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THE MYTH THAT INSULATING BOARDS SERVES LONG-TERM VALUE

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According to an influential view in corporate law writings and debates, pressure from shareholders leads companies to take myopic actions that are costly in the long term, and insulating boards from such pressure serves the long-term interests of companies as well as their shareholders. This board insulation claim has been regularly invoked in a wide range of contexts to support existing or tighter limits on shareholder rights and involvement. This paper subjects this view to a comprehensive examination and finds it wanting.

In contrast to what insulation advocates commonly assume, the existence of short investment horizons and inefficient market prices does not necessarily mean that board insulation can be expected to serve long-term value. While board insulation may produce some beneficial long-term effects, this paper shows that it can also be expected to produce significant long-term costs. Furthermore, the available empirical evidence provides no support for the claim that board insulation increases overall value in the long term. To the contrary, the evidence favors the view that board insulation at current or higher levels does not serve the long-term interests of companies and their shareholders. The paper concludes that policymakers and institutional investors should reject the arguments made for board insulation in the name of long-term value.

Keywords: Short-termism, myopia, corporate governance, shareholders, boards, managers, long-term value, investor horizons, shareholder rights, shareholder power, shareholder activism, takeovers, corporate elections, entrenchment, antitakeover defenses, market efficiency, hedge funds

JEL Classification: D21, G32, G34, G35, G38, K22

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INTRODUCTION

This Essay focuses on a central and influential claim that has been playing a key role in corporate governance debates for many years: the claim that insulating boards from shareholder pressure—and limiting shareholder power and rights for this purpose—serves the long-term interests of publicly traded companies and their long-term shareholders. This Essay subjects the claims of insulation advocates to a comprehensive analysis and finds them wanting. The belief that current or even higher levels of insulating boards serve long-term value, I conclude, has shaky conceptual foundations and is not supported by the existing body of empirical evidence.

According to the board insulation view, inefficient capital markets and short investor horizons couple to produce a problem of "short-termism." Short-termism refers to companies taking actions that are profitable in the short term but value-decreasing in the long term, such as increasing near-term earnings by cutting research that would pay off later on. Activist investors with short investment horizons, it is argued, seek actions that boost short-term stock price at the expense of long-term value and often succeed in pressuring companies to take such actions. Furthermore, it is claimed, when corporate arrangements facilitate shareholders' ability to replace or influence directors, fear of activist intervention in the absence of satisfactory short-term results produces pressure on management to focus excessively on the short term to the detriment of long-term value.

Insulation advocates contend that the long-term costs of short-termism, produced by both shareholder interventions and fears of such interventions, make it desirable to shield boards from shareholders. Insulating boards from short-term shareholder pressure, it is argued, enables them to focus on enhancing long-term value and thereby better serve the long-term interests of companies and their shareholders.

The stakes in this debate are high. Arguments supporting the long-term benefits of board insulation have played a central role in corporate law policy debates for at least three decades. These arguments have been advanced by prominent legal academics,[1] economics and business professors,[2] management thought leaders,[3] business columnists,[4] organiz-

1. E.g., Lynn Stout, The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public 63–73 (2012); Stephen M. Bainbridge, Response, Director Primacy and Shareholder Disempowerment, 119 Harv. L. Rev. 1735, 1744–51 (2006) [hereinafter Bainbridge, Director Primacy]; William W. Bratton & Michael L. Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653, 653–54, 657–59 (2010).

2. E.g., Justin Fox & Jay W. Lorsch, What Good Are Shareholders?, Harvard Bus. Rev., July–Aug. 2012, at 49, 51 (discussing problems created by increase in shareholder power

ations,[5] a report commissioned by the British government,[6] and noted corporate lawyers.[7] Indeed, invoking the alleged long-term benefits of board insulation has been a standard and key argument in a wide range of significant corporate law debates, including those concerning takeover defenses, impediments to shareholders' ability to replace directors, and limitations on the rights of shareholders with short holding periods.[8]

Furthermore, insulation advocates have been successful in influencing important public officials and policymakers. Chancellor Leo Strine and Justice Jack Jacobs, prominent figures in the Delaware judiciary, have expressed strong short-termism concerns.[9] Congress held hearings on the subject.[10] When William Donaldson was Chairman of the Securities and Exchange Commission (SEC), he accepted that short-termism is a

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and rise of short-term investors); Michael E. Porter, Capital Choices: Changing the Way America Invests in Industry, J. Applied Corp. Fin., Summer 1992, at 4, 4–11 (arguing pressure coming from shareholders with short horizons discourages long-term investments).

3. E.g., Peter F. Drucker, Editorial, A Crisis of Capitalism, Wall St. J., Sept. 30, 1986, at A32 (arguing outside pressures push top managements toward short-term decisions).

4. E.g., Joe Nocera, What Is Business Waiting For?, N.Y. Times, Aug. 16, 2011, at A21; Andrew Ross Sorkin, 'Shareholder Democracy' Can Mask Abuses, N.Y. Times, Feb. 25, 2013, at B1.

5. E.g., Aspen Inst., Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management 2–3 (2009) [hereinafter Aspen Inst., Overcoming Short-Termism], available at http://www.aspeninstitute.org/sites/default/files/content/docs/business%20and%20society%20program/overcome_short_state0909.pdf (on file with the *Columbia Law Review*) (expressing concern about pressures exerted by short-term holders to promote changes not beneficial in long term).

6. John Kay, The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report 9 (2012) [hereinafter The Kay Report], available at http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf (on file with the *Columbia Law Review*) (concluding incentives and behavior of institutional investors discourage corporate decisionmaking that serves long-term value).

7. E.g., Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187, 187–88, 203, 210–12 (1991) [hereinafter Lipton & Rosenblum, Quinquennial Election] (arguing institutional stockholders and takeover activity produce short-term bias, making it desirable to insulate management from pressure by short-term shareholders).

8. See infra Part I.C (discussing corporate law debates in which claims based on long-term costs of shareholder power have played significant roles).

9. See Jack B. Jacobs, "Patient Capital": Can Delaware Corporate Law Help Revive It?, 68 Wash. & Lee L. Rev. 1645, 1649, 1657–63 (2011) (expressing concern about short-term mindset of institutional investors and legal developments empowering shareholders); Leo E. Strine, Jr., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, 66 Bus. Law. 1, 17–19, 26 (2010) [hereinafter Strine, One Fundamental Question] (expressing concern about shareholders' increasing focus on short-term results and suggesting limits on ability of activist shareholders to make proposals motivated by short-term interests).

10. Short-Termism in Financial Markets: Hearing Before the Subcomm. on Econ. Policy of the U.S. Comm. on Banking, Hous., & Urban Affairs, 111th Cong. 11 (2010).

"fundamental problem."[11] When adopting a 2010 rule to provide shareholders with access to the company's proxy card, the SEC was responsive to short-termism arguments by limiting the provided access to shareholders who have held their shares for more than three years.[12] Indeed, even institutional investors, who are otherwise reluctant to support limiting shareholder rights, have shown substantial willingness to accept the validity and significance of short-termism concerns.[13]

The substantial impact of the claims made by insulation advocates might be partly due to the asserted gravity of their concerns. According to insulation advocates, short-termism has "substantial corporate and societal costs,"[14] has "created a national problem that needs to be fixed,"[15] represents "a disease that infects American business and distorts management and boardroom judgment,"[16] and has "eroded faith in corporations continuing to be the foundation of the American free enterprise system."[17] Indeed, some writings about short-termism have even suggested shareholder pressure was a cause of the Enron and WorldCom scandals,[18] the crash of 1987,[19] and the excessive risk-taking by financial firms in the run-up to the 2008–2009 financial crisis.[20]

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11. William H. Donaldson, Chairman, Sec. & Exch. Comm'n, Speech by SEC Chairman: 2005 CFA Institute Annual Conference (May 8, 2005) (transcript available at http://www.sec.gov/news/speech/spch050805whd.htm (on file with the *Columbia Law Review*)); see Dean Krehmeyer, Matthew Orsagh & Kurt N. Schacht, CFA Ctr. for Fin. Mkt. Integrity & Bus. Roundtable Inst. for Corporate Ethics, Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors and Analysts Can Refocus on Long-Term Value 3 (2006) [hereinafter CFA & Business Roundtable Report], available at http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf (on file with the *Columbia Law Review*) (characterizing Donaldson's view on short-termism).

12. See Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,697–99 (Sept. 16, 2010) [hereinafter Director Nominations] (discussing holding period requirement and comments to requirement). The Proxy Access Rule (Rule 14a-11) was invalidated in Business Roundtable v. SEC, 647 F.3d 1144, 1154–56 (D.C. Cir. 2011).

13. See infra notes 47–48 and accompanying text (providing examples of short-termism concerns expressed by prominent members of institutional investor community).

14. Lipton & Rosenblum, Quinquennial Election, supra note 7, at 203.

15. Jacobs, supra note 9, at 1657.

16. Martin Lipton, Jay W. Lorsch & Theodore N. Mirvis, Wachtell, Lipton, Rosen & Katz, The Proposed "Shareholder Bill of Rights Act of 2009," The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (May 12, 2009, 4:56 PM), http://blogs.law.harvard.edu/corpgov/2009/05/12/the-proposed-%E2%80%9Cshareholder-bill-of-rights-act-of-2009%E2%80%9D/(on file with the *Columbia Law Review*).

17. Aspen Inst., Overcoming Short-Termism, supra note 5, at 2.

18. 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) [hereinafter Strine, True Corporate Republic] (noting "increasing sway of institutional investors over corporations, and the institutions' laser-beam focus on quarter-to-quarter earnings, helped create managerial incentives that contributed to the debacles at corporations like Enron, WorldCom, HealthSouth, and Adelphia").

As a supporter of shareholder rights and engagement, I have often encountered opposition to my work based on short-termism concerns. Stephen Bainbridge and Chancellor Strine invoked such concerns in response pieces to my article arguing for increased shareholder power.[21] So, too, did Martin Lipton and his coauthors in response pieces to each of three articles I wrote about takeover defenses, proxy access, and reform of corporate elections.[22] Last year, when a clinical program I direct represented eight institutional investors in bringing about board declassification in over forty Standard & Poor's 500 ("S&P 500") companies, the law firm Wachtell, Lipton, Rosen & Katz issued a strongly worded criticism of this work on the grounds that eliminating staggered boards and thereby reducing board insulation is "harmful to companies that focus on long-term value creation."[23]

While insulation advocates have used strong rhetoric in expressing their concerns, they have failed to provide an adequate basis for their claims. These claims rely on critical and unsubstantiated premises, overlook significant long-term costs of board insulation, and are not backed by

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19. Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. Pa. L. Rev. 1, 72 (1987) [hereinafter Lipton, Finance Corporatism] ("The overleveraged takeover and the short-term oriented speculative activity associated with the takeover frenzy of the eighties were, predictably, significant factors leading to the [1987] crash.").

20. See Lipton, Lorsch & Mirvis, supra note 16 (identifying "coincidence of increased stockholder pressure for high returns and weakened prudential regulation" as "key contributors to the current crises").

21. See Bainbridge, supra note 1, at 1744–51 (suggesting short-term horizons of some shareholders justify some limitations on shareholder power); Strine, True Corporate Republic, supra note 18, at 1764–65, 1769 (discussing disadvantages of tilting direction of corporate policy toward short-term thinking), both responding to Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005) [hereinafter Bebchuk, Shareholder Power].

22. Martin Lipton & Steven A. Rosenblum, Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come, 59 Bus. Law. 67, 78–79 (2003) [hereinafter Lipton & Rosenblum, Proxy Access] (responding to Lucian Arye Bebchuk, The Case for Shareholder Access to the Ballot, 59 Bus. Law. 43 (2003)) (raising short-termism concerns to oppose proxy access reform); Martin Lipton & William Savitt, The Many Myths of Lucian Bebchuk, 93 Va. L. Rev. 733, 745–47 (2007) (responding to Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675 (2007)) (raising short-termism concerns to oppose reforms in corporate elections); Martin Lipton, Pills, Polls, and Professors Redux, 69 U. Chi. L. Rev. 1037, 1041–42, 1058 (2002) (responding to Lucian Arye Bebchuk, The Case Against Board Veto in Corporate Takeovers, 69 U. Chi. L. Rev. 973 (2002)) (raising short-termism concerns to support takeover defenses).

23. Martin Lipton, Theodore N. Mirvis, Daniel A. Neff & David A. Katz, Wachtell, Lipton, Rosen & Katz, Harvard's Shareholder Rights Project Is Wrong, The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (March 23, 2012, 10:38 AM) [hereinafter Wachtell Memorandum, Shareholder Rights Project], http://blogs.law.harvard.edu/corpgov/2012/03/23/harvards-shareholder-rights-project-is-wrong (on file with the *Columbia Law Review*) (raising short-termism arguments in support of staggered boards). For a review of the work done by the Shareholder Rights Project, see Lucian Bebchuk, Scott Hirst & June Rhee, Towards the Declassification of S&P 500 Boards, 3 Harvard Bus. L. Rev. 157 (2013).

empirical evidence. Indeed, an analysis of the long-term effects of board insulation, informed by the relevant theoretical and empirical literature, does not support such insulation; instead, it indicates that the overall effect of insulation at current or higher levels is negative rather than positive.[24]

Contrary to what insulation advocates commonly presume, the existence of inefficient capital markets and short investor horizons does not imply that the long-term effects of board insulation are positive overall. While board insulation might produce some long-term benefits, insulation advocates overlook the fact that these benefits might be outweighed by significant countervailing costs.

In particular, with inefficient market pricing and short investor horizons, it is theoretically possible that activists might, in some cases, want companies to act in ways that are not value-maximizing in the long term. However, it is far from clear how often such situations arise. Furthermore, to the extent that they do arise often, the question remains whether their expected costs exceed the expected benefits from activists' clear interest in seeking actions that are positive in both the short term and the long term.

Similarly, fears of activist intervention and the arrangements facilitating it might theoretically lead some management teams to make distorted decisions with respect to long-term investments. The expected costs of such decisions, however, have to be weighed against the expected long-term benefits of activist stockholder interventions, including the accountability and discipline they produce. Such accountability and discipline provide incentives to avoid shirking, empire building, and other departures from shareholder interests that are costly both in the short and the long term. Thus, there are good reasons for questioning whether board insulation serves long-term value.

Furthermore, I point out patterns of behavior that reflect widespread and consistent views among sophisticated and well-informed market participants that activist interventions and arrangements facilitating them do not decrease value in the long term. At a minimum, insulation advocates should recognize that they have been making contestable empirical claims that must be backed up by evidence. Insulation advocates, however, have thus far largely failed to acknowledge the countervailing long-term costs of board insulation, the empirically contestable nature of

24. My analysis builds on, but is far more developed and comprehensive than, the arguments I made in prior works to question claims for board insulation in the name of long-term value. See, e.g., Bebchuk, Shareholder Power, supra note 21, at 883–85 (explaining why short-termism arguments do not undermine case for empowering shareholders); Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675, 723–24 (2007) [hereinafter Bebchuk, Shareholder Franchise] (explaining why such arguments do not undermine case for strengthening shareholder power to replace directors). I also build on the analysis of the benefits of activism by outside blockholders contained in Lucian Bebchuk & Robert Jackson, The Law and Economics of Blockholder Disclosure, 2 Harvard Bus. L. Rev. 40 (2012).

their claims, and the need for evidence. Indeed, they have made their assertions about the long-term benefits of board insulation as if those assertions could be fully derived from theory or indisputable impressions.[25]

Fortunately, empirical evidence that can shed light on the long-term effects of board insulation has been accumulating over the past decade. This Essay provides a full review and analysis of the relevant empirical work by researchers. I show that this body of work does not support the claims of insulation advocates: The data does not support the claim that activist campaigns are followed in the long term by losses to the shareholders of targeted companies or by declines in the operating performance of these companies; and the data similarly does not support the claim that arrangements providing stronger board insulation benefit companies or their shareholders.

