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Corporate Governance in Search of the Shareholder-Manager Balance of Power

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CORPORATE GOVERNANCE IN SEARCH OF THE SHAREHOLDER-MANAGER BALANCE OF POWER

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INTRODUCTION

Recent legislation intended to strengthen shareholder power over managers and the Board of Directors ("Board" or "Boards") through legislative measures such as say on pay, compensation clawbacks, and requiring Boards to submit themselves for re-election in the United States ("U.S."), United Kingdom ("U.K."), and Australia has led to the strengthening of blockholder (i.e. investment funds, hedge funds, etc.) power over managers and the rest of the shareholder body. At the same time, these developments also enable managers to act opportunistically and protect their interests by being more accommodating to the demands of blockholders. The formation of such alliances between managers and blockholders can negatively impact the rest of the shareholder body and should therefore be brought to account. This article examines the causes and consequences of these developments, and ways of addressing the resulting issues.

Corporation law provides for a formalised legal model of power sharing between the Board and shareholders, with the Board as the centrepiece. Under this formalised structure, senior managers are hired by and are responsible to the Board, with the Board itself accountable to the shareholder body at its general meeting. As to whether this ideal was ever achieved, should be achieved, or can be achieved outside of the proprietary or private company setup, has been the subject of some debate.[1] Nevertheless, the search for this holy grail continues, if only for the reason that managerial and Board accountability to the shareholder body is regarded as being the best way to ensure the efficiency, competitiveness, and accountability of the corporation. Ensuring the latter has been a continuing process, and a challenge to all concerned. Phrases such as "pay without performance"[2] and "strong managers, weak owners,"[3] suggest that managers

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[1] *See generally* Walter Werner, *Corporations Law in Search of its Future*, 81 COLUM. L. REV. 1611 (1982); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

[2] *See* LUCIAN A. BEBCHUK & JESSE M. FRIED, Pay Without Performance, The Unfulfilled Promise of Executive Compensation (2004).

seem to have got the better of Boards and shareholders. At the same time, attempts to ensure shareholder control over managers have not been altogether welcome.[4] The last two decades have seen a series of legislative measures introduced to make Boards and managers more accountable to the shareholder body, ranging from the requirement that managerial compensation be subjected to review by the shareholder body, to the requirement that Board members submit themselves for re-election annually.[5] These developments, however, appear to have produced somewhat unanticipated outcomes: the emergence of blockholder[6] power as a major controlling influence within the corporation on the one hand, and the opportunity for managers[7] to advance their self-interest by being more accommodating to blockholder interests.

This article examines the growing influence of blockholder power on the corporate power shareholding relationship in the U.S., U.K., and Australia following the introduction of the regulatory measures referred to above. These latter jurisdictions, in addition to being advanced industrial economies, also share the characteristics of a common language and system of Corporation Law that has its roots in U.K. Company Law.[8] It seeks to make three points. The first is that it is important to disentangle the need for managerial accountability from the purported role of blockholders in facilitating this accountability. The issue, in other words, is not so much about making managers and boards accountable to the shareholder body, as it is about the role of blockholders in bringing this about. Second, that the recent legislative changes empower blockholders to lean on managers to adopt courses of action favorable to blockholders, but which may not necessarily be in the interests of the corporation and its other shareholders. This is because the interests of blockholders and of the general share-

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[3] MARK J. ROE, STRONG MANAGERS WEAK OWNERS, THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

[4] *See generally* Anabtawi & Stout, *supra* note 1; Lipton, *supra* note 1.

[5] *See infra* in Part III.

[6] Blockholders mean transient controlling interests held by private equity funds, activist hedge funds, pension funds and other investment funds able by themselves or in alliance with other shareholder groupings to persuade managers to implement changes they have in mind, including the transfer of control. The discussion here is of blockholders in widely dispersed shareholding corporations, and excludes control retained by individuals/families.

[7] The term managers as used in this article varies with the context, and refers to Executive directors such as the Chief Executive Officer and the Chief Financial Officer where the discussion is about their accountability to the Board of directors, and at other times to the entire Board of which the CEO and CFO are part of.

[8] The terms corporations, company, enterprise and firm are used interchangeably here, as are corporations' law and company law.

holder body often diverge, as much as the interests of managers and shareholders do, generating with agency problems of its own. Third, these developments create the opportunity for managers and blockholders to further their respective interests at the expense of the rest of the shareholder body, rather than increase the accountability of managers to the general shareholder body. The challenges posed to corporate governance by managers and blockholders acting together is the subject of study in this article.

The discussion in the article is structured as follows. Part I examines the shaping of power relationships in the large modern corporation. Part II investigates how the strategy of stock based incentive compensation helped managers to further consolidate their power. Part III examines how say on pay and associated legislation attempts to swing the balance of power in favor of the shareholder body. Part IV examines the ascendancy of blockholder power. Part V examines likely outcomes in the manager-blockholder relationship under the present set up. Part VI concludes the discussion presented in this article.[9]

I. Boards, Managers, Shareholders, and Blockholders

Following Berle and Means, a substantial part of corporation law and governance has been concerned with addressing the separation problem and the erosion of shareholder power vis a vis managers.[10] Three developments in the marketplace in these early stages accounted for this erosion. First, the large corporation's need to access funds from the public, particularly equity funds, from a large and scattered cohort of shareholders unable to communicate with each other—otherwise, known as the coordination problem—made them almost entirely dependent on managers to do so. Second, the need for fulltime professional managers to run the enterprise saw a diminution of both shareholder and Board power. Third, the ability of managers to recommend appointments and reappointments to the Board (and more recently to Board committees), recommend compensation packages to be paid to Board members and the appointment of remuneration consultants, control over information provided to financial analysts (and the ability to manipulate earnings reports), as well as the formulation of takeover defences in the face of hostile bids, assisted managers in consolidating their control. Consequently, managers emerged as the most powerful of this group of power brokers, enjoying an almost unfettered hand in the carrying on of the business activities of the enterprise.

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9 The article does not consider individual/family blockholders as they generally hold for the long term and are more the exception than the norm.

10 *See generally* Adolf A. Berle & Gardiner Means, The Modern Corporation and Private Property (1932) (discussing the governance theory of separating ownership and control).

Moreover, to the extent that managers could keep the Board and shareholders from uniting against them, and otherwise appease controlling shareholders, they enjoyed control over the enterprise.

Attempts to restrain managerial power from within the corporation appears to have had mixed success, with the pendulum swinging to and fro. For example, as managers were able to game incentive compensation schemes[11] intended to reward effort and success, pay legislation, which requires compensation packages to be approved by the shareholder body, followed. This has been strengthened in the U.K. and U.S. by legislation enabling the clawback of compensation already paid out. Moreover, the U.K. Corporate Governance Code 2012 requires board members of the top 350 Financial Times Stock Exchange ("FTSE") companies to submit themselves for re-election every year, while Australia's "two-strike" rule requires Boards to submit themselves for re-election in the event the executive compensation package approved by the Board is rejected at a second consecutive annual general meeting.[12] There are three prongs to these regulatory measures.[13] First, there is the requirement that managerial pay be approved by the shareholder body at its Annual General Meeting. Second, as managerial compensation is ultimately the responsibility of the Board, and since it is Boards that are subject to the two strike rule or to annual re-election as the case may be, it is expected that the Board will take much greater care in ensuring that managerial pay is linked to managerial performance, and that managers earn their pay. Third, and most importantly, the measures seek to ensure on the one hand the independence of the Board from managers, and on the other their dependence on the shareholder body.[14] The cumulative impact of these measures then has been to subject managers to greater accountability to both the Board and the shareholder body. Put more simply, these changes make both Boards and managers more accountable to the shareholder body. In the context of the marketplace, however, as distinct from the shareholder body as an abstract entity, they also beg the question as to what is meant by the shareholder body. The phenomenon of the "controlling" shareholder or shareholder block has always been a feature of Corporation Law and governance. In fact, corporate governance has at various times seen controlling shareholder blocks as providing the balance to managerial control. But, as this article highlights, the control wielded by present day blockholders is far more strategic and potent than the power wielded by blockholders previously. It is in this latter day context that the power

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[11] *See* discussion *infra* Part II .

[12] *See* discussion *infra* Part III.

[13] *See* discussion *infra* Part III.

[14] *See* discussion *infra* Part IV.

of blockholders to "discipline" managers as they see fit, and to lean on them to do their bidding must be understood and evaluated. For example, the U.S. experience on the effectiveness and scope of intervention by activist funds is revealing, as evidenced in the following:

> Recently, hedge funds have pressured McDonald's to spin off major assets in an IPO; asked Time Warner to change its business strategy; threatened or commenced proxy contests at HJ Heinz, Master Energy, KT&G, infoUSA, Sitel, and GenCorp; made a bid to acquire Houston Exploration; pushed for a merger between Euronext and Deutsche Borse; pushed for 'changes in management and strategy' at Nabi Biopharmaceuticals; opposed acquisitions by Novartis of the remaining 58% stake in Chiron, by Sears Holdings of the 46% minority interest in Sears Canada, by Micron of Lexar Media, and by a group of private equity firms of VNU; threatened litigation against Delphi; and pushed for litigation against Calpine that led to the ouster of its two top executives.[15]

Reports indicate that in 2013, blockholders in the U.S. ran 82 public campaigns against U.S. companies with market values in excess of $500 million.[16] While not all blockholders are activists, the activities of those that are has caused much unrest.[17] Blockholders range from passive institutional shareholders, to more recently, activist investment and hedge funds.[18] Their actions may complement or substitute the activities of arbitrageurs and hostile bidders.[19] While one of the cornerstones of corporation law is the notion that each share of a class of shares has the same rights and entitlements as any other share of that class, the market nevertheless pays a premium for a shareholding that can transfer or facilitate control of the entity, as controlling share

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[15] *Id.*

[16] *See* Tim Binsted, *Advisers Warn of Surge in Activism*, AUSTL. FIN. REV., June 2, 2014, at 28, *available at* https://advance.lexis.com/api/permalink/1927a093-a3a8-4821-b66c-1f215670051f/?context=1000516.

[17] *See id.*

[18] *See, e.g.*, Alex Edmans, *Blockholders and Corporate Governance* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 19573, 2013), *available at* http://www.nber.org/papers/w19573 (discussing how blockholders engage in and affect corporate governance).

