TURNING A SHORT-TERM FLING INTO A LONG-TERM COMMITMENT: BOARD DUTIES IN A NEW ERA

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Corporate boards face significant pressure to make decisions that maximize profits in the short run. That pressure comes in part from executives who are financially rewarded for short-term profits despite the long-term risks associated with those profit-making activities. The current financial crisis, where executives at AIG and numerous other institutions ignored the long-term risks associated with their mortgage-backed securities investments, arose largely because those executives were compensated for the short-term profits generated by those investments despite their longer-term risks. Pressure on boards for short-term profits also comes from activist investors who seek to make quick money off of trading in stocks whose prices overly reflect short-term firm values.

Yet this excessive focus on producing short-term profits runs counter to the interests of non-short-termist investors, other corporate constituents, as well as our economy and society as a whole in creating corporate enterprises that are profitable on an enduring basis. Once again, the current financial crisis provides a lens through which we can see the distressing impact – both to individual businesses as well as to the entire U.S community - of an excessive focus on short-term profits.

I propose a solution to address this problem of short-termism. Under my proposal, directors would be required to make decisions that are in the long-term best interest of stockholders and the corporation under their fiduciary duties. I explain in the article why I propose fixing the short-termism problem through fiduciary duties as well as how, practically, my proposal would be implemented.
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INTRODUCTION

There is significant pressure on boards of directors, both from executives as well as from investors, to oversee businesses that generate profits in the short term. That often leads to board decisions directed at producing profits over a short period of time, such as six months or a year, without regard to the ill effects of those decisions on the longer-term health of the business. This tendency to manage for the short term, or “short-termism,” in large part explains the near collapse of institutions like AIG and Merrill Lynch that seemed almost impregnable just over a year ago, as these institutions failed to address the long-term risks associated with their mortgage-related investments.¹

The pressure from executives on boards is widely believed to be due to executive compensation arrangements that reward executives for short-term profits. This is apparent from the recent passage of two economic stimulus laws that impose severe limits on executive compensation that is not tied to long-term performance.² While the Obama administration and Congress have seized on the current financial crisis and the dire need for capital to attempt to restrict key executives and other top employees from being financially rewarded for risky, short-term decisions, it seems obvious that excessive short-termism is not confined to the tidy group of individuals whose compensation is regulated at institutions that obtain an investment from the U.S. Treasury.

Moreover, it seems too simple and convenient to blame short-termism entirely on the compensation arrangements of executives. In fact, short-termism seems to be pandemic throughout our public corporation model. For example, there is clear evidence that public company investors have short investment horizons, holding their investments on average for seven quarters.³ Hedge funds are short-term investors on steroids, holding

¹ See discussion infra Part II, discussing the role of short-termism in the recent economic crisis.
² See discussion infra Part I Section C, discussing the new stimulus laws.
their investments in public companies for an average of only one and a half quarters. 4 But public company boards do not set their firms’ business objectives for a one and a half quarter or even a seven quarter time period. Rather, boards typically oversee the adoption of business plans that set out their firms’ goals, and strategies to reach those goals, over the subsequent five year, or longer, period. 5 A firm’s strategy also generally contemplates how the enterprise can achieve success on an enduring basis – such as over a ten or 20 year period. 6 That means that investors hold their shares on average for less than half the time that boards look to in overseeing the implementation of the corporation’s business plan, and a fraction of the time during which corporations’ strategies are implemented.

While investors are purveyors of capital, and do not manage corporate affairs, their short-termism nevertheless significantly affects board decisions. This is apparent from the recent wave of investor activism, which has enabled investors to influence boards much more significantly than they had previously been able to do. 7 This is due in large part to the informal channels investors have been using to influence boards, such as public demand letters and publicity campaigns. 8 This informal strain of activism has, in turn, enabled investors to expand the types of requests that they make on boards to matters beyond the scope of what has been considered appropriate for shareholder action. This is particularly concerning as the investors who most commonly use these informal channels of influence are investors, such as hedge funds, which have the shortest of investment horizons. 9 The longer-term, impairing effects of many of these instances of activism tend to support the conclusion that these investors are using these channels of influence to their short-term advantage, despite the potentially long-term impairing effects they have on the firm.

Yet even with these pressures on boards – from investors as well as executives - to create short-term value, directors are supposed to have an unyielding fiduciary duty to act in the best interest of the entire corporate enterprise of which she is a director, including the best interest of its stockholders. 10 This is reflected in the fiduciary duties every director owes to that corporation and its stockholders. 11

Thus we must ask - are directors, by furthering the interests of short-term investors and executives, meeting their fiduciary duties? Or does – or more importantly, should - fiduciary duties require that they oversee a corporation’s affairs with a view to

4 See id. (finding that hedge funds hold shares for an average of 1.5 quarters).
5 See discussion infra Part I.A.1.
6 See id.
7 See discussion infra Part I.B.
8 See id.
9 See id.
10 See discussion infra Part III.
11 See id.
furthering the corporation’s long-term success? These are the positive and normative questions I address in this article.\textsuperscript{12}

While other scholars have focused on the problem of short-termism in the modern corporation, they generally have focused on the market for corporate control as the primary source for board short-termism.\textsuperscript{13} But the wave of investor activism that has emerged over the past decade has shown that investors are able to influence boards outside of the takeover context, and even outside of the stockholder voting franchise. It has also become apparent that boards have been perpetuating this short-term corporate vision through executive compensation, where they have been rewarding executives for generating short-term profits without regard to the ill effects the efforts that created those profits have on the long-term. This, in turn, has created an additional source of pressure on boards to manage for the short-term, again, absent any takeover proposal. Because of these developments and the insights gained from them, this article proposes a mechanism to keep directors more focused on long-term profitability outside of the takeover context, all without requiring significant changes to the current scheme of fiduciary duties.\textsuperscript{14}

This article also uniquely explains how directors may discharge their fiduciary duties in the interest of both shareholders and non-shareholder constituents outside of the takeover context. While communitarian scholars have for some time advocated boards’ consideration of non-shareholder interests in making business decisions, they have tended to alienate shareholder primacist scholars who believe that the corporation should be

\textsuperscript{12} While this article focuses on the fiduciary duties of directors, the principles are also applicable to executive officers, who also have fiduciary duties to the same constituencies as directors. See Gantler v. Stephens, No. 132, 2008, 2009 WL 188828, at *9 (Del. Jan. 27, 2009) (holding that “corporate officers owe fiduciary duties that are identical to those owed by corporate directors”).

\textsuperscript{13} See e.g. Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187, 225 (1991) (identifying, as the essence of the proposal, “to convert every fifth annual meeting of stockholders into a meaningful referendum on essential questions of corporate strategy and control, and to limit severely the ability of stockholders to effect changes in control between quinquennial meetings.”).

\textsuperscript{14} My proposal would complement the proposal recently made by Professors Iman Anabtawi and Lynn Stout. See Iman Anabtawi & Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255 (2008). Under their proposal, every activist investor who has a material, pecuniary interest in any matter over which it successfully influences company action (regardless of its stock ownership percentage) would have fiduciary duties to other investors similar to those currently imposed on controlling stockholders. See id. at 1295. However, as they admit, Professors’ Anabtawi’s and Stout’s proposal might not be as usefully applied to address the conflict between investors in their investment horizons. See id. at 1290, 1301 (“It should be noted that the requirement that the plaintiff allege facts showing a material benefit not shared by other shareholders presents an obstacle to the use of shareholder fiduciary duties to address conflicts between short-term and long-term shareholders…Thus, the expanded shareholder fiduciary duty we propose may prove more difficult to employ against conflicts of interest due to investors’ differing time horizons than to other shareholder conflicts of interest.”). My proposal would address this conflict by imposing on the board the duty to manage the corporation for the benefit of long-term stockholders and other corporate constituents, even where short-term activist investors attempted to influence those decisions.
managed for the primary benefit of stockholders. This article bridges the gap between these two groups of scholars in the non-takeover context by proposing a way for boards to discharge their fiduciary duties in the interest of shareholders and non-shareholders alike without exposing directors to liability to non-shareholders for breaches of those duties.

The remainder of this article proceeds as follows:

Part I reviews the sources of short-termism. The discussion includes an analysis of how activist investors, particularly hedge funds, influence board decisions, exacerbating the board’s focus on the short-term. It also examines executive compensation as a source of pressure on boards to manage for the short-term.

Part II reveals why short-termism is bad, not just for individual businesses, but also for the health of our economy and society. This discussion looks at the economic and social costs of short-termism through the lens of the recent financial crisis, tracing the roots of that crisis to short-termism.

Part III then examines what it means under current law for directors to act “in the best interests of the corporation and its stockholders” under directors’ fiduciary duties. While the discussion reveals that directors have absolute discretion to decide over what time period to look in determining what amounts to the best interest of the corporation and its stockholders, guidance from Delaware courts imply a judicial preference for decisions that consider the long-term interest of the corporation. However, as I argue in this section, this grant of broad discretion leaves directors susceptible to influence by executives and activist investors for decisions that benefit those constituents’ interests, even where that potentially impairs the corporation’s long-term profitability.

In Part IV I examine whether it would in fact be in stockholders’ and non-stockholder constituents’ best interest for a corporation to be managed for the long term, where the board is not faced with a takeover decision. As that discussion shows, in fact each of these groups would benefit from a corporation being managed towards the objective of sustainable profitability.

My proposal, discussed in Part V, would impose on directors the duty to act in the long-term best interest of the corporation and its shareholders where the board is not faced with a takeover proposal. While some Delaware courts have expressed a preference for this type of long-term standard, they have generally not required it. Instead they have deferred to the board to set the time period for realization of corporate profitability. My proposal would eliminate the link between short-termism and board decisions by eliminating boards’ discretion to make decisions aimed solely or primarily at generating profits in the short-term. To comply with this reformulated duty, boards would need to consider how the relevant action would impact the corporate enterprise in the long-term and only pursue actions that were primarily aimed at generating that long-term benefit. This would also lead to decisions that are truly in the interests of both the corporation and its shareholders based on the conclusion in Part IV that those interests are indeed aligned in the long-term.

Part VI then concludes.
I. SOURCES OF CORPORATE SHORT-TERMISM

This section traces the sources of short-termism in the modern public corporation. It begins in Part A by assessing the sources of investor short-termism. As Sub-section 1 explains, the root of investor short-termism is the rise of the public corporation and the creation of the stock market, which encourages speculative trading by investors. Sub-section 2 explains how the information that is provided to those public company investors perpetuates their desire for short-term profits.

Because investors do not manage or oversee the operation of the corporations in which they invest, this short-termism might seem to be inapposite to the time period over which corporations are managed. But as Part B explains, investor short-termism impacts board decisions, both through the shareholder voting franchise (Sub-section 1) as well as through investor activism (Sub-section 2).

Part C assesses why executives want boards to be short-termists and how they influence boards to pursue their short-term agendas.

A. Sources of Investor Short-termism

Any discussion of why investors are short-termists necessarily begins with a discussion of the stock market, and how our stock market supports the short-term, speculative nature of public company investments.

1. Speculative Nature of Investments in Public Companies

Use of the corporate form in the U.S. became widespread in the 19th century, during the wave of industrialization.\footnote{Lawrence E. Mitchell, The Speculation Economy: How Finance Triumphed Over Industry 8, 11-12 (Berrett-Koehler Publishers, Inc. 2007) (describing how the Industrial Revolution led to the growth in size and number of corporations, partnerships and proprietorships and the blossomed use of the business corporation starting in the 1840s and 1850s with the expansion of railroads).} The corporations formed during that era were largely closely-held corporations in which the stock was held by founders, their families and friends and a limited number of associates.\footnote{Id. at 9.} However, starting in the late 19th century and early 20th century, the size of corporations grew significantly, largely due to a wave of mergers.\footnote{Id. (describing the wave of mergers from 1897 to 1903 as arising due to the desire to reduce competition, create efficiencies in size and management, and generate proceeds from the issuance of stock to the public).}

With this growth in corporate size came a broad expansion in the investor base.\footnote{Id. at 4 (noting that as a result of the merger wave, middle class investors were drawn to the market for the first time and that following the panic of 1907, small investors increased their numbers, “pick[ing] among the bargains that were the leavings of the plutocrats”).} As a result, investors held securities not out of any particular interest to finance a business, but as a way to make a profit – or for speculation.\footnote{Id. at 4-5 (describing the evolution of securities held by investors from bonds to preferred stock to common stock).}
That, in turn, gave rise to the need for a stock market, where investors could buy and sell securities to realize on the value of their investments.\textsuperscript{20} As Berle and Means recognized as early as 1932, investors of public companies thus became mere purveyors of capital, having relinquished the right to manage physical assets in exchange for liquidity.\textsuperscript{21}

The speculative nature of investments in U.S. publicly traded companies is apparent from the rate at which those securities are traded. For example, in 2006, shares of NYSE-listed companies turned over at a rate of 118%.\textsuperscript{22} That means that on average, every share of stock of a NYSE-listed company was traded at least once during the year.\textsuperscript{23} Active trading evidences speculation, for it shows that investors only hold securities for purposes of making money from those shares – not out of any interest in the success of the underlying business, which operates with respect to a much longer period of time.\textsuperscript{24}

Perhaps nothing depicts the speculative nature of public company shares better than the takeover wave of the 1980s. During that period, institutional investors were able to purchase targets at significant discounts to their fair market values using the targets’ assets as security and the acquirers’ stock as currency.\textsuperscript{25} Investors approved these transactions not because they promised a future of corporate growth and success, but simply because they provided the investors with an opportunity to realize on their investments in the short term.\textsuperscript{26}


\textsuperscript{21} Id. at 286.

\textsuperscript{22} MITCHELL, supra note 15, at 1 (citing study by John R. Graham et al., The Economic Implications of Corporate Financial Reporting, 40 J. ACCT. \& ECON. 3 (2005)).

\textsuperscript{23} Undoubtedly some investors traded more than once in 2006 while others held for the entire year.

\textsuperscript{24} See the discussion in this Section, infra, as to the period of time that management typically considers in setting a business plan.

\textsuperscript{25} See Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. PA. L. REV. 1, 32-33 (1987).

\textsuperscript{26} See Lipton & Rosenblum, supra note 13, at 213-214 (“The hostile takeover wave of the last decade both caused and resulted from stockholders' short-term bias. A dominant stockholder population anxious to accept a takeover premium encourages the hostile acquiror with the likelihood that a premium bid will succeed or that a higher bid will prevail, allowing the first potential acquiror to profit on shares of the corporation it purchased prior to making its bid. Moreover, the short-term bias tends to result in greater discounting by the market of the long-term profits of the firm, leaving the market valuation of the corporation well below the true value of the enterprise. The acquiror is thus able to make a bid that is below the corporation's value (measured in terms of the future income streams but discounted at a lower rate than that typically produced by the short-term bias). Yet the bid, so long as it is at a premium to the market, is likely to be well received by stockholders.”).
The rise of the derivatives market compounded the short-termism of public company investors. That is because investors typically do not hold options or other derivatives for longer than nine months. Moreover, investors who hold derivative securities are typically large institutions that take large positions in those securities. That fact, coupled with the sheer size of the derivatives market, often means that trades by investors in derivative securities often create movement in the price of the underlying security. Investors then attempt to profit off of these adjustments by increased trading, despite the fact that these adjustments do not reflect any actual change in the business of, or available information about, the issuer of the security.

While speculation has characterized U.S. publicly traded securities since the early 1900s, the speculative nature of equity securities has become much more notable in the last eight years, since the explosion in the use of hedge funds as investment vehicles. According to one study, hedge funds hold their public company investments for an average of 1.5 quarters, or approximately four and a half months. This holding period is much shorter than the average seven-quarter holding period for investors on the whole. One of the oft-cited reasons why hedge funds have shorter investment horizons

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28 *Id.* at 165.
29 *Id.* at 176.
30 *Id.*
31 See *id.* at 177 (arguing that these adjustments in the price of the underlying security following significant trades in the derivatives market represent a market overreaction).
32 See Greenwood & Schor, supra note 3, at 13 (finding that the median position at hedge funds is held for 1.5 quarters); see also Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579 (2006) (stating that the average turnover rate among stock mutual funds was 117 percent in 2004 and that some hedge funds turn over their portfolios nearly three times that much); Sebastian Mallaby, *Hands Off Hedge Funds*, 86 FOREIGN AFF. 91, 92 (2007), available at http://www.foreignaffairs.org/20070101faessay86107/sebastian-mallaby/hands-off-hedge-funds.html (estimating that hedge funds account for approximately one-third of turnover in U.S. equities and an even higher share in exotic financial instruments); Matteo Tonello, *Hedge Fund Activism: Findings and Recommendations for Corporations and Investors* 11 (The Conference Board, Inc., Research Report R-1434-08-RR, 2008) (hereinafter, Tonello, *Hedge Fund Activism*) (finding that hedge funds represent an estimated 30% of total equity trading volume in the U.S., while they only account for approximately 5% of assets under management). But see William R. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L. J. 1375, 1413 (2007) ([T]he activists' holding record, while not pristine, shows that most commit to their targets for at least the intermediate term.”).
than other investors is the structure of their managers’ compensation – namely, a large component of hedge fund managers’ compensation is tied to total fund profits. Managers whose compensation is tied to fund profits tend to more actively manage their portfolios because they constantly seek opportunities to increase their funds’ profits through speculative trading in an attempt to increase their compensation. Other factors that might explain hedge funds’ heightened short-termism include hedge fund managers’ desire to post attractive results to raise additional funds, as well as fund managers’ ability to act more nimbly than other investors, as hedge funds are typically not regulated under the Investment Company Act. Moreover, their managers are generally not

34 See Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1064 (2007) (stating that hedge fund managers are typically paid a percentage of profits earned); April Klein & Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, NYU, Law and Economics Research Paper No. 06-41 at 6 (October, 2006), available at http://ssrn.com/abstract=913362 (finding that hedge fund managers’ compensation typically includes a percentage of profits – usually 5-40% - and that this compensation structure often leads managers to use activism to increase targets’ share prices). Kahan & Rock, supra note 34, at 1064-65 (arguing that the fact that hedge fund managers are paid a percentage of profits earned means that they have a big stake in the success of their funds’ investments.). Because hedge fund manager compensation is not clawed back due to subsequent losses, there is no incentive to ensure those profits are sustained.

