

THE LONG AND SHORT OF CORPORATE GOVERNANCE

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Abstract

A movement is growing among commentators in the academy, the bench, and the bar that sees short-term shareholders—especially activist institutional shareholders—as a threat to the long-term best interests of publicly traded corporations. These “long-and-short” commentators argue that institutions with short investment horizons tend to favor short-term corporate governance gimmicks that temporarily “pump up” stock prices but depress corporate value in the long run. As a remedy, they propose that activist institutional shareholders need an accountability mechanism, such as fiduciary duties applicable to officers and directors in corporate law.

The argument’s intuitive mantra—that short-term investment horizon leads to short-term governance—has received considerable purchase among the bench and bar. However, the simple seemingly intuitive connection between short investment horizon and governance horizon is not at all clear when one digs beneath the surface of the assertion. Finance theory would suggest that differences between short-term and long-term value would be quickly eliminated by arbitrage activity. To the extent that there are limits to arbitrage, these limits are unlikely to apply to the type of activism pushed by institutional investors, such as corporate governance reforms. In all, the short-termism perspective developed in law reviews lacks even a plausible basis in any mainstream work in finance, whether classical or behavioral.

In addition, the long-and-short argument is fundamentally incompatible with bedrock principles of corporate law. Recognizing a distinction between the interests of short-term and long-term shareholders would make even ordinary board decisions involve a conflict of interest and therefore subject to entire fairness review rather than the business judgment rule. Such a change would mean paralysis in corporate affairs, as virtually every decision could be challenged in court. This Article predicts that the “investment horizon” debate portends a coming collision of interests that

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will have dramatic implications for the corporate landscape, including the possible demise of Delaware as corporate jurisdiction of choice.

INTRODUCTION

The law of corporate governance is heading for a showdown. In recent years, a growing chorus of commentators in the academy,¹ bench,² business³ and the press⁴ has argued that short-term investors, especially short-term activist institutional investors, wield too much influence over corporate governance. The core problem, according to these commentators, is that institutional investors who do not plan to hold shares for a long period of time (those with short “investment horizons”) pressure corporate managers to pursue myopic policies (short “governance horizons”). The myopic policies pushed by short-term shareholders purportedly produce temporary increases in stock price but undermine long-term value. As a result, according to this view, short-termism requires new regulation or new liability to curb shareholders that “push for corporate strategies that they believe will temporarily inflate stock prices.”⁵

The notion that short investment horizons lead to short governance horizons, which this Article refers to as the “long-and-short” perspective, has intuitive appeal. The starting point is that institutions, especially hedge funds, are thought to have short investment horizons because they plan to hold shares in any particular company for a short period of time. As a result, these institutions care only about the short-term price of the stock (during their holding period), rather than the long-term prospects of the stock (after they will have sold the stock). Consequently, the institutions are thought to put pressure on managers “to pursue myopic business strategies that don’t build lasting value,” and “raise share prices just long enough that [the institution] can sell and move on to the next stock that might see a short-term bump in its stock.”⁶ Thus, as the proportion of investors with short investment horizons rise, we should expect to see managers respond by

¹ See *infra* notes 32 to 52 and accompanying text.

² The most vocal judge on this issue is Chancellor Leo Strine, the new Chief Justice of the Delaware Supreme Court. But former Chief Justice Steele and Justice Jacobs have also been forceful in the long-and-short debate. See, e.g., Jack B. Jacobs, *Patient Capital”: Can Delaware Corporate Law Help Revive It?*, 68 WASH & LEE L. REV. 1645 (2011).

³ See, e.g. THE ASPEN INST. BUS. & SOC’Y PROGRAM, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT (2009); Business Roundtable.

⁴ Steven Pearlstein, *How the cult of shareholder value wrecked American business*, WASH. POST WONKBLOG (Sep. 9, 2013), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/09/09/how-the-cult-of-shareholder-value-wrecked-american-business>.

⁵ Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1292 (2008).

⁶ LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 67 (2012).

behaving myopically to temporarily produce a “bump” in the short-term stock price at the expense of the long-term stock price.

The argument has gathered widespread acceptance among practitioners, business people and academics.⁷ Indeed two prominent commentators recently described the conflict between short-term and long-term investment horizon as “sharpest and most comprehensive criticism” of shareholder activism.⁸ More importantly, perhaps, the argument has been influential with prominent judges, as multiple members of the Delaware judiciary have joined the movement in suggesting in speeches and writings that institutional short-termism calls for changes in the corporate governance system.⁹ The long-and-short commentators see the situation so seriously that they have attributed stock market crashes, Enron and WorldCom, and even occasional lackluster American macroeconomic performance to short-termism.¹⁰ Although the “long-and-short” perspective is not new, the growing consensus between commentators and judges that short-term investors are a problem forebodes an intervention designed to limit their influence in corporate governance.

The long-and-short debate is one of those instances, however, where intuition is not a reliable guide. Even assuming that institutional investors have short investment horizons,¹¹ the linchpin of the argument—that short-horizon investors will push for policies harmful in the long-term—is lacks a foundation. That assertion is inconsistent with basic principles of mainstream financial economics.¹² If market participants pressure managers to produce a temporary “bump” in the short-term stock price, market participants will have strong incentives to dump the stock causing a correction to the long-term value, meaning that the difference between short-term and long-term prices is not sustainable. It is true that there are

⁷ See Lucian A. Bebchuk, *The Myth that Insulating Directors Serves Long-Term Value*, 113 COLUM. L. REV. 1646-1648 (2013).

⁸ Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1083.