To the contrary, the existing body of evidence that this Essay reviews favors the view that shareholder ability to intervene and engage with companies provides long-term benefits to companies, shareholders, and the economy. This evidence, including a recent empirical study by Alon Brav, Wei Jiang, and myself on the long-term effects of hedge fund activism,[26] indicates that activists target companies whose operating performance lags behind peers, and that their interventions are followed by consistent and long-term improvements in operating performance.[27]

Furthermore, the evidence indicates that, anticipating such improvements, market capitalization of targeted companies appreciates when activist campaigns are announced, and that these initial stock price spikes are not reversed in the long term as insulation advocates fear. In addition, arrangements that insulate boards from shareholders and shareholder pressure have been consistently associated with lower firm value and worse operating performance.[28]

Thus, the existing theoretical understanding and the available empirical evidence do not support the claims of insulation advocates. Going forward, public officials and institutional investors would do well to

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25. See, e.g., Martin Lipton, Wachtell, Lipton, Rosen & Katz, Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy, The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Feb. 26, 2013, 9:22 AM) [hereinafter Wachtell Memorandum, Bite the Apple], http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy (on file with the *Columbia Law Review*) (basing support for board insulation on "decades . . . of experience" that he and his colleagues have accumulated while advising companies).

26. Lucian A. Bebchuk, Alon Brav & Wei Jiang, The Long-Term Effects of Hedge Fund Activism (July 2013) (unpublished manuscript), available at http://papers.ssrn.com/abstract=2291577 (on file with the *Columbia Law Review*).

27. See infra Part II.C.3–4 (presenting empirical evidence on operating performance and stock returns).

28. See infra Part III.C.2 (arguing empirical evidence indicates board insulation results in decreased firm performance).

reject arguments that are based on the asserted long-term benefits of board insulation.

Before proceeding, I would like to stress that I do not argue—nor do I believe—that the optimal level of board insulation is zero. The board insulation view—the view that I do seek to challenge—refers throughout to the view that existing or higher levels of insulation are beneficial in the long term. This view has been employed as a key argument against reforms that would weaken current insulation levels, whether in some or all companies, as well as in favor of changes that would strengthen insulation levels. Insulation advocates have argued that short-termism concerns warrant opposition to any reforms that weaken boards' insulation from short-term pressures and support for changes that provide additional insulation from such pressures.[29] Because the existing body of empirical evidence is based on studying behavior and outcomes under existing arrangements and the variation found in them, it provides a good basis for examining this view (but not of the consequences of moving to a radically lower insulation level).

I also should note that my focus in this Essay is on arguments for board insulation as an instrument for serving the interests of long-term shareholders. Board insulation may also be supported as an instrument for protecting the interests of stakeholders like employees.[30] Such claims are beyond the scope of this Essay, and I address them elsewhere.[31] Given the key role that arguments based on long-term value have played in supporting board insulation, this Essay focuses on those arguments.

Having clarified the scope of the "board insulation view" that this Essay examines, it is also worth commenting on the shorthand "insulation advocates" that I use for simplicity. The term is intended to encompass individuals that vary substantially in their positions on many specific arrangements that affect the degree of board insulation. What is common for these individuals, and makes it useful to group them together for the purposes of this Essay's analysis, is that they view the possibility of short-term pressures from shareholders as a significant factor in favor of board insulation arrangements. Thus, these individuals view long-term considerations as weighing in favor of board insulation, whether or not

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29. See, e.g., Martin Lipton, Wachtell, Lipton, Rosen & Katz, Current Thoughts About Activism, The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Aug. 9, 2013, 9:15 AM), http://blogs.law.harvard.edu/corpgov/2013/08/09/current-thoughts-about-activism/ (on file with the *Columbia Law Review*) (arguing in favor of such approach).

30. But cf. Jesse M. Fried, The Uneasy Case for Favoring Long-Term Shareholders 2–7 (European Corporate Governance Inst. Working Paper Series in Law, Working Paper No. 200, 2013), available at http://ssrn.com/abstract=2227080 (on file with the *Columbia Law Review*) (suggesting even long-term shareholders have incentives to maximize own interests at expense of other investors, including new shareholders buying stock in their company).

31. See, e.g., Bebchuk, Shareholder Power, supra note 21, at 908–13 (responding to claim increasing shareholder power may have adverse effects on stakeholders); Bebchuk, Shareholder Franchise, supra note 24, at 729–31 (same).

they end up supporting any particular insulation arrangement. This view—that long-term considerations weigh in favor of existing or even higher insulation levels—is the one that I examine, and find wanting, in this Essay.

Finally, this Essay does not examine how, or whether, it would be desirable to induce institutional investors to focus more on the long term or otherwise change their behavior. I plan to examine possible reforms of institutional investors in other work. Here, the focus is on whether—taking as given institutional investors, their investment horizons, and any imperfections or shortcomings they might have—insulating boards from shareholder pressure is beneficial or detrimental in the long term.

The remainder of this Essay is organized as follows: Part I discusses the significance and wide range of implications of the view that board insulation serves long-term value; Part II analyzes the claim that activist interventions are overall detrimental to the long-term interests of shareholders and companies; and Part III focuses on the claim that arrangements that facilitate shareholder interventions, and the fears that such interventions generate, have a long-term negative impact on companies and their shareholders. The Essay concludes that, going forward, policymakers and institutional investors should reject the arguments regularly made for insulating boards in the name of long-term value.

I. THE STAKES

This Part discusses the significance and wide-ranging implications of the debate over the long-term consequences of board insulation. Claims that board insulation is beneficial in the long term have long played a central role in debates on corporate law and corporate governance.[32] Section A discusses the prevalence of such claims and the considerable influence they have had on public officials and institutional investors. Section B describes the gravity that board insulation advocates have ascribed to the concerns underlying their views. Finally, Section C illustrates the wide-ranging implications of the subject by discussing four corporate law debates in which the considered claims have played a significant role.

A. *Extensive Use and Influence*

The arguments made by insulation advocates have a long history. Martin Lipton relied on short-termism concerns and the asserted long-term benefits of board insulation in a 1979 article supporting takeover

32. For a discussion of the persistent influence of short-termism arguments on corporate law policy thinking, see Mark J. Roe, Corporate Short-Termism—In the Boardroom and in the Courtroom, 69 Bus. Law. (forthcoming 2013) (manuscript at 3–6), available at http://ssrn.com/abstract=2239132 (on file with the *Columbia Law Review*).

defenses.[33] During the 1980s, prominent business school academics and business thought leaders argued that short-termism was an important driver of the United States' dismal performance during that period.[34] Since then, short-termism claims have been regularly invoked—and have provided the strongest ammunition—to defend arrangements that insulate boards, to resist reforms that could weaken such insulation, and to explain corporate failures and crises. Overall, the use of such claims has continued unabated for more than thirty years.

The significance of the short-termism claims is reinforced by the prominence and diversity of those who advocate for them. Such claims have been advanced by well-known law professors such as Stephen Bainbridge, William Bratton, Lynn Stout, and Michael Wachter;[35] prominent economics and business school professors such as Jay Lorsch and Michael Porter;[36] management thought leaders such as Peter Drucker;[37] the Business Roundtable Institute for Corporate Ethics and the CFA Centre for Financial Market Integrity;[38] a report authored by John Kay, a prominent British economist, under a government commission;[39] task forces of the Aspen Institute;[40] prominent corporate lawyers such as Martin Lipton;[41] and an American Bar Association committee.[42]

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33. Martin Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law 101, 104–05 (1979) [hereinafter Lipton, Takeover Bids].

34. See, e.g., Robert S. Kaplan, The Evolution of Management Acct., 59 Accounting Rev. 390, 408–09 (1984) (discussing problems resulting from "excessive focus on short-term financial performance"); Drucker, supra note 3 (noting "short-term focus has been a major contributing factor to the bad performance and decline of" U.S. industries); Robert H. Hayes & William J. Abernathy, Managing Our Way to Economic Decline, Harvard Bus. Rev., July–Aug. 1980, at 67, 68 (attributing "disproportionate loss of competitive vigor by U.S. companies" to short-term focus of management); Porter, supra note 2, at 10 (expressing concerns about U.S. firms' focus on short-term results due to pressure from stock market and institutional investors).

35. See, e.g., Iman Anabtawi & Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255, 1290–92 (2008) (arguing for shareholder duties that would deter short-termism); Bainbridge, supra note 1, at 1745–51 (suggesting short-term horizons of some shareholders justify some limitations on shareholder power); Bratton & Wachter, supra note 1, at 726–28 (arguing shareholder empowerment leads to increased focus on short-term results).

36. See, e.g., Fox & Lorsch, supra note 2, at 51 (supporting corporate governance reforms favoring long-term shareholders over short-term traders); Porter, supra note 2, at 4–5 (arguing U.S. companies focus more on short-term results than companies in some other advanced economies).

37. See, e.g., Drucker, supra note 3 (expressing concerns about effects of short-termism on performance of U.S. industries).

38. CFA & Business Roundtable Report, supra note 11, at 3 (viewing short-termism as critical issue).

39. The Kay Report, supra note 6, at 14–20 (suggesting short-termism to be reason for decline of once-prominent British corporations).

40. Aspen Inst., Long-Term Value Creation: Guiding Principles for Corporations and Investors 3 (2007) [hereinafter Aspen Inst., Value Creation], available at http://www.aspeninstitute.org/atf/cf/%7BDEB6F227-659B-4EC8-8F84-8DF23CA704F5%7D/FinalPrinciples.

Furthermore, insulation advocates have successfully influenced important public officials and policymakers, who have come to accept the validity of short-termism claims as a significant component of their own policy worldviews. In a series of articles on the subject, Chancellor Leo Strine of Delaware's influential Court of Chancery expressed strong support for short-termism claims and highlighted their significance in his views on corporate law policy.[43] Justice Jack Jacobs of the Delaware Supreme Court also expressed short-termism concerns and suggested that they might warrant changes that would further insulate directors from shareholder pressure.[44] When serving as SEC Chairman, William Donaldson accepted that short-termism is a critical issue.[45] In designing the proxy access rule it adopted in August 2010 to provide shareholders with access to the corporate ballot, the SEC was persuaded by short-termism arguments to limit the use of that rule to shareholders holding shares for more than three years.[46]

Insulation advocates have succeeded in influencing the views not only of public officials but also of institutional investors, another key group. While institutional investors are otherwise reluctant to support limits on shareholder rights, they have shown a willingness to accept the validity of arguments based on the long-term benefits of board insulation. Signatories of the Aspen Institute reports—which put forward short-termism claims—include prominent members of the institutional investor community, such as officers of the California Public Employees' Retirement System (CalPERS), California State Teachers' Retirement System, New York State

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pdf (on file with the *Columbia Law Review*) (noting short-termism "constrains" businesses); Aspen Inst., Overcoming Short-Termism, supra note 5, at 3 (expressing concern about pressures exerted by short-term holders).

41. See, e.g., Lipton & Savitt, supra note 22, at 746–47 (making arguments relying on negative effects of short-termism); Lipton & Rosenblum, Quinquennial Election, supra note 7, at 187–88, 203, 210–12 (same); Lipton, Takeover Bids, supra note 33, at 104 (same); Lipton, Lorsch & Mirvis, supra note 16, at 1 (same).

42. See Letter from Jeffrey W. Rubin, Chair, Comm. on Fed. Regulation of Sec., Am. Bar Ass'n Bus. Law Section, to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 15–21, 31 (Aug. 31, 2009) [hereinafter ABA Letter], available at http://www.sec.gov/comments/s7-10-09/s71009-456.pdf (suggesting proxy access rights should be limited to long-term shareholders).

43. E.g., Strine, One Fundamental Question, supra note 9, at 26 (noting stockholders must look beyond short-term thinking to create long-term wealth); Leo E. Strine, Jr., Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance, 33 J. Corp. L. 1, 12–13 (2007) [hereinafter Strine, Toward Common Sense] (suggesting empowerment of all stockholders may disproportionately strengthen hand of activist institutions focused on short-term results).

44. Jacobs, supra note 9, at 1649, 1657–63 (highlighting detrimental effects of pressure to generate short-term profits).

45. Donaldson, supra note 11; see also CFA & Business Roundtable Report, supra note 11, at 3 (characterizing Donaldson's position).

46. See supra note 12 and accompanying text (discussing SEC's attempt to implement holding period requirement).

Common Retirement Fund, Florida State Board of Administration, Teachers Insurance and Annuities Association-College Retirement Equities Fund (TIAA-CREF), Universities Superannuation Scheme, and the U.K. Council of Institutional Investors.[47] Furthermore, in comments filed with the SEC, some prominent institutional investors supported limiting the use of proxy access rights to shareholders who have held their shares in the company for a long time.[48]

B. *Asserted Gravity*

The impact that insulation advocates have had is, in my view, at least partly due to the gravity of the concerns they have raised. For insulation advocates, the long-term costs of shareholder power and activism, and the corresponding long-term benefits of board insulation, are not just one consideration among many that policymakers should take into account. Rather, these advocates maintain that short-termism concerns should play a decisive role in the shaping of corporate rules and arrangements.

To illustrate the asserted gravity of their concerns, it is useful to note some of the language used by insulation advocates. They have stated, for example, that short-termism threatens the "overall health of the economy,"[49] that it has "substantial corporate and societal costs,"[50] and that "the policy considerations in favor of not jeopardizing the economy are so strong that not even a remote risk is acceptable."[51] Martin Lipton, Jay Lorsch, and Theodore Mirvis asserted that short-termism is "a disease that infects American business and distorts management and boardroom

47. Aspen Inst., Value Creation, supra note 40, at 2 (listing prominent subscribers to reports).

48. See Letter from Hye-Won Choi, Senior Vice President & Head, Corporate Governance, Teachers Ins. & Annuity Ass'n-Coll. Ret. Equities Fund, to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 4–5 (Aug. 17, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-217.pdf (on file with the *Columbia Law Review*) (stating "Commission should adopt a two-year holding period requirement"); Letter from Chris DeRose, Chief Exec. Officer, Ohio Pub. Emps. Ret. Sys., to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 2–3 (Aug. 17, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-208.pdf (on file with the *Columbia Law Review*) (claiming "more appropriate continuous ownership period is two-years"); Letter from Gerald W. McEntee, Int'l President, Am. Fed'n of State, Cnty. & Mun. Emps., Am. Fed'n of Labor & Cong. of Indus. Org., to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 9 (Aug. 7, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-88.pdf (on file with the *Columbia Law Review*) (supporting, subject to certain conditions, "even longer holding period, such as the two-year period"); cf. Letter from Heidi Stam, Managing Dir. & Gen. Counsel, Vanguard Grp., Inc., to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 3–4 (Aug. 18, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-326.pdf (on file with the *Columbia Law Review*) ("[R]aising the beneficial ownership and holding period requirements in the Proposed Rules is critical to protect long-term shareholder value and interests.").