35 See Anabtawi, supra note 32, at 580 (noting the relationship between hedge funds’ performance and their ability to raise additional funds from the capital markets, and arguing that this contributes to a preoccupation with short-term results).

36 See U.S. Sec. & Exch. Comm’n, Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission ix, 33-36 (September 2003), available at http://www.sec.gov/news/studies/hedgefunds0903.pdf (hereinafter, SEC Report, Hedge Funds) (“Hedge funds generally do not have limited time horizons, although a number of factors, including an inability to consistently achieve positive returns, often contribute to a relatively shorter life span than that of other investment vehicles.”); Kahan & Rock, supra note 34, at 1062-63 (noting that while hedge funds are not subject to specific regulatory constraints, they must comply with rules applicable to investors generally, such as disclosure requirements under section 13(d) of the Securities Exchange Act and the short swing profit rules under section 16(b) under that act). The incoming administration has suggested that new regulations will be adopted so that hedge funds, private equity funds and other presently unrelated investment vehicles no longer operate free of regulation. See Modernizing the U.S. Financial Regulatory System Before the Sen. Comm. On Banking, Housing, and Urban Affairs, 111th Cong. 5 (Feb. 4, 2009) (statement of Paul A. Volcker, Chair of the Presidential Recovery Advisory Bd.), available at http://banking.senate.gov/public/_files/VolckerTestimony2409.pdf. Moreover, since January of this year members of Congress have proposed legislation to regulate private funds, including the Hedge Fund Transparency Act introduced by Senators Grassley and Levin on January 29, 2009, which would require hedge, private equity and venture capital funds to register with the SEC and maintain certain books and records as prescribed by the SEC; The Hedge Fund Advisor Registration Act of 2009 introduced by Reps. Castle and Capuano on January 27, 2009, which would require investment advisors for hedge, private equity and venture capital funds to register with the SEC; The Pension Security Act of 2009 introduced by Rep. Castle on January 27, 2009,
regulated under the Investment Advisers Act.\[^{38}\] This absence of regulation, including leverage restrictions and reporting requirements, allows hedge funds to take larger, less diversified positions in companies (including those with smaller, less liquid stock) than can many other institutional investors.\[^{39}\] This flexibility also allows them to hedge their risks associated with these investments to a greater extent than can other institutional investors.\[^{40}\] The net result is that hedge funds can realize larger gains from short-term trades than can other investors.

As the foregoing discussion reveals, investors tend to hold their public company investments for speculative purposes. That leads them to trade relatively frequently to try to optimize their gains from those investments. Hedge funds on average trade more frequently than other investors for reasons attributed to their unique, unregulated structure.

Yet public companies do not use a similar short period of time for the appreciation of corporate gains.\[^{41}\] Rather, they typically seek to generate profits over a longer period of time.\[^{42}\] That goal is apparent from the business plans adopted by corporate executives under board oversight, which typically state firms’ objectives over the subsequent five-year or longer period.\[^{43}\] And in fact most firms set strategies that look to achieving objectives over a period much longer than five or ten years.\[^{44}\] In any case, even if we assume that businesses seek to be successful over a five-year period, that is over twice as long as the period during which investors on average hold their shares.

which would require pension funds to disclose plans’ investments in hedge funds; and The Hedge Fund Study Act introduced by Rep. Castle on January 27, 2009, which would direct the President’s Working Group on Financial Markets to conduct a study of the hedge fund industry.

\[^{38}\] SEC Report, Hedge Funds, supra note 37, at 33-36.

\[^{39}\] Id. at 4, 33, 37-39.

\[^{40}\] Id. at 4-5; see also Kahan & Rock, supra note 34, at 1063 (noting that hedge funds can use derivatives to accumulate large economic positions without disclosure); Tonello, Hedge Fund Activism, supra note 32, at 29.

\[^{41}\] See BERLE & MEANS, supra note 20, at 282 (“Today, the life of the investment as such is either long, or indefinite, or perhaps perpetual, and the public investor cannot accordingly count on the release of his capital through repayment); Roger Lowenstein, Go Long, N.Y. TIMES, Jan. 6, 2009, at MM9, available at http://www.nytimes.com/2009/01/11/magazine/11wwln-lede-t.html?scp=15&sq=long%20term&st=cse (“Public-securities markets are a wondrous artifice precisely because they offer permanent capital to industry and short-term liquidity to investors.”).

\[^{42}\] See BERLE & MEANS, supra note 20, at 282; Lowenstein, supra note 41, at MM9.

\[^{43}\] See L.J. BOURGEOIS III ET AL., STRATEGIC MANAGEMENT: A MANAGERIAL PERSPECTIVE 302 (2nd edition, The Dryden Press 1999) (stating that all organizations of any size must plan, and that planning tends to include the development of an overarching five or ten-year strategic plan); FRED R. DAVID, STRATEGIC MANAGEMENT: CONCEPTS 12-13 (12th ed. Pearson Education Inc. 2009) (indicating that strategies, or the means to reach objectives, are long-term oriented and typically affect a corporation’s prosperity over the next five or more years); Lipton & Rosenblum, supra note 13, at 229 (noting that a standard business plan covers five years).

\[^{44}\] This is apparent from the long durations of most public companies, as well as the default rule that corporations exist perpetually. See DEL. CODE ANN. tit. 8, §102(b)(5)(West 2009).
That alone might argue in favor of severing investors from most business decisions, for investors’ time horizons for the realization of value from their investments is much shorter than the time horizons set by corporations for the achievement of their corporate objectives.

Still, the counter-argument is compelling: namely, despite the fact that investors have short holding periods, the value of their investments reflect not only the short-term value, but also the long-term value, of the investee corporation. That is because the stock market is efficient. Thus stock prices reflect not simply the value of firms based on anticipated returns over any particular investor’s holding period, but indefinitely. That means that investors do not necessarily favor decisions that generate results in the short term, for the values they place on their investments also reflect the profits to be generated in the long term. I will address this argument next.

2. Short-Term Information Bias

In a perfectly efficient stock market, stock prices would indeed fully reflect the intrinsic values of the firms whose stock are traded on that market. To capture a firm’s intrinsic value, a firm’s stock price must reflect not only the firm’s value in the short-term, but also its value in the long-term. This theory of the stock market – as being perfectly efficient - is referred to as the efficient capital market hypothesis, or ECMH. Under the ECMH, if a company’s stock price at any time does not fully reflect a proportion of the firm’s true value represented by a share of that stock, then investors will buy that firm’s stock (if the stock price is lower than the firm’s true value) or sell that firm’s stock (if the stock price is higher than the firm’s true value) until the stock price does reflect a proportionate share of the firm’s true value. Thus adherents to the ECMH hail frequent trading as a mechanism to make the stock market more efficient, as each trade causes a firm’s stock price to get closer to the firm’s true value.

One necessary predicate to the ECMH is the availability to investors of all relevant information about a firm, for that is the only way investors can know a firm’s true value– and determine whether its stock price undervalues or overvalues the firm.

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46 Anabtawi, supra note 32, at 581 (arguing that pursuant to the efficient market theory, an investor’s time horizon would not matter since stock prices would reflect long-term values).

47 Rose, supra note 45, at 542; Stout, Market Inefficiency, supra note 45, at 636.

48 See e.g. Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 355-57 (6th ed. 2000) (arguing that arbitrageurs immediately eliminate any discrepancy between stock prices and firm values by trading).

49 Rose, supra note 45, at 542; Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 551-552 (1984). But see id. at 569-79 (arguing that while not all information is immediately and costlessly available, what makes the ECMH non-trivial is its prediction that the market will act as if it were immediately and costlessly available).
However, information – especially that concerning the long-term value of a firm - is not “perfect” for a number of reasons.\(^{50}\)

For one, not all information concerning a firm’s long-term value is either available or economically feasible to recover.\(^{51}\) For example, where a firm faces a pending lawsuit, it may not be possible for the firm’s managers to understand for some time all of the facts underlying that suit and how it will likely be resolved. That, in turn, means that investors will not receive information about that potential long-term liability, and will not factor it into their determination of a firm’s intrinsic value.

Even where information about a firm’s future is available, it is not necessarily in investors’ interest for that information to be publicly disclosed. For example, if a firm were to publicly disclose what its managers believed was the most likely outcome of a lawsuit that has been – or could be - lodged against the firm, that information would serve as a cue to the plaintiffs and potential plaintiffs as to the existence of such a lawsuit, as well as how much it may be worth.\(^{52}\) Yet failing to have that information would

\(^{50}\) Moreover, as Professor Lynn Stout has argued, a market that is perfect in information is not necessarily efficient in determining fundamental value because (1) arbitrage is not costless, (2) arbitrageurs have access to finite amount of money, (3) arbitrageurs are risk-averse, and (4) arbitrageurs can only profit from information if the rest of the market eventually becomes aware of that information and comes to agree with the arbitrageur’s assessment of value). See Stout, \textit{Market Inefficiency, supra} note 45, at 656. The Delaware courts have recognized the possibility that the stock market is not efficient. For example, in \textit{Paramount}, the Delaware Chancery Court authorized the Paramount board to consider stock market inefficiencies in deciding whether or not to approve a takeover offer. See \textit{Paramount Commc’n, Inc. v. Time Inc., No.’s 10866, 10670, & 10935, 1989 WL 79880, at *19 (Del. Ch. Jul. 14, 1989), affirmed, 571 A.2d 1140 (Del. 1989)}, (“Directors may operate on the theory that the stock market valuation is ‘wrong’ in some sense, without breaching faith with shareholders. No one, after all, has access to more information concerning the corporation’s present and future condition.”); \textit{see also} Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1376 (Del. 1995) (citing \textit{Paramount Commc’n Inc. v. Time Inc., 571 A.2d at 1153}) (“[D]irectors of a Delaware corporation have the prerogative to determine that the market undervalue its stock and to protect its stockholders from offers that do not reflect the long term value of the corporation under its present management plan.”).

\(^{51}\) \textit{ROSE, supra} note 45, at 542-43 (noting the controversy surrounding the strong form of the ECMH, which presumes that stock prices capture all relevant information – both public and private – about a corporation).

\(^{52}\) This is a significant issue under proposed new Financial Accounting Standard (FAS) 5, which would require disclosure about loss contingencies (including potential lawsuits) that are more than “remote” (currently only disclosure is required for “probable” contingent losses). See \textit{DISCLOSURE OF CERTAIN LOSS CONTINGENCIES: AN AMENDMENT OF FASB STATEMENT NO. 5 AND 141(R)}, Proposed Statement of Fin. Accounting Standards No. 5 and 141(R), Exposure Draft, § 5 (Fin. Accounting Standards Bd. 2008). In addition, proposed FAS 5 would require firms to disclose a description of the factors that are likely to affect the ultimate outcome of that potential loss, a qualitative assessment of the most likely outcome, and significant assumptions made in estimating the amounts disclosed. \textit{Id.} at § 7. The American Bar Association has written a letter to the Financial Accounting Standards Board emphatically objecting to the proposed changes to this rule on the basis that that disclosure would threaten the attorney-client privilege, that there is much
impair investors’ ability to value the firm in the long-term – when the liability may be realized.

As another example, it is generally not in investors’ interest for firms to disclose detailed information about future prospects and business strategies. For example, if a firm disclosed its marketing strategy and identified geographic regions or sectors for growth, that information would tip the firm’s hand to its competitors, which could enable the competitors to use that information to their advantage. Yet not having that information impairs investors’ ability to estimate with any accuracy the firm’s future cash flows generated by future sales of those products in those regions. That, in turn, impairs their ability to calculate the firm’s intrinsic value, as that is typically calculated using an estimation of future cash flows, discounted for the future.\textsuperscript{53}

Because of the uncertainty involving future events and circumstances, accounting rules tend to undervalue or not value “future assets,” or assets which may not be realized for some time. For example, firms may not recognize revenue in connection with the sale of a good or service until the good or service is delivered, the price for the good or service is fixed or determined and collectability is reasonably assured.\textsuperscript{54} That means that uncertainty in estimating loss contingencies and that this would create the potential for shareholder lawsuits if these estimates turn out to be wrong. \textit{See} Letter from William H. Neukom, President, Am. Bar Ass’n, to Robert H. Herz, Chairman, Fin. Acct. Standards Board (Aug. 5, 2008), available at http://www.fasb.org/ocl/1600-100/52265.pdf.\textsuperscript{53} \textbf{TIM KOLLER ET AL.}, \textit{VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES} 56 (4th ed. John Wiley & Sons, Inc. 2005). Yet another example, long-recognized by the Delaware courts, is the potential detrimental impact premature disclosure of a possible sale transaction might have on stockholders. \textit{See} Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 847 n. 5 (Del. 1987) (“[T]he effect of premature disclosure of merger discussions may be substantial. The probability of completing a merger benefiting all shareholders may well hinge on secrecy during the negotiation process.”).

\textsuperscript{54} SEC Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68,936 (1999). In addition, there must be persuasive evidence that an arrangement for the sale of the good or service exists. \textit{Id.} The SEC passed SAB 101 to prevent companies from recognizing revenue early, often done to manage their earnings. Jennifer Altamuro et al., \textit{Motives for Early Revenue Recognition: Evidence from SEC Staff Accounting Bulletin (SAB) 101} 1 (Aug. 1, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=335780. However, it has prevented firms from including in their financial statements expected future cash flows, which means that investors get less information about the future cash flows of their investee firms than they did before SAB 101. \textit{Id.} at 4. Several trade groups, recognizing the importance of non-financial disclosure as to future expectations, have proposed increasing these types of disclosure. \textit{See e.g.} Am. Inst. of Certified Public Acct., Enhanced Business Reporting Consortium, \textit{The Enhanced Business Reporting Framework} (Oct. 2005), available at http://www.ebr360.com/downloads/ebr.framework.publicexposure.2005.10.pdf (describing a framework to encourage companies to report extra-financial matters). Of course to the extent that investors rely on financial information in making investment decisions, increased non-financial disclosure may not impact, or only minimally impact, their computation of firm value.
unless a company publicly announces a future sale, investors do not factor that information into their determination of a firm’s intrinsic value, again tending to cause that calculation to ignore the value of important future assets.

As another example, accounting rules do not permit firms to include the value of their brands or their relationships with suppliers, customers and employees in their calculation of intangible assets. Moreover, accounting rules require firms to expense research and development (R&D) costs as they are incurred instead of permitting firms to capitalize those costs over the useful life of the inventions that result from the R&D. This, then, leads to a reduction in profits for the period in which these expenses are incurred without any corresponding increase in assets. While the purpose of this rule may have been to encourage investments in R&D, in reality this means that current investors shoulder the burden of all R&D costs, while they may (or may not) appreciate the long-term benefits of those expenditures. This likely explains some investors’ reluctance for firms to make investments in R&D. Yet intangible assets may comprise


57 See Tonello, Revisiting Stock Market Short-Termism, supra note 56, at 28-29 (arguing that current financial reporting principles operate as a disincentive to invest in research, innovation and other drivers of value because investments in intangibles are expensed, not capitalized, like those on physical and financial assets); see also Enzo Baglieri et al., Evaluating Intangible Assets: The Measurement of R&D Performance 2-3 (March 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=278260 (noting that because of the high degree of uncertainty surrounding R&D activities, the difficulty in measuring the value of the output of R&D and the dependency on other corporate functions, R&D has always been treated as an expense center).

58 See Xuan-Thao Nguyen & Jeffrey A. Maine, Acquiring Innovation, 57 Am. U. L. Rev. 775, 793 (2008) (explaining the justification for the rule that R&D may be expensed as incurred, instead of capitalized, as the encouragement of new research and development activity and stimulation of economic growth and technological development).

59 See Anabtawi, supra note 32, at 580 (arguing that stock prices can temporarily be increased by increasing short-term earnings by, for example, cutting research and development expenses or capital expenditures); Lipton & Rosenblum, supra note 13, at 210 (arguing that managers seeking to satisfy the short-term expectations of institutional investors sacrifice investments for the future, such as research and development and capital expenditures). But see KOLLER ET AL., supra note 53, at 78 (arguing that stock markets reward R&D and advertising expenditures even though those expenditures may negatively affect short-term earnings); Kahan & Rock, supra note 34, at 1085-87 (noting the active debate as to whether the stock market undervalues long-term investments
a significant part of a corporation’s intrinsic value.\textsuperscript{60} That means that financial
statements may not accurately capture one of the key drivers of future cash flows, which
again, are typically used to calculate a firm’s intrinsic value.\textsuperscript{61}

Moreover, investors tend to overly discount the value of future returns, even
when they are disclosed.\textsuperscript{62} This is undoubtedly due in large part to the unreliability of a
future stream of cash flows.\textsuperscript{63} While investors cannot be blamed for the tendency to rely
on more certain historic information rather than uncertain statements as to the future, it
further explains why a firm’s stock price might not accurately depict the long-term value
of a firm even as to information as to future assets, liabilities and risks that is disclosed.

The fact that accounting rules, and the financial statements prepared employing
those rules, fail to capture the value of firms’ long-term assets and liabilities has
significant implications, for a number of studies have found that investors tend to rely
heavily, if not entirely, on financial statements in making their investment decisions.\textsuperscript{64}
That means that investors overly rely on short-term financial metrics in determining
relative to short-term investments and the lack of clear empirical evidence showing that capital
markets are not efficient).

