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Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance

Roberta Romano†

Institutional investors have increasingly engaged in corporate governance activities, introducing proxy proposals and negotiating with management, with a goal of improving corporate performance. As shareholder activism has increased, financial economists have sought to measure its effect on performance. This Article reviews the corporate finance literature on institutional investors' activities in corporate governance and uses the findings of the empirical literature to inform normative recommendations for the proxy process. In brief, there is an apparent paradox: notwithstanding the development of shareholder activism and commentators' generally positive assessments of it, the empirical research indicates that such activism has little or no effect on targeted firms' performance. This implies that activist institutions ought to reassess their agendas, in order to use their resources more effectively. The Article takes a two-pronged approach to furthering this aim. First, it suggests a mechanism of internal control, whereby funds would engage in periodic review of their shareholder-activism programs to identify the most fruitful governance objectives. Second, it seeks ways to provide incentives to undertake such internal reevaluations, advocating elimination or significant reduction of the subsidy of proposal sponsorship under the SEC rules unless a proposal achieves substantial voting support or permitting firms' shareholders to choose what level of subsidy they wish to provide to proposal sponsors. The estimated savings from eliminating the subsidy for proposals that fail to receive at least 40% of the votes ranges from $293 million to $1.9 billion.


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Introduction

Institutional investors have, in the past decade, increasingly engaged in corporate governance activities, introducing proposals under rule 14a-8, the Securities and Exchange Commission’s (SEC) proxy proposal rule,\(^1\) and privately negotiating with management of targeted firms with the stated goal of improving corporate performance. For example, since the mid-1980s, institutions have submitted to hundreds of firms shareholder proposals on corporate governance consisting principally of proposals to eliminate defensive tactics to takeovers, to adopt confidential proxy voting, to enhance board independence, and to restrict executive compensation. Before 1986, only a small set of individual investors

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\(^1\) 17 C.F.R. § 240.14a-8 (2000).
engaged in such activism: from 1979-83, religious groups and six or seven individuals, depending on the year, submitted more than half of all proposals, which ranged in the hundreds every year. From 1986 until the early 1990s, five institutions (four public pension funds and the pension fund of university teachers and administrators) accounted for almost 20% of all proposals. Since 1994, unions have overtaken public pension funds as the most active corporate governance proposal sponsors.

Commentators have, in general, commended institutional shareholder activism, at least in part from a belief that it would replicate the blockholding-based governance systems of Germany and Japan and thereby fill the void in managerial monitoring which occurred at the end of the 1980s with the decline in hostile takeovers in the United States (although the bloom now is off Germany and Japan's corporate governance systems given far superior U.S. economic performance for more than a decade and the increase in hostile takeover activity in recent years). In this view, more active engagement in corporate governance by institutional investors can substitute for the discipline imposed on managers by the threat of a hostile takeover.

As shareholder activism on corporate governance matters has become more pervasive, financial economists have attempted to measure the effect of such activism on targeted firms' performance. Although the finance literature focuses, among institutional investors, on proposals by public pension funds, given the relatively recent appearance of union activism, because most union proposals are not substantively different from those sponsored by public pension funds, it is unlikely that the findings would differ markedly for union proposals. This contention is supported by the

5 Id. at 52.
fact that, for union proposals involving corporate governance, voting
levels, which are an excellent proxy for the value of a proposal, do not
significantly differ from those obtained for public pension fund proposals
on the same subjects.\footnote{Thomas & Martin, supra note 4, at 68 (finding no significant difference in voting outcomes). For a discussion of why voting support is a proxy for the proposal's benefit to shareholders see text accompanying note 156, infra. The support level is lower, but insignificantly so, when the sponsoring union is involved in a labor dispute. Thomas & Martin, at 63, 69. It must be noted, however, that some firms follow a policy of not identifying proposal sponsors in their proxy materials, including firms with union-sponsored proposals. E.g., Eastman Kodak Proxy (Mar. 13, 1996) (sponsors not identified, indicates names and addresses will be furnished upon request). The sponsors of Kodak's 1996 proposals were an individual and the Teamsters Union. IRRC, Checklist of 1996 Shareholder proposals, IRRC CORPORATE GOVERNANCE BULLETIN 27 (July-Sept. 1996). Because Thomas and Martin did not examine only proposals in proxies identifying the proponents for their analysis but instead used the IRRC data that identifies proposal sponsors, it is possible that union proposals' support is indistinguishable from other pension funds' proposals' support only when the voting shareholders do not know the identities of the sponsors. Although Thomas and Martin's sample's mix of firms identifying and not identifying proposal sponsors is not known because firm policies on identifying sponsors appear to be random with respect to the proponents' identities, it is improbable that the results would differ if they had analyzed only proposals whose sponsors were identified in the proxies. While some recent research indicates that the market response to negotiated shareholder proposals has changed from positive to negative in the late 1990s, which may well be a function of the change in identity of the proposal sponsors, N.K. Chidambaran & Tracie Woidtke, The Role of Negotiations in Corporate Governance: Evidence from Withdrawn Shareholder-Initiated Proposals (Dec. 1999) (unpublished manuscript, on file with the Yale Journal on Regulation), as discussed in subsection II.B.3, infra, the market reaction to negotiations is best explained as updating of information regarding the quality of management, rather than as evidence of the value of a proposal.}

This Article reviews the corporate finance literature on corporate
governance activism involving shareholder proposals and uses it to inform
normative recommendations concerning the proposal process. The finance
literature presents an apparent paradox: notwithstanding commentators’
generally positive assessment of the development of such shareholder
activism, the empirical studies suggest that it has an insignificant effect on
targeted firms' performance. Very few studies find evidence of a positive
impact, and some even find a significant negative stock price effect from
activism.

There have been two literature reviews, by Jonathan Karpoff and
Bernard Black, that reach the same negative assessment of shareholder
activism's impact, but they have not focused on the gulf between the
empirical and normative literature.\footnote{See Bernard Black, Shareholder Activism and Corporate Governance in the United States, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (Peter Newman ed., 1998); Jonathan M. Karpoff, Does Shareholder Activism Work? A Survey of Empirical Findings (Apr. 22, 1998) (unpublished manuscript, on file with the Yale Journal on Regulation). In addition, Stuart Gillan and Laura Starks survey all forms of institutional investor activism and not solely shareholder proposals; they conclude that there is no empirical evidence that such activity improves operating or long-term market performance, although in theory it is beneficial for large shareholders to become active monitors of management. See Stuart L. Gillan & Laura T. Starks, A Survey of Shareholder Activism: Motivation and Empirical Evidence, CONTEMPORARY FINANCE DIGEST, Autumn 1998, at 10, 31.} Jonathan Karpoff seeks to reconcile the disparate conclusions in finance studies, which he emphasizes are due
to different definitions of what counts as a success and thus are more apparent than real; his objective is not to explain the gulf between the finance literature and the legal commentary. Bernard Black, who in light of the empirical finance literature shifted from an optimistic assessment of institutional investor activism to that of a "pessimist," offers a set of possible explanations for the overall insignificance of activism: that most proposals are precatory and are ignored by management; that institutional investors are unable to organize effectively to influence management or are uninformed about what issues to propose; and that the overall level of activism—a small number of institutions spending a trivial amount of money—is low.

The precatory content of shareholder proposals is not sufficient to explain the insignificant price effects. Management often responds to precatory proposals, even those receiving less than a majority of the shares. For instance, of 118 firms adopting confidential voting for the proxy process, a proposal for confidential voting was offered at only one-third of the firms, and in only four cases did the proposal receive a majority of votes. It is possible that the market does not react to shareholder proposals because most proposals do not obtain sufficient support to evoke a management response, rather than because the proposal must be couched in precatory language. The reasoning would be that because shareholder proposals do not obtain a majority of votes, there is little reason to assume that the management action sought by the proponent will be adopted, and hence there is nothing to price. However, the support for proposals has been increasing over time, it is considerable for specific categories of proposals and, as noted, management may respond to a proposal that does not obtain majority support. This suggests that studies should find significant price effects for proposals offered in the later years of samples in which voting support increased, or at least for the subsamples of proposals that can be expected to obtain relatively high voting support and to induce a management response. The lack of significant positive price effects for such subsamples of proposals, in conjunction with findings of significant negative price effects in some studies for some subsamples of proposals, implies that something is at work other than the explanation that the market assumes proposals will be ignored by management.

Black’s explanation of proposals’ insignificant price effects as due to institutions’ inability to organize effectively is also unpersuasive, as the

9 Karpoff, supra note 8, at 1-2.
10 Black, supra note 8, at 463. The recent move to offer proposals that would require management action is discussed in the text accompanying notes 35-36, infra.
institutional investors who sponsor proposals hold nontrivial blocks in many firms and have networking organizations on corporate governance activities that largely mitigate collective action concerns. His alternative contention that these shareholders have limited information concerning which proposals are efficacious is consistent with this Article’s explanation that the apparent paradox is related to the substance of submitted proposals but it is not the sole explanation of the data—fund managers might well be informed about which proposals are useful and still champion fruitless proposals if managers obtain personal benefits from submitting such proposals, given the absence of strong incentives of boards of public funds to monitor their staff. The fact that in contrast to public pension funds, private pension and mutual funds do not engage in activism has been explained by the competitive nature of the industry, or more pejoratively, as cost-conscious private funds’ free-riding on the expenditures of activist public funds. I would emphasize a further, complementary explanation, that such institutions’ managers are less likely to obtain personal (private) benefits from engaging in shareholder activism than public and union fund managers. Both explanations are supported by survey data indicating that private fund managers perceive the costs and benefits of shareholder activism differently from public pension fund managers.

Finally Black’s explanation that proposals’ insignificant price impact is due to the overall low level of shareholder activism is an incomplete explanation: it is not institutions’ low expenditure level, but rather the specific objectives of their activism, that have resulted in the absence of a price effect. Even if institutions were to spend more resources on their proposals in order to ensure voting success, unless the subject of their proposals was also significantly altered, there would be no change in the stock price reaction. It is the thesis of this Article that the problem with shareholder activism is that the governance reforms that institutions are proposing have no significant cash flow effects.

This Article provides an alternative explanation of the apparent

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13 See text accompanying notes 17, 181-183 infra (discussing possible private benefits).
15 While the number of institutions engaging in activism is very small (not much more than a dozen), the number of entities that have engaged in hostile takeovers is not that much greater when compared to the differential magnitude of the price effects. For example, in 1986, only 40 out of 3,300 takeovers were hostile offers, and that was an all time high, Michael C. Jensen, Takeovers: Their Causes and Consequences, 2 J. ECON. PERSP., Winter 1998, at 21, 22, and the premiums in hostile takeovers are incorporated in the stock price immediately upon the announcement of the bid, often with significant run-up (averaging 40% of the eventual premium) prior to the announcement, Gregg A. Jarrell & Annette B. Poulsen, Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?, 5 J.L. ECON. & Org. 225, 226-27, 244 (1989).
paradox in the literature that I believe is preferable to Black’s conjectures, because it can rationalize the disparate findings of insignificance and significance in the empirical studies as well as the finding that management is often responsive to shareholder activism despite its precatory form. Namely, financial economists have not been able to identify a positive performance effect of shareholder activism because much of that activism is, in fact, misdirected. I reach this conclusion by relating the studies of shareholder activism to the studies of the underlying corporate governance devices that are the object of that activity. A review of that literature makes evident that, for a very large proportion of the governance structures that are the focus of shareholder activism, such as independent boards of directors, limits on executive compensation, and confidential proxy voting, there is a paucity or utter absence of data that demonstrate that such devices improve performance. Hence, it should not be surprising that shareholder activism directed at reforming those governance structures does not produce positive results, and that this result would persist regardless of proposals’ expected voting support.

Negotiated agreements between institutional investors and management, after which a proposal is withdrawn, on occasion produce positive price effects. The Article provides an explanation, based on updating of information on firm quality, of this distinctive result compared to that for submitted proposals: given that the substantive distributions of withdrawn and submitted proposals are indistinguishable, the withdrawn proposal induces a positive price effect because it provides information about management quality otherwise obscured by the firm’s poor performance (that the managers desire to be responsive to investor concerns and will not seek to entrench themselves and prevent shareholders from taking actions, such as accepting a takeover bid, that improve firm value). A negative price effect is analogously understood as the response to a negotiation indicating to the market that management’s quality is lower than previously believed. The information-updating explanation is preferable to a more straightforward value-maximizing explanation of the empirical results, that when management negotiates with a shareholder and the proposal is withdrawn it is because it is a value-maximizing proposal, and when management does not negotiate, it is because the proposal is not value-maximizing. The value-maximizing explanation is inconsistent with the studies that find negative price effects from negotiations. It is also unsatisfactory because there is not sufficient heterogeneity among proposal targets to explain why the same type of proposal would be value-maximizing for some firms (where it is withdrawn) and not others, which would be required by this explanation given that the empirical results are indistinguishable by proposal type.

The wide gulf between the prior perceptions of commentators and
pension fund managers and the reality conveyed by the data presents a perplexing picture: why are time and effort being devoted to fruitless or marginal activities? This Article does not answer this question directly, although there is a plausible explanation relating to pursuit of personal benefits (such as political ambitions or collective bargaining goals) rather than portfolio firm value-maximization by proposal proponents, who are not private sector fund managers. There are also data substantiating this conjecture: the New York City public pension fund manager emphasized her activism in seeking election to higher office,\(^\text{16}\) and union funds have targeted firms where there were ongoing contract negotiations.\(^\text{17}\) This Article takes problematic motivational issues as a given and seeks instead to recommend devices to provide fund boards in charge of oversight, as well as fund managers, with more information and incentives to minimize the effect of agency problems on portfolio performance.

The Article takes a two-pronged approach to the problem of ineffective shareholder activism. First, the Article recommends adoption of a mechanism of internal control, something akin to a good management practice, whereby funds would engage in periodic comprehensive review of their shareholder-activism programs to identify the most fruitful governance objectives. Such evaluations would increase information and thereby improve the quality of decision-making and aid in ensuring that funds' proxy activities are directed at maximizing portfolio firms' value. This should increase the benefit from activism to the beneficiaries of the funds, and is accordingly an appropriate policy from the perspective of the fiduciary obligations of fund managers. To provide an impetus for individual compliance, the Article recommends that industry associations adopt good-practice standards for activism programs that will furnish guidelines for individual funds. It also suggests the use of independent third parties, such as public accounting firms, to certify that funds' activism programs have been thoroughly reviewed.

The Article further advocates changing the SEC proxy proposal rules to reduce the current subsidy of proposal sponsorship unless a proposal achieves substantial voting success, or to permit firms to opt out, in whole or in part, of the current subsidized proposal regime.\(^\text{18}\) This second reform

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\(^{16}\) Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 822 (1993). In the public pension fund activism article I suggested structural changes to align public fund managers' interests with beneficiaries', and hence I do not pursue that route here but instead focus on more incremental changes related to addressing the immediate problem, ineffective use of the shareholder proposal process.

\(^{17}\) Thomas & Martin, *supra* note 4, at 61-62.

\(^{18}\) Other commentators have advocated repealing rule 14a-8, emphasizing that shareholders should not have to subsidize a proxy proposal process dominated by individual gadflies whose proposals obtained at most trivial support. *E.g.*, George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1 (1985) [hereinafter Dent, *Study*]; Liebeler, *supra* note 2. As discussed in section III-B infra, the introduction of institutional investors with higher levels of
proposal will provide incentives for funds to undertake comprehensive internal revaluations of their shareholder proposal programs because unsuccessful policies (those that do not garner substantial support) will become more expensive to pursue. For example, the estimated present value of the cost of the current regime, compared to one of the proposed reforms, subsidization of only shareholder proposals obtaining 40% of the votes cast, ranges between $293 million and $1.9 billion. It would also better track the state-law approach to the reimbursement of expenses of proxy fights, which are not covered by the SEC shareholder proposal rule, in which successful challengers can recover their costs. In contrast to shareholder proposals, proxy fights are not typically waged over marginal matters, and the empirical literature has consistently identified significant positive wealth effects from this activity. No doubt the difference in the wealth effects of proxy fights and shareholder proposals is a function of the different incentives created by the cost reimbursement rules: in contrast to sponsors of shareholder proposals who bear no financial risk, proxy fight contestants will incur the substantial expense of a contest only where they expect a victory to produce a significant improvement in corporate performance.

I. Explaining the Negligible Impact of Shareholder Activism on Performance

This section reconciles the seeming disparity between the goals of pension fund activism—shareholder proposals and private negotiations with management—with the empirical literature that finds that such activism has, at best, minimal impact on corporate performance. It does so by relating the empirical research on the effect of pension fund corporate governance activism on firm performance to the empirical research on the ownership and whose proposals attain higher support levels does not alter the cost-benefit conclusion, that subsidizing the proposal process is inefficacious. See also George W. Dent Jr., Proxy Regulation in Search of a Propose: A Reply to Professor Ryan, 23 GA. L. REV. 815, 823 (1989) (hereinafter Dent, Response) (in light of institutional activism, shifting from advocacy in his prior article of the repeal of rule 14a-8 to suggesting that the SEC require proposal sponsors to post a bond, recoverable if voting support is "respectable").

19 See, e.g., Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (1955). To obtain reimbursement, the proxy fight must be over policy and not personal issues, id., but it is not terribly difficult to characterize personal disputes as policy disagreements.

performance effects of the underlying governance objectives of shareholder activists. It begins, however, by sketching which firms are targeted, in order to establish that shareholder proposals should, in fact, be evaluated by their impact on corporate performance.

A. What firms do institutional investors target?

To ensure that it is appropriate to evaluate the efficacy of institutional investors' activism by whether there is an impact on corporate performance, it is necessary to identify which firms activist pension funds target. Namely, are they targeting poorly performing firms? For if pension funds' efforts at improving corporate governance are not related to concerns over corporate performance, then using improvement in performance as a benchmark for evaluating funds' behavior would be inappropriate. In particular, we would not expect to find significant performance effects from shareholder proposals if targeted firms were among the top-tier performers, for such firms would be less able to improve their performance significantly. As there may be a number of firms in a fund's portfolio with subpar performance, in considering the impact of activism on performance it is also necessary to ascertain whether funds follow target selection strategies that can be considered rational: namely, do they select firms for which they have a higher probability of success, on the assumption that a successful campaign is essential for performance improvements.

1. Targets of Shareholder Activism are Poor Performers

Several studies find that firms that are the targets of shareholder activism are, indeed, poor performers (compared to market or industry-peers) on a variety of stock and accounting measures: abnormal stock returns, growth in operating income, return on assets, operating return on sales, sales growth, and market-to-book ratio. However, not all studies

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find significant differences on all measures. In part, differences among studies are a function of the selection criteria of the activist institutions. Since 1988, for instance, the California Public Employees' Retirement System (CalPERS) has explicitly chosen its targets from among the poor performers in its portfolio, whereas the Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF) uses firms' corporate governance characteristics rather than a performance criterion. Not surprisingly, the one study focusing solely on TIAA-CREF's initiatives did not find the targets to have been poor performers. But even TIAA-CREF's objectives are explicitly couched in the ideal of improving performance. The finding of target firms' subpar performance across a variety of samples of institutional investor activism supports the notion that the appropriate benchmark for measuring the value of corporate governance shareholder proposals is their impact upon corporate performance.

2. Targets Have High Institutional and Low Insider Shareholdings

There are also considerable data that institutional investors select their targets strategically to increase the probability of success—that is, they consider the composition of the firm's shareholder voting pool, and not simply performance, in choosing proposal targets. Several studies find a negative relation between the receipt of shareholder proposals and insider ownership, and a positive relation between proposal receipt and institutional ownership. In fact, TIAA-CREF expressly uses institutional
ownership as a criterion for target selection.\textsuperscript{27} This strategic behavior is consistent with the selection of targets for which the probability of success is high. Insiders, of course, are not expected to vote for proposals restricting their discretion or otherwise requiring them to establish governance structures that they have not voluntarily adopted. Institutional shareholders, who have far greater incentives to engage in informed voting compared to individual shareholders because of the size and extent of their holdings, are hypothesized to vote for proposals enhancing shareholders' ability to monitor management with greater frequency than other outside investors. And indeed, that is precisely the way such investors vote: the percentage of votes cast for shareholder proposals is negatively related to insider ownership and positively related to institutional ownership.\textsuperscript{28}

It is reassuring that studies find a positive correlation between proposal submission and institutional shareholdings, as it suggests that pension funds that are corporate governance activists are, in fact, concerned with the success of their undertakings. But it should be noted that the studies all involved the targets of public pension fund activism, so it is not known whether union funds follow a similar strategy.

We can, accordingly, conclude that public pension funds sponsoring corporate governance proposals are not engaged in symbolic politics, as is true of sponsors of social responsibility proposals (proposals addressing social issues and corporate social policy, such as, doing business in Northern Ireland or animal testing), which receive far more limited support than corporate governance proposals. For example, in 1994, social responsibility proposals rarely received more than 20\% of the vote while corporate governance proposals at times received 40\%,\textsuperscript{29} and in 1991-92, 51 of 169 corporate governance proposals received more than 33\% of the

\textsuperscript{27} Carleton et al., supra note 23, at 1339. Mark Huson suggests institutional ownership is also a criterion for CalPERS. See Mark Huson, Does Governance Matter? Evidence from CalPERS Interventions 4 (Inst. for Fin. Research, Faculty of Bus., Univ. of Alberta Working Paper No. 3-97, July 1997) (finding that firms with low institutional ownership were excluded from CalPERS's targeting).

\textsuperscript{28} Stuart L. Gillan & Laura T. Starks, Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors, 57 J. Fin. ECON. 275, 295 (2000) (finding that percentage of votes cast for shareholder proposals is positively related to institutional ownership); Lilli A. Gordon & John Pound, Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance Proposals, 48 J. Fin. 697, 713 (1993) (finding that percentage of votes cast for shareholder proposals is negatively related to inside ownership and positively related to high percentages of institutional ownership).