[19] *See* Paul H. Edelman & Randall S. Thomas, *Selectica Resets the Trigger on the Poison Pill: Where Should the Delaware Courts Go Next?*, 87 IND. L.J. 1087, 1115 (2012) (discussing shareholder rights plans ("poison pills") and their effects on corporations and state law).

blocks embody the synergies of both power and control.[20] Moreover, in times past, while even substantial shareholders may have been generally happy to leave managers alone if they received a steady flow of dividend income alongside appreciating share values, the emergence of blockholders capable of dislodging Boards and managers to their advantage appears to have changed the setup considerably.[21]

The consequence has been that both Board power and shareholder power is now split: from Boards, to Boards and managers; from shareholders, to blockholders and all other shareholders; and from shares with the right to vote, receive dividends, and return of paid up capital, to shares hived of voting rights for enjoyment by another.[22] More recently, managerial power itself has come to be split, at least nominally, from managers to managers and Board committees.[23] Powers previously subject to managerial control if not in fact exercised by managers, are now exercised by specialist committees consisting of a combination of inside and outside experts with little or no control by managers.[24] These include the appointments, audit, remuneration, and risk management committees.[25] How these centers of power impact on each other, and how they interrelate with each other, form an integral part of the framework of corporate governance. The results of these splits have been interesting: while the transfer of power from the Board-manager to Board committees (answerable either directly to the shareholder meeting or indirectly through the Board) may have weakened managerial power regarding the shareholder body, the emergence of blockholder power would appear to impact both Board and shareholder power.[26] Yet, ad hoc groupings of power may emerge as warranted by the circumstances (e.g., between Boards and shareholders against managers (on executive compensation); managers and Boards against shareholders (in the face of a hostile bid); managers, Boards, and shareholders against blockholders to prevent managers being leant on; and more importantly of blockholders and managers

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[20] *See* Thomas D. Hall, *Valuing Closely Held Stock: Control Premiums and Minority Discounts*, 31 EMORY L.J. 139, 147 (1982) (discussing the valuation of stock and the incentives and motives behind such valuation.

[21] *See generally* Edmans, *supra* note 18; Hall, *supra* note 20.

[22] *See generally* Robert C. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561 (1981) (discussing the evolution and changes to capitalism in four stages of growth).

[23] *Id.*

[24] *See, e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1468 (2007).

[25] *See id.*

[26] *See generally* Edmans, *supra* note 18, at 1.

against other shareholders).[27] The interplay of these forces highlight the dynamic nature of the relationship between the parties—of the tussle between strong Boards, strong managers, and dominant shareholders such as blockholders, each bearing influence on the other—and of the forces that emerge to constantly recast the relational dynamics between them. These developments no doubt have radically transformed the nature and exercise of power sharing within the corporation. As will be seen from the discussion following, the challenge confronting corporate governance now is to address the eventuality of managers and blockholders acting together to further their respective interests as against the rest of the shareholder body.

II. Executive Compensation and Management Empowerment

Executive compensation in the U.S., U.K., and Australian jurisdictions consists of a basic fixed salary, annual bonuses tied to accounting performance, long term incentive plans (i.e. restricted stock options, multiyear accounting based performance plans and retirement programs), and stock options based on the appreciation of the firm's stock.[28] The last component of the package—stock, and stock options—links pay to performance by giving managers an ownership stake in the company, and consequently a greater interest in its success.[29] As articulated by Jensen and Meckling, it is not how much you pay, but how you pay.[30] Yet, until about 1984, fewer than half of the CEOs of listed companies even in the U.S. received stock or stock options in any given year.[31] Following the trends set by the leveraged buyouts of the 1980s and their flow on effects, stock options have become an integral feature of executive compensation particularly as incentive payments, so much so that while cash remains a staple part of

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[27] *Id.*

[28] *See, e.g.*, Gian Luca Clementi & Thomas F. Cooley, *Executive Compensation: Facts* 2–3 (Nat'l Bureau of Econ. Research, Working Paper No. 15426, 2009), *available at* http://www.nber.org/papers/w15426; Carola Frydman & Dirk Jenter, *CEO Compensation* 5 (Nat'l Bureau of Econ. Research, Working Paper No. 16585, 2010), *available at* http://www.nber.org/papers/w16585.

[29] *See* Frydman & Jenter, *supra* note 28, at 5.

[30] *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 4 J. FIN. ECON. 305 (1976) (discussing the link between Jensen's theory of the firm with governance of the firm itself, and of overcoming these problems through a scheme of targeted and structured executive compensation).

[31] *See* Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15 J. APPLIED CORP. FIN. 21, 22 (2003).

the remuneration package, stock based compensation now constitutes the bulk of the package received by executives in large corporations.[32]

A question subject to much debate is whether explicit monetary based incentive schemes are superior to those without these incentives and, if so, what form these schemes should take.[33] The concern is that the bonus incentive culture leads to a narrowing in the cognitive focus of managers and thus, a move away from other behavioral aspects such as conforming to notions of reciprocity, desire for social approval, and the challenge of fulfilling interesting tasks for its own sake—which are all incentives traditionally perceived as being the key enforcers of normative managerial behavior.[34] In other words, the concern is that traditional counts of normative behavior and the reward of doing the right thing for its own sake are not only being crowded out by the bonus stock incentive culture, but it also led to the generation of perverse incentives for managers.[35] While this debate is informative, of greater concern in relation to the Anglo jurisdictions has been the problem of gaming by managers of their compensation packages.

Managers game both the amount of the package they receive, and the realization value of the stock based component of their packages.[36] Gaming has been done through practices such as target based budgeting and earnings management.[37] These practices give the appearance of stability and steady progress of the company's business activity for which managers will be rewarded with increased compensation packages,[38] enhanced job security,[39] discretionary payments even where the firm has not been a market success, and termination payments even where this has not been provided for in their contract.

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[32] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFILLED PROMISE OF EXECUTIVE COMPENSATION 1, 7 (2004).

[33] *See generally* Ernst Fehr & Armin Falk, *Psychological Foundations of Incentives*, 46 EUR. ECON. REV. 687 (2002) (discussing the effects of various economic incentives and concluding that monetary incentives may cause harm); Ernst Fehr & Simon Gächter, *Do Incentive Contracts Undermine Voluntary Cooperation?* 1 (Inst. for Empirical Research in Econ., Univ. of Zurich, Working Paper No. 34, 2002), *available at* http://ssrn.com/abstract=313028.

[34] *See, e.g.*, Fehr & Falk, *supra* note 22, at 687–88.

[35] *See also* Nina Mazar, On Amir & Dan Ariely, *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. MARKETING RES. 633, 642 (2008).

[36] *See, e.g.*, John C. Coffee, Jr., *What Caused Enron – A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 270, 297–98 (2004).

[37] *See id.* at 298.

[38] *See, e.g.*, Paul M. Healy & James M. Wahlen, *A Review of the Earnings Management Literature and its Implications for Standard Setting*, 13 ACCT. HORIZONS 365, 380 (1999).

[39] *See generally* Marcia Millon Cornett, Jamie John McNutt & Hassan Theranian, *Corporate Governance and Earnings Management at Large US Bank Holding Companies,* 15 J. CORP. FIN., 412, 412 (2009).

Evidence linking earnings management with increased managerial compensation in the form of options and restricted options is considerable, especially where top management compensation is more closely tied to the value of stock based compensation and CEOs hold large options positions.[40] Studies confirm that governance mechanisms which stress CEO pay for performance encourage CEOs to manage earnings and improve reported earnings quality, stock based option compensation adversely affect monitoring and to cause a dramatic decline in the quality of the reported earnings caused by either disguising or not revealing the nature and extent of the benefits contained in these packages.[41] This is despite the existence of elaborate and extensive disclosure rules in relation to compensation packages, for disclosure can be avoided by information not being presented clearly and understandably, or is not meaningful or responsive to disclosure requirements.[42]

There is plentiful evidence of how gaming influences share price, and how managers reap benefits by opportunistic realisation of options and shares following it. A leading study on this point by Cicero concludes as follows:

> When examined in aggregate, the evidence that executives manipulate stock option exercise is not strong. However, when exercises are separated into sub-samples based on the exercise strategy employed, evidence of opportunistic behaviour emerges: Exercises accompanied by a sale of shares are followed by negative abnormal returns; exercises not accompanied by stock disposition are preceded by a decline in stock price and followed by an increase in stock price, such that exercise occurs at a price trough; and exercises where the executive delivers shares to the company are associated with abnormally low returns immediately after exercise that turn positive thereafter. In each of these cases, the return patterns suggest that executives timed option exercises based on private information to enhance their returns.[43]

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[40] *See* James Ang, Yingmei Cheng & Sarah Fulmer, Clawing Back Executive Pay (Jan. 2013) (unpublished manuscript) (on file with authors), *available at* http://ssrn.com/astract=2139818.

[41] *See id.* at 10–11.

[42] *See, e.g.*, John W. White, Dir., Div. of Corp. Finance, U.S. Sec. & Exch Comm'n, Where's the Analysis, Speech by SEC Staff at the 2nd Annual Proxy Disclosure Conference San Francisco, California (Oct. 9, 2007), *available at* https://www.sec.gov/news/speech/2007/spch100907jww.htm.

[43] David C. Cicero, *The Manipulation of Executive Stock Option Exercise Strategies: Information Timing and Backdating,* 64 J. FIN., 2627, 2658 (2009).

The downside of such managed financials is that it grants the overvalued entity access to capital priced below the normal risk-return assessment of the marketplace with all its shortcomings.[44] It is no surprise that capital markets reacted negatively to such practices by increasing the risk profile of such firms and increasing the cost of capital, particularly debt capital to the entity.[45] But, such responses are at best a second-best solution with all its drawbacks in that it has caused the stakes for managerial risk-taking, and with it, excessive remuneration grants to be even higher—with managers awarded greater rewards for increased risk-taking and accompanying higher returns.