\textsuperscript{60} See Baruch Lev, Intangibles: Management, Measurement and Reporting 77
(Brookings Institution Press, 2001) (“Extensive empirical research, particularly on discovery
intangibles (R&D, patents, innovations) and organizational intangibles (information technology,
brands, customer acquisition costs), has established the existence of strong links between these
investments and corporate value and performance. This record corroborates the considerable
value creation potential of intangibles resulting from their nonrivalry, increasing returns, and net
work effects . . . .”); Baglieri et al., supra note 57, at 2 (arguing that intangible assets are
increasingly considered the ultimate roots of a company’s success).

\textsuperscript{61} See supra note 53 and accompanying text.

\textsuperscript{62} Anabtawi, supra note 32, at 581 (“Numerous studies have shown that the stock market places a
disproportionately high value on a company’s near-term earnings by placing an excessively high
discount rate on its future expected earnings.”); Hazen, supra note 27, at 181 (“There is
considerable evidence that stock prices do not accurately discount the future.”); Wayne Joerdng,
Are Stock Prices Excessively Sensitive to Current Information?, 9 J. Econ. Behav. & Org. 71, 72
(1988) (arguing that stock markets are overly sensitive to short run factors).

\textsuperscript{63} Berle & Means, supra note 20, at 320 (“[A]nd it is not easy, if indeed, it is possible at all, to
disclose anything other than that which has actually occurred.”). This is exemplified by the
increase in stock price caused by the recognition of revenues in a current period instead of a future
period. With the large number of restatements, perhaps investors are also discounting the value of
past results.

\textsuperscript{64} See Committee for Economic Development, Built to Last, supra note 56, passim (noting that
emphasis on quarterly earnings, compensation tied to earnings per share, shortened CEO tenures,
and financial reports that fail to adequately inform about company performance impede the task of
building long-term value; and arguing that the false precision of financial statements feeds the
focus by managers, traders and analysts on earnings per share); Tonello, Revisiting Stock Market
Short-Termism, supra note 56, at 8 (citing a study done by the U.S. National Bureau of Economic
Research, Duke University and University of Washington, finding that a majority of companies
view financial indicators based on earnings (especially earnings-per-share) as a key metric of
performance).
firms’ intrinsic values. Investor determination of firm values from short-term financial metrics undoubtedly leads to a determination that is overly representative of a firm’s value in the short term.

Still, some investors, particularly professional managers, do try to adjust for some of the shortcomings of financial statement disclosures in determining a firm’s intrinsic value. Yet not all investors have the resources available to do so. That means that different investors might calculate a firm’s intrinsic value differently, leading to stock trades that cause a firm’s stock price to bounce around between different perceived intrinsic values. And even for the investors who do adjust for financial statement shortcomings, they must do so extrapolating longer-term values from information that is disclosed and that has a short-term bent. That, too, would seem to impair their ability to accurately determine a firm’s intrinsic value.

Investors’ over-reliance on short-term financial metrics in determining firms’ intrinsic values is exacerbated by firms’ public release of guidance as to expected earnings during the subsequent quarter. Where a corporation issues quarterly earnings guidance, management often feels pressure to meet or beat that guidance for fear of disappointing investors whose expectations were set by that guidance, as disappointed investors tend to punish a corporation through selling its stock. Consequently, pressure to meet investors’ expectations set through earnings guidance may cause managers, including the board, to manage with the goal of keeping a firm’s stock price high, notwithstanding the impairing effect that might have on long-term corporate performance. For example, it might lead boards to forego incurring R&D expenses and


66 See Stout, Market Inefficiency, supra note 45, at 653 (indicating that studies suggest that where information is technical and difficult to understand, stock prices do not quickly adjust to reflect it).

67 See David Millon, Symposium, Corporate Irresponsibility: America’s Newest Export?: Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?, 70 GEO. WASH. L. REV. 890, 892 (2002) (finding that companies that fall short of analyst earnings targets by even a penny a share can see an immediate plunge of 25% or more in their stock price); Committee for Economic Development, Built to Last, supra note 56, at 5 (revealing evidence which shows that firms that issue quarterly earnings guidance attract more transient investors and have higher trading volumes than companies that do not issue earnings guidance); Graham et al., supra note 22, at 67 (noting that a majority of the over 400 Chief Financial Officers surveyed “admit[ted] to sacrificing long-term economic value to hit a target or to smooth short-term earnings”).

68 See MITCHELL, supra note 15, at 1 (“A recent survey of more than four hundred chief financial officers of major American corporations revealed that almost 80 percent of them would have at least moderately mutilated their businesses in order to meet analysts’ quarterly profit estimates.”); The Aspen Institute, Long-Term Value Creation: Guiding Principles for Corporations and Investors 1.4 (June 2007) (hereinafter Aspen Institute, Guiding Principles); Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations 7 (Mar. 2007), available at http://www.uschamber.com/NR/drdonlyres/eozwwssfrqzdmm3hd5iogqhp6h2ngxwdpr77qw2bungtpzvi5we
hiring of new employees, simply to ensure the projections are met. It might also lead to the temptation to manage earnings to maintain consistent, positive numbers. While there is support from some in the business and investment communities to curb the issuance of quarterly earnings guidance, approximately half of all public corporations still provide this type of guidance.
Still other market imperfections which tend to cause a short-term bias can be identified in the rubble of the current financial crisis, where investors seemed to all but ignore the risks – even those that were disclosed to them - about the potential collapse of the housing market. There are a number of theories supporting this failure. One is that investors were caught up in the euphoria of the housing bubble, leading them to choose to not understand what they were buying.\textsuperscript{72} Under this premise, information at to long-term risks, while disclosed, was simply ignored. Another is that investors were simply following the herd, buying securities that everyone else was buying.\textsuperscript{73} Thus investors got caught up in the stampede to buy securities notwithstanding the disclosed long-term risks of those securities. Still another is that investors tended to over-identify with events that they were familiar with (increases in the prices of mortgage-related securities) and believed them likely to continue.\textsuperscript{74} Each of these cognitive limitations can explain why investors ignore or fail to appreciate long-term risks, even when they are disclosed.\textsuperscript{75} Thus these, too, might explain why investors focus on short-term profits generated by their investments notwithstanding the longer-term risks associated with the business strategies of those firms.

3. **Summary**

As the foregoing discussion reveals, the lack of public disclosure as to the value of future assets and future sources of cash flows, as well as future risks and liabilities, leads investors to undervalue those long-term assets, liabilities and risks in determining the intrinsic values of public firms. Moreover, investors may, due to cognitive limitations, fail to appreciate the long-term risks of their investments. These market imperfections seem to cause investors to favor business decisions that positively impact stock prices in the short term, notwithstanding the potential adverse effect of those decisions on the long-term. While some investors can more accurately determine the intrinsic value of a firm due to their sophistication and resources, their ability to do so is impaired by the lack of information they receive as to long-term values. Moreover, their trades would not necessarily cause a firm’s stock price to approach a true value which appropriately included the long-term value of that firm, as other investors also trading in that firm’s securities who do not have the sophistication needed and resources available other long-term drivers of performance on which to make investment decisions. *But see Disclosure Advisory Board Responds to Chamber of Commerce Recommendations on Earnings Guidance* (Mar. 21, 2007), available at http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/03-21-2007/0004550656&EDATE= (arguing that eliminating quarterly earnings guidance is too sweeping, and favoring a balancing of short-term and long-term guidance relative to qualitative and quantitative measures).\textsuperscript{72} Steven Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 382 (2008).

\textsuperscript{73} *Id.*

\textsuperscript{74} *Id.* at 382-83.

\textsuperscript{75} Investors might also ignore disclose where they can defer to more easily interpreted investment signals such as rating agencies’ securities ratings. *Id.* at 382.
to calculate a firm’s long-term value would be trading using a true value that tends to depict the shorter-term value of the firm.

That is not to say that every investor desires to maximize its profits from an investment over a short period of time. In fact many investors do have as an investment strategy holding stock for a long period of time. Moreover, some large institutions are long-term investors by necessity, for due their sheer size, they will inevitably end up holding position in the same firms in the future. But it argues in favor of exercising caution when considering whether to implement investors’ recommendations and demands in relation to how to manage the corporation, particularly where those demands are made by investors who are known to have short investment horizons.

B. Investor Short-Termism Affects Board Decisions

The fact that investors desire short-term results does not necessarily translate into firms that are managed for the short-term. That is because directors oversee the business and affairs of the corporations on whose boards they serve. On that basis alone it would seem that boards should be impervious to investors’ demands for short-term results. Yet there are a number of reasons why boards are short-termisms as a result of this investor short-termism. Sub-section 1 examines how investors affect board decisions through the shareholder franchise. Sub-section 2 then explores how investors have started to influence board decisions through non-collective, targeted activism.

1. Investors Influence Board Decisions Through the Voting Franchise

Investors elect directors, typically on an annual basis. The right to elect to directors gives investors significant power over boards, for it means that ultimately,
boards must be accountable to investors for their actions. That, in turn, means that
directors must to an extent be obliging of investors’ wishes, including their wishes for
short-term profits, if the directors want to be reelected.

Yet there are many who challenge the effectiveness of this accountability
mechanism, not only because the board, typically through a nominating committee,
decides which candidates to nominate on behalf of the company, but also because it is
typically only those candidates who are included in the company’s proxy statement.80
Thus the solicitation of proxies for any competing slate of directors must generally be
paid for by the investor putting forth the competing slate.81

Still, the risk of non-reelection undoubtedly seems real to directors, particularly
as investors increasingly use the threat of a proxy contest to get their director nominees
in the company’s slate of directors.82 Investors have also been increasing their say over
board composition through provisions of the bylaws or corporate policies, adopted by
many companies at the behest of stockholders, which call for the resignation of any
director not receiving the support of a majority of stockholders.83 While investors must

80 See Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 VA. L. REV. 675, 680, 688-95 (May, 2007) (noting the importance of the shareholder franchise and arguing that legal and practical impediments impair shareholders’ ability to exercise that franchise to replace the board); Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. REV. 811, 821, 823-24, 843, 886-89 (1992) (arguing that the expense of proxy contests (which are not shared by all shareholders), the risk of insider-trading and short-swng profit liability for stockholders whose nominees are elected to the board and other legal hurdles discourage the exercise by shareholders of their voice).
81 Bebchuk, supra note 80, at 688-91; Black, supra note 80, at 821.
82 See discussion infra Part I.B.2.
83 See Henry T. C. Hu & Jay Lawrence Westbrook, Abolition of the Corporate Duty to Creditors, 107 COLUM. L. REV. 1321, 1386 (2007) (“At the start of 2005, fewer than thirty of the Standard & Poor’s 500 had bylaws or policies requiring a majority voting standard. By early 2006, this figure had increased to roughly 145.”); William K. Sjostrom, Jr. & Young Sang Kim, Majority Voting for the Election of Directors, 40 CONN. L. REV. 459, 473 (2007) (“[A]s of February 2007, more than 371 public companies, including at least 52% of S&P 500 companies and 45% of Fortune 500 companies, had implemented some form of majority voting.”). Investors have also been proposing bylaws which would require firm reimbursement of proxy contests in some circumstances. See e.g. CA., Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 229-30 (Del. 2008) (describing a stockholder-proposed bylaw amendment that would require the company to reimburse the expenses of a stockholder who successfully has at least one of its directors elected to the board in a contested election). Still, as the Delaware Supreme Court indicated in that case, these types of bylaws cannot remove the discretion from the board to not reimburse these expenses where this would be required under its fiduciary duties. See id. at 239-40. In addition, the new e-proxy rules and 1990 proxy rule amendments make it easier, and less expensive, for shareholders to solicit proxies for competing slates of directors. Richard Morrissey, Proxy Solicitation Through The Internet Sullivan & Cromwell Briefing, December 14, 2006, 1643 PLI/Corp 583, 587 (PLI
pay the costs of soliciting proxies in favor of the election of a competing slate of directors, they often can include these types of bylaw and policy proposals on the company’s proxy statement under Securities and Exchange (SEC) Rule 14a-8. That means that the company must pay the cost of soliciting proxies to vote on these matters.

Stockholders have also been including “say on pay” proposals – or proposals requesting that the board obtain an advisory vote from the stockholders indicating whether they approve or disapprove of management’s compensation packages – on company proxy statements. All of these shareholders proposals are useful in that they afford stockholders a way to collectively make recommendations to management without forcing them to pay for the solicitation of proxies in support of the proposal. However, management may exclude from the company’s proxy statement any such proposal that would be improper under state law, as well as any proposal that relates to a company’s “ordinary business operations”. These exclusions likely explain why shareholder proposals under Rule 14a-8 have generally been limited to matters of corporate governance or social responsibility proposals that do not affect the corporation as a
profit-making institution, and have often taken the form of precatory –or non-binding – proposals.  

Investors also have the right to vote on certain significant transactions. These transactions include mergers, sales of all or substantially all of firms’ assets and dissolutions. That means that boards may not pursue these types of transactions without shareholder support, and in that way, are held accountable to stockholders. Perhaps more importantly, any board decision to implement defenses to a takeover offer must meet higher-than-normal fiduciary duty standards. 

Yet these voting rights do not give shareholders the power to initiate these types of takeover transactions. Rather, they must be approved by the board, who then must submit the transaction to the stockholders for approval. Stockholders do, however, have the right to initiate a sale of their stock, either in a stand-alone transaction or to an acquirer through a collective tender offer. This is undoubtedly one of the most important tools stockholders have traditionally used to keep boards in line with their interests, for it allows stockholders to vote against the board by using their feet. Still, boards have traditionally employed any number of defenses to either prevent or make more difficult takeovers via tender offers. These defenses include the poison pill, parachute payments

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87 See SEC Div. of Corp. Fin. Staff Legal Bulletin No. 14, Shareholder Proposals (Jul. 13, 2001), available at http://www.sec.gov/interps/legal/cfslb14.htm (“In our experience, we have found that proposals that are binding on the company face a much greater likelihood of being improper under state law and, therefore, excludable under rule 14a-8(i)(1)”; Bernard S. Black, Shareholder Passivity Reexamined, 89 MICH. L. REV. 520, 541 (1990).

88 See DEL. CODE ANN. tit. 8, §§251, 271, 275 (West 2009).

89 See e.g. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985) (setting forth an “enhanced duty” before the business judgment rule is applied to a board’s decision to adopt defensive measures in response to a takeover offer because of the “omnipresent specter that a board may be acting primarily in its own interest”).

90 See DEL. CODE ANN. tit. 8, §§251, 271, 275 (West 2009).

91 See Julian Velasco, The Fundamental Rights of the Shareholder, 40 U.C. DAVIS L. REV 407, 409, 425 (2006) (arguing that the right to sell shares is one of the most fundamental rights of shareholders because it allows shareholders to obtain the economic benefits from their investments and allows shareholders to exit if they become dissatisfied with management).

92 A poison pill is a device through which current stockholders, excluding the attempting acquirer, receive the right to convert a security into additional shares of stock at an extreme discount, thereby making the takeover significantly more expensive for the potential acquirer. See DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 1085-91 (Aspen Pub. 5th ed. 2002). The Delaware courts more highly scrutinize these types of defensive measures, particularly when they are taken in the face of a pending takeover offer, than they do other business decisions. See e.g. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 954 (“Because of the omnipresent specter that a board may be acting primarily in its own interests [where the board is addressing a pending takeover offer], rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.”). Recently a number of stockholders have proposed bylaw amendments which require stockholder approval before the
to executives, and a staggered board structure. Moreover, Delaware, like many other states, has an anti-takeover statute that deters takeovers structured as tender offers. Still, many of these board-adopted defensive measures are in decline as many of these measures are perceived as simply ways to entrench the board, rather than mechanisms boards may use to protect investors from coercive and inadequate takeover offers. Golden parachutes have been especially susceptible to challenge as pressure mounts on boards to tie manager compensation to long-term performance. In any event, it would be unduly simplistic to assume that directors always seek to avoid a takeover due to their self-interest in remaining as directors. In fact, with the current wave of pressure on directors to hold stock and have some “skin in the game,” it may be in directors’ interest to consummate a takeover to realize the value of their stock holdings.

Even without an actual takeover offer, the mere possibility that a potential acquirer will make an unwanted offer undoubtedly keeps boards accountable to stockholders. This is typically manifested through board actions aimed at maintaining a high stock price, thereby making it less likely that an acquirer can offer an attractive control premium to the shareholders.

Finally, stockholders have the right to approve amendments to a firm’s charter submitted to them by the board, as well as the right to amend the bylaws without director action. Stockholders have actually been increasingly using the right to amend the board can renew a poison pill. See Victor Lewkow & Sarah ten Siethoff, *The Embattled Poison Pill*, Practising Law Institute, Contests for Corporate Control 2007: Current Offensive & Defensive Strategies in M&A Transactions, 1584 PLI/Corp 403, 405 (2007).

93 This defense triggers a large balloon payment to certain executive officers upon a change in control, thus making the acquisition more expensive. BLOCK ET AL., supra note 92, at 1296-98.

94 This type of “shark repellant” makes it impossible to replace the entire board at a single annual stockholders meeting. *Id. at* 1246, 1249, 1278-83.

95 See DEL. CODE ANN. tit. 8, §203 (West 2009).


97 See BLOCK ET AL., supra note 92, at 1298 (explaining the many grounds on which golden parachutes have been criticized and noting they are often *de minimus* in comparison to the deal size); see also discussion supra Part I.C. (explaining how recent laws restrict the payment of golden parachutes by companies receiving funds from the U.S. Treasury).