\textsuperscript{29} See William L. Cary & Melvin A. Eisenberg, Corporations: Cases and Materials 374 (7th ed. unabr. 1995).
vote compared to only 1 of 165 social responsibility proposals.\(^3\) In addition, although no social responsibility proposal has ever passed, from 1986-90, 25 corporate governance proposals received a majority of the votes;\(^3\) and the number of corporate governance proposals obtaining a majority has continued to increase dramatically in the 1990s, with 30 passing in 1999 alone.\(^3\)

Of course, a proposal’s passing does not mean that it will be adopted—to be submissible under the SEC rules, proposals involving ordinary business decisions must be precatory because corporate law delegates such decision-making to the board.\(^3\) Although many boards respond even to unsuccessful proposals, boards can and, on occasion, do disregard majority votes, particularly on takeover defense rescissions.\(^3\)

Recent shareholder proposals have sought to prevent the possibility of such an outcome by phrasing the proposal as a bylaw amendment (which, if passed, would mandate board action). Whether such a strategy is permissible has not yet been adjudicated in Delaware, but an Oklahoma court upheld the inclusion of this type of proposal under the SEC proposal rules as a proper subject for shareholder action, under a state statute similar to Delaware’s.\(^3\) The issue has also been the subject of extensive commentary, most of which advocates permitting such bylaw proposals, or some subset of them.\(^3\)

Notwithstanding the still open question whether an

\(^{30}\) John & Klein, supra note 21, at 16. In the 1980s, social responsibility proposals gained less than 3% of the votes. Liebeler, supra note 2, at 450-52. Average support for corporate governance proposals increased throughout the 1980s and for the five highest support categories ranged from 25.8% to 42.1% by 1990. Sander, supra note 3 at 5. While social responsibility proposals’ support has also increased, the averages for the two highest support categories were 12.4% and 9.75% in 1990. See id. at C-2 to C-8 (my calculation). Social responsibility proposals are not a focus of this article because they are not advanced in order to improve corporate performance and are consequently, not compatible with the objective of U.S. corporate law, which is to maximize share value.

\(^{31}\) Sander, supra note 3, at 86.

\(^{32}\) IRRC CORPORATE GOVERNANCE BULLETIN, April-June 1999, at 4 (finding that in 1999, 41 shareholder corporate governance proposals received more than 50% of the votes cast and, based on the company’s voting requirements, 30 of these passed, all but two of which involved elimination of takeover defenses). The vast majority of firms’ annual meetings are held in the first half of the year (March-May), so the IRRC reports a year’s proxy season results in June.

\(^{33}\) 17 C.F.R. § 240.14a-8(i) (2000). Proposals involving matters that are subject to shareholder action are submissible in non-precatory form.

\(^{34}\) E.g., Lawrence A. Hamermesh, Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?, 73 Tul. L. Rev. 409, 421-22 (1998) (describing an example of such conduct by Fleming Companies, Inc.).

\(^{35}\) Int’l Bhd. of Teamsters Gen. Fund v. Fleming Companies, Inc., No. CIV-96-1650-A, 1997 U.S. Dist. LEXIS 2980 (W.D. Okla. Jan 24, 1997). The issue is whether poison pills are a proper subject for shareholder action (i.e., bylaw amendments) or ordinary business matters that are within the authority of the board.

intransigent management can be required to adopt the policies that are the subject of a successful (majority-supported) shareholder proposal, given the data on firm targeting, we can conclude that institutional sponsors of corporate governance proposals are attempting to use their resources effectively in their choice of targets.

B. What is the Relation Between Activism and Performance?

Shareholder proposals have no significant effect on firm performance, but private negotiations over proposals in advance of the shareholders’ meeting often have a short-term positive impact, and, on occasion, even a negative impact. This section reviews and reconciles these seeming inconsistent data.

1. Studies of Proxy Proposals

Despite the apparent rationality of public pension funds’ targeting—targeted firms tend to be poor performers with a shareholder pool that is predisposed to vote for corporate governance proposals—there is an absence of evidence that such activism has any discernible positive impact on corporate performance. Across the most comprehensive studies of shareholder proposals, there is a uniform finding of no significant relation between proposal submissions and target firm performance. The studies...

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(questionsing validity and advisability of bylaw proposals); Jonathan R. Macey, The Legality and Utility of the Shareholder Rights Bylaw, 26 HOFSTRA L. REV. 835, 864-69 (1998) (advocating that bylaw proposals are valid under state law). A further open question is whether boards can subsequently repeal shareholder-passed bylaws. For differing positions on this issue see Coffee, supra, at 616-18 (suggesting that a board might be able to repeal such a bylaw but that, by careful crafting, shareholders can limit a board’s ability to do so) and Hamermesh, supra note 34, at 469-75 (maintaining that boards can amend shareholder-adopted bylaws under Delaware law).

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37 See Del Guercio & Hawkins, supra note 3; Gillan & Starks, supra note 28; Karpoff et al., supra note 21; Wahal, supra note 21; Catherine M. Daily et al., Institutional Investor Activism: Follow the Leaders? 30 (1996) (unpublished manuscript, on file with the Yale Journal on Regulation). Because the Daily et al. study does not provide information on the proposals’ content, which is the focus of this Article’s analysis, it is not discussed. When the performance measure is the short-term stock price (abnormal return) reaction to a particular “event,” such as the announcement of submission of a shareholder proposal or the initiation of negotiation over a proposal, the econometric methodology used to determine the performance effect is called an event study. Event studies investigate the impact of new information upon expected stock returns, which are estimated by an asset pricing model that most commonly depends on the return on the market; the residual of the linear regression of the stock return of event firms on the market return during the event interval is the abnormal return or performance measure due to the event, as it represents the change in stock return beyond the model’s predicted return in the absence of the event. Stephen Brown & Jerold B. Warner, Using Daily Stock Returns: The Case of Event Studies, 14 J. FIN. ECON. 205 (1985). Because the power of the tests in event studies is well-specified for large sample sizes with precise event dates, see, e.g., A. Craig MacKinlay, Event Studies in Economics and Finance, 35 J. ECON. LIT. 13, 30-31 (1997), criteria which are met in the shareholder activism studies emphasized in this Article, the findings of insignificance for proxy proposals are not due to imprecision in the event study methodology.

One study found a significant long-term positive valuation effect of shareholder activism, see...
are summarized in Table 1. Although the overall conclusion is that proposals do not affect performance, in each of the comprehensive studies of shareholder proposals there are subsamples that have significant effects: the significant positive returns are not related to proposal submission activity, but the significant negative returns are.

**TABLE 1. PERFORMANCE EFFECTS OF SHAREHOLDER PROPOSALS ON CORPORATE GOVERNANCE**

<table>
<thead>
<tr>
<th>Study</th>
<th>No. Proposals</th>
<th>No. Firms</th>
<th>Sponsors</th>
<th>Years</th>
<th>Performance Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Del Guercio &amp; Hawkins (1999)</td>
<td>224</td>
<td>125</td>
<td>5 activist funds</td>
<td>1987-93</td>
<td>insignificant</td>
</tr>
<tr>
<td>Forjan (1999)</td>
<td>798</td>
<td>467</td>
<td>Individuals &amp; institutions</td>
<td>1978-91</td>
<td>negative</td>
</tr>
<tr>
<td>Gillan &amp; Starks (2000)</td>
<td>2,042</td>
<td>452</td>
<td>Individuals &amp; institutions (institutions)</td>
<td>1987-94</td>
<td>insignificant</td>
</tr>
<tr>
<td>Karpoff et al. (1996)</td>
<td>522</td>
<td>269</td>
<td>Individuals &amp; institutions</td>
<td>1986-90</td>
<td>insignificant</td>
</tr>
<tr>
<td>Smith (1996)</td>
<td>78</td>
<td>51*</td>
<td>CalPERS</td>
<td>1987-93</td>
<td>insignificant</td>
</tr>
<tr>
<td>Wahal (1996)</td>
<td>306</td>
<td>146</td>
<td>9 activist funds</td>
<td>1987-93</td>
<td>insignificant</td>
</tr>
</tbody>
</table>

Note: n.a. = information not available

*39 and 20 for some statistical tests

Sunil Wahal, for example, finds no significant improvement in the long-term stock or accounting performance in the targets of public pension fund activism, both for submitted proxy proposals and nonproxy contact (sending a letter to management expressing concern about performance without subsequently introducing a proxy proposal). But Wahal does find

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Aigbe Akhigbe et al., Long-term Valuation Effects of Shareholder Activism, 7 APPLIED FIN. ECON. 567, 570 (1997) (144 firms, average abnormal stock returns of 23% by three years after activism). This study is not included in the table because it combined shareholder proposals with proxy fights. The study's performance results are driven by the proxy fights in the sample. Although the authors did not classify their sample by activism form (i.e., individuals seeking a block of board seats are not differentiated from proposals to add independent directors to the board), they did classify it by activist type: institutional investor, individual and groups of large shareholders, with the latter two categories consisting of individuals known for engaging in proxy fights. Id. at 569. They find the individual and shareholder group variables are positively related to the size of the abnormal return, id. at 572, which indicates that the significance of their results depends on the proxy fights in the sample.
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a significant short-term stock price effect for the nonproxy contacts around the announcement of their targeting, in contrast to the proxy proposals. Jonathan Karpoff, Paul Malatesta and Ralph Walkling also find no significant stock price reaction to proxy proposals and no operating performance improvements over one to three years following the shareholder proposal (for all firms and for the subset of firms where the proposal was offered by CalPERS). But for a subset of proposals—those involving executive compensation—the stock price reaction to the proposal was significantly negative. However, a multivariate regression did not confirm a significant difference between compensation-related and other proposals.

Stuart Gillan and Laura Starks similarly find no significant stock price reaction to proxy proposals offered by institutional investors, but a significant negative stock price reaction to the subset of proposals seeking rescission of poison pills that are sponsored by institutional investors. Diane Del Guercio and Jennifer Hawkins also find no significant stock price effect from proxy proposals around the announcement date or in the long term (measured over three years after the proposal) and no significant improvements in long-term operating performance. In addition, in contrast to Wahal, they do not find any difference in announcement date returns when their sample is divided into proxy proposals and negotiated outcomes (nonproxy contact). But they do find a significant positive stock price effect for proposals offered by the State of Wisconsin Investment Board (SWIB) around the outcome date (the annual meeting date or the news date of a withdrawn proposal), and marginally significant (10% level) negative returns on the announcement date for proposals relating to antitakeover defenses and board composition or structure.

39 See Karpoff et al., supra note 21, at 380-83, 390-91. Karpoff et al.'s sample includes proposals by both public pension funds and other investors; the stock price effects are insignificant whether the proposals are separately grouped by type of proponent (such as by a pension fund or an individual investor) or aggregated together. Although the results were significantly negative for the full sample on the day after the proxy mailing date, see id., at 381 tbl. 4, they do not explicitly report this result and instead report the insignificance of the negative cumulative returns.

40 Id. at 382. As discussed in part II.B.2.c. infra, and as evident in the Karpoff et al. data, executive compensation proposals are a small fraction of the proposals offered by institutional investors, and this undoubtedly contributes to the difference between their result and the absence of negative price effects in the aggregate data of the other studies, which do not separately examine this proposal category.

41 Gillan & Starks, supra note 28, at 298-99. In contrast to the results in Karpoff et al., supra note 21, Gillan & Starks further find a small positive stock price reaction (.2%) to the full set of individually-sponsored proposals. Gillan & Starks, supra note 28, at 299.

42 See Del Guercio & Hawkins, supra note 3, at 322-26 tbl. 8.

43 See id. tbl. 8. Two other findings of significant positive returns in Del Guercio and Hawkins' study are, in my judgment, problematic and are therefore not relied upon in this article's analysis. They find significant positive returns on the outcome dates for the sample of proposals sponsored by CalPERS but the significance of this subsample is driven by one firm with a confounding event—at the same time as the outcome date for CalPERS's proposal to rescind Avon Products' poison
Finally, James Forjan, whose sample of proposals is not limited to institutional investor activism, finds a significantly negative stock price reaction on the proxy mailing date for firms subject to a shareholder proposal in the 1978-91 proxy seasons; the abnormal return is not significant when cumulated over one and two day intervals before and after the mailing date. Whether the finding would persist were the sample restricted to proposals by institutional sponsors as in the previously-discussed studies of Wahal, Karpoff et al., and Del Guercio and Hawkins is not known. Disaggregated by proposal type, the significant negative returns occur solely for proposals to repeal staggered boards and to ban greenmail or golden parachutes. Forjan further finds that for a subset of 27 firms where management reached an early agreement with the proposal sponsor or where the proposal passed with a majority vote, the announcement effect is significantly positive.

A more narrowly-gauged study by Michael Smith, focused solely on proposals sponsored by CalPERS, the largest activist public pension fund, reports similar results to those of the broader-based studies. Smith finds
no significant stock price effect and no long-term effect on the firms’
operating performance from CalPERS’s activism, but a positive stock
price effect for the subset of CalPERS’s proposals that succeeded. 
However, what Smith classifies as successful proposals partially overlaps
with Wahal’s nonproxy category, as they are described as instances where
the targeted firm either adopted the shareholder resolution or reached a
settlement with CalPERS which resulted in the proposal’s withdrawal. In
addition, he finds a negative stock price effect upon the targeting event for
the subsample of proposals offered in 1987-88, the sample years when
CalPERS was selecting targets by the presence of antitakeover defenses
rather than financial performance, and during which none of its efforts
succeeded, in contrast to the later years’ corporate governance proposals.

Similarly, a study of the proposals submitted by the United
Shareholders’ Association (USA), a non-profit shareholder advocacy
organization which was founded by T. Boone Pickens, a prominent hostile
takeover bidder during the 1980s, and whose members were primarily
small shareholders, also found no significant stock price effect. Announcement of a successful negotiation agreement that resulted in a
potential proposal’s withdrawal, however, produced a positive stock price
effect.

2. Why Do Proposals Have Insignificant Performance Effects?

The consistent findings of statistical insignificance for shareholder
proposals are most plausibly a function of the value of the corporate
governance mechanisms that are the objects of the proposals. The
governance mechanisms of greatest interest to shareholder activists—
board reforms, takeover defenses, executive compensation, and
confidential voting—have been the subject of extensive research. In brief,
the types of board and compensation reforms advocated by proposal
sponsors have not been found to be value-enhancing corporate governance
devices; the results of the empirical research on antitakeover devices are
ambiguous, with only some findings of a negative impact from some of the
tactics that shareholder proposals seek to rescind; and the implementation
of confidential voting has no impact on voting outcomes or on firm
performance.

a. Boards of Directors

A focus of shareholder proposals that is typically commended by

48 Strickland et al., supra note 21, at 335.
49 Id. at 334.
commentators entails altering board composition and structure to enhance the board's independence from management.⁵⁰ Proposals of such board reforms range from 9% to 16% of the total corporate governance proposals in the shareholder activism studies.⁵¹ However, the firms with board characteristics on which shareholder proposals focus, firms whose boards have a majority of independent directors or that split the function of board chairman and chief executive officer (CEO), do not perform significantly better than those whose boards, respectively, have fewer outside directors⁵²


⁵¹ E.g., Del Guercio & Hawkins, supra note 3, at 298 (finding that board independence issues comprise 9% of proposals); Gillan & Starks, supra note 28, at 286-87 tbl. 3 (stating that board and committee independence proposals comprise 14% of proposals and 9% of institutions' proposals); Smith, supra note 23, at 234 (stating that board independence proposals comprise 9% of identifiable proposals); Wahal, supra note 21, at 9 (stating that board independence issues comprise 16% of proposals). Karpoff et al. do not report any board independence proposals in their identification of proposals' content. Karpoff et al., supra note 21, at 372.

⁵² The extensive literature is reviewed in Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 BUS. LAW. 921 (1999) and Roberta Romano, Corporate Law and Corporate Governance, 5 INDUS. & CORP. CHANGE 277, 284-90 (1996). The overwhelming majority of studies find no significant correlation between performance and independence, with a few finding a negative relation, including one of the most recent and comprehensive studies, that by Bhagat and Black. Bhagat & Black, supra, at 944-49 (finding a negative effect on performance where a super-majority of board is independent). Only one study, again one of the more recent ones, finds a positive relation. Millstein & MacAvoy, supra note 50. The text adopts the findings of the vast majority of studies, that there is no relation between independence and performance, and de-emphasizes the disparate results of these two more recent studies, because both the Bhagat & Black and Millstein & MacAvoy studies use time series performance data but have only one observation of independence, which makes it difficult to attribute with confidence the measured performance (and change in performance) to the board's independence, as we do not know whether the independence measure is constant over the period. Bhagat & Black, supra (noting that the independence measure is from 1994 while performance is tracked from 1985-95); Millstein & MacAvoy, supra note 50 (noting that the independence measure is from 1994 while performance is averaged over 1991-95). An additional concern regarding the Millstein & MacAvoy study is that it does not use the composition of the board to measure independence, nor does it use standard stock price and accounting measures of performance. It uses instead, as its measure of board independence, the grade assigned to a company by CalPERS, based on the firm's response to a survey requesting a report on compliance with the guidelines for boards created by General Motors (GM); its performance measure is a variant of a popular practitioner measure of firm value known as EVA, representing the difference between earnings and the firm's return on capital. Although there are definitely benefits from trying to identify an alternative measure of board independence than directors' formal affiliations, as the latter approach may obscure organizational nuances in which not all independent boards are equally effective, use of the CalPERS survey is not particularly better in this regard, as categorization by the presence of formal guidelines or procedures may also mask important operational differences. In addition, the independence measure poses selection bias, as firms self-reported their compliance levels. Firms that felt they would not provide CalPERS with the responses it was seeking in all likelihood did not complete the survey, or the respondents provided information that they believed would satisfy CalPERS, regardless of actual practices. The endogeneity of guideline adoption means that a test will be unable to distinguish whether good performers adopt the GM guidelines or whether the guidelines result in improved performance. In addition, the key component of EVA, return on capital, is extremely difficult to measure, making this a less desirable performance measure to use than stock and earnings measures, as it is not readily comparable across studies. One would have more confidence in Millstein & MacAvoy's results, for example, if they had used multiple measures of performance, as is done by other authors, including more conventional stock and accounting data, as well as EVA, and found the same significant relation whatever the performance measure.
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or do not split these positions. 53

Although independent boards do not affect performance, and hence cannot be said to perform an ongoing monitoring function, they may provide an episodic monitoring function by benefiting shareholders in extraordinary or crisis situations. 54 For example, Michael Weisbach found that there is a higher probability of CEO turnover after significant poor performance when outsiders control the board compared to insider-controlled boards, although Wayne Mikkelson and Megan Partch find no correlation between board composition, CEO turnover, and performance. 55 Consistent with a crisis-management view, an event study of the appointment of an outside director reports a significant positive price effect even when a majority is already independent. 56 Appointing an independent director could signal that a company plans to address business problems, even if board composition does not affect the firm’s long-run profitability.

The research on the effect of outside boards for takeover targets is also ambiguous: one study found that board composition does not affect the likelihood of a takeover or the size of the premium, 57 while another found that shareholder premiums were higher for targets with outsider-dominated boards, particularly when the firm resisted the bid, but board composition did not affect the success of a bid, and the mean total takeover

53 Of six studies of the split in office, four find no difference or, in fact, an improvement in performance in the firms where the positions are not split. B. Ram Baliga et al., CEO Duality and Firm Performance: What’s the Fuss?, 17 STRATEGIC MGMT J. 41 (1996) (finding no significant announcement stock price or long-term accounting operating performance effects); S.V. Berg & S.K. Smith, CEO and Board Chairman: A Quantitative Study of Dual vs. Unitary Board Leadership, 3 DIRECTORS & BOARDS: THE J. OF CORP. ACTION 34-37 (1978) (reporting mixed and inconclusive results using several financial indices and concluding no significant difference); James A. Brickley et al., Leadership Structure: Separating the CEO and Chairman of the Board, 3 J. CORP. FIN. 189 (1997) (noting that there is no difference or improved performance for firms where the positions are not separated, using stock price and accounting measures of performance); Rajeswarrao S. Chaganti et al., Corporate Board Size, Composition and Corporate Failures in Retailing Industry, 22 J. MGMT. STUD. 400 (1985) (finding no difference in failure rate in retail industry). Whereas two studies find improved performance in firms where the positions are split. Lynn Pi & Stephen G. Timme, Corporate Control and Bank Efficiency, 17 J. BANKING & FIN. 515 (1993) (noting that banks with non-chairman chief executive officers and with higher stock ownership level of such chairmen have higher returns on assets); Paula L. Rechner & Dan R. Dalton, CEO Duality and Organizational Performance: A Longitudinal Analysis, 12 STRATEGIC MGMT. J. 155 (1991) (finding better accounting performance measures in split position firms). This Article accepts the results of the majority of the studies, that splitting the positions does not improve performance, particularly because that is the finding of the most comprehensive and sophisticated study, which is also the most recent, that by Brickley et al., supra.

54 Romano, supra note 52, at 290-91.


57 Anil Shivdasani, Board Composition, Ownership Structure, and Hostile Takeovers, 16 J. ACCT. & ECON. 167 (1993).
gain was not significantly different for outsider board firms (i.e., the
greater gains to target shareholders with independent boards came from
lower bidder returns). Finally, management-led buyouts of firms with
outsider boards have higher abnormal returns than those with insider
boards and takeover bidders with outsider boards experience less
negative abnormal returns on the announcement of their bids than those
with insider boards, while the data on the impact of independent boards
on the value obtained from divestitures are ambiguous.

Because the vast majority of firms will not be involved in hostile
takeovers or management buyouts, the expected benefit from increasing
board independence for the average firm is quite low, particularly as there
are no data indicating that the frequency of these acquisitive events is
higher for firms with independent boards. Moreover, the probability of
CEO turnover after poor performance, although it may well be higher for
independent boards, is still extremely low and, of course, the board's
independent composition did not avert the poor performance. It would
therefore be fair to conclude that the benefit to shareholders from an
independent board's performance in certain extraordinary situations is
sufficiently limited to render more decisive, for assessing the significance
of board composition reform, the overwhelming evidence that independent
boards do not produce performance improvements. This point has even
more force because the finding of a positive impact on decision-making of
independent boards in extraordinary circumstances is itself in controversy
as it is not uniformly identified in the literature.

One explanation for the failure to find performance improvements
with independent boards is that the optimal board structure may well vary
across firms. Because the choice of board structure is endogenous to
management, if firms with different requirements select differing
proportions of outside directors, then we would not expect to find
significant performance effects in a cross-sectional study of boards.
Shareholder proposals to change board structure, accordingly, will not
enhance firm value where management has already optimized on the
board's independence dimension; they will enhance value only if

58 James F. Cotter et al., Do Independent Directors Enhance Target Shareholder Wealth
59 Chun Lee et al., Board Composition and Shareholder Wealth: The Case of Management
60 John W. Byrd & Kent A. Hickman, Do Outside Directors Monitor Managers? Evidence
From Tender Offer Bids, 32 J. FIN. ECON. 195 (1992).
61 Robert C. Hanson & Moon H. Song, Managerial Ownership, Board Structure, and the
Division of Gains in Divestitures, 6 J. CORP. FIN. 55, 67-68 (2000) (noting that the size of selling
firms' abnormal stock returns is significantly positively related to a variable interacting the presence of
a positive total gain on the sale and the proportion of outside directors, albeit significantly negatively
related to the proportion of outside directors; however, when abnormal returns for only firms whose
sales produced a positive total gain are examined, board composition is not significant).
management has made a mistake. The failure to document positive price effects from shareholder proposals on board composition thus suggests that pension funds do not possess superior information regarding optimal board structure and, correlative, that activism is not functioning to improve a suboptimal board composition decision. Supporting this inference is the fact that firms that are targeted for shareholder proposals typically already have a majority of outside directors, and they may well have a higher proportion of outsiders than non-targeted firms.

