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Corporations: The Short-Termism Debate.

Jonathan Macey
Yale Law School
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MILLENNIALS, EQUITY, AND THE RULE OF LAW

CORPORATIONS: THE SHORT-TERMISM DEBATE

Panelists:

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PROFESSOR JONATHAN R. MACEY, Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law, Yale Law School

PROFESSOR ROBERT T. MILLER, Professor of Law and F. Arnold Daum Fellow in Corporate Law, University of Iowa College of Law

STEVEN A. ROSENBLUM, Partner, Wachtell, Lipton, Rosen & Katz

Moderator:

HON. E. NORMAN VEASEY, Former Chief Justice, Delaware Supreme Court

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JUDGE E. NORMAN VEASEY: I'm Norm Veasey, and I was Chief Justice of the Delaware Supreme Court for a twelve-year term, until 2004. Before that I was a corporate litigator at Richards, Layton & Finger in Wilmington, Delaware, where I live. After I left the court in 2004, I was a senior partner at Weil, Gotshal & Manges in Wilmington and in New York. I left Weil Gotshal at the end of 2013 because I wanted to do more arbitrations and mediations, and I was being conflicted out of a lot of those engagements, so I went to a small firm in Wilmington, Delaware, called Gordon, Fournaris & Mammarella, and that’s where I’ve been concentrating on that work ever since.

It’s a pleasure for me to be here and relive some of these experiences in corporate law, which I watch with great interest and sometimes I have an arbitration or mediation case involving them. But I’m no longer on the court, as I mentioned earlier. I’ve been off for ten years. In that ten-year period, the composition of the Delaware Supreme Court and the Delaware Court of Chancery has changed. When I was on the court, Randy Holland was on the court. He’s still on the court but he’s the only one who's still on the court. The new Chief Justice is Leo Strine, and we have Justice Valihura and Justice Vaughn. We have a vacancy, because Justice Ridgely has announced his retirement, coming up soon. His retirement will not be effective until January 31st.

We have a new Chancellor, Andre Bouchard, and I haven’t seen any significant change in the jurisprudence. So one of the things that’s good about Delaware law is its stability. We have, as you know, over sixty percent of the Fortune 500 companies incorporated in Delaware and about half of the major public corporations in the United States. So, there is a lot of litigation in Delaware involving corporate governance and the like.

The Delaware Supreme Court has about 700 cases every year, for five members, and they churn them out in an average of about forty-five days. The Court of Chancery is even faster. But the Supreme Court has a small amount of its docket on corporate law. They do everything—death penalty, worker’s comp, and the like—and they take all these cases. Delaware has no intermediate appellate court.
So when we talk about corporate governance, we talk a lot about Delaware jurisprudence. I’m going to introduce the panel in a minute, but one of the things that I’ve found interesting is an article by Professor Mark Roe at Harvard, that I was asked to review for the Business Lawyer. It was published in the Business Lawyer, and it is called “Corporate Short-Termism in the Boardroom and in the Courtroom.” It is in 68 Business Lawyer 978, August 2013. He talks about whether the short-termism, long-termism debate or issue is something that lawmakers in Delaware, or elsewhere, should get engaged in, and he said no.

So I think that what we need to talk about here is those kinds of things and how they play into the corporate law. Now there are some members of the Delaware judiciary who have said things about short-termism versus long-termism. Chancellor Chandler recently addressed that question in the Airgas case, in the context of a poison pill, and Chief Justice Strine has written about it. So there are a lot of those materials that are out there. I think that you have to balance the business judgment rule with getting involved in these kinds of things. So in the context of a poison pill, it seems that one of the issues is, is there a threat to the corporation, and is the threat related to short-termism, long-termism issues. That’s what Chancellor Chandler talked about a bit in the Airgas case.

I know our panel, who are experts in corporate law, corporate governance, and economics, will be addressing a lot of these issues, and I look forward to hearing from them.

We’re going to start off with Professor Bebchuk. Lucian Bebchuk is certainly known to almost everybody in this field. He is Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School. He holds an LL.M. and an S.J.D. from Harvard Law School and an M.A. and Ph.D. in economics from the Harvard Economics Department. He is the author or co-author of more than 100 research papers, as well as the widely acclaimed book, Pay Without Performance: The Unfulfilled Promise of Executive Compensation. He has been a frequent contributor to policymaking, practice, and public debate in the fields of corporate governance and financial regulation, and was included in the list of the 100 Most Influential Players in Corporate Governance.
He will go first and he will speak for about twenty-five minutes, and he has some slides. He will be followed by Steve Rosenblum. Steve is a partner at Wachtell, Lipton, Rosen & Katz. Steve has been a partner at Wachtell Lipton since 1989 and serves as co-chair of the firm’s corporate department. He focuses on mergers and acquisitions, buyouts, takeover defense, shareholder and hedge fund activism, proxy fights, joint ventures, corporate governance, and securities laws. So he is in the trenches in these areas. He does it every day and he does it well, and he’s recognized by Chambers Global as one of the world’s leading transactional lawyers. He received his J.D. from Yale Law School in 1982 and his B.A. from Harvard College magna cum laude and Phi Beta Kappa in 1978. He’s a member of the ABA Committee on Corporate Laws, and I’m on that committee, too, so we’re colleagues there. He’s written and participated in panels on a number of topics, including mergers and acquisitions, shareholder and hedge fund activism, corporate disclosure, proxy reform, and corporate governance.

Jonathan Macey is a Professor at Yale Law School. He is a professor of corporate law, corporate finance, and securities law, and he is also a professor at the Yale School of Management, so he’s got a foot in both camps. He is the author of several books, including the two-volume treatise, Macey on Corporation Law, co-authored two leading casebooks, and so forth. He was awarded the Paul M. Bator Prize for Excellence in Teaching, Scholarship, and Public Service, and awarded the teaching award by the Yale Law Women, in recognition of his committed excellence in teaching, mentoring, and inspiring. He earned his B.A. cum laude from Harvard, his J.D. from Yale Law School, and his Ph.D. Honoris Causa from Stockholm School of Economics.

Last but not least is Robert Miller. Robert Miller is Professor of Law and the Arnold F. Daum Fellow in Corporate Law at the University of Iowa. His scholarship includes concerns about corporate matters, securities law, the economic analysis of law, and the philosophy of law. He received his J.D. from Yale Law School, where he was Senior Editor of the Yale Law Journal. He earned his M.A. and M.Phil.—Master of Philosophy—degrees from Columbia. He earned his B.A. in philosophy and mathematics from Columbia College. He teaches mergers and acquisitions, law
and economics, corporate finance, business associations, antitrust, and contracts. Before entering academia, Professor Miller was an associate at Wachtell Lipton.

So without further ado from me, I would like to invite Professor Bebchuk to come to the podium.

PROFESSOR LUCIAN A. BEBCHUK: Thank you very much. I'll be sharing with you the findings of a paper that is jointly written with Alon Brav and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism." It's forthcoming next spring. For anyone who is interested, it's available on SSRN and on my home page.

What we tried to do is to resolve empirically and test the validity of a claim that has been playing a key role in the debate on short-termism. There is a claim that we refer to as the "myopic activists" claim. The claim is that interventions by investors that do not have very long investment horizons—and people often refer to activist hedge funds as the most significant investors of this kind—that interventions by them produce short-sighted, myopic corporate changes, which come at the expense of long-term performance and value. Therefore, on this view, activist interventions are, in the long term, detrimental both to companies and to their long-term shareholders.

This is a claim that has been put forward, forcefully and impassionately, by a great number of writers. Many have been on the perspective of an issuer or an issuer advisor. Just to quote two examples of strongly expressed views about this claim, William George, recently in an op-ed in the New York Times, says that activist investors are trying to drive up the share price and book quick profits, but then they bail out and they leave corporate management to clean up the mess. Similarly, a Wachtell Lipton memo on activism expresses a similarly strong view. It says that activist investors are preying on American corporations to create short-term increases in the market price of the stock at the expense of long-term value.