98 See Hazen, *supra* note 27, at 182.


100 See DEL. CODE ANN. tit. 8, §109(a), 242 (West 2009); see also CA., Inc. v. AFSCME Employees Pension Plan, 953 A.2d at 232 (holding that the stockholders’ power to amend the bylaws cannot be non-consensually eliminated or limited by anyone other than the legislature).
bylaws to give themselves a more effective voice in the election of directors.\footnote{See e.g. CA., Inc. v. AFSCME Employees Pension Plan, 953 A.2d at 229-30 (describing a stockholder-proposed bylaw amendment that would require the company to reimburse the expenses of a stockholder who successfully has at least one of its directors elected to the board in a contested election).} While bylaws only define the processes and procedures by which board decisions are made,\footnote{See id. at 234-35 (“It is a well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.”).} it is clear that regulating those processes and procedures can have a significant impact on the substance of the decisions made using them.\footnote{For example, as the Delaware Supreme Court noted in \textit{AFSCME}, stockholders may adopt a bylaw requiring the reimbursement of any stockholder for its proxy expenses incurred in conducting a successful competing proxy solicitation, as that primarily relates to the process for the election of directors; provided that, as was not the case with the AFSCME-proposed bylaw, the board retains the authority to deny such reimbursement where to do so would be required by their fiduciary duties. \textit{Id.} at 234-40.}

As the foregoing discussion reveals, shareholders may hold directors accountable to their interests through their statutory voting rights. Most importantly, shareholders have the right to elect directors, which is becoming increasingly effective as a result of majority vote bylaws and policies. They also have the right to approve many significant transactions. These accountability mechanisms allow stockholders to influence board decisions. Still, the success of these voting mechanisms typically requires the vote of a majority of shareholders. That means that they are less useful to minority investors seeking to influence board actions. That, perhaps, explains the rise of the non-voting channels of influence discussed next.

2. \textit{Investors Influence Board Decisions Outside of the Voting Franchise – Modern Trends in Activism}

The foregoing discussion does not reveal the true extent of investor influence on boards, for it depicts investors who are limited in their mode of influence to the stockholder voting franchise. But this is no longer true, particularly in the wave of activism that has emerged following the numerous collapses of the early 21\textsuperscript{st} century, where many boards were perceived as having failed to actively oversee the corporations under their charge.\footnote{But see Klein & Zur, \textit{supra} note 34, at 10 (noting that institutional investors began to seek changes using informal communications starting in the 1980s, but these efforts had little impact on firm performance or stock price).}

In this new era of activism, investors influence boards directly, without involving other stockholders. Some of the mechanisms employed by investors to influence boards include demand letters sent to the board,\footnote{See e.g. \textit{The Children’s Investment Master Fund Urges CSX to Take Immediate Action to Improve Corporate Governance and Business Performance}, Oct. 16, 2007, available at http://www.businesswire.com/portal/site/home/index.jsp?epi-} often made public through the filing of the
letter on a Schedule 13D, and publicity campaigns. Investors have also been using the threat of a proxy contest to obtain board concessions, often leading the board to include the threatening investor’s candidates in the slate of directors nominated by the board.

Through these informal channels, investors have been expanding their scope of influence beyond matters on which they have a voting right. Investors, especially hedge funds, now commonly seek to influence boards on ordinary business decisions, such as the sale of dormant assets or lines of business, the decrease of capital expenditures,

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106 See e.g. CNET Networks, Inc., Beneficial Ownership Report (Schedule 13D), at 7-9 (Dec. 26, 2007) (filed by Jana Partners LLC) (disclosing a letter revealing Jana’s intention to increase CNET’s board size and to solicit proxies in favor of Jana’s nominees.); Motorola, Inc., Definitive Additional Materials (Schedule 14A), at Exh. 1 (May 1, 2007) (filed by Icahn Partners L.P.) (disclosing a letter from Icahn Partners L.P. to Motorola, Inc. shareholders bidding for a single board seat in order to provide accountability and calling Motorola ‘troubled’).

107 See e.g. Ackerman/Pershing Square Capital conference for McDonalds’ shareholders; Ackerman/Pershing Square Capital conference for Target shareholders (held Wed. Oct. 29, 2008); see also Kahan & Rock, supra note 34, at 1029.

108 See Kahan & Rock, supra note 34, at 1029; Klein & Zur, supra note 34, at 67.


and the payment of dividends or repurchase of shares.\textsuperscript{111} They also seek to influence board decisions as to potential takeovers before the matter is to be voted on by stockholders.\textsuperscript{112}

Based on the impact they have had on firms, many of these activist efforts appear designed to deliver a short-term spike in stock price. For example, April Klein and Emanuel Zur found that the stock prices of the targets of hedge fund activism were abnormally high throughout the year following activism.\textsuperscript{113} Yet they found no evidence that those targets in fact became more profitable in terms of return on assets or cash flows from operations one year following the activism.\textsuperscript{114} On the contrary, they found a deterioration in those firms’ profitability one year following the activism.\textsuperscript{115} Other studies and reports have found similar, deleterious long-term effects of this type of activism on public corporations.\textsuperscript{116} Even if we cannot conclusively establish that any

\begin{itemize}
  \item Ramius LLC’s letter to CKE Restaurants’ CEO stating its overall disappointment with CKR’s fundamental performance and calling for capital expenditure reductions.
  \item See e.g. OpenTV Corp., Beneficial Ownership Report (Schedule 13D), at 7-8 (Dec. 18, 2008) (filed by Discovery Equity Partners, L.P.) (disclosing a shareholder proposal from investor Discovery Equity Partners proposing that OpenTV Corp. conduct a Dutch auction tender offer and repurchase shares of its stock); Brooks Automation, Inc., Beneficial Ownership Report (Schedule 13D/A, Amend. No.7), at Exh. 1 (Sep. 27, 2007) (filed by The D3 Family Fund, L.P.) (disclosing a letter from investor David Nierenberg to Robert Lepofsky, the chief executive officer of Brooks Automation, demanding that Brooks Automation repurchase shares of its stock over the next 3-4 years).
  \item Klein & Zur, supra note 34, at 38, 40.
  \item Id. at 40; see also Alon Brav et al., supra note 33, at 3 (finding a statistically meaningless reaction from the market for capital structure-related activism and governance-related activism). \textit{But see id.} (finding a positive abnormal return where hedge funds are active in changing a company’s business strategy or a sale of the company).
  \item Klein & Zur, supra note 34, at 40 (concluding that the one-year post-investment abnormal returns are consistent with the activist making \textit{short-term} value-enhancing changes to the target firm). Klein and Zur found that hedge fund targets were not particularly poor performers. \textit{See id.} at 24 (finding that the targets of hedge funds have higher earnings, are financially healthier, and have more cash on their balance sheets when compared to targets of other entrepreneurial activists). \textit{But see Greenwood & Schor, supra note 3, at 24 (finding that hedge funds’ targets underperformed relative to other firms in their industry). While the Klein/Zur study does not look at the impact of this activism over a period of longer than one year, the data does suggest that returns, while initially positive, decrease over time. See Klein & Zur, supra note 34, at 40.}
  \item See e.g. Jonathan Karpoff et al., \textit{Corporate Governance and Shareholder Initiatives: Empirical Evidence}, 42 J. FIN. ECON. 356, 365-69 (1996) (finding shareholder proposals targeting corporate governance issues ineffective at increasing shareholder value or improving firm’s longer-term operating performance); Klein & Zur, supra note 34, at 43 (finding that there is no immediate
particular case of activism is designed to generate short-term returns for investors, the empirical evidence of the effects of activism does suggest the truth of this conclusion in many cases. This conclusion also seems consistent with the conclusion in Section A that investors, particularly hedge funds, are short-termists who desire short-term results. We should indeed expect investors who are short-termists and who use a strategy of activism to use their sway to bring about short-term results, and to not care about the adverse impacts that might have on a firm in the long term, when the fund is no longer a holder of that firm’s stock.

Many of the reasons discussed in Section A as to why hedge funds are often shorter-term investors than other investors also explain why many hedge funds are more active than other investors. Namely, because hedge funds are not subject to the diversification requirement under the Investment Company Act, they can take larger stakes in public companies than can other institutional investors that are subject to that act. That, in turn, enables hedge funds to receive a larger proportionate share of the benefits generated by their activism than they otherwise would with a smaller ownership percentage. Moreover, because they generally earn a percentage of fund profits, fund managers have an incentive to use activism to bring about corporate decisions that generate profits in the short term. This incentive exists notwithstanding any longer-

increase in the firm’s accounting profitability or other firm performance indicators either pre or post activism; on the contrary, there is evidence that earnings-per-share ratios (EPS) may decline in the year following the investment that triggers 13D filing requirements; Francis H. Byrd et al., Short-Term Shareholder Activists Degrade Creditworthiness of Rated Companies, Moody’s Investor Service, Special Comment 1 (June 2007), available at http://www.moodys.com/moodys/cust/research/MDCdocs/12/200660000441326.pdf?search=7&searchQuery=byrd&click=1 (reporting the results of a study by Moody’s Investor Services finding a tie between activist efforts and credit downgrades and noting a common theme in negative rating actions based on a company’s adoption of a more aggressive financial policy). But see Roberta Romano, Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance, 17 YALE J. ON REG. 174, 177 (2001) (noting that the empirical evidence suggests that shareholder activism has an insignificant effect on targeted firms’ performance, and that while a few studies find evidence of a positive impact, other studies find a significant negative stock price effect from activism); Jonathan Karpoff, The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings 13 (U. of Wash. Working Paper, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=885365 (seeking to summarize inconsistent results of activism and arguing that the persuasive evidence is that average abnormal long-run returns are not significantly positive).

117 In their study, Robin Greenwood and Michael Schor found that hedge funds engaged in activism using 13D filings more than four times as often as other institutional investors. See Greenwood & Schor, supra note 3, at 10.

118 See supra note 40 and accompanying text.

119 See Kahan & Rock, supra note 34, at 1062 (arguing that evidence suggests that hedge funds enjoy significant economies of scale).

120 See supra note 34 and accompanying text.
term downside to the firm from those decisions. The fact that hedge funds can reduce or eliminate the economic risk associated with their investments might also explain their disproportionate activism, for it creates an incentive for them to influence decisions not only that cause stock price spikes, but also that cause stock prices to drop to allow them to profit off of those downward adjustments.

As the foregoing discussion reveals, investors are becoming increasingly influential in corporate decision-making through non-voting channels. Empirical evidence suggests that some of those activist efforts impair firm profitability in the long-term. Yet even on an unempirical level, investor short-termism coupled with the rise of activism is worrisome, for it leads intuitively to the conclusion that investors will, on occasion, use activism to bring about decisions that create short-term value, even where that might impair the long-term well-being of a firm.

Advocates of shareholder voice have justified shareholders’ ability to influence the board on the basis that shareholders as a class would never vote to adopt measures that did not benefit shareholders collectively – as represented by approval by a majority of shareholders. This was supported by the number of shareholder proposals that addressed social concerns of pension funds that did not receive majority vote approval. But now that shareholders are affecting corporate decisions outside of the shareholder franchise, it once again raises the concern that shareholders are influencing board decisions in their own self-interest, without any “cleansing” majority shareholder vote to ensure their actions benefit the majority of shareholders. The fact that many activist

121 This is the same phenomenon that causes officers to be short-termists that is discussed infra in Part I.C.
122 See supra note 40 and accompanying text.
123 The King Pharmaceuticals-Mylan Laboratories merger is one of the primary examples of a hedge fund hedging away its economic risk associated with a firm’s stock and then supporting a merger of that firm with another in which the hedge fund owned a substantial interest at a price that stockholders generally viewed as inadequate. See Kahan & Rock, supra note 34, at 1075 (describing the Mylan Laboratories transaction as a “particularly extreme form of a hedging-related conflict”). While the hedge fund did not use activism to influence the Mylan Laboratories board to seek a merger, it is not difficult to imagine a situation where a hedge fund would seek to influence that decision through activism. See also Anabtawi & Stout, supra note 14, at 1286-87 (indicating that conflicts between activists and other shareholders can exist when activist shareholders take “adverse positions” in derivatives or in securities offered by other companies, and citing as an example a hedge fund that takes a net short position in a company, which allows the hedge fund to profit from its status as a shareholder, and pushes for corporate strategies that drive share price down).
125 See discussion supra note 87 and accompanying discussion.
investors have shorter investment horizons than other investors only contributes to the long-term risk to corporations of this type of activism.

C. Executive Officer Short-Termism Affects Board Decisions

Investors are not the only class of corporate constituent that has reasons to pressure the board for decisions that yield short-term profits. Executive officers also have reasons to want a corporation to be profitable in the short-term.

The primary rationale for executives’ short-term focus is the prevalence of the executive compensation practice of tying executive compensation to short-term financial metrics such as stock price and earnings per share. This creates an incentive for officers to manage with the goal of maximizing short-term profits, thereby increasing the amount of their compensation. This short-termism by officers impacts boards, for boards rely heavily on officers to provide the information they need to make business decisions.

Thus officers have an incentive – and the means - to provide information favoring short-term business decisions. Boards also rely heavily on officers in forming strategy, for boards are effectively overseers of the strategic-planning process. Again, to the extent officers control the strategy-setting agenda and information flow to the board, that process is undoubtedly imbued by officers’ short-term agenda. This is particularly true as boards become more independent per SEC and stock exchange rules, placing them more at the mercy of corporate insiders for information and strategic ideas.

Committee for Economic Development, Built to Last, supra note 56, at 3 (“Performance triggers for incentive payments, when used, are often tied to short-term financial indicators such as annual earnings per share or share-price performance. Such targets encourage executives to adopt too short a time horizon and to focus too much on short-term share price and accounting measures and not enough on long-term strategic development.”).

127 See Committee for Economic Development, Built to Last, supra note 56, at 3.

128 Franklin A. Gevurtz, The Historical and Political Origins of the Corporate Board of Directors, 33 HOFSTRA L. REV. 89, 105 (2004) (“As a practical matter, the outside directors must rely on information presented to them by the corporation’s officers when making decisions….Given these constraints of time and information, the board can hardly initiate much of any corporate strategy or decisions. Instead, the board’s role largely falls to approval of such strategies and decisions as officers bring before the board.”).


There is a strong movement afoot to tie officer compensation to long-term performance targets. This is exemplified by the large number of proposals made by shareholders since 2006 requesting that shareholders be given an advisory vote on executives’ compensation, or a “say on pay”. While those proposals generally do not identify as their goal a desire to tie management compensation to long-term performance, boards seem to interpret that as their implicit purpose, as they generally respond by identifying how their compensation arrangements already award managers for long-term profitability.

The federal government, too, has immersed itself in this movement towards coupling manager compensation and long-term corporate performance. While the world awaited a quick Congressional response to the financial crisis which threatened the survival of insurance giant AIG and banks Bank of America and Citigroup, among others, Congress debated how to limit the profit-based compensation of the executives whose institution were ailing and needed financial assistance. The result was a host of restrictions in the law setting forth the U.S. Treasury’s initial effort at a bail-out – the Emergency Economic Stabilization Act of 2008, or EESA - aimed at de-coupling executive compensation and short-term performance at companies that receive meaningful financial assistance from the U.S. Treasury. These restrictions include a prohibition on senior executives’ compensation for “unnecessary and excessive risks that threaten the value of the financial institution.” Moreover, those executives must repay any income awarded to them due to financial performance that later turns out to be

Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 GEO. L. J. 797, 803 (2001) (arguing that objective outsiders also serve a useful purpose in strategic planning as they can expose insiders’ biases).


132 See supra note 85 and accompanying text.

133 See e.g. Exxon Mobil Corp., Additional definitive proxy soliciting materials and Rule 14(a)(12) material (Schedule 14A), at 2 (May 12, 2008) (“The Board works diligently to ensure that the Company’s compensation philosophy and elements drive behavior that is aligned with long-term shareholder value creation.”); UnitedHealth Group Inc., Definitive Proxy Statement (Schedule 14A), at 21(Apr. 28, 2008) (“We endeavor to closely align these goals [the achievement of enterprise, business unit and individual goals] with shareholder interests by defining expected business, customer and employee outcomes that create shareholder value over the longer term.”); General Motors Corp., Definitive Proxy Statement (Schedule 14A), at 26 (Apr. 25, 2008) (identifying as one of the purposes of long-term compensation (but not short-term compensation) as focusing on “stockholder value”).


136 Id. at § 5221(b)(2)(A).
materially erroneous.\textsuperscript{137} And none of those executives may receive a severance bonus upon a change in control while the Treasury holds its investment.\textsuperscript{138} Congress passed a second bail-out law – the American Recovery and Reinvestment Act of 2009, or ARRA - on the heels of the EESA, with the goal of stimulating the U.S. economy primarily through federal tax cuts, job creation and domestic spending initiatives.\textsuperscript{139} The AARA greatly expands on the EESA’s compensation restrictions by capping the amount of incentive compensation that may be paid to senior executives of companies that receive financial assistance under the EESA to one third of the amount of their salaries.\textsuperscript{140} Yet the AARA goes further, capping the salaries, not only of top executives, but also of the next 20 most highly paid employees, at companies that receive exceptional assistance from the U.S. Treasury.\textsuperscript{141} While these restrictions follow on the heels of the EESA’s efforts to curb the mis-match between executive compensation and true long-term performance, they clearly go further by limiting the total compensation (regardless of long-term profitability) that may be paid to the most highly compensated employees at all companies that receive funds from the U.S. Treasury.\textsuperscript{142}

These new bail-out laws are clearly targeted at limiting the incentives for executives to manage in a way that benefits themselves financially in the short-term, notwithstanding the future risks those decisions pose, including the disappearance of those profits over the long-term. Still, the EESA and ARRA only apply to firms that

\textsuperscript{137} Id. at § 5221(b)(2)(B). This requirement is similar to the claw-back provision of the Sarbanes-Oxley Act of 2002, though SOX requires misconduct for the claw-back requirement to kick in. See 12 U.S.C.A. § 7243(a) (West 2009).