A study by Anup Agrawal and Charles Knoeber, which attempts to control statistically for the problem of the endogeneity of corporate governance devices, provides further data that are at odds with the belief of proponents of independent boards. They find a negative impact on performance from board independence after controlling for other governance devices and thus contend that firms are currently suboptimizing board composition by nominating too many outside directors.

In a subsequent paper, Agrawal and Knoeber examined board composition more closely and identified a subset of "political" outside directors whose career experience is conjectured to aid firms' governmental interactions, that is, directors with political experience or law degrees (such as former high-level government and military officials serving on aerospace and defense firms' boards). They suggest that the negative correlation between performance and board composition identified in their earlier article may be spurious, in that firms subject to political interference are poor performers and also have more outside directors, particularly of the political variety. Consequently, board composition choices may not be suboptimal, as they initially concluded. Regardless of which of Agrawal and Knoeber's contentions is correct, whether corporate boards have the optimal number of outside directors or too many, their research implies that the market will not positively value shareholder proposals seeking to move boards any further along the independence dimension.

b. Takeover Defenses

The most popular type of proposal sponsored by institutional

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62 John & Klein, supra note 21.
63 See Smith, supra note 23, at 240 (noting that targets have fewer insider directors than control sample firms, but the difference is not statistically significant).
66 Id.
investors (between 36% to 48% of institutional proposals) involves elimination of takeover defenses, and the overwhelming majority of these proposals concern rescission of poison pills.\(^6\) The empirical literature on the price effects of the adoption of poison pills is, however, inconclusive. Initial studies reported a significant negative price effect on the adoption of a poison pill,\(^6\) but the results of subsequent research are mixed, with one study still finding a negative effect and several studies reporting no significant price effect for pills adopted after 1984.\(^6\) Moreover, one study found a positive price effect for pill adoptions where the board of directors consists of a majority of outsiders and a negative effect for firms with insider boards.\(^7\)

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\(^6\) Del Guercio & Hawkins, supra note 3, at 298 (finding that 41% of proposals involved defensive tactics and of these 75% are poison pill proposals); Gillan & Starks, supra note 28, at 286-87 tbl. 3 (finding that 48% of institutional investor proposals involved defensive tactics and of these 61% are poison pill proposals); Smith, supra note 23, at 234 (finding that 45% of identifiable and 38% of total proposals involved defensive tactics, and 77% of those are poison pill proposals); Wahal, supra note 21, at 9 (finding that 36% of proposals involved defensive tactics and of these 81% are poison pill proposals). The proportion in the Karpoff et al. study is not accurately identifiable: the category, "external corporate control market issues," which comprises 49% of identifiable institutional investor proposals (breakdown by type not provided), excludes several defensive tactic proposals, such as eliminating a staggered board, which are instead included in the category "internal corporate governance issues," along with a variety of proposals that are not takeover-related, such as confidential voting. Karpoff et al., supra note 21, at 372.

\(^7\) Gregg Jarrell & Annette B. Poulsen, Shark Repellents and Poison Pills: Stockholder Protection - From the Good Guys or the Bad Guys?, 4 MIDLAND CORP. FIN. J. 39, 46 (1986) (reporting that firms without confounding events and firms subject to takeover speculation had negative returns); Paul H. Malatesta & Ralph A. Walkling, Poison Pill Securities: Stockholder Wealth, Profitability and Ownership Structure, 20 J. FIN. ECON. 347 (1988) (reporting that the full sample had negative returns as did firms without confounding effects); Michael Ryngaert, The Effect of Poison Pill Securities on Shareholder Wealth, 20 J. FIN. ECON. 377 (1988) (reporting that firms subject to takeover speculation as well as firms without confounding events had negative returns); Gregg Jarrell & Michael Ryngaert, Office of Chief Economist of the Securities and Exchange Commission, The Effects of Poison Pills on the Wealth of Target Shareholders (Oct. 23, 1986) (reporting that firms subject to takeover speculation without confounding effects had negative returns). But even these studies had either full or subsamples of firms with insignificant price effects.

\(^6\) Robert Comment & G. William Schwert, Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures, 39 J. FIN. ECON. 3, 21 (1995) (finding no significant effect); Sudip Datta & Mai Iskandar-Datta, Takeover Defenses and Wealth Effects on Securityholders: The Case of Poison Pill Adoptions, 20 J. BANKING & FIN. 1231, 1242-43 (1996) (showing insignificant findings for the full sample but significantly negative for a small subset of nine firms that were subject to a takeover); Dana J. Johnson & Nancy L. Meade, Shareholder Wealth Effects of Poison Pills in the Presence of Anti-Takeover Amendments, 12 J. APPLIED BUS. RES. 10 (1996) (finding an insignificant effect); James M. Mahoney et al., The Differential Impact on Shareholder Wealth of Various Antitakeover Provisions, 17 MANAGERIAL & DECISION ECON. 331 (1998) (finding a negative price effect for pills adopted during the period 1984-88). It should be noted that there is an interpretation of the insignificant effects of pills in later-year event studies that is consistent with their having a negative impact on shareholder wealth: the adoption of poison pills after the tactic was upheld by the Delaware Supreme Court in 1985 could have been anticipated by shareholders and thus the negative impact was already impounded in the stock price at the pill announcement date. In this interpretation, the appropriate event for determining the impact of poison pills is the 1985 judicial decision.

\(^7\) James A. Brickley et al., Outside Directors and the Adoption of Poison Pills, 35 J. FIN. ECON. 371, 379 (1994). The sample period was 1984-86, which includes the year 1984 during which other studies have found negative price effects. Id. at 375; Comment & Schwert, supra note 69, at 21.
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The finding by one study of a positive impact of board composition on market reactions to pills suggests that investors view independent boards as having a higher probability of using a pill to run an auction and raise the premium received rather than to deter a control transfer and that, under such circumstances, they prefer to trade off a decreased probability of a bid for an increased probability of an auction, should a bid occur. Indeed, Brickley et al. found that bids for firms with pills and independent boards resulted in significantly more auctions than firms with pills but without independent boards. This is consistent with the finding that independent boards generate higher target shareholder gains but not a higher rate of successful bids — a higher frequency of auctions provides an explanation for these data. This finding also suggests another difficulty in interpreting the empirical literature that may explain the disparate empirical results: a pill adoption may provide new information to investors concerning a firm’s probability of a takeover, or management’s level of resistance to a bid, and hence price effects may be a function of the market’s assessment of that information (that is, a signalling effect) rather than the value attributed to the pill itself.

Further complicating the interpretation of the impact of poison pill adoptions, the efficacy of a pill’s defensive effect, and hence the market reaction, may be related to other defenses already in place. While this contention is theoretically plausible, the few studies examining the price effect of pill adoptions in conjunction with antitakeover charter amendments have disparate results: they find either no difference or a more positive return for firms with a prior antitakeover amendment. It must be noted, however, that the results of studies of the adoption of antitakeover charter amendments are also mixed, with the most frequent result being a statistically insignificant price effect.

71 Brickley et al., supra note 70, at 386-87.
72 Johnson & Meade, supra note 69, at 15-16 (finding that firms that did not have any antitakeover charter amendments had insignificant negative abnormal returns while firms with fair price or supermajority amendments had insignificant positive abnormal returns, and the difference in mean abnormal return for the two groups is significant at 10%; when the antitakeover amendment firms are subdivided by type, the returns to the firms with fair price provisions in place are significantly positive and significantly different from the firms with no amendments but not from the firms with supermajority amendments); Ryngaert, supra note 68 (finding no significant differences in abnormal returns for firms with or without classified board amendments and fair price or supermajority amendments). The Johnson & Meade data thus would appear to indicate that shareholder wealth effects from pills are lower for firms with no prior defenses. Johnson & Meade, supra note 69, at 15.
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surprising since shareholders must approve the amendments, and we would not expect them to vote for provisions that are contrary to their interest. Indeed, Anup Agrawal and Gershon Mandelkar find a positive relation between the wealth effect of an antitakeover charter amendment proposal and the firm's institutional ownership (presumably the firm's most informed voters).\textsuperscript{74} Moreover, in contrast to the poison pill studies, there is a more negative stock price reaction to charter amendments when the board is outsider-dominated.\textsuperscript{75} Thus, the benefits to shareholders from independent board composition with regard to defensive tactics are, in fact, ambiguous.

The studies of the interaction of poison pills and charter amendments may not be the best test of the thesis that the efficacy of a poison pill depends on firms' other defenses, however, because the most prevalent amendment in the study samples, a fair price provision, has little impact on a pill's defensive potency. A more informative test would be to examine the most effective defense in conjunction with a pill, a staggered board, rather than aggregated data on antitakeover charter amendments. Although even here, the impact may be largely theoretical for it is unlikely that a management which lost a proxy fight would continue to retain a pill and resist the bid. The limited impact of a staggered board in practice is, without doubt, a reason why pills were recrafted to include deadhand provisions that sought to lock in which directors could redeem a pill, albeit unsuccessfully, as these tactics were struck down by the courts.\textsuperscript{76}

\textsuperscript{74} Anup Agrawal & Gershon N. Mandelker, \textit{Large Shareholders and the Monitoring of Managers: The Case of Antitakeover Charter Amendments}, 25 J. FIN. & QUANT. ANALYSIS 143, 159 (1990). Despite this finding, it is possible that shareholders vote for value-decreasing charter amendments: Bhagat & Jeffers estimate that, regardless of the extent of firms' institutional ownership, defensive charter amendments have an adverse effect on firm value when the insignificant returns upon the proxy announcement are adjusted for the market's anticipation of the proposal. Bhagat and Jeffers believe that a self-selection effect is working in which only certain firms, albeit indistinguishable by institutional ownership, propose defensive amendments, but they do not offer an explanation for why these firms' informed investors vote for amendments that decrease share value. Bhagat & Jeffers, \textit{supra} note 73. A possible explanation of the study's results that is consistent with rational voting by institutions is that the anticipation-adjusted decline in price is not an indicia of a negative value of the approved defenses but rather is an information effect, that is, an adverse updating by the market regarding the firms' management quality or acquisition prospects, analogous to the explanation of the price effects of nonproxy negotiations. \textit{Infra} note 134 and accompanying text.


\textsuperscript{76} E.g., Quicktum Design Systems, Inc. v. Mentor Graphics Corp., 721 A.2d 1281 (Del.)
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The ambiguous results concerning the wealth effects of poison pills parallel the disagreement among commentators over the efficacy of takeover auctions, as a pill's principal impact, providing management with time to find a preferred bidder, is to foster an auction rather than to end preclusively a bid. It is therefore not surprising that shareholder proposals to rescind poison pills have not produced positive stock price effects. Rescission would be expected to improve performance only if pill adoption were more unequivocally a value-decreasing event.

The discussion of the corporate finance literature on takeover defenses has focused on poison pills not only because they are the subject of the most prevalent shareholder proposal on defensive tactics' repeal, but also because some studies have found significant performance effects for subsets of proposals containing poison pill rescissions. Before discussing those results in relation to the finance literature, it must be noted that the defenses besides poison pills that are the most common subject of shareholder proposals, cumulative voting, staggered boards, and golden parachutes, have not been as intensively empirically investigated as poison pills. The wealth effects reported in the small number of studies examining such defenses are not uniformly negative but are also positive or insignificant, calling into question the efficacy of proposals to rescind them, similar to the inference drawn from the research on poison pills. For example, although the one study of board-sponsored amendments to eliminate cumulative voting found a negative price effect, the one study of the adoption of golden parachutes found positive price effects, and the two charter amendment studies that separated out proposals to classify the board found no significant effect. These findings suggest that only proposals to restore cumulative voting might produce a beneficial wealth effect for shareholders, but the only shareholder activism study that separately reported the impact of this type of proposal, the study by Forjan, found no significant effect. It should further be noted that Forjan also

78 Studies showing that firms with poison pills are not subject to fewer successful takeover bids than firms without such defenses include Jamil Aboumeri, Poison Pills and Shareholder Value 1992-96, 68 ASPEN LAW AND BUSINESS CORPORATION 24, at 1 (Dec. 15, 1997) and Comment & Schwert, supra note 69.
79 Sanjai Bhagat & James A. Brickley, Cumulative Voting: The Value of Minority Shareholder Voting Rights, 27 J. L. & Econ. 339 (1984). The one study of charter amendments that separated out cumulative voting reductions from the other amendments also found a significant negative effect, but the sample size is small (21 proposals). Mahoney et al., supra note 69, at 537.
81 Jarrell & Poulsen, supra note 73; Mahoney et al., supra note 69.
82 Forjan, supra note 21, at 67 (noting 207 proposals).
found a negative price effect for proposals to rescind golden parachutes and staggered boards, defenses which have been found to have positive or insignificant price effects, a combination of findings consistent with the conclusion that such proposals are misguided from the perspective of shareholder wealth-maximization.

Smith’s finding of a significant negative price effect for the CalPERS’s proposals in 1987-88 which focused on takeover defenses and were largely poison pill proposals, Gillan and Starks’ similar finding for institutional investors’ poison pill proposals, and Del Guercio and Hawkins’ finding of a marginally significant negative price effect for antitakeover and board proposals (the bulk of the proposals in the group are antitakeover proposals, and poison pill rescissions predominate among these proposals), are consistent with the studies finding that poison pills do not decrease shareholder wealth and may, on occasion, increase it. This interpretation of the literature is supported by a study of poison pill shareholder proposals that found targeted firms more frequently revise their poison pills than nontargeted firms. If such revisions, undertaken by management’s being responsive to shareholder actions, weaken a pill’s effectiveness, a negative market response anticipating such an effect could be observed.

83 Antitakeover provisions comprised 110 of 140 proposals in Del Guercio and Hawkins’ grouping, with the most frequent (83) being rescission of a poison pill. Del Guercio & Hawkins, supra note 3, at 298 (calculated from tbl. 1). Pills are the subject of virtually all of the proposals submitted in 1987-88 in Smith’s sample (15 of 17). Smith, supra note 23, at 234 tbl. 1. Del Guercio and Hawkins also found that virtually all of the SWIB proposals that had a positive price effect at the time of the outcome date (the annual meeting date or the news date of a withdrawn proposal) were proposals to rescind poison pills. Del Guercio & Hawkins, supra note 3, at 298. One explanation for this contrary result might be market anticipation of a subsequent acquisition given knowledge of the level of shareholder support for pill rescission, as the date is after the vote. But Del Guercio and Hawkins report that SWIB’s targets were not significantly more likely to be subject to a takeover attempt than other sample firms, although targets receiving antitakeover proposals were. Id. at 318-19. An alternative explanation is that the result is spurious (that is, due to some other factor) because the event date is the shareholder meeting date, in contrast to the event date in the studies that identified negative effects, the proxy mailing date: random samples using annual meeting dates produce significant positive returns, in contrast to those using proxy mailing dates. James A. Brickley, Interpreting Common Stock Returns around Proxy Statement Disclosures and Annual Shareholder Meetings, 21 J. Fin. & Quant. Analysis 343, 346-47 (1986). Finally, SWIB, as an active stock-picking fund, is well-informed concerning its specified targets and focuses on antitakeover issues, in contrast to other activist institutions that are more heavily indexed and hence less informed about the particulars of their portfolio firms. Del Guercio & Hawkins, supra note 3, at 301, 305-06. SWIB might therefore be better able to identify firms where pill rescissions do maximize share value than other proponents of such measures, whose proposals, along with SWIB’s, are included in the studies finding negative price effects. Accordingly, firm-specific information (such as board composition), which appears in the finance literature to effect significantly the impact of poison pills on firms, may also affect the efficacy of shareholder proposals to repeal such defenses, and explain the contrary finding regarding SWIB’s proposals.

84 An alternative interpretation of the negative stock price effect of poison pill proposals as a signal of management quality rather than an assessment of the value of a pill, will be discussed in the next section, because it is dependent on the finding of positive price effects from private negotiations with management concerning poison pill rescissions. Part II-B-3, infra.

85 Bizjak & Marquette, supra note 21.
c. Executive Compensation

Proposals concerning executive compensation, which typically seek reductions in the level of pay, are a much smaller proportion of corporate governance proposals than the antitakeover proposals. In the Karpoff et al. study, they were approximately 10% of identified proposals (42 of 408), and none were sponsored by pension funds. Although there are also no compensation proposals in Del Guercio and Hawkins' study of pension fund activism, public pension funds do sponsor this type of proposal, while at a far lower rate than proposals on defensive tactics (less than 10% of their proposals).

This category of proposals was the subset producing negative price effects in the Karpoff et al. study. The substance of the proposals may explain this fact: proposals calling for limits on executive compensation are at odds with the empirical literature that finds that compensation and performance are positively correlated. A majority of the compensation-related shareholder proposals in the Karpoff et al. study called for limits on executive pay or requirements that directors own stock. While directors' compensation in stock might function as an incentive-aligning device that improves performance, in fact, studies investigating the relation between performance and directors' stock ownership have not consistently documented a significant positive relation. It should also be noted that all

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86 See Karpoff et al., supra note 21, at 372.
87 Del Guercio & Hawkins, supra note 3, at 297-98 (noting that no compensation proposals, including proposals to cap executive pay, are sponsored by the pension funds in the sample).
88 Wahal, supra note 21, at 9 (observing that compensation proposals are 4% of proposals); Smith, supra note 23, at 234 (noting that compensation proposals are 8% of identifiable proposals and 6% of total proposals). Smith does not report separate performance results for this proposal category. Wahal does not examine performance effects by proposal category. In Gillan and Starks' sample, executive compensation proposals comprise .02% of the proposals sponsored by institutions. Gillan & Starks, supra note 28, at 287 tbl. 3.
90 Karpoff et al., supra note 21, at 371.
91 E.g., Sanjai Bhagat et al., Director Ownership. Corporate Performance and Management Turnover, 54 BUS. LAW. 885, 907 (1999) (noting the positive relation between past performance and directors' stock ownership); Mehran, supra note 89, at 180 (no relation); Randall Morck et al., Management Ownership and Corporate Performance: An Empirical Analysis, 20 J. FIN. ECON. 293 (1988) (nonlinear relation). It should be noted that Bhagat et al. do not test precisely whether ownership improves performance, because they are correlating stock ownership with past, not future performance (that is, they find performance in 1991-92 is positively correlated with ownership in 1993). They did find that a dummy variable indicating whether directors were given stock options in 1992 and 1993 was significantly related to stock returns in 1994, but there was no relation between grants and stock returns in any of the other sample years. Bhagat et al., supra, at 899 tbl. 4, panel B7.
five of the CalPERS-sponsored executive compensation proposals in Smith's study were proposals to reduce top management's compensation, and it is important to add that, despite the small number, these proposals were 15% of the proposals Smith identified as successful, the same success rate achieved by the takeover defense proposals in his sample.\(^2\)

Two studies have focused solely on the impact upon actual pay levels of executive compensation proposals. The initial study of the effect on firm compensation policy of shareholder proposals involving executive compensation, by Marilyn Johnson, Susan Porter, and Margaret Shackell, found that both compensation levels and sensitivity of pay to performance decreased for firms targeted by CalPERS, but there was no significant effect on compensation from the submission of a shareholder proposal in general.\(^3\) Although their study does not indicate whether CalPERS's activism was directed at compensation issues for all of the targeted sample firms, it does provide anecdotal instances of management agreeing to reduce executive pay after meetings with CalPERS.\(^4\) Their anecdotes are consistent with Smith's reported high success rate of CalPERS's executive compensation proposals (80%).\(^5\) Given the literature detailing the positive impact of total compensation, as well as incentive (equity) compensation, on performance, to the extent CalPERS's activism results in lower compensation that is less sensitive to performance, it is not beneficial to targeted firms' shareholders.

The second study, by Randall Thomas and Kenneth Martin, found that the compensation of targeted firms' CEOs did not increase as rapidly as that of non-targeted firms' CEOs after targeting, but the decrease was not statistically significant.\(^6\) This corroborates the results of Johnson et al.'s study concerning the absence of an impact of compensation proposals. Prior to targeting, Thomas and Martin find that the targeted firms' managers had higher compensation than the average compensation

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Bhagat et al. also find that CEO turnover appears to be more frequent with higher stock ownership by directors, given poor performance, id. at 909, a result consistent with Weisbach’s finding of higher CEO turnover in poor performers with independent boards, see Weisbach, supra note 55, but this result on director equity ownership and CEO turnover is not robust across all of the regression models, see Bhagat et al., supra, at 910.

\(^2\) Smith, supra note 23, at 234.

\(^3\) Marilyn F. Johnson et al., Stakeholder Pressure and the Structure of Executive Compensation 20 (May 1997) (unpublished manuscript, on file with the Yale Journal on Regulation) (examining a sample of 186 firms, 26 with proposals and 4 targeted by CalPERS; noting that compensation levels and sensitivity to performance were unaffected by shareholder proposal but negatively affected by identification as a target of CalPERS).

\(^4\) Id.

\(^5\) Smith, supra note 23, at 234 (noting that 4 of 5 proposals to reduce executive compensation were successful).

Less is More

of managers in similarly-sized firms in their industry, and received more of their compensation in the form of incentive pay (stock options) than non-targeted firm managers, but only the cash salary component is statistically different. 97 The higher than industry-average compensation level persisted after the proposal, despite the lower rate of increase in pay. 98 After targeting, the targeted firms' CEOs' compensation packages shifted more toward cash than to long-term incentive compensation (that is, stock options, not cash salaries were reduced). 99 Although this difference was also not statistically significant, it is a result, similar to that of the Johnson et al. study, that suggests that executive compensation proposals do not benefit shareholders because they reduce, rather than promote, the use of the compensation form that better aligns shareholder and manager interests than fixed-cash payments, incentive stock options. 100 In fact, adoptions of incentive compensation plans have positive price effects. 101

The conclusion that shareholder activism involving compensation issues is non-value-maximizing is further supported by the finding of Andrew Prevost and John Wagster that firms on CalPERS's 1990 and 1991 "hit list"—the firms CalPERS was publicly targeting under its shareholder activism program in those years—experienced a negative stock price effect to two events in 1992: Congressional hearings on a bill to permit shareholder resolutions on executive compensation and increase proxy disclosure on compensation, and an SEC proposal thereafter to increase the shareholder votes required on executive compensation issues and to adopt a new method of valuing stock options in proxy statements. 102

Prevost and Wagster interpret these data as indicating that facilitating corporate governance directed at executive compensation by increased disclosure rules does not benefit shareholders because the disclosure, equally available to stakeholders with interests other than value-maximization, such as unions, political activists and the press, as it is to

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97 Id. at 1063.
98 Id. at 1065. Thomas and Martin use a different year than Johnson et al. for post-proposal compensation, which, besides the difference in sample composition, may explain the slight difference in results. When they examine compensation two years after the proposal, they find the decrease in incentive pay is significant, as well as the increase in salary. Id. at 1067.
99 Id. at 1065-66. In fact, one of the results that Thomas and Martin state they cannot explain, the finding that the CEO's industry-adjusted compensation level post-proposal is higher for individual rather than union sponsors, id. at 1069, can be explained when considered in conjunction with Johnson et al.'s findings: namely, institutional investors exercise more influence on compensation committees than individuals.
100 For the classic statement of the optimal incentive compensation package for an agent see Bengt Holmstrom, Moral Hazard in Teams, 13 Bell J. Econ. 324 (1979).
101 See James A. Brickley et al., The Impact of Long-Range Managerial Compensation Plans on Shareholder Wealth, 7 J. Account. & Econ. 115, 125-26 (1985).
investors, will encourage stakeholder pressure on boards to weaken the
"pay-for-performance" sensitivity of management compensation.\textsuperscript{103} Their
explanation of the data is corroborated by the studies of executive
compensation proposals: a negative stock price reaction to the SEC
disclosure rule indicates an expectation that firms will be pressured to
diminish incentive compensation plans. This expectation is borne out, as
the performance sensitivity of the pay of executives at CalPERS-targeted
firms decreased significantly, and at union-targeted firms decreased, albeit
insignificantly, after being targeted subsequent to the SEC rule change.