49. Lipton, Takeover Bids, supra note 33, at 104.

50. Lipton & Rosenblum, Quinquennial Election, supra note 7, at 203.

51. Lipton, Takeover Bids, supra note 33, at 105.

judgment."[52] And the Aspen Institute gravely pronounced that "short-term objectives have eroded faith in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy."[53] The gravity of asserted concerns has registered with prominent Delaware judges; Justice Jacobs, for example, has accepted that short-termism "has created a national problem that needs to be fixed,"[54] and that "the major problem is the short-term mindset of the American institutional investor community."[55]

Indeed, insulation advocates view the asserted long-term costs of shareholder activism to be so significant that they have put them forward as explanations for major macroeconomic problems and crises. During the 1980s and early 1990s, insulation advocates viewed short-termism as the cause for the inferior performance of the U.S. economy relative to the economies of Germany and Japan during that period.[56]

Michael Porter, for example, argued at the time that the pressure coming from shareholders with short horizons discouraged U.S. companies from making long-term investments that were necessary to compete with German and Japanese companies.[57] Martin Lipton and Steven Rosenblum warned that unless the corporate governance system of the United States could provide companies with the same insulation from short-term shareholder pressure enjoyed by German and Japanese companies, "the relative health of American . . . corporations, and the relative wealth of their stockholders, will inevitably erode."[58]

The dire predictions about U.S. companies falling behind those in Germany and Japan did not subsequently pan out. They have been replaced, however, by other assertions concerning the grave consequences of shareholder pressure. For example, writings about short-termism blame shareholder pressure for contributing to the wave of corporate scandals in the past decade. In particular, they have suggested that such pressure "helped create managerial incentives that contributed to the debacles at corporations like Enron, WorldCom, HealthSouth and Adelphia,"[59] and

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52. Lipton, Lorsch & Mirvis, supra note 16.

53. Aspen Inst., Overcoming Short-Termism, supra note 5, at 2.

54. Jacobs, supra note 9, at 1657.

55. Id. at 1662.

56. See, e.g., Lipton & Rosenblum, Quinquennial Election, supra note 7, at 218–22 (suggesting U.S. companies should insulate boards from short-term shareholder pressure at same level as German and Japanese companies); Porter, supra note 2, at 4–11 (arguing short-term pressure from shareholders contributed to weakening ability of U.S. companies to compete with German and Japanese companies). See generally Hayes & Abernathy, supra note 34 (expressing concerns about U.S. managers' focus on short-term financial gain at expense of long-term competitiveness).

57. Porter, supra note 2, at 4–11.

58. Lipton & Rosenblum, Quinquennial Election, supra note 7, at 218.

59. Strine, True Corporate Republic, supra note 18, at 1764.

that "[m]anaging to the market was characteristic of . . . companies that contributed to market meltdown."[60]

Shareholder pressure has also been blamed for major financial crises. Back in the 1980s, writings about short-termism asserted that investors who focused on the short term were "significant factors leading to" the market crash of October 1987.[61] More recently, such writings have contended that shareholder pressure substantially contributed to the financial crisis of 2008–2009.[62] Some have argued that "[i]ncreased stockholder power is directly responsible for the short-termist fixation that led to the current crises,"[63] while others have expressed concern that the crisis was fueled by investor pressure on financial companies' boards to pursue high returns.[64]

Insulation advocates, and others writing about short-termism, clearly feel strongly about the subject. They view the long-term costs of shareholder power and activism as large and the threats posed by them as grave. But are these strongly expressed concerns backed by sound theory and solid evidence? As Parts II and III will demonstrate, the answer is no.

C. *Range of Implications*

The allocation of power between boards and shareholders, and the ability of shareholders to influence directors and corporate decision-making, are the product of many legal rules and arrangements. Thus, the view that insulating boards from shareholder pressure and influence is beneficial in the long term has implications for a wide range of issues in the area of corporate law. It is not surprising, then, that short-termism claims have played an important role in many corporate debates over the years and, unless discredited, will likely continue to play such a role in the future. To illustrate the scope of these implications, I now discuss four corporate law debates in which claims based on the long-term benefits of board insulation have played a significant role.

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60. Strine, Toward Common Sense, supra note 43, at 16.

61. Lipton, Finance Corporatism, supra note 19, at 72.

62. For a discussion of short-termism as a major cause for the financial crisis, see generally Lynne L. Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 J. Corp. L. 265 (2012).

63. Lipton, Lorsch & Mirvis, supra note 16, at 2.

64. See Leo E. Strine Jr., Why Excessive Risk-Taking Is Not Unexpected, N.Y. Times: Dealbook (Oct. 5, 2009, 1:30 PM), http://dealbook.nytimes.com/2009/10/05/dealbook-dialogue-leo-strine/ (on file with the *Columbia Law Review*) (noting "to the extent that the [2008 financial] crisis is related to the relationship between stockholders and boards, the real concern seems to be that boards were warmly receptive to investor calls for them to pursue high returns through activities involving great risk and high leverage"); see also Dallas, supra note 62, at 267 ("The financial crisis of 2007–2009 was preceded by a period of financial firms seeking short-term profit regardless of long-term consequences." (footnote omitted)).

1. *Shareholder Power in General.* — At the most general level, insulation advocates believe that increased shareholder power, voice, or involvement is detrimental to long-term value. In their view, companies and their long-term shareholders would ultimately be better off if shareholders had their hands tied and could not exert influence over boards. And since insulation advocates generally view reforms that give shareholders more power or facilitate shareholder involvement as counterproductive, they seek to roll back such reforms.

When Senator Charles Schumer suggested federal legislation that would have substantially expanded shareholder rights in a number of ways (the Shareholder Bill of Rights Act of 2009),[65] short-termism claims were invoked in strong opposition. Insulation advocates argued that the increase in shareholder rights "would fuel the very stockholder-generated short-termist pressure that, in the view of many observers, contributed significantly to the financial and economic crises we face today" and that "[t]he stockholder-centric view . . . embedded in the proposed Act . . . cannot be the cure for the very short-termist disease it spawned."[66]

Such arguments have succeeded in influencing the views of prominent Delaware judges. In an essay on the virtues of "patient capital," Justice Jacobs expressed his concern about "legal developments that empower shareholders to force corporate boards and managements to be more responsive to their immediate agendas."[67] He noted that "[i]n today's world, the shareholders of public companies are highly motivated to influence the company's board and executives to govern for the short-term," and he warned that the combination of increased shareholder power with shareholder willingness to use it has created a serious national problem.[68]

Similarly, in an essay on the fundamentals of corporate governance, Chancellor Strine suggested that the long-term costs of shareholder activism provide a basis for opposing the increasing empowerment of shareholders.[69] He expressed concern that "undifferentiated empowerment of these so-called stockholders may disproportionately strengthen the hand

65. E.g., Press Release, Senator Charles E. Schumer, Schumer, Cantwell Announce 'Shareholder Bill of Rights' to Impose Greater Accountability on Corporate America (May 19, 2009), http://www.schumer.senate.gov/new_website/record.cfm?id=313468 (on file with the *Columbia Law Review*) (describing proposed legislation's objectives and major components). Senator Schumer's proposed bill intended to implement, by federal mandate, a series of measures to strengthen shareholder rights, including facilitating stockholders' proxy access, ending staggered boards at all companies, and requiring that all directors receive a majority of votes cast to be elected. Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (proposing changes to Securities Exchange Act of 1934).

66. Lipton, Lorsch & Mirvis, supra note 16.

67. Jacobs, supra note 9, at 1652.

68. Id. at 1657.

69. Strine, Toward Common Sense, supra note 43, at 7.

of activist institutions that have short-term or non-financial objectives that are at odds with the interests of individual index fund investors."[70]

2. *Takeover Defenses.* — Turning now to particular rules, the extent to which incumbents are insulated from shareholder pressure depends on the extent to which they are insulated from the possibility of removal via a hostile takeover. Insulation advocates have, therefore, long used concerns about short-termism as grounds for supporting impediments to hostile takeovers. Martin Lipton stressed this concern in 1979 in his first major article in support of takeover defenses[71] and in the following year in an exchange on takeover defenses with Frank Easterbrook and Daniel Fischel.[72] Since then, Martin Lipton and others have made extensive use of short-termism claims to warn of the dangers of a regime that facilitates takeovers as well as to support strong defensive tactics and a board veto on acquisitions.[73]

Using short-termism to support strong takeover defenses continues to this day. Over the past decade, many large public companies with staggered boards, which provide strong antitakeover protection, have agreed to eliminate this takeover defense.[74] In 2012, the law firm Wachtell, Lipton, Rosen & Katz issued strongly worded memoranda criticizing the submission of board declassification proposals and the resulting large-scale dismantling of staggered boards.[75] The firm's main argument for opposing this development despite the substantial majorities of shareholders voting for the declassification proposals: short-termism. The firm asserted that "it is our experience that the absence of a staggered board . . . is harmful to companies that focus on long-term value creation," that staggered boards "remain an important feature to allow American corporations to invest in the future," and that the dismantling of staggered

70. Id.

71. Lipton, Takeover Bids, supra note 33, at 104–05.

72. See Martin Lipton, Commentary, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*,* 55 N.Y.U. L. Rev. 1231, 1234 (1980) (responding to Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981)) (stating regime facilitating hostile takeovers "would have a material adverse effect on long-term planning").

73. Lipton & Rosenblum, Quinquennial Election, supra note 7, at 203, 213–14 (stating "[t]o the extent these defenses are removed . . . the ill effects of the current short-term bias will be exacerbated").

74. See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 Stan. L. Rev. 887, 900–39 (2002) (providing theoretical, empirical, and policy analysis of effectiveness of staggered boards as antitakeover tool); Bebchuk, Hirst & Rhee, supra note 23, at 158–60, 167–71 (providing data on large-scale dismantling of staggered boards resulting from 2012 work of Shareholder Rights Project as well as during preceding decade).

75. Martin Lipton, Daniel A. Neff, Andrew Brownstein, Adam O. Emmerich, David A. Katz & Trevor S. Norwitz, Wachtell, Lipton, Rosen & Katz, Harvard's Shareholder Rights Project Is Still Wrong, The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Nov. 30, 2012, 8:55 AM), http://blogs.law.harvard.edu/corpgov/2012/11/30/harvards-shareholder-rights-project-is-still-wrong (on file with the *Columbia Law Review*).

boards "would exacerbate the short-term pressures under which American companies are forced to operate."[76]

The use of short-termism claims to support takeover defenses seems to have had an impact on Delaware judges, and has thereby contributed to the development of the body of Delaware doctrine that provides boards with wide latitude to block hostile offers.[77] In an article on Delaware's approach to corporate law, Chancellor Strine discussed the short-termism concerns and their relevance for the rules governing hostile takeovers. He explained that, without board power to block offers from proceeding to shareholders, institutional investors focused on short-term results might prefer to accept a "low-ball bid" rather than support "the board's demand for independence until a full-priced bid comes along."[78] In the context of antitakeover defenses, insulation advocates have thus far prevailed.

3. *Corporate Elections.* — The rules governing corporate elections also considerably influence the extent to which boards are attentive to shareholder preferences. Some insulation advocates oppose any reform that makes it easier for shareholders to replace directors, thereby making directors more accountable to shareholders. They argue that such reform "perversely incentivizes directors to generate immediate returns at the cost of future growth, at the expense of the corporation and its shareholders (and the economy as a whole)."[79]

Over the past decade, attempts to invigorate corporate elections and strengthen shareholder power to replace directors have focused on the possibility of providing shareholders with "proxy access"—that is, the power to place some director candidates on the corporate ballot. Not surprisingly, companies, corporate advisers, and management groups have invoked short-termism claims to oppose proxy access altogether or to argue for substantial restrictions of its use. Among those making such arguments in comments filed with the SEC are the Business Roundtable,[80] the U.S. Chamber of Commerce,[81] major companies such as IBM and

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76. Wachtell Memorandum, Shareholder Rights Project, supra note 23.

77. Chancellor Chandler's monumental decision in *Airgas* provides a comprehensive review of this development over the twenty-five years since Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985). Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 94–105 (Del. Ch. 2011).

78. Leo E. Strine, Jr., The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face, 30 Del. J. Corp. L. 673, 689 (2005).

79. Lipton & Savitt, supra note 22, at 747.

80. See Letter from Alexander M. Cutler, Chair, Corporate Leadership Initiative, Bus. Roundtable, to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 14–17 (Aug. 17, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-267.pdf (on file with the *Columbia Law Review*) (arguing proposed proxy access rules will promote unhealthy emphasis on short-termism).

81. See Letter from David T. Hirschmann, President & Chief Exec. Officer, Ctr. for Capital Mkts. Competitiveness, U.S. Chamber of Commerce, to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 3–4 (Jan. 19, 2010), available at http://www.sec.gov/comments/s7-10-

McDonald's,[82] an American Bar Association committee,[83] and prominent law firms representing issuers.[84]

Interest in limiting shareholders' power and ability to replace directors has led insulation advocates to propose moving from annual shareholder voting on directors to voting only every several years. Relying on short-termism claims, Martin Lipton and Steven Rosenblum proposed holding elections for directors only once every five years.[85] They argued that tying shareholders hands for five years is desirable to "permit the delegation of control of the corporation to its managers for sufficiently long periods of time to allow them to make the decisions necessary for the long-term health of their corporation."[86]

In his 2011 essay on short-termism, Justice Jacobs accepted this reasoning and recommended that the Delaware Code be amended to allow companies to adopt charter provisions that provide for board elections every five years.[87] In his view, the reliance on "annual elections, with their adverse impact on the incentives of corporate managements and boards to plan and innovate for the long-term," needs to be reconsidered because "we are losing out in the globalized economy, and therefore need patient capital to enable us to compete effectively."[88] According to Justice Jacobs, five-year terms for directors are beneficial because they would "liberate the directors to manage the firm for the longer term required to create and develop the innovative products and services that would enable the American economy to become competitive again."[89]

09/s71009-618.pdf (on file with the *Columbia Law Review*) (arguing proposed rules may lead to greater short-termism).

82. See Letter from Samuel J. Palmisano, Chairman, President & Chief Exec. Officer, Int'l Bus. Machs. Corp., to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n 1–2 (Aug. 20, 2010), available at http://www.sec.gov/comments/s7-10-09/s71009-692.pdf (on file with the *Columbia Law Review*) (urging SEC to reject proxy access rule because it is likely to have "significant[] adverse impact on companies' business strategies as they respond on a repeated basis to short-term concerns"); Letter from Gloria Santona, Exec. Vice President, Gen. Counsel & Sec'y, McDonald's Corp., to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 4 (Aug. 24, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-504.pdf (on file with the *Columbia Law Review*) (expressing concern proxy access rule will be used by short-term holders for their own gain).