\textsuperscript{139} American Recovery and Reinvestment Act preamble.

\textsuperscript{140} Id. at §7001. Moreover, this incentive compensation may only be paid in the form of restricted stock. Id.

\textsuperscript{141} Id. This restriction applies to officers and employees at companies that receive more than $500 million in funding under the TARP established under the EESA. Id. The act also expands the ban on golden parachutes under the EESA so that it applies to all companies that receive funds from the U.S. Treasury under the TARP. Id. This act more broadly implements some of the guidelines that had previously been promulgated by the U.S. Treasury, also aimed at limiting the compensation of top executives. See U.S. Dept. of Treasury, Treasury Announces New Restrictions On Executive Compensation (Feb. 4, 2009), available at: http://www.ustreas.gov/press/releases/tg15.htm. In these guidelines, the Treasury also called for the SEC’s cooperation to pass regulations that require compensation committees of all public financial institutions to review and disclose executive and certain employee compensation arrangements and explain how these compensation arrangements are consistent with promoting sound risk management and long-term value creation for their companies and their shareholders. Id.

\textsuperscript{142} As Professor Lucien Bebchuk has argued, the restriction “[m]andating that at least two-thirds of an executive’s total pay be decoupled from performance, as the stimulus bill does, is a step in the wrong direction”, as it constrains boards’ ability to reward executives for long-term performance. Lucien Bebchuk, Congress Gets Punitive on Executive Pay, WALL ST. J., Feb. 16, 2009, available at http://online.wsj.com/article/SB123483031127995587.html.
receive financial assistance from the U.S. Treasury – and many of the restrictions only apply to the senior executives at firms that receive significant financial assistance. Yet it should be obvious that the compensation problems that these laws seek to address are not limited to the few institutions that obtain financial assistance from the U.S. Treasury. Nevertheless, through these laws Congress likely sought to set new standards in the area of executive compensation, to be followed by boards of firms that do not receive the U.S. Treasury’s financial assistance. This is consistent with the message that has been repeatedly delivered by President Obama’s administration that the administration is placing at the top of its agenda curbing the mis-match between executive compensation and corporate performance.

D. **Summary**

While the stock market would, in an ideal world, cause investors to price a corporation’s stock at its true value, we do not live in an ideal world. Stock prices overly reflect the short-term values of firms. That largely stems from investors’ over-reliance on financial statements that fail to capture firms’ long-term values, as well as the speculative nature of public company investments which promote active trading and short holding periods. While not every investor is a “short-termist”, these information biases would tend to make investors more short-termists than they might otherwise be. Investor short-termism also emerges from investors’ cognitive limitations, exemplified by the current

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143 This seems to be yet another example of Congress treading on state corporate law’s domain of regulating internal affairs of corporations incorporated in those states. See THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 800 (2005) (noting a departure after the Sarbanes-Oxley Act of 2002 from the dichotomy where states define officers’ and directors’ duties and federal securities laws regulate information provided to investors). On that basis, I question whether a federal, one-size fits all legislation in the area of executive compensation is the best way to address the problem of excessive short-termism, especially given the myriad of different reasons why investors and boards are short-termists, as discussed in this article. My recommendation for addressing the short-termism problem in a more general way is discussed in Part V.

144 See e.g. Pres. Barack Obama, Remarks by President Barack Obama on Executive Compensation with Secretary Geithner (Feb. 4, 2009), available at http://www.whitehouse.gov/the_press_office/RemarksbyPresidentBarackObamaOnExecutiveCompensationSecretaryGeithner (“[I]n order to restore our financial system, we’ve got to restore trust. And in order to restore trust, we’ve got to make certain that taxpayer funds are not subsidizing excessive compensation packages on Wall Street…. [W]hat gets people upset – and rightfully so – are executives being rewarded for failure. Especially when those rewards are subsidized by U.S. taxpayers.”); Treasury Announces New Restrictions On Executive Compensation (Feb. 4, 2009), available at http://www.treas.gov/press/releases/tg15.htm (“[The] standards [referring to the new Treasury guidelines on executive pay] . . . mark the beginning of a long-term effort to examine both the degree that executive compensation structures at financial institutions contributed to our current financial crisis and how corporate governance and compensation rules can be reformed to better promote long-term value and growth for shareholders, companies, workers and the economy at large and to prevent such financial crises from occurring again.”).
financial crisis in which investors were caught up in the housing bubble and herded to the same financial securities despite the long-term risks of those investments.

Investors whose investment strategies include activism tend to have shorter investment horizons than the average investor. These investors have been using techniques outside of the shareholder franchise to compel boards to make decisions that benefit these investors in the short term, while having a potential value-destroying impact on the corporation in the long-term. Directors are not impervious to these short-term pressures, not only because they risk not being reelected if they appear to be unresponsive to shareholder demands, but also because they are exposed to the risk of ouster in connection with a takeover transaction if they do not maintain a high stock price. Directors likely also focus on short-term performance because that is the time period as to which executives are concerned, due to the nature of their compensation. That impacts the board because the executive officers are the board’s primary source for information about the corporation’s operations as well as areas for growth. Moreover, the executive officers actually develop and implement the corporation’s strategy while the board merely oversees that from its independence perch.

But is short-termism necessarily a bad thing? In other words, might it not be a good thing to allow investors and managers to profit off of short-term stock price movements, even if that impairs a corporation’s long-term success? That is the question that I turn to next.

II. IS SHORT-TERMISM BAD?

We need to look no further than the current financial melt-down to get a sense of the ill effects of corporate short-termism, not just on individual business enterprises, but on the entire U.S. economy and community. To set the stage, we must first understand the role of short-termism in causing the recent crisis.

Leading up to the current financial crisis, financial institutions took large positions in mortgage-backed securities (MBOs) and collateralized debt obligations (CDOs). MBOs are securities whose payment derives principally or entirely from mortgage loans, while CDOs are securities whose payment derives from a mixed pool of mortgage loans and other receivables. When home prices plummeted in 2008, many borrowers defaulted on their loans, including loans that backed MBOs and CDOs. The

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146 Schwarcz, supra note 72, at 376. There is a separate class of securities that is backed by a mixed pool of MBOs and other asset-backed securities (ABSs), referred to as ABS CDOs. Id. To the extent those pools contain MBOs, they, too, derive their payments from mortgage loans. Id.

147 Id. at 378-79.
result was either the impairment, or total loss, in value of MBOs and CDOs, particularly those that were more junior in priority of payment.\textsuperscript{148} One of the primary reasons why financial institutions invested so heavily in these securities is that they failed to appreciate the longer-term risks associated with these investments - particularly the risk of a housing market collapse.\textsuperscript{149} This may have resulted from the euphoria of the moment (i.e. a bubble), where investors failed to pay close attention to what they were buying,\textsuperscript{150} or the herding phenomenon, meaning investors simply followed the pack to invest in MBOs and CDOs.\textsuperscript{151} Or it may have resulted from factors similar to those that impel executives to manage for the short-term – namely, compensation for originators and investment bankers that was tied to short-term success (i.e. security placement) notwithstanding the longer-term risks of an investment in the securities they originated and sold.\textsuperscript{152} As a consequence, many firms had large exposures to MBOs and CDOs that, once the longer-term risks materialized, generated tremendous firm losses, reversing previously realized profits.\textsuperscript{153}

These losses have had a significant impact not only on the particular firms that invested in the MBOs and CDOs, but also on the entire U.S. economy. Due to the failure of so many financial institutions, the credit markets have seized up, making it very difficult for U.S. businesses to get the debt financing they need to operate.\textsuperscript{154} This has, in turn, led to a dramatic decline in capital spending and R\&D spending.\textsuperscript{155} This is alarming, for capital investments and R\&D are the lifeblood of corporate growth.\textsuperscript{156} Without these types of investments and expenditures, there would be no new

\textsuperscript{148} Id.
\textsuperscript{149} Id. at 379 (arguing that the failure of investors to envision a worst-case scenario that would result from the fall of the housing market reflected to some extent a failure to take a sufficiently long term view of risk); see also Lowenstein, supra note 41 (“Nobody [who invested in MBOs and in the banks that own them] was thinking about what these companies were worth, only about the next quotation on the screen”). But see Schwarcz, supra note 72, at 380 (arguing that the failure to have forecasted a worst-case possibility such as the experience of the Great Depression is inevitable since that is assessed \textit{ex ante}).
\textsuperscript{150} Schwarcz, supra note 72, at 382.
\textsuperscript{151} Id.
\textsuperscript{152} See id. at 384-85
\textsuperscript{153} Though not for the originators and fund managers whose compensation was not clawed back following these losses. Id.
\textsuperscript{155} See id. at 5 (“After advancing 7.5% in 2006, the pace of spending by businesses on new plant and equipment slowed to 5.0% in 2007, and through the second quarter of 2008 that pace had slowed to about 2.3%.”).
income-producing assets, and no new innovations, to steam corporate growth. A firm creates wealth through a capital investment or R&D expenditure by investing in new products and ways to commercialize existing products and services. But it takes time for these investments to materialize.

The seizing up of the credit-markets post-crisis does not alone explain the decline in capital investments and R&D expenditures. This is also due in part to pressure placed on managers to forego R&D and capital expenditures as a way to boost corporate profits. Unless this pressure is alleviated, the trend towards decreasing levels of capital investments and R&D may continue, leading to a decline in innovation and entrepreneurship in the U.S.

The financial crisis also shows the significant social cost of the failure of numerous large U.S. public companies. Since the start of the current recession, the U.S. unemployment rate has soared to 7.2% from 4.9% in December 2007. And the trend towards increasing unemployment seems to be continuing.

All of these and other adverse consequences of the financial crisis reaffirm the view of the corporation – specifically the public corporation - as not simply an autonomous, self-contained economic unit, but instead as a key member of the economic and social fabric of the U.S. economy. Recognizing the impact of the crisis on U.S. businesses, the economy and citizens, the federal government has staged the largest cumulative financial assistance package ever conceived, providing to date over $2.1 trillion in capital to U.S. businesses as well as more than $212 million to individual

visited Mar. 2, 2009) (“An inadequate rate of reinvestment in science and technology is hampering America’s feeder system for entrepreneurship.”); Statement of President Barack Obama (Jan. 3, 2009), available at http://change.gov/newsroom/entry/american_recovery_and_reinvestment/ (“We must make strategic investments that will serve as a down payment on our long-term economic future”).

157 See William T. Allen & Leo E. Strine, Jr., When The Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton’s Vision of the Corporate Law, 60 BUS. LAW. 1383, 1388 (2005) (“For him [referring to Martin Lipton], social wealth is actually created, not in financial markets, but within corporations – where research scientists invent products, engineers plan, and marketing and production people at all levels of the corporation develop and execute strategies to deliver attractive goods and services efficiently.”); Porter, supra note 156.

158 See discussion supra Part I.A.2.


160 U.S. Department of Labor statistics show that there has been an increase in unemployment in every month since December 2007. Id.

161 Berle and Means recognized this to be true over 75 years ago. See BERLE & MEANS, supra note 20, at 1 (describing the public corporation as a “major social institution”).
taxpayers. The terms of the financial assistance clearly show a policy in favor of U.S. businesses creating sustainable business models. This is reflected in the compensation provisions of the EESA and ARRA, as well as in the conditions placed on the funds made available to the big-three U.S. automakers. It is also apparent from repeated messages delivered by the Obama administration that U.S. businesses need to be successful in the long-term.

In summary, the current financial crisis has shown the ills of corporate short-termism on U.S. businesses as well as on our national economy and citizenry. Not only did businesses fail to appreciate risks associated with their investments due to their short-term profit-induced stupor, but they also failed to protect themselves from those risks. The collective impact has been numerous corporate failures, a serious contraction in credit markets, an alarming decline in employment and an overall skepticism as to the strength of the U.S. economy.

That is not to say that corporations, and corporation law, should be designed to enhance social wealth without regard to financial returns to investors. In fact, if directors ignored or placed a second priority on stockholders’ financial interests, investors would undoubtedly be reluctant to part with their money for fear that their investments would simply be used to create wealth for others in society. But corporate law, as other law, reflects a series of policy choices. Thus the policies that serve as the foundation for our corporation laws should reflect the reality that the purpose of corporations is not simply to generate wealth for the corporate “owners” in the short term, but to generate wealth for those owners in the longer-term, as well as wealth for our society as a whole. As William Allen, former Chancellor of the Delaware Chancery Court, and Vice Chancellor Strine have keenly observed on this point, “corporation law itself, in this view

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163 See discussion supra notes 135-141 and accompanying text.

164 Both Congress and the administration set as a condition to financial assistance to any of the big-three U.S. automakers that it present a business plan showing how it could be profitable on a sustainable basis. See U.S. Department of the Treasury - Program Descriptions - Automotive Industry Financing Program, available at http://www.treas.gov/initiatives/eesa/program-descriptions/aifp.shtml (stating that the Automotive Industry Financing Program “will require steps be taken by participating firms to implement plans that achieve long-term viability”).

165 See e.g. Statement of President Barack Obama (Jan. 3, 2009), available at http://change.gov/newsroom/entry/american_recovery_and_reinvestment/__ (“We need an American Recovery and Reinvestment Plan that not only creates jobs in the short-term but spurs economic growth and competitiveness in the long-term”).

166 See Lipton & Rosenblum, supra note 13, at 193 (“Given the corporation’s origins as a historical and legal construct created for specific public policy reasons, the state naturally may choose to condition the use of the corporate form upon compliance with rules that advance societal goals, even if those goals clash with stockholder interests.”).
[referring to Martin Lipton’s institutionalist view] is seen as but a part of a larger economic and social policy that sought and seeks to promote wealth creation, not simply for the benefit of stockholders and managers, but more generally for the benefit of a nation…“167

As a vital component to the creation of durable societal wealth, corporations must look to being successful in the long-term, to give their capital investments time to germinate and yield returns. It is counterproductive to this goal for corporations to focus primarily on generating profits for their investors on a quarter-to-quarter or even year-to-year basis.168 Because long-term wealth creation is a substantial policy concern, corporate laws should be designed to further that interest, and to dissuade corporate players from pursing counter-productive goals.

The obvious question then becomes: how do we fix our system so that it achieves the goal of long-term value creation? Perhaps the best place to start is at the board level, as directors are the hubs that keeps the corporate spokes together. It is thus to the board that I turn to next.

III. WHAT IT MEANS FOR DIRECTORS TO ACT IN THE BEST INTEREST OF THE CORPORATION AND ITS STOCKHOLDERS

As I discuss in Part I, investors in public companies as well as some executives have reasons to want corporations to generate profits in the short-term. Part I also explains how those investors and executives can influence boards to make decisions that are responsive to their short-term interests. However as I explain in Part II, managing a corporation for the benefit of those short-term interests is antithetical to the goal of creating sustainable wealth for individual businesses and for our economy.

This section explains why directors have the freedom to be responsive to investors’ and executives’ short-term interests under their fiduciary duties, even thought that runs counter to the interests of long-term minded investors, other corporate constituents and our economy. This discussion focuses on Delaware law, not only because it is the jurisdiction where the majority of public corporations are

167 Allen & Strine, supra note 157, at 1385; Leo E. Strine, Jr., Response, Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America, 119 HARV. L. REV. 1759, 1764 (2006) (“The primary goal of corporate law [under the traditionalist perspective], therefore, is not to prevent failure at each and every firm to the fullest extent possible, but to facilitate the maximum creation of durable societal wealth by all firms.”).

168 The many business and investment leaders who met at the Conference Board’s Corporate/Investment summit echoed this sentiment. As their report states, “Undoubtedly, the health of an economic system depends on its ability to perform well year after year – not only during the next quarter.” Tonello, Revisiting Stock Market Short-Termism, supra note 56, at 5; see also Lipton & Rosenblum, supra note 13, at 192 (“The health and stability of these economies [referring to the economies of the U.S. and U.K.] depends on the ability of corporations to maintain healthy and stable business operations over the long term and to compete in world markets.”).
incorporated, but also because Delaware law is followed, or looked to for guidance by, courts in other jurisdictions.

A. Introduction

Directors oversee the management of the business and affairs of the corporation on whose board they serve. In this capacity, they are described as fiduciaries of the corporation and its shareholders. That means that in exercising their powers, directors must comply with their fiduciary duties.

In Delaware, directors owe the fiduciary duties of care and loyalty. Under the duty of care, every director must become informed of all material information reasonably available before making a business decision. However, directors are only liable for failing to comply with that duty where their failure amounts to gross negligence. And even then they might not be liable if the corporation has an exculpation charter provision or otherwise agrees to exculpate the directors for breaches of the duty of care.

The duty of loyalty mandates that every director act in good faith in a manner she reasonably believes to be in the best interests of the corporation and its shareholders.

169 See BLOCK ET AL., supra note 92, at 20-23 (finding that a majority of public corporations are incorporated in Delaware).

170 Nadelle Grossman, Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform, 2007 FORDHAM J. OF CORP. & FIN. L. 397 (2007); see also Dennis J. Connolly & Bess M. Parrish, Current Issues Involving the Application of Exculpation and the Business Judgment Rule to Creditors' Suits Against Directors of Insolvent Corporations, 2006 ANN. SURV. OF BANKR. LAW Part I § 1, at II(A) (2006) (“Many courts look to the Delaware jurisprudence in connection with analyzing corporate law issues, although, as a matter of choice of law, under the ‘internal affairs doctrine,’ fiduciary duty issues are decided by the law of the state of incorporation.”).