At the same time, the prevailing system under which stock based compensation was based was found to offer managers perverse incentives to engage in excessive risk taking,[46] and in the crowding out of what would be beneficial to the corporation in the long term by what was favorable to it in the short term.[47] This led to an almost exclusive focus on share price, and as a consequence further reinforced the focus on short-termism.[48] Another problem with executive incentive schemes was that benefits accrued from mere market-wide growth regardless of whether the particular firm lagged or even lost ground to competitors provided the share price improved; even worse was the payment of bonuses despite declining share prices.[49] The lack of alignment was exacerbated by golden- handshakes.[50] It has also been observed that problems associated with executive compensation stem

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[44] *See* Micheal C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5, 10 (2005).

[45] *See* Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 293–96 (2012).

[46] *See* Lucian A Bebchuk & Holger Spamann, *Regulating Bankers Pay*, 98 GEO. L.J. 247, 275 (2010).

[47] *See* Ernst Fehr & Simon Gachter, *Do Incentive Contracts Crowd Out Voluntary Cooperation?* 26 (Uni. of S. Cal. Ctr. for Law, Econs & Org., Research Paper No. C01-3, 2001), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229047*.

[48] *See* ROE, *supra* note 3.

[49] *See The Fascinating History of the Great British Executive Pay Boom*, HAVINGTHEIRCAKE.COM, http://www.havingtheircake.com/content/2_Our%20financial+industrial%20system/5_Reward/fact%20and%20opinion/10_The%20Great%20British%20Executive%20Pay%20Boom.php (last visited Mar. 14, 2015); Graham Hiscott & James Lyons, *Great Bank Robbers: Bailed-Out RBS Pays £250m in Bonuses Despite £500m Fine*, MIRROR (Jan. 30, 2013), http://www.mirror.co.uk/money/city-news/bankers-bonuses-rbs-pays-250m-1562901

[50] Defined as "a stipulation in an employment agreement which states that the employer will provide a significant severance package if the employee loses their job." *Golden Handshake*, INVESTOPEDIA (last visited Feb. 23, 2015), http://www.investopedia.com/terms/g/golden-handshake.asp.

from structural defects in the corporate governance structures which enable executives to exert considerable influence over their boards; more concerning is the observation that these structural defects tend to weaken and distort managerial incentives and have the result of imposing a larger cost on shareholders than the excessive compensation itself.[51]

Additionally, while the stake held by managers is very small when compared to the totality of the modern public company's share capital, the fact that the bulk of their compensation is in the form of stock based compensation means that they have a much larger share of their investment tied in with the corporation than any institutional shareholder would. Consequently, excessive risk taking at the expense of creditors and preference or preferred shareholders will benefit managers more than other shareholders. Managers are further encouraged by the fact that they bear little of the costs of excessive risk taking especially where they hold a substantial amount of stock options which offers them all the benefits of upside and little or no downside. Likewise, the increased cost of debt associated with stock options is yet another downside born by all of the shareholders.[52] The 2008 financial crisis demonstrated how shareholders could be adversely affected by managers taking excessive risks.[53] Consequently, the "Ulysses strategy" (i.e. the imposition of constraints on managers through present commitments on their future behavior and by precluding future options of behavior open to them) that underlies agency theory appears not to have been sufficiently persuasive in ensuring that managers place the interests of the corporation above their own. While there is nothing illegal in managers extracting the best compensation package for themselves in their bargaining with the Board, or in ensuring that the entity's share price remains high, what is of concern is the harm flowing from the manipulation of the entity's financials.[54] In the face of this, more structured and detailed requirements for disclosure of

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[51] *See* Healy & Wahlen, *supra* note 26, at 370–75; Michel Jensen & Kevin Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 47–48 (European Corporate Governance Inst. of Fin., Working Paper No. 44/2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305.

[52] *See, e.g.*, *supra* note 33, at 251.

[53] *See* John McCormack, Morgan Stanley & Judy Weiker, *Rethinking "Strength of Incentives" for Executives of Financial Institutions,* 22 J. APPLIED CORP. FIN., 65 (2010).

[54] *See, e.g.*, Patrick Durkin, *Profits of Top Companies Come Under Surveillance*, AUSTL. BUS. INTELLIGENCE, OCT. 29, 2011, at 1, *available at* http://www.highbeam.com/doc/1G1-273632626.html (reporting that "nine of the 100 biggest listed companies who claimed they made a 2010-11 profit actually made a loss[ ]" according to a report by accounting firm KPMG).

compensation packages have been imposed. The success of such measures is of course dependent on getting managers to comply—a requirement which lies at the heart of the problem.

More innovative has been the adoption of what appears to be a two-tiered strategy. First, a shareholder vote on pay, popularly referred to as "say on pay," which requires the shareholder body at its General Meeting to vote on the compensation packages. This has been adopted in all three jurisdictions. The second tier of legislation differs as between the three jurisdictions: the US and UK (as from January 2015) have adopted what is popularly known as a "clawback" provision which enables the recovery of compensation for non-performance, while the UK Corporate Governance Code requires Board members of the top 350 FTSE companies to submit themselves to re-election annually, with Australia having its own version in the form of the "two-strike" rule which may require the incumbent board to submit themselves to re-election. These are examined in the next Part. For convenience, the term SOP trilogy is used below as a heuristic to capture the legislative responses to address the problem of executive compensation and corporate governance.

III. Say on Pay and the Restoration of Shareholder power

Say on pay ("SOP") legislation, as noted, requires managerial compensation packages to be specifically approved by shareholders at the company Annual General Meeting. SOP has been further reinforced in the U.S. by laws enabling the clawback of compensation already paid out (also to come into force in the U.K. as of January 2015), and in Australia with the two-strike rule.[55] More importantly, the U.K. Corporate Governance Code requires Board members of the top 350 FTSE Companies to submit themselves for re-election every year.[56] SOP attempts to draw on all three constituent parts of the rela-

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[55] *See* discussion *infra* Part III.

[56] *See* Financial Reporting Council, The UK Corporate Governance Code 16 (2012) (providing guidelines for re-lections and stating that:

> "[a]ll directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. . . . All directors of FTSE 350 companies should be subject to annual election by shareholders. All other directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. Non-executive directors who have served longer than nine years should be subject to annual re-election. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election. . . . The board should set out to

tionship triangle to ensure that managerial compensation packages are the product of arms-length bargaining between managers and the Board. The underlying objective of this three pronged strategy has been to grant shareholders a voice to convey displeasure, require managers to justify their compensation packages in the face of clawback, and force Boards as ultimate gatekeepers of the corporation to take the fall where shareholders express discontent with the compensation packages awarded to managers. There certainly are very good reasons for this. In the US context, Bebchuk found that in the wake of poor performance and shareholder dissatisfaction, directors faced very little risk of being ousted, that the shareholders' ability to replace directors was extremely limited, and that outside the hostile takeover context, the incidence of electoral challenges to directors as practically negligible in the past decade.[57] These measures, however, go beyond countervailing the excesses of executive compensation, to a remodelling of the manager-shareholder balance of power, and have generated agency problems of their own. The implications of these developments are examined below.

A. *Shareholder Vote on Pay*

The justification for SOP is that it provides the opportunity for shareholders to comment on each of the components of the package e.g. salary, bonus, retirement benefits, and perquisites. Its objective is to ensure transparent processes and, therefore, accountability of the compensation process. While the centrepiece of the strategy is the remuneration report,[58] the information required to be disclosed varies by jurisdiction. For example, U.S. laws require disclosure of the remuneration of the five highest remunerated officers. including the CEO and the CFO, to be made at least once every three years, while the U.K. and Australia require disclosure of the remuneration received by all key employees annually and has to be submitted along with the annual accounts of the firm.

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shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role.").

[57] Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 44–45 (2003).

[58] *See, e.g.*, *Corporations Act 2001* ss 202B, 250SA, 300A, 250R(2) (Austl.) (specifying, in section 300A, the specific contents requirements of the remuneration report and stating, in section 250R(2), what makes a shareholder vote on the remuneration report a mandatory agenda item at the AGM of a listed company).

The U.K. was the first to introduce a non-binding,[59] advisory vote by shareholders on executive remuneration in 2002,[60] followed by Australia in 2004,[61] and the United States in 2010.[62] Since October 2013, the SOP has been made binding on all stock market listed companies in the U.K., but still remains persuasive only in the U.S. and Australia. Nevertheless, the expectation, even in the two latter jurisdictions, is that the open and public nature of the information will force boards to implement shareholder demands.[63] There is evidence of this; for example, in the U.S., firms that failed two consecutive votes changed the unpopular policy, with the majority changing after one failed vote.[64] One study shows that of the firms surveyed in that study, 31% stated that in response to a SOP vote, and subsequent shareholder consultations, they changed their pay practices.[65] Occidental Petroleum and KeyCorp are examples of the success of SOP in the U.S. These companies changed their practices following majority opposition and in the subsequent year responded with overwhelming votes of support.[66] Some even pre-empted the vote by changing policy with directors attempting to protect their reputations.[67] These factors highlight

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[59] *See generally* Companies Act, 2006, § 439 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/2006/46/contents (inferring that as of October 2009, say on pay vote has been made binding on all Listed Companies in the UK).

[60] *Id.* The United Kingdom was the forerunner in mandating that shareholders be allowed a *non-binding*, or advisory vote on pay. Section 439 of the UK Companies Act mandates a vote on director pay at the yearly accounts meeting. Directors are expected to have disclosed their remuneration package in a "Remuneration Report" (section 420). Failure to do this leads to fines.

[61] *See Corporations Act 2001* ss 250R(2), 250R(3). The Netherlands, Norway, Sweden, and Denmark provide for a binding shareholder vote. *See* Jim Corkery & Sabina Medarevic, *Executive Remuneration Under Scrutiny: The Cutting Edge of the 'Shareholder Spring'*, CORP. GOVERNANCE EJOURNAL, 1, 9 (2013), *available at* http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1027&context=cgej. This was proposed in the UK in 2011 but not implemented.

[62] *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank*].

[63] *See* Peter Iliev & Svetla Vitanova, *The Effect of Say-on-Pay in the U.S.*, 1, 2 (Pa. State Uni. Dep't of Fin., 2015), *available at* http://ssrn.com/abstract=2235064.

[64] *See* Symposium, *Dodd-Frank's Say on Pay: Will it lead to a greater role for shareholders in corporate governance?*, 97 *Cornell Law Review*, 1215, 1256 (2012) [hereinafter Thomas].