Given the content of many compensation proposals—to limit pay and
restrict incentive compensation practices—it is not a surprise that
shareholder activism, when compensation is the object, has not been found
to improve performance. The perverse effects that would accompany the
adoption of such proposals—decreased incentives for managers to increase
share value—in all likelihood explains the negative stock price reaction to
CalPERS’s activism in connection with such proposals, as there is a higher
probability that boards will respond to CalPERS’s compensation demands
(and indeed they have done so), than to the individual shareholders who
more typically sponsor compensation proposals. It must also be noted that
other shareholders appear to be aware of the problematic value of the
proposals. Compensation proposals receive far less voting support than
other corporate governance proposals, typically not much more than 10%
compared to over 30% for proposals involving defensive tactics.\textsuperscript{104}

One recent form of executive compensation proposal involves
preventing the resetting of executive stock option contracts (or subjecting
resetting to shareholder approval). If options are not repriced after stock
price declines, the executive receiving them will be unable to profit from
that form of incentive compensation (the option exercise price will be
above the stock price at expiration). Shareholders opposed to repricing
contend that it simply rewards poor performance, in contrast to repricing
firms’ contentions that it is necessary to retain valuable employees whose
compensation has otherwise declined.\textsuperscript{105} This category of proposal has,
unfortunately, not been empirically studied, as it is a relatively new object of activism. Because of recent accounting changes for the treatment of repriced options, the number of firms reporting option repricing has declined over the past year. Consequently, shareholder proposals to prohibit repricing may not prove to be prevalent enough to become a subject worthy of empirical research.

Although there has been no empirical research on shareholder proposals to prevent repricing, there has been some investigation on the efficacy of option resetting, and this research does not support a conclusion that it should be banned as activist investors have proposed: studies have found that the impact on shareholders of option repricing is insignificant, although the impact on the executives whose options are repriced is great. In addition, a study examining the characteristics of firms that reprice options found that it does not entrench management because the top management turnover of firms repricing options is significantly higher the year after the repricing than the CEO turnover for non-repricers. Because we do not know whether these are voluntary or involuntary departures, this finding may also undercut the contention in favor of repricing that it is necessary to retain top managers. However, among repricing firms, the CEO turnover rate was significantly higher when the CEO's option was not repriced (40% of the repricing firms) compared to when it was, and thus the authors conclude that the relation between repricing and turnover shows up in higher turnover in the absence of repricing rather than lower turnover in its presence, which supports the rationale offered for repricing by its proponents.

d. **Confidential Voting**

Proposals to adopt confidential voting are equal to proposals to

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106 IRRC, *Number of Companies Repricing Options Has Plummeted, IRRC Finds, 11 IRRC CORPORATE GOVERNANCE HIGHLIGHTS 105* (July 7, 2000).
107 *E.g.*, Menachem Brenner et al., *Altering the Terms of Executive Stock Options, 57 J. FIN. ECON. 103* (2000); Don M. Chance et al., *The 'Repricing' of Executive Stock Options, 57 J. FIN. ECON. 129* (2000); N. K. Chidambaran & Nagpurmanand R. Prabhala, “Executive Stock Option Repricing, Internal Governance Mechanisms, and Management Turnover” (July 2001) (unpublished manuscript on file with the *Yale Journal on Regulation*). Besides these empirical studies of the effects of option repricing, the optimality of repricing behavior has been formally modelled. Viral Acharya et al. find that in most cases (except where managerial influence on compensation practices is extremely high), resetting benefits shareholders (it increases firm value) compared to a compensation policy that precommits to never resetting. Viral Acharya et al., *On the Optimality of Resetting Executive Stock Options, 57 J. FIN. ECON. 65* (2000). This model suggests that empirical studies involving the most recent type of compensation proposal, option repricing prohibitions, will not alter the inference drawn from the prior literature, that the objects of shareholder initiatives regarding executive compensation do not enhance firm value and may indeed lower it.

109 *Id.* at 24-25.
eliminate defensive tactics in frequency of institutional sponsorship, ranging from 18% to 44% of the proposals in studies of institutional investor activism. In contrast to the other categories of shareholder proposals, which are substantively directed, proposals for confidential voting seek to alter shareholder voting patterns and thereby recalibrate the internal dynamics of the firm with the expectation that this will improve performance. The rationale for this expectation is that conflicts of interest prevent certain shareholders from voting against management where to do so would maximize share value.

In particular, proponents of confidential voting contend that money managers aspire to do business with the firm whose shares they hold, such as to manage the firm’s pension fund, and that such business prospects would be jeopardized by voting against management. They correspondingly expect that these money managers will not feel constrained to vote with management when it is against their interest as shareholders, were management to be unable to ascertain how they voted (that is, they believe that confidential voting will eliminate institutional investors’ conflicts of interest in proxy voting).

It is intuitively plausible to expect voting institutions to affect outcomes: in the U.S. election context, for instance, the adoption of

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110 See Del Guercio & Hawkins, supra note 3, at 298 (showing that confidential voting proposals comprise 44% of proposals; over 70% of these proposals were sponsored by one fund, NYCERS); Gillan & Starks, supra note 28, at 286-87 tbl. 3 (showing that confidential voting proposals comprise 12% of proposals and 31% of institutions’ proposals); Smith, supra note 23, at 234 (showing that confidential voting proposals comprise 18% of identifiable proposals and 15% of all proposals); Wahal, supra note 21, at 9 (showing that confidential voting proposals comprise 41% of proposals). Confidential voting proposals in the Karpoff et al. study are included in the “internal corporate governance issues” category (51% of identifiable institutional investors’ proposals), which contains a variety of other proposals, including some more properly classified as defensive tactics, such as eliminating a staggered board. See Karpoff et al., supra note 21, at 372.


113 E.g., Pound, supra note 111; LTV Corp., supra note 112. There is no systematic evidence that this hypothesis is correct, however. One study provides indirect evidence on the issue that appears consistent with the hypothesis: Brickley et al. report that support for management proposals is higher when the voting pool contains more institutional investors that may have business relations with the firms (i.e., banks and insurance companies). James A. Brickley et al., Ownership Structure and Voting on Anti-takeover Amendments, 20 J. FIN. ECON. 267 (1988). However, this study does not observe institutional investors’ actual votes, so we do not know if the institutions that the authors deem “pressure sensitive” (banks and insurance companies) were supporting management at higher rates than other shareholders (nor does the study control for the presence or absence of confidential voting, which is the actual hypothesis of interest for evaluating the efficacy of shareholder proposals to implement confidential voting). In fact, there has been one case study in which the author was able to correlate votes with shareholders, and it found, in contrast to the Brickley et al. study, that the financial institutions that had specific business relations with the targeted corporation did not vote in favor of management at a higher rate than institutions that did not have such “pressure-sensitive” relations. Karen Van Nuys, Corporate Governance through the Proxy Process: Evidence from the 1989 Honeywell Proxy Solicitation, 34 J. FIN. ECON. 101 (1993).
“Australian” ballots—state-prepared and administered ballots that are secret, in contrast to the party ballot system—was associated with an increase in ticket-splitting, although the change in ballot form (organized by office rather than party) appears to have had a more significant effect than the confidentiality of the ballot.\textsuperscript{114} However, it is also quite possible that the main effect of the Australian ballot was not to alter voting outcomes but rather, to reduce party expenditures on election campaigns, as it eliminated the bribes parties were paying voters under the open ballot system because they no longer could be assured of the bribes’ desired outcome.\textsuperscript{115} Under this alternative hypothesis, the procedural reform was adopted because it was in the interest of the major political parties, and not simply due to effective reformist agitation. The analogy in the proxy context is that confidential voting is adopted by managers because they do not expect it to produce voting outcomes that are adverse to their interest.

I conducted the one study of the effect of confidential shareholder voting and concluded that it doesn’t matter.\textsuperscript{116} Paralleling the findings concerning shareholder proposals substantively directed at improving corporate governance by reforming board composition, repealing takeover defenses and altering executive compensation, confidential voting has no significant impact on voting outcomes. In particular, after controlling for the widely-reported trend of increasing voting support for shareholder proposals in the 1990s,\textsuperscript{117} there is no significant difference in voting


\textsuperscript{115} Alan Gerber provides a model for when political parties would prefer secret to open ballots in order to reduce bribery. Alan Gerber, \textit{The Adoption of the Secret Ballot} (June 1993) (unpublished manuscript, on file with the \textit{Yale Journal on Regulation}). The conditions under which U.S. states switched to the Australian ballot in the late 19th century—increasingly competitive elections—are consistent with his model’s predictions. In support of this hypothesis, in a history of the reform, L.E. Fredman states that over time, several observers pointed out that the Australian ballot checked obvious bribery abuses but did not seriously weaken the power of political machines. L.E. FREDMAN, \textit{THE AUSTRALIAN BALLOT: THE STORY OF AN AMERICAN REFORM} 85 (1968). In addition, Jac Heckelman examines voting turnout in the presence of secret ballots and finds that there is a positive income effect, which suggests that the poor were more likely to vote prior to the enactment of secret ballots (that is, when they could sell their votes). Jac C. Heckelman, \textit{Revisiting the Relationship Between Secret Ballots and Turnout}, \textit{28 AM. POL. Q.} 194, 205 (2000). Ian Ayres and Jeremy Bulow note that some commentators contend that the Australian ballot was adopted to weaken mass political activism, particularly by the labor movement. Ian Ayres & Jeremy Bulow, \textit{The Donation Booth: Mandating Donor Anonymity to Disrupt the Market for Political Influence}, \textit{50 STAN. L. REV.} 837, 840 n.9 (1998). Whatever the accuracy of that hypothesis in the political arena, it does not appear to have much weight in the shareholder proxy voting context, because union funds support confidential voting proposals.

\textsuperscript{116} Romano, \textit{supra} note 11. My study examines the difference in mean voting outcomes on shareholder, as well as management, proposals before and after a firms’ adoption of confidential voting, for 118 firms adopting confidential voting between 1987-97.

\textsuperscript{117} See, e.g., \textit{GEORGESON & COMPANY, INC., 1998 ANNUAL MEETING SEASON WRAP-UP CORPORATE GOVERNANCE 7} (1998) (graph of votes for poison pill proposals from 1987 through 1999, shows steady increase in support from 20% to 45%); \textit{IRRC, Average voting results on major corporate governance shareholder proposals, IRRC CORPORATE GOVERNANCE BULLETIN 20} (July-Sept. 1995)
support for shareholder proposals after the adoption of confidential voting. Because the average support level varies with the type of proposal, separate comparisons were also performed controlling for proposal types. In the most robust test of the hypothesis, the subset of shareholder proposals to repeal or modify defensive tactics, support goes up over time at a rate similar to that reported in the general literature (1.8% a year), but there is no independent increase in voting support after the adoption of confidential voting. The support for management proposals increased more dramatically than that for shareholder proposals after the adoption of confidential voting, but again, when controlling for a time trend, the effect of the voting procedure disappeared.

The change in voting procedure also had no impact on performance: there was no stock price effect upon the announcement of the procedural change, nor did long run stock performance improve over one to three years after its implementation. Of course, if, as this Article contends, the object of the overwhelming majority of shareholder proposals does not improve performance, than changing the voting procedure to enhance the probability of such proposals’ adoption will not improve performance either.

The insignificant impact of confidential voting on voting outcomes plausibly explains why many firms voluntarily adopt the procedure: it doesn’t matter. The conclusion to draw from the data on confidential voting is consistent with the overall conclusion drawn from the more extensive empirical literature studying the three other principal categories of shareholder proposals: the benefit of promoting such proposals is, at best, marginal, because the procedure has no discernible behavioral effect.

(indicating an increase (decrease) in average votes from 1994 to 1995 of over 3% for 8 (2) shareholder proposal categories, and an increase (decrease) of less than 1% in 1 (3) categories, and none of the categories with decreases involved defensive tactics); IRRC, Voting on U.S. Governance Shareholder Resolutions, XV IRRC CORPORATE GOVERNANCE BULLETIN 3 (Apr.-June 1998) (indicating increasing support levels for poison pill and staggered board proposals, as well as board independence proposals in 1998 compared to 1997 proxy votes but decreases in executive compensation and cumulative voting proposal support levels); Gillan & Starks, supra note 28, at 295-96 (describing increase in mean support of shareholder proposals after 1990) SANDER, supra note 3, at 4-5 (indicating that the average support for almost all types of shareholder proposals increased over five years 1986-90, and noting that three categories experienced over 10 point increases, two of which involved defensive tactics).

118 Romano, supra note 11, at 23-24.

119 To check whether there is a sample selection bias—that is, whether only firms whose shares are not held by the private institutional investors which are posited to have conflicting interests under non-anonymous voting, see text and accompanying notes 111-12, supra. I examined the portfolios of the largest private equity mutual fund managers and managers of pension accounts (as identified in Pensions and Investments as the largest fund managers) and found no evidence of such a bias: these funds held significantly more positions in the firms that have adopted confidential voting than in a random sample of firms that have not adopted confidential voting. See Romano, supra note 11, at 24-25.
3. Private Negotiation and Information Updating Regarding Managerial Quality

In contrast to submitted proposals, institutional investors' private negotiation governance strategies on occasion produce significant positive stock price effects. These results are consistent with, as previously discussed, Wahal's finding distinguishing between submitted proxy proposals and successful private negotiations that obviated the need for a proposal, Smith's finding of a positive effect for successful targeting (assuming this subsample is dominated by instances of nonproxy rather than proxy activism), and Forjan's finding of a positive announcement effect for successful negotiations (assuming that the cases of negotiations dominate those of the proposals that passed in his 27-firm sample combining the two cases). Two more recent studies, however, find that negotiation activity in the mid-1990s is associated with a negative effect on performance. The studies of negotiated agreements are summarized in Table 2.

Willard Carleton, James Nelson and Michael Weisbach examined the impact of the corporate governance activities of TIAA-CREF, which seeks to negotiate privately with firms it has targeted and typically reaches an agreement with management that results in its not having to submit a proposal. Carleton et al. found no significant changes in accounting measures of long-term performance from TIAA-CREF's activism, but the stock price effect of the initial targeting was significant, depending on the substantive content of the negotiations. It was significantly positive for targeting with the goal of restricting poison pills, significantly negative for targeting seeking to increase the diversity of the composition of the board of directors, and insignificant for targeting to institute confidential voting.

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120 Carleton et al., supra note 23, at 1356.
121 Id. at 1351. The stock price effects around the time in which the firms publicly announced their action to comply with TIAA-CREF's demands were generally not statistically significant, but these were not robust tests because very few firms publicly announced these actions (number of observations ranged from 1-11 firms, depending on the subsample). Id.
### Table 2. Performance Effects of Shareholder Negotiations (Nonproxy Targeting) on Corporate Governance

<table>
<thead>
<tr>
<th>Study</th>
<th>No. Non-proxy targeting</th>
<th>No. Firms</th>
<th>Sponsors</th>
<th>Years</th>
<th>Performance Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chidambaran &amp; Woidtke (1999)</td>
<td>224</td>
<td>168</td>
<td>Individuals &amp; institutions</td>
<td>1985-95</td>
<td>insignificant *</td>
</tr>
<tr>
<td>Crutchley et al. (2000)</td>
<td>n.a.</td>
<td>47</td>
<td>CalPERS's target list</td>
<td>1992-97</td>
<td>insignificant b</td>
</tr>
<tr>
<td>Del Guercio &amp; Hawkins (1999)</td>
<td>16</td>
<td>n.a.</td>
<td>5 activist funds</td>
<td>1987-93</td>
<td>insignificant</td>
</tr>
<tr>
<td>Forjan (1999)</td>
<td>27</td>
<td>27</td>
<td>Individuals &amp; institutions</td>
<td>1978-91</td>
<td>positive</td>
</tr>
<tr>
<td>Smith (1996)</td>
<td>n.a.</td>
<td>19</td>
<td>CalPERS</td>
<td>1987-93</td>
<td>positive</td>
</tr>
<tr>
<td>Strickland et al. (1996)</td>
<td>53</td>
<td>34</td>
<td>USA</td>
<td>1992-93</td>
<td>positive</td>
</tr>
<tr>
<td>Wahal (1996)</td>
<td>50</td>
<td>n.a.</td>
<td>9 activist funds</td>
<td>1987-93</td>
<td>positive</td>
</tr>
</tbody>
</table>

Note: n.a. = information not available

* Negative for public and union funds after 1992
b Pre-1994 targets positive; post-1994 targets negative

Another positive finding concerning “behind the scenes” activism involves a study by Deon Strickland, Kenneth Wiles and Marc Zenner of the firms targeted by USA. When management agreed to USA’s requested changes prior to the proxy proposal submission deadline, the targeted firms experienced positive stock price effects in contrast to the insignificant effect when USA presented a proxy proposal. The negotiated agreements involved takeover defenses (subdivided into poison pill and golden parachute removal proposals), board composition and confidential voting; contrary to the TIAA-CREF study, there was no difference in the sign and significance of the price effects across USA’s three types of...
proposals. To identify the source of the wealth gain for the subset of agreements to remove takeover defenses, Strickland et al. calculated the firms’ abnormal returns on the announcement of the defenses’ adoptions: they were insignificantly negative for poison pills and insignificantly positive for golden parachutes. There was also no relation between the abnormal returns upon the announcement of the defenses and the abnormal returns upon the announcement of their negotiated removal, which makes it difficult to identify the source of the wealth gain from the negotiations.

Tim Opler and Jonathan Sokobin examined the returns of firms on the Council of Institutional Investors’ (CII) “focus-list” of poor performers. The CII is an organization of public and private pension funds that serves as a clearinghouse for the funds’ corporate governance activities. Opler and Sokobin find that the targeted firms experience better market and operating performance than the market as a whole and other benchmark portfolios in the year subsequent to their inclusion on the CII list. They infer from this result that coordinated investor action that takes place behind the scenes (“quiet activism”) is effective in improving firm performance, in contrast to the proxy proposal route, which often involves campaigns by one investor, and for which studies do not find positive effects. This is only an inference because we do not know whether the firms on the focus-list were indeed the targets of institutional investor activism. But it is consistent with the findings of Carleton et al., Smith, Strickland et al. and Wahal concerning privately negotiated (nonproposal) activism by institutional investors.

Claire Crutchley, Carl Hudson, and Marlin Jensen investigate targeting activities of CalPERS by examining the stock price reaction to a firm’s initial placement on the fund’s publicly announced list of targets. They find a short-run positive price effect but conclude that for the full sample there is no lasting impact on performance. They then divide their sample in two, the early years, 1992-94, when CalPERS’s activist corporate governance campaign was quite visible, and the later years, 1995-97, when it played a “quieter,” that is, a less visible, behind-the-scenes role. Crutchley et al. find that over the year after targeting, the early years’ subsample has a significantly positive cumulative return, whereas the later years subsample’s cumulative return is negative. After finding that restructuring actions taken by the targeted firms after targeting do not

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125 Id. at 334.
126 Id. at 335.
127 OPLER & SOKOBIN, supra note 21.
128 Id. at 6-8, 19.
129 Claire E. Crutchley et al., The Shareholder Wealth Effects of CalPERS’ Activism, 7 FIN. SERVICES REV. (forthcoming).
130 Id. at ms. 9, tbl. 4.
131 Id. at ms. 10.
affect the size of the abnormal return, their conclusion, in contrast to that of Opler and Sokobin, is that visible or aggressive public activism, and not quiet activism, increases shareholder wealth.\footnote{132}

Finally, N.K. Chidambaran and Tracie Woidtke studied the shareholder proposals that were withdrawn from 1989-1995.\footnote{133} They find that the characteristics of firms where proposals are withdrawn have changed over time, particularly after the adoption in 1992 by the SEC of changes in the proxy process intended to facilitate shareholder communication. In contrast to the other four studies evaluating negotiations over proposals, their measure of firm value is the change over the proposal year in Tobin's Q, the ratio of the firm's market value to book value. A Tobin's Q that is greater than 1 indicates that the market values the firm's assets above their book value (that is, the firm has significant intangible asset value). This is commonly interpreted as an indicium of good performance. Although for the full sample of withdrawn proposals there is no significant performance effect, for the set of proposals withdrawn post-1992 whose sponsors were public or union funds, there is a negative valuation effect (a statistically significant decrease in Tobin's Q), in contrast to proposals withdrawn before 1992, where the valuation effect (change in Tobin's Q) was positive, albeit insignificant.\footnote{134}

Chidambaran and Woidtke interpret the data as indicating that the 1992 proxy reforms provided institutional investors with excessive bargaining power such that they became able to pressure managers to accept non-value-maximizing proposals. This is because the firms whose proposals were withdrawn after 1992 had lower levels of management stock ownership than the firms whose proposals were withdrawn before 1992, and they reason that institutional pressure to adopt non-value-maximizing proposals will be more effective where management does not have significant voting power.\footnote{135} Hence, Chidambaran and Woidtke also reach a conclusion diametrically opposed to that of Opler and Sokobin.

\footnote{132} Id. at ms. 10-12, tbl. 5.  
\footnote{133} Chidambaran & Woidtke, supra note 7.  
\footnote{134} Id. at 16-17, 28 tbl. 6.  
\footnote{135} Id. at 3, 19. These data suggest that negotiated compromises were more likely to occur when proposals were value-maximizing propositions before 1992 than post-1992. Chidambaran and Woidtke buttress this contention with an examination of the subset of proposals for which they can classify whether management adopted the withdrawn proposal as-is or whether the parties reached a compromise on the proposal's substance; they find that post-1992, proposals accepted as-is had a significant negative impact on firm value, and before 1992, compromises had a significant positive effect, id. at 18-19, but they do not indicate how representative, or what percentage, of the full sample this subsample is. Their conclusions are consistent with those of Stephen Choi, who, also finding that after the 1992 proxy reforms, unions and religious groups increased their sponsorship of proposals and the proposal targets had higher levels of insider ownership, concludes that post-1992 proposal sponsors were more interested in using the proxy process as a bargaining tool than as a way to maximize shareholder welfare. Stephen Choi, Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms, 16 J.L. ECON. & ORG. 233, 266 (2000).}
concerning behind-the-scenes activism by institutional investors, that it is not a shareholder wealth-enhancing activity.