So this is a claim that is frequently involved and forcefully put forward. The stakes are also significant, because it's a claim that has been raised in a wide range of corporate contexts and corporate debates to support arrangements that reduce the power and the influence of activist investors. Just to give you a few
examples, it's used to argue for tightening certain rules, for low-threshold, ten percent poison pills, for maintaining staggered boards, which institutional investors have long been resisting, and to advocate for changes that would limit the rights of short-term shareholders. And, in particular, activist engagements disclaim it's used as the basis for an approach that is advocated for boards to follow. What is suggested is that, by and large, boards should "circle the wagons" and view activists as an adversary that the best outcome would be if it could be defeated.

Now, this is a claim that, in our view, requires testing. If you take the view that market prices are efficient, which John Macey here subscribes to, then you can rule out this view on the basis of your assumptions about market efficiency because, if the stock prices in the short term fully reflect long-term values, then this problem goes away. But what we are doing in our work is we are willing to accept that markets sometimes might be inefficient, but even if they are inefficient, as I show in a paper published last year in the Columbia Law Review, it doesn't follow that this problem exists. It could exist, but it wouldn't necessarily exist because there are effects going in both directions, and, therefore, the short-termism claim, the myopic activism claim is really a testable, empirical position, and even though this claim has been around and has been put forward forcefully for about three decades, the people supporting it have not provided empirical support.

Last year, Marty Lipton and I had a debate at The Conference Board in New York, and following this debate, Wachtell Lipton issued a memo authored by Marty in which he challenged me, kind of accepting the need for empirical testing, that the important question for resolving the different views between him and me with respect to hedge fund activists. The important question, Marty said, was to study for companies that are the subject of hedge fund activism and remain independent. What is the impact on the operational performance and stock price performance relative to the benchmark after a 24-month period? So he was urging that empirical work be done that doesn't look just at short-term consequences but looks at stock price and operating performance after a 24-month period. And Mike Weisbach and I, we undertook a
direct empirical test of this very question, based on the full universe of about 2,000 activist interventions that took place during the period of 1994 to 2007.

So what we see is that when we look at two standard metrics for measuring operating performance financial economists used, return on assets and Tobin's Q—and these are the averages for the targets of activist interventions for a 5-year period. So we take a long-term, 5-year-out look at the data, and what we see is the targets, by and large, are underperforming relative to their industry, so they start low, and following the activist intervention, things improve. Now, the myopic activist claim, except that things improve after a year or two, but it takes the view that those improvements are transient, that what is happening is that firms cut their investments, pay dividends, do things that improve operating performance in the short term, but cannibalize—come at the expense of long-term results. But what we see is that things don’t return to a point below the starting point, as is feared by the myopic activist claim, but rather five years out operating performance using those two metrics is significantly better than when the activists emerged.

This was just looking at averages, but if you look at the study you see this comes up very clearly in a regression analysis, which is what one should rely on, so controlling for the relevant characteristics we find that 3, 4, and 5 years out after the activist intervention the levels of both Q and ROA are higher than at the time of the intervention. Moreover, the difference is both statistically significant and economically meaningful.

We next looked at what might be the most important measure of all, and that is the impact on stockholder wealth. The graph now that you see in front of you is just the short-term reaction when activists emerge and they make certain defilings that lets the world know of their existence. What you see in this is just document results that have been known for some time, much before our work, that the market reacts very positively to the emergence of activists. There is about six percent positive abnormal return, on average. Those who put forward the myopic activist claim accept this pattern, but what they have been arguing strongly, for a long time, is that this is a short-term spike in the market, but the markets are inefficient in pricing in the
short term. Those initial increases are later on reversed when the long-term consequences of the activism come to the surface, and the long-term reversal, in the long term, makes shareholders worse off.

What we do is we look using a number of alternative ways that financial economists use for such purposes. We look at stock returns three years out and five years out, starting in months after the activists emerge, so right after the short-term spike that I just showed you. And what we see is that three- and five-year returns, depending on the specification, are either practically zero or positive, but in no specifications are the statistics significant. So the long-term reversal that issuers have been asserting is simply not coming up in the data. It's not there. Rather, markets, by and large, do not fail to appreciate the long-term consequences of activist interventions, and the short-term spikes that the companies assert in the filings by and large are an accurate, on the average, pricing of the long-term consequences.

We next look at another concern that those who advance the myopic activist claim have been putting forward, and that's the concern that the hedge fund activists are making money and so do their investors, but the bill is footed, as it were, by the long-term shareholders that remain after the activists bail out. So what we do is we test this pump-and-dump view by looking at returns in the 3 years that follow when the activists exist, and again we see this long-term reversal that has been feared is not there in the data.

We also look at subsets of activist interventions, those subsets that seem to have produced the strongest fears and resistance from issuers. One subset is the subset of "adversary interventions." Those are the interventions where the emerging activist takes a somewhat adversarial approach, perhaps threatens a proxy fight or takes a similar step, and we see the pattern that we saw earlier, that there is no long-term deterioration and no long-term damage to companies and their shareholder is there. What we see is that five years out the companies are doing better off than when the activists emerged. And the same holds true for activist interventions that are followed either by a reduction in long-term investment or by an
increase in dividend payouts, so the things that critics have been concerned reduce long-term value.

We also tested another concern that has been raised that activist interventions make companies more vulnerable to downturns, and especially had this effect during the financial crisis. We test this and the regression analysis shows that this concern, again, does not show up in the data, that the targets of activist interventions did not fare worse during the financial crisis.

So those are our findings. Since we issued the primary versions of our study, the study has received some attention but it has also been strongly criticized in three long and detailed memos that Wachtell Lipton published. Steve might speak to this, but let me explain briefly what we explained in our response to those memos, which we published, why we do not find this detailed criticism to hold and to provide a basis for Wachtell’s opposition to relying on the findings of our study.

All the memos are available on the Harvard Law School Corporate Governance blog, but to summarize them very quickly we find in them a number of claims. One claim is that Q and ROA are imperfect measures of operating performance. We agree there is no measure of operating performance that is perfect, but those are really the standard measures and the most widely used by financial economists. And, interestingly, Wachtell did not advocate, nor does it advocate now, an alternative measure. It just seeks to avoid reliance on empirical work. And that is something that Wachtell also said explicitly in its memos. It took the view that given the inherent imperfections of empirical analysis, it is better not to rely on empirical analysis in this debate, but rather rely on the depths of real-word experience of business leaders and their advisors. But that doesn’t seem right to me. Given that what the debate is about—stock returns and operating performance—and that those are parameters for which objective data is available and can be used, empirical evidence provides a superior tool to report from involved individuals on either side of this practice.

A third claim that was made is that activists do not produce improvements but are simply good stock pickers. We discussed in our paper a number of reasons why our finding suggests that, at
least partly, there is causality going from interventions to the improvements in stockholder wealth and operating performance, as we document. But in any event, if issuers were to shift to a stock-picker's claim, this would represent a new position that does not provide a basis for opposing and for trying to limit activist interventions.

Fourth, Wachtell has a long, about twenty-page, memo that has a long list of twenty-seven studies suggesting that the evidence is mixed, but we did a review of all the twenty-seven studies—it’s available, again, on the Harvard Law School Corporate Governance Blog and if you want to form a judgment on this issue, look at it—but our conclusion was that not a single study of the twenty-seven listed and cited contradicts or is even inconsistent with our findings.

The last claim is that even if hedge fund activists do not hurt the target companies with which they engage, they might have some negative effects on companies that are not targeted, that might begin to behave in a shortsighted fashion. But it's interesting to see this kind of claim coming from Wachtell, because as an advisor to boards, Wachtell should take the view that corporate directors should focus on the interests of their shareholders rather than on what happens to other companies, and relying on externalities when there is something that is beneficial for your own company cannot really provide the basis for taking an adversarial approach to activist interventions.

Let me then end with our conclusions. What we find is that the myopic activist claim that has been around for a long time is one that clearly has been strongly felt by participants in the debate but is just not empirically supported, is just not there in the data, and I would like to stress that our data is not based on a sample but on the universe of all activist interventions during a long period of time. So, going forward, in our view, policymakers, institutional investors, and boards should, first of all, not accept arguments that are based on the claim that activist interventions tend to be detrimental to long-term value, and that the result rejects calls that are made that advocate legal and corporate arrangements that impede and discourage interventions by shareholders.

Thank you.
JUDGE E. NORMAN VEASEY: Steve Rosenblum.