[65] *See id.* at 2; James F. Cotter, *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 982 (2013).

[66] *See* Thomas, *supra* note 64, at 1259.

[67] *See generally* Fabrizio Ferri & David Oesch, *Management Influence on Investors: Evidence From Shareholder Votes on the Frequency of Pay* (Columbia Bus. Sch., Research Paper No. 13–17, 2014), *available at* http://ssrn.com/abstract=2238999.

effective shareholder accountability.[68] U.S. commentators observe that SOP has "catalysed greater management attention to shareholder concerns, an increased shareholder interest in voting on corporate governance, and a broader dialogue on pay issues between management and shareholders."[69] Similarly, U.K. commentators observe that investors perceive it to be a value-enhancing monitoring mechanism, and useful to pressure firms to remove controversial pay practices and increase sensitivity of pay to poor performance.[70] Overall, SOP appears to have, at least in the U.S., changed the culture of firms with more performance-based measures introduced, and caused Boards to be more proactive. For example, according to a 2011 survey of 834 directors, 72% said that they would reconsider executive pay plans even if majority support was received.[71] Moreover, items such as pensions, tax payments, excessive severance and perks, and paying the tax liabilities of executives have all been subjected to closer scrutiny.[72] Directors also face potential liability for breaches of fiduciary duties and corporate waste following a negative SOP vote, with U.K. data showing that eight of the thirty-seven that received a negative vote were also subjected to lawsuits.[73] Corporate advisors are now required to position the company to avoid a negative vote or defend against a lawsuit.[74] One study summarises the U.S. position as follows:

> First, we find evidence that SOP votes are sensitive to firm risk, excessive compensation, accounting quality and financial performance. Second, we find that boards react to SOP rejection votes by subsequently reducing the level of excessive compensation. Third, our results present evidence to suggest that shareholder voting rights—even when nonbinding—could be an effective mechanism of corporate governance that addresses the problem of incomplete contracts and management rent extraction.[75]

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68 *Id.* at 6.

69 Thomas, *supra* note 64, at 1256.

70 Ferri, *supra* note 67, at 28.

71 Thomas, *supra* note 64, at 1263.

72 *Id.* at 1257.

73 *Id.* at 1261.

74 *Id.* at 1262.

75 *See* Marinilka B. Kimbro & Danielle Xu, *Shareholders Have a Say on Executive Compensation: Evidence from Say-on-pay in the United States* (finding statistically that, while only 1.2 percent of the Russell 3000 failed in obtaining the requisite 50 percent approval as required under the US legislation in 2011, and 2.5% failed in 2012, 10.3 percent and 11.07 percent received more than 25% opposition or rejection votes in 2011 and 2012 respectively. Australia, it will be recalled, requires only a 25 percent shareholder vote).

The Australian approach has its origins in the Productivity Commission Report, which observed, first, that incentive pay "imported" from the U.S. and introduced without appropriate hurdles had spurred pay rises in the 1990s, and that more recent complex incentive pay may have delivered unanticipated "upside"; secondly, that some termination payments looked excessive and indicated compliant Boards; and thirdly, that instances of "excessive" payments and perceived inappropriate behavior could reduce investor and community trust in the corporate sector more broadly with adverse ramifications for equity markets.[76] The study concluded against capping pay or introducing a binding shareholder vote as being impractical and costly, emphasising instead the need to ensure Board control and accountability.[77] The study recommended strengthening the corporate governance framework by removing conflicts of interest by, for example, establishing independent remuneration committees and improved processes for use of remuneration consultants, promoting Board accountability and shareholder engagement through enhanced pay disclosure, as well as strengthening sanctions against Boards that are unresponsive to shareholders SOP.[78]

B. Compensation Claw-back

Clawback provisions are seen as a useful tool in improving the link between pay and performance by introducing greater accountability because compensation is usually tied to accounting numbers or formula results which if misstated, need to be adjusted.[79] Clawbacks are aimed at enabling the recovery of compensation paid erroneously, because, in the language of pay for performance, "'what wasn't earned must be returned.'"[80] In this sense, they are as much preventative as they are remedial or punitive. As expressed in the following testimony to the U.S. Senate Committee: "a tough claw-back policy is an essential element of a meaningful 'pay for performance' philosophy. If executives are rewarded for 'hitting their numbers'—and it turns out that they failed to do so—they should not profit."[81]

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[76] The Productivity Commission Inquiry Report, *Executive Remuneration in Australia*, No. 49, Melbourne, Dec. 2009, at xiv.
[77] *Id.*
[78] *Id.*
[79] James S. Ang et al, *Clawing Back Executive Compensation* 6–8 (Midwest Fin. Ass'n Annual Meeting Paper, 2013)), *available at* http://dx.doi.org/10.2139/ssrn.2139818.
[80] Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 670 (2005).
[81] *See* Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs, 111th Cong. 47–48 (2009) (statement

While the U.S. enacted the first claw-back provision in 2002 in the form of s304 of the Sarbanes Oxley Act[82] ("SOX"), (later strengthened by the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010,[83] establishing new rules relating to executive compensation), nevertheless, its scope has been truncated in many ways.[84] The U.K. claw-back provision comes into effect in January 2015.[85] Australia has presently decided against clawback legislation. Under proposals forward by the previous Labor government, instead of claw-back, a "comply or explain" approach was to be adopted for misstatements made in respect of the previous three financial years.[86] It was felt that claw-backs could inhibit managers from undertaking high risk, high return investment strategies to the detriment of business and innova-

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of Ann Yerger, Executive Director, Council of Institutional Investors), *available at* http://www.banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Hearing&Hearing_ID=c754606c-0b95-4139-a38a-63e63b4b3fa9.

[82] Public Company Accounting Reform and Investor Protection Act, H.R. 5070, 107th Cong. (2002).

[83] *Dodd-Frank*, *supra* note 48.

[84] For example, U.S. law requires that where a firm is required to restate its financial statements due to "material noncompliance" with financial reporting requirements under the securities laws, the company will recover from current and former "executive officers" any "incentive-based compensation" (including any stock option award) that is (i) based on "erroneous data," (ii) received during the "3-year period preceding the date on which the company becomes required to prepare an accounting restatement," and (iii) in excess of what would have been paid if calculated under the restatement. *See Dodd–Frank*, *supra* note 48, § 954. As would have been noted, the provisions only apply to CEO's and CFO's following a restatement due to "material noncompliance" as a result of misconduct. *Id.* The three year time limitation period of when a clawback provision can be used opens up a gaping loophole in that it enables the manipulation of, if not total avoidance of the provisions by the simple act of delaying the issuing of the restatement. Moreover, it does not apply to indirect gains. *Id.*

[85] U.K., HOUSE OF COMMONS TREASURY COMM., BANKING CRISIS: REFORMING CORPORATE GOVERNANCE AND PAY IN THE CITY 23 (2009) (containing a section that addressed the issue of claw-backs, bonus deferral and share-based remuneration in the banking sector. Included in this section is the exploration of a "practice of recovering bonuses where, for example, the profits on which the bonus payment was made turn out to be illusory or do not materialise."). The publication concludes that the use of mechanisms to defer or claw-back bonus payments from executives should be encouraged to align the interests of executives more closely with those of shareholders. *Id.* at 15.

[86] AUSTL. GOV.,THE CLAW-BACK OF EXECUTIVE REMUNERATION WHERE FINANCIAL STATEMENTS ARE MATERIALLY MISSTATED 11 (2010), *available at*, http://archive.treasury.gov.au/documents/1926/PDF/101220%20Clawback%20of%20executive%20remuneration%20-%20Final%20-%20Approved.pdf.

tion.[87] At the same time, it recognized the effectiveness of claw-backs in discouraging managers from taking questionable actions that may lift stock prices in the short term, but which may ultimately result in financial restatements.[88]

C. Board Re-elections

As noted, the U.K. Corporate Governance Code requires all Board members of Standard and Poors 350 companies to submit themselves for re-election every year. Australia has also implicitly accepted that rejuvenated boards will exercise discipline following suit in a different form with its two-strike rule.[89] It grants shareholders the right to vote out the Board if 25% or more votes are cast against adopting the company's remuneration report at two successive AGMs.

Views on the effectiveness of the two-strike rule are mixed. Supporters of the rule, like Stephen Mayne, the Research Director of the Australian Shareholders' Association, which represents retail shareholders, argue that the regime is having a profoundly positive

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[87] INVESTOR'S WORKING GROUP, CFA INST. CTR. FOR FIN. MKT INTEGRITY & COUNCIL OF INSTITUTIONAL INVESTORS, U.S. FINANCIAL REGULATORY REFORM: AN INVESTOR'S PERSPECTIVE 23 (2009), *available at* http://www.cfainstitute.org/ethics/Documents/us_investors_working_group_report.pdf.

[88] *Id.*

[89] The application of the two-strike rule as follows:

> "Th[e] Division applies in relation to a listed company if: (a) at an AGM (the later AGM) of the company, at least 25% of the votes cast on a resolution that the remuneration report be adopted were against adoption of the report; and (b) at the immediately preceding AGM (the earlier AGM) of the company, at least 25% of the votes cast on a resolution that the remuneration report be adopted were against adoption of the report; and (c) a resolution was not put to the vote at the earlier AGM under an earlier application of section 250V."

Corporations Act 2001 (Cth) S 250U (Austl.). The provisions requires a listed company that has received a no vote of at least 25% shareholders (the "first strike") to ensure that its remuneration report in the subsequent year provides an explanation of the board's proposed action in response to shareholders' concerns, or an explanation as to why no action is proposed to be taken. If the remuneration report again receives 25% or more 'no' votes (the "second strike") at the subsequent year's AGM, its shareholders will be permitted to vote at that AGM on whether the existing board is to be replaced and another meeting (spill meeting) held to consider the election of directors. *Id.* §250V. If 50% or more shareholders vote to hold the spill meeting, the spill meeting must be held within 90 days and all persons who held the position of director when the remuneration report was considered will be forced to vacate their office and stand for re-election. *Id.*

effect.[90] This is supported by a recent survey of executive pay in the ASX100, conducted by the Australian Council of Superannuation Investors ("ACSI"), finding that executive pay declined 8.9% in 2011, largely due to decreasing bonuses.[91] There is evidence of greater compensation and performance alignment following the introduction of the rule.[92] A broader effect of the rule has been its use as a more general way of expressing dissatisfaction with managerial decisions,[93] more particularly, as an ousting weapon to oust company directors.[94] Critics argue its limited effectiveness, pointing to the ease of ensuring Board re-election in any spill meeting called for by shareholders, due to the significant voting power that many company Boards possess; or, for that matter, the controlling shareholder power.[95] Despite Boards' inability to vote on their own remuneration due to conflicts of interest,

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[90] *Two-Strike Rule*, CHQA (Dec. 13, 2013), http://chqa.minterellison.com/blogcustom.aspx?entry=163.