83. ABA Letter, supra note 42, at 6, 15–21, 31 (evaluating SEC proxy access proposal).

84. See, e.g., Letter from Cravath, Swaine & Moore LLP, Davis Polk & Wardwell LLP, Latham & Watkins, LLP, Simpson Thacher & Bartlett LLP, Skadden, Arps, Slate, Meagher & Flom LLP, Sullivan & Cromwell LLP & Wachtell, Lipton, Rosen & Katz, to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 15-16 (Aug. 17, 2009), available at http://www.sec.gov/comments/s7-10-09/s71009-212.pdf (on file with the *Columbia Law Review*) (suggesting restrictions on proxy access); see also Lipton & Rosenblum, Proxy Access, supra note 22, at 78–79 (invoking short-termism claims to oppose proxy access).

85. Lipton & Rosenblum, Quinquennial Election, supra note 7, at 225–30.

86. Id. at 224.

87. Jacobs, supra note 9, at 1660–64.

88. Id. at 1660.

89. Id. at 1658–59.

It is worth noting that, in addition to being used to support constraints on shareholder power to replace directors, short-termism concerns have been invoked to oppose extending shareholder powers beyond director elections. In an essay discussing a proposal to allow shareholders to initiate charter amendments, Chancellor Strine expressed opposition to the proposal, relying in part on a concern that "tilting the direction of corporate policy toward short-term thinking is counterproductive."[90]

4. *Limiting Rights of Shareholders with Short Holding Periods.* — A standard feature of corporate arrangements and rules is that they provide shareholders with the same rights per share regardless of when the shareholders came to own their shares; when A buys B's shares, A usually steps into B's shoes and obtains the same rights that B had. Some insulation advocates, however, have proposed that shareholders who have held their shares for shorter periods be granted weaker rights. Because such arrangements could be designed to decrease the voting power of activists that buy a stake in an underperforming company in hopes of turning it around, and to provide a disproportionately large voting power to insiders, they can further insulate directors from shareholder pressure.

Insulation advocates have long been planting the seeds for acceptance of differential treatment of shareholders depending on the length of the holding period. Suggestions to this effect go back at least to the 1980s, when Martin Lipton suggested inferior voting rights for short-term shareholders as a way of protecting long-term shareholders from short-termism costs.[91] Such suggestions have also been made as recently as last year, when Justin Fox and Jay Lorsch suggested adopting "a sliding scale on which voting power increases with the length of ownership" or "restrict[ing] voting in corporate elections of any kind to those who have owned their shares for at least [one] year."[92]

Importantly, public officials seem to be increasingly receptive to accepting, as suggested by insulation advocates, the distinction between shareholders with longer and shorter holding periods. In *Williams v. Geier*, the Delaware Supreme Court upheld the validity of a charter provision that granted superior voting rights to shareholders who held their shares for a continuous three-year period.[93] The company's justification for this arrangement, which the court did not question, was to "[m]aintain ability to maximize long-term value for shareholders," avoid "impairing ability of management to maintain focus on long-term values rather than short-term

90. Strine, True Corporate Republic, supra note 18, at 1769.

91. Lipton, Finance Corporatism, supra note 19, at 28 (supporting use of inferior voting rights for short-term shareholders to protect boards from takeovers).

92. Fox & Lorsch, supra note 2, at 56–57.

93. 671 A.2d 1368, 1385 (Del. 1996). The charter provision in this case provided shareholders holding shares for less than three years with one-tenth of the voting power per share of shareholders holding shares for more than three years. Id. at 1372.

business cycles," and "[p]rotect long-term commitment to continued growth and investment in machine tool business."[94]

Furthermore, in 2010, Chancellor Strine expressed concern about the ability of activist stockholders with short investment horizons to submit proposals to companies. This concern led Chancellor Strine to support the principle that "stockholders who propose long-lasting corporate governance changes should have a substantial, long-term interest that gives them a motive to want the corporation to prosper."[95]

When the SEC adopted the proxy access rule three years ago (later invalidated on procedural grounds by the D.C. Circuit[96]), it chose to limit the use of this rule to shareholders with a substantial holding period of at least three years.[97] The SEC's decision was made in response to comments filed by the Business Roundtable, the Committee on Investment of Employee Benefit Assets, IBM, McDonald's, and the Society of Corporate Secretaries in support of such a requirement.[98] This decision reflects the SEC's acceptance of the argument that the adoption of a limitation on short-term stakeholders is necessary to serve the interests of long-term shareholders.[99]

As institutional investors have become more receptive to short-termism concerns, they have also become open to the idea of different rights for shareholders depending on length of holdings.[100] Indeed, the Generation Foundation, an arm of Generation Investment Management, recently commissioned consulting company Mercer to study the possibility of encouraging shareholders to hold shares for long periods (and thereby have a long-term focus) through "loyalty rewards" of extra dividends, warrants, and additional voting rights.[101] Mercer's announcement of the

94. Id.

95. Strine, One Fundamental Question, supra note 9, at 7.

96. Bus. Roundtable v. SEC, 647 F.3d 1144, 1144 (D.C. Cir. 2011).

97. See, e.g, supra note 12 and accompanying text (discussing SEC's attempted adoption of proxy access rule).

98. See, e.g., Director Nominations, supra note 12, at 56,697–98 (discussing commenters who supported increasing duration of minimum holding period to ensure use of rule was limited to long-term shareholders); see also supra notes 80–84 and accompanying text (listing proponents of longer-term proxy access rule).

99. Director Nominations, supra note 12, at 56,697–98 (discussing short-termism as main type of argument raised in favor of adding significant holding requirement).

100. See, e.g., supra note 48 and accompanying text (describing comment letters written by prominent institutional investors in support of limiting proxy access to long-term shareholders).

101. E.g., Barry B. Burr, Mercer Seeks Long-Term Shareholder Rewards Program from Corporations, Pensions & Investments (Dec. 6, 2012), http://www.pionline.com/article/20121206/DAILYREG/121209930 (on file with the *Columbia Law Review*).

project described it as a response to concerns that short-termism may be damaging the way that companies are managed.[102]

II. ACTIVIST INTERVENTIONS

A. *The Claim*

Although insulation advocates often lump them together, there are two different mechanisms through which shareholder pressure is alleged to produce long-term costs. This Part focuses on activist interventions—that is, shareholder pressure to take particular actions—and the claim that the actions sought by such interventions are commonly detrimental to long-term value. I refer to this claim—that activists with short-term orientation urge actions that are profitable in the short term but value-reducing in the longer term—as *the myopic activists claim*.

Part III discusses a complementary claim: that fear of shareholder intervention (or even removal by shareholders) in the event that management fails to deliver good short-run outcomes leads management itself to initiate and take actions that are profitable in the short term but detrimental in the long term. I refer to this claim as *the counterproductive accountability claim*.

Activists might seek a wide range of actions. Operational activists seek changes in the company's business strategy and mode of operations—proposing, for example, divesting assets, changing investment or payout levels, altering the capital structure, or replacing the CEO.[103] In recent cases that received some attention, hedge fund manager David Einhorn urged Apple to start distributing to shareholders some of the large cash holdings it had accumulated,[104] and hedge fund Elliott Capital Management urged Hess to undergo major structural changes.[105] Because developing an operational change often requires first acquiring a substantial amount of company-specific information, operational activists commonly hold a significant stake in the company and hope to benefit

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102. Press Release, Mercer, Mercer to Research Ways in Which Corporations Can Build Long-Term Shareholder Loyalty (Dec. 5, 2012), http://www.mercer.com/press-releases/1494240 (on file with the *Columbia Law Review*).

103. For discussions of the range of operational changes sought by activists, see William W. Bratton, Hedge Funds and Governance Targets*,* 95 Geo. L.J. 1375, 1409–18 (2007) (describing different financial outcomes of hedge funds' activism); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. Fin. 1729, 1741–45 (2008) [hereinafter Brav et al., Hedge Fund Activism] (describing and classifying motives behind hedge fund activism).

104. For discussions of this activist intervention, see Steven M. Davidoff, Why Einhorn's Win May Be Apple's Gain*,* N.Y. Times: Dealbook (Feb. 26, 2013, 10:02 AM), http://dealbook.nytimes.com/2013/02/26/why-einhorns-win-may-be-apples-gain/ (on file with the *Columbia Law Review*); Wachtell Memorandum, Bite the Apple, supra note 25.

105. E.g., Elliott Management Calls for Board Shake-Up at Hess*,* N.Y. Times: Dealbook (Jan. 29, 2013, 8:38 AM), http://dealbook.nytimes.com/2013/01/29/elliott-management-calls-for-board-shake-up-at-hess/ (on file with the *Columbia Law Review*).

from the appreciation in the value of the stake that would result from implementing the change. For this reason, operational activism is commonly limited to activist hedge funds or large outside blockholders.[106]

Governance activists seek changes in the arrangements and practices that determine how the company is governed. Governance activists might, for example, seek to eliminate staggered boards or other provisions that are viewed as deviating from best governance practices. While governance changes do not directly impact the company's operations, such changes are often motivated by the activist's belief that they would be conducive to performance improvements later on. Governance changes are often sought by activist hedge funds that also seek some operational changes.[107] However, because developing suggestions for governance changes often does not require significant investment in firm-specific information, activists urging governance changes include shareholders, such as public pension funds, which do not have a concentrated position in the company.[108]

For these various types of activist-initiated changes, insulation advocates make the myopic activists claim that the actions being sought are overall (or on average) value-decreasing in the long term even though they might seem profitable in the short term. Some supporters of this view have argued that shareholder activists "are preying on American corporations to create short-term increases in the market price of their stock at the expense of long-term value,"[109] and have referred, for example, to shareholder pressure on companies to make cuts in "research and development expenses, capital expenditures, market development, and new business ventures, simply because they promise to pay off only in the

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106. See generally Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1069–70, 1088–89 (2007) (explaining "incentives for a fund to engage in activism depend on its stake in a portfolio company" and hedge funds often purchase sizeable stakes of five to ten percent and "then seek to influence corporate strategies").

107. See Brav et al., Hedge Fund Activism, supra note 103, at 1741–45 (classifying motives behind hedge fund activism into five categories and noting these categories "are not mutually exclusive as one activist event can target multiple issues").

108. Kahan & Rock, supra note 106, at 1048–62 (discussing limited incentives of mutual funds and pension funds to make substantial investments in acquiring company specific information). For discussions of the differences between operational activists and governance activists, and the investors that engage in each type of activism, see Brian R. Cheffins & John Armour, The Past, Present, and Future of Shareholder Activism by Hedge Funds, 37 J. Corp. L. 51, 56 (2011); Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863, 889–96 (2013).

109. Martin Lipton, Wachtell, Lipton, Rosen & Katz, Important Questions About Activist Hedge Funds, The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Mar. 9, 2013, 10:10 AM) [hereinafter Wachtell Memorandum, Activist Hedge Funds], http://blogs.law.harvard.edu/corpgov/2013/03/09/important-questions-about-activist-hedge-funds/ (on file with the *Columbia Law Review*).

long term."[110] Insulating boards from such pressure, it is argued, would avoid actions that are value-reducing in the long term.

In examining whether there is a good basis for policymakers to accept the validity of the myopic activists claim, this Part proceeds in two stages. First, section B discusses the claim's conceptual structure and the critical empirical propositions that must be true for the claim to be valid. The analysis shows that, rather than being self-evident, the myopic activists claim is a contestable empirical proposition and that, as a matter of theory, there are good reasons to question its validity. Then, section C examines the available empirical evidence and shows that it fails to support the myopic investment claim; to the contrary, the significant body of available empirical evidence supports the view that activist interventions increase long-term value.

B. *Structure and Critical Elements*

1. *Conceptual Structure.* — Writings about short-termism stress that many activist investors have short investment horizons.[111] Chancellor Strine, for example, explained the essence of the problem as he saw it in the following way: "[I]n corporate polities, unlike nation-states, the citizenry can easily depart and not 'eat their own cooking.' As a result, there is a danger that activist stockholders will make proposals motivated by interests other than maximizing the long-term, sustainable profitability of the corporation."[112] Not having to eat their own cooking, so the argument goes, activist short-horizon shareholders will cook a meal that will not taste good to shareholders that stay with the company after the activists depart.

To understand the claim's nature and structure, it is useful to consider the following paradigmatic situation. A public company has three stages in its life: Period *0*, the present period in which an activist shareholder emerges and urges the public company to take certain actions; Period *1*, the "short term," in which the activist unloads its shares but other shareholders remain; and Period *2*, the "long term," in which the full consequences of all actions undertaken in Period *0* become clear.

Let us denote by V_1 and V_2 the value of the company's shares in Period *1* and Period *2*, respectively. Insulation advocates believe that, given the

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110. Lipton & Rosenblum, Quinquennial Election, supra note 7, at 210.

111. See, e.g., Jacobs, supra note 9, at 1651 ("It is increasingly the case that the 'agenda setters in corporate policy discussions are highly leveraged hedge funds that have no long-term commitment to the corporations in which they invest.'" (quoting Strine, One Fundamental Question, supra note 9, at 12)); Strine, One Fundamental Question, supra note 9, at 8 (arguing "[m]any activist investors hold their stock for a very short period of time and may have the potential to reap profits based on short-term trading strategies that arbitrage corporate policies").

112. Strine, One Fundamental Question, supra note 9, at 8.

activist's interest in having actions with a positive impact on V_1, the actions that the activist seeks can be expected to have a negative impact on V_2.

In taking this view, insulation advocates rely on two premises that are worth noting at the outset. One premise is that, in modern capital markets, activist investors largely have short horizons.[113] This assumption enables insulation advocates to assume that activists focus on V_1, the value of shares in the short term, rather than on V_2, the long-term share value. If activists intended to keep their shares through Period *2*, they would expect to "eat their own cooking" and would not have a reason to seek actions that have a positive effect on V_1 but a negative effect on V_2.

There are reasons to believe that insulation advocates overestimate the extent to which activist investors, and shareholders in general, have short horizons. While insulation advocates point to the increase in the volume of trading over time, this increase might be driven by an increase in high-frequency trading by a minority of investors and not reflect shortened horizons for most institutional investors.[114] Indeed, recent empirical work suggests that the holding duration of institutional investors has been stable over the past quarter of a century and, if anything, lengthened slightly over time.[115] And it is far from clear that activist investors have shorter investment horizons than other shareholders.[116] For the sake of analysis, however, this Essay accepts the validity of the short-horizon assumption and assumes that all activist shareholders plan to get out in Period *1*.

The second premise on which insulation advocates rely is that stock market prices are informationally inefficient—that is, the prices are not generally set at levels representing the best estimate of long-term share

113. See, e.g., Jacobs, supra note 9, at 1651 (noting "blue chip institutional investors, which control 70% of our publicly traded companies, are 'more short-term speculators' than 'committed, long-term investors'" (quoting Strine, One Fundamental Question, supra note 9, at 11)); Strine, One Fundamental Question, supra note 9, at 8, 10–11 (noting "many activist investors hold their stock for a very short period of time" and "[w]hat is even more disturbing than hedge fund turnover is the gerbil-like trading activity of the mutual fund industry").