STEVEN A. ROSENBLUM: Hi. Well, I don't have a slide set but I guess I should be somewhat flattered that Lucian spent so much time attacking our firm, because at least it shows he's paying attention. I will start by acknowledging that I don't have a Ph.D. in economics and I don't have the qualifications to do regression analyses and statistical studies, and try to attack Lucian's methodology. A couple of my partners do have more economic background, and I think one of the memos Lucian cited does indicate some of the flaws that we see in the methodology, which Lucian doesn't think are flaws, not surprisingly. More recently there are a couple of papers that have been written by an economist named Yvan Allaire, who has a Ph.D. from M.I.T., so he is certainly more qualified than I am, and he raises some issues and concerns about Lucian's methodology.

I think the Allaire paper does appeal or has some points that appeal to my view of the world based on over thirty years of advising companies and boards, but I don't think that I can really sit here and say Lucian's methodology is right or wrong. I think there are questions about it that others have raised, and I'll let those speak for themselves.

I can, however, make a few comments on these issues based on my real-world experience. I know Lucian doesn't really like real-world experience. He tends to dismiss it as anecdotal evidence and believes that these studies and regression analyses and so forth are really the right way of looking at these issues. I tend to be somewhat skeptical about statistical studies because I think, perhaps intuitively, but I do think that you can use statistics to prove almost anything. Lucian sometimes asks, "Well, why don't we run our own studies?" and I guess my response is we all have day jobs at Wachtell Lipton. But it does somewhat surprise me that the academic world seems to be monolithic in its distrust of corporations and managements and boards. Some of the pieces that my classmate, Jon Macey, has written take this up. Even when I was in law school, I took corporations with a new young professor who was focused on the central problem of corporations being an agency problem and selfish managers stealing money from the shareholders. I wonder why there's not a similar agency
problem with money managers who are agents for other people’s money as well.

What I’d like to do, though, rather than trying to assess or critique Lucian’s methodology, is to say let’s assume that Lucian is right, that this study and all of his observations are completely accurate and that, on average, the five-year performance of about 2,000 companies that experienced activist activity from 1994 to 2007, that those companies outperformed the market over a three-year and five-year period thereafter. Assuming all that is true, I’m not really sure what it proves. Lucian talked about causality, and the paper actually concedes that causality is a harder thing to prove. But let’s take one hypothesis as to what might explain that, assuming that Lucian’s numbers are true, and it’s a hypothesis that, I think, has some basis in what I’ve seen in terms of the way companies are run.

Let’s assume that companies tend to underperform when they’re spending a lot of money on investments for the future. They ramp up their CAPEX spending, they ramp up their investment in long-term R&D, and that hurts earnings in the near term. So for some period of time those companies are underperforming. Let’s assume that those companies are more likely to be targeted by activists, and I think that’s one of the points that Lucian’s paper does make, which he didn’t cover in his presentation, but that underperforming companies tend to be disproportionately targeted by activists. And let’s assume that the companies respond to the activist activity by reversing course, cutting back on investment, cutting back on CAPEX. They will experience, for some period of time, an increase in earnings and an increase in performance, and perhaps a corresponding increase in stock price, and you can sustain that for some period. It’s not black and white. You don’t suddenly flip a switch from one to the other, but you can sustain that performance after you’ve been investing for some period of time and underperforming. You can sustain outperformance for some period of time, even a three-year or five-year time period. Lucian views three to five years as long-term. I don’t view that as long-term. I think long-term is much longer than three to five years.

So if the scenario I just hypothesized is what’s happening, then even if Lucian’s numbers are correct, it doesn’t mean that the
activity is healthy in the long run, and that's just one example. I could probably come up with other examples of what might explain the numbers, if they're true, that don't result in the policy conclusions that Lucian reaches from his numbers.

I think equally importantly, from my perspective in advising companies and boards for quite a long time, the problem of short-termism goes way beyond activism and activist interventions. Really, every publicly traded company is subject to what I think of as the tyranny of quarterly earnings. If you miss your quarterly earnings, you get punished, and that's just a fact of life for every public company, and that's been true before activists. I think activists may exacerbate the issue but it's an issue that overlays every board and every management of a public company, and they respond to it. If you talk to managers, if you talk to boards, they do want to invest for the long term and they do want to do what's right for the company, but they also feel constrained and feel the need to manage within the constraints of meeting their quarterly earnings, and that drives a lot of activity that I think is not healthy for companies in the long term.

Take one example. Last year Michael Dell took Dell, Inc., private, and in the interest of full disclosure we represented Michael in that transaction. And the motivating factor in his decision to take the company private was that he felt he could not take, as a public company, the steps that he needed to take to transform the company for the future. He basically said, “What I need to do here will hurt short-term earnings, it'll punish the stock price, and we won't be allowed to get to the long-term because somebody will come in and intervene before we can get there.” So he spent the entire year waging a battle to take the company private and endured a lot of criticism. People said he was doing it for the money. I mean, he's worth enough that he's not doing it for the money. He was doing it for the future of the company, and there are other examples of people taking companies private for exactly that reason.

A few minutes ago I said I didn't feel qualified to critique the methodology of Lucian's study but there is one observation I do feel qualified to make, because it's essentially definitionally true, which is that you can't measure the world that might have been, By that I mean you can't measure the world in which companies
are not surrounded by short-term pressures and where they have
the unconstrained ability to manage for the long term, because
that world doesn’t exist, and it hasn’t existed for quite some time,
if ever. And here’s where I think we really do need to listen to
experiential evidence, or what Lucian dismisses as anecdotal
evidence, because in the real world there really is widespread
consensus among managers, among boards, even among major
institutional shareholders, that there are short-term pressures
that are causing boards and managers to manage their companies
suboptimally, and it’s something that needs to be addressed.

Finally, I feel the need to comment on Lucian’s claim that my
firm, I think his words were we “advise boards to circle the
wagons and take an adversarial approach towards activists,” and
then, in his conclusion, “the adversarial approach towards
activists that Wachtell recommends.” Actually, we don’t
recommend that. I will tell you the advice that I gave a board last
week in dealing with an activist, and it’s the same advice I’ve
given many boards and that my senior partner, Marty Lipton, has
given many boards, which is that you should talk to the activist,
you should listen to the activist, you should consider the activist’s
ideas, and if the activist’s ideas make sense you shouldn’t have
pride of authorship. The duty of the board is to pursue what is
best for the company. There’s a point, I think, that Lucian and we
can agree on. That is the duty of the board.

By the way, that’s not the duty of the activist. The activist
doesn’t have duties to the company the way the board has duties
to the company. And our advice to boards is that if the activist’s
ideas make sense, adopt them. And we advise boards to think
about what an activist would propose if an activist were to get into
the stock, and think about whether those ideas make sense. But
our advice is also that the board is the proper body to make the
final decision. It feels sometimes that Lucian would like to put
boards and managers in a box and tell them, “Your role is to do
whatever the activist or the institutional shareholder tells you to
do.” From my point of view, in the real world, that would be a
formula for disaster.

So those are my comments.

[Applause.]
JUDGE E. NORMAN VEASEY: Professor Macey.

PROFESSOR JONATHAN R. MACEY: Thank you. Thank you very much. It's really terrific to be here and to join in this debate on short-term and long-term. I have just a few basic comments that I'd like to make to provide my perspective on a couple of these issues.

I'm a part of the monolith. There are a couple of monoliths. One is the Wachtell monolith and the other, I guess, is what was described as the academia monolith, and I'm kind of unapologetic about it. I do think it's not such a bad life to exist in an evidence-based world, and I want to kind of defend the kind of evidence it is that we're talking about.

First, I want to run through what's at stake in this argument and in extremely simple terms, which I hope will be not only simple but also maybe a little bit controversial, what is at stake here. I thought in Steven's comments he actually did an excellent job of teeing up what some of these issues are. One is the comment that was made about management—what is it that academia has against management? Here the answer is nothing, that I do agree with Steven that the agency cost model, certainly in my own research, teaching and orientation, something that's very much on the floor, the notion is not that management is bad. The notion is simply that we can all do a better job. We can all do a better job in what we do and that there's some value to having monitoring and oversight of the people who have their fiduciary responsibility to run companies.