The conventional explanation of the findings of positive performance effects from successful negotiations and insignificant effects from proposal submissions is that managers negotiate only when proposals are value-maximizing, and shareholders bid the price up in anticipation of the proposal’s implementation. Proposals that are submitted, in this view, are those that management recognizes as non-value-maximizing, and therefore not worthy of negotiation. There is no market reaction to submissions because, although the proposal is negatively assessed, it is not expected to pass (or not expected to be implemented by management if passed). To reconcile the finding of a negative reaction to a proposal sponsored by institutional investors in Gillan and Starks’s study, the value-maximization explanation needs to contend that the market believes a non-value-maximizing proposal might be adopted if sponsored by an institutional investor. The finding of negative performance effects from negotiations in the studies of Crutchley et al. and Chidambaran and Woidtke, however, cannot be rationalized by this explanation, since their findings suggest that, to the contrary, management negotiates over non-value-maximizing proposals.

A more helpful explanation that better reconciles the paradoxical finding of positive and negative performance effects from negotiated agreements (private activism) and insignificant effects from shareholder proposals on the same issues is a screening explanation of management behavior. In a context in which investors are not informed about management quality while managers are informed, shareholder proposal negotiations can provide investors with a means to screen the high- from the low-quality managers. From this perspective, the positive (negative) price effects from private activism are not indicia of a positive (negative) assessment of the subject matter of the activism (i.e., whether it is value-maximizing), but rather, indicate investors’ assessment of management’s quality, that it will be (will not be) responsive to shareholders’ concerns over the need to improve firm value.

136 There is a large economics literature on adverse selection (markets with products of varying quality which cannot be observed prior to purchase); for a good textbook introduction to screening (also termed self-selection) and signalling models in which markets overcome adverse selection; the difference in model depends on which party, the uninformed or informed, acts first. See, e.g., DAVID KREPS, A COURSE IN MICROECONOMIC THEORY 625-652 (1990). The argument in the text draws from this literature, but it is not a rigorous application because it is not an exact fit with a screening model. Although the uninformed act first – investors target management with proposals – they do not offer different discrete contracts, as in a screening model, and managements instead sort themselves by their different responses to the uniformly offered “contract,” a more active role associated with signalling models in which the informed move first. I believe the analogy is apt despite the imprecision because under plausible conditions both screening and signalling models produce outcomes in which high- and low-quality managers are identified (that is, separating equilibria).
The difference in stock price reaction to proposals and negotiations in this explanation is a function of learning—information updating concerning management quality by the market from the occurrence of shareholder activism—rather than the market’s assessment of the value of the underlying activism’s objectives. The market views nonproxy (negotiated settlement) activism as a screen for determining that management quality is high: because management was sufficiently responsive to the institutional investor’s concern that it was willing to withdraw its proposal, investors update their evaluation of management quality as less prone to self-entrenchment and more apt to improve performance. If an institutional investor’s proposal is submitted instead of withdrawn, it could provide negative information regarding management’s quality, as it would indicate management’s non-responsiveness to shareholder concerns, or low quality. But failure to negotiate, in this scenario, need not provide new information, because the market will have already perceived the management of targeted firms to be of low quality given prior poor performance. Hence, we would intuitively not expect studies consistently to observe a negative stock price effect upon proposal submissions.

The information-revealing story of the stock price effects of negotiations raises several questions. First, why would the reaction to a proposal enable investors to screen management’s quality? The information concerning management’s response to shareholder activism is informative in this scenario because it enables investors to screen, from among poorly performing firms, those with lower-quality management because it would be more expensive for low-quality, rather than high-quality managers to be responsive. This is an equilibrium story only if it is costly for lower-quality managers to mimic higher-quality managers by negotiating proposal withdrawals. Successful negotiation will clearly be a more costly strategy for lower-quality managers to undertake compared to higher-quality managers when the subject is a proposal to eliminate a defensive tactic: the former type of managers are more likely to be the target of a hostile bid and replaced. This factor makes the high-quality managers’ action not easily mimicked by poor-quality management even for proposal categories where the impact will not be as clearly disparate across managerial quality: since most firms do not experience only one type of proposal,137 lower-quality managers cannot negotiate over only one type of proposal while refusing to negotiate over proposals on takeover defenses.

A second question raised by the information-updating explanation of

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137 For example, of firms that have adopted confidential voting, two-thirds of those receiving a proposal to eliminate a defensive tactic received another type of proposal at the same meeting. Romano, supra note 11.
the stock price effects of negotiated agreements is why managers do not signal quality on their own, instead of waiting to react to action by uninformed investors (shareholder proposals). The response is that the explanation is not offered as the sole means by which adverse selection problems in equity markets are resolved. Management may signal an investment's quality by other means, for instance, through the choice of capital structure, auditor selection, stock ownership, or underpricing of an initial public offering. Rather, shareholder proposals can induce further (and possibly more precise) sorting of managerial quality to the extent that poor performance diminishes the credibility of other signals managers provide regarding their quality. Managers might not expect shareholders to reassess their quality negatively upon poor performance, especially if this were an industry-wide phenomenon, and therefore they might not believe that further signalling was necessary. Such perceptions by managers would be consistent with the fact that not all poorly performing firms are targeted by institutional investors. In this scenario, a shareholder proposal reveals information to managers regarding the market's updated perception of their quality, and thereby evokes further sorting in response.

It should be noted that all of the studies finding uniform positive price effects associated with private negotiations had sample periods ending in 1993. The negative reaction to private activism in the mid-1990s suggests that the self selection induced by such activity now indicates low rather than high management quality. The change in the identity of proposal sponsors – from public pension funds to union funds – in conjunction with some change in the type of proposal – an increase in proposals on executive compensation – could explain the changed market perception of the negotiation process. In addition, the cumulation of experience

138 See, e.g., Hayne E. Leland & David H. Pyle, Informational Asymmetries, Financial Structure, and Financial Intermediation, 32 J. Fin. 371 (1977) (stock ownership); Stephen A. Ross, The Determination of Financial Structure: The Incentive-Signalling Approach, 8 Bell J. Econ. 23 (1977) (capital structure); Sheridan Titman & Brett Trueman, Information Quality and the Valuation of New Issues, 8 J. Acct. & Econ. 159 (1986) (auditor selection); Ivo Welch, Seasoned Offerings, Imitation Costs, and the Underpricing of Initial Public Offerings, 44 J. Fin. 421 (1989) (underpricing of initial public offerings). There are numerous signalling models directed at explaining underpricing of initial public offerings, and the empirical support is mixed. See, e.g., Narasimhan Jegadeesh et al., An Empirical Investigation of IPO Returns and Subsequent Equity Offerings, 34 J. Fin. Econ. 153 (1993). The signalling literature typically considers the need for management to signal the quality of the firm's projects rather than the quality of the managersthemselves, but in practice it is often difficult to distinguish between these replacement of managers does not always resolve a firm's difficulties and thus this Article does not attempt to do so either.

139 There could be different information provided to investors from union activism if management, in exchange for termination of a corporate governance campaign by a union, capitulates to employment-related demands that it would otherwise reject. Then while a failed negotiation would indicate to the market that management had opted not to engage in compromising tactics, a withdrawn proposal would indicate that management had entered into a disadvantageous labor deal, and successful negotiations should produce a negative, not positive, price effect when the activist is a union as opposed to a pension fund. There is some anecdotal evidence that prolonged union campaigns are
indicating that past negotiations did not improve performance might lead investors to reassess the significance of proposals as a screen: private negotiated activism, in this information-updating scenario, is viewed as redirecting management’s time and energy away from improving performance to less useful activities, and hence makes it more likely that low-, rather than high-quality managers respond to investor initiatives. In these changed circumstances, the costly screen provided by high-quality managers that low-quality managers cannot duplicate is the absence of a response. This is plausible if a failure to respond to activism provides information to takeover bidders that the firm has a set of dissatisfied institutional investors who would be receptive to a bid, for low-quality managers have more at risk from being the subject of a hostile bid than high-quality ones.

Alternatively, if the subsample of firms experiencing negative valuation effects in the post-1992 samples had been targets of proposal negotiations previously, then the negative effect could be explained as a downward revision of prior beliefs regarding managerial quality because shareholders had to come back with additional proposals. The downward-revision hypothesis is provided support by a study of proxy proposals by Andrew Prevost and Ramesh Rao, which subdivided firms between those receiving proposals sponsored by institutional investors known to engage in pre-submission negotiations, such as CalPERS, and those receiving proposals from other public fund investors, and then subdivided the activist-investor targets between those receiving proposals over more than one year and those receiving proposals only once. Not only do Prevost

on occasion successful in obtaining management accommodation. For example, the Amalgamated Clothing and Textile Workers Union’s corporate campaign against J.P. Stevens, which was part of its efforts to organize the company’s workforce, succeeded in getting management to bargain with the union, as evidenced by a settlement term in which the union promised not to engage in further corporate campaign tactics. Stewart J. Schwab & Randall S. Thomas, Realigning Corporate Governance: Shareholder Activism by Labor Unions, 96 Mich. L. Rev. 1018, 1033 (1998). Bolstering a differential information explanation is the fact that, in contrast to public pension funds which typically have substantial holdings in their targeted firms, union funds often hold the minimally necessary number of shares to be eligible to submit a proposal under the SEC rule, see, e.g., IRRC, Plummeting Stock Prices Are Forcing Shareholders to Withdraw Proposals, 12 Corporate Governance Highlights 30 (Feb. 23, 2001). This indicates that the motivation for union activism is not to improve the performance of an existing investment portfolio. But most union proposals are not sponsored in the context of labor disputes. Moreover, managements did not initially enter into negotiations with union proposal sponsors, which explains, at least in part, the increase in the share of proposals sponsored by unions after 1992 reported by Choi, supra note 133. In recent years, management has begun to negotiate with unions. See, e.g., IRRC, Update on Union Funds, 11 Corporate Governance Highlights 17 (Feb. 4, 2000). To the extent that unions make up a larger percentage of the sponsors of the withdrawn proposals in the post-1992 subsample in the Chidambaran and Woidtke study, the difference in information content is a possible explanation of their finding of a negative valuation effect from proposal withdrawals. This interpretation would enable the information-updating explanation to reconcile all of the activism studies’ disparate performance effects.

and Rao find a significant negative price effect for the 32 proposals submitted by the activist funds and no significant effect for the overall sample, but they also find that the negative wealth effects last for much wider event intervals for the 10 multiple year proposal firms than for the 22 single proposal firms.\textsuperscript{144}

Admittedly, the Prevost and Rao study's sample size is small. But the findings are entirely consistent with the information-updating explanation. The returns are significant only for proposals submitted by institutions whose pre-proposal activism is highly visible. These are situations in which the proposal's appearance on the proxy indicates to the market that management was not responsive to the investor, and the information effect is magnified for firms receiving multiple proposals.

Prevost and Rao's data suggest that in instances of multiple submissions, investors update their beliefs concerning management quality. Investors conclude that a persistently unresponsive management will be unwilling or unable to undertake necessary steps to improve firm value. That is, investors learn that the targets are firms with low-quality management as the managers have not learned from their "first exposure" to institutions' proposals how to avert future submissions.\textsuperscript{142} Thus, they lower their expected valuation of the firm's future cash flows.

All of Prevost and Rao's findings of negative significance are independent of proposal category, further corroborating the information-updating hypothesis. Moreover, the expectation of poor performance due to low management quality offered as the interpretation of the more negative statistical results for multiple-proposal firms is a rational expectation: that is, it is in fact borne out by subsequent data. Prevost and Rao report that both long-run stock returns and accounting measures of long-term performance decline significantly for the multiple-proposal firms, but not for the single-proposal firms.\textsuperscript{143} In short, management that does not respond to institutional investors' concerns—managers of firms where proposals are actually submitted for a vote—are conjectured by investors to be managers of low quality, and that assessment is confirmed when a second proposal is submitted. And the screen is accurate: the longer term subsequent performance of firms with such managers is worse.

Finally, where the Carleton et al. study's results of significance differ from those of the shareholder proposal studies,\textsuperscript{144} a screening explanation

\begin{itemize}
\item\textsuperscript{141} Id. at 188-92.
\item\textsuperscript{142} See id. at 193.
\item\textsuperscript{143} Id. at 194-99.
\item\textsuperscript{144} Carleton et al.'s varying findings of statistical significance based on the content of TIAA-CREF's activism can be reconciled with the empirical literature on the underlying governance devices. The finding that TIAA-CREF's efforts to increase board diversity has a negative impact on performance is consistent with one study that identified value-maximizing boards (boards chosen by leveraged buyout firms going public) as having fewer female directors than the average board. See
\end{itemize}
of institutional activism seems especially apt at reconciling the differences, compared to a value-maximizing explanation of such behavior. Carleton et al. found that private negotiations involving restrictions on poison pills had a positive impact, compared to the negative impact of antitakeover proposals (which were primarily poison-pill-rescission proposals) in the Smith and Gillan and Starks studies, and the marginally significant negative result in the Del Guercio and Hawkins study. Although Carleton et al.'s result is consistent with the initial empirical studies that found a negative wealth effect of poison pills, it is also consistent with a management-quality-updating explanation: Smith, Gillan and Starks, and Del Guercio and Hawkins, who do not find positive price effects, are examining submitted proposals whereas Carleton et al., who find positive effects, are not. Thus the management of the firms in Carleton et al.'s study could have been perceived as more responsive to investor concerns and thus less prone to entrenchment in the use of a poison pill defense, than those in the other three studies. In addition, CalPERS's activity in early years concentrated on defensive tactics, and this is the period for which Crutchley et al. found that its activism had a positive price effect. It is, however, inconsistent with Smith's finding of a negative effect from defensive tactic activism by CalPERS, although Smith's result was for an earlier time period than that covered by the Carleton et al. study.

The value-maximizing explanation could also explain the difference between the results on defensive tactic activism in Carleton et al. and the shareholder proposal studies on the rationale that, in contrast to other institutions, TIAA-CREF accurately targeted firms that would not be benefited by takeover defenses, and all institutional targeting is aggregated in studies finding no price effect. It is more difficult for it to explain satisfactorily the finding that not all of TIAA-CREF's negotiations produce positive effects. If, as the value-maximizing explanation maintains, management only negotiates over proposals that will improve performance, then either all of TIAA-CREF's negotiations and not only poison pill negotiations, should be positively assessed or management should not have entered into negotiations over the proposals that were not value-maximizing (those for which the price effect was not positive). The

Robert Gertner & Steven N. Kaplan, The Value-Maximizing Board (Dec. 1996) (unpublished manuscript, on file with the Yale Journal on Regulation). The studies relating board composition to performance do not examine directors' personal attributes of gender and race, the object of TIAA-CREF's proposal, but the failure to find a positive effect on performance in the more general board studies of director independence is consistent with the finding that TIAA-CREF's board proposals do not increase target firm value, because increasing director diversity typically would be achieved by the addition of independent directors under TIAA-CREF's policy. The finding of insignificance for confidential voting adoptions is consistent with the finding that the practice does not significantly affect voting outcomes. See Romano, supra note 11. The finding of a positive impact for negotiations on poison pills is consistent with the results of the earliest empirical studies of negative price reactions to pill adoptions, as well as with a signalling explanation, which is discussed in the text.
mixed results in the Carleton et al. study can be reconciled with the value-maximizing explanation of negotiations by maintaining that two of the three foci of TIAA-CREF’s activism have very little impact on performance. This is consistent with this Article’s analysis of institutional activism and bolsters this Article’s conclusion that such activity needs to be reassessed.

I have elaborated and emphasized the information-updating explanation over the value-maximization explanation of the findings in studies of nonproxy (negotiated) activism because it has greater explanatory power, particularly with regard to the finding that private activism in recent years has had a negative effect. It reconciles more of the disparities across the entire set of shareholder activism studies than does the value-maximizing explanation. Interpreting the price effect as information on management quality explains why a particular type of proposal may have a price effect when privately raised with management but not when appearing in a proxy, and why that effect might differ when management negotiates with a different type of institution. The positive price effect relates to management’s quality, not any specific action that is being undertaken to improve performance. At the same time, the information-updating explanation is consistent with the finding that targeted firms’ long-term performance does not improve significantly, whatever the form of activism. Even a high-quality management will not improve performance if it must direct its time and effort to the implementation of shareholders’ proposals that have no effect on performance.

4. Structural Changes Following Shareholder Activism

In addition to examining the impact of activism on performance, some studies investigate whether firms engage in corporate restructurings or other governance reforms after they have been targeted by institutional investors. The rationale is that the undertaking of significant structural change by firms after a proxy targeting is an alternative means by which to gauge the success of shareholder activism. The assumption is that such changes will eventually improve performance. This scenario would provide a concrete basis for the information-updating explanation of the positive returns to nonproxy activism: The market expects a more responsive management to adopt policies that will increase shareholder wealth, and the anticipation of such action explains the positive returns. It would, at best, provide only tangential support for the value-maximizing explanation of positive returns to nonproxy activism, because the price effect is supposed to be measuring the subject of the negotiations. The link for that explanation would be that the outcome of the negotiated
agreements, such as a board composition change or a takeover defense rescission, produced the subsequent restructurings.

There is considerable divergence across studies concerning whether targeted firms make significant structural changes, such as firing the CEO or selling substantial assets. The differences would appear to be related to the studies’ variation in findings concerning stock price performance. Karpoff et al., who found no stock price effects, find little evidence of policy changes in direct response to a proxy vote, and, in particular, that CEO turnover is not related to receipt of a shareholder proposal. The studies finding subsample positive stock price effects, however, tend to find an increase in the level of asset divestitures of the targeted firms. For instance, Smith finds no significant difference in CEO turnover in targeted firms compared to industry and performance control groups, but significantly higher sales of assets by the targeted firms. And Opler and Sokobin find a decrease in CEO turnover but an increase in asset sales after activist targeting.

The fit is less exact with the results in Del Guercio and Hawkins: they find significantly more newspaper reports of restructuring activity and increased employee, but not increased CEO, turnover in targeted firms compared to an industry and performance control group as well as for various subsamples, and increased CEO and employee turnover for the board proposal subsample, but neither the full sample nor the subsamples experiencing significant restructuring activity had significant positive returns. Mark Huson also finds that CalPERS targets engage in more asset divestitures than a set of control firms over three years subsequent to the targeting, although the control group is quite imprecise (the control firms are either smaller or better performers than the CalPERS targets); he does not, however, investigate the price effects of the targeting.

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145 See Karpoff et al., supra note 21, at 388.
146 See Smith, supra note 23, at 241, 248.
147 See OPLER & SOKOBIN, supra note 21, at 17-18.
148 See Del Guercio & Hawkins, supra note 3, at 308-313. Because the positive returns for the CalPERS subsample disappear when Avon Products, a takeover target, is excluded from the subsample, this is not a true positive return subsample. In addition, there is no direct connection between the takeover bid for Avon Products and the institutional activism under study.
149 Huson finds that there is a more significant price effect of the announcement of divestitures and other events, such as acquisitions and joint venture agreements, for the shareholder-proposal targets than the control firms, and in particular, that the effects were negative for such events announced before the CalPERS targeting and positive for those announced after the targeting. Id. at 15-18. He concludes that these data evince that CalPERS’s activism improves firm decisionmaking. Id. at 19. This conclusion is quite tenuous. In addition to the difficulty of attributing events occurring over a three year period after targeting to that targeting, he does not provide any specific information concerning the divestitures that produced a negative effect three years prior to targeting compared to the divestitures producing the positive effect after targeting, which would increase one’s confidence in attributing the difference to CalPERS’s intervention, as opposed to characteristics of the divestitures, or change in the business environment for divestitures over the time periods in question.
Finally it should be noted that while TIAA-CREF's activism was successful—Carleton et al. find that virtually all of the firms targeted by TIAA-CREF adapted their governance structures to accommodate the fund's objective—^150—the changes in TIAA-CREF-targeted firms reported by Carleton et al. are less substantial than the structural changes examined in other studies, such as CEO turnover and asset dispositions. The responses to TIAA-CREF's activism consist of refinements to poison pill plans, establishment of confidential voting, and commitments to increase minority and female representation on boards. It is improbable that these modest adjustments to corporate policy affect performance by leading to the more substantive responses found in the other studies, a conclusion supported by the absence of positive significance for most of the TIAA-CREF negotiated settlements. The sole positive price effects subsample, the poison pill negotiations, raise the prospect of potential premiums, or future CEO change or asset sales if no bid is forthcoming, after a pill's relaxation. Unfortunately, this hypothesis cannot be tested because Carleton et al. do not investigate whether the TIAA-CREF-targeted firms subsequently experienced any restructurings.

The suggestion of a three-way association among positive price effects, shareholder activism, and subsequent structural changes, is consistent with the research examining the impact on performance of the most substantial form of investor activism: proxy fights for control. Studies of proxy contests consistently find more favorable effects from this form of investor activism than do studies of shareholder proposals. The stock price reactions to proxy fights are significantly positive (whether or not the dissidents actually win).^151 Moreover, the contests have significant firm-level consequences: firms that are the subject of proxy fights for control typically experience top management turnover regardless of outcome and they are often sold or liquidated shortly thereafter. ^152 This result—the high frequency of subsequent acquisition, restructuring or CEO change—in all likelihood accounts for the increase in value created by the initiation of a proxy fight compared to a proxy proposal. In fact, the most recent and most comprehensive study of proxy fights finds that most of the positive price effects of proxy contests are driven by firms that are acquired soon after the contest; when there is no acquisition, the gains in shareholder wealth from the proxy fight are sustained only by firms whose CEO is replaced. ^153 And, of course, the literature is replete with the

^150 See Carleton et al., supra note 23, at 1336, 1343 (noting that agreements were reached over 95% of the time and that targets complied with TIAA-CREF's request in over 85% of the agreements).

^151 See supra note 20.

^152 See DeAngelo & DeAngelo, supra note 20.