114. See Roe, supra note 32, at 18–20 (noting increase in aggregate trading volume does not imply shortening of investment horizons).

115. See, e.g., Martijn Cremers, Ankur Pareek & Zacharias Sautner, Stock Duration and Misvaluation 10-13 (Feb. 14, 2013) (unpublished manuscript), available at http://papers.ssrn.com/abstract=2190437 (on file with the *Columbia Law Review*) (reporting holding durations of institutional investors have been stable and even lengthened slightly since 1985).

116. See Dionysia Katelouzou, Myths and Realities of Hedge Fund Activism: Some Empirical Evidence, 7 Va. L. & Bus. Rev. 459, 476–83 (2013) (providing evidence substantial fraction of activist hedge funds have long investment horizons); Aswath Damodaran, Marty Lipton: Shareholder Champion, Stakeholder Protector or Management Tool?, Musings on Mkts. (Mar. 9, 2013, 4:05 PM), http://aswathdamodaran. blogspot.com/2013/03/marty-lipton-shareholder-champion.html (on file with the *Columbia Law Review*) (questioning belief activist investors are typically short-term investors).

value that can be derived from all available public information.[117] This assumption of market inefficiency is necessary to maintain that actions sought by activists might be expected to have a positive effect on V_1 but a negative effect on V_2: If markets were generally efficient, then any action expected to have a negative effect on V_2 would also have a negative effect on V_1. As with the short-horizons assumption, this Essay accepts the validity of the inefficient market assumption for the purpose of my analysis.

2. *Four Types of Corporate Actions.* — At this stage, it is useful to introduce a taxonomy of possible corporate actions that is based on their short-term and long-term consequences. In particular, actions that activists consider seeking may be usefully divided into four sets:

(i) PN actions: Actions that are expected to have a positive effect on short-term value but a negative effect on long-term value;
(ii) PP actions: Actions that are expected to have a positive effect on both short-term value and long-term value;
(iii) NP actions: Actions that are expected to have a negative effect on short-term value but a positive effect on long-term value; and
(iv) NN actions: Actions that are expected to have a negative effect on both short-term value and long-term value.

The myopic activist claim focuses on group (i), the PN actions—actions that activists allegedly pursue for their short-term benefits despite their long-term negative consequences. The short-horizon and inefficient pricing assumptions must be true if such PN actions are to be sought by activists. If capital markets were informationally efficient, there would be no PN actions, as all actions expected to have a negative effect on long-term value would also have a negative effect on short-term value. And if activists generally had long horizons and focused on V_2, they would not have an interest in seeking any PN actions, anyway.

While each of the assumptions about informational inefficiency and short horizons is necessary for the myopic activists claim, they are insufficient to validate the claim. In particular, while the above two assumptions are necessary for any concern about PN actions to exist, they do not justify focusing solely on such actions. As the next two subsections explain, insulation advocates have not paid sufficient attention to the other three groups of actions, and a consideration of these groups casts doubt on the

117. See, e.g., Anabtawi & Stout, supra note 35, at 1290–91 (stating "stock market prices often depart substantially from reasonable estimates of fundamental economic value"); Bratton & Wachter, supra note 1, at 691–94 (stating financial markets are not efficient and surveying related literature); Lipton & Rosenblum, Quinquennial Election, supra note 7, at 208–10 (arguing stock market is generally inefficient by referring to economic literature accepting stock market can and does misprice stocks).

insulation advocates' focus on PN actions and, in turn, on the myopic activists claim.

3. *Activists' Incentives to Seek Actions with Positive Long-Term Payoffs.* — While insulation advocates focus on the costs resulting from activists seeking actions with negative long-term consequences, they overlook the benefits that result from activists seeking some actions that belong to group (ii), the PP actions—that is, actions that are expected to have a positive effect on both short-term and long-term value. Neither the short-horizon premise nor the market inefficiency premise rules out activists seeking such actions, and there are good reasons to expect that activists would often do so.

To be sure, the short-horizon assumption implies that activists do not seek actions with positive long-term consequences *because* of these long-term consequences. But while activists do not seek positive long-term consequences for their own sake, they certainly have no reason to avoid actions with such consequences and, in fact, have strong incentives to seek them when the action's effect on short-term value is expected to at least partly reflect its positive effect on long-term value.

Similarly, while the assumption of market inefficiency implies that changes in short-term value do not always reflect expected changes in long-term value, it certainly does not imply that the two generally move in opposite directions. Even those most skeptical of market efficiency are unlikely to take the view that the market is largely clueless, incapable of ever recognizing the beneficial changes that are expected to have a positive effect on long-term value.

Indeed, even if the market is highly imperfect in judging the long-term consequences of corporate actions, it is plausible for short-term and long-term changes in value to be at least positively correlated; that is, actions that can be expected to be positive in the long term are, on average, more likely to be perceived by the market as positive in the short term. And even if short-term and long-term value changes are not positively correlated, it is highly plausible that there are many cases in which the market can be expected to recognize in the short term, either fully or partly, the beneficial long-term consequences of certain corporate actions.

The positive long-term payoffs of some actions—say, replacing a CEO who is widely viewed as incompetent or abandoning a pet investment project that is widely viewed as value-decreasing—are clearly or at least partly observable to market participants. In such cases, short-horizon activists will have an incentive to pursue interventions that can be expected to have a positive effect on long-term value.[118]

118. In a recent paper, Stephen Bainbridge granted my claim that activists have an incentive to pursue PP changes but expressed skepticism that activists would be able to identify such PP changes given that they are likely to have less information and expertise than the incumbent managers and directors. Stephen M. Bainbridge, Preserving Director Primacy by Managing Shareholder Interventions (UCLA School of Law, Law-Econ. Research

Thus, even accepting that activists pursue some ultimately negative actions that produce long-term costs, it is necessary to weigh those costs against the countervailing benefits resulting from activists pursuing actions that have positive effects on both short-term and long-term value. Given these benefits, for the myopic activists claim to be valid, it must be the case that (a) the expected benefits of activist-initiated actions with positive long-term consequences, do not exceed (b) the expected costs of activist-initiated actions with negative long-term consequences. Having discussed why (a) could well be significant, I now turn to assess whether (b) should be expected to be significant.

4. *Excessive Concern About Actions with Negative Long-Term Payoffs?* — As explained earlier, the two premises of insulation advocates—that markets are informationally inefficient and that activists have short horizons—imply that activists might seek some PN actions. However, the question remains how common such situations are. Moreover, while they have focused on the costs of such situations, insulation advocates have largely overlooked factors that limit these costs.

To begin, as Robert Jackson and I pointed out, activist investors, including investors with short horizons, can generally expect to succeed in getting companies to take certain actions only if other shareholders support these actions.[119] Furthermore, corporate actions can be expected to produce the elevated short-term prices that short-horizon activists seek only if the actions would lead other investors to be willing to buy shares at elevated prices at the time in which the activists sell.

In particular, insulation advocates have failed to explain why actions with negative long-term payoffs should commonly be expected to have a positive effect on short-term value and thus be attractive for activists with short horizons. Many actions that are negative in the long term (e.g., cancelling an investment project that is critical to the company's future success) are highly likely to be recognized right away as such by the market. It might be the case that actions with negative long-term payoffs commonly belong to the NN category; that is, they can be expected to have a negative effect not only on long-term value but also on short-term value.

Consider situations of the kind that insulation advocates often use to illustrate their concerns. Suppose that an activist seeks to have dividends increased, which might leave the company with fewer funds for investments or other expenditures. Insulation advocates view such a situation as being detrimental to long-term value. In their view, while the increased dividend can be expected to spike the short-term share value, it will be

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Paper No. 13-09), available at http://ssrn.com/abstract=2298415 (on file with the *Columbia Law Review*). But outside shareholders could well be expected to identify situations in which the company could benefit from cutting investment in the CEO's pet project or replacing a failing CEO and, importantly, might have incentives to bring about change that incumbents lack.

119. Bebchuk & Jackson, supra note 24, at 51–53. This point is also stressed by Gilson & Gordon, supra note 108, at 897.

detrimental in the long run, with the stock price gain likely to be more than fully reversed as the consequences of reduced investments or expenditures materialize. Martin Lipton, for instance, viewed the recent attempt by activist David Einhorn to persuade Apple to distribute some of its large cash holdings as a clarion example of activism that will adversely affect the long-term interests of Apple and its long-horizon shareholders.[120]

The confidence with which insulation advocates reach such conclusions is puzzling. For the activist to sell shares at a profit in the short run, other investors must be willing to buy at the increased price and subsequently bear the long-term consequences of the corporate actions. If other shareholders in the aggregate react positively to the corporate action, how can insulation advocates presume that this is an overreaction? Should not the fact that numerous professional money managers are willing to buy shares at the increased price give these writers some pause? Note that such situations have been taking place frequently. If the prices are commonly reversed, so that V_2 commonly falls below V_1, why have money managers failed to observe and adapt to this pattern?

Furthermore, there is no basis for insulation advocates to presume that activist-initiated reductions in investments or expenditures are likely to be value-reducing in the long term. Financial economists and corporate law scholars have devoted significant attention to management's excessive tendency to avoid distributing excess cash or assets to shareholders.[121] Indeed, scholars view this tendency as a significant agency problem facing public companies.[122]

Because managers' personal interest might disfavor taking actions that would reduce the size of the empire under the managers' control, they might elect to maintain excessive levels of investments and cash

120. Wachtell Memorandum, Bite the Apple, supra note 25.

121. See, e.g., Sanford J. Grossman & Oliver D. Hart, Corporate Financial Structure and Managerial Incentives, *in* The Economics of Information and Uncertainty 107, 107–30 (John J. McCall ed., 1982) (explaining managers have interest in increasing resources under their firm's control); Oliver Hart & John Moore, Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management, 85 Am. Econ. Rev. 567, 568–71 (1995) (analyzing benefits of leading management to avoid empire building and discourage free cash flow); Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. 323, 323–28 (1986) (explaining payouts to shareholders reduce resources under managers' control and discussing role of debt in motivating organizational efficiency).

122. See, e.g., Henry Hansmann, The Ownership of Enterprise 38 (1996) (noting management retaining excess cash is problematic because it is not visible to observers and other managers generally approve such conduct); Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.–Oct. 1989, at 61, 66 (discussing agency problems related to free cash flow); see also Margaret M. Blair & Martha A. Schary, Industry-Level Indicators of Free Cash Flow, *in* The Deal Decade 99, 128 (Margaret M. Blair ed., 1993) (discussing factors leading to excessive free cash flow).

holdings.[123] This view receives support from empirical studies.[124] Thus, insulation advocates overlook the fact that reducing cash holdings and investments might move companies closer to, rather than away from, the levels of cash holdings and investments that are optimal for the long term.

While insulation advocates believe that money managers in the aggregate fail to correctly price the effects of changes in payout policies or reduced investment levels, this belief is inconsistent with beliefs that some of these advocates have expressed in other contexts. In particular, some insulation advocates oppose mandatory rules and support broad contractual freedom in corporate law on the grounds that markets can accurately price the consequences of governance provisions.[125] But if markets are presumed to do a good job at pricing governance provisions at the IPO, why do insulation advocates presume that they commonly fail to perceive the value destruction expected to follow from actions such as increased payouts or reduced investments?

In my view, insulation advocates should be reluctant to assert that stock prices are overreacting and that they recognize this overreaction but money managers with real money on the line do not. At a minimum, insulation advocates should not make such assertions without some empirical evidence that, in fact, such activist interventions are commonly followed by negative stock returns in the long term. As this Essay explains, however, this is not what the evidence shows.

C. *Lack of Empirical Support*

1. *The Need for Empirical Evidence.* — The analysis has thus far shown that assuming short horizons and informational inefficiency does not by itself validate the myopic activists claim that, on average, actions sought by activists can be expected to be value-decreasing in the long term. Although these assumptions imply that the actions sought by activists can be expected to produce some long-term costs, such costs might actually be lower than the expected long-term benefits produced by these actions.

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123. Hart & Moore, supra note 121, at 568 (analyzing use of debt as tool for inducing managers to avoid making unprofitable empire-building investments).

124. See, e.g., Jarrad Harford, Corporate Cash Reserves and Acquisitions, 54 J. Fin. 1969, 1970, 1995 (1999) (showing excess cash leads managers to make value-decreasing investment decisions); Sheridan Titman, K.C. John Wei & Feixue Xie, Capital Investments and Stock Returns, 39 J. Fin. & Quantitative Analysis 677, 683–89 (2004) (reporting firms with greatest increase in levels of capital investment generally achieve lower stock returns for five subsequent years).

125. See, e.g., Bainbridge, Director Primacy, supra note 1, at 1736–44 ("The mechanism by which securities are priced 'ensures that the price reflects the terms of governance and operation' offered by the firm." (quoting Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 18 (1991)); Lynn A. Stout, Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem, 55 Stan. L. Rev. 845, 853–56 (2002) (arguing use of staggered boards in IPOs reflects institutional investors' correct estimate of long-term effects of antitakeover defenses).

Thus, the myopic activists claim is, at best, a contestable proposition that cannot be asserted without evidence to support it.

Insulation advocates have thus far failed to provide empirical evidence showing that activist interventions are followed in the long term by losses to target companies or their shareholders. Indeed, these advocates have largely even failed to acknowledge the need for such evidence. None of the organizations that press for board insulation in the name of long-term value and that command significant resources, such as the Business Roundtable, the Aspen Institute, or Wachtell, Lipton, Rosen & Katz, have thus far attempted to conduct or commission research that would use the substantial data available on the financial performance of firms and shareholders to validate their myopic activists hypothesis.

Although insulation advocates have failed to provide empirical evidence for this claim, some have stressed that it is strongly confirmed by their experiences. Martin Lipton, for example, wrote earlier this year that his short-termism concerns are based on "the decades of [his] firm's experience in advising corporations."[126] Furthermore, in response to the subsequent release of an empirical study by Alon Brav, Wei Jiang, and myself on the long-term effects of hedge fund activism, Martin Lipton and other senior lawyers at Wachtell, Lipton, Rosen & Katz issued a memorandum urging reliance on the "depth of real-world experience" of corporate leaders rather than on empirical evidence.[127]

Such reported experiences, however, are not a good basis for policymaking. Martin Lipton would surely oppose policymakers' relying on claims by leaders of activist hedge funds that activist interventions are beneficial in the long term if these claims were based solely on the leaders' professed experience. Rather than rely on the reported experience of involved parties, it would be best to base policymaking on what can be learned from the substantial amount of objective financial data available about the performance of public firms and the investors holding their shares.

While advising reliance on his and his firm's experience, Martin Lipton asserts that "academics' self-selected stock market statistics are meaningless."[128] However, in my view, statistics provided by academic research provide objective evidence that is valuable for policymaking. When confronting a study that they view as flawed, researchers respond by countering it with research that avoids such flaws, not by dismissing the use of empirical results altogether.