⁹ See, e.g., Stanfordlawschool, *Shareholder Empowerment vs. Board Authority*, YOUTUBE (Nov 15, 2011), <http://www.youtube.com/watch?v=Bnw1AXi3b-c>; Jacobs, *supra* note 2, at 1657-1661 (describing dangers of short-term investors and proposing longer terms and more insulation for corporate directors to counter short-term thinking).

¹⁰ See Bebchuk, *supra* note 7, at 1649-1651.

¹¹ There are reasons to think that even this claim is not true, and that the majority of institutions have horizons no different from those of other shareholders. See Bebchuk, *supra* note 7, at 1661.

¹² See, e.g., Bernard Black and Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U.L. REV. 521, 532-533 (2002) (arguing that “the asserted distinction between short-term and long-term investors” is “nonsensical” because under “elementary principles of finance, even short-term investors have an incentive to maximize the firm's long-term value.”)

behavioral finance theories that support the *possibility* of differences between short-term and long-term prices, but the corporate governance literature fails to engage with or often even articulate the underlying theory. As a result, the long-and-short arguments rest on a set of controversial, unarticulated, and often internally inconsistent assumptions about financial markets, and represent a rickety theory of financial markets not a theory of corporate governance.

In addition to resting on shaky and unarticulated assumptions about financial markets, the premise of the long-and-short movement is also fundamentally incompatible with bedrock principles of corporate law. The core premise of the argument is that the interests of shareholders with long horizons conflict with those with short horizons. However, the rarely acknowledged fact is that such recognition of conflicts of interest among shareholders based on investment horizon would overturn much of corporate law. Corporate law treats shareholders' interests qua shareholders as fungible, a fundamental underpinning of corporate law that is necessary to explain the business judgment rule treatment of dividends, share repurchases, and other routine corporate actions. If different investment horizons have different interests that implicate the duty of loyalty, conflicts of interest would be ubiquitous. Shareholders with different investment horizons would have conflicts with one another. Since managers are usually shareholders, they too would have conflicts with other shareholders that would arise in virtually every corporate decision. In effect, such a recognition would render the business judgment rule a dead letter.¹³

This Article argues that the long-and-short debate is an overreaction to market and corporate governance activities that are neither new nor accurately theorized by the growing long-and-short literature. This Article develops these arguments in five parts. Part I describes the long-and-short argument and its proposals for constraining activist investors. This Part endeavors to bring some clarity to the core arguments of the long-and-short theorists, which is plagued by inconsistency and vagueness. Part II is the analytical core of this Article, which demonstrates that the long-and short theory of short-term versus long-term investment horizon is implicitly a theory of finance, and an unlikely one at that. Part III illustrates how the seemingly innocuous long-and-short proposals would undermine much of American corporate law, including essentially eliminating the business judgment rule. Part IV exposes the open secret that the short-term versus long-term debate is not really a debate about investment horizon, but instead a thinly veiled attempt to deviate from the shareholder wealth maximization imperative. Part V explains how the growing long-and-short

¹³ See *infra* Part III.

movement poses a potentially serious threat to Delaware's dominance in American corporate law.

I. THE LONG AND SHORT OF CORPORATE GOVERNANCE

The long-and-short argument is relatively straightforward to describe. It starts with the premise that many investors, especially institutional investors, do not plan to hold their shares for long periods of time and therefore have short investment horizons. These short-term investors are thought to pressure managers to take short-term oriented actions in order to increase the short term price of shares.¹⁴ This works, according to the long-and-short theorists, because short term investors will penalize (or not sufficiently reward) long term investments, pushing the price down (or not as high as it should be) if management undertakes long-term strategies. Thus, the argument is that management will take actions designed to increase (or maintain) share price in the short term, even though these actions will reduce share price in the long term.

The linchpin of the long-and-short movement is that there is a conflict between long-term and short-term shareholder interests in corporate governance. According to the long-and-short perspective, shareholders who plan to hold their shares only for a short period of time favor myopic corporate governance gimmicks that result in temporary stock price increases. This often means putting pressure on managers by facilitating takeovers. In contrast, long-term shareholders favor sustainable strategies over years or decades that the market does not reward immediately but pay off in the long-run. This often means insulating managers from market pressures that would facilitate takeovers.

The long-and-short literature has been vague, however, about exactly how corporate governance reforms promoted by institutional shareholders increase short-term value but harm long-term value. This Part attempts to define a theoretically coherent core of consensus among the commentators around three key steps in the long-and-short argument: (1) shareholders have different "investment horizons" based on the planned duration of shareholding, (2) shareholders with shorter investment horizons have

¹⁴ See, e.g., Bebchuk, *supra* note 7. Bebchuk distinguishes between two types of mechanisms alleged by the long-and-short theorists. The first is "shareholder pressure to take particular actions" that are short-term oriented, and the second is that "the fear of shareholder intervention (or even removal by shareholders) ... leads management itself to initiate and take actions that are profitable in the short term but detrimental in the long term." *Id.* Although I agree that these two are analytically distinct, I largely combine the two because actions in the first category typically require the cooperation of management, which is allegedly procured through the pressure in the second category. The distinction makes no difference for the argument in this Article.

different interests from those with longer investment horizons; (3) the different interests of short-term shareholders lead to different corporate governance and policy preferences from those of longer-term shareholders.

The next section describes the background principal agent model against which the long-and-short theorists are responding. Part I-B then explains the long-and-short objection based on investment horizon. Section I-C then explains the long-and-short theory of the connection between investment horizon and the governance horizon.