^153 Mulherin & Poulsen, supra note 20, at 280, 299, 303. DeAngelo and DeAngelo also concluded that the bulk of the gains were from subsequent acquisitions. See DeAngelo & DeAngelo,
positive effect on target shareholder wealth from acquisitions.\textsuperscript{154}

From a cost-benefit perspective, it is not surprising that more restructuring occurs after proxy fights than after shareholder proposals, and that, accordingly, the performance effect of proxy fights is greater than that of proxy proposals. Proxy fights are a far more expensive form of shareholder activism than shareholder proposals and restructuring is typically the contestants' objective. The insignificant effect on performance of shareholder proposals may relate to the low-level efforts of investors engaging in such activism,\textsuperscript{155} compared to proxy fights. But while it is true that proxy proposal activism is inexpensive compared to proxy contests, the insignificant performance results of shareholder activism are, in my judgment, due to its objectives: independent boards, compensation limits, confidential voting and, albeit more ambiguously, poison pill rescissions, are not only inexpensive actions to undertake compared to the goals of a proxy fight or corporate takeover (division sales and top management change) but they are also corporate governance devices that do not have any measurable effect on share value.

II. Improving the Impact of Corporate Governance Activism

The striking absence of evidence that shareholder activism improves targeted firms' performance raises the core question whether institutions should reassess their shareholder proposal agenda, in order to manage their resources more effectively. This Article takes a two-pronged approach to the issue. First, it suggests a mechanism of internal control, whereby fund boards would engage in periodic review of their staff's shareholder-activity programs to identify the most fruitful governance objectives. Second, it advocates increasing the incentive to undertake internal reevaluations by proposing elimination or substantial reduction of the subsidy of proxy proposal sponsorship unless a proposal achieves substantial voting support.

A. \textit{Internal Controls: Refocusing Activist Programs}

One means of reducing the likelihood that shareholder activism is a non-value-maximizing activity is to improve the quality of decision-making by institutional investors by encouraging implementation of comprehensive, formal internal reviews of corporate governance


\textsuperscript{155} See Black, supra note 8; cf. Carleton et al., supra note 23, at 1357 (concluding shareholder activism is not a substitute for takeovers but "a way that institutions spend more limited resources to accomplish much more modest goals").
programs. Such reviews should include an evaluation of the empirical research relating to the objective of contemplated proposals or private negotiations, as well as the voting outcome of previously submitted proposals. The review should be forwarded to the fund board and not simply the officers or employees supervising activism programs. This would enable a fund board to identify better what activity is worthwhile, facilitating the fulfillment of their fiduciary obligations to fund beneficiaries. A formal mechanism of reporting on a fund’s activities and their effectiveness would put fund trustees and fund managers on a more equal footing and thus lessen the possibility that better-informed managers could rationalize an agenda to a board in terms of good corporate governance practices that consists, in fact, of non-value-enhancing proposals.

The formal review of corporate governance activities should also be incorporated in the fund’s annual report or statement sent to beneficiaries or holders of fund shares. As a publicly available document, it will be of use to fund participants willing to expend the effort to monitor fund managers’ efforts at enhancing the value of their portfolio. In addition, legislators and taxpayers who finance public pensions will also be better able to identify inappropriate expenditures that could affect the funding of plan assets for which they are legally liable.

What should be a fund’s response to the proposed review? At minimum, proxy proposals that have a negative impact upon performance given the literature on corporate governance devices, such as those involving executive compensation limits, ought to be scrapped in favor of those whose effect is at least arguably ambiguous, such as, proposals to relax takeover defenses. Such a policy will also require the fund’s staff to develop firm-specific knowledge to engage in activism: just as the empirical literature finds that the stock price effect of takeover defenses varies with firm characteristics, such as board composition and firm size, proposals to eliminate those defenses would, accordingly, be more beneficial for some firms than others. If a fund does not possess adequate firm-specific knowledge, proposals whose impact is highly firm-dependent, such as takeover defense rescissions, ought to be discouraged. In fact, some institutional investors are aware of this problem and have adapted their governance activities accordingly. For instance, Del Guercio and Hawkins note that the heavily-indexed New York City pension fund does not sponsor poison pill proposals because they “require too much company-specific knowledge.”


157 Del Guercio & Hawkins, supra note 3, at 305-06.
Similarly, proxy proposals that receive little support from other investors (which not surprisingly invariably are those whose substantive objectives produce the least positive impact on firm value) should be reevaluated, with an eye to their elimination. The reasoning for such a criterion is that support levels are an excellent proxy for the judgment of other informed investors that the proposal is in their interest. Hence, proposals that obtain a higher level of voting support have a higher probability of being those that maximize share value. Only if shareholders' beliefs are biased concerning the value of a specific type of proposal, would the level of voting support not be an accurate proxy for the proposal's impact on performance.

Given the large number and diversity of institutional investors and their information sources, however, systematic errors across investors over proposal valuation effects is simply not a plausible scenario. The more plausible assumption is that shareholder mistakes on the value of a particular governance device are randomly distributed. In such a scenario, with a large number of voting shareholders, investor errors will cancel out and the proportion of yes votes is the best estimate of the proposal's value.

A case in point involves proposals on defensive tactics. Jamil Aboumeri, for instance, notes that it is surprising that shareholders vote in large numbers to rescind poison pills despite his research showing substantial benefits from those defenses. The literature on the impact of poison pills on takeovers is, however, ambiguous and, in particular, the effect appears to vary considerably with firm characteristics. It is therefore altogether reasonable for investors to believe that the removal of a pill will be beneficial for some firms, and to support such proposals, notwithstanding Aboumeri's claim. There is, however, a potential non-random error in this context which would affect the significance attributable to voting results. If uninformed shareholders believe that the institutional sponsors of proposals on defensive tactics are informed about the relevant firm-level characteristics, and the sponsors are not so informed, then the proposals might attract more votes than justified at specific firms. The comprehensive review procedure would mitigate such a problem, for as institutions conscientiously engage in activist program reevaluations, they will thereafter undertake such proposals only when they have the requisite firm-specific knowledge.

Periodic program review is also important because shareholder activism in the proxy process is not costless, even though it is certainly

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158 Cf. Schwab & Thomas, supra note 137, at 1082-83 (arguing that other shareholders are more likely to support union-sponsored proposals that have potential to improve performance than those concerned with labor-related interests).

159 Aboumeri, supra note 78, at 5.

160 See, e.g., supra note 70 and accompanying text.
inexpensive compared to activism involving control changes. For example, CalPERS estimates the annual cost of its activism program at $500,000 (which is .002% of the fund's domestic holdings). Del Guercio and Hawkins indicate that the activist pension funds in their study similarly spent less than half of a basis point per year on their corporate governance programs, with an expenditure range from $50,000 to $1 million. They also state that TIAA-CREF spends annually $1 million or .002% of assets on its corporate governance program. Other corporate governance strategies, such as voting against management proposals and board nominees of poorly-performing firms, are far cheaper to implement than an activist agenda; for instance, one estimate of the annual cost of a "just vote no" program is $100,000.

Given the cost differential between active and passive mechanisms of monitoring management and the ineffectiveness of shareholder activism at improving corporate performance, from a fiduciary standpoint, fund managers ought to have to justify program expenditures to their boards. Identifying which specific corporate structures or processes enhance share value by reference to readily available data, rather than wishful thinking concerning their effects, will improve the quality of decision-making and should produce corporate governance programs which are consonant with the funds' fiduciary obligations. Although it could be contended that the expected decline in proposals due to adoption of such a thorough review process would reduce the information obtained regarding management quality from a proposal submission indicating failed negotiation, in fact, the effect, in all likelihood, would be heightened. Funds will shift to proposals that are more likely to obtain higher voting support, such as defensive tactic rescissions, and hence ones more costly for low-quality managers to negotiate over.

The details of an appropriately enhanced system of internal control for a shareholder activism program have not been minutely specified. The reasons are two-fold. First, because the benefit of some corporate governance mechanisms vary with firm-specific characteristics, too-minutely specified criteria would freeze a fund's ability to respond differentially to varying situations. Second, given the dynamic evolution of the corporate form and governance devices, it would not be prudent to advocate the termination of all corporate governance activism. Instead, a filter mechanism regarding the proposals the fund submits ought to be implemented, which takes account of the literature but which is

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161 See Smith, supra note 23, at 245.
162 Del Guercio & Hawkins, supra note 3, at 328.
163 Id. at 328 n.4.
sufficiently fluid to be able to adapt to new findings and circumstances. Pension fund boards should find implementation of the proposed review process sufficiently desirable to do so voluntarily as a good management practice. But it might well be difficult for boards to evaluate their programs' efficacy, as they are not likely to possess the requisite expertise. Inability to evaluate an activism program effectively, in turn, might lead to hesitancy in adopting the proposed formal review process or implementing it effectively.

A potentially more important problem for implementation is a fund board that is subject to political pressure itself: board members are often political appointees or elected officials, who may support an activist agenda favored by constituents, and be led to place less weight on concerns over portfolio value than would be other fiduciaries. Politicization of a fund board would greatly attenuate the incentive to undertake the proposed review. In such cases, implementing the review procedure may well be in the interest of the fund managers, for it could provide political cover for a manager focused on maximizing the value of portfolio firms from a politicized board whose members are instead interested in implementing political and social investment objectives.

Politicization has been a problem, for instance, for the CalPERS staff. Politicians on the fund's board recently advanced an investment policy opposed by the staff for financial reasons, tobacco stock divestment, and the staff recommended amending proposed divestiture legislation supported by the State Treasurer, a fund board member, to include indemnification for "board members, money managers and others connected with the fund from potential liabilities" from implementing the policy if the bill were enacted. Indeed, the political composition of the CalPERS board is considered to affect "every single activity" of the fund, "from the benefits side to investment policy to corporate governance." To the extent that the source of non-value-maximizing activism is fund boards and not fund managers, it would be in the managers' self-interest to implement the proposed review procedure that provides external evaluations to the fund board, as it would be a shield against potential fiduciary liability.

There are a number of possible avenues for achieving widespread adoption of adequate internal control practices despite deficiencies in expertise or incentives within a fund's administration, the most promising being the promulgation of good practice standards by industry

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165 See Romano, supra note 16.
166 Joel Chemoff, CalPERS Mulls Political Issues, PENSIONS & INVESTMENTS, May 1, 2000, at 1.
167 Joel Chemoff, CalPERS Tilts Toward Labor, PENSIONS & INVESTMENTS, May 1, 2000, at 3.
associations. If the Government Finance Officers Association (GFOA) or the Investment Company Institute (ICI), the trade groups for public pension fund officials and private mutual funds, respectively, for example, were to adopt good practice guidelines that included comprehensive evaluations of shareholder activism programs, this would have a salutary impact on individual fund practices. External pressure generated by reputable organizations' recommendation of a serious review process could mitigate political pressures on board members to not conform to the practice. It would surely be a source of support to fund managers seeking to fulfill their fiduciary obligations against a politicized board.

The CII and national union organizations such as the AFL-CIO, which have been active promoters and coordinators of the corporate governance movement, could also perform such a guidance function. In addition, private organizations, including business trade organizations such as the Business Roundtable, the National Association of Corporate Directors and the Conference Board, the corporate bar, stock exchanges and public accounting firms, could be recruited to formulate standards for shareholder activism programs. All of these business private organizations have already been involved in varying degrees in devising recommendations for corporate governance standards for boards of directors and audit committees. 168

The involvement of private sector organizations in the establishment of good practices is important because government entities are rarely as knowledgeable as private organizations regarding the best institutional procedures. The gap in expertise between regulators and the regulated is well illustrated by what has occurred in the establishment of international capital standards for banks. In the most recent international capital standard adopted for market risk, banking regulators have acknowledged that they lag significantly behind the banking industry in risk measurement expertise: they adopted an internal model approach to the calculation of market risk, in which the bank's, rather than the regulator's, model estimates the value at risk in the bank's portfolio and therefore establishes the amount of capital required. 169

An alternative route for attaining widespread formal review of fund activism is to mandate the review through a certification requirement:

168 For a list of business and bar organizations that have produced corporate governance standards for boards see Millstein & MacAvoy, supra note 50, at 1288-89 & nn. 21-22. The New York Stock Exchange and National Association for Securities Dealers, in response to SEC concerns, created the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which issued a report in February 1999 with recommendations for improving audit committees, and accounting firms have followed up with statements of audit committee standards. E.g., PRICEWATERHOUSECOOPERS, AUDIT COMMITTEES: BEST PRACTICES FOR PROTECTING SHAREHOLDER INTERESTS (1999); KPMG, SHAPING THE AUDIT COMMITTEE AGENDA (1999).

funds could be required to obtain a letter from an independent third party, such as the firm’s auditor, on a periodic basis, certifying that the institution has undertaken a comprehensive review of its activism program.\textsuperscript{170} Certification of such a process is altogether reasonable, and in accord with current trends in auditing, in particular, the movement to certify processes rather than transactions or outputs (items that are verifiable quantitatively and hence the substance of traditional audits).\textsuperscript{171} Moreover, accounting firms in recent years have been required to review a variety of qualitative information concerning firms’ internal controls, including information relating to issues such as year 2000 compliance,\textsuperscript{172} and they have increasingly been marketing their auditing services as “assurance services,” through which they express a willingness to certify matters beyond financial accounting data during an audit.\textsuperscript{173}

In addition, a special committee of the American Institute of Certified Public Accountants (AICPA) created in 1994 to report on the “current state and future” of audit and assurance services, defined “assurance services” as “independent professional services that improve the quality of information, or its content, for decision makers.”\textsuperscript{174} It proposed examples of assurance services that comport with certification of activism program reviews: assurance regarding compliance with company policies, and assurance regarding investment managers’ conformity with performance presentation standards.\textsuperscript{175} Quite clearly, evaluation of the effectiveness of a review of corporate governance programs is no less certifiable by an auditor than the other nonfinancial matters that auditing firms have

\textsuperscript{170} To the extent that there is concern that such work could compromise the independence of the auditor, use of a different public accounting firm could be required. But this work would not appear to create a significant independence issue as it does not constitute self-review of the auditing function as do other appraisal and valuation services. See, e.g., ISB Gives Guidance to Auditors on Derivatives Accounting, Fed. Sec. L. Rep. (CCH) No. 1919, at 3 (Apr. 17, 2000) (discussing interpretation of Independence Standards Board regarding auditors’ provision of assistance on the implementation of FAS 133, a new standard for accounting for derivatives).

\textsuperscript{171} See, e.g., KPMG, THE FINANCIAL STATEMENT AUDIT 9 (1999); Anita Dennis, Becoming a Business Partner: Toward a More Dynamic Internal Audit Department, 183 J. ACCT. 72, 74 (1997) (quoting, “we used to analyze transactions; now we analyze the processes,” Robert Brewer, director of Audits at Praxair, a $4 billion supplier of industrial gases).


\textsuperscript{173} The websites of several accounting firms refer to their provision of “assurance services” in conjunction with traditional auditing services. See, e.g., KPMG Global Services at http://www.kpmg.com/ services (last visited April 16, 2001) (stating that “KPMG is a leading provider of assurance, tax and legal, consulting and financial advisory services . . . . The Assurance practice helps clients manage risk so they can focus on their core businesses”); PricewaterhouseCoopers Health Care Practice, Assurance and Business Advisory Service, at http://www.pwchealth.com (last visited April 16, 2001) (stating that their “global Assurance and Business Advisory Services (ABAS) offer [clients] a broad range of innovative and cost-effective solutions: We provide Assurance on the financial performance and operations of your business”).


\textsuperscript{175} Id.
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undertaken in recent years. Indeed, auditors' experience in such areas makes them better suited to undertake a certifying function than other professionals with expertise in the proxy process, such as lawyers and consulting firms. To the extent that standards of good practices for activist programs are developed, the accountants could certify whether the fund was in compliance with such standards, and not simply that it has engaged in a comprehensive review.

If certification of reviews of activism programs were required by fund regulators, then institutional investors plainly would have to undertake the necessary evaluative reviews. But the varied identity of proposal sponsors and potential sponsors renders implementation of a uniform certification requirement problematic. For example, public pension funds are regulated by state legislatures, union pension funds are regulated by the Department of Labor (DoL), and mutual funds, which have not been involved in corporate governance activism but have been encouraged to do so, are regulated by the SEC. Moreover, in the absence of a promulgated standard of good activism practices, the certification requirement will not provide very effective protection for fund beneficiaries, for the independent third party verifies only the undertaking of a comprehensive review, and not the outcome—the efficacy of the fund’s program. These concerns suggest the need to craft an additional mechanism to ensure that fund managers’ incentives are aligned with engaging in an investor activism program that maximizes the value of the fund’s portfolio.

B. External Controls: Shifting the Financial Burden of Shareholder Proposals

Beyond the difficulty of implementing a certification requirement to ensure compliance with the proposed comprehensive review of activism programs, there is a further problem with relying solely on internal

176 Accounting regulatory bodies, such as the Government Accounting Standards Board (GASB) and Financial Accounting Standards Board (FASB), are not the appropriate locus of authority for such certification, as their mandates are directed at disclosures of the costs and revenues of firm output.

177 E.g., Romano, supra note 16, at 800.


179 See Robert McGough & Pui-Wing Tam, Bogle Urges Role in Corporate Governance, WALL ST. J., Oct. 21, 1999, at C23 (reporting John Bogle, founder of the Vanguard Group, as having called on mutual funds to “live up to their responsibility of corporate citizenship” and promote better corporate governance and wield their voting power to oppose management on issues harmful to shareholders, such as excessive stock options).

controls to resolve fund beneficiaries' problem that fund activist programs are not cost-effective. Because the most active funds are public pension funds that are defined benefit plans, their beneficiaries' payouts are independent of the funds' endowment. Hence fund managers will not have powerful incentives to adopt comprehensive evaluations even if some funds would for fear of adverse signalling, since their beneficiaries are not as actively monitoring fund performance as are shareholders of mutual funds. Politicians are also not likely to target fund activism out of concern about taxpayer expense as the expenditures on such activities are relatively small and some non-value-maximizing forms of activism may actually provide political benefits: limiting executive compensation, for instance, has been a perennial focus of Congressional attention. Consequently, another mechanism is necessary to incentivize public pension fund managers.

One means of providing an incentive to fund managers to engage in more cost-effective forms of activism is to eliminate the subsidy of losing proposals under the SEC's proxy proposal rules. If funds incur the cost of a losing proposal, then the fund managers will have to scrutinize, on a continuing basis, the fund's corporate governance program, to determine which proposals are most likely to attract voting support, because their cash position will be affected if they do not. Admittedly, the incentive created by this proposal is low-powered, as fund beneficiaries are not likely to be able to monitor fund outflows or budget reallocations due to a poorly performing corporate governance program. But over time the expenses from losing proposal reimbursements will affect fund performance, and the fund board will have increased incentives to intervene. It is in the interest of fund managers to avoid such board action, as it could have adverse employment repercussions beyond the immediate curtailment of discretion upon the intervention, and managers anticipating the possibility of such action will adjust their behavior regarding shareholder proposals from the outset.

1. Should Proxy Proposals Be Subsidized?

It is textbook economics that parties bearing the full cost of their actions make better decisions than those that do not. When a party does not bear the full cost of its activity, it will engage in more of the activity, for in equating the marginal benefits and costs of the enterprise, a lower level of benefit from the activity suffices to meet the reduced cost. But under the shareholder proposal regime, this analysis is generally thought to be

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181 See I.R.C. § 162(m) (2001) (eliminating tax deductibility of executive compensation over $1 million unless performance-based and performance goals set by compensation committee with two independent directors and approved by shareholders).
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overridden by collective action concerns. Namely, if the cost of action by an individual shareholder is greater than the shareholder's pro rata benefit, albeit less than the aggregate gain to all shareholders, the activity will be under-, rather than over-supplied. The proxy proposal regime assumes that this is the proper calculation of the costs and benefits of shareholder proposals.

But where there are private benefits from the shareholder's action, that is, benefits that accrue solely to the proposal sponsor and that are not proportionately shared by all shareholders, as is the case with an increase in firm value, then matching pro-rated costs and benefits will not produce the optimal level of activity. This is because when costs are allocated across all shareholders, small private benefits will induce individual action that does not benefit the shareholders in the aggregate. 182

It is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. The disparity in identity of sponsors—the predominance of public and union funds, which, in contrast to private sector funds, are not in competition for investor dollars—is strongly suggestive of their presence. Examples of potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, 183 as well as advancements in personal employment, the "revolving door" issue for government employees, whose salaries are considerably lower than the private sector. It is possible that engaging in activism will enhance an individual's subsequent job opportunities, analogous to suggestions that prosecutors bring high profile criminal cases either to further political careers or partnerships in top criminal defense firms, a charge directed at the white collar crime prosecutions brought by Rudolph Guliani, a U.S. attorney who later became Mayor of New York, and others in his office who went on to prominent law firms. 184 For example, a top official involved in CalPERS's corporate governance program, Richard Koppes, left the fund and joined a law firm that advises management on takeover defenses after leaving the fund. Because such career concerns—enhancement of political


183 See, e.g., Paul Jarley & Cheryl L. Maranto, Union Corporate Campaigns: An Assessment, 43 INDUS. & LAB. REL. REV. 505 (1990) (discussing relation between use of corporate campaigns and accomplishment of traditional union goals); Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445, 479-81 (1991) (discussing political entrepreneurship of public and private pension fund managers active in corporate governance); Romano, supra note 16, at 801-19, 822 (discussing political interests of, benefits to, and pressures on, public pension fund managers); Schwab & Thomas, supra note 137, at 1032-34 (discussing labor's corporate campaigns).

reputations or subsequent employment opportunities—do not provide a commensurate benefit to private fund managers, we do not find them engaging in investor activism.

The private benefits implicated in career concerns also have a higher likelihood of being present in certain classes of proposals than others. For example, proposals to limit executive compensation and increase board diversity, appealing to populist sentiment or the political preferences of some constituents, are more likely to enhance political reputations for fund managers than confidential voting or takeover defense rescission proposals. There is far greater media publicity surrounding executive compensation and minority representation issues, and these proposals implicate the kinds of social issues on which political reputations can be advanced, in contrast to more mundane corporate governance devices. This conjecture has plausibility given the far lower level of voting support for executive compensation and board proposals compared to confidential voting and defensive tactic proposals by those who have a financial stake in firms.

A broader set of proposals—all those making managers’ lives more uncomfortable—may provide private benefits to union fund managers seeking a more accommodating management; these include proposals rescinding takeover tactics as well as proposals to limit executive pay and enhance board independence. But these proposals may also be offered strategically, to gain support and good will from other investors that is hoped will carry over to future issues of greater importance to labor. Although such a carryover is a “private” benefit to the union, it is not a “private” benefit in the strict sense because any gain from the specific proposal, such as an increase in stock value from rescission of a poison pill, is a pro rata gain.