Now, it's possible that we could say, well, we could have this oversight simply by operation of law. We impose the fiduciary duties of care, and we impose the fiduciary duty of loyalty, and that's enough. What the monolith side says, and what I say is it's not a bad thing to have—and this is hypocritical, I realize, coming from a Yale person—but it's not such a bad thing to have grades for corporate management.

[Laughter.]

PROFESSOR JONATHAN R. MACEY: And the grades that we have for corporate management are share prices. Managers can say, "Well, I don't like the grading system. I don't like the grading system. It makes me do homework a lot and I'd
rather have more time for reflection and repose.” The controversy goes deeper than that though. It’s also a question about how much power should management and the board of directors have over the corporations that they’re entrusted to run on behalf of the shareholders. I don’t think that shareholders have a lot of power right now. I’m not saying it’s a bad thing. I’m just saying it’s a descriptive matter. It is the law in every state, most notably, and importantly, Delaware, that the business and affairs of a corporation are run by or under the direction of the corporation’s board of directors. And so all that this debate really is about is around the edges, should management really be able to deprive shareholders of a potential to have an activist investor come in and agitate for change in ways that management finds uncomfortable or maybe a little embarrassing or things like that? So, really, what this debate is about is accountability.

Now, I want to talk a little bit about the counter-factual, and make three very quick points. One is, the study that Lucian and his co-author did, and that Steve is criticizing basically says, look, an activist investor comes in, and when the activist investor comes in there’s an immediate and very significant, in the twenty percent range, increase in the stock of the company that is the subject of the activist investor’s investment. And then, at the behest of Marty Lipton, who now says he doesn’t like data, Lucian went out and collected all this data, and says, “Well, the share price stays up for three or five years.” Now we’re told, “Well, these aren’t good measures. They’re the only measures available, and three to five years is not a particularly good amount of time. Let’s look at a longer period of time.”

There are two issues I have with that. Number one is, this is not true, but let’s assume that after a three-year period of big-time share increase after an activist investor comes in, let’s say the share price of the target company plummets to twenty percent below the activist investor price. I think that would be a bad thing but it would in no way cause me to think that, gee, we should somehow exalt incumbent management over activist investors? Why? Well, the reason is very simple. If I’m a shareholder in a target company and somebody comes in and purchases shares and causes the value of my equity to go up in a very short period of time by twenty percent, and even if I think the share price may
drop in thirty-five years, I can respond to that problem so simply by selling my shares now. So the idea is if people don’t like activist investors, if they think that they’re going to destroy long-term value, I don’t like to do things in a hurry but I could probably mosey over to my computer and log on and sell shares that I have in a company if I’m given a three- to five-year period to do so. So I’m simply not particularly worried about this plummet, although it would be very strange and interesting if the share price somehow did go down in this longer three- to five-year period. It would be very interesting to see that and logically and econometrically it would be challenging to figure out how this would be somehow attributable to an action by an activist investor that occurred five years prior, and who’s no longer involved in any way in the company. It’s conceivable. It just doesn’t seem very logical to me.

The second thing I want to say is to talk about, what exactly is it that we mean when we talk about the long term? So it’s longer than five years. I teach a course with a guy from Morgan Stanley named Greg Fleming, and he graciously told me he likes these slides and asked that I use them. The slides are essentially showing how the long term and the short term are converging.

One slide here is simply looking at a number of different technologies, starting with the light bulb that took forty-six years to become part of mainstream use, to things like the cell phone and other more modern technologies, where entire mass patterns of individual consumption at the retail level are occurring in a shorter time span than we want to give management to worry about things. Obviously there are famous stories about changing in computing power. My personal favorite is, let’s look at the installation of a new pope in Saint Peter’s Square in 2005. Everybody is sitting around, watching and waiting, and then we fast forward to 2013, the same exact scene, and we see clearly a major difference in technology with respect to how people are receiving this. So we’re moving in a pretty fast world.

This slide is just the previous two, side by side. The next slide is basically saying that companies don’t last particularly long these days in comparison with the past. If you look at the population of U.S. companies in the S&P 500, they don’t stay there very long. There’s constant change and flux. Again, I feel a
little bit uncomfortable saying this, having the benefit of tenure, but things out in the real world, I do realize that they’re different—that’s why, Steve, I’m so happy in academia, I suppose. I just don’t think that the world as it exists gives us the time that we may need.

This final slide simply shows, again, kind of how much more quickly things are moving these days. In the far left column we see these iconic American companies—Coca-Cola, Boeing, Lilly—taking a century, essentially, to reach a market capitalization of $100 billion. We flash forward today and we see Google and Facebook going in less than ten years—a tremendous increase—and there’s no reason to believe that this rate of acceleration is going to slow down. Similarly, we see equal rapidity with respect to a value destruction, that is the speed with which companies like BlackBerry, Sony, Kodak can lose billions of dollars or all of their market capitalization, all of their value for shareholders.

With respect to this long-term, short-term debate and the position that’s taken, I’m reminded that one of my favorite movies Apollo 13, starring Tom Hanks, where he and his colleague on the LEM device are hurtling back to the United States and they’re asked to make various adjustments, and Tom Hanks says to the Space Control Center in Houston, “We simply don’t have that much time.”

Thank you.

[Applause.]

PROFESSOR ROBERT T. MILLER: Let me first say that we had hoped to have Bill Allen, former Chancellor Allen of the Delaware Court of Chancery, here instead of me, but unfortunately his health doesn’t permit him to be with us today. Besides being on the faculty at New York University, Bill is, of course, of counsel at Wachtell Lipton. He would probably be more inclined to agree with Steve than with Lucian or Jon. Although I’m responsible, and not Bill, for everything I’m about to say, I see my job here as to try to put the best case forward for there being a legitimate problem with short-termism.

Thinking about that issue, the first thing that struck me was that there are many people concerned about short-termism (Professor Bebchuk lists lots of them in the first section of his
Columbia Law Review article from last year), and it may be that these people are not all concerned about quite the same problem. In most cases, they're motivated by what they think of as clear examples of activist shareholders, along with the market more generally, pushing boards of directors to engage in short-term rather than long-term projects, and they see this as being bad. And they certainly start off with nothing like Professor Bebchuk's evidence, but sort of an intuition or an impression that something is wrong here.

From that, it's not immediately clear exactly what the problem is. In a very interesting section of Professor Bebchuk's paper—the section I think is actually the more important and revealing—he has to take about three or four pages to nail down precisely what the supposed problem is before he can go out and do an empirical study on the issue as he finally defines it. So he has to do a bit of interpretation on what the problem is in order to formulate a proposition that is sufficiently specific to be proved or disproved by statistical, empirical evidence. And what I'm going to suggest is that the interpretation that Professor Bebchuk uses, which is undoubtedly one that many people actually have in mind, is nevertheless not the only interpretation of the alleged problem with short-termism. In fact, there is another interpretation of what the problem is, and this interpretation is not touched one way or the other by Professor Bebchuk's statistical analysis. Moreover, I think that this interpretation probably better captures what the best informed people who worry about short-termism are actually concerned about.

As you'll recall, Professor Bebchuk's interpretation includes the idea that activist shareholders, along with the market generally, force boards of directors to undertake actions that cause share prices to go up in the short term (however you define that) but down in the long term (however you define that), and he very rightly points out that this is only possible if markets are informationally inefficient in some pretty important ways. For, if markets are informationally efficient and if this problem really exists, it's impossible to see why, if we all know the price is going to go down in the long term, the price doesn't also go down in the short term as well. If we all know the price is going down tomorrow, that means the price is going to go down today, so the
problem can't exist. In Professor Bebchuk’s formulation—and as I say, this is the formulation that a lot of people do have in mind—there is an assumption that the market is, in this very important and systematic way, inefficient.

The interpretation I'm about to give you is one that’s consistent with the market being efficient in all relevant ways. So what is this other possible interpretation? I ask you to take a step back and imagine that there is a given investment and two investors each considering whether or not to make the investment. What should they do? Well, the first thing they have to do is they have to determine what they think the future cash flows of this investment will be. Let’s assume they agree completely on what those cash flows are likely to be.