126. Wachtell Memorandum, Bite the Apple, supra note 25.

127. Martin Lipton, The Bebchuk Syllogism, The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Aug. 26, 2013, 12:32 PM) [hereinafter Wachtell Memorandum, Bebchuk Syllogism], https://blogs.law.harvard.edu/corpgov/2013/08/26/the-bebchuk-syllogism/ (on file with the *Columbia Law Review*).

128. Wachtell Memorandum, Bite the Apple, supra note 25.

Therefore, anyone interested in the myopic activists claim and its policy implications should take the empirical evidence seriously. Below, this Essay examines the body of relevant empirical evidence produced by financial economists over the past decade and concludes that it does not support the myopic activists claim. To the contrary, the evidence favors the view that activist interventions benefit targeted companies and their shareholders both in the short term and in the long term.

2. *Do Money Managers Believe the Claim?* — Before discussing the evidence produced by financial economists, I would like to note some facts that provide a basis for initial skepticism concerning the myopic activists claim. Insulation advocates believe that, after the initial spike accompanying the announcement of an activist campaign through an activist investor's filing of a Schedule 13D,[129] the stock returns of the targeted company can be expected to underperform in subsequent years. This implies that, following such an announcement, an investing strategy that bets against the stocks of the targeted company should be expected to produce superior returns.

Suppose that the adverse long-term effects of an activist intervention hypothesized by insulation advocates are realized during the five-year period following one month after the filing of a Schedule 13D. In that case, for any broad index of U.S. stocks, holding the index as is would be inferior to holding an investment product (offered through a mutual fund, an exchange-traded fund (ETF), or otherwise) that would be based on the index with the following single refinement: underweighting the stock of companies targeted by activists during the aforementioned five-year period, and correspondingly overweighting the stocks of other companies included in the index. Nonetheless, although there are thousands of investment products in the United States that offer investments in a wide range of indices with numerous variants and refinements, there is not, to the best of my knowledge, a single money manager offering an investment product based wholly or partly on the prediction that companies targeted by activists underperform in the years following the activist intervention.

Furthermore, given this prediction, such companies should present a profitable opportunity for shorting by hedge funds and other money managers that focus on investing in shorts or in special situations. The recent case of Herbalife, in which hedge fund manager Daniel Loeb took an opposite position from that of hedge fund manager Bill Ackman, vividly illustrates that rival hedge funds are willing to bet against each other when they expect that there is money to be made by doing so.[130] However, I am

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129. See 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-1 (2011) (requiring, together, beneficial owners of more than five percent of voting class of registered company's equity to file within ten days Schedule 13D, reporting acquisition and other information such as identity and background of acquirer and purpose of purchase).

130. E.g., Juliet Chung, Emily Glazer & Gregory Zuckerman, Billionaires Take Sides Over Herbalife, Wall St. J. (Aug. 7, 2013), http://online.wsj.com/article/SB10001424127887323838204578654082809374320.html (on file with the *Columbia Law Review*).

not aware of any hedge fund or other money manager that uses a systematic strategy of betting against targets of activist campaigns by taking long-term short positions in such stocks.

Insulation advocates might respond that the absence of such investment products merely reflects the market's current failure to recognize the long-term adverse effects of activist interventions. However, for an investment product to exist, all that is necessary is that *some* of the market participants, not most of them, believe in the prediction underlying the investment product. Furthermore, it is worth noting that the marketplace currently features a vast number of ETFs and hedge funds, catering to the diverse beliefs and predictions of investors.[131]

Thus, the absence of any investment products based on the long-term underperformance of activist-targeted companies suggests that even though many insulation advocates have been prepared to assert the myopic activists claim, they and others have been unwilling to put real money on investment strategies this claim suggests. The absence of considered investment products is consistent with the empirical evidence discussed in the next subsection. As I now turn to explain, the evidence indicates that, contrary to the predictions of the myopic activists claim, such investment products would not have been profitable.

3. *Evidence on Operating Performance.* — Insulation advocates believe that, in the long term, activism has adverse effects on the operating performance of the targeted companies and that insulating boards from activist intervention is therefore beneficial for long-term operating performance. The asserted adverse effect of activist interventions on long-term operation performance provides a proposition that can and should be tested using available data. However, insulation advocates have thus far made this assertion without empirical evidence to support it. Nonetheless, significant empirical evidence has been assembled over the past decade, and it provides no support for the asserted adverse effect of activist interventions on operating performance.

To begin, the two studies by Alon Brav and his coauthors examined changes in operating performance during the two years following the filing of a 13D.[132] These studies used three standard metrics that financial economists employ for measuring operating performance: return on assets (ROA), operating profit margin, and Tobin's Q (which measures the effectiveness with which a company turns a given book value into

131. For information about the huge number and large diversity of ETFs tracking various investment strategies, see ETF Center, Yahoo! Finance, http://finance.yahoo.com/etf/ (on file with the *Columbia Law Review*) (last visited Sept. 23, 2013).

132. Brav et al., Hedge Fund Activism, supra note 103, at 1770–73 (examining changes in operating performance after 13D schedules filings); Alon Brav, Wei Jiang & Hyunseob Kim, Hedge Fund Activism: A Review, 4 Found. & Trends Fin. 185, 221–30 (2009) [hereinafter Brav et al., A Review] (documenting hedge fund activism improves firms' share value, return on assets, and Tobin's Q).

shareholder value).[133] The studies found that targets of activist interventions experienced significant improvement in these metrics during the two years following the announcement of the interventions, as compared to similar firms not targeted.[134] Furthermore, the studies found that the target companies were underperforming before the interventions and that their performances recovered during the subsequent two-year period.[135]

Subsequent studies corroborate these findings of improved operating performance following activist interventions. A study by Nicole Boyson and Robert Mooradian reports that targets of intense activism benefited from an increase in ROA in the first year after the initiation of activism and from an even higher increase in the subsequent two years.[136] A study by Christopher Clifford, which examined a different sample of activist situations, documented that targets of activists benefited from improved performance (reflected in higher ROA) in each of the three years following the activist event.[137]

While the above studies used publicly available data from companies' financial reports about the companies' overall financial performance, a study by Alon Brav, Wei Jiang, and Hyunseob Kim extended the scope of investigation. It used nonpublic data that companies provided confidentially to the U.S. Census Bureau about the performances of plants they owned.[138] Using alternative measures of plant productivity, the authors focused on changes in operating performance at the manufacturing plants of companies that were targets of activism.[139] They found a pattern that is consistent with activist intervention increasing, rather than decreasing, the efficiency of plants.

In particular, Alon Brav, Wei Jiang, and Hyunseob Kim showed that the productivity of plants owned by target firms displayed a "V-shaped" pattern: Compared to the productivity of control plants of similar size and

133. Brav et al., A Review, supra note 132, at 208, 225; Brav et al., Hedge Fund Activism, supra note 103, at 1770–71.

134. Brav et al., A Review, supra note 132, at 221–30; Brav et al., Hedge Fund Activism, supra note 103, at 1770–73.

135. Brav et al., A Review, supra note 132, at 221–30; Brav et al., Hedge Fund Activism, supra note 103, at 1749–55, 1770–74.

136. Nicole M. Boyson & Robert M. Mooradian, Intense Hedge Fund Activists 21–25 (Oct. 12, 2009) (unpublished manuscript), available at http://ssrn.com/abstract=1492641 (on file with the *Columbia Law Review*).

137. Christopher P. Clifford, Value Creation or Destruction? Hedge Funds as Shareholder Activists, 14 J. Corp. Fin. 323, 329–31 (2008).

138. Alon Brav, Wei Jiang & Hyunseob Kim, The Real Effects of Hedge Fund Activism: Productivity, Risk, and Product Market Competition 5 (Nat'l Bureau of Econ. Research, Working Paper No. 17517, 2011), available at http://www.nber.org/papers/w17517.pdf (on file with the *Columbia Law Review*).

139. Id. at 2. The two measures on which the study focuses are (i) each plant's total factory productivity, which is defined as the difference between the actual and predicted output given inputs, and (ii) each plant's operating profit margin, which is defined as total output minus material and labor costs scaled by total output. Id. at 7–8.

age in the same industry, the productivity of a targeted company's plants deteriorated significantly during the two years preceding the intervention and then rebounded substantially in the two years following it.[140] Overall, the study's findings are consistent with the view that activists target companies that have fallen behind in their relative performance and that the "kick in the pants" provided by activism leads to improvement in performance.

Insulation advocates might challenge the conclusiveness of the above studies by arguing that the time periods the studies examined were not long enough and that the improved performance subsequent to activist interventions came at the expense of performance beyond the period examined by the studies. One prominent supporter of the myopic activists claim has recently argued that the important question is, "For companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance . . . , not just in the short period after announcement of the activist interest, but after a 24-month period[?]"[141]

This question is fully answered in a study that Alon Brav, Wei Jiang, and I recently conducted to examine the long-term effects of activism (the "BBJ study").[142] The BBJ study provides a comprehensive empirical investigation of the long-term effects of hedge fund activism, including its effects on operating performance.[143]

Our study uses a dataset consisting of the full universe of approximately 2,000 interventions by activist hedge funds during the period 1994–2007.[144] For each activist effort we identify the month (the intervention month) in which the activist initiative was first publicly disclosed (usually through the filing of a Schedule 13D).[145] We track the companies during a long period—five years—following the intervention month.[146]

Consistent with the results of prior empirical work, the BBJ study finds that activists did not tend to target well-performing companies.[147]

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140. Id. at 20.

141. Wachtell Memorandum, Bite the Apple, supra note 25.

142. Bebchuk, Brav & Jiang, supra note 26.

143. A critique of our study was put forward in a memorandum by Wachtell, Lipton, Rosen & Katz. See Wachtell Memorandum, Bebchuk Syllogism, supra note 127. For a detailed response fully addressing this criticism, see Lucian Bebchuk, Alon Brav & Wei Jiang, Don't Run Away from the Evidence: A Reply to Wachtell Lipton, The Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Sept. 17, 2013, 9:00 AM), available at http://blogs.law.harvard.edu/corpgov/2013/09/17/dont-run-away-from-the-evidence-a-reply-to-wachtell-lipton/ (on file with the *Columbia Law Review*).

144. Id. at Section II.

145. Id.

146. Id.

147. Id. at Section III.C.

Rather, the companies targeted by activists were those whose operating performance relative to peer companies was worse, and in decline, during the preintervention years.[148]

Furthermore, the decline in performance relative to industry peers was reversed following the activist intervention. Operating performance improved, and this improvement did not come at the expense of performance later on.[149] During the third, fourth, and fifth years following the activist intervention, operating performance tended to be better, not worse, than during the preintervention period.[150] On average, the companies targeted by activists substantially reduced their gap with industry peers in terms of ROA and Tobin's Q.[151] Thus, during the long, five-year time window that we examine, the declines in long-term operating performance feared by supporters of the myopic activists claim are not found in the data.

The BBJ study also examines two subsets of activist interventions that are most resisted and criticized: first, interventions that lower or constrain long-term investments by enhancing leverage, enhancing shareholder payouts, or reducing investments and, second, adversarial interventions employing hostile tactics. In both cases, the study finds, interventions were followed by improvements in operating performance during the five-year period following the intervention, and no evidence is found for the adverse long-term effects asserted by opponents.[152]

Finally, our study examines whether activist interventions render targeted companies more vulnerable to economic shocks. In particular, we examine whether companies targeted by activist interventions during the years preceding the financial crisis fared worse in the subsequent crisis. We find no evidence that precrisis interventions by activists were associated with greater declines in operating performance or higher incidences of financial distress during the crisis.[153]

Overall, the empirical analysis of companies' operating performance discussed above provides no support for insulation advocates and their myopic activists claim. The asserted long-term costs to targeted companies and their shareholders are not supported by the data. Activists' interventions target companies that have been underperforming, and such interventions are followed by improvements in operating performance that persist in the long term. Judging by their effect on long-term operating performance, such interventions appear to benefit, not harm, companies and their long-term shareholders.

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148. Id.
149. Id. at Section III.
150. Id.
151. Id.
152. Id.
153. Id. at Section VI.

4. *Evidence on Stock Returns.* — A significant body of empirical evidence indicates that when activists disclose their presence by filing a Schedule 13D, the market reacts positively to the news and the stock price of the target appreciates. One leading study of the subject was published in 2008 by Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas. Using a hand-collected dataset of over 1,000 activist interventions between 2001 and 2006, the study found that the announcement of activism had a positive effect on the target's stock price, producing an abnormal stock return of seven to eight percent during the forty-day announcement window.[154]

The other leading study, published simultaneously, was conducted by April Klein and Emanuel Zur. Focusing on 151 activist campaigns by hedge funds and 154 activist campaigns by other entities (private equity firms, venture capitalists, asset management groups, and private individuals), the study found that both types of campaigns led to positive market reactions around the activist's filing date.[155] These reactions produced average abnormal returns of about ten percent for activist hedge funds and about five percent for the other types of activist entities.[156]

These initial findings were corroborated by three subsequent studies by Nicole Boyson and Robert Mooradian,[157] Christopher Clifford,[158] and Robin Greenwood and Michael Schor.[159] Each of these studies found that 13D filings by activists were accompanied by positive stock market reactions.

It is worth noting that a study conducted in a different environment provided consistent findings. Marco Becht, Julian Franks, Colin Mayer, and Stefano Rossi studied activist engagement by the Hermes U.K. Focus Fund.[160] The engagements were commonly aimed at bringing about substantial changes in the target companies' governance structure, such as replacing the CEO or chairman, or increasing cash payouts to shareholders.[161] Examining a significant number of instances in which funds' engagement objectives were achieved, the study found that positive and

154. Brav et al., Hedge Fund Activism, supra note 103, at 1755–60.

155. April Klein & Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187, 207–11 (2009).

156. Id. at 225.

157. Boyson & Mooradian, supra note 136, at 17–21 (reporting targets of intense activism have 10.5% cumulative abnormal return around 13D filing date).

158. Clifford, supra note 137, at 328–29 (reporting firms targeted by active blockholders experience positive and significant excess returns surrounding filing date).

159. Robin Greenwood & Michael Schor, Investor Activism and Takeovers, 92 J. Fin. Econ. 362, 362–75 (2009) (showing positive abnormal returns around 13D filing date).

160. Marco Becht, Julian Franks, Colin Mayer & Stefano Rossi, Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund, 22 Rev. Fin. Stud. 3093 (2009) (finding positive abnormal returns accompany activist fund's achievement of engagement objectives).

161. Id. at 3113–17.

significant abnormal returns (about five percent in the seven-day event window) accompanied the announcement of the change.[162]

Financial economists have interpreted the above findings as supportive of the view that hedge fund activists provide benefits to, rather than impose costs on, the targets of their campaigns.[163] However, insulation advocates dismiss the significance of findings based on short-term stock reactions, asserting that the short-term stock price appreciation is more than fully reversed in the long term, leaving long-term shareholders worse off.[164] This proposition has clear empirical implications that make it testable using publicly available data.