A. *The Background Model*

The long-and-short literature usually takes as its point of comparison the prototypical principal-agent model of the corporation.¹⁵ The principal-agent model posits that suppliers of financial capital (the shareholder) hire managers of the firm (the officers and directors) to carry on a business.¹⁶ The managers are charged with maximizing the value of the firm but because managers typically own only a fraction of the total equity of the firm, they have incentives to take actions that benefit themselves, rather than the corporation. Accordingly, some means of monitoring the performance or bonding management is necessary to constrain the agency costs that would otherwise result from misaligned incentives.¹⁷

There are a number of ways in which on agency costs might be constrained, but most relevant to corporate governance activism is the shareholder franchise, including the ability to replace management.¹⁸ A common rationale for the franchise reasons that shareholders are entrusted with voting power because they are the “residual claimants,” standing last in line for payment, and receiving the residual worth of the firm only when,

¹⁵ See, e.g., Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 U.C.L.A. L. REV. 562 (2006) (describing the principal-agent theory of corporate governance); Margaret Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248-265 (1999) (objecting to the principal-agent model and advocating an alternative team production theory of the corporation). The classic treatment of the principal-agent model is Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976).

¹⁶ See Andrei Shleifer; Robert W. Vishny, *A Survey of Corporate Governance*, 53 J. FIN. 737, 740-741 (1997).

¹⁷ Monitoring itself imposes costs, which together with the residual costs of misaligned incentives and bonding costs collectively constitute “agency costs.” See *id.*

¹⁸ Other constraints include the capital markets, the product markets, incentive compensation arrangements, fiduciary duties, and the market for corporate control. See, e.g., Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811, 831-832 (1992).

all fixed claims are paid.¹⁹ As a result, of all the stakeholders in the firm, shareholders “receive most of the marginal gains and incur most of the marginal costs” in corporate decisions, which is thought to give them the best set of incentives.²⁰ That is not to say that the shareholders themselves may not have incentives that conflict with those of other holders of claims on the corporation. But those other claimants protect themselves through contracts.²¹ In the end, the “shareholders are the group with the appropriate incentives” to maximize the value of the firm.²²

Although they may have the appropriate incentives as a group, shareholders face a collective action problem in monitoring management.²³ Most shareholders are passive investors with only a fractional stake in the corporation.²⁴ If a shareholder expended resources in monitoring management, he or she would only receive a portion of the benefit, while bearing all of the costs.²⁵ Monitoring is a public good, and as a result shareholders have incentives to “free ride” on the governance efforts of others.²⁶ One way to overcome the collective action problem is to aggregate the shares and votes in fewer hands, so that more concentrated shareholders would have stronger incentives to expend resources in monitoring management.²⁷ Aggregating shares and votes would, in essence, bring ownership and control back together.

The extreme case of aggregation overcoming the collective action problem is the hostile takeover.²⁸ If a company is poorly managed, its share price will drop in the market. The depressed share price would attract a hostile bidder, who would launch a tender offer for the shares, acquiring the voting rights with those shares. Thus, the voting rights would be

¹⁹ Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 403 (1983).

²⁰ *Id.*

²¹ *See id.* at 404-405.

²² *Id.*

²³ On collective action problems generally, *see* MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (2d ed. 1971). In the corporate context, this is a consequence of what Professor Mark Roe calls the “classic story” of the Berle-Means separation of ownership from control in the widely held corporation. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 12-13 (1991).

²⁴ *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1170-1171 (1981).

²⁵ *Id.*

²⁶ Oliver Hart, *Corporate Governance: Some Theory and Implications*, 105 ECON. J. 678, 681 (1995).

²⁷ Easterbrook and Fischel, *supra* note 19, at 402-403.

²⁸ The classic exposition of this is found in Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

concentrated in the hands of the bidder who has the economic incentives to improve firm value, and would replace the underperforming management. This would serve both to provide ex ante incentives to existing management to act in the shareholders' best interests and remove managers ex post who failed to act in shareholders' best interests.

The prospects for the hostile takeover as a solution to corporate governance problems were effectively squashed by Delaware's case law and statutory enactments in the late 1980s and early 1990s, however, and the idea of the market for corporate control receded into the background. As that happened, however, the rise of the institutional investors began. As institutional investors increased their holdings in public companies, scholars increasingly viewed institutions as the potential champions of the rationally apathetic shareholder.²⁹ Larger shareholders have better incentives to collect information and monitor management.³⁰ The institutions, which held comparatively large stakes in the corporation and had more sophistication than retail shareholders could potentially provide meaningful monitoring through elections.

The idea that large, institutional shareholders could provide monitoring works according to standard financial theory because shareholders have fungible and therefore identical interests in the corporation. Thus, what benefits the large institution that holds many shares (but not a controlling stake) benefits the retail investor who holds only a few shares. This makes it possible for a few large shareholders to serve as champions for the interests of all shareholders, although the "free-riding" problem will prevent perfect monitoring unless all of the stock is acquired.³¹

B. *The Investment Horizon Objection*

The long-and-short literature rejects the key underpinnings of the institutional shareholder monitoring solution, just as it did the hostile takeover solution. It contends that that long-term shareholders have

²⁹ See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 575-91 (1990) (1990) (arguing that institutional shareholders have the incentives to monitor management); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811, 830-839 (1992) (arguing that "institutional voice can improve corporate performance"); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

³⁰ See Andrei Shleifer; Robert W. Vishny, *A Survey of Corporate Governance*, 53 J. FIN. 737, 754 (1997).