The next thing they have to do is discount those cash flows back to present value to figure out how much they should pay for them today. So, what rate should they use? Well, that depends on the riskiness of the cash flows. Let’s say they agree on that (you can imagine them agreeing on the variance or standard deviation of the expected cash flows, for example). Do the two investors then necessarily agree on the discount rate? Answer—no, because they might have different risk tolerances. Let’s assume they have the same risk tolerance as well. At this point, will they agree on the discount rate? The answer is again no. And one of the reasons that this will be, the primary one, I think, is that different people have different values for the pure time value of money. Some people want their money faster than others.

Everyone prefers money faster rather than slower, but for some people the preference is stronger and for other people the preference is weaker. Because of this, the people who want their money back faster will tend to use high discount rates. The people who are willing to get their money back later will use lower discount rates. So even when people agree completely on the objective characteristics (expected values, standard deviations) of the future cash flows related to the investment, they might value it differently if they have different discount rates, because of when they want their money back and what their preferences are, how much they're willing to sacrifice today in order to get a dollar tomorrow.
This is very important in this debate. Imagine two investors, one of whom wants his money back faster than the other—i.e., one of whom has a higher discount rate solely because of time-value of money concerns. Imagine these two investors are now considering two separate investments. In one the cash comes back quickly. It's front-end-loaded on cash flows. In the other, the cash comes back later. It's back-end-loaded on cash flows. These two people may agree on all the objective characteristics of two investments (expected cash flows, standard deviations, etc.) but nevertheless disagree on which investment they'd prefer to have. People with higher discount rates will tend to favor the investment with front-end-loaded cash flows. People with lower discount rates will tend to favor the investment with back-end-loaded cash flows. Even though they agree completely on everything about the characteristics of the two investments, one could choose one and one could choose the other, because of their different discount rates that they're applying. And I'm eliding over a few details at this point, but, in general, if you have a higher discount rate you will tend to be a short-termer, and if you have a lower discount rate, you will tend to be a long-termer.

Now, why is this important? Well, consider the short-term, long-term problem like this. There are lots of people who invest in the market, individuals who are investing because they are investing for their retirement, they are investing to pay for their children's college, they're investing to pay for their children's wedding, and they want their money back in twenty or thirty or forty years. I'm forty-four years old; I still think of myself as having a thirty-year time horizon on my investments. I'm still in low-cap, high-risk stocks. Other people are going to want their money back faster. Those would be, for example, activist shareholders, and possibly—and Steve touched on this point—the large mutual funds who are managed by agents on generally behalf of small, long-term investors, which agents nevertheless themselves have shorter time horizons and so higher discount rates because they are judged according to whether or not they beat the market over short periods of time, such as quarters or years. They are judged on rather short-term results. Their compensation is based on short-term results. It's possible that the people running the mutual funds and running the money market
funds and so on are looking for short-term results and so have higher discount rates than the individuals who are investing for the long term.

Now, imagine we have a company whose board of directors has decided on a certain project. The project is basically a long-term project. If you discount the cash flows from this project at lower rate, reflecting a lower time-value of money, it turns out the shares should be worth $60 a share. But, the company's shares trade in a market dominated by large institutions, and the people who are running these institutions are going to be applying higher discount rates reflecting a higher time-value of money. So when you get the market rate, which is a blend of everybody's rate, the shares don't trade at $60; they're trading at $50.

And then along comes an activist shareholder. He requests a meeting with the board of directors, and he says to the directors, “You guys are all wet. You shouldn't have these long-term projects. You should have a shorter-term project. Let me show you what it is. If you switch to the short-term project and you apply higher discount rates to it, you know what? Your share price will go up from $50 to $55.” And this can be completely correct. The board of directors, knowing that the money managers and the active shareholders and ISS will tend to favor this, capitulates. They change their project from the long-term to the short-term project. The market, with its preference for higher rates reflecting a high time-value of money, likes this. The company's share price goes up from $50 to $55, and it stays there, completely consistent with everything Professor Bebchuk has found. However, if the company had stayed with the long-term project, and if the lower discount rate reflecting a lower time-value of money were given effect in the market, the shares would actually trade at $60.

Does this actually happen? My guess is sometimes yes, it does. How often does it happen? I have no idea. The people to whom it does happen tend to hire Steve, so Steve probably sees a lot of examples like this, and that may be why, in his experience, short-termism seems to be a significant problem. Is Steve's experience representative of the market as whole, or does he just see a self-selecting group of companies who tend to have this problem? I don't know, but I leave you with one suggestive fact about how often problems like this may actually happen.
Whenever there is a contested shareholder election and the activists are pitted against management in a proxy contest, whether to take over the board or just to elect a short slate, there is one constituency among the shareholders that very consistently votes for management by large majorities. Do you know who those people are? Retail investors, the people who undoubtedly have long-term goals in mind.

Now, you may say, yes, those people who are generally unsophisticated and they’re bamboozled by management. Possibly. Nowadays, however, when activist shareholders wage very public campaigns in proxy contexts, it would seem that unsophisticated retail investors are just as likely to be bamboozled by the activists as by the directors. Thus, it may be that the retail investors are getting it right. The large institutional shareholders tend to do what ISS tells them to do, and sometimes they vote with management and sometimes they vote with the activists, probably with a strong tilt towards voting with the activists. Maybe, the institutional shareholders are smarter, but maybe too they’re suffering from the agency problem and they’re implementing higher discount rates for reasons of their own, not the lower discount rates the individuals who invest for their retirements would prefer.

So I think it’s possible in this interpretation that the market is perfectly efficient, Professor Bebchuk’s results are absolutely correct, and, nevertheless, there is a significant problem with short-termism in the market. Thank you.

[Applause.]

JUDGE E. NORMAN VEASEY: Okay. I sat down there so I could see the slides, see the speakers better. But now we’ll let the games begin. First of all, why don’t we take some questions and then I’ll have the panel interact with each other.

PROFESSOR LUCIAN A. BEBCHUK: Could we do reactions first?

JUDGE E. NORMAN VEASEY: Yes, but first we’ll take some questions.

PROFESSOR RICHARD EPSTEIN: [Speaking off mic.]

JUDGE E. NORMAN VEASEY: Who wants to take that one on? All right, Robert.
PROFESSOR ROBERT T. MILLER: Could you just say it a little more clearly, because I'm not sure I quite followed it, how the market would get segmented into long-term and short-term? Do you mean by different companies?

PROFESSOR RICHARD EPSTEIN: Assuming the market is efficient, if there are different projects, some of which have front-end loaded cash flows and others of which have back-end loaded cash flows, wouldn't you expect that these projects would get separated and that they'd each get done, each backed by the investors who, because of their difference discount rates, value the project mostly highly?

PROFESSOR ROBERT T. MILLER: I think the answer to that is it doesn't work that way, because what you're talking about is whether the particular assets of the corporation are going to get deployed into this use or that use. It's not physically possible to do both projects. And we might be able to think of cases where, if we have a long-term business and a short-term business, and you spin one out or something like that, but in general, no. We're talking about which way particular goods and services inside the business are going to get used. I know you had a second question too, and but all I heard of it was, "Am I right that . . . ?" The answer to that second question is probably yes, but the only reason I have for that Richard is that I think you're usually right.

[Laughter.]

JUDGE E. NORMAN VEASEY: Okay. Lucian?

PROFESSOR LUCIAN A. BEBCHUK: Richard, you are usually right but in this case you might be right but I think you are focusing, on Robert did, on a situation which is not part of our work, just factually. So both of you are concerned, and Steven was concerned before, about what happens after five years, and if things turn badly after five years, you are concerned that some retirees would suffer. And Steven was saying, "Why did you choose to look for five years?" So, a few reactions to this. One is we chose to look—and Robert was saying we spent some time defining the question—we actually took our question from Martin Lipton. I had a quote on the slide, Martin Lipton said, "Look at the operating performance and the stock returns after two years." So Steven says you look for two after five. You academics have a lot of
time. You did two to five. Why don’t you look five to eight? Probably if we didn’t find anything there you would say, look from ten to twenty.

So the reasons are the following. One is CEOs right now have an average tenure which is not higher than five years. If you take just an inside, on average, given those numbers, they probably have, from this point on, a horizon that isn’t longer than three years. So the idea that if we insulated the CEO, and the CEO has a horizon of four years, you would get someone that focuses ten years from now. It’s probably not there. More importantly, I think we have every reason to believe that this effect doesn’t show up after five years. It can be done, but if you really believed that you have this effect, then, Steve, you could become even wealthier than as a partner at Wachtell Lipton. You can just have an index fund that takes the shorts companies five years after activism, and if you are right that there is a decline, that ETF would be better for us to invest for retirement than an ETF that holds companies five years.