171 DEL. CODE ANN. tit. 8, §141(a) (West 2009).


174 Id. at 367 (“Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders.”).


176 Id. The business judgment rule explains this disparity between the standard of conduct and standard of liability for breaches of the duty of care. Under that rule, business decisions are presumed to have been made in good faith, on an informed basis, and in an honest belief that the action taken is in the best interest of the corporation. Id. To rebut that presumption, a stockholder must prove that the board failed to so inform itself, and that failure amounted to gross negligence. Id.

177 See DEL. CODE ANN. tit. 8, §102(b)(7) (West 2009); Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) (“Our jurisprudence since the adoption of the statute has consistently stood for the proposition that a Section 102(b)(7) charter provision bars a claim that is found to state only a due care violation.”).

178 Cede & Co. v. Technicolor, Inc., 634 A.2d at 361 (citing Pogostin v. Rice., 480 A.2d 619, 624 (Del. 1984)).
Courts most often analyze the duty of loyalty by explaining how a director violates that duty. In that regard, a director fails to act in the best interest of the corporation and its stockholders where she acts in a way that works injury to the corporation or deprives the corporation of a profit or advantage that her skills and ability might bring to the corporation, or that the corporation would make in the exercise of its powers.

Moreover, a director violates her duty of loyalty where she acts in bad faith. The Delaware Supreme Court has identified at least three ways in which a director can be found to have acted in bad faith. One way is to consciously disregard her duties. Bad faith also exists where a director acts with a subjective intent to harm a corporation. A third type of bad faith involves a director who acts carelessly with a higher state of culpability than gross negligence, though it is not entirely clear exactly what level of culpability is required.

But fiduciary duties are not merely proscriptive, indicating what conduct a director may not engage in. They also requires directors to affirmatively protect the interests of the corporation committed to her charge. This affirmative aspect of fiduciary duties is important, for it instructs directors that their business decisions and oversight responsibilities must be implemented not merely to avoid breaching a duty of trust to the corporation, but to affirmatively advance the corporation’s purpose.

Delaware court decisions have focused much less on this positive aspect of fiduciary duties than on their proscriptive aspects. That is undoubtedly due to the fact that the cases that appear before the Delaware courts involve sub-par director conduct, where the courts are asked to determine whether that conduct meets the minimum standard of loyalty or care. Yet it is important to understand exactly what the affirmative

\[179\] See e.g. Cede & Co., 634 A.2d at 362 (“Classing examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.”).

\[180\] Cede & Co., 634 A.2d at 361; Guth v. Loft, 5 A.2d at 510.

\[181\] Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006) (clarifying that the failure to act in good faith results in liability because it is a necessary condition to compliance with the duty of loyalty).

\[182\] See In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006).

\[183\] Id. at 66-67.

\[184\] Id. at 64.

\[185\] See id. at 64-66.

\[186\] Cede & Co. at 361; Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (“Not only do these principles demand that corporate fiduciaries absolutely refrain from any act which breaches the trust reposed in them, but also to affirmatively protect and defend those interests entrusted to them.”) (italics added); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 954 (“[T]he board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source.”); Guth v. Loft, 5 A.2d at 510.
aspect of fiduciary duties requires, for that establishes what purpose, and for whose benefit, directors must manage and oversee corporate affairs.\textsuperscript{187}

It seems particularly important to determine how directors affirmatively act in the best interest of the corporation and its stockholders in the current environment, as investors are increasingly placing pressure on boards to make decisions that yield short-term results and executive compensation arrangements have been further driving managers to press boards to proceed in that direction. By determining what the corporation’s and its stockholders’ true interests are that directors must advance, directors should be able to more clearly determine whether their decisions are truly in the best interest of the constituents who they must protect under their fiduciary duties.

The remaining portion of this Part IV explores how the Delaware courts have interpreted and applied the positive duty to act in the “best interest of the corporation and its stockholders”.

\textbf{B. Acting in the Best Interest of the Corporation and its Stockholders}

In Delaware, courts generally interpret the affirmative duty to act in the best interest of the corporation and its stockholders as imposing on directors the duty to advance corporate wealth through profitability.\textsuperscript{188} While courts generally state this guiding principle to be true, they do not provide any consistent explanation as to the basis

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\item[\textsuperscript{187}]While not implementing a corporation’s purpose would most likely amount to disloyal conduct under the duty of loyalty, it could also amount to a breach of the duty of care, for under their duty of care, directors must undertake sufficient processes to make informed decisions that further the corporation’s purpose. See \textit{In re Walt Disney Co. Derivative Litig.}, 907 A.2d 693, 749 (Del. Ch. 2005) (quoting \textit{In re Caremark Int’l Inc. Derivative Litig.}, 698 A.2d 959, 967-68 (Del. Ch. 1996), aff’d, 906 A.2d 27 (Del. 2006) (“[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through ‘stupid’ to ‘egregious’ or ‘irrational’, provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests.”)); Sean J. Griffith, \textit{Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence}, 55 DUKE L.J. 1, 41-42 (2007) (“The duty of care, in other words, contains within itself an assumption that the decisionmaker is motivated by the corporation's business purpose.”). While the duty of care largely lacks teeth, as directors can be exculpated for liability arising out of breaches of that duty, directors’ failure to exercise sufficient care may create liability where that failure amounts to bad faith. See \textit{supra} notes 177 and 183 and accompanying text.
\item[\textsuperscript{188}]See \textit{Paramount Commc’n, Inc. v. Time Inc.}, 571 A.2d at 1150 (“This broad mandate [referring to the board’s duty to manage the business and affairs of a corporation under the Delaware General Corporation Law §141(a)] includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability.”); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 787 (Del. Ch. 2004) (“[D]irectors-as fiduciaries in equity-are primarily focused on generating economic returns that will exceed what is required to pay bills in order to deliver a return to the company's stockholders who provided equity capital and agreed to bear the residual risk associated with the firm's operations.”) (italics added).
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for it. Yet there seems to be two distinct rationales for this corporate purpose, seen in two separate lines of cases.

In the first lines of cases, the Delaware courts have suggested that directors must make decisions with the *sole objective* of maximizing profits because that is what stockholders, the sole residual beneficiaries of the corporation, want. Presumably the stream of logic flows as follows: common stockholders are the residual beneficiaries of a corporation because when a stockholder invests in a corporation’s common stock, that stock entitles the holder to a proportionate share in the assets of the enterprise after all claims of debtors and other claimants are paid. That means that on dissolution, shareholders receive the value of a corporation’s assets in excess of its debts. Not surprisingly, the difference between the value of assets and debts on a corporation’s balance sheet is called “shareholders’ equity.” Shareholders’ equity grows when the value of assets increases (without a corresponding increase in debts), which occurs through the accumulation of profits. Thus the more profits a corporation earns, the higher will be its shareholders’ equity (until those profits are distributed to stockholders or used in operations).

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190 See e.g. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (“The directors of Delaware corporations have ‘the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners’….they [referring to the shareholders] are the ultimate beneficiaries of the corporation’s growth and increased value.”). For cases referring to shareholders as the sole residual beneficiaries, at least where a corporation is solvent, see N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d at 101 (“When a corporation is solvent, those duties [referring to fiduciary duties] may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation’s growth and increased value”) (italics in original); Applebaum v. Avaya, Inc., 812 A.2d 880, 886 n. 7 (Del. 2002) (“Shares of stock are issued to provide a verifiable property interest for the residual claimants of the corporation”); see also Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 613 (2006) (noting, as the basis on which only shareholders receive voting rights, that shareholders are the only constituents with a residual, unfixed, ex-post claim on corporate assets and earnings).

191 See DEL. CODE ANN. tit. 8, §281 (West 2009) (requiring, in dissolution, that all non-shareholder claimants’ claims be paid first, and thereafter “any remaining assets shall be distributed to the stockholders of the dissolved corporation”).


Yet by indicating the corporate purpose in terms *only* of what stockholders want (profits), some courts have effectively ignored what the interest of the “corporation” is. The flaw in this construction, of course, is that Delaware courts consistently pronounce fiduciary duties as being owed to both stockholders and the corporation.194 We must therefore assume that both are intended to be covered by fiduciary duties. The fact that the inclusion of both the “corporation” and the “stockholders” in fiduciary duties has persisted for so long and been referred to so pervasively in Delaware court opinions lends further support to the fact that these bodies are both intended to be included.195

Perhaps these courts only look at the interest of stockholders in assessing to whom fiduciary duties are owed as only stockholders have the right to enforce fiduciary duties against directors.196 Yet that does not mean that directors do not owe the corporation these duties. As is true with the duty of care, where directors aspire to become informed of all information reasonably available before making decisions yet are not liable unless their failure to do so amounts to gross negligence, there is an aspirational aspect to fiduciary duties. This aspirational aspect often leads courts to instruct directors how they *should* perform their duties as directors, even if there is no liability flowing from the failure to meet that standard.197 Perhaps courts in this line of cases do not separately analyze (or mention) the duty owed to the corporation because they believe the interests of the corporation and its stockholders are exactly the same.198

In the second line of cases, the Delaware courts have recognized that the corporation’s interest is a unique component of fiduciary duties, and have authorized the board to consider that interest separately from the interest of stockholders.199 In those

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194 See *supra* note 172 and accompanying text.
195 Delaware statutory law also supports the distinction between the corporation and its stockholders. See *e.g.* DEL. CODE ANN. tit. 8, §121 (West 2009) (describing a corporation’s general powers and distinguishing the corporation from its officers, directors and stockholders).
196 N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d at 101. Though upon a corporation becoming insolvent, its creditors, too, may enforce the directors’ fiduciary duties. *Id.*
197 See *Veasey, supra* note 129, at 1416 (explaining the difference between a standard of conduct, which is an aspirational standard for what is expected of directors, and a standard of review, which governs whether a director will be held liable).
198 See *e.g.* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d at 101 (“It is well settled that directors owe fiduciary duties *to the corporation*. When a corporation is *solvent*, these duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation ….”) (first italics added, the rest in original).
199 See *e.g.* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 954-956 (authorizing the board to consider shareholder and non-shareholder interests at stake in considering whether the best interest of the corporation and its shareholders requires directors to pursue a takeover bid); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d at 788 (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’n Corp., No. No. 12150, 1991 WL 277613, at *34 & n. 55 (Del. Ch. Dec. 30, 1991).) (“The obligation of directors in that context of high risk and uncertainty [referring to the zone of insolvency] … was not ‘merely [to be] the agent of the residue risk bearers’ but rather to remember their fiduciary duties to ‘the corporate enterprise’ itself, in the sense that the directors
cases, the courts have typically presumed that the corporation’s interest, like stockholders’ interest, is in corporate profitability. Yet they generally have made this assumption without any analysis as to what the corporation’s interest is or why it is in profitability. Thus the presumption underlying these decisions, like the cases discussed above, seems to be that board decisions designed to enhance corporate profitability are in the interests of both the corporation and its stockholders, and thus there are no inconsistent interests to consider.

Still, the Delaware courts have on occasion suggested that the interest of the corporation may differ from the interest of stockholders, at least in the takeover context. Unocal, decided in 1985, involved a challenged Unocal board decision to offer to repurchase Unocal stock for cash as a defensive measure, to prevent Unocal stockholders from tendering shares to Mesa pursuant to its two-tiered coercive tender offer. In that case, the Delaware Supreme Court held that the Unocal board had “a fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived”. This language, as well as other consistent language in this opinion, shows that the Court viewed the interest of stockholders as simply one component of the interest of the corporation. Moreover, the Court authorized the board, in evaluating Unocal’s interest, to consider the interests of its constituencies other than shareholders, and referred specifically to the interests of creditors, customers, employees, and “perhaps even the community generally” for this purpose. This suggests that the interests of non-stockholder constituents might differ from the interests of stockholders, for if they were the same, there would be no need to authorize the board to consider them independently. Still, the Court did not indicate what have an obligation ‘to the community of interest that sustained the corporation ....’ and to preserve and, if prudently possible, to maximize the corporation’s value to best satisfy the legitimate claims of all its constituents, and not simply to pursue the course of action that stockholders might favor as best for them.”. 

See e.g. Paramount Commc’n, Inc. v. Time Inc., 571 A.2d at 1150 (“This broad mandate [referring to the board’s authority to manage a corporation’s business and affairs under 8 Del.C. §141(a)] includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability.”); TW Services, Inc. v. Crown, No.’s 10427 & 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) (indicating that the board, outside of Revlon mode, has a duty to the corporation and its shareholders to seek long term values).

Still, some of these decisions suggest that the corporation’s and stockholders’ interests in profitability are only aligned in the long-term. See e.g. TW Services, Inc. v. Crown, No.’s 10427 & 10298, 1989 WL 20290, at *7 (“I take it as non-controversial that, under established and conventional conceptions, directors owe duties of loyalty to the corporation and to the shareholders; that this conjunctive expression is not usually problematic because the interests of shareholders as a class are seen as congruent with those of the corporation in the long run”).

See e.g. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 946, 949-951.

See id. at 949-951.

Id. at 954 (italics added); see Stout, Dodge v. Ford, supra note 189, at 170 (arguing that this language shows that the corporation and stockholders are not the same under the duty of loyalty).

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 955.
the interests of these constituencies were, and instead deferred to the board to make that determination.\textsuperscript{206}

Moreover, the Court in \textit{Unocal} did not indicate that the board could place the interests of non-shareholder constituents \textit{above} – or even on equal footing to – the interests of stockholders. And in fact the Court subsequently indicated in \textit{Revlon} that the board can only consider the interests of non-stockholder constituents so long as they are “rationally related” to the interests of stockholders in profit maximization.\textsuperscript{207} While this statement in \textit{Revlon} was likely dicta,\textsuperscript{208} subsequent cases citing to this proposition from \textit{Revlon} indicates judicial support for it, even where a corporation is not in “\textit{Revlon}” mode.\textsuperscript{209}

Nor was the board in \textit{Unocal} or in the other discussed cases \textit{required} to consider non-shareholders’ interests. At most, the courts simply \textit{permitted} the boards to consider those interests. While the courts have not explained why this consideration is only permissive despite the fact fiduciary duties seemingly require a consideration of the corporation’s interest as well as stockholders’ interest, logic and intuition suggest that it is due to the fact that the discussed cases were decided in the takeover context. In that

\textsuperscript{206}See \textit{id}.

\textsuperscript{207}Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (1986) (referring to \textit{Unocal} for the proposition that a board may have regard for various constituencies in discharging its responsibilities under \textit{Unocal}, provided there are “rationally related benefits accruing to the stockholders”).

\textsuperscript{208}The statement was likely dicta as the holding in \textit{Revlon} applies only where the sale of control of a corporation is inevitable (and thus the board may not consider the interests of non-stockholders).

\textsuperscript{209}See \textit{e.g. In re Toys “R” Us, Inc. S’holder Litig.,} 877 A.2d 975, 999 n. 32 (Del. Ch. 2005) (indicating that the portion of the Delaware Supreme Court’s holding in \textit{Revlon} restricting directors to consider non-shareholder constituencies’ interests only where those interests are rationally related to some benefit to stockholders tempered language in \textit{Unocal}, but also suggesting that this limitation only applies in the context of a decision to sell a company under \textit{Revlon}). The notion that the interests of the stockholders are primary, and the interests of other constituents secondary, can be traced back to as early as 1919, when the Michigan Supreme Court decided \textit{Dodge v. Ford}. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919). In that case, the Michigan Supreme Court held that “[a] business corporation is organized and carried on \textit{primarily} for the \textit{profit of the stockholders}.” \textit{Id}. at 684 (emphasis added). Moreover, as that court held, “it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others…” \textit{Id}. \textit{See} \textit{Stout, Dodge v. Ford, supra} note 189, at 165 (arguing that \textit{Dodge v. Ford} is routinely employed as the only legal authority for the proposition that corporate law requires corporations to have a legal duty to put shareholders’ interests above all others). But see Jonathan R. Macey, \textit{A Close Read of An Excellent Commentary on Dodge v. Ford}, 3 VA. L. & BUS. R. 177, 178-79 (2008) (noting that the American Law Institute’s \textit{Principles of Corporate Governance} are consistent with \textit{Dodge v. Ford}’s core lesson that corporate officers and directors have a duty to manage the corporation for the purpose of maximizing profits for the benefit of shareholders, and arguing that profit maximization is only a default rule).
context, the interest of stockholders is most likely to diverge from the interest of other corporate constituents, for the former would be expected to favor any takeover proposal that promised proceeds in excess of investors’ perceived intrinsic values, while the latter would likely disfavor any proposal that meant discontinuance of the firm.\textsuperscript{210} Perhaps for similar reasons, the courts in the discussed takeover cases did not require that the boards fix any particular time period for achievement of the corporate purpose.\textsuperscript{211} Again, this is likely due to the fact that in the takeover context, the board is faced with the decision of whether or not to abandon the corporation’s long-term strategy in favor of a short-term sale. Thus the takeover context seems to necessitate a broad conferral of discretion on the board as to the interests to be considered and corporate purpose to be achieved.