³¹ Although it is possible that an institution (just like management) could provide itself with private benefits that do not accrue to shareholders generally, see Hart, *supra* note 26, at 683, such misbehavior is likely to be more easily observed than simple mismanagement.

different interests from short-term shareholders. As a result, shares are not fungible and therefore shareholders are not homogenous in their preferences regarding corporate policy. Instead of embracing a model of a homogeneous “principal,” the long-and-short theorists see shareholders as a motley assortment of actors with a variety of differing and conflicting interests.³² Accordingly, there is no single “residual” owner of the corporation who is the ideal repository of voting control over the corporation, and therefore no champion for the shareholders as a whole. In a sense, this is a rejection of the concept of a “principal” in the principal-agent approach.

The core argument of the long-and-short theorists is that there is a deep conflict among shareholders *as shareholders*. The conflict derives from the differing investment horizons of shareholders, which are thought to translate into different policy preferences over governance. The theory is that shareholders who plan to hold their shares for a relatively short period of time have interests in maximizing share price in the short-term, while shareholders who plan to hold their shares for a longer period of time have interests in maximizing share price in the longer term. Hence, some corporate policies will benefit short-term shareholders and others will benefit long-term shareholders, creating a conflict of interest. To the extent that short-term shareholders engage in corporate governance activism, that activism may harm the interests of longer-term shareholders.

The long-and-short distinction has produced a flurry of articles since the early 1990s.³³ The core theme of these articles is that there is a “stark difference” between the interests of short-term and long-term investors.³⁴ The argument is that “[s]hort-term shareholders prefer managers to maximize short-run share price, while long-term shareholders prefer to forego immediate gains in favor of maximizing long-run shareholder value.”³⁵ The two groups have interests that diverge not occasionally, but

³² See, e.g. *See, e.g.*, Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 U.C.L.A. L. REV. 562, 564 (2006) (asserting that there “deep rifts among the interests of large blockholders” and “the characterization of shareholders as having interests that are fundamentally in harmony with one another” “does not reflect the existing pattern of share ownership in U.S. public companies.”)

³³ Kelli A. Alces, *The Equity Trustee*, 42 ARIZ. ST. L.J. 717, 728-731 (2010); Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 492-494 (2008); Anabtawi, *supra* note 15, at 579-583; Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822, 1839-1849 (2011). Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513 (1993).

³⁴ See Alces, *supra* note 33, at 728.

³⁵ See Anabtawi, *supra* note 15, at 579.

rather “they are in conflict most of the time.”³⁶ As a result, shareholders are not a homogenous group seeking to maximize a single quantity such as a stock price, but a variegated collection of investors with significant disagreement about corporate policy.

The problem is exacerbated, according to the long-and-short literature, is the increasing influence of institutional investors in corporate governance. Not all institutional investors are equally objectionable to all long-and-short commentators. Those institutions that are perceived to be permanent shareholders, such as pension funds, are sometimes lauded.³⁷ Singled out for singular contempt are hedge funds and arbitrageurs, who are described as “favor[ing] a short-term spike in the share price over long-term wealth creation.”³⁸ The criticism of hedge funds has become the most virulent in recent years, and indeed they have become the central focus in the long-and-short debate. As Kahan and Rock put it:

Short-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism. The other dark side problems represent relatively isolated and narrow concerns that do not relate to hedge fund activism as a whole. Short-termism, by contrast, arguably pervades hedge fund activism, and the accusation that hedge funds induce managerial short-termism has become the main ammunition for hedge fund critics.³⁹

Although the long-and-short movement has grown primarily in scholarly journals, it has deeply influenced the thinking of the judiciary. In fact, a significant percentage of the members of the influential Delaware judiciary appear to have joined the long-and-short movement, endorsing the idea that short-term and long-term shareholders have different interests.⁴⁰

³⁶ Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C.L. REV. 137, 140 (1991).

³⁷ See, e.g., Anabtawi, *supra* note 15, at 580 (distinguishing between the short-term horizons of mutual funds and hedge funds on the one hand and the long-term horizons of pension funds and insurance companies on the other).

³⁸ 93 Va. L. Rev. 733,746. Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003) (describing hedge funds as “seek[ing] to push the corporation into steps designed to create a short-term pop in the company's share price.”)

³⁹ Kahan & Rock, *supra* note 8, at 1087.

⁴⁰ William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1085 (“one must distinguish between the interests of a short-term stockholder who has bought

The judges often go farther than that, however, singling out institutional investors as the culprits in short-term investing. The former Chief Justice of Delaware has referred to institutional investors as acting in “wolf packs.”⁴¹ Another former Delaware Supreme Court justice claims that the rise of institutional investors has caused a focus on “short-term profits, often at the expense of the long term.”⁴² In another article he writes that there is an “impatient capital problem needs to be fixed” using “changes in current U.S. corporate law.”⁴³ The new Supreme Court justice and former Delaware Chancellor sees the institutional activists engaging in “gimmicks” to “pump up stock prices in the short term”⁴⁴ And argues that institutional investors with short-term investment horizons encourage companies to take too much risk.⁴⁵

The phrase “short-term shareholder” might conjure up visions of high frequency computerized trading. If such shareholders were exerting power over corporate governance then the long-and-short argument would have some validity. But the long-and-short theorists are not aiming at such traders as they cannot exercise any governance influence with their transient positions anyway. At the low end, the long-and-short theorists believe that it takes five years of shareholding to transition out of the “short-term” category,⁴⁶ while others believe that even a decade of shareholding is short-term.⁴⁷ Thus, the long-and-short theorists, in many cases, see as “short-

into a stock after hearing of takeover rumors and the interests of a hypothetical investor who has entrusted his capital to the corporation for an indefinite and lengthy period of time. A merger deal that would satisfy the former may not satisfy the latter because it could diminish the corporation's ability to deliver higher long-term returns.”) The relevant corporate law judiciary in Delaware consists of the Court of Chancery, which has five members, see <http://courts.delaware.gov/Chancery/judges.stm>, and the Supreme Court, which also has five members, see <http://courts.delaware.gov/Supreme/justices.stm>.