Now, nobody in the market is trying to do this, which suggests to me that there isn’t really any significant belief in this world that five years out there is a reversal. But if you want we can go and do this. The only thing that I would like you to do say to this wonderful audience is if we do—because Martin says the important question is to look after two years. So my sense was if the numbers come out differently, that might lead him to refine his views somewhat. Now, when I listen to you it seems that you remain kind of completely with the same view, even though the numbers came differently. If you tell me, if you look at the numbers from five years to ten years, and if you don’t see a reversal, that would affect my view, we’ll be happy to do the study for you.

STEVEN A. ROSENBLUM: I don’t know what the study would show if you did it because every study you’ve done supports your world view and your ideology, so that’s why I’m a skeptic about statistics. I concede that I don’t have the economics background to attack the methodology. I think I was trying to make a different point, which is that even if the studies are right, there’s just no doubt in my mind—and you can say it’s anecdotal and I’ve only seen a small subset, and you can do a study of a
universe of 2,000 to disprove what I’m about to say—but there’s no
doubt in my mind that companies and managers and boards are
constrained by short-term pressures in the decisions they make
day to day, and that there’s no way to test whether the world
would be better or worse if they weren’t constrained.

PROFESSOR LUCIAN A. BEBCHUK: There’s no piece of
evidence in the world that would convince you to change your
views?

STEVEN A. ROSENBLUM: As to what I see, in terms of
the actions taken and the thought processes taken by the
companies that we interact with, no, I wouldn’t change my view
because it’s what I’ve seen.

JUDGE E. NORMAN VEASEY: Jon.

PROFESSOR JONATHAN R. MACEY: I have to jump in
just for a moment on Steve’s side, in the following way, which is
what Steven said was that there’s no doubt in his mind, and,
frankly, there’s no doubt in my mind either that managers are
constrained by the short term. Now, what comes next is what’s
important, which is Steven says that bad, and I’m saying it’s good,
and to that I want to add that—and this is the agency cost view
and I will plead guilty—is I think it’s a good thing. This is a
manifestation of the agency view that I embrace. I think it’s a
good thing for managers to be constrained.

I’d like to spend just twenty seconds pondering the following
question, which is, how would we organize a world such that
management is not constrained in the short term? So it’s not
enough to get rid of activist investors. As Steven said—and I think
he was absolutely right—in his remarks initially, this is a broader
question than just activists. The first thing we would have to do, I
think, is to get rid of quarterly reporting, because what’s
happening is managers have the market, analysts who follow
stock are coming up with numbers, whisper numbers, consensus
numbers about what earnings are going to be per share in a
particular time period, the quarter, and people are really focused
on that, and the earnings may be disappointing, and the stock
goes down, the earnings may be better than expected and the
stock price goes up—this is causing managers to focus on the short
term.
Now, my point is twofold. Number one, I think the cure would be way worse than the disease of getting rid of financial reporting, so there was no benchmark against which to base, and that one of the things I'd really like to hear from the kind of alternative camp is if we are going to move to a world in which we seriously try to address what is, in my view, improperly but is being characterized as a problem of focusing on short-termism, what is going to replace it? Because right now what we have—and here's the one example of the academic world not being monolithic—there's a person at Cornell, Lynn Stout, who has written this book that's very consistent with the sort of Wachtell view of the world, saying managers should be unconstrained, that that's the approach. The approach seems to be either we have a world in which people are cowering in the face of stock prices and are having to focus too much on the short term, or on the short term, or a world in which we have unconstrained management. We're not going to find a utopia where we somehow wave a wand and everybody is happy with the way U.S. public companies are being run, or with the performance of such companies.

So I guess in an imperfect world, where I'm forced to choose between an unconstrained management model and a world in which management feels pressure to perform in order to avoid shareholder activism or takeovers or board anxiety and pressure, you know, I'd take the short-term world.

STEVEN A. ROSENBLUM: Jon, I think you're creating a binary choice. Those aren't the only two choices. For example, there are jurisdictions where you don't have quarterly financial reporting. That doesn't mean that you get rid of financial reporting all together.

PROFESSOR JONATHAN R. MACEY: I just said get rid of quarterly—

STEVEN A. ROSENBLUM: Or you could have annual—

PROFESSOR JONATHAN R. MACEY: Right, or every five years.

STEVEN A. ROSENBLUM: I actually think it would be good to get rid of quarterly financial reporting.

PROFESSOR JONATHAN R. MACEY: Wow. Okay. Thank you for letting me know that. All right.

[Laughter.]
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PROFESSOR JONATHAN R. MACEY: I thought it was just a ten-day window. This is getting better all the time.

[Laughter.]

STEVEN A. ROSENBLUM: We were talking before the panel about an article that Marty and I did back in 1991, proposing five-year terms for boards and having them elected once every five years, but having full proxy access. We've been opposing proxy access in its current incarnation, but in that context we proposed having a full proxy access system. We're not trying to get rid of accountability. As I said before, we counsel our clients to talk with activists. Certainly every company, every responsible company, is out on a regular basis with a very significant program to talk to their major shareholders and get input and consider ideas. And maybe this is where we differ. My experience is that boards tend to be responsible. Not every board is responsible—I can't say I've never seen a bad board—but boards tend to be responsible. Directors tend to want to do the right thing. And the goal is putting them in a position where they can.

JUDGE E. NORMAN VEASEY: Lucian, go ahead.

PROFESSOR LUCIAN A. BEBCHUK: Steven, can you maybe explain to us—you have this strong preference not to use empirical evidence and to rely on impressions by significant individuals, and I understand that you talk with a lot of people who are your clients who say, "We feel this adversely affects our companies." Now, you probably have, on the other side, if some hedge fund activist told you our experiences, that we produce huge amount of value, you would probably not be willing to have public policy be based on the impressions of the activist, and I wouldn't do so either. That's why I think we need empirical evidence to somehow resolve when you have impressions on both sides, when both sides have their interests.

So the idea that, in this area of public policy, we would put aside the evidence and would base them on the views of one side of the practice—does that seem to you the best way?

STEVEN A. ROSENBLUM: Lucian, I think the kind of studies that you run, and I think Norm said you have over 100 research papers, are inherently limited. I'm not saying that you shouldn't run them—they're interesting to read—but I don't think
that’s the sole basis for setting policy and I think your unwillingness to go out into the real world and understand how businesses are run and what people are thinking is equally subject to criticism as your criticism of us for not accepting your studies at face value.

PROFESSOR LUCIAN A. BEBCHUK: There is a marketplace of ideas in financial economics, so when I write a paper, there are a lot of financial economists who are interested in publishing papers, and if you see there are many issues Corporate Finance where people are coming up with mixed evidence and evidence on both sides, and people are working on those issues. I understand that you don’t find my study, but doesn’t it bother you that there isn’t a study which is the opposite conclusion, and does it bother you, or wouldn’t you want to try to facilitate people who would study this? Because Martin, in his memo, said the important question was not what business leaders think but the important question is what is the effect on stock returns and operating performance. Those are hard numbers.

JUDGE E. NORMAN VEASEY: Before you answer that, Jon wants to say something.

PROFESSOR JONATHAN R. MACEY: I’m learning a lot and enjoying myself tremendously. I would like to focus on this comment about should we get rid of quarterly reports and move to some other timing sequence for reporting such that we don’t focus people very much on the short term, and the first thing I thought to myself is, this would be a great study because we could take a bunch of companies that did only annual financial reportings and some that did quarterly, but we’re never going to be able to do that because the companies that only did this annually would be in violation of the federal securities laws. But we do have a set, which are companies that are closely held—limited liability companies, companies that aren’t subject to the securities laws’ reporting requirements; they’re only subject to state law, and state law only requires annual reporting, but we observe that these companies, nevertheless, provide their investors with quarterly reports. That is, people aren’t willing to invest in companies and wait a year prior to looking at financial results. That, to me, is some evidence that the quarterly reporting system is superior.
One question that maybe we should address frontally is this issue of in an equation and deciding corporate policy, how much weight should we give to what managers say as distinct from what investors say? The investor argument is it's their money. The management argument is the one that you make, which is certainly right, which is, well, management are inside the company, the investors are outside the company. They have all this institutional knowledge and detail.