Surprisingly, however, insulation advocates have not tried to test this key proposition empirically or commission or encourage such testing by others, nor have they provided any empirical support for the reversal and long-term underperformance they assert. And it now turns out that the evidence in fact does not support their view. To begin, the leading study on hedge fund activism by Alon Brav and his coauthors, referred to above, also examined the returns of activist targets in the two years following an activist event. The study found no evidence of the stock price reversal feared by insulation advocates in either the first or second year following the activist event.[165]

This finding casts significant doubt on the myopic activists claim because, to the extent that activist interventions are value-decreasing in the long term, it would be plausible to expect the market to start noticing their detrimental consequences within two years. However, insulation advocates might still maintain that it usually takes more than two years for the long-term detrimental effects of activist interventions to be recognized and reflected in stock returns. Martin Lipton, for example, has argued that the important question is "what . . . the impact on . . . stock price performance relative to the benchmark . . . [is] after a 24-month period."[166]

This challenge, however, is fully met by the study conducted by Alon Brav, Wei Jiang, and myself.[167] After confirming prior findings concerning the initial stock price spike accompanying interventions, which we find to be approximately six percent, we proceed to examine whether this initial

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162. Id.

163. See, e.g., Brav et al., A Review, supra note 132, at 185–246 (analyzing empirical work on hedge fund activism and concluding such activism benefits shareholders).

164. See, e.g., Wachtell Memorandum, Bite the Apple, supra note 25 ("[A]cademics' self-selected stock market statistics are meaningless in evaluating the effects of short-termism.").

165. E.g., supra notes 138–140 and accompanying text.

166. Wachtell Memorandum, Bite the Apple, supra note 25.

167. Bebchuk, Brav & Jiang, supra note 26.

stock price is reversed in the long term, as the myopic activists claim asserts.[168]

In investigating the presence of negative abnormal returns during the five-year period following interventions, the BBJ study employs the standard methods used by financial economists for detecting under-performance relative to the returns of similar companies.[169] First, it examines whether the returns to targeted companies were systematically lower during the considered five-year period than what would be expected given standard asset pricing models.[170] Second, it examines whether the returns to targeted companies were lower than those of "matched" firms—that is, firms that are similar in terms of size and industry.[171] Third, using a portfolio approach, it examines whether a portfolio that took a position in each targeted company after the 13D announcement window—and retained this position for the subsequent five years—underperformed relative to its risk characteristics.[172]

Using each of these methods, the study finds no evidence of the asserted reversal of fortune during the five-year period following the 13D announcement window.[173] To the contrary, the targets of activism did not exhibit abnormal negative returns during any part of that period.[174]

Finally, the BBJ study analyzes long-term returns following the decisions of activist hedge funds to start liquidating their holdings in the activist target.[175] The background for this analysis was the evidence that investors in activist hedge funds have been making significant positive returns.[176] Brav, Jiang, Partnoy, and Thomas found that activist investors capture positive abnormal returns between the month prior to the Schedule 13D filing date and their exit date,[177] and the study by Boyson and Mooradian reached a similar conclusion.[178] Furthermore, a subsequent study by Brav and his coauthors reported that activist hedge funds have outperformed the returns of equity-oriented hedge funds of similar size and age.[179]

Insulation advocates are likely to react to such evidence by asserting that, even though activism might produce profits for activist hedge funds,

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168. Id. at Section IV.

169. Id.

170. Id. at Section IV.B.1.

171. Id. at Section IV.B.2.

172. Id. at Section IV.B.3.

173. Id. at Section IV.D.

174. Id.

175. Id. at Section IV.C.

176. Id.

177. Brav et al., Hedge Fund Activism, supra note 103, at 1760.

178. Boyson & Mooradian, supra note 136, at 25–30 (finding abnormally high returns to hedge funds engaged in intense activism).

179. Alon Brav, Wei Jiang, Frank Partnoy & Randall S. Thomas, The Returns to Hedge Fund Activism, Fin. Analysts J., Nov.–Dec. 2008, at 45, 54–56.

it makes long-term shareholders in the targeted companies worse off. Indeed, some insulation advocates have recently suggested that, while "[a]ctivist hedge funds are reportedly outperforming many other asset classes," the value they capture is "appropriated from fellow stockholders with longer-term investment horizons."[180] Such divergence in the returns to activists and long-term shareholders can be expected only if activist hedge funds succeed in getting out before the stock prices decline. This pump-and-dump view implies that activist targets experience negative abnormal returns in the years following activists' departure—yet another proposition that can be empirically tested using publicly available data about stock returns.

The BBJ study subjects this pump-and-dump proposition to an empirical test. In particular, the BBJ study examines whether targets of activist hedge funds experience negative abnormal returns in the three years after the activist discloses that its holding has fallen below the five-percent threshold that subjects investors to significant disclosure requirements.[181] Again using the three standard methods for detecting the existence of abnormal stock returns, the study finds no evidence that long-term shareholders of target companies experience negative abnormal returns during the three-year period following the activist's reducing its stake below five percent.[182]

Overall, analyzing the publicly available data on stock returns provides no support for the myopic activists claim that activist intervention makes shareholders of target companies worse off in the long term. The emerging picture is that, taking a fully long-term perspective, the market does not fail to appreciate the long-term consequences of activism as insulation advocates fear it does. Rather, the stock appreciation accompanying activists' initial announcement reflects the market's correct anticipation of the intervention's effect, and the initial positive stock reaction is not reversed in the long term. The significant long-term losses to shareholders of activist targets on which insulation advocates have been resting their case are not found in the data.

III. FEARS OF ACTIVIST INTERVENTIONS

A. *The Claim*

This Essay now turns to the second channel through which shareholder power, rights, and engagement are claimed to be detrimental to long-term shareholder value. Insulation advocates argue that, even when shareholders do not actually intervene, the fear that they might do so if they are not pleased with short-term results pressures directors and executives to focus excessively on these short-term results. This focus might

180. Wachtell Memorandum, Activist Hedge Funds, supra note 109.
181. Bebchuk, Brav & Jiang, supra note 26.
182. Id.

lead such insiders to take myopic actions that are value-increasing in the short term but value-decreasing in the long term. From the perspective of insulation advocates, accountability to shareholders and the disciplinary pressure produced by such accountability are actually counterproductive, making shareholders worse off in the long term.[183] I shall therefore refer to this claim of insulation advocates as the counterproductive accountability claim.

The counterproductive accountability claim supplements and reinforces the insulation advocates' myopic activists claim. Both claims suggest a channel through which shareholder power and rights, and the resulting shareholder ability to intervene, adversely affect the long-term interests of companies and their shareholders. The myopic activists claim, however, focuses on actions that are specifically sought by activists and produced following activist intervention. By contrast, the counterproductive accountability claim focuses on actions that are directly chosen by insiders to avert the prospect of future shareholder intervention, and perhaps even replacement, by shareholders dissatisfied with the company's short-term results.

Section B begins by discussing the conceptual structure and the critical premises of the counterproductive accountability claim. The discipline imposed by the fear of shareholder intervention, and the resulting pressure to produce good outcomes in the short term, might indeed distort some insiders' decisions concerning long-term investments. However, such discipline also yields significant benefits in both the short term and the long term. These benefits result from both discouraging deviation from shareholder interests and facilitating the removal of managers who are not well suited to their positions. In the long term, such discipline is beneficial when these benefits can be expected to exceed the costs of distortions in long-term investment decisions. Thus, at a minimum, the counterproductive accountability claim is not a self-evident proposition that can be derived from theory but a contestable proposition that requires evidence.

Section C begins, as did Part II, by noting some facts that cast doubt on the validity of the counterproductive accountability claim. It then turns to examining the body of empirical evidence produced by financial economists and concludes that this body of work does not support the counterproductive accountability claim. To the contrary, the evidence favors the view that board insulation is detrimental, rather than beneficial, to the long-term interest of public companies and their shareholders.

B. *Structure and Critical Premises*

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183. See, e.g., Lipton & Savitt, supra note 22, at 735, 747 (arguing corporate election reforms that make it easier for shareholders to replace directors "perversely incentivize[] directors to generate immediate returns at the cost of future growth, at the expense of the corporation and its shareholders (and the economy as a whole)").

1. *The Potential Long-Term Benefits of Board Insulation.* — I would like to note at the outset my acceptance that, as a matter of theory, short-term accountability might produce some distortions of long-term investments that board insulation might eliminate. Indeed, in the early 1990s, I coauthored one of the first models showing how such distortions could arise.[184] As explained below, theoretical models assuming that managers' inside information is not fully observable to public investors conclude that insiders' concern about short-term results might distort their decisions regarding long-term investments, although theory alone cannot indicate the direction of the distortions and whether they are economically meaningful.

The first analysis of such distortions was done by Jeremy Stein, who developed models in which the level of investment in long-term projects is not known to market participants, an assumption that seems especially fitting for management's investments of its own time and effort.[185] In these models, because shareholders judging whether short-term results are satisfactory are not able to observe the level of investment in long-term projects, the threat of adverse consequences in the event of disappointing short-term results discourages investment in such projects.

Another model, which Lars Stole and I developed, analyzes the case in which the level of investment in long-term projects is observable to market participants, but the quality or expected profitability of that investment is not.[186] Under this assumption, which might well fit many cases in which firms make long-term capital investments in "hard assets," accountability to shareholders and insiders' interest in keeping shareholders pleased lead to *excessive* investments in long-term projects.[187] A higher level of long-term investment, which shareholders are able to observe, will signal insiders' confidence in the profitability of the project and thus improve shareholders' expectations of the firm's long-term prospects.[188] This signaling effect leads insiders to invest excessively in long-term projects.[189]

In any event, whichever direction distortions are expected to take in any given set of circumstances, the pressure to produce good short-term results to keep shareholders content can, in theory, distort the level of

184. Lucian A. Bebchuk & Lars A. Stole, Do Short-Term Objectives Lead to Under- or Over-Investment in Long-Term Projects?, 48 J. Fin. 719 (1993).

185. See Jeremy C. Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, 104 Q.J. Econ. 655 (1989) (developing model explaining why, in presence of asymmetric information, managers may behave myopically even when faced with rational stock market); Jeremy C. Stein, Takeover Threats and Managerial Myopia, 96 J. Pol. Econ. 61 (1988) (analyzing how myopic behavior might arise when takeover threats lead managers to seek high stock price in short term).

186. Bebchuk & Stole, supra note 184, at 720–21.

187. Id. at 725–27.

188. Id. at 724–25.

189. Id.

long-term investments. When designing legal policy, however, the important question is how significant these distortions are. It is thus worth noting that empirical work investigating the influence of board insulation on research-and-development investments has produced mixed results.[190]

Furthermore, even if accountability produces significant, costly distortions of long-term investment levels, these costs need to be balanced against the long-term benefits of accountability before one can conclude that board insulation is overall beneficial in the long term. I now turn to these long-term benefits of accountability and corresponding long-term costs of board insulation.

2. *The Long-Term Costs of Board Insulation.* — Even assuming that shareholder power to replace directors produces certain costly distortions of long-term investments, it must be taken into account that the disciplinary force generated by accountability to shareholders also produces significant benefits—both in the short term and in the long term. Without board insulation, the fear of being replaced by shareholders gives insiders incentives to avoid observable departures from shareholder interests.

Board insulation eliminates or substantially weakens this important source of incentives to serve shareholders. Thus, it can be expected to increase slack, empire building, excessive pay, and other forms of private benefits. It can also be expected to make insiders more inclined to act in ways that are beneficial to or convenient for themselves but costly to shareholders.

The evidence indicates that board insulation does indeed have such adverse effects. Two studies—one by Marianne Bertrand and Sendhil Mullainathan and one by Gerald Garvey and Gordon Hanka—found that stronger antitakeover statutes increase managerial slack.[191] Paul Gompers, Joy Ishii, and Andrew Metrick showed that companies whose managers enjoy more protection from takeovers are more likely to engage

190. See, e.g., Mark S. Johnson & Ramesh P. Rao, The Impact of Antitakeover Amendments on Corporate Financial Performance, 32 Fin. Rev. 659, 686–87 (1997) (finding antitakeover amendments not associated with adverse effects on shareholders); Lisa K. Meulbroeck et al., Shark Repellents and Managerial Myopia: An Empirical Test, 98 J. Pol. Econ. 1108, 1116 (1990) (finding antitakeover amendments are associated with decreased research, development, and sales).

191. Marianne Bertrand & Sendhil Mullainathan, Is There Discretion in Wage Setting? A Test Using Takeover Legislation, 30 RAND J. Econ. 535, 535 (1999) (finding state antitakeover legislation, which reduced takeover threat and increased management insulation, led to increase in managerial slack); Gerald T. Garvey & Gordon Hanka, Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage, 54 J. Fin. 519, 520 (1999) (reporting passage of second-generation state antitakeover laws led firms protected by these laws to suboptimal use of debt).

in empire building.[192] Consistent with this latter finding, a study by Ronald Masulis, Cong Wang, and Fei Xie demonstrated that firms with classified boards are more likely to be associated with undesirable acquisition decisions—that is, acquisition announcements that the market judges to be value-reducing.[193] And a recent study by Vyacheslav Fos shows that the threat of a proxy fight has a disciplinary force that induces management to improve operating performance.[194]

In addition, there is evidence that board insulation enables managers to increase their own benefits. Kenneth Borokhovich, Kelly Brunarski, and Robert Parrino found that managers of companies with stronger antitakeover defenses enjoy higher compensation levels.[195] Bertrand and Mullainathan obtained similar findings for managers who are protected by antitakeover statutes.[196] Finally, a study by Olubunmi Faleye found that classified boards, which considerably enhance board insulation, are associated with pay packages that are less sensitive to performance.[197]

In addition to lowering the incentives to serve shareholders, board insulation has adverse effects on the chances that executives or directors will be replaced when doing so is desirable. Over time, it might become clear that some executives or directors are not well suited for their positions, either because of poor performance or for other reasons. Insulating boards from shareholder intervention might prevent or delay beneficial replacements of such leaders. Confirming the existence of this effect of board insulation, Faleye reports that classified boards are associated with a weakening of the relationship between CEO turnover and company performance.[198] Because it is important to ensure that companies are led by individuals who are well suited for their roles, the impediments to

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192. Paul A. Gompers, Joy L. Ishii & Andrew Metrick, Corporate Governance and Equity Prices, 118 Q.J. Econ. 107, 132–45 (2003) (showing firms with weaker shareholder rights were more likely to expand through corporate acquisitions).

193. Ronald W. Masulis, Cong Wang & Fei Xie, Corporate Governance and Acquirer Returns, 62 J. Fin. 1851, 1883–84 (2007) (documenting companies with governance provisions insulating directors are more likely to make acquisition decisions that are value-decreasing, as judged by stock market's reaction to acquisition announcements).

194. Vyacheslav Fos, The Disciplinary Effects of Proxy Contests (Mar. 2013) (unpublished manuscript), available at http://ssrn.com/abstract=1705707 (on file with the *Columbia Law Review*).

195. Kenneth A. Borokhovich, Kelly R. Brunarski & Robert Parrino, CEO Contracting and Antitakeover Amendments, 52 J. Fin. 1495, 1505–16 (1997) (finding association between antitakeover defenses and above-market levels of compensation).