[91] Rachel Alembakis, ASX100 CEO Pay Bonuses Decline, THE SUSTAINABILITY REPORT (Sept. 19, 2012), http://www.thesustainabilityreport.com.au/asx100-ceo-pay-bonuses-decline/2748/.

[92] For example, according to ACSI executive Byrne, corporations "had responded to the first strike by forgoing bonuses and salary hikes and adjusting requirements for extra pay." Georgia Wilkins, *Two-Strikes' Rule Hits Directors*, THE SYDNEY MORNING HERALD (Oct. 8, 2012), http://www.smh.com.au/business/agm-season/twostrikes-rule-hits-directors-20121008-278sc.html. Blue Scope Steel is an example that has responded by "reducing overall bonuses by 67 per cent . . ." *See* Cliona O'Dowd, *Two Strikes' Falls Foul*, BUSINESS SPECTATOR (Nov. 27, 2012), http://www.businessspectator.com.au/article/2012/11/27/resources-and-energy/two-strikes-falls-foul.

[93] An Australian example is that of Penrice Soda Holdings, whose Chairman David Trebeck claims that the two-strike rule was being used for "broader grievances[ ]" with Penrice as Penrice's executives "hadn't been granted a pay rise for two years. *See* Tim Boreham & Glenda Korporaal, *Companies Agonize Over Two-Strike Rule*, THE AUSTRALIAN (Nov. 3, 2012), http://www.theaustralian.com.au/business/companies/companies-agonise-over-two-strikes-rule/story-fn91v9q3-1226509479517.

[94] *Id.*

[95] The rule has also suffered from some technical defects. A matter overlooked when the legislation was implemented was the fact that most company constitutions require a nomination for an alternative board member at least 45-60 days in advance of any spill. But under two-strike, following a spill, boards can technically elect to hold an Extraordinary General Meeting straight away (immediately after the AGM) so long as it is within 90 days of receiving the second strike. Linc Energy took advantage of this legislative loophole by contemporaneously holding the spill meeting straight after the AGM. Such a let out means that a company can ensure that there is no genuine opportunity for dissenting shareholders to put up an alternative board nomination. The requiring of a sufficient period of time between the spill and the EGM to enable a challenger to put up an alternative board would appear, therefore, to be necessary. *See* Peter Jolly, Partner & Gina Bozinovski,

there is a bar to them using their power to re-elect current directors once a spill has occurred. Australian examples include Linc Energy[96] and Cabcharge which used their "majority share holdings to avoid a board spill."[97] Similarly, Hill and Isherwood indicated that they would use their influence in Globe International to "re-elect the existing directors,"[98] as have Linc Energy.[99] Another example is that of James Packer quoted as saying that he would use his 46% shareholding "in the casino operator to . . . reinstate every board member if" there were re-elections as a result of the two-strike rule.[100] Such criticisms, though valid with respect to companies with substantial shareholders in control, would be irrelevant in respect of the large corporation with dispersed shareholdings. A point has also been made of the additional costs associated with holding a spill meeting, and of executives preparing for a spill meeting,[101] though this is also true of all shareholder originated actions, a notable example being the shareholder derivative action.

Several observations need to be made at this point. The first is that mandating Boards to submit themselves to election either annually or subject to a strike requirement helps overcome the coordination problem endemic to entities with disparate shareholdings, and the difficulties associated with access to the corporate proxy voting machinery.[102] Second, the use of rented votes or empty voting (i.e. in the separation of voting rights from the economic interest in shares, with blockholders acquiring the right to vote only, but not the downside of negative movements in the price of the stocks over which voting rights have been acquired), helps blockholders acquire a strategic controlling vote in the entity cheaply, effectively, and discreetly.[103] Third, the fact that many investors do not vote helps further strengthen the influence

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Two Strikes Rule - Playing by the Rules, LEXOLOGY (Jan. 30, 2013), http://www.lexology.com/library/detail.aspx?g=bcc534ff-c2d1-410f-a140-780837f04977.

[96] O'Dowd, *supra* note 92.

[97] Mathew Smith, *Penrice Soda Directors Survive First Ever Two-Strike Spill*, BRW. (Jan. 25, 2013), http://www.brw.com.au/p/leadership/penrice_soda_directors_survive_first_FhuyeT7iM6M7mRlvXrJbTK. .

[98] O'Dowd, *supra* note 92.

[99] *Id.*

[100] James Frost, *Sevior Backs Executive Two-Strike Pay Tule*, THE AUSTRALIAN (Oct. 29, 2011), http://www.theaustralian.com.au/business/companies/sevior-backs-executive-two-strikes-pay-rule/story-fn91v9q3-1226179957662.

[101] *Cf. Id.*

[102] Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815-16 (2006).

[103] *Id.*

of blockholders in the entity.[104] While such a strategy makes good sense in the context of the recent history of executive compensation, it overlooks the likelihood of the gamekeeper (manager) and the monitor (blockholder) together acting as poachers of corporate property. In other words, SOP legislation has had the curious effect of not only strengthening the power of blockholders, but of also creating opportunities for managers to act in concert with blockholders against the rest of the shareholder body. Corporate governance has come full circle: just as much as stock based incentive compensation which was intended to overcome the shareholder-manager incentive problem begot its own agency problems (unintended though this may have been), the SOP strategy of strengthening blockholder power has generated in its wake its own set of agency problems—the likelihood of blockholders and shareholders acting in concert against the rest of the general shareholder body. These observations are elaborated below.

IV. From Institutional Shareholder Passivity to Blockholder Hyperactivity

Institutional investor power was once seen as the force through which recalcitrant managers could be brought to account, their investment showed that their predominant interest was to protect and preserve the interests of their own investor constituency than in setting right the entities in which they invested. More simply, their concern was to ensure the security and capital appreciation of their investment, with an eye to liquidity, requiring them to balance ease of exit (to ensure liquidity) with the benefits of exercising control (participating in the management of their investee entities). Consequently, interventions by them in the affairs of the corporations they invested in were rare, and undertaken only when needed to protect their particular investments.[105] The emergence of blockholders as managerial disciplinarians and facilitators of control has radically transformed this picture of institutional passivity.

Blockholder success is attributable to a number of factors that have coalesced together. These include the availability of investment funds, the ability of investment vehicles to specifically target and obtain funds from wealthy investors free of disclosure and reporting regulations, freedom of fund managers to invest these funds at their discretion, their ability to tie these funds in for periods of time, passivity on the part of institutional investors, changes to the 1992 proxy

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104 *Cf.* Susan E.K. Christoffersen et al., *Vote Trading and Information Aggregation* 2–3 (European Corporate Governance Inst., Working Paper No. 141/2007, 2007).

105 John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1311 (1991).

regulations in the U.S., the growth of commercial shareholder advisory firms, and financial innovation which helped develop the practice of empty voting.[106] Pension and mutual funds, for example, have been able to aggregate the savings of millions of individuals into enormous investment portfolios in the three jurisdictions, with all of these funds taking stakes in investment and hedge funds, the mainstay of blockholder activity.[107] Moreover, changes to proxy regulations in the U.S. in 1992 enabled pension, mutual, and hedge funds to combine together and vote as a single large voting block. The change also made it possible for these investment funds to communicate with each other as well as with other shareholders their views on corporate policy. Another contributing factor has been the growth of commercial shareholder advisory firms such as Institutional Shareholder Services ("ISS") specializing in advising pension and mutual funds on how to vote the proxies of the shares held in their investment portfolios.[108] These advisory services help coordinate the voting policies of many different institutional investors into one voting block controlled by the advisory service itself, reducing the collective action problem associated with widely dispersed shareholdings. Furthermore, the growth of financial innovation in the form of debt and equity hybrids, options and SWAP derivatives, and the shorting of borrowed shares along with a corresponding call option to hedge the underlying exposure taken have all contributed to putting corporations into play. As investment in hedge funds is limited to wealthy investors, they fall outside the ambit of seeking funds from the general public, and as a consequence lightly regulated.[109] Moreover, the absence of need for a diversified investment portfolio has made it easier for hedge fund managers to take concentrated positions that impact on the market, thereby increasing the counterparty risk exposure of the hedge fund to the particular transaction. Hedge funds have found an ideal investment paradise in this environment, despite the many publicised debacles.[110]

Moreover, the hedge fund practice of using multiple brokers to invest their fund monies ensures that no single broker will have the whole picture. Also, the fact that the stress tests and other tools used by a prime broker to monitor counterparty risk profile apply only in

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[106] *See generally* Franklin Edwards, *Hedge Funds and the Collapse of Long Term Capital Management*, 13 J. ECON. PERSP., 189, 193, 197 (1999); David Shirreff, *Lessons From the Collapse of Hedge Fund, Long term Capital management*, (Int'l Fin. Risk Inst., 1999), *available at* http://emlab.berkeley.edu/users/webfac/craine/e137_f03/137lessons.pdf.

[107] *See* Edwards, *supra* note 91, at 193–94.

[108] *See* Stephen J. Choi, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 650–51 (2009).

[109] *Id.* at 190–91.