My preferences are pretty well known at this point, but I do think that's an interesting data point is to just observe what companies do when they're not constrained.

JUDGE E. NORMAN VEASEY: Steve.

STEVEN A. ROSENBLUM: I think in the U.S. it's true that when a company gets taken private it continues with quarterly reports because that's what investors are used to in the U.S. It's not the case in every jurisdiction around the world that you have quarterly financial reporting. The other thing is private companies tend to want to be at least in a position to go public at some point. So I think to some extent it's inertia and custom that causes the private companies to continue with the quarterly reporting. But I do think private companies have an advantage in the short-term versus long-term issue because I think private companies tend to have, anyway, a core of share owners who are a cohesive, smaller group, who do have a longer time horizon. They don't have an infinite time horizon but they're looking at a three-year to five-year time horizon. Private equity firms will tell you they want to know the quarterly earnings because that's what they're used to, but if you miss a quarter, or two quarters, or three quarters, as long as they're happy with why you're doing it and where you're going with it in the longer term, they're fine.

JUDGE E. NORMAN VEASEY: Let's let Robert jump in here, if he wants to.

PROFESSOR ROBERT T. MILLER: I do. Here are two points about what we mean by the short or the long term, and they sort of pull in opposite directions. Imagine an investment banker is valuing a company. What the bankers usually start with are five-year cash flow projections for the company, and then they have to have some notion the value of all cash flows after those five years, and that's called the terminal value in the discounted
cash flow analysis. It turns out that probably, depending on the rates you're using and the growth rates and so on, more than half of the value of the company, maybe a lot more, is in that terminal value, and the way you calculate the terminal value is you take the cash flow in year five, and you assume it's going to grow at a certain rate from now until the end of the world. You treat it as a growing annuity. So most of the value of the company is stuff that happens after five years, so that tells you that the "long term" should be understood to be the period that's way out there, beyond five years, because it's assumptions about that time period that are determining more than half the value of the shares today.

On the other hand, everybody knows that you can't realistically plan a business more than five years in advance. Almost no businesses make make ten- and fifteen-year plans. When the bankers come to the company and they say, "Give us your cash flow projections," the company sometimes only has three years, and they have to create the fourth and fifth year specifically for the bankers. So we are always attributing large values to companies based on our expectations about events far in the future, after five years, when we know we don't really have any good ability to plan that far. So where should the long-term be? Standard valuation techniques suggest both that it should be beyond five years and that anything beyond five years is largely unknowable. This is paradoxical, at best, simply incoherent at worst.

PROFESSOR LUCIAN A. BEBCHUK: I think that both Robert and Steven have skepticism about the wisdom of investors that is not warranted. Both of you say, look, this is this long tail, and the investors can't really appreciate it. Only the managers can see and place value on it. But if any of you just looked at stock prices, you'll see that that's unlikely to be true. Just look at high-tech companies. So, on the one side, we have Apple that trades at the low PE ratio. Why does it trade at the low PE ratio? Exactly because there are investors who are looking out six, seven—I mean, if everybody was not looking seven years from now, it would trade at the much higher multiple, but they are looking seven years from now, and they are doubting that they would be able, correctly or incorrectly— they would be able to maintain the kind of earnings.
At the same time, there are companies that trade at massive multiples, like Twitter or Facebook. Why? Because there are investors who are looking out and they are speculating that in seven years or in twelve years from now that we'll be making profits. Now, those are people who invest massive resources, who spend a lot of time thinking about those issues, and it seems to me that both Robert and Steven are just not placing appropriate weight on the wisdom of investors in understanding the world.

JUDGE E. NORMAN VEASEY: We have people at the microphones and others who want to ask questions. Please get in line at the microphone, but please go ahead, sir.

ATTENDEE: The differentiation between short term and long term as it's being discussed in this room right here right now seems to be a bit artificial. It doesn't matter if it's five years, ten years. The truth of the matter is a good long-term investment is a series of good short-term investments, and really what makes the difference between a good long-term investment or a poor long-term investment is the strategy that's used over the course of the short term. And I think that this plays to what Steven has been saying, or trying to say, is that there isn't really any way of quantifying the strategy that's being employed. So the statistics do tell us a lot, and I don't think there's anybody in this room that's attempting to argue that an empirical approach to a problem is not a good one, but you have to know what it is that you're measuring.

So when you look—has anyone played chess? Have the panelists played chess before?

PROFESSOR JONATHAN R. MACEY: Yes.

JUDGE E. NORMAN VEASEY: Sure.

ATTENDEE: Yes. Okay. If you look at a chessboard at three moves into the game and then you look at the chessboard again twenty moves into the game and you do an empirical analysis of the difference between the positioning of the pieces at those two points in time, it really doesn't tell you anything.

So if you look at the positioning of a stock price at one point in time and then you look at the positioning of that stock price at another point in time, that tells you just as little as the chess board did. So it seems to me that the conversation is kind of missing the point a little bit, and I'd just like to know, is there...
anyone who thinks that, really, strategy is the key piece here that nobody has really been talking about?

JUDGE E. NORMAN VEASEY: Well, let's start with Professor Macey is answering that.

PROFESSOR JONATHAN R. MACEY: Well, two things. One, with respect to your chess premise, the fact is that we observe in chess, people resign before games are over, and it must be the case, because they don't resign before the game starts, that the new positions of the pieces on the board as the game progresses is providing them with some information about the quality of their strategy and the quality of their opponent's strategy, or to put it differently, share prices reflect the market's assessment, i.e., an unbiased assessment, of the qualities, of the strategies that management is deploying as they go about running the company. And the debate is about the market's efficacy and accuracy with respect to a comparison between the market's ability to evaluate long-term strategy versus short-term strategy.

Something that Robert just said, it was completely devastating to the position he's taking, that somehow that managers are focused maybe too much on the short term, is that we have an acknowledgment that when we look at, when we value companies, a very large portion of that value is valuations about how much wealth a company is going to contribute in the long term; that is, what are the values of the business five years out. Those are assessments about strategy because no one is talking about the breakup value of these companies. Nobody is talking about taking the assets and just selling them. People are talking about valuing them as an ongoing concern which means valuing the strategy that's being used in the deployment of those assets, and the question is are share prices a legitimate mechanism for evaluating strategy, and people obviously disagree here. I kind of think yes, and other people think maybe not so much.

JUDGE E. NORMAN VEASEY: Okay. We have fifteen minutes to go. We have four more people, at least four more people who want to ask questions. Please, sir, go ahead.

ATTENDEE: Thank you. I haven't heard anything in this discussion so far about the impact of corporate taxation and capital gains taxation, and I raise that because I think it's generally accepted that not only corporations, but investors are
heavily influenced by the tax laws in terms of, from a corporate standpoint, how they invest, where they invest, how they fund that investment, and of course, investors from the standpoint of, again, what their tax status is. In a way, we've seen that in the recent debate over inversions with U.S. companies merging into foreign companies in order to reduce their tax bill.

My question is this. As we talk about corporate short-termism or the lack thereof, how should that debate feed into the debate that supposedly will become more intense next year over corporate tax reform? To the extent that taxes do influence both corporate management and investors—and we're talking about public policy—what should be the input of this panel and folks like you on the corporate tax reform debate that is supposed to increase next year?

JUDGE E. NORMAN VEASEY: Steve?

STEVE A. ROSENBLUM: Well, I think the whole question of tax policy is a very important question, and I'm not really sure how it feeds into the short-term versus long-term debate, but I do think that certainly at the corporate level the tax structure does drive behavior that can also be suboptimal in the same way that slavery to short-term quarterly earnings can drive suboptimal behavior.

In particular, some of what was driving inversion transactions is the fact that you have multinational corporations that have huge amounts of cash trapped overseas, that they don't really have a good use for overseas, but if they try to bring it back to the U.S., they'll have huge tax leakage, so they leave it overseas in suboptimal uses. And I think that's an issue that needs to be addressed. The corporations were trying to do that with self-help, with the inversion transactions. The inversion debate has a lot of other issues involved, but I think if tax policy is going to say we don't want inversions because we don't want U.S. companies moving offshore, then we have to address the ability to rationalize the tax system to allow companies to make use of their offshore cash rationally.