If this is indeed the rationale for this broad conferral of discretion on the board, then we might expect to see judicial guidance indicating that outside of the takeover context, boards must consider the best interests of the corporation and its stockholders in the long term in discharging its fiduciary duties, for there would be no competing short-term option. Indeed a number of courts have suggested a judicial preference for directors to manage for the long-term.\textsuperscript{212} Yet they generally do not require it.\textsuperscript{213} Thus absent a takeover, courts still defer to the board to decide the time period over which the goal of profitability is to be achieved.\textsuperscript{214} That means that the board must decide whether to

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\item \textsuperscript{210} See discussion infra Part IV.
\item \textsuperscript{211} See e.g. Paramount Commc’n, Inc. v. Time Inc., 571 A.2d at 1150 (“[T]he question of ‘long-term’ versus ‘short-term’ values is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon.”).
\item \textsuperscript{212} See e.g. TW Services, Inc. v. Crown, No.’s 10427 & 10298, 1989 WL 20290, at *7 (“[D]irectors, in managing the business and affairs of the corporation, may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected”). In fact, the Delaware Chancery Court has in at least two cases suggested that outside of a sale transaction, the board must maximize long-term values. See e.g. id. (“Thus, broadly, directors may be said to owe a duty to shareholders as a class to manage the corporation within the law, with due care and in a way intended to maximize the long run interests of shareholders.”); Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (“It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation’s stockholders; that they may sometimes do so “at the expense” of others (even assuming that a transaction which one may refuse to enter into can meaningfully be said to be at his expense.”). Other academics have also observed that the Delaware courts seem to favor the long-term. See e.g. Bernard Black & Reinier Kraakman, Delaware’s Takeover Law: The Uncertain Search for Hidden Value, 96 N.W. U. L. REV. 521, 527 (2002) (inferring from Revlon that directors should seek to maximize long-term shareholder value where a corporation is not in Revlon mode).
\item \textsuperscript{213} But see Katz v. Oak Indus. Inc., 508 A.2d at 879 (“[I]t is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation’s stockholders.”).
\item \textsuperscript{214} See e.g. Hahn v. Carter-Wallace, Inc., 1987 WL 18429, at *2 (Del. Ch. Oct. 9, 1987) (“While reasonable men may disagree as to whether long-term growth objectives should prevail over short-
achieve the goal of profitability over a six-month period, year period, five year period, or some other time period, so long as that time period is justifiable under the corporation’s business plan.215

But this lack of judicial guidance absent a takeover proposal would seem to permit directors to make decisions that are primarily aimed at generating short-term profits, even where that comes at the expense of long-term profitability to the detriment of long-term shareholders and other constituents. Normatively, then, we must ask – should directors have this absolute discretion where no takeover proposal is pending, or should fiduciary duty law require directors to manage corporations in that context for the long-term? The answer to this question depends on establishing that the interest of shareholders and the corporation are in fact aligned in the long term, as so often is presumed to be true, for if they are indeed aligned in the long-term, then the board would be able to discharge this duty to both stockholders and non-stockholders simultaneously. It is thus to this point that I turn to next.

IV. THE INTERESTS OF THE CORPORATION AND ITS STOCKHOLDERS ARE ALIGNED IN THE LONG-TERM

As Part III reveals, under existing fiduciary duty law, directors may make business decision that are designed to yield short-term profits, even if that comes at the expense of long-term profitability. That is because Delaware fiduciary duty law gives directors absolute discretion to decide the time horizon for achievement of the corporate purpose. Yet a number of Delaware jurists have indicated that directors should manage for the long-term.216 As is discussed in Part III, this seems to be based on their assumption that in the long-term, stockholders’ and non-stockholders’ interests are aligned.217 In this Part IV, I analyze whether the interests of stockholders and non-stockholders are indeed aligned in the long-term. I begin by analyzing the interests of stockholders (Section A) and then turn to the interests of the corporation, represented, in addition to shareholders, by its non-stockholder constituents (Section B).

A. Stockholders’ Interest In Long Term Profitability

As is discussed in Part III, stockholders are residual beneficiaries.218 That means that on dissolution, they receive the value of a corporation’s assets in excess of its liabilities.219 A corporation’s assets grow through the accumulation of profits.220 Thus

215 See Paramount Commc’n, Inc. v. Time Inc., 571 A.2d at 1154 (“Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.”).
216 See supra note 212 and accompanying discussion.
217 See id.
218 See supra notes 190-193 and accompanying discussion.
219 See id.
220 See id.
shareholders clearly have an interest in a corporation’s profitability. The receipt of periodic dividends also explains their interest in profitability, for dividends are generally paid out of a corporation’s profits. The more profits a corporation generates, the greater the likelihood that those profits will be in excess of what the company needs to operate, and will be distributed to stockholders. But do investors have an interest in a firm’s long-term profitability? If the efficient capital market hypothesis were true, then certainly investors would want a corporation to generate profits on a sustained basis, for that would mean the corporation would be generating cash flows into the future, thereby leading to a high intrinsic value calculated from those cash flows. But as I argue in Part I.A., investors have many reasons to want profits to be generated in the short term, given the short-term bias inherent in stock prices. Still, some investors – particularly those who hold their shares for a longer period of time – are less interested in short-term spikes in stock prices, for they do not trade their shares in the short term to capitalize on those price fluctuations. Moreover, significant institutional investors often take a long-term view to their investments out of necessity, for they inevitably will hold on repeated occasions stock in the same firms. Thus it seems investors diverge in the period over which they seek corporate profitability. But how can these divergent investment horizons be reconciled such that directors know how to act in the best interest of stockholders?

221 Though this may not be true for investors who have hedged away their economic interest. The interests of those investors will be ignored for purposes of this analysis, not because they do not exist, but because there are clear policy reasons why corporations should not be managed with their interests in mind.

222 18 C.J.S. Corporations § 362 (2008) (“As a general rule, dividends can be declared and paid out of net profits only”). While dividends are typically declared and paid out of profits, in Delaware they may be declared even where a corporation does not have profits out of a corporation’s surplus. See DEL. CODE ANN. tit. 8, §170 (West 2009). Surplus generally refers to the amount by which a corporation’s net assets (its assets minus its liabilities) exceed the amount determined by the board to constitute “capital”. See id. at §154. Generally “capital” is at least equal to the number of shares issued in all subscriptions multiplied by those shares’ par values. See id.

223 While the fact that a corporation has generated a high level of profits increases the chances that the board will pay those profits out as dividends, it does not meant that boards are obligated to do so. In fact boards are not required to pay dividends except where the failure to do so amounts to an abuse of discretion. Gabelli & Co. v. Liggett Group Inc., 479 A.2d 276, 280 (Del. 1984) (citing Eshleman v. Keenan, 194 A. 40, 43 (Del. Ch. 1937)) (“[C]ourts act to compel the declaration of a dividend only upon a demonstration ‘that the withholding of it is explicable only on the theory of an oppressive or fraudulent abuse of discretion.’”).

224 See discussion supra Part I.A.

225 Id.

226 Id.

227 Id.

228 See Anabtawi & Stout, supra note 14, at 1283-92 (arguing that investors have disparate interests, including as to investment horizon).
Delaware courts recognize that not all shareholders have the same interests.\textsuperscript{229} And they have repeatedly authorized the board to favor the interests of long-term shareholders over short-term shareholders where a corporation is not “for sale” under Revlon.\textsuperscript{230} That means that directors can fulfill their fiduciary duties to stockholders by making business decisions and overseeing strategies aimed at furthering corporate profitability on a sustained basis. But again, the lack of a judicial mandate as to the temporal aspect of fiduciary duties suggests that directors can also fulfill their fiduciary duties to stockholders by acting in the best interest of short-term stockholders and making decisions that yield profits in the short-term, even where that might impair longer-term profitability.\textsuperscript{231}

B. Corporation’s Interest in Long Term Profitability

We must first identify who the corporation is before we can determine whether the “corporation” has an interest in long-term profitability. Guidance on this emerges from Unocal, where the Delaware Supreme Court held that the corporation’s interest is represented by the interests of its various constituents.\textsuperscript{232} The Court in that case also

\textsuperscript{229}See Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1386 (citing Paramount Commc’n, Inc. v. QVC Network, Inc., 637 A.2d 34, 45-46 (Del. 1994)); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (“It is well established in our jurisprudence that stockholders need not always be treated equally for all purposes.”). In fact this aspect of fiduciary duty law also seems to have been accepted by the Delaware legislature through its passage of an anti-takeover statute which limits certain rights only of a tender offerors but not other stockholders. See Del. Code Ann. tit. 8, §203 (West 2009).

\textsuperscript{230}See e.g. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1386 (citing Paramount Commc’n, Inc. v. QVC Network, Inc., 637 A.2d at 45-46 (“This Court has stated that distinctions among types of shareholders are neither inappropriate nor irrelevant for a board of directors to make, e.g., distinctions between long-term shareholders and short-term profit-takers, such as arbitrageurs, and their stockholding objectives.”); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 955-956 (“[A] board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.”); TW Services, Inc. v. Crown, No.’s 10427 & 10298, 1989 WL 20290, at *7 (“[D]irectors, in managing the business and affairs of the corporation, may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected”); see also Hazen, supra note 27, at 142 (“When observers speak in terms of interests other than short-term wealth maximization, they are referring to these non-shareholder constituencies.”). A number of academics also support managing for the long term. See e.g. Velasco, supra note 91, at 454 (arguing that social responsibility theory has persuaded much of society that many conflicts between shareholder and non-shareholders arise only from a short-term perspective and their interests may merge in a long-term perspective because of the benefits of harmonious and productive relationships).

\textsuperscript{231}See discussion supra Part III.B.

\textsuperscript{232}See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 955 (noting, as the second element of the standard of proof for board adoption of defensive measures to a takeover offer, a balancing of the takeover bid and its effect on the corporate enterprise, and for purposes of weighing the interest of
identified the types of constituents that boards may consider when assessing the interest of the corporation, specifying creditors, customers, employees and the community. While the Court indicated that this was a non-exclusive listing, these seem to be the most commonly identified non-shareholder corporate constituents. Thus the following analysis will look to these constituents to identify whether they are interested in long-term profitability.

1. Creditors

Creditors of a corporation are persons to whom the corporation owes money or other property. Creditors are typically thought of as being either trade creditors, to whom the corporation owes money in connection with its purchase of goods and services, or borrowed money creditors, from whom the corporation borrows money for its operations.

It seems clear that a creditor’s primary interest is for a corporation to be able to repay its debts to the creditor as they become due. That means that every creditor wants the corporation to be financially successful, at least over the term of the debt, to be able to repay the debt according to its terms. In fact the more profitable a corporation is, the less any creditor has to worry about a potential risk of the corporation not being able to repay its debts to the creditor and other potentially senior and pari passu creditors. Moreover, both types of creditors would likely also want a corporation to grow so that it would either need to buy larger amounts of goods and services on credit, in the case of trade creditors, or borrow larger sums, thereby generating higher interest income, in the case of borrowed money creditors. Thus creditors indeed seem to be primarily interested in corporate profitability over the long term.

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233 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 955.


236 Trade creditors are generally thought of as relationship lenders, while borrowed-money creditors are thought of as financial statement lenders. Of course this ignores “performance” creditors, or parties to whom performance (other than the payment of money) is owed.

237 This describes generally creditors’ interest in having the corporation perform its contract with the creditor.

238 This is true despite the fact that creditor and stockholders likely have different tolerances for risk, particularly in the zone of insolvency. See Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863
2. Customers

Customers are primarily interested in obtaining quality products and services at low prices. Repeat customers, or customers who tend to buy the same products and services from the same suppliers, undoubtedly want a corporation that they buy those goods and services from to continue to exist so that it continues to supply them with quality goods and services. That means that on some level, they want a corporation to be profitable so that its continued existence is justified. A corporation that is profitable is also more likely to reinvest those profits in new and improved products and services, which also runs to the benefit of repeat as well as single-time customers.

Moreover, to the extent that a corporation’s products come with a warranty, customers undoubtedly want the corporation to remain in business and have profits, at least so that the corporation has assets beyond its other liabilities to satisfy its warranty obligations to the customers.

Thus all customers would seem to desire a corporation that to some extent is profitable on a sustainable basis. Still, customers are not necessarily interested in a corporation maximizing its profits, as that likely means that the profits came at their expense through high prices paid on consumed products and services. Thus customers, like creditors, would likely favor a corporation to be profitable on a sustained basis, but would likely favor a lower level of profitability than creditors, at least to the extent profits came at their expense.

3. Employees

Employees are primarily concerned with maintaining their jobs and getting good compensation and other benefits over the course of that employment. In addition, employees undoubtedly seek to obtain intangible benefits from their jobs, such as praise and enhanced knowledge. This, in turn, means that employees generally want a corporation to be financially successful and to continue in existence, so that it may continue to serve as an employer and provider of those benefits. In fact, employees would be expected to want a corporation to be highly profitable, as those profits would likely trickle down to some extent to them. That would be especially true for employees a portion of whose compensation is tied to the corporation’s success, whether through a cash bonus plan, stock option plan or other plan tied to the firm’s success. Moreover, to the extent that a corporation views itself as a value-creating enterprise in the long term, it would be expected to treat its employees better, investing more resources in their education, health and safety to yield returns over the long term. That is not to say that

A.2d at 790 n. 57. Yet as the Delaware Chancery Court pointed out, even in that context, both stockholders and creditors are interested in increasing the economic value of the firm. Id. at 792. 239 This reduces transaction costs of having to repeatedly research new suppliers. See Sanford M. Jacoby, The Future of Labor and Finance, 30 COMP. LAW. & POL’Y J. 111, 116 (2008) (“When shareholders and business strategies are guided by long-term considerations, they will, allegedly, encourage the treatment of employees not [SIC] a cost but as an asset deserving of training, job security, and fair treatment that promotes low turnover and high
just because an employer is successful on a continuing basis, every employee will retain her job and receive good benefits – there are a number of other reasons, such as job performance, that factor into an employee’s compensation and retention. However it seems intuitive that an employer is much more likely to pay better benefits and retain employees when it is continuing on a path of profitability rather than experiencing losses. Thus it seems clear that employees would also seem to want a corporation to be profitable on a sustainable basis.

Still, some employees (such as executive officers) who receive a high level of compensation based on short-term profits would likely be willing to forego some level of future profits, and risk corporate longevity, in exchange for short-term profits. That is not to say that they are not interested in future profits – but simply that they might support decisions that lead to profits in the near term rather than sustained profits over the long term given the large size of their pay package, the time value of money and the uncertainty of future profits and continued employment. Yet it seems unreasonable for any employee to expect to be compensated for short-term profits that either derive from accounting manipulations or from decisions that do not properly reflect the risks inherent in them. This is apparent from the many public tongue-lashings received by executives whose compensation for 2008 was high despite large firm losses, as well as from the number of investor and policy-maker calls for reform of this pay practice. Thus while we cannot conclude that this entire class of constituents favors long-term profitability, the

productivity. A focus on the long-term also encourages companies to pay attention to future liabilities in areas such as employment regulation..."

Perhaps the primary example is the tremendous rate of job loss in the current economic downturn. See supra notes 159-160 and accompanying text.

This proposition may not be as true for independent contractors, which are increasingly used by firms to avoid having to pay unemployment and other benefits. See Katherine Van Wezel Stone et al., Proceedings: Employment Protection for Atypical Workers: Proceedings of the 2006 Annual Meeting, Association of American Law Schools Section on Labor Relations and Employment Law, 10 Empl. Rts. & Employ. Pol'y J. 233 (2006) ("There is an explosion of new kinds of workers in employment relationships that do not fall within the normal employee category. Whether they are contingent workers, leased workers, agency temporary workers, or dependent/independent contractors, there are many kinds of people performing work at the low end of the labor market who do not fit into the conventional definitions of employee and therefore are not entitled to the normal range of protections that we teach and write about."). Still, even independent contractors would likely be able to obtain more attractive compensation packages and other benefits from, and be retained on a more consistent basis by, a firm that was profitable on a sustainable basis.

See discussion supra Part I.C.

This is similar to the conflict between long-term stockholders and short-term stockholders.

See e.g. Louise Story, On Wall Street, Bonuses, Not Profits, Were Real, N.Y. TIMES, Dec. 17, 2008, at A1, available at http://www.nytimes.com/2008/12/18/business/18pay.html (noting the enormous size of the 2006 bonuses Merrill Lynch paid to its CEO and traders, even though Merrill’s earnings for that year turned out to be a mirage, and noting criticism of pay practices which awarded large bonuses based on ephemeral earnings).

See discussion supra Part I.C.
executive compensation movement suggests that we discount those interests created by inflated, short-term compensation arrangements.

4. Community

Identifying who makes up the community where a corporation operates is no simple task, for that undoubtedly depends on the nature of the business and where it is located. But as a general matter, individuals who live where a corporation conducts its operations presumably want a corporation to contribute as much economically to the community as possible. This includes, perhaps first and foremost, paying taxes. It also means supplying good jobs. Both of these occur where a corporation is profitable on a sustained basis, for only then will it be able to continue to supply local jobs. Obviously the more profitable a corporation is, the higher the amount of taxes it pays, thereby contributing more resources to the community for civic projects and the like.

To be sure, some community constituents might not be interested in a corporation’s profitability. For instance, environmental groups would want a corporation to shut down its operations that have an adverse impact on the environment, regardless of the impact of that move on the corporation’s profits. But it would seem to undermine the exercise of determining a constituent’s interest if we focused on the interests of the few exceptional interest groups rather than the larger community of interests who fit within this constituency class. Moreover, by focusing the community interest on those who live where the corporation operates, it seems legislatures that have adopted constituency statutes have decided to focus on the community interests identified above rather than on more global interests.

C. Summary

As the foregoing discussion shows, shareholders want a corporation to be profitable. While some shareholders would prefer that those profits be realized in the

\[247\] State constituency statutes, as well as academic commentary, suggest that the relevant community to consider is that where the corporation operates. See e.g. N.J. STAT. ANN. §14A:6-1(2)(b) (West 2009) (in making business decisions, the board may consider “the effects of the action on the community in which the corporation operates”) (italics added); N.Y. BUS. CORP. LAW §717(b)(2) (Gould 2009) (indicating that in making business decisions, the board may consider, among other things, the communities in which the corporation does business); Roberta S. Karmel, Implications of the Stakeholder Model, 61 GEO. WASH. L. REV. 1156, 1172 (1993) (analyzing what the community’s interest is by reference to the community where the corporation’s plant or office is located).

\[248\] See Ryan J. York, Comment, Visages of Janus: The Heavy Burden of Other Constituency Anti-Takeover Statutes on Shareholders and the Efficient Market For Corporate Control, 38 WILLAMETTE L. REV. 187, 197 (2002) (identifying as the community’s only identifiable interests the payment of taxes and the supply of local jobs).

\[249\] Id.

\[250\] Yet they, too, might want a corporation to generate profits, if the corporation would use those profits to not only remediate the corporation’s adverse impacts on the environment, but to also remediate others’ impact on the environment. This, however, would be unlikely.
short term, others would favor more sustained profitability. Courts have consistently authorized boards to favor the interests of long-term shareholders. Moreover, even for short-term shareholders, it would certainly be *in their interest* for the corporation to be profitable in the long term, even if they have spurious market reasons to favor short-term profits.