⁴¹ Stanfordlawschool, *Shareholder Empowerment vs. Board Authority*, YOUTUBE (Nov 15, 2011), <http://www.youtube.com/watch?v=Bnw1AXi3b-c>.

⁴² Jacobs, *supra* note 2, at 1650.

⁴³ *Id.* at 1649.

⁴⁴ Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 12 (2010)

⁴⁵ Leo E. Strine, Jr., *Why Excessive Risk-Taking Is Not Unexpected*, N.Y. TIMES DEALBOOK (Oct. 5, 2009, 1:30 PM), <http://dealbook.blogs.nytimes.com/2009/10/05/dealbook-dialogue-leo-strine/>

⁴⁶ See Aspen Inst., *Long-Term Value Creation: Guiding Principles for Corporations and Investors 1* (2007), available at <http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/FinalPrinciples.pdf>.

⁴⁷ Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1774, n. 40 (2006) (describing stock returns over “a thirteen-year period” as “a sitcom-length rather than a motion picture-length view.”) Assuming this metaphor is “to scale,” then Chancellor

term” shareholders as those who plan to hold for years, or even a decade.

The broad-based consensus that short-term, institutional shareholders have interests that conflict with those of other shareholders seems to be well established among the long-and-short adherents. How institutional shareholders are purported to put those interests into action is described in the next section.

C. Short-Term Markets Cause Short-Term Management Strategy

The reason why the investment horizon of shareholders matters, according to the long-and-short theorists, is because activist short-term shareholders pressure management to take short-term corporate governance policies.⁴⁸ If investors have different investment horizons and different investment horizons lead to conflicting interests over corporate policy, then short-term shareholders might want different corporate policies from investors with longer horizons.⁴⁹ As a result, the short-termers might use their individual or collective influence to pressure management to adopt short-term policies that could harm long-term shareholders.

The key step in this argument is that there are presumed to be certain concrete policies that short-term investors and harm long-term investors. There is a cluster of corporate policies that long-and-short adherents typically identify as serving the short-term interests. The first, perhaps surprisingly, are dividends and share repurchases. In particular, they rail against leverage and repurchases of stock. They argue that institutions want to increase “short-term earnings” by cutting research and development.⁵⁰ More than anything, the long-and-short commentators despise the combination of leverage returning cash to shareholders.⁵¹

Strine is thinking of at least three decades.

⁴⁸ See, e.g., David P. Porter, *Institutional Investors and Their Role in Corporate Governance: Reflections by a “Recovering” Corporate Governance Lawyer*, 59 CASE W. RES. L. REV. 627, 678 (“[H]edge funds pressure Boards to ignore the long-term and, especially, to favor the short-term interests of the shareholders versus the long-term interests of the corporation as a whole.”)

⁴⁹ Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1745 (2006) (“Shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, which is likely to result in disagreements about corporate strategy.”)

⁵⁰ See, e.g., Anabtawi, *supra* note 15, at 580-582. See also Anabtawi and Stout, *supra* note 5, at 1291 (“Third, stock price can be driven upward temporarily by increasing short-term earnings at the expense of long term results, e.g., by cutting research and development, or by moving revenues from future periods into the current accounting period.”); Estreicher, *supra* note 33, at 551-560.

⁵¹ Roberta Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1 (2004) (“During the 1980s, the pressure for high overall

All of these actions require the intervention of managers, so the long-and-short commentators argue that managers who know better take these myopic actions because of pressures in the capital markets and from activist investors. The argument is that myopic markets will penalize managers for long-term investment, pressuring them to govern for short-term objectives.⁵² Similarly, activist investors will push for board seats and other corporate policy changes when the stock price falls, pressuring managers to take actions that will satisfy the myopic capital markets. Managers take these actions because they fear being ousted in a proxy campaign or being subject to a hostile takeover of their firm.

The long-and-short argument focuses on the possibility that activist shareholders push for corporate policy that will increase share price in the short term but decrease share price in the long term. The entire argument, therefore turns on the questions of whether the markets are myopic in a systematic, predictable ways that allow short-term shareholders to reap benefits at the expense of longer-term shareholders. The next Part explores this question from the perspective of financial economics.

II. A THEORY OF GOVERNANCE IS A THEORY OF FINANCIAL MARKETS

The long-and-short analysis set forth above all hinges on a series of interconnected claims: (1) that short-term stock prices differ systematically from long-term stock prices, (2) that these differences are predictable to short-term investors, allowing the investors to agitate for policies that temporarily “pump up” the stock price, and (3) that in the absence of capital market discipline managers would take a longer governance horizon that would better serve long-term corporate interests. Each of these claims must be true for the long-and-short argument to provide any useful information about corporate governance.

This Part dissects these claims one-by-one, finding that each of them rests on highly dubious assertions. The first claim is met at the outset with the “arbitrage objection,”⁵³ described below. The second claim connects stock prices to corporate governance in a way that implicitly adopts a highly implausible and internally inconsistent theory of corporate finance. The third claim implicates dubious behavioral assumptions about corporate

return by institutional investors in U.S. corporations resulted in an unhealthy leveraging of U.S. corporations to meet that demand. Funds were borrowed to pay dividends to shareholders, in the form of ordinary cash distributions, share repurchases, or takeover premiums.”)

⁵² Nadelle Grossman, *Turning a Short-Term Fling into a Long-Term Commitment: Board Duties in A New Era*, 43 U. MICH. J.L. REFORM 905, 922-932 (2010).