From the individual perspective, it's actually interesting. I think our general view or experience is that a lot of institutional shareholders are actually not tax motivated, even though their decisions in terms of trading and holding periods and so forth
have a significant impact on the tax consequences for their investors. But it's one of the agency problems that I mentioned in passing about money managers. They are judged in terms of their pretax return. So they make decisions that are not always mindful of the tax impact on their underlying investors, which I think is a disconnect that ought to be addressed, but nobody seems to really be focused on it.

**JUDGE E. NORMAN VEASEY:** Okay. Let's get the next question, please.

**ATTENDEE:** Okay. Well, if you just turn on CNBC on the subject of activists, the party line will be, "We like it when they go after weak managements, but we don't like it when they go after strong managements. The empirical data you've shown seems to say mostly the hedge funds in the past, the activists have done over underperformers. However, I could easily see in the future, as corporations up their game and we have more and more activist hedge funds, that they'll start going after a different class of targets and the data will change. I think the empirical data is fine, but it doesn't tell me anything about what I should do for public policy or what that's going to look like in the future.

Now, my question is as follows. For anyone on the panel who would like to respond, we haven't heard a word about nonvoting stock, fully entrenched management, blessed by the shareholders, sometimes generations in the past, and those management, they still have to live in a short-term world. They have to produce quarterly earnings, but they have some of the pressures off them. Has there been a lot of empirical work on that and how they perform? What's your view of that? That would be the co-op, I think, in Richard Epstein's world.

**JUDGE E. NORMAN VEASEY:** Lucian?

**PROFESSOR LUCIAN A. BEBCHUK:** You had two questions. So on the first one about companies that are not underperforming, the data from the past includes some companies. Most of the companies were underperforming.

But there might be a company that is performing well but has some population problems, like it's doing well, its current business, but it's holding too much cash. It would make sense in such a case for activists to engage with it.
The important point to remember is that activists have a built-in reason to go only after companies whose value they can improve because, in the end, if they are not going to improve their value, they are not going to make a profit.

On your second question, yes, there is some data that shows that dual class companies perform less well. This is consistent with the views that Jon was expressing before that not having any discipline leads to managerial slack, and this raises issues of public policies, a complicated question, because, obviously, those companies went public with this structure, and that's something that should be taken into account. But there is evidence that is consistent with the possibility that insulation from the market, also in the context of nonvoting stock, has adverse consequences.

JUDGE E. NORMAN VEASEY: Okay. There's another question out there. Sir, please.

ATTENDEE: Yes. As a private investor in dozens of publicly traded companies and a scrupulous reader of their annual reports and proxy statements, I have found two things. One is the corporation's management has a huge advantage in public communication to its shareholders over all opposing views, and number two, in many cases, compensation of board and management is not terribly reflective of results of the corporation. They all use the same consultants who make the same studies, using the same comparables, which are the same companies that use my company as a comparable, and they all come to the conclusion that compensation should go up, even though the stock price and dividends are down, not always, but very often.

So as a retail investor, my question is, if we eliminate activist shareholder involvement or severely curtail it, what other mechanisms are there to move a management that is sitting there very comfortably and there are very few mechanisms to otherwise move them to action to make them do things to increase shareholder value or change things when they're not going in the correct direction, other than out of their benevolence or the goodness of their hearts?

JUDGE E. NORMAN VEASEY: Who wants to take that?

STEVEN A. ROSENBLUM: I think benevolence and goodness of heart is actually a pretty powerful motivator, and I say that a little facetiously, but honestly, part of the concern I
have with the academic literature is the widespread distrust of boards and managers. I am not going to say every board and every manager is good, but I also think it’s a vast injustice to say that every board and every manager is just trying to look out for themselves and they need to be disciplined.

I don’t think we should get rid of shareholders. I don’t even think we should get rid of activists. I think as my senior partner, Marty Lipton, famously said a few months ago, there are good activists, and he named a few. And he named a few bad activists, which created probably more controversy than it should have. But as I said before, our advice is that boards and managers should listen to the shareholders and should understand what their views are.

The question of compensation is a whole different topic that we could have a whole panel on, but the irony is that part of what’s responsible for the massive rise in executive compensation is the notion which came from the activists or the institutions that you want to align the interest of managers with the interest of shareholders, so you’ve got more and more stock compensation. Stock compensation is riskier, so managers ask for more of it proportionally, and you end up with these outsized compensation packages, which honestly some of them I can’t defend. But it’s a function of the trend to stock compensation, that and the fact that the SEC keeps requiring more and more disclosure so every single executive knows exactly what every other single executive is making down to the penny. It has created this spiral that, personally, I think does need to be addressed and gotten under control.

JUDGE E. NORMAN VEASEY: Okay, Jon?

PROFESSOR JONATHAN R. MACEY: I just quickly wanted to dispel the canard, Steven, that those of us who think activist investors bring good value to companies somehow think that all management is malevolent because the fact is—

STEVEN A. ROSENBLUM: I didn’t say malevolent, but self-interested and needing discipline.

PROFESSOR JONATHAN R. MACEY: In needing it. So the point merely is that if you look at the universe of U.S. companies, only an extremely small percentage are subject to activist agitation. So the idea is in order for me to feel comfortable
in my position analytically, it's sufficient for there to be some small subset of public companies whose managers are not acting in shareholders' interests sufficiently such that they cause a significant enough gap in the market price versus the price under an alternative, more vigorous management structure to attract the interest of these activists because their shares are so undervalued.

In other words, most companies, I do think it is true that activist investors have an effect on management even if companies that they don't specifically target because people want to keep—managers want to keep their share prices high in order to avoid being an attractive target for an activist investor, but I don't see that as an indictment of all of management at all. That it's just to say it's a very large world out there, and a lot of managers—and not all of them—some of them could be doing a better job.

JUDGE E. NORMAN VEASEY: Okay. Wait. Whoa, whoa, whoa. We have questions out there. We have a limited amount of time. Lucian, if you have a thirty-second comment on this question, please do it.

PROFESSOR LUCIAN A. BEBCHUK: Yeah. I also want—

JUDGE E. NORMAN VEASEY: And Robert.

PROFESSOR LUCIAN A. BEBCHUK: —to make a comment. My view is not that executives and directors are, quote/unquote, bad people. We stress in our book Pay Without Performance that examines those issues that we fully accept that directors are the best and the brightest. The issue is that—and I think that it shouldn't—people in the Federalist Society convention should be fully prepared about this—that we generally believe that most individuals are subject to economic incentives. When we think that sometimes regulators or people in various positions are not performing well, it's not because we think that they are bad people. We think that they might not have the right set of constraints or disciplines or incentives.

JUDGE E. NORMAN VEASEY: Okay. Robert?

PROFESSOR LUCIAN A. BEBCHUK: And the incentives are critical.

JUDGE E. NORMAN VEASEY: Your thirty-second comment?
PROFESSOR ROBERT A. MILLER: Falls very nicely after that. I don't think there's a serious problem with activist investors either. One thing that Lucian says very wisely in his article is that activist investors succeed only if they can convince a good part of the market or their shareholder base that they are right. So if there is a problem here, it's that the fund managers and the pension managers have perverse incentives precisely because they're agents and are judged on short-term results rather than longer term results that their investors would really care about.

Again, I would be with Lucian there. It's not that they're bad people. It's that they're subject to the wrong set of incentives.

JUDGE E. NORMAN VEASEY: Okay. Last question.

ATTENDEE: Steve, in light of your clients’ complaints about all this, has there been an uptick in go-private deals, and if not, why not?

JUDGE E. NORMAN VEASEY: Steve?

STEVEN A. ROSENBLUM: I think go-private deals ebb and flow, and they are subject to a lot of other factors: feasibility, the ability to get financing at good rates, the ability to pay a premium that will be attractive to shareholders to get the deal done. I think there are certainly a lot of people who are interested in the possibility of going private, but there are a lot of factors that go into whether a company actually goes private.

JUDGE E. NORMAN VEASEY: Okay. Thanks to this panel, and thanks to this audience. We appreciate it very much.

[Applause.]