196. Marianne Bertrand & Sendhil Mullainathan, Executive Compensation and Incentives: The Impact of Takeover Legislation 4 (Nat'l Bureau of Econ. Research, Working Paper No. 6830, 1999), available at http://www.nber.org/papers/w6830.pdf (on file with the *Columbia Law Review*) (reporting antitakeover legislation was followed by CEO pay raises).

197. Olubunmi Faleye, Classified Boards, Firm Value, and Managerial Entrenchment, 83 J. Fin. Econ. 501, 525–26 (2007) (analyzing association between staggered boards and sensitivity of pay to performance).

198. Id. at 524–25.

beneficial replacements brought about by board insulation represent significant costs.

Thus, board insulation has long-term costs that are likely to be significant. Accordingly, concluding that board insulation will produce some long-term benefits by addressing some distortions of decisions involving long-term investments is not sufficient for establishing the counterproductive accountability claim of insulation advocates. It is also necessary to show that these benefits exceed the long-term costs of board insulation. The counterproductive accountability claim is therefore, at best, a contestable proposition; its validity is not self-evident or derivable from theoretical reasoning alone and thus needs to be backed by evidence. However, as discussed in the next section, existing empirical evidence favors the opposite view: that board insulation is overall value-decreasing in the long term.

C. *Lack of Empirical Support*

1. *Some Telling Background Facts.* — Before turning to the empirical evidence reported by financial economists, it is worth noting two facts that provide a significant basis for doubting the validity of the counterproductive accountability claim. The first background fact is that, although insulation advocates have been putting forward the counterproductive accountability claim for many years, the voting decisions of institutional investors continue to reflect their widespread belief that arrangements increasing board insulation are likely to be value-decreasing, not value-enhancing, in the long term.

In particular, having a staggered board considerably enhances the extent to which directors are insulated from shareholder pressure, and insulation advocates have stressed that staggered boards enable directors to focus on and improve long-term results. Indeed, when opposing their shareholders' proposals to eliminate classified boards, companies regularly refer to the long-term benefits of the insulation provided by staggered boards. Nonetheless, the voting outcomes of the numerous shareholder proposals to declassify boards in recent years clearly reflect institutional investors' widespread rejection of the counterproductive accountability claim. In particular, over the past three years, shareholders of S&P 500 companies have voted on a large number of proposals to declassify boards, and the overwhelming majority of these proposals have passed, receiving on average more than seventy-five percent of the votes cast.[199]

199. See Bebchuk, Hirst & Rhee, supra note 23, at 171–74 (reporting results of many successful precatory proposals, submitted by institutional investors represented by Shareholder Rights Project, which passed in 2012). Additional information on successful 2012–2013 precatory proposals can be found at the Shareholder Rights Project website.58 Successful Precatory Proposals by SRP-Represented Investors, Shareholder Rights Project,

Insulation advocates might argue that some institutional investors vote for board declassification because they have short investment horizons and not because they believe in the long-term benefits of reduced board insulation. It is therefore worth noting that strong and general support for board declassification is stated in the proxy voting guidelines, and consequently in the voting decisions, of institutional investors that have undoubtedly long investment horizons.

Because public pension funds use their investments to meet large long-term liabilities, they are widely regarded as investors with very long investment horizons, and they allocate a substantial fraction of their portfolios to long-term investments in all the companies included in broad market indices. It is therefore telling that public pension funds generally support board declassification and thus the reduced insulation and increased accountability to shareholders that come with annual elections. For example, CalPERS's proxy voting guidelines state that "[a]ll directors should be elected annually,"[200] and TIAA-CREF similarly states that it supports "shareholder resolutions asking that each member of the board stand for re-election annually."[201] The governance policies of the Council of Institutional Investors, an association of numerous pension funds, state clearly and without noting any exceptions that "[b]oards should not be classified (staggered)."[202]

Strong support for board declassification has also been offered by private managers, such as BlackRock, State Street, and Vanguard, that focus on providing mutual funds, ETFs, and other products that invest funds in a passive, long-term fashion in specified broad indices of stocks. The proxy voting guidelines of BlackRock, State Street, and Vanguard all express general support for board declassification proposals.[203]

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http://srp.law.harvard.edu/companies-voting-on-proposals.shtml (on file with the *Columbia Law Review*) (last visited Sept. 23, 2013).

200. Cal. Pub. Emps. Ret. Sys., Global Principles of Accountable Corporate Governance 37 (2011), available at https://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/201111/item03b.pdf (on file with the *Columbia Law Review*).

201. Teachers Ins. & Annuities Assoc.-Coll. Ret. Equities Fund, Policy Statement on Corporate Governance 18 (6th ed. 2011), available at https://www.tiaa-cref.org/public/pdf/pubs/pdf/governance_policy.pdf (on file with the *Columbia Law Review*).

202. Council of Institutional Investors, Corporate Governance Policies 3 (2012), available at http://www.cii.org/files/ciicorporategovernancepolicies/04_19_13_cii_corp_gov_policies.pdf (on file with the *Columbia Law Review*).

203. BlackRock, Inc., Proxy Voting Guidelines for U.S. Securities 5 (2012), available at http://us.ishares.com/content/en_us/repository/resource/proxy_voting_guidelines.pdf (on file with the *Columbia Law Review*) ("[W]e typically vote . . . for proposals to eliminate board classification."); State St. Global Advisors, Summary of Global Proxy Voting and Engagement Principles at SSgA 2-3 (2013), available at http://www.ssga.com/library/firm/513378_Summary_of_Global_Proxy_Voting_and_Engagement_Principles_at_SSgACCRI1362774096.pdf (on file with the *Columbia Law Review*) (discussing State Street's engagement methods); The Vanguard Grp., Update on Proxy Voting (June 30, 2012), https://investor.vanguard.com/about/update-on-proxy-voting-june-30-2012 (on file with the *Columbia Law Review*) ("We also are observing incremental increases in shareholder

Thus, to maintain their counterproductive accountability claim and the board insulation view resting on it, insulation advocates must hold that the leading institutional investors with long investment horizons generally fail to recognize their own long-term interests. Without evidence to back such a claim, however, it is hardly persuasive. Institutional investors have been confronting proposals to declassify boards—and companies have been declassifying their boards in response to such proposals—for a long time. During this period, institutional investors' views have been informed by arguments made repeatedly and forcefully by insulation advocates.

Furthermore, more than sixty percent of the S&P 500 companies with classified boards declassified between 1999 and 2012,[204] and the views of institutional investors have thus been informed by observing what happened at those companies. Their observations, however, have not led institutional investors to soften their opposition to board insulation via classified boards. To the contrary, the percentage of votes cast in favor of proposals to declassify boards has been trending up for the past two decades, reaching more than eighty percent of the votes cast in the 2012 proxy season.[205] In my view, this consistent pattern should give insulation advocates some pause; without evidence to support their views, they should be reluctant to assert that they know the long-term interests of long-term investors better than the investors themselves.

The second background fact worth noting is that the alleged costs of short-term accountability, and the countervailing benefits of such accountability, are not only relevant within the context of public companies with widespread ownership. They can also be expected to arise in any other context in which one or more individuals ("the managers") manage some operating assets that are financed by individuals or entities ("the owners") that do not have the same information as the managers and thus cannot perfectly monitor their decisions and performance.

In any such situation, confronting the manager with the prospect of easily being replaced might produce some long-term costs, as it makes the manager focus excessively on the short term; however, it should also be expected to generate some long-term benefits by reducing slack and facilitating the manager's replacement when needed. As a matter of theory,

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rights and continue to advocate for improvements through both our proxy voting and engagement with company officials . . . includ[ing] declassification of boards . . . ."); see also Scott Fenn & Bradley Robinson, IRRC Inst., Proxy Voting by Exchange-Traded Funds: An Analysis of ETF Voting Policies, Practices and Patterns 8–15, 19–22 (2009), available at http://www.irrcinstitute.org/pdf/FINAL%20ETF%20Study%20-%20June%2030,%202009.pdf (on file with the *Columbia Law Review*) (analyzing proxy voting policies, guidelines, and recent voting records of seven largest exchange-traded fund sponsors, including Vanguard and State Street).

204. Bebchuk, Hirst & Rhee, supra note 23, at 165–66.

205. See id. at 171–72, 177–84 (reviewing work of Shareholder Rights Project and reporting results of thirty-eight successful precatory proposals passed in 2012 with average support of eighty-two percent of votes cast).

to the extent that the long-term costs are sufficiently substantial, it might be in the owners' long-term interests to tie their own hands and "insulate" the manager to preclude the manager's short-term replacement, even if the manager's short-term performance appears unsatisfactory. In such cases, one would expect owners to adopt such arrangements and commit themselves upfront, in their own long-term interests, to guarantee managers a long horizon and tenure.

However, I am unaware of such insulation arrangements being used to any significant extent for managers of operating assets other than public company executives. Insulation advocates themselves have not provided any examples, and they have limited their arguments to the context of public companies. Of course, it might be that this context is one in which either the long-term benefits of such insulation are exceptionally large or the long-term costs are exceptionally low—or both. However, an examination of this special context should be informed by the observation that such insulation is not found in the many other contexts in which owners retain the power to replace managers of operating assets, despite their inability to monitor or assess those managers' short-term performances. This observation again counsels against accepting the counterproductive accountability claim without significant empirical evidence in its support. And as this Essay now turns to show, this claim is not supported by the available empirical evidence.

2. *The Evidence.* — Insulation advocates argue that increased board insulation makes companies and their long-term shareholders better off. The best way to test this proposition is by comparing the performance of public companies that vary in the extent to which their corporate governance arrangements insulate the board from shareholders. The counterproductive accountability claim implies that greater board insulation can be expected to be associated with improved operating performance. Finding such a pattern would be necessary to support this view. A significant body of empirical evidence produced by financial economists, however, reaches the opposite conclusion.

This Essay already noted the evidence supporting the claims that higher board insulation is associated with more empire building, more extraction of private benefits, and greater decoupling of CEO tenure and performance.[206] Given the possibility that board insulation also produces some long-term benefits, however, the key question is whether board insulation is overall associated with higher or lower operating performance and firm valuation.

To begin, the aforementioned influential empirical study by Gompers, Ishii, and Metrick put forward a Governance Index ("G-Index") based on twenty-four governance provisions that limit or weaken shareholder

206. Supra Part III.B.2.

power in publicly traded companies.[207] Comparing the performances during the 1990s of a large number of public companies that had different G-Index levels, the study found that companies that provide insiders with greater insulation by weakening shareholder rights had lower profits and lower sales growth. Furthermore, such firms were associated with lower firm value, as measured by Tobin's Q, with the effect becoming more pronounced over time.

A subsequent study by Alma Cohen, Allen Ferrell, and I put forward an index, called the E-Index, for measuring the extent to which a company's insiders are insulated from shareholders.[208] The E-Index was based on the subset of six provisions in the G-Index that matter the most. We examined the association between a firm's E-Index score and its value during the period of 1990–2003 and found that higher levels of entrenchment and insulation were associated with significantly lower company values.[209]

Consistent results were found in studies of the effects of staggered boards, which is widely regarded as a key provision for determining the extent to which a board is insulated. In a 2005 study, Alma Cohen and I found that, from 1990–2001, staggered boards were associated, contrary to the beliefs of insulation advocates, with an economically meaningful reduction in firm value.[210] Our finding of an association between classified boards and lower firm valuation was subsequently confirmed by Faleye's study[211] as well as by a study by Michael Frakes.[212] In addition, in a study of recent judicial rulings concerning the validity of shareholder-adopted bylaws that weaken the force of staggered boards, Alma Cohen and Charles Wang found that the stock market reactions accompanying these rulings reflected the market's belief that staggered boards bring about reduced firm value.[213]

Finally, in a recent article, Alma Cohen, Charles Wang, and I provide evidence from recent years on the association between board insulation

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207. Gompers, Ishii & Metrick, supra note 192, at 114–19. The G-Index is a proxy for the balance of power between managers and shareholders, and is formed by giving each firm one point for every provision that restricts shareholder rights. Examples of such provisions are staggered boards, supermajority requirements, and limits on shareholder power to call a special meeting.

208. Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, What Matters in Corporate Governance?, 22 Rev. Fin. Stud. 783, 784–85 (2009).

209. Id. at 785–88.

210. Lucian A. Bebchuk & Alma Cohen, The Costs of Entrenched Boards, 78 J. Fin. Econ. 409, 430 (2005).

211. Faleye, supra note 197, at 509.

212. Michael Frakes, Classified Boards and Firm Value, 32 Del. J. Corp. L. 113, 132, 145–49 (2007).

213. Alma Cohen & Charles C.Y. Wang, How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment, J. Fin. Econ. (forthcoming), available at http://ssrn.com/abstract=2141410 (on file with the *Columbia Law Review*).

and the value and performance of firms.[214] We document that the relationship that the G-Index and E-Index had with operating performance during the 1990s remained strong and, indeed, became even more pronounced between 2002 and 2008. In particular, we find that greater insulation is associated with an economically meaningful reduction in industry-adjusted firm value, ROA, sales growth (over five-year, three-year, and one-year windows), and net profit margin.[215]

The findings discussed above indicate the long-time persistence and robustness of the documented association between stronger board insulation and poorer firm performance. Thus, like the myopic activists claim, the counterproductive accountability claim advanced by insulation advocates is not supported by the empirical evidence. To the contrary, the existing body of evidence supports the view that existing or higher levels of board insulation are value-decreasing both in the short term and the long term.

CONCLUSION

Arguments for board insulation in the name of long-term shareholder value have been used extensively, and with significant influence, in a wide range of policy debates. This Essay has provided a comprehensive review of these arguments and found them wanting.

The discussion has provided an analytical framework for assessing the claims of insulation advocates and has identified the critical propositions that must be valid for their claims to hold. It has shown that shareholder engagement, and arrangements facilitating it, also have significant long-term benefits, which insulation advocates have overlooked or downplayed. Claims that existing (or higher) board insulation levels are overall value-enhancing in the long term are, at best, contestable propositions that must be assessed in light of the available empirical evidence.

This Essay's review of the significant body of such empirical evidence indicates that it provides no support for the claims of insulation advocates. To the contrary, the evidence supports the view that, overall, shareholder engagement and arrangements facilitating it are beneficial for companies and their shareholders in both the short term and the long term.

This Essay's analysis concludes that existing theoretical learning and the available empirical evidence do not provide a basis for insulating boards in the name of long-term shareholder value. To the contrary, they support the view that existing (or higher) levels of board insulation

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214. Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, Learning and the Disappearing Association Between Governance and Returns, 108 J. Fin. Econ. 323 (2013).

215. Id. at 341–43 (finding association between governance indices and operating performance was negative and statistically significant both from 1990–2001 and from 2002–2008).

produce long-term costs that exceed their long-term benefits. Providing shareholders with power and rights that enable them to hold directors accountable is overall beneficial for companies and their long-term shareholders in both the short term and the long term.

Policymakers and institutional investors should, going forward, reject the arguments for limiting the rights and involvement of shareholders that are regularly made in the name of long-term value. I hope that the framework of analysis provided in this Essay, and the conclusions it reaches, will prove useful for any future examination of short-termism concerns and for the many ongoing policy debates in which such concerns are invoked.

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