⁵³ See Alon Brav, J.B. Heaton, & Si Li, *The Limits of the Limits of Arbitrage*, 14 REV. FIN. 157, 158 (2010).

managers. This Part argues that the capital markets, far from being the source of a difference between short-term and long-term values, are actually the reason for their equivalence.

A. *The Arbitrage Objection*

The long-and-short argument contends that short-term shareholders agitate for corporate policies and governance arrangements that “pump up” the short-term prices but will cause lower long-term prices. An immediate objection to this account arises: why would short-term prices differ from long-term prices as a result of shareholder activism? If the markets do not correctly value long-term strategies, why would not rational arbitrageurs take advantage of this and drive the mispricing out of the market? This simple economic logic, which might be called the “arbitrage objection,”⁵⁴ is a foundational concept in the theory of efficient capital markets.

As an example, suppose that the long-and-short theorists are right that short-term investors irrationally undervalue research and development expenditures. If corporate management refused to capitulate to short-term market pressures, investing in research and development even though that causes the company to miss its earnings estimate, the stock price would drop according to the long-and-short theorists. The arbitrage objection would suggest that other, longer-term investors would buy up the stock of this well-managed company bidding the price back up. Thus, the incentives of the capital markets lead to the conclusion that “the distinction between maximizing firm value for the present versus maximizing firm value for the future is wholly false” and “characterizing some shareholders as ‘temporary’ (only interested in the short run) and others as ‘permanent’ (only interested in the long run) is fatuous.”⁵⁵

The same type of analysis applies to activist investors who pressure management for corporate governance reforms. The long-and-short theorists contend that these types of activists are after a short-term price increase as the market reacts to changes in corporate governance, such as de-classifying the board of directors. But the stock would not increase, even in the short term, in response to a destructive long-term policy. After all, in order for an activist to profit from a “short-term” increase, “other investors must be willing to buy at the increased price and subsequently bear the long-term consequences of the corporate actions.”⁵⁶ The most elementary financial economics would suggest that “[i]f a governance provision does not serve

⁵⁴ *Id.* at 158.

⁵⁵ Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 481.

⁵⁶ Bebchuk, *supra* note 7, at 1665.

long-term shareholder value, its adoption will likely reduce short-term prices (which reflect expectations about long-term value)."⁵⁷ This is a basic implication of a minimally efficient market.

The concept of efficient markets comes in two related but analytically distinct versions. The first version holds that “portfolio managers cannot outperform the market to an important extent by trading using publicly available information.”⁵⁸ The second holds that “financial market prices represent rational assessments of fundamental values.”⁵⁹ Although the second claim is important for certain econometric purposes,⁶⁰ the first version is the one applicable to the long-and-short argument, because an assumption of that argument is that stock price movements are predictable in the short- and long-term, and therefore it is possible for portfolio managers to outperform the market.⁶¹

The efficient markets claim could be expressed in many ways, but a robust form of market efficiency means that “security prices fully reflect all available information.”⁶² But few people claim that, because there are positive costs to information and trading.⁶³ It’s the “efficient capital markets,” not the “perfect capital markets” hypothesis, and really only critics of the hypothesis define efficiency as requiring perfection.⁶⁴ Even the “founder” of the efficient capital markets research program says that that “extreme version” of the hypothesis is “surely false.”⁶⁵ Thus, “prices reflect information to the point where the marginal benefits of acting on information (the profits to be made) do not exceed the marginal costs.”⁶⁶

⁵⁷ Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1802 (2006).

⁵⁸ Lawrence Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591, 593 (1986).

⁵⁹ *Id.*

⁶⁰ For example, certain event studies rely on the “fundamental values” claim. *See id.*

⁶¹ The long-and-short theorists move back and forth between the two different versions. At some moments they focus on the “fundamental value” version of efficient markets. *See, e.g.,* Anabtawi, *supra* note 15, at 581. At other moments they acknowledge there are these two different versions of the ECMH, “informational efficiency” (focusing on “whether information can be used to extract trading profits”) and “fundamental value efficiency” (focusing on whether “market prices mirror the best possible estimates, in light of all available information, of the actual economic values of securities.” Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 639-641 (2003).

⁶² Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575 (1991).

⁶³ *Id.*

⁶⁴ *See, e.g.,* Grossman, *supra* note 52, at 914 (“This theory of the stock market - as being perfectly efficient - is referred to as the efficient capital market hypothesis, or ECMH.”)

⁶⁵ Fama, *supra* note 62, at 1575.

⁶⁶ *Id.*

Instead, the argument is that the “market is efficient with respect to information set θ_t if it is impossible to make economic profits by trading on the basis of information set θ_t .”⁶⁷

In order for short-term prices to differ in predictable ways from long-term prices, the capital markets must be inefficient. Even the long-and-short theorists concede that if markets are efficient, there is no distinction between short-term and long term,⁶⁸ and therefore no long-and-short argument. In other words, at best the long-and-short argument can possibly have validity only to the extent that the market is inefficient.

B. The Behavioral Finance Reply

The long-and-short theorists claim, therefore, that markets are not efficient,⁶⁹ and that these inefficiencies lead to a focus on short-term value rather than long-term value.⁷⁰ The claim that markets are not efficient draws upon a rich literature in behavioral finance,⁷¹ “an alternative view of financial market” in which “systematic and significant deviations from [market] efficiency are expected to persist for long periods of time.”⁷² The umbrella of behavioral finance is very broad, but contains at least three broad research agendas:⁷³ (1) psychology of decision-making in the Kahneman and Tversky heuristics and biases agenda, (2) contrarian investing and calendar effects, which includes mean reversion and momentum, and (3) the “noise trader” research, which includes the “limits of arbitrage” argument. These approaches have developed to attempt to

⁶⁷ Michael C. Jensen, *Some anomalous evidence regarding market efficiency*, 6 J. FIN. ECON. 95, 96 (1978).