[110] *Id.* at 193.

relation to transactions dealt with by that particular broker means that the full extent of the risks involved cannot be known. The result is that hedge funds are able to externalize their risks beyond the investors in the fund and on to the regulated market (prime brokers, banks, and their shareholders), to other market players, and to the community generally.[111] Consequently, there have been calls for the regulation of hedge funds in the U.S., the European Union ("E.U."), and in Australia. Calls in the U.S. have been prompted by concerns of market integrity and systemic risk flowing from the exemptions and exclusions from the federal securities laws that permitted a private market in securities to thrive in ways that may have harmed the public markets.[112] Calls in the E.U. have been sparked by the need to curb the activism of these funds, as well as associated practices such as empty voting. Against this, however, those favoring investment fund activism see such activity as promoting shareholder democracy and generating managerial efficiency.[113]

When seen in the context of the changes to the corporate scene that investment funds can bring about, concerns over making the SOP vote binding (as in the U.K.), of clawbacks (as in the U.S., and in the U.K. as from January 2015), and Boards being required to submit themselves for re-election are easier to comprehend. These changes not only arm shareholders with very potent weapons to keep Boards in control, but also to help overcome the lack of coordination problem endemic to large shareholder bodies. More to the point, these changes confer enormous power on blockholders, as they enable them to intervene effectively and strategically in the management and governance of the large corporation.

In discussing the U.S. scene, well known corporate lawyer and author Martin Lipton has observed that "attacks by activist hedge funds" constitutes the number one key issue for directors.[114] This is understandable in light of what hedge funds can do to instil fear in managers.[115] Yet, the question remains as to what exactly it is that

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[111] Edwards, *supra* note 106, at 195–200; Shirreff, *supra* note 106, at 5.

[112] *See* Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n., Hedge Fund Regulation on the Horizon – Don't Shoot the Messenger, Address at Hedgeworld Fund Services Conference, New York (June 18, 2009), *available at www.sec.gov/news/speech/2009/spch061809laa.htm* [hereinafter *Aguilar*].

[113] *See* Kahan & Rock, *supra* note 14, at 1026 (citing *Battling for Corporate America*, ECONOMIST, Mar. 09, 2006, at 69, 69–71).

[114] Kahan & Rock, *supra* note 14 at 1026 (citing Client Memorandum from Martin Lipton, Watchell, Rosen & Kats, Attacks by Activist Hedge Funds (Mar. 7, 2006) (on file with author)).

[115] Binsted, *supra* note 16, at 28 (quoting Australian lawyer Jeremy Leibler who stated that "'Directors are really worried about this. In shareholder activist scenarios, unlike other legal actions, it has less to do with the success of winning the

blockholders deliver. For example, Bratton[116] observes that U.S. "hedge funds prove better at extracting target concessions and getting into boardrooms than at yielding long-term, market-beating financial gain" and that "[o]verall the hedge funds' talents appear best suited to address matters that can be interrogated from outside the target," such as cash disgorgements and asset sales which can be gauged from publicly available information, than with value creating initiatives such as reducing operating costs which require "hands on confrontation" based on information available from the inside with the results yielding no overall evidence of constructive input at this level.[117] Bratton, for example, has found that in the US:[118]

> [A]ctivist intervention led to something tangible in 88 percent of the cases, whether an asset sale, a stepped up cash payout, a board seat, or a legislative concession . . . [while] only a minority of the targets' stock prices beat market indices over the period of engagement, with financial underperformance being particularly notable in cases where the hedge fund entered the target boardroom.[119]

More to the point is that if blockholders are able to lean on managers to do their bidding, it follows that managers will act to please blockholders in order to safeguard their position within the corporation (employment contract, stock based incentive compensation and the like). The emergence of a coalition of interests between managers and blockholders will in these circumstances be inevitable. Given this, the opportunity to cause harm to the corporation and to the rest of the shareholders from potential self-dealing by both blockholders and managers, albeit by another name (e.g. share buy backs, special dividends, sale of assets or even the entire firm),[120] will be immense. There is an interesting parallel here between managerial gaming of their compensation packages assisted by compliant Boards, and blockholder exploitation of their rented control positions assisted by compliant managers: both harm the corporation; more so, in the

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action and more to do with psychology and perception' . . . 'Activists target directors. As soon as they tip the scales beyond what directors expect they will be exposed to it will change the way directors act.'").

116 William W. Bratton, *Hedge Funds and Governance Targets: Long-Term Results* 1–2 (Uni. of Pa. Sch. of Law, Research Paper No. 10-17, 2008)

117 *Id.*

118 *Id.* The study takes a second look at a database of 114 activist hedge fund investments between 2002 and December 31, 2006, published in 2007, and an updated database from January 2007 to June 2009.

119 Bratton, *supra* note 116, at 2.

120 *See* Anabtawi & Stout *supra* note 1, at 1279.

latter situation where managers decide to go along with blockholder demands. Even if it can be said that the overall effect of managers doing the bidding of blockholders will result in a trickle down of benefits to the rest of the shareholder body, the question still arises whether transfers of control transactions through rented control should be subject to regulation. Moreover, the fact that rented control is a new phenomenon falling within the bounds of existing law does not mean that the matter should be left there; rather, it means that its causes and concerns should be freshly looked at and where necessary new forms of addressing the problems they gives rise to should be considered.

V. Reconsidering Management and Blockholder Power

The discussion in this article so far looked at how the current SOP legislation has resulted in a redistribution of power as between managers, Boards, and shareholders. Moreover, the rebalancing has been not so much by way of a reduction of managerial powers, as from the attempted imposition of greater accountability on managers to Boards and shareholders, and improved shareholder coordination. This Part examines whether the empowerment of blockholder power caused by this rebalancing (whether or not intended) impacts negatively on managers and other shareholders, and if so how, and which aspect of it should be addressed. Three issues are canvassed in this context: First, the problems presented by rented or empty voting; secondly, whether the premium received for transfer of control should be accountable to the corporation; and thirdly, whether blockholder power should be made accountable.

A. *Rented or Empty Voting*

It is trite knowledge that shares embody three entitlements, namely, the right to vote, to dividends when declared, and to a return of capital in the event of liquidation. All such entitlements are by reference to each class of shares, and are prorated by reference to each share. The practice has grown by which each of these entitlements is packaged as a commodity in its own right and rented out separately, enabling its holder to momentarily exercise the legal claims attached to it, whether of the right to vote, or to dividend. The transfer of rights under these contracts is for a very limited period (may even be limited to a specific purpose), alongside the undertaking by the transferor to buyback the asset. In other words, the transaction has more the characteristics of a lease than a sale. During its duration, there is the spectre of different claimants to the right to vote and to dividends, alongside the lessor as residual owner of these rights. For corporations and tax law purposes, the name entered on the corporate register at a particular reference date is conclusive of the matter. Reputedly, the rights under these shares are leased out for a fee without the knowledge of the owners of these shares by the brokers and institutional investors entrusted with its custody as part of their business and investment activity. Estimates are that acquirers obtain these entitlements very cheaply,[121] and without exposure to the downside of a drop in value of the share itself for the period of the exercise of the right.[122]

Empty voting can be resorted to by blockholders, as well as managers and Boards (in addition to their use of the proxy machinery).[123] While blockholders use it to facilitate transfers of control, managers and Boards may use it to effect a managerial buyout, or the leveraged buyout of another corporation, or for use simply as a defensive strategy in the face of a hostile bid in jurisdictions where the taking of defensive actions are not prohibited. Thus, it takes the form of a two-edged sword having the potential to destroy the purported manager-shareholder power on a massive scale. In all, at least four scenarios can be contemplated in the use of empty voting:

(1) Blockholder use of it to facilitate the transfer of control;

(2) Target managers and blockholder use of it to facilitate transfer of control;

(3) Target managers use it to engage in defensive actions, unless prohibited (as under the U.K. City Code Rules);

(4) Target managers and Board use it to engage in a management buyout, leveraged buyout.

Clearly, the practice has a negative impact on corporate governance as it weakens the dependence-independence strategy of governance. More to the point is that managers (and Boards for that matter) when placed in a vulnerable position will seek allies, the most readily available of which are blockholders. Its very existence flies in the face of the clamour for institutional shareholders to facilitate greater managerial accountability to the shareholder body.

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[121] *See* Mark Hulbert, *One Borrowed Share, But One Very Real Vote*, N.Y. TIMES (Apr. 16, 2006), http://www.nytimes.com/2006/04/16/business/yourmoney/16stra.html. Hulbert states, "As long as you have the collateral, borrowing shares is very inexpensive. The annual cost can be as low as 20 basis points, or two-tenths of a percentage point, on the cash that is put up. And because the borrower must hold the shares for just one day in order to have voting rights, the interest can be almost nothing. The cost to borrow $1 million of stock for one day, for example, could be less than $6.00."

[122] *Id.*

[123] *See generally* William L. Tolbert, Jr., Leslie H. Lepow, & John F. Cox, *Briefly: Borrowed Voting*, (AEI Legal Center for the Public Interest) (vol. 11 no. 8 2008) *available at* http://www.aei.org/wp-content/uploads/2011/10/20080515_Briefly_v11n8_web.pdf.

B. Premiums on Controlling Votes

The argument that premiums received for transfer of controlling interests should be made accountable to the corporation have been justified on the grounds that (1) transfers of control amount to an appropriation of a corporate opportunity,[124] (2) the control premium is a corporate asset,[125] (3) shareholders owe a fiduciary obligation to non-controlling shareholders,[126] and (4) sharing of the premium based on the inherent principle of equal opportunity in corporation law. Of these, the equal opportunity justification has had the highest traction and is now firmly enshrined in corporate takeovers law generally. The claim that the sale of control amounts to the transfer of a corporate opportunity has had no reception at all in the courts of any of the jurisdictions discussed in this article. It has been criticised on the ground that it is hard to spell out any opportunity of the corporation taken advantage of by the seller of control.[127] From the buyer's perspective, it is no more than the case of the stock being more valuable to the buyer than to anyone else provided that control passed with it. The claim of control as a corporate asset is based on the ground that control is in itself not a property right, but a power position which is "adventitious" and which among other things, enables the controller to appoint the board. The argument is that controlling stock comprises of its investment value and an appurtenant power of control. And unlike stockholders, directors, however chosen, have to act according to their honest business judgment and in the best interests of the corporation. As stated by Berle:

> The position of a majority shareholder, with his capacity to control, is thus not a 'property right' in the same sense as his right to participate in dividends, or in liquidation or the like. His control power is really adventitious, a by-product of the corporate capacity to choose a board of directors by less than unanimity. This is why the control power – capacity to choose a management – is a corporate asset, not an individual one.[128]

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[124] *See* Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property, 337–38 (1932).