Moreover, non-shareholders generally also want a corporation to be profitable in the long-term, for profitable corporations can increase the compensation they pay to their employees. They can also satisfy their warranty obligations owed to customers, and supply customers with new and improved products and services. Profitable corporations have more resources with which to repay creditors, and may provide creditors with additional lending opportunities. Needless to say, more profitable corporations pay higher taxes and employ more people, which benefits the citizens who live in the communities where those taxes are paid and jobs are made available.

V. **REFORMULATING FIDUCIARY DUTIES SO THAT THEY REQUIRE DIRECTORS TO ACT IN THE LONG TERM BEST INTEREST OF THE STOCKHOLDERS AND THE CORPORATION**

As is discussed above, all of a corporation’s constituencies – shareholders and non-shareholders alike - seem to share some commonality of interest – they all seek a corporation that is profitable on a sustained basis. That is true despite the fact that customers would not want a corporation to be too profitable, as that comes at their expense, and certain employees favor a corporation being profitable in the short-term due to their compensation arrangements. Also as is discussed above, a number of Delaware courts have recognized this coincidence of interests on profitability over the long term. Yet as the discussion in Part III reveals, Delaware courts give boards wide discretion to decide over what time period a corporation should be managed for the purpose of generating profits. Consistently, they also give boards wide discretion to decide whether to consider non-stockholders’ interests in making business decisions, as the courts generally presume that those interests will be protected by a focus on the long-term. The discussion in Part IV shows how those interests generally are protected by a focus on long-term profitability.

While the cases discussed in Part IV revealing this discretion were primarily decided in the context of takeovers, neither they nor other Delaware cases generally impose any duty on the board to manage with the goal of creating long-term profitability; rather, they leave the time period over which the goal of profitability is to be achieved up to the board. Because of this discretion, directors are more susceptible to influence by interest groups such as short-term investors and executives, who benefit from decisions that yield short-term profits. Yet ultimately those decisions may run counter not only to the interests of the longer-term stockholders and other constituents, but also to our economy.
Given what seems to be a strong policy in favor of managing for the long-term, and the fact that corporate law reflects policy,\textsuperscript{251} I believe corporate law should implement that policy through fiduciary duties. My proposal for doing so is set out in Section A. Section A also explains why I propose implementing this long-term agenda through fiduciary duties as well as how this proposal would effectively be implemented. Then in Section B I set out and respond to a number of likely critiques.

\textbf{A. My Proposal}

To implement the strong public policy in favor of corporations that are managed for the long-term, as well as the general coincidence of corporate interest in the long-term, I propose that directors be \textit{required} to make decisions \textit{primarily} for the purpose of advancing the long-term best interest of the corporation and its stockholders. That means that every time the board is faced with a business decision, it would need to consider how that would benefit the corporation and the stockholders in the long term, and make decisions that are aimed at achieving that objective. In effect that would mean that directors would need to determine how every business decision implemented the corporation’s business plan, for the business plan sets out sets out the corporation’s long-term objectives as well as strategies to achieve those objectives.\textsuperscript{252}

Under my proposal, board decisions would continue to be protected by the business judgment rule.\textsuperscript{253} But clarifying that fiduciary duties are mandatorily long-term in nature outside of the takeover context would force directors to conduct analyses (in compliance with their duty of care) that would enable them to decide whether each business decision would be primarily beneficial to the corporation and the stockholders in

\textsuperscript{251} See supra note 166 and accompanying text.

\textsuperscript{252} This proposal is similar to one component of a proposal made by Professor John Matheson and Brent Olson over 15 years ago. See John H. Matheson & Brent A. Olson, \textit{Corporate Law and the Longterm Shareholder Model of Corporate Governance}, 76 MINN. L. REV. 1313, 1376-77 (1992). (proposing that the corporate purpose be to advance the interest of the corporation and its long-term shareholders). However, the goal of Matheson’s and Olson’s proposal appears to be to provide long-term shareholders with the incentive and ability to monitor the board with respect to conflict-of-interest and fundamental transactions. \textit{See id.} at 1315, 1376-81. According to Matheson and Olson, by giving institutional investors – seen as the quintessential long-term shareholder s- a more meaningful voice in governance, those investors will have a greater incentive to view their holding as long term, as they will no longer feel locked out of the governance process. \textit{Id.} at 1322. My proposal also seeks to focus directors on the long-term. However, my proposal places the impetus on the board, as the fulcrum of the corporate business lever, to reflect the long-term interests of stockholders and the corporation. I believe this makes sense given the fact that many large institutional shareholders are not long-term shareholders. Moreover, by focusing all fiduciary duties on the long-term, rather than simply the duties owed to shareholders, I believe my proposal would more appropriately reflect the interests of shareholder as well as the other corporate interests at stake, even if only shareholders would have standing to enforce those duties. Recent developments pertaining to executive compensation practices as well as investor activism would also seem to make my proposal propitious.

\textsuperscript{253} See supra note 176 and accompanying text for a discussion of the business judgment rule.
the long-term- and their failure to do so could amount to a conscious disregard for their duties and thus an act in bad faith. This, then, could lead to a breach of the duty of loyalty. That would likely mean that directors would have to increasingly consider non-financial factors in making decisions, for the long-term often cannot be summed up in a neat financial calculation. But the challenge of valuing the long-term effects of corporate decisions should not preclude their primary importance.

Because this reformulated duty would only require directors to primarily act in the long-term best interest of the stockholders and the corporation, directors could, in compliance with this duty, consider the interests of short-term shareholders in making business decisions. This would give directors some flexibility in making business decisions that provide short-term profits. However, it would not permit them to place those short-term interests above, or even on equal footing to, the long-term interests of stockholders and other corporate constituents.

This interpretation would also more faithfully implement directors’ fiduciary duties, which require that directors not only consider the interests of stockholders, but also the interest of the corporation. Moreover, this proposal would be consistent with existing jurisprudence, such as *Revlon*, which indicates that any temporal limit on directors’ discretion in making business decisions should be imposed on directors through the over-arching fiduciary duties that directors owe to the corporation and its shareholders rather than through any specific aspect of the duty of care or loyalty. Still, as I mention above, this limit on director discretion would likely be implemented through the duty of loyalty where a board consciously disregards its duty to act primarily with the objective of long-term profitability and thus is seen as having acted in bad faith.

By focusing on the board, my proposal would be tasking some of the most highly respected and knowledgeable businessmen with implementing the policy of generating economic and social wealth for particular corporate enterprises as well as our country.

This reinterpretation of the corporate purpose would also provide directors with much-needed guidance as to how to discharge their fiduciary duties, particularly in an era where they are faced with pressures from executives as well as from investors to make decisions that generate short-term profits. As the Delaware Supreme Court has acknowledged, one of the objectives of Delaware fiduciary duty law is to provide directors with “clear signal beacons and brightly lined-channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its

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254 See supra Part III for a discussion of how a conscious disregard of duties can lead to liability for a breach of the duty of loyalty.
255 See supra Part I.A.2 for a discussion of the limits of financial statements to capture a firm’s performance.
256 See Malpiede v. Townson, 780 A.2d at 1083 (“Revlon emphasizes that the board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise); In re Lukens Inc. S’holders Litig., 757 A.2d 720, 730-31 (Del. Ch. 1999) (“Revlon duties' refer only to a director's performance of his or her duties of care, good faith and loyalty in the unique factual circumstance of a sale of control over the corporate enterprise.”).
shareholders.”257 This proposal would in fact provide some clarity as to what corporate purposes directors must seek to achieve. This, in turn, should enhance accountability of directors to shareholders, for removing an element of discretion from the board gives shareholders a more clearly defined standard to which to hold directors accountable. And since the reformulated duty would lead directors to act in the interest of both shareholders and the corporation, shareholders (at least the long-term shareholders) would indeed serve as a proxy for the corporation in enforcing this duty, for doing so would be in the interest of both.

Still, this reformulation of fiduciary duties would not apply in all contexts. Specifically, because the reformulated duty would require directors to consider how to maximize profits under the corporation’s long-term strategy, it would not apply in the context where the board was faced with a potential takeover or other similar sale transaction in which the future of the corporation was being questioned.258 Indeed it is in that context where the board is deciding the very question of whether or not to scrap the corporation’s long-term strategy in favor of a sale.259 If the board were forced in that context to only consider the long-term interests of the shareholders and the corporation, the board might never approve any sale transaction, for a sale is not typically an event that delivers profits into the future. Thus in that context it makes sense to continue to permit directors to consider not only the long-term interests of stockholders and the corporation, but also their short-term interests. Again, this might explain why the cases discussed in Part III give directors such broad discretion.

That is not to turn a blind eye to the fact that the market for corporate control plays a large role in the problem of short-termism that I have identified. But it is rather to acknowledge that different aspects of the short-termism problem may require different fixes, and that my proposed fix addressed one source (though not the only source) of the short-termism problem. It also has the added benefit of approaching the short-termism problem in an incremental way, with the goal both of increasing the chances of adoption as well as providing an opportunity to reflect on the impact of the proposal without too

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258 This would also be true with respect to the corporation’s dissolution.
259 This would generally include mergers, asset sales, exchange offers and tender offers, where shareholders would receive cash or other property in consideration for their equity interests, resulting either in a significant change in the capital structure of the corporation or in the disappearance of the corporation. See Ian B. Lee, Corporate Law, Profit Maximization, and the “Responsible” Shareholder, 10 STAN. J. L. BUS. & FIN. 31, 35-36 (2005) (identifying as the paradigmatic situations in which stockholders’ and other constituencies’ interests diverge as the hostile takeover context and financial distress); Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 TEX. L. REV. 579, 605-06 (1992) (describing transactions involving substantial distributions of wealth to stockholders as one class of transaction in which conflicts between stockholders and non-stockholder constituents most commonly arise).
many major shifts in the law at once. Thus my proposal might complement other legal changes that would implement a policy promoting sustainable wealth-creation. Such other changes might include, for example, new disclosure rules that would provide investors with a better sense of a firm’s long-term intrinsic value, as well as tax and other incentives to encourage the devotion of resources to R&D.

Perhaps the best way to see how my recommendation would be implemented is by way of example. Let us suppose that the five-year strategic plan (determined by management subject to board oversight) of a widget manufacturing corporation called Widget Co., with operations in the western United States, includes expanding its operations into the Midwest. Let us also suppose that an activist investors of Widget Co., Active Investor, sends a demand letter to the board of Widget Co. demanding the sale of dormant manufacturing assets and the distribution of the proceeds from that sale to shareholders. Under existing law, Widget Co.’s board could make the decision to comply with Activist Investor’s demands simply on the basis that it would benefit investors in the short term. In fact the board might follow this course of action to avoid seeming uncooperative with Activist Investor. However, suppose that the assets requested to be sold would be perfect for Widget Co.’s expansion into the Midwest. Thus perhaps the board’s decision to sell them would not be in the best interest of Widget Co. and its stockholders, at least in the long term. Under my proposal, to comply with its fiduciary duties, the board would need to determine whether selling those assets was primarily in the stockholders’ and corporation’s long-term best interest. To do that, the board would need to look at Widget Co.’s business plan as well as at how selling the assets would impact that business plan in the future. If, after this analysis, the board decided that Widget Co’s business plan would be more effectively implemented by selling off the assets and buying different assets in the Midwest, and that Widget Co. did not need those proceeds for projected expenditures under the business plan, then it should proceed with the course of action requested by Activist Investor. If, however, the board decided that Widget Co.’s business plan would be more effectively implemented by keeping the dormant assets until they were needed in Mexico, then it should proceed in that fashion. In either case, under my proposal, the board would need to consider Widget Co.’s long-term business plan and how each course of action would have implemented that plan to comply with its fiduciary duties.

B. Responses to Anticipated Critique

Let me address a number of criticisms that I anticipate will be made to my proposal.

First, opponents will undoubtedly argue that my proposal removes from stockholders an ability to influence certain board decisions that they favor. The proposal would in fact do that, for it would strip from the board the discretion to make decisions that are primarily aimed at generating short-term profits, including where that is due to a

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260 Though arguably all of the new executive compensation rules might impair our ability to assess and measure independently the impact of this proposal on the problem of short-termism.
request from a stockholder. That, in turn, would mean that some stockholders would effectively have less power to influence the board. But that is one of the primary purposes of the proposal – to remove from directors the discretion to manage for the short-term, whether that be due to stockholder influence, officer influence or other reasons. Moreover, the proposal would give some stockholders – particularly long-term stockholders, more power, for it would give them a more clearly defined standard by which to hold director conduct.

This leads to the second potential challenge – that this proposal could cause an increase in suits against boards. While it is possible that shareholders will commence more suits against directors to enforce this more clearly defined standard, directors would still be protected from needless suits under the business judgment rule. Moreover, the other procedural protections that shield directors from needless fiduciary duty suits – such as the requirement that stockholders first make demand on the board unless demand would be excused as being futile, and that stockholder plaintiffs state their claims with particularity - would continue to apply. Thus directors would realistically only face liability for failing to meet this new aspect of fiduciary duties where they consciously disregarded their charge of advancing long-term profitability, which would amount to bad faith and thus a breach of the duty of loyalty. Yet it is precisely in those circumstances where the board should face liability, for if a board is not considering how a non-takeover decision will allow a corporation to implement its strategy in the long-term, the board should be held accountable for that failure.

A third potential criticism is that by requiring directors to consider the interests of non-shareholders in making business decisions, directors may act contrary to the interests of stockholders. This is one of the primary concerns raised by shareholder primacists, who believe that the corporation should be managed solely for the benefit of shareholders. However, as I argued in Part IV, long-term profitability is in the interest of both stockholders and the corporation’s other stakeholders. Thus directors would not be acting to the stockholders’ detriment by focusing on long-term profitability. Moreover, directors would continue to have the discretion to decide, as between the different corporate constituents, how to allocate those profits.

Fourth, critics might argue that stockholders can simply defeat the long-term mandate under my proposal by replacing the board with directors who are sympathetic to their short-term demands. While stockholders would have the same right to remove and elect directors under my proposal that they currently have, they would not be able to elect directors simply as a means of obtaining favorable short-term action, for every director would be obligated to manage the corporation for the purpose of long-term profitability. While it is true that new directors might persuade management to change the corporate strategy to one that involves removal of certain business lines (thus leading to, for example, the sale of assets and distribution of cash to investors), even in those contexts

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261 *See supra* note 78 and accompanying discussion.
the board’s decisions would need to be part of a larger, coherent business strategy aimed at creating long-term wealth rather than being the result of an investor push for short-term returns.

Fifth, critics might challenge whether this proposal would in fact change the substance of any board decision, as directors could always find a way to rationalize how any decision would benefit the corporation and stockholders in the long term. But one of the benefits of this proposal is that it will force the board, under its duty of care, to become informed in a way that allows it to determine whether a given action will in fact produce long-term profits. Failing to become informed in this way could amount to a conscious disregard of duties and, again, an act in bad faith. Even ignoring the prospect of liability, most directors will undoubtedly opt to become informed about whether their decisions truly advance the goal of long-term profitability once they are clear that this is their required objective. Thus even if the substance of board decisions remains difficult to regulate under the reformulated duty, the processes that must be undertaken for the board to decide whether an action meets the reformulated duty should afford much protection to long-term stockholders and other constituents.

Finally, critics will argue that the proposal ignores the problem of short-termism caused by the market for corporate control. Numerous academics have identified the takeover market as one of the primary reasons why directors manage for the short term. But I discuss above, it does not seem to be appropriate to adopt a one-size-fits-all solution to the short-term problem, particularly as takeover decisions involve a challenge to a corporation’s long-term business objectives that are not present for non-takeover decisions. Yet there are many pressures on boards to be short-termists outside of the takeover context that should be addressed, particularly given the rise of the hedge fund and investor activism. That fact, however, should not mean that we only approach the problem through one comprehensive fix. In fact, as I argue above, there are many reasons to adopt an incremental approach to the short-termism problem.

VI. CONCLUSION

While directors are not required under their fiduciary duties to make decisions that yield short-term profits, the pressures on them to do just that are substantial and real. They are increasingly being pressured by investors, who claim to simply be seeking value for shareholders, to make decisions that do in fact deliver value to investors – but only in the short-term. They are also increasingly influenced by executives, who receive lavish bonuses upon the generation of short-term profits, to go along with corporate decisions that continue to produce those short-term profits. Yet the net effect of many of these decisions has been to cut off a firm’s source of long-term cash flows, and to ignore long-term risks. The current economic crisis reveals not only the devastating impact on specific businesses of this excessive focus on short-termism, but also the disastrous impact on the entire U.S. economy and citizenry of this short-termism plague. While no single measure can be expected to fix this short-termism problem, we certainly should not

264 See supra note 13 and accompanying text.
sit idly by while companies continue to collapse, employees continue to lose jobs and investors continue to lose their investments due to prior short-sighted decisions. As the new administration starts to consider how to fix the problem of short-termism, so, too, should the Delaware courts, which enforce directors’ oversight and management responsibilities. They should, in my view, lead the charge, not by implementing a sweeping reform, but by simply eliminating unnecessary discretion as to the time period over which corporations should seek to achieve profitability.