Although it may have had relevance historically, the rationale advanced for the shareholder proposal rule’s subsidization of sponsors’ costs, a collective action problem, has little relevance for contemporary capital markets, in which a majority of shares is held by institutional investors. Institutional investors own large blocks of stock and often cannot sell shares in a poorly-managed firm because their fund is indexed to a portfolio including that firm. Consequently, they experience far less of

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185 For example, the New York City controller and trustee for New York City Employees’ Retirement Funds, when running for the Democratic party nomination for U.S. Senate, highlighted her fund’s sponsorship of proposals for independent directors, in order to obtain “more accountable management,” including elimination of “fat executive compensation plans.” Elizabeth Holtzman, When Management Falls Down on the Job: Pension Funds Can Put Independent Directors on the Board, WASH. POST, May 26, 1992, at A17.

186 See CAROLYN K. BRANCATO, INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 19-20 (1997) (reporting that in 1995, institutional investors held 50% of total U.S. equity, including 57.2% of the largest 1000 firms).
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a free rider problem than the individual shareholder whose hypothesized dilemma motivated adoption of a cost-subsidization regime.

In addition, there are a number of organizations, such as the CII, the Investor Responsibility Research Center (IRRC) and the Institutional Shareholders Service (ISS),\(^\text{187}\) that collect and disseminate information to institutional investors concerning corporate governance issues, which further reduces the need for a regulatory solution to a hypothesized collective action problem. The AFL-CIO has also published a detailed set of voting guidelines for union funds\(^\text{188}\) and the possibilities of inexpensive and widespread dissemination of information through the internet are already present and potentially enormous. Besides the websites of the AFL-CIO, CalPERS, CII and other organizations that detail their corporate governance activities, some small activist funds are posting on their websites how they have voted their proxies and are encouraging use of their sites to facilitate individual shareholder participation in an activist agenda.\(^\text{189}\)

2. Proposed Reform of the Proposal Process

Subsidization is not necessary for active use of the proxy process by investors and, in fact, it has created perverse incentives for institutional investors, as the best available data suggest that fund managers are not using the proposal process in furtherance of the best interest of their beneficiaries.\(^\text{190}\) This Article accordingly advocates revising the present proxy proposal regime to reduce such incentives. It presents three alternative approaches that would all have the salutary effect of changing funds’ incentives by reducing the subsidy: (i) adoption of a vote cutoff below which the sponsor must fully reimburse the firm for the cost of submitting the proposal; (ii) use of a sliding scale of reimbursement depending on the level of votes obtained; and (iii) shareholder selection of the extent of subsidization of proposals. The third option is my preferred approach, but in contrast to the other two proposals, it is at odds with the mandatory approach of the SEC rules.

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\(^{187}\) The ISS is a private consulting firm that provides advice on proxy voting and other voting services to institutional investors.


\(^ {189}\) See IRRC, New Websites Post Proxy Voting Activity, 10 IRRC CORPORATE GOVERNANCE HIGHLIGHTS 65 (Apr. 16, 1999) (noting that Domini Social Investments, a socially responsible investment fund, is posting how its Equity Fund has voted shares in its 400 firms as well as adding an investor activism center with information on social issue proxy proposals and permitting email to CEOs of targeted firms).

\(^ {190}\) Individual investors may, of course, also misuse the process if they obtain consumption, rather than investment, benefits from offering proposals that are not in the interest of the other shareholders.
The proposition that shareholders should finance their proposals is not a novel idea. Commentators writing in the 1980s critiqued the shareholder proposal subsidy, contending that the mismatched incentives for individual shareholders arising from the subsidy were greater than the benefits from reducing free rider problems. Specifically, these commentators emphasized the extremely low voting support for the proposals and the small number of "professional gadfly" individual sponsors. Although the critique of the regime necessarily differed in the 1980s' context of individual sponsors and low support levels, the policy position is equally apt today in the quite different landscape of institutions' higher-support-generating proposals.

In particular, the essential incentive mismatch of the rule identified by earlier critiques is as relevant for institutional as it is for individual investors, given the opportunity for fund managers to obtain private benefits from proposal sponsorship. If institutional sponsors obtain private benefits, then not only is there even less cause for other shareholders to subsidize such activity, but also, special cause for concern: such benefits accrue to the fund manager and not the fund beneficiaries, who are in a similar position to that of the other shareholders, as they benefit solely from proposals producing performance improvements. Moreover, the free rider problem justifying subsidization of individual investor action is mitigated for institutions given their larger ownership positions and their participation in trade organizations that assemble detailed information on governance issues. Finally, the corporate finance literature, which was not available to 1980s commentators, strongly bolsters the case for altering the policy of subsidized access to the proxy machinery because it indicates persuasively that proposal sponsors are frequently not pursuing a value-maximizing agenda.

Critics of the shareholder proposal regime have advocated repeal of the entire SEC rule governing proxy proposals. Complete repeal may well be a worthy ideal, as voting rules are more properly issues of state corporate law than federal securities law, and securities regulation would be better served by a competitive state regime rather than the current federal regulatory monopoly. But such a reform goes well

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191 See, e.g., Dent, Response, supra note 18, at 819, 821 (distinguishing traditional from antitakeover proposals as not cost-justified); Dent, Study, supra note 18, at 4-8, 14-16; Daniel R. Fischel, The Corporate Governance Movement, 35 VAND. L. REV. 1259, 1279 (1982) (criticizing rule for cost subsidization); Liebler, supra note 2, at 447-57.
192 See Dent, Study, supra note 18 (advocating repeal of rule); Liebler, supra note 2, at 453 (same).
194 See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359 (1998) (advocating comprehensive reform of the federal securities law by permitting issuers to choose their securities regime, analogous to the choice of corporate charter,
beyond the immediate problem identified in this Article, which is the absence of incentives for proposal sponsors, and more specifically, fund managers to increase the efficacy of their corporate governance activities within the contours of the existing shareholder proposal regime. This Article focuses on the one piece of the proxy proposal regime that if altered would have the greatest impact on institutional activism because it has the greatest potential incentive effect, the subsidization of shareholder proposals.

It should be noted that under the SEC proxy proposal rules, proposals that fail to attain a specified number of votes (under 3% or 10%, depending on the number of times the proposal was previously submitted) can be excluded for three years. These threshold vote resubmission requirements do weed out proposals least likely to improve firm value, but given the large and growing number of proposals every year on subjects that have no apparent impact on firm value, they insufficiently address the institutional investor incentive issues of concern in this Article. Although the voting threshold for resubmission could be raised even further to a level closer to that required for voting success, this would not incentivize activist investors to reevaluate their agenda as well as would reducing the subsidy for proposals failing to achieve higher voting levels. This is because an increased threshold requirement can be easily avoided. Activist investors could simply offer alternative substantive proposals to an individual firm each year where the threshold was not met, as well as shift the firm which is the object of their targeting each year, a strategy that would not be difficult to implement for active public pension funds that hold shares in hundreds of firms.

The first proposal is elimination of the subsidy, unless the proposal gains substantial support. Such an approach is consistent with the state-law approach to the collective action problem: proxy contestants must pay their own expenses, although shareholders may approve successful challengers’ expenditures ex post. The strongest source of support for such a reform is the fact that the state-law approach to cost recovery has been more successful than the federal proxy regime in aligning individual

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from among the fifty states as well as the SEC or other nations). The present Article underscores the merit of such an approach: the SEC has not formulated proxy proposal rules that ensure institutional investors have appropriate incentives in using the process to improve the value of the targeted firm.

193 Rule 14a-8(i)(12), 17 C.F.R. 240.14a-8(i)(12) (a company may exclude a proposal that obtained less than 3% if proposed once within the preceding 5 calendar years, less than 6% if proposed twice within the preceding 5 calendar years, or less than 10% if proposed 3 or more times within the preceding 5 calendar years; the term of the exclusion is for 3 calendar years from the last time in which the proposal was included in the firm’s proxy materials).

shareholders' incentives with the aggregate interest. In contrast to the shareholder proposal regime, proxy fights are not devoted to social issues tangentially related to corporate governance or to inconsequential structural reforms that have no relation to the profitability of corporate operations. More importantly, they result in significant improvements in firm performance while shareholder proposals do not. The superior outcome from the operation of state law should not be surprising: the competition across states for corporate charters produces laws that tend to enhance shareholder welfare, and the absence of competition in the federal securities regime renders it considerably less responsive to investors' concerns, and therefore less likely to produce wealth-maximizing rules.\(^{197}\)

Absolute success (50%), the state-law proxy expense reimbursement standard, need not be the standard for retention of full subsidization of the proposal. Rather, an appropriate benchmark for success could be 40%, by analogy to success in the takeover process. Hostile takeovers, which offer shareholders a substantial premium for tendering, for example, rarely obtain 100% of outstanding shares, but rather, more typically obtain 75%, as there are inevitably shareholders who cannot or do not tender their shares in time; the number of tendered shares rises to over 85% when the bidder's pre-offer shareholdings are included.\(^{198}\) A 40% success rate for proxy proposal reimbursement is therefore roughly equivalent to the tendering rate in the average successful takeover (that is, it is 80% of 50%).

A 40% support cut-off level for reimbursement is advanced as a reference point for discussion, with the caveat that too low a reimbursement threshold will discourage institutions' scrutiny of the efficacy of their activism, leaving too much room for the sponsorship of proposals whose private benefits outweigh aggregate gains.\(^{199}\)

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197 For a discussion of the efficacy of state competition compared to federal law see ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); for a specific analysis concerning the proxy process see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 81-84 (1991) (noting that federal proxy rules are not entitled to the same presumption of efficiency as rules firms would adopt themselves under state law).

198 See Robert Comment & Gregg A. Jarrell, Two-Tier and Negotiated Tender Offers: The Imprisonment of the Free-riding Shareholder, 19 J. FIN. ECON. 283, 301 (1987) (finding that hostile tender offers for any or all shares obtain on average 75.1% of outstanding shares, for a total of 87.7% when average bidder pre-offer holdings are included).

199 Other commentators have considered different benchmarks. For instance, George Dent, who modified his position favoring repeal of the shareholder proposal rule in the 1990s when institutions became active on takeover issues, advocates requiring the posting of a bond to cover corporate costs if a proposal does not garner a respectable level of support, and while he does not specify a numerical criterion for the proposal, he suggests 20% as one possible minimum. Dent, Response, supra note 18, at 823. In addition, Bebchuk and Kahan would retain the actual success (50%) rule for proxy fights, although they suggest, without specifying a concrete number, that a lower threshold may be appropriate for proxy fights over issues as opposed to board seats. See Bebchuk & Kahan, supra note 180, at 1122, 1128. They are not, of course, discussing shareholder proposals, where the costs of the action are much lower and the private benefits, given the parties involved,
alternative approach that could work as well is a sliding scale of proportional reimbursement: the successful proponent is fully reimbursed, and thereafter, the reimbursement rate is proportionate to the votes received in relation to the votes necessary for success. Thus, the sponsor whose proposal obtains a 40% vote share does not have free access but rather, pays 20% of the proposal’s costs (that is, the reimbursement is 40% of 50%). However, the sliding scale approach could also incorporate the 40% level of the first (cut-off) approach as the measure of “success” for free access, and proportionately reduce the subsidy for vote levels below 40%. Under this second approach, a proposal sponsor always receives some cost subsidization (the subsidy is reduced, but never eliminated completely).

A relaxed standard of success for proposal reimbursement (less than 40% or the sliding scale approach) would be appropriate despite the significantly higher threshold at state law for proxy fight expenditure reimbursement, if the potential private benefits to proponents of shareholder proposals are far lower than the private benefits realizable to proxy fight contestants. In such a scenario, the adverse incentive effect of subsidization due to a divergence in private and social benefits would be reduced. For example, if private benefits are nonexistent, the proposals offered would uniformly be expected to increase share value (but we would also expect such proposals to receive high levels of support). There is, however, no compelling reason to expect private benefits to be zero in the shareholder proposal context, particularly given institutions’ continued pursuit of specific proposals despite an absence of any proven performance effects, the glaring disparity across the types of institutions—public rather than private funds—that engage in such activity, and the failure of the vast majority of proposals to receive even close to a majority of the votes. Accordingly, setting a meaningful threshold for proposal subsidization is highly desirable.

In addition, to the extent that the social benefits of the proposal are significant compared to private benefits, more shareholders can be expected to vote for the proposal. In this regard, establishing a sufficiently high voting threshold is a means of ensuring the proper private-social benefit calculation by the proposal sponsor. While the costs of a corporate governance proposal are not likely to vary with the substance of the proposal the private benefits may well do so.

The first two approaches to reduce the shareholder proposal subsidy (whether achieved by a specified cut-off, such as 40%, for obtaining any reimbursement or through a sliding scale reduction in reimbursement amount) have the all-or-nothing approach of all SEC rules: they are qualitatively different.
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mandatory regulations applicable to all issuers. But a third approach, which I find more attractive, is to permit firms, by shareholder vote, to choose their proxy proposal regime, opting from among full, partial, or no subsidy regimes, for all or some proposals or proposal sponsors. Such an optional approach would, in fact, mesh with the enabling feature of state corporate law, and in this respect is a more fitting approach for proxy procedures than a mandatory rule, because the proxy process (voting) is integrally related to a corporation's internal affairs, the subject matter of state law, which recognizes the necessity for firms to tailor governance devices to their particular needs.

It is not at all self-evident that elimination of the subsidy for shareholder proposals will emerge as the most prevalent choice of issuers under an optional proposal regime. Institutional investors who engage in corporate activism will not be predisposed to opt for a regime that eliminates the current subsidy of their activity. However, as activist shareholders hold only a small proportion of any corporation's stock, they will need the support of other shareholders to maintain a full subsidization regime. Hence, the benefit of an optional approach to expenditures on the proxy proposal process is that the decision to subsidize proposals will be voluntarily rendered by the firm's stockholders as a group, rather than imposed upon them by SEC fiat. Of course, the pension fund beneficiaries who bear the cost of institutional activism that is non-value-maximizing will not benefit from this approach if the majority of a firm's investors do not wish to withdraw the subsidy.

None of the alternative reimbursement proposals explicitly requires management to reimburse the corporation for shareholder proposals it opposes that are adopted, or for management proposals that are defeated. It might be desirable to have symmetrical treatment, as there is no reason for shareholders to incur expenditures by management opposing proposals that they support, or proposing matters that they do not wish to be implemented. The potential loss of the screening value of a proposal's submission compared to private negotiations that could result from a reduction in proposal activity when proposal sponsors are at risk of loss of the subsidy will not, however, be offset by symmetrical reimbursement.

200 As an alternative to her proposal to repeal the shareholder proposal regime, Susan Liebeler also proposed that corporations should adopt bylaws imposing minimum ownership requirements in order to bring proposals before the annual meeting that were greater than the SEC's minimal threshold requirement, as well as bylaws requiring reimbursement of the cost of proposals. Liebeler, supra note 2, at 462, 464. She considered these second-best measures to protect corporate interests while the SEC rule remained on the books. By choosing a bylaw for the reimbursement rule, in contrast to this article's proposal, Liebeler's proposal would permit management to eliminate the subsidy without shareholder approval, as managers typically can amend bylaws on their own. See, e.g., DEL. CODE ANN. tit. 8, § 109 (1998) (stating that corporate charter may confer power to adopt, amend or repeal bylaws on directors). The difference in decision-maker is the reason why, in contrast to the discussion in the text, Leibeler expects firm-level choice to result in elimination of the subsidy.
treatment for managers. This is because if managers bear a personal cost upon their position’s defeat, they should be more willing to negotiate over a proposal’s withdrawal (that is, requiring managerial reimbursement enhances the shareholder-sponsor’s bargaining position), regardless of the manager’s quality.

There are two principal reasons not to mandate a symmetrical requirement of management reimbursement. First, it is impossible to implement and police such a requirement because any such reimbursements can be easily covered by increased compensation to the managers without detection. Second, the rationale for permitting managers to respond to a shareholder proposal, as well as to submit proposals, provision of information to shareholders from those better-situated to identify benefits and costs of specific proposals, cuts against charging management for losing proposals. The financial risk imposed by a reimbursement requirement may result in a reduction of the information management provides shareholders regarding proposals. The reasons for not mandating a managerial reimbursement requirement are further arguments in favor of the optional approach to proposal subsidization: given the tradeoff entailed by a policy of managerial reimbursement, the appropriate choice may well vary across firms, making it preferable to permit each firm’s investors to choose whether to treat managers and shareholders symmetrically with regard to the cost of proposals.

Finally, because the determination of a proposal sponsor’s required reimbursement occurs after the firm has incurred the proposal’s submission costs, there is a problem regarding enforcement of the proposed reform. Namely, there must be a method of ensuring that a sponsor of a losing proposal pays the firm the requisite reimbursement amount. There are, at least, two possible solutions to this problem. One approach is to require that proposal sponsors post a bond, analogous to securities-for-expenses statutes in state corporation codes, which require the plaintiff in a shareholder suit to post a bond to cover defense costs should the plaintiff lose. The size of the bond would vary according to which of the three reimbursement schemes were adopted and could vary based on the substance of the proposal, using as a benchmark the expected vote given historical voting data across firms by proposal types. A second approach is to precondition the right to submit a proposal upon the stockholder’s not having outstanding any reimbursement due to a firm from a losing proposal. This condition would be added to the other eligibility criteria in rule 14a-8, the continuous ownership of a specified

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201 E.g., CAL. CORP. CODE § 800 (West 2001) (stating that at motion of defendant, court may require plaintiff to post a bond for reasonable expenses, not to exceed $50,000). Dent advanced such a proposal. See Dent, Response, supra note 18, at 823.
amount of stock.\textsuperscript{202}

The first approach, posting a bond, has a higher likelihood of restricting the use of the proposal process by small-resource organizations and individual investors, compared to the second approach, as they need to have cash on hand in advance of a proposal's submission. It is thus probable that it will be subject to greater criticism than the reimbursement proposal itself for chilling proposals. But it is the preferable approach, because the second approach creates additional enforcement problems.

In particular, a ban on subsequent proposals would have to apply to all proposals to be offered at any firm in the future and not simply proposals at the firm which was not reimbursed. Otherwise, a shareholder could repeatedly put up losing proposals by choosing a new target, without ever having to make a reimbursement payment. While the specific firm that has not been reimbursed by a particular sponsor would be able to enforce the approach because it knows who has not paid a bill, it would be no simple task for other firms to determine whether a shareholder proposal proponent was in default to another firm. The SEC would have to create and maintain an elaborate national registry for issuers to report delinquent proposal proponents, and make it accessible to all registrants to track potential proposal sponsors (or have agency staff enforce the reimbursement requirement, a costly arrangement).

In addition, the subsequent proposal ban approach may be subject to abuse due to a sponsor identification problem. Some organizations, most typically union funds whose members hold shares in their individual capacity, use individual shareholders to sponsor their proposals. These organizations would then not be subject to the subsequent prohibition, even though they had supported losing proposals that were not reimbursed, because they could continue to engage in activism by finding new individual sponsors. It would be exceedingly difficult, however, to apply the subsequent proposal ban to an entity other than the official sponsor of a losing proposal (the individual in these instances), as it could result in unwieldy litigation over whether or not a shareholder was acting independently, and the point of the reform is to rationalize and render more effective the shareholder proposal regime. Indeed, the precondition of payment before another proposal can be proffered could generate additional subjects of litigation, such as, disputes over the assessed cost of a losing proposal, as payment of the assessed amount determines the right of the shareholder to engage in subsequent activism. All of these concerns render the posting of a bond a more cost-effective mechanism than subsequent proposal prohibition for ensuring that the reform to end the

\textsuperscript{202} 17 C.F.R. § 240.14a-8(b) (2000) (stating that to be eligible to submit a proposal under rule, proponent must have held continuously at least $2,000 in market value or 1% of stock entitled to vote on proposal, for at least one year by the date of the proposal's submission).
subsidy has bite—that the sponsors of losing proposals bear their cost.

3. Would Reducing the Shareholder Proposal Subsidy Be Effective?

Would a shift in the cost of the shareholder proposal regime in fact create an incentive for institutional investors to engage in a comprehensive evaluation of their activism programs? The data on corporate expenditures on shareholder proposals are sketchy and imprecise, but the best and only available estimate suggests that eliminating the subsidy would have a salutary incentive effect. The data source of the best estimate is the SEC. In a 1998 release regarding proposed reforms of the proxy proposal rule, the SEC indicated that respondents to a 1997 agency-administered questionnaire reported an average (median) expenditure of approximately $50,000 ($10,000) on printing, distribution and tabulation costs for including a shareholder proposal, and $37,000 ($10,000) on the determination whether to include a proposal.

The mean estimates submitted to the SEC imply that eliminating the subsidization of shareholder proposals would add almost 20% to CalPERS's current expenditures on its activist program with just one proposal failure. Such an effect should provide an impetus to the CalPERS staff to fine-tune its program. Using the lower median cost estimate of $20,000 instead of the average estimate of $87,000, incentives for the staff to be more selective regarding proposal sponsorship would be more attenuated, as it would require CalPERS to incur at least four defeats under a full subsidy elimination regime to approach the 20% mark.

In actual practice, the impact of the reform on a fund like CalPERS would be quite variable because its record of success varies considerably: in 1998, for instance, CalPERS sponsored four proposals, only one of which obtained more than 40% of the votes, whereas in 1995 it sponsored

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203 Amendments to Rules on Shareholder Proposals, 17 C.F.R. 240 (1998) (Release No. 34-40,018) (describing 80 firms reporting on proposal inclusion determination costs and 67 reporting on printing and other direct costs). The SEC noted that it was unclear whether the responses it received accounted for more than one proposal. Id. This estimate was one of only three estimates that I could find. The second estimate was in response to a request for information on the cost of compliance with the shareholder proposal rules in 1976: the SEC received one estimate, from a firm which reported it spent $22,450 per included proposal, and $3,740 per excluded proposal, for a total expenditure of over $150,000 on 16 proposals. Proposed Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Securities Exchange Act Release No. 34-19,135, 47 Fed. Reg. 47,420, 47,424 n.17 (Oct. 14, 1982). Given the absence of a basis to judge the representativeness of this firm, this estimate is useless. The third estimate I found is in Susan Liebeler's article proposing repeal of the rule, from an informal survey conducted by the American Society of Corporate Secretaries (ASCS) in response to proposed changes in the shareholder proposal rule in 1982: the ASCS reported an average cost of $94,775 per company or $10,275 per proposal. Liebeler, supra note 2, at 454 n.157. Even adjusting for inflation, the 1997 SEC survey cost estimate is much higher (five times) than the 1982 ASCS estimate.
only two proposals, both of which met the 40% test.\textsuperscript{204} Thus, under the first approach with a 40% cutoff for reimbursement, CalPERS's 1998 activism would have cost between 12% to 52% of its activism budget, depending on whether the median or mean SEC estimate is used as the reimbursement benchmark, while its 1995 agenda would have had no cost impact. Under the partial reimbursement of the second proposed approach, the cost of CalPERS's activism would obviously be less, and hence the incentive to review that activity seriously would be that much weaker.