⁶⁸ Anabtawi, *supra* note 15, at 581 (explaining that “in an efficient stock market, the time horizon of a shareholder should not affect how that shareholder would like to see the firm managed.”); *see also* Kahan & Rock, *supra* note 8, at 1084 (explaining that without capital market myopia, “interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons.”) Some have argued that managerial myopia can exist even in the context of efficient markets, but that is a different argument. Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989).

⁶⁹ *See generally* Stout, *supra* note 61. *See also* Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: Quinquennial Election of Directors*, 58 U. CHI. L.R. 187, 198-199 (1991).

⁷⁰ Grossman, *supra* note 52, at 914-922.

⁷¹ For a recent accessible introduction to behavioral finance, see EDWIN T. BURTON & SUNIT N. SHAH, *BEHAVIORAL FINANCE: UNDERSTANDING THE SOCIAL, COGNITIVE AND ECONOMIC DEBATES* (2013).

⁷² ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* 2 (2000).

⁷³ BURTON AND SHAH, *supra* note 71, at 222.

explain a set of so-called “anomalies” in the markets.⁷⁴

The most relevant literature in behavioral finance to the long-and-short debate, however, is the “limits of arbitrage” research in the noise trader approach. In these models, the “market” is populated by two types of participants, “noise traders” who do not assess a stock’s value accurately, and arbitrageurs, who do. The coordinated action of the noise traders can cause the price of stocks to deviate from their fundamental values. But the prices do not quickly adjust to the noise traders’ actions because of limits on the ability of arbitrageurs to address stock mispricing.⁷⁵ These limits typically derive from capital market imperfections in the arbitrageurs’ own sources of funds and the way in which their performance is assessed. Prices may deviate even farther from the inefficient price created by the noise traders, and therefore arbitrage becomes risky, limiting arbitrage participation. As a result, the behavioral finance theorists argue, “in contrast to the efficient markets theory, real-world arbitrage is risky and therefore limited.”⁷⁶

The reason that the limits to arbitrage approach is relevant to the long-and-short debate is that it provides explanations for why short-term prices could *theoretically* diverge from long-term prices. The capital market imperfections or the evaluation of arbitrageurs’ performance by their own investors can lead to short investment horizons for the arbitrageurs, keeping short-term prices different from long-term prices for some time. In addition, investors with short horizons may lead to informational inefficiencies and suboptimal allocation of research effort through “herding” behavior that might further cause prices to deviate from fundamentals.⁷⁷ These articles show that myopic market behavior is at least possible from a theoretical perspective. The evidence has made many less confident in the relevance of the efficient markets hypothesis than they once were.⁷⁸

⁷⁴ For example, one of the classic “anomalies” is the case of closed-end funds, which tend to trade at discounts to their net asset values. See Summers, *supra* note 58, at 600.

⁷⁵ See, e.g., Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35 (1997) (developing a model of how arbitrage activity might fail to correct divergence of asset prices from fundamental value).

⁷⁶ SHELIFER, *supra* note 72, at [].

⁷⁷ Kenneth A. Froot, David S. Scharfstein, & Jeremy C. Stein, *Herd on the Street: Informational Inefficiencies in a Market with Short-Term Speculation*, 47 J. FIN. 146, 1462-1463 (1992) (arguing that short-term horizons of speculators can lead to informational inefficiencies in the market as speculators “herd” on particular pieces of information, misallocating research effort). Investors may even invest in information unrelated to fundamental values. *Id.*

⁷⁸ Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 397 (2004) (arguing that although ECMH “remains more or less intact after Enron as a theoretical academic construct, it is not obvious what relevance, if any, the theory still holds”).

Limits of arbitrage models vary but they typically share a common underlying assumption, namely that arbitrage opportunities are hard to identify, and therefore “arbitrage resources are heavily concentrated in the hands of a few investors that are highly specialized in trading a few assets.”⁷⁹ This means that “only a relatively small number of specialists understand the return anomaly well enough to exploit it.”⁸⁰ As a result, the limited arbitrage arena will be limited to mispricing that relates to arcane details, rather than well-understood phenomena. This limitation on the limits of arbitrage model plays an important role in the discussion that follows.

C. The Indeterminacy Problem

The behavioral finance literature has raised many valid objections to the efficient capital markets hypothesis in certain limited circumstances. Although behavioral finance models are very controversial in mainstream finance research,⁸¹ they appear to capture important ways in which markets might deviate from efficiency. The long-and-short theorists tend to exaggerate the extent to which the efficient markets hypothesis has been undermined; indeed, it appears that a cluster of law review articles have concluded that efficient markets hypothesis has been refuted inside an echo chamber of a few authors.⁸² In reality, the degree to which there are limits to arbitrage is highly controversial in the finance literature.⁸³ There is no doubt, however, that behavioral finance approaches have been influential.

The problem is that even if one accepted that capital markets are not always efficient, it is not sufficient to substantiate the long-and-short perspective simply say that markets are inefficient. Even if we jettison the

⁷⁹ Shleifer and Vishny, *supra* note 75, at 52.

⁸⁰ *Id.* at 53.

⁸¹ See *infra* notes __ to __ and accompanying text.

⁸² One article asserts that the “ECMH, however, is no longer regarded as an accurate description of the real world.” Anabtawi, *supra* note 15, at 581. For that proposition, the author cites a page from a law review article. See *id.* at 581 n. 94 and accompanying text (citing Stout, *supra* note 61, at 667).

