceeded thoughtfully, and undoubtedly will produce continued refinement in other states. It would not seem warranted to short circuit these developments by newly federalizing these aspects of corporate governance.

4. Radically altering the respective federal-state roles would seem particularly ill-advised in light of the fact that many of the issues raised in the proposed legislation are already being significantly addressed by voluntary action taken by public companies. The number of companies electing all directors annually has dramatically increased in recent years (reportedly, 64% of S&P 500 and 50% of S&P 1,500 companies now elect all directors each year). Some form of majority voting on directors is now reportedly utilized for 75% of corporate boards. Of the S&P 500, nearly 40% now have split the Chair/CEO roles, and 95% have an independent lead director or the practical equivalent. Corporate boards are already at least 80% comprised of independent directors in 90% of the cases. The TARP legislation has already caused stockholder votes on executive compensation at the hundreds of stockholder meetings held this year by companies accepting TARP funds. Over 20 additional public companies have agreed to hold such advisory votes annually.

5. Perhaps most fundamentally, the legislation's stated ultimate goal of prioritizing "long-term health" and stability of our corporate economic system would be undermined by the proposed specific provisions of the Act. It is essential to recognize that the key contributors to the current crises were the coincidence of increased stockholder pressure for high returns and weakened prudential regulation. Government policy makers appear to have determined that reinstituting sensible prudential regulation (at the federal as well as even international level) is a necessary part of the fix. But enhancing stockholder power — the direction taken in the proposed Stockholder Bill of Rights Act — would exacerbate, not alleviate, an important part of the underlying dynamic that caused the current crises. That course is a serious mistake, especially when the government has done nothing to either encourage (or require) that money managers — the real "stockholders" today — think and act on a long-term basis.

While there can be no claim of a consensus on the point, thoughtful corporate governance observers have recognized the direct causal relationship between the current crises and stockholder-generated short-termism driving over-leverage and excessive risk-taking in pursuit of unsustainable returns, coupled with under-investment in the long term. The November 10, 2008 Statement on the Global Financial Crisis by the International Corporate Governance Network declared that "[i]t is true that shareholders sometimes encouraged companies, including investment banks, to ramp up short-term returns through leverage," and that: "Institutional shareholders must recognize their responsibility to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working. Pension funds and those in a similar position of hiring fund managers should insist that fund managers put sufficient resources into governance that delivers long term value." It is certainly time for the

entire corporate governance movement to recognize that the true interest of the American investor is long-term value creation and stability.

Accordingly, it is submitted that realization of the Act's goal of long-term stability and profitability warrants the embrace of pragmatic measures that would promote long-term value, instead of going along with yet further stockholder empowerment in the absence of any effort to encourage the essential long-termist perspective. Time-phased shareholder voting structures that would provide long-term shareholders a greater number of votes per share should become a permissible option. Quinquennial rather than annual or triennial elections of corporate board members should be revisited. Institutions should discontinue the practice of compensating fund managers based on quarterly performance. Corporate America should discontinue the practice of issuing quarterly earnings guidance as recommended by the Aspen Institute's Corporate Values Strategy Group and as adopted by General Electric and other prominent companies.

The stockholder-centric view exemplified by the heyday of stockholder activism, and embedded in the proposed Act, cannot be the cure for the very short-termist disease it spawned. One vivid and undeniable lesson of the current financial crisis is that not only stockholders are impacted in a meltdown. Employees who devote their lives to building stockholder value are a very painful example. Communities, suppliers, creditors, indeed, the whole range of constituencies who support the creation and maintenance of stock value, are likewise impacted and have a legitimate stake in the governance and reform debate.

There is no simple panacea. The drivers of short-termism have gained considerable momentum in recent years, and shareholder activists have entrenched many corporate governance mandates that exacerbate these pressures – measures that Senator Schumer's proposed Act would not alleviate and may indeed foster. Board members who approve poison pills, classified board structures, supermajority voting requirements and other safeguards against the pressures of hostile takeovers and short-termism face a considerable risk of a "withhold the vote" or "vote no" campaign when they stand for reelection. Influential proxy voting advisory firms carefully monitor companies for any deviations from corporate governance alleged "best practices" and punish disobedient directors with adverse vote recommendations.

It is time to use the opportunity for fresh thinking that the current crisis affords to reconsider fundamental changes that could restore the ability of boards and managers to run America's companies for our long-term best interest. Short-termism has become deeply ingrained. Inertia is a powerful force. But it may be that the astounding losses we have now seen are enough of a stimulus to steer us back. Companies, directors, managers, shareholders, regulators, other market participants, and political leaders should embrace pragmatic measures that promote long-term value, instead of going along with a new frenzy of shareholder activism and misguided corporate governance reforms built on that failed model. This crisis would be a terrible thing to waste.