[125] *Id.*

[126] *See generally Jones v. H. F. Ahmanson & Co.*, 81 Cal. Rptr. 592 (1969) (holding defendant controlling shareholders had a fiduciary duty not to abuse their power to control the corporation to the detriment of the minority shareholders).

[127] *See* William D. Andrews, *Stockholders Right to Equal Opportunity in the Sale of Shares*, 78 HARV.L. REV. 505, 517 (1965).

[128] Adolf A. Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L. REV. 628, 638 (1965).

Framed differently, the claim is that control shares will not be worth as much if the rights of the minority must be respected (i.e. the premium has to be shared between all shareholders). Berle supplements this theory in a later article he published, adding that control:

> [I]s no longer solely an attribute of stock ownership, though stock ownership plays a part. It is no longer merely a definable portion of the bundles of rights held by stockholders, whether separable or inseparable from the stock itself. It is not a 'thing' but a function . . . with substantial public responsibilities.[129]

In the U.S., the early case of *Jones v. Ahmanson* recognized an unrestricted fiduciary obligation on majority stockholders in the sale of control situations, though the corporation itself had suffered no harm. It has not been received into the U.K. or Australian law, and has not had much traction even in the U.S. outside of California.[130] The equal opportunity theory advocated by Jennings[131] has been developed mainly by Andrews.[132] Andrews rejects the corporate asset theory on grounds that it focuses on the buyer rather than the seller, and that the focus should be on the seller for the premium received.[133] What is violated in a sale of control situation is the right of all shareholders to have an equal opportunity to participate rateably in the sale of stock pursuant to an offer to purchase control.[134] The equal opportunity rule neither compels nor prohibits a sale of stock at any particular price.[135] Nor does it compel a prospective purchaser to make an open offer for all of the shares in the company on the same terms.[136] The only requirement is that the offer be made equally or proportionately available to all stockholders.[137] The equal opportunity theory seeks to achieve the same result as the corporate asset theory (i.e., both seek to ensure that non-controlling shareholders are not excluded from a sale

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[129] Adolf A. Berle, Jr., *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212, 1215 (1958).

[130] *Jones v. Ahmanson*, 81 Cal. Rptr. 592, 599 (Cal. 1969).

[131] *See* Richard W. Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV 1, 16–17 (1956).

[132] William D. Andrews, *The Shareholder's Right to Equal Opportunity in the Sale of Shares*, HARV. L. REV. 505, 516–17 (1965).

[133] *Id.*

[134] The leading case on the subject is the US case of *Perlman v. Feldman*. 219 F.2d 173, 178 (1955) (analyzing the sale by a shareholder of a controlling shareholder interest to an outside third party. The relief granted was to require an accounting directly to non-participating shareholders for the premium received by the seller of control).

[135] Andrews, *supra* note 132, 516.

[136] *Id.*

[137] *Id.*

of shares to a new controller).[138] They differ in that while the corporate asset theory attempts to prevent the controller from retaining all the premium, the equal opportunity theory allows the minority shareholders to sell their shares, or at least as great a proportion as the controllers sell, and at the same price.[139] It also allows the minority shareholders to opt out of the enterprise if they fear oppression or self-dealing of the corporation by the new controllers.[140] Thus, the equal opportunity theory goes further than the corporate asset theory as far as minority shareholders are concerned, and the equal opportunity justification can be seen as representing the flip-side of corporate law's notion that each class of shares has the same rights as any other share of that class, namely, equal right to vote, dividends, and return of capital upon liquidation.[141] In this sense, the rule simply seeks to ensure an equal right of exit to all shareholders in transfer of control situations. Accordingly, the rule has become an integral part of the takeovers law in Australia, the U.K., and U.S.[142] Perhaps then it may be appropriate to consider whether transactions facilitating corporate control be subject to greater scrutiny than they are at present.

C. *Blockholder Power and its Accountability*

In discussing blockholder accountability, it is necessary to distinguish the ends from the means of ensuring managerial and Board accountability.[143] Unlike the former, the latter has been much contested. The concerns expressed in this article, therefore, are not about the former—managers and Boards being accountable to the shareholder body—but rather about the role played by blockholders.

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138 *Id.* at 528.
139 *Id.* at 527.
140 *Id.* at 551.
141 *Id.* at 522.
142 These rules, embodied in the Australian takeover laws and contained originally in the *Companies (Acquisition of Shares) Act 1980* (Cth) (Austl.). They follow the recommendations of The Eggleston Committee, and are referred to as the Eggleston Rules. *See generally* AUST., CO. LAW ADVISORY COMM., REPORT TO THE STANDING COMMITTEE OF ATTORNEYS-GENERAL ON DISCLOSURE OF SUBSTANTIAL SHAREHOLDINGS AND TAKEOVERS (1969), *available at* http://www.parliament.vic.gov.au/papers/govpub/VPARL1968-69NoC1.pdf. On the U.K., *see generally* John Armour & David A. Skeel, *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, 95 GEO.L.J. 1727 (2007); and for a comparative study see Jennifer G. Hill, *Takeovers, Poison Pills and Protectionism in Comparative Corporate Governance* (European Corporate Governance Inst., Law Working Paper No. 168/2010, 2010), *available at* http://ssrn.com/abstract=1704745.
143 *See generally* WACHTELL, LIPTON, ROSEN & KATZ, TAKEOVER LAW AND PRACTICE 128 (2014).

Blockholder success is attributable to their ability to access large amounts of funds tied in for a period of time to be deployed on targets of their choosing.[144] More importantly, their success is attributable to the fact that they have been able to reconcile the conflicting demands of control and exit, which has been the bugbear of institutional investors. Blockholders buy to sell (not as part of an investment portfolio), and strike strategically to have their preferences given effect to, and/or bring about transfers of corporate control.[145] Their very presence puts corporate managers on notice.[146] While they have ostensibly filled the governance role once expected of institutional investors, there remain concerns about the way they acquire the ability to transfer control (renting of power through empty voting), their disinterest in the well-being of the target entity itself by their having little if any skin in the game (minimal equity stake), their ability to engage in self-dealing, ability to lean on target managers to do their bidding, to receive premiums on the transfer of control, and for their lack of accountability to the general shareholder body of their target corporations or for that matter to the shareholder body of any public corporation.[147] At best, their accountability is to a small coterie of investors in the funds they manage. The last point highlights an underlying tension between the goals of corporation law and finance theory. While corporation law sees the corporation as a legal entity answerable for its legal actions, and its officers answerable to its internal constituency through layers of accountability by way of the AGM and internal and external compliance processes, financial markets see the corporation as being regulated by the marketplace through the capital, managerial, and

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[144] *See generally id.* at 4.
[145] *Id.* at 6, 56–60.
[146] A recent example is the role of how a substantial shareholder was able to extract collateral benefits for the shares he held in a second company, under a takeover scheme of arrangement for another company in which he also held shares (the benefit amounted to nearly A$ 200 million for a shareholding of 11.8% in the second company). Woolworths (South Africa) held 87.88% of shares in Country Road (an Australian company), while Solomon Lew (the shareholder in question) held 11.8% of its shares. Upon Woolworths announcing a bid for David Jones (another Australian company), Lew bought in 9.9% of David Jones shares, and another 12% voting control (rented control coupled with appropriate hedging contracts) and threatened to block the bid by Woolworths for David Jones. Woolworths bought over Lew's shares in Country Road at a premium of A$17 per share (netting Lew nearly A$200 million on the transaction), and bought out all of the shares in David Jones, including those of Mr Lew. *See generally* Memorandum from Melissa Hennessy, Gen.Counsel. & Assistant Sec'y, Country Road Group, to ASX Market Announcements, Austrl. Sec. Exch. (July 21, 2014), *available at* http://member.afraccess.com/media?id=CMN://3A408887&filename=20140721/CTY_01534815.pdf.
[147] *See* WACHTELL, LIPTON, ROSEN & KATZ, *supra* note 128, at 6–8.

takeovers market where the overall result is captured in its share price. It is for this reason that corporation law sees the protection of minority shareholders rights and transfers of control as ends in themselves and requiring regulatory control, whereas finance theory sees it as items of property rights to be traded.

Commentators favoring the emergence of blockholders see it as a useful countervailing force against recalcitrant managers that also ensures Board independence from managers while increasing Board dependence on shareholders. Bebchuk claims that previously, directors in the U.S. faced very little risk of being ousted in the wake of poor performance and shareholder dissatisfaction, that shareholder ability to replace directors was extremely limited, and that outside the hostile takeover context, the incidence of electoral challenges to directors as being practically negligible in the past decade.[148] Those opposed to increased shareholder power, however, see this development as overturning the balance of power within the corporation, and counterproductive. Even if it be the case that the emergence of blockholder power has helped resolve the separation problem as framed by Berle and Means, and has the useful result of making managers more accountable, opportunistic behavior by blockholders may be as detrimental, if not more, to the rest of the shareholder body as is with managerial opportunism.[149] More to the point is that protagonists on both sides of the argument fail to give adequate attention to the real problem facing corporate governance: this is the emergence of a blockholder-manager coalition of interests and their acting to benefit themselves at the expense of the rest of the shareholder body.

To explain further, it is necessary to remember that blockholder fund managers are confronted with double and multiple agency problems. This flows from the fact that blockholder managers rely on the investment skills of specialists outside their organizations to invest on their behalf. Moreover, even in a best case scenario of a single agency situation, since the prime obligation of blockholders is to those that have entrusted them with funds for investment, blockholders would rationally act to further the interests of their own constituency. Likewise, managers of the target or investee corporation faced with the prospect of termination will act to save their positions, or at least get the best deal possible for themselves in the circumstances. Hence the temptation for blockholders and target managers to

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[148] Bebchuk, *supra* note 32, at 43–44.