⁸³ Unlike legal academics, finance professors appear to accept weak form efficiency and are deeply divided about semi-strong form efficiency. In a recent survey, approximately seven times as many finance professors agreed with the weak form of the ECMH than disagreed with it. See James S. Doran, David R. Peterson, and Colby Wright, *Confidence, Opinions of Market Efficiency, and Investment Behavior of Finance Professors*, 13 J. FIN. MARKETS 174, 179 (2010). In addition, approximately twice as many finance professors agreed with the semi-strong form of the ECMH than disagreed with it. See *id.* It should be noted that in the case of the semi-strong version, the percentage of finance professors who were “neutral” was very significant—51%, see *id.*, a fact that suggests a level of uncertainty incompatible with the categorical claims of legal scholars.

efficient market approach, the implications for corporate governance are unclear, because the implications depends *in what way* the market is inefficient. There is no single “behavioral theory” of finance. Instead, there are “competing behavioral explanations” for many phenomena that offers behavioral finance theorists “numerous degrees of freedom.”⁸⁴ As a result, behavioral finance specialists themselves explain that “[t]o make sharp predictions, behavioral models often need to specify the form of agents’ irrationality.”⁸⁵ This is where behavioral finance in particular and theories of bounded rationality in general tend to break down. One must specify the type of inefficiency of the relevant market, and show the mechanism between that specific type of inefficiency and the mispricing as a result of corporate governance activism.

In this way, the indeterminacy of behavioral theories, taken collectively, stands in stark contrast to the determinacy of the efficient markets theory. If we adopt the efficient market approach, the prescriptive behavior for managers is often clear. The market price is the best estimate of long-term value so, for example, management should not stand in the way of a premium offer to take over the whole company.⁸⁶ Of course, the fact that market efficiency produces specific predictions and behavioral theories do not does not, in itself, provide a reason to adopt the efficient market theory. But this fact does put the onus on those who reject the efficient markets hypothesis to propose a specific alternative that is consistent with their policy recommendations. The problem for the long-and-short theorists is that there is no specific alternative to market efficiency that behavioral finance scholars agree upon.⁸⁷

The long-and-short theorists who write in law reviews, however, do not trouble themselves with these details. They rarely, if ever, articulate the specific mechanism by which stock prices will differ in the short term from those in the long term. Instead, the assumption is simply that market inefficiency leads automatically to short investment horizons dictating short-term behavior. Indeed, the long-and-short accounts are so inadequate that the only clear exposition of them comes from an article arguing against the long-and-short approach.⁸⁸

The problem for the long-and-short argument is that although

⁸⁴ Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in *ADVANCES IN BEHAVIORAL FINANCE* 64 (Richard H. Thaler ed., 2005).

⁸⁵ *Id.* at 2.

⁸⁶ This is what has become known as the “passivity thesis” of Easterbrook and Fischel. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *HARV. L. REV.* 1161 (1981).

⁸⁷ See Eugene F. Fama, *Market efficiency, long-term returns, and behavioral finance*, 49 *J. FIN. ECON.* 283, 284 (1998).

⁸⁸ Bebchuk, *supra* note 7, 1660-1666.

market inefficiency is a necessary condition to the argument of the long-and-short theorists, it is not a sufficient condition.⁸⁹ We may well have market inefficiency without implying the long-and-short model of management-market interaction. To make a credible argument, the movement would need to “specify biases in information processing that cause the same investors to under-react to some types of events and over-react to others.”⁹⁰ In other words, they need to explain why an action supported by activists would have positive short-term price effect and negative long-term price effect.⁹¹

Specifying a model that could simultaneously account for all of the long-and-short’s predictions would be a daunting task. The typical long-and-short argument contends that institutional shareholders intentionally inflate stock prices temporarily through corporate governance activism, while somehow concealing the negative effects of this activity from the broader market, which is fooled into inflating the stock price. To pull this off would require heroic assumptions about their prediction of the exact way in which markets are inefficient. It would also require heroic assumptions about the ability of the short-term investors to not only predict the short-term price but also to predict the long-term price.

The limits to arbitrage discussion makes it clear why corporate governance activism could never form the basis of short-term mispricing. The reason that arbitrage is limited is because of the limited number of people with the specialization to engage in the arcane strategies of arbitrage.⁹² But governance activists have a standard short list of reforms that they push, such as adding outside directors, eliminating staggered boards, redeeming poison pills, declaring dividends of excess cash, and the like. These are not obscure market details that are hidden from all but specialist arbitrageurs; they are “big picture” matters of policy with which all market participants have complete familiarity. Hence, if there were an anomaly in pricing these types of policies, that anomaly would be well understood by now. And as prominent behavioral finance theorists have noted, once the anomaly becomes well understood, the anomalies go away.⁹³

Further, even if the market is inefficient in the sense that there are strategies that could exploit secret information that produces price differentials, governance provisions are particularly unlikely to be the secret information that makes the markets inefficient. As Professor Bebchuk

⁸⁹ See, e.g., *id.* at 1661-1662.

⁹⁰ Fama, *supra* note 87, at 284.

⁹¹ Bebchuk, *supra* note 7, at 1664-1665.

⁹² See *supra* notes ___ to ___ and accompanying text.

⁹³ Shleifer and Vishny, *supra* note 75, at 53-54.

writes,

"[i]t is far from clear that the governance provisions favored by [short-term] shareholders would commonly deviate from those favored by long-term shareholders. If a governance arrangement is widely viewed as detrimental to long-term share value, its long-run effect