Clearly the incentive provided by the proposed reform will depend on the cost that a losing proposal sponsor must pay, as well as the extent of the investor's activism program. But unless the investor's demand for activism is inelastic, a dubious proposition given conventional economic assumptions, the reform will result in its sponsoring fewer proposals, or retaining the same number but being more selective concerning which proposals are submitted, as either approach (full or partial reimbursement) will raise the cost of activism that does not have broad support across shareholders. Either adjustment in fund behavior will have a similar outcome: there will be fewer instances of low-vote-attracting proposals.

For a more comprehensive perspective on the costs of the shareholder proposal process of the proposed reforms, the effect of the proposed subsidy reduction can be estimated for shareholder proposals submitted in 1997 and 1998. The IRRC reported the voting results for 254 of 255 shareholder proposals on corporate governance submitted to 175 firms in 1998, and for 283 proposals submitted to 179 firms in 1997.\textsuperscript{205} The absolute number of proposals receiving over 50% of the votes cast is about the same in the two years, 32 and 31, respectively, and an additional 26 (28) proposals in 1998 (1997) received at least 40% of the votes, the proposed cutoff for sponsors' full reimbursement. Thus, a 40% cutoff would result in reimbursement of 23% of the 1998 submitted proposals (21% of 1997 proposals). The average level of support was 26% in 1998 and 24% in 1997, an increase of 2%, similar to the annual increase in support for shareholder proposals on defensive tactics reported by organizations collecting voting data, such as the IRRC and the proxy solicitation firm, Georgeson & Company.\textsuperscript{206} The medians reveal a similar

\textsuperscript{204} IRRC, Checklist of 1998 U.S. Corporate Governance Shareholder Proposals, IRRC CORPORATE GOVERNANCE BULLETIN 27-32 (Apr.-June 1998); IRRC, Checklist of 1995 Shareholder Proposals, IRRC CORPORATE GOVERNANCE BULLETIN 24-33 (July-Sept. 1995). In recent years CalPERS has significantly cut back on the number of proposals it has submitted for a vote, although it still targets a dozen firms. Paul Sweeney, Clash by Proxy, ACROSS THE BOARD, May 1996, at 21, 25 (noting that in 1995, CalPERS fund pushed for vote on only 2 proposals of 10 firms contacted with resolutions, and expects to file proposals at only 3 or 4 meetings in 1996). Elimination of the cost subsidization rule undoubtedly will reinforce this trend.


\textsuperscript{206} GEORGESON & COMPANY, INC., 1998 ANNUAL MEETING SEASON WRAP-UP CORPORATE
increase, 20.3% in 1997 compared to 23% in 1998. Thus a 20% vote cutoff for subsidization would cover half of the proposals submitted in these two years. The bottom quartile of the distribution of votes on shareholder proposals in 1998 (1997) consists of proposals with less than 10% (9%) of the votes cast.

The cost of the shareholder proposal regime, using the SEC estimates for the 1998 data, is indicated in Table 3 in the 0% cutoff row in the table (the current regime subsidizes all proposals), as is the cost of a reformed regime under a variety of vote cutoff levels.\textsuperscript{207} As the table indicates, the cost is non-trivial from the point of view of individual proposal sponsors who would otherwise be paying these amounts, but not when compared to the aggregate market value of publicly traded firms. To determine the subsidy for proposals not attracting a majority, the 50% cutoff row estimates are subtracted from those in the 0% cutoff row; this provides an estimate of $22 million in 1997 and $19 million in 1998, using the SEC’s mean estimate of $87,000 in corporate expenditures per proposal, for an average over the two years of nearly $21 million. Averaging over the two years, the subsidy ranges from $18 million to $7 million, for a vote cutoff of 40% and 10% respectively (which approximate the top and lower quartiles of the distribution of votes cast).\textsuperscript{208} Another way to express this result is that elimination of the subsidy for proposals that fail to obtain 40% of the votes would save targeted firms $18 million annually.

\begin{itemize}
\item \textsuperscript{207} The table uses votes as a percentage of votes cast to classify proposals. For less than 10% of the corporate governance proposals reported in the data sources cited in note 203, supra, the company specified a different voting requirement in its proxy statement. As a result, the cutoff assigned in Table 3 to 21 corporate governance proposals in 1997 and 22 in 1998 would be lower, using the firms’ vote tally. Thus, the figures in the text underestimate the cost of the regime if one were to use as the cutoff percentage the vote necessary for a proposal’s passage rather than the percentage of votes cast.
\item \textsuperscript{208} The subsidy for a 40% cutoff is determined by subtracting the amount in the 40% row from the amount in the 0% row; similarly, the subsidy for a 10% cutoff is determined by subtracting the amount in the 10% row from the amount in the 0% row.
\item \textsuperscript{209} E.g., Schreiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978) (majority cannot ratify waste of assets); Rosenfeld v. Fairchild Engine, 128 N.E.2d 291 (N.Y. 1955) (limitation of proxy fight expenditure reimbursement). Although managers can spend corporate assets on charitable contributions without shareholder approval, A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, appeal dismissed, 346 U.S. 861 (1953), consistent with corporate law’s centralization in management of decision-making that does not involve fundamental corporate changes, this nonmajoritarian context is not a relevant benchmark because management is not the source of the decision to subsidize shareholder proposals. The SEC’s proxy regime is one of the only instances in which an allocation of corporate assets is determined by individual shareholders without a need to obtain the support of at least a majority of the owners. The only other instance is derivative lawsuits, but in that context, the minority shareholder’s ability to expend corporate resources on the litigation is greatly restricted by state courts.
\end{itemize}
### TABLE 3. ESTIMATED COST OF SHAREHOLDER PROPOSAL REGIME 1997-98

#### PANEL A: CORPORATE GOVERNANCE PROPOSALS

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>50%</td>
<td>31</td>
<td>32</td>
<td>$2.7 ($0.6)</td>
<td>$2.8 ($0.6)</td>
</tr>
<tr>
<td>40%</td>
<td>59</td>
<td>58</td>
<td>$5 ($1.2)</td>
<td>$5 ($1.2)</td>
</tr>
<tr>
<td>30%</td>
<td>94</td>
<td>91</td>
<td>$8.2 ($1.9)</td>
<td>$7.9 ($1.8)</td>
</tr>
<tr>
<td>20%</td>
<td>142</td>
<td>141</td>
<td>$12.4 ($2.8)</td>
<td>$12.3 ($2.8)</td>
</tr>
<tr>
<td>10%</td>
<td>196</td>
<td>188</td>
<td>$17.1 ($3.9)</td>
<td>$16.4 ($3.8)</td>
</tr>
<tr>
<td>0%</td>
<td>283</td>
<td>254</td>
<td>$24.6 ($5.7)</td>
<td>$22.1 ($5.1)</td>
</tr>
</tbody>
</table>

#### PANEL B. SOCIAL RESPONSIBILITY PROPOSALS

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>40%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>30%</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>$.09 ($0.02)</td>
</tr>
<tr>
<td>20%</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>$.2 ($0.04)</td>
</tr>
<tr>
<td>10%</td>
<td>14</td>
<td>16</td>
<td>$1.2 ($0.3)</td>
<td>$1.4 ($0.3)</td>
</tr>
<tr>
<td>0%</td>
<td>95</td>
<td>104</td>
<td>$8.3 ($1.9)</td>
<td>$9.1 ($2.1)</td>
</tr>
</tbody>
</table>


Although this Article is directed at corporate governance proposals, the proposed reduction in the subsidy for shareholder proposals should be applied across-the-board, to social responsibility as well as corporate
governance proposals. There are two reasons for doing this. First, it is sometimes difficult to classify a proposal: the TIAA-CREF proposals to diversify the composition of boards, for instance, can be considered to fall into either category, as can proposals to link executive compensation to multipliers of employee compensation or social performance criteria. If the subsidy varied by category, it would encourage proponents to reword corporate governance proposals in order to be classified as social responsibility proposals, which could result in the submission of proposals even more poorly suited to improve performance than current proposals. Second, and more important, the SEC’s inclusion of such shareholder proposals perversely stands corporate law on its head, because it permits a minority of shareholders to dictate the expenditure of corporate funds for non-profit-maximizing uses when core principles of corporate law require unanimity for waste of assets, and prohibit reimbursement of proxy expenses for contests undertaken for personal reasons.\textsuperscript{210}

The estimate of the cost of the shareholder proposal regime is greater when social responsibility proposals are included in the calculation: although fewer in number than corporate governance proposals, these proposals receive far lower levels of support. The second panel in Table 3 contains a parallel calculation of the cost of the subsidy for social responsibility proposals submitted in 1997 and 1998.\textsuperscript{211} As no such proposal received a majority of the votes, the subsidy for proposals not attracting a majority is simply the estimate in the 0\% cutoff row, $9.1 million in 1998 and $8.3 million in 1997, respectively, using, as before, the SEC’s mean proposal expenditure estimate of $87,000. Combining the estimated cost of these proposals with that of the corporate governance proposals...

\textsuperscript{210} E.g., Schreiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978) (majority cannot ratify waste of assets); Rosenfeld v. Fairchild Engine, 128 N.E.2d 291 (N.Y. 1955) (limitation of proxy fight expenditure reimbursement). Although managers can spend corporate assets on charitable contributions without shareholder approval, A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, appeal dismissed, 346 U.S. 861 (1953), consistent with corporate law’s centralization in management of decision-making that does not involve fundamental corporate changes, this nonmajoritarian context is not a relevant benchmark because management is not the source of the decision to subsidize shareholder proposals. The SEC’s proxy regime is one of the only instances in which an allocation of corporate assets is determined by individual shareholders without a need to obtain the support of at least a majority of the owners. The only other instance is derivative lawsuits, but in that context, the minority shareholder’s ability to expend corporate resources on the litigation is greatly restricted by state courts.

\textsuperscript{211} Voting results on social responsibility proposals were obtained from IRRC, SOCIAL POLICY SHAREHOLDER RESOLUTIONS IN 1997: ISSUES, VOTES AND VIEWS OF INSTITUTIONAL INVESTORS (Jan. 1998) (hereinafter IRRC, SOCIAL 1997) and IRRC, SOCIAL POLICY SHAREHOLDER RESOLUTIONS IN 1998: ISSUES, VOTES AND VIEWS OF INSTITUTIONAL INVESTORS (Jan. 1999). Where a proposal is an overlap—that is, where it is tracked by both IRRC services—it is counted as a corporate governance proposal (there were 20 overlaps in 1997, and 17 in 1998). The withdrawal and omission rate for the social responsibility proposals is high: including overlapping proposals, by my count, of 299 initial social responsibility proposals in 1997, 115 came to a vote, and in 1998, 121 of 293 tracked proposals came to a vote.
proposals, using a voting cutoff of either 40% or 10% and averaging the cost over the two years, results in an estimated cost savings that ranges from $27 million to $14 million.

As this calculation, shown in Table 3, indicates, the proposed elimination or reduction of the subsidy of shareholder proposals should have a much greater impact on social responsibility proposals than corporate governance proposals because such proposals receive much lower levels of support. But this would be a felicitous outcome from the viewpoint of corporate law as social responsibility proposals are not directed at maximizing share value, which is the aim of corporate law. In this context, an additional attractive benefit of the third reform option, shareholder selection of the proposal regime, is that it returns the proxy process to the corporate law decision-making norm, whereby the minority is bound by the majority,\textsuperscript{212} as a majority of the shareholders would choose the extent of the subsidization of shareholder proposals. In short, it, as well as the alternative proposed reforms, would put an end to what has been an egregious abuse of the proxy process.

The average cost per firm in 1998 of corporate governance proposals is approximately $126,000, and in 1997, it is $140,000. The 1998 average cost falls to $110,000 and $97,000 if proposals obtaining 50% and 40% of the votes, respectively, are excluded. The comparable figures for 1997 are $123,000 and $109,000 respectively. But as two-thirds of the firms received only one corporate governance proposal in each year, their estimated expenditure is $87,000. To understand the robustness of these figures, we need to consider the distribution of proposals obtaining a majority of the votes, as these proposals should be subsidized by the regime. The distribution of corporate governance proposals across firms by year and voting support is reported in Table 4.\textsuperscript{213} Of the firms receiving only one corporate governance proposal, in both years, 13 firms' proposals obtained a majority of the votes cast. Of the firms experiencing multiple corporate governance proposals, over the two years, the proposals of only three firms all obtained over 50% of the votes (eight proposals). For most of the firms receiving more than one proposal, no proposal obtained 50% of the votes (55 of 67 such firms in 1997 and 39 of 55 in 1998). This means that the cost of the regime to multiple proposal firms is much higher than the estimated average, reaching as high as $435,000 for the two firms

\textsuperscript{212} For example, fundamental changes to the corporate form require the vote of at least a majority of the shareholders. \textit{E.g.}, Del. Code Ann. tit. 8 §§ 242, 251, 271 (1998) (holding that majority stockholder vote required for charter amendment, merger, and sale of assets).

\textsuperscript{213} The Article does not undertake a similar calculation for social responsibility proposals because they are not the focus of concern of this article and they appear to be slightly less clustered across target firms than corporate governance proposals. For example, in 1997, of 74 firms voting on such proposals, 55 or 74% voted on only one proposal, and only two (3%) voted on more than two proposals. IRRC \textit{SOCIAL} 1997, supra note 208, at 77-84.
Less is More

in 1998 with five proposals, and $348,000 for two firms with four proposals in 1997, none of which obtained 50% of the votes.

### TABLE 4. DISTRIBUTION OF CORPORATE GOVERNANCE PROPOSALS BY FIRM AND VOTING SUPPORT 1997-98

<table>
<thead>
<tr>
<th>No. of proposals</th>
<th>No. of firms 1997</th>
<th>No. of firms with 50% (40%) proposals 1997</th>
<th>No. of firms 1998</th>
<th>No. of firms with 50% (40%) proposals 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>112</td>
<td>13 (14)</td>
<td>120</td>
<td>13 (9)</td>
</tr>
<tr>
<td>2</td>
<td>40</td>
<td>4 (7)</td>
<td>38</td>
<td>14 (8)*</td>
</tr>
<tr>
<td>3</td>
<td>21</td>
<td>6 (1)*</td>
<td>11</td>
<td>1 (5)</td>
</tr>
<tr>
<td>4</td>
<td>2</td>
<td>1 (3)</td>
<td>4</td>
<td>1 (1)</td>
</tr>
<tr>
<td>5</td>
<td>4</td>
<td>1 (0)</td>
<td>2</td>
<td>0 (0)</td>
</tr>
</tbody>
</table>

Notes: The columns "No. of firms with 50% (40%)" indicate the number of firms where a proposal obtained at least 50% (between 40-49%) of the votes cast, of the firms receiving the number of proposals indicated in the cell’s row in the year indicated in the cell’s column. *indicates a cell in which one firm has been counted more than once (in both the 50% and 40% entries) because it received one proposal that obtained 50% and one that obtained between 40%-49% of the votes cast.


The distribution pattern is similar if the vote cutoff is 40%; while nine (14) more single proposal and 13 (11) more multiple proposal firms meet this criterion in 1998 (1997), again, most of the additional multiple proposal firms had only one proposal that obtained over 40% of the votes (10 in 1998 and nine in 1997). Of course, the cost estimates are conservative because none of the estimates, whether by firm or in the aggregate, include the resources expended by firms on omitted proposals (proposals excluded for failing to meet the SEC’s criteria for submission). Yet the resources spent on omitted proposals—the expenditure on determining whether to include a proposal—are approximately equal to the additional expenditure on those that are included—the mailing and distribution costs (SEC estimates of a mean of $37,000 compared to $50,000, and of identical medians of $10,000). From this perspective, all of the cost figures presented considerably higher than they actually are.

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214 Nor are expenditures on withdrawn proposals (proposals for which the firm and sponsor negotiated an agreement resulting in the proposal’s withdrawal) included. How many of these proposals would have received a substantial proportion of votes is unknown. While we might expect management to reach a negotiated settlement only on proposals that it deems likely to obtain a high level of support, the negative performance associated with such compromises in recent years reported by the Chidambaran and Woidtke study cautions that this may not be the case. Chidambaran & Woidtke, supra note 8.

215 Supra note 203 and accompanying text.
underestimate the cost of the regime.

The cost estimates in Table 3, even if refined to reflect the actual distribution of proposals across firms, do not impose a heavy burden on shareholders who are subsidizing proposal sponsors and voting against the proposals. But even seemingly low annual expenditures add up: the present value of the cost of the regime is, at a minimum, $315 million, using the historical market risk premium of 9.2% as the capitalization rate. This is a minimum because there is considerable debate over whether this is an accurate estimate of the equity risk premium: it was significantly lower in the nineteenth century and beginning of the twentieth century, and many financial economists predict a lower premium in the future. Using as the capitalization rate, for example, the average risk premium from either 1802-1870 or 1871-1925, 1.4% and 4.4% respectively, or the overall average premium of 5.1% from 1802-1997, the subsidy of shareholder proposals under the current regime is $2.1 billion, $659 million or $569 million. The savings to firms from eliminating the subsidy for shareholder proposals that fail to receive at least 40% of the votes ranges, across the differing historical capitalization rates, from $1.9 billion to $293 million. These sums are not trivial. Moreover, the estimates are conservatively biased because they assume there will be no growth in the number of proposals presented, although the number has increased over time.

Some might contend that because the cost estimates are quite modest compared to the market value of publicly-traded firms, it is unnecessary to rein in the subsidy as the problem is self-correcting: informed funds can be expected to revise their activist strategies in the face of the new learning of the finance literature. In this view, it is better for shareholders to bear the relatively low cost of the subsidy during an adjustment period in which institutions reassess their activist programs, than for them to operate under a reformed regime that reduced the subsidy. There are two rationales that could be advanced in support of this position. First, a reduction in the subsidy could undermine whatever deterrent effect is provided by

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216 See, e.g., STEPHEN A. ROSS ET AL., CORPORATE FINANCE 227-28 (5th ed. 1999) (stating that equity risk premium averaged 9.2% from 1926 to 1997). The present value of a perpetuity is the annual cash flow divided by the capitalization rate. Id. at 120. The numerator used for this calculation is the average over 1997 and 1998 of the cost of corporate governance and social responsibility proposals that did not obtain a majority of votes (the estimates in the 50% cutoff row subtracted from those in the 0% cutoff row in Table 3), or $29 million. If the proposed 40% cutoff for full reimbursement were adopted, the numerator would be $27 million.

217 Id. at 228 (stating that risk premium averaged 1.4% from 1802-1870 and 4.4% from 1871-1925).

218 E.g., BRADFORD CORNELL, THE EQUITY RISK PREMIUM 200 (1999) (reasonable forward-looking range for risk premium of 5% to 7%). The capitalized cost using this rate range is from $580 million to $414 million.

219 ROSS ET AL., supra note 216, at 228.
Less is More

shareholder proposals, and second, it could decrease the extent of governance innovations that arise from institutional investors' experimentation with governance reforms through proposal sponsorship, as they would no longer be able to offer, at no cost to themselves, proposals that take several years of submission before they achieve substantial support.

These objections to the need for reform are not, however, persuasive. A significant deterrent effect is improbable because of the lack of any performance effect from, and the infrequency of top management turnover after, proposal submissions. In addition, the experimentation aspect of shareholder proposals is attenuated: the governance proposals offered by institutional investors have not been directed at novel devices for which there have been no empirical research on performance effects. For example, the drive to propose independent directors in the 1990s occurred after most firms' boards had a majority of outside directors and substantial research had been undertaken regarding their impact, and the defensive tactics that were the object of the initiation of shareholder proposals had been the subject of prior empirical study, although the performance effect of defenses has been found to differ over time, which has changed the calculus concerning the efficacy of shareholder targeting of them. But experimentation over governance reforms will not be eliminated by a reduction in the subsidy—it will instead require a higher threshold for action.

Most important, the premise of the contention, that activist institutions will significantly alter their governance programs as the results of the finance literature are publicized, is dubious. The disparity in proposal sponsorship across public and private fund managers strongly suggests that there is an agency problem, so that the regime will not, in fact, be subject to self-correction. The current regime provides no incentive to mitigate an agency problem in institutional proposal sponsorship. Instead, it encourages the submission of proposals that have private benefits and hence may not be value-maximizing, by allocating proposal costs across all shareholders. Accordingly, the more compelling response to the current regime's relatively low annual cost compared to market capitalization is to recognize that the low cost is a contributing factor to the tolerance of a wasteful regime.

Although the case is exceedingly strong for reducing, if not for eliminating, the subsidization of shareholder proposals, in all likelihood, such a reform of the proxy proposal process will be politically difficult to implement. It is improbable that politically well-connected institutions (public pension funds and unions) which have been obtaining access to the proxy process for free will voluntarily agree to begin paying for it. Indeed, institutional investors have opposed even minor changes that could limit
their free access to the proxy process, such as an increase in the minimum threshold of votes required for a proposal’s resubmission in a subsequent year.  It is, however, hoped that this Article’s marshaling of the evidence and analysis of the dismal ineffectiveness of the institutional investor activism agenda will alter the view of those investors (or at least of nonactivist institutional investors) of the proposal process such that they will acknowledge, and support, the need for meaningful reform.

Conclusion

Shareholder proposals, although an increasingly prominent feature of institutional investor corporate governance activism since the mid-1980s, have not had a significant impact on firm performance. The most plausible explanation for the absence of a discernible positive effect has been large scale misdirection in the form that such activism has taken: many proposals have focused on reforming board composition and structure and limiting executive compensation, yet empirical studies of such reforms consistently indicate that they do not improve performance. In addition, proposals to implement confidential voting also provide no benefit because the procedural change does not significantly alter voting outcomes. Finally, proposals to remove takeover defenses need to be directed at firms where they will do the most good, such as those with insider-controlled boards, yet proposal sponsors often lack the knowledge of specific firm characteristics to engage in precision targeting, diminishing the likelihood that the proposal will improve performance.

Although submitting a proposal is not as expensive as other forms of shareholder activism, such as waging a proxy fight, the lackluster results of such activity suggest that institutional investors should implement greater internal controls to monitor their corporate governance programs, redirecting the resources expended on activism to their highest valued use. Adoption of industry-wide good practice standards for corporate governance programs and third-party certification of the internal review process would spur individual funds to undertake careful and comprehensive reviews of their activism programs.

Fund managers’ incentives to engage in ongoing scrutiny of their governance programs would further be enhanced were the federal rules for shareholder proposals revised to require proposal sponsors either to incur the full cost of a losing proposal or a substantial part of the cost, or, better still, to permit firms by a shareholder vote to select their proposal subsidization regime. By increasing the probability that institutional efforts

220 See SEC Finalizes Changes to Shareholder Proposal Rules, 69 ASPEN LAW & BUSINESS CORPORATION 13, at 13 (July 1, 1998).
at corporate governance activism will improve targeted firms' share values, these recommendations will not only benefit all targeted firm shareholders but will also encourage fund boards to perform more attentively their fiduciary obligations to fund beneficiaries.