[149] There is also ample evidence which suggest that such gains as are made by shareholders come at the expense of creditor and employee entitlements. *See, e.g.*, Allaire & Firsirotu, *Hedge Funds as Activist Shareholders: Passing Phenomenon or Grave-Diggers of Public Corporations?* (Jan. 27, 2007), *available at* http://ssrn.com/abstract=961828.

act together to further their respective interests as against the rest of the investors in the target company is very great, with the consequent harm to the target entity in these circumstances being considerable. It is this which needs safeguarding against. The point is underscored in an article by Coffee on institutional investors, where he refers to shifting coalitions being forever present in corporate governance.[150] Although he makes that observation in the context of defensive actions in the face of hostile takeover bids, its logic applies equally aptly to the developments in corporate governance discussed in this article. In other words, the downside of blockholder activity must be seen as being of equal concern alongside whatever upside it must deliver. Seeing blockholder activity purely in terms of a countervailing force to managerial agency problems which should be encouraged, ignores not only the agency problems that blockholder activity generates, but also overlooks the cumulative impact of the manager-blockholder coalition.

This raises the important question of what it is that the requirement that board members submit themselves to re-election annually or biannually is intended to achieve: whether it is intended to ensure that the sentiments expressed in the shareholder vote in relation to executive compensation are given effect to, or to make board replacement generally easier? If the former, then a binding shareholder vote would on the face of it appear to suffice; if the latter, then the issue of whether defensive strategies should be made available should be considered.[151] The question assumes considerable significance in light of blockholder power to dictate managerial actions. The point is underscored in the following observation by Bratton and Wachter:

> [S]hareholder empowerment delivers management a simple and emphatic marching order: manage to maximise the market price of the stock. This is exactly what the managers of a critical set of financial firms did in recent years. They managed to a market that focused on increasing observable earnings, and as it turned out,

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[150] Coffee, *supra* note 105, 1367.

[151] RULE 21 of The UK Takeover Code prohibits managers from taking any action which may frustrate the bid ("frustrating action") without the approval of shareholders in general meeting. PANEL ON TAKEOVERS AND MERGERS, THE TAKEOVER CODE (2013), *available* at http://www.thetakeoverpanel.org.uk/wp-content/up loads/2008/11/code.pdf. The provisions of the Code are now part of UK Company Law. s28 Companies Act, 2006, c. 46 §28 . The Code is the basis of EU Takeover Law following Directive 2004/25/EC, of the European Parliament and of the Council of April 21, 2004 on Takeover Bids. The US counterpart is the Williams Act 1968, which amends the Securities Exchange Act 1934. *See* 15 U.S.C. §§ 78m(d)-(e), 78n(d-(f) (1976) (adding §§ 13(d-(e), 14(d)-(f) to Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §§ 78a-78kk (1976)).

> they failed to factor in concomitant increases in risk that went largely unobserved. The fact that management bears primary responsibility for the disastrous results does not suffice to effect a policy connection between increased shareholder power and sound regulatory reform.[152]

These observations when transplanted to a situation where blockholders act in concert with managers appear to seriously jeopardize the manager-shareholder power balance envisaged in the large modern corporation of today.

CONCLUSION

This article highlights how the contest for power and influence within the corporation has moved from the domain of Boards, managers, institutional investors, to influence wielded by blockholders, and to blockholders acting in concert with managers. Hostile takeover bids, despite their excesses, can perform the role of a useful marketplace disciplinarian of corporate managers. However, its feasibility depends on its being facilitated by arbitrageurs, institutional investors, and now blockholders. While blockholder power is useful in this sense and should be welcome, it also has the downside of self-dealing, lack of accountability, and of power over the shareholder body without really being a shareholder. One of the cardinal messages from agency theory is that the entity's interests are best furthered by those who have skin in the game. It is for this reason that agency theory based executive compensation advocates the use of stock based compensation. By implication, therefore, those engaged in rented control as much as those who rent out shares (brokers and institutional investors) would rarely if at all see their personal wellbeing as being synonymous with the wellbeing of the target entity.

There has been a vigorous discussion on the subject of the shareholder-manager balance of power especially in the U.S. Yet, the bulk of these discussions focus mainly on the shareholder-manager power divide, and ignore the more important aspect of the consequences of controlling groups, ostensibly part of the general shareholder body, acting to further their own interests. This is evident, for example, in the contributions by Martin Lipton[153] (countering the increase of shareholder power, at the expense of board power, and in

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[152] William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 654 (2010).

[153] Martin Lipton, *Takeover Bids in the Target's Boardroom* 35 BUS. LAW. 101 (1979).

relation to takeover defences) and Bebchuk and Fried[154] (for board independence from executives, in the context of executive compensation accountability). Earlier in time even Arrow[155] saw the Board-shareholder relationship as a zero sum game where an increase in shareholder power meant a diminution of Board power. Likewise, even Lipton's observations on the then emerging role of arbitrageurs and hedge funds as speculators rather than investors[156] viewed hedge funds in the context of Board power, and not as impacting on shareholder power itself. Important as these contributions are, they seem to view the emergence of blockholder power as an extension of shareholder power generally. It is here that the more recent contributions by Gilson and Gordon,[157] and Anabtawi and Stout[158] bear special relevance to the discussion.

Gilson and Gordon argue for a balancing out of the roles played by mutual and pension funds on the one hand, and hedge funds on the other for the benefit of capital markets.[159] While accepting that mutual funds and pension funds tend to be passive investors not engaged in initiating important proposals, they argue that by encouraging them to serve as governance intermediaries in respect particularly of proposals initiated by shareholder activists such as hedge funds would result in increased benefits all around.[160] This, they claim would act "to potentiate institutional investor voice, to increase the value of the vote, and thereby to reduce the agency costs" that they identify in the intermediation process by financial intermediaries.[161] It still remains though that pension funds and mutual funds, like hedge funds, may not be interested in the welfare of the investee corporation for its own sake, but as an avenue to further the interests of their own investor constituency, and this precisely is the problem presented by investment fund activity.[162] In other words, their proposal overlooks the element of self-dealing by blockholders, especially by investment and hedge funds. While corporation law has a long history of containing self-dealing by Board members and managers, self-dealing by

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[154] Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues, 30* J. CORP. L. 647; *see also* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (responding to Bebchuk).
[155] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 78 (1974).
[156] Lipton, *supra* at note 114.
[157] *See generally* 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, 869 (2013).
[158] *See* Anabtawi & Stout, *supra* note 1.
[159] Gilson & Gordon, *supra* note 142, at 868–69.
[160] *Id.* at 876.
[161] *Id.* at 864.
[162] *Id.* at 896.

blockholders[163] has been spared such accountability. Anabtawi and Stout[164] meet this problem squarely and argue for a comprehensive theory of accountability for pension and investment funds through the imposition of a fiduciary duty on them, given the ability of these new controllers to lever Boards and executives to their way of thinking. Under the proposal, investment funds are to be subject to the fiduciary obligations of loyalty and good faith where they are found to "control" the corporation (i.e. where a particular shareholder can formally or informally influence corporate behavior with respect to a particular issue from which that shareholder will stand to derive a pecuniary gain to which other shareholders are not).[165] Such a requirement would be particularly useful to ensure the welfare of the general shareholder body in the situation facing corporate governance at present.

There have been some interesting developments on investment and institutional shareholder power in the U.K. The Stewardship Code[166] brought out by the U.K. Financial Review Council in 2010, sets out good governance practices for institutional investors[167] based on a set of principles which require institutional investors to declare how they will discharge their stewardship responsibilities; have a robust policy on managing conflicts of interest in relation to their stewardship role; monitor their investee companies; state when and how they will escalate their stewardship duties; act collectively with other investors where appropriate; have a clear policy on voting and disclosure of voting activity; and report periodically on their stewarding and voting activities.[168] Institutional investors are regarded as stewards under the Code and are urged to actively monitor and engage with their investee corporation.[169] The Code also requires institutional investors to act on a "comply or explain" basis when engaging with investee firms, while asset managers are required to report on whether or not they applied the Code.[170] Critics of the Code argue that given portfolio diversification, relatively short holding periods, and passivity in

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[163] Anabtawi & Stout, *supra* note 1, at 30–31.

[164] *Id.*

[165] *Id.* at 50.

[166] U.K., Fin. Reporting Council, The UK Stewardship Code (2012), *available at* https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf.

[167] Defined in the Code as asset owners and asset managers with equity holdings in UK listed companies; asset owners include pension funds, insurance companies, investment trusts and other collective investment vehicles. The Code also applies by extension to service providers such as proxy advisors and investment consultants. *Id.* at 1–2.

[168] *Id.* at 5.

[169] *Id.* at 7.

[170] *Id.* at 4.

tracking a market index, institutional investors are rationally apathetic to corporate governance decisions.[171] They also point to the lack of correlation between shareholder activism by traditional institutional investors or improved corporate governance practices and the maximisation of shareholder value. Some critics, placing their faith on efficient markets, reject the notion of long termism and short termism as well as the basis on which much of the criticism is levelled by stewardship advocates against institutional owners.[172] Worthy though they are, their concern is to protect the interests of the fund members, and not of the investee company shareholders,[173] whose interests are the concern of this article. It is in this context that the proposal advanced by Anabtawi and Stout discussed above makes eminent sense as a way out of the current crisis posed by blockholder power to corporate governance. Corporate governance has in this sense entered its fifth stage of evolution: from Berle and Means separation to agency theory accountability, followed by the SOP tilt in favor of shareholders to the rise of blockholder power, to the present where blockholder power and managerial power can in combination work against the interests of the larger body of shareholders. Two alternative strategies are open to corporate governance to address the present problem: draw a wedge between the manager-blockholder coalition of interests, or harness it in a way that will promote the interests of the entire shareholder body. While the solution of imposing a fiduciary obligation on controlling shareholders proposed by Anabtawi and Stout is in line with the latter solution, it would be difficult to apply it to managers in the face of the business judgment rule. In the circumstances, the better alternative is to drive a wedge between the blockholder-manager coalition of interests by requiring on the one hand managerial passivity along with the requirement that the demand made by blockholders be put to the general shareholder body, and on the other the imposition of a fiduciary obligation on blockholders. This way, there will be no prohibitions placed on blockholder activity itself.

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171 Matteo Tonello, *The separation of ownership from ownership*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 23, 2013), http://blogs.law.harvard.edu/corpgov/2013/11/25/the-separation-of-ownership-from-ownership/.

172 *Id.*

173 As evident in the preamble explaining the underlying aim of the Code principles, where it is stated, "[s]o as to protect and enhance the value that accrues to the ultimate beneficiary, institutional investors should." The U.K Stewardship Code, *supra* note 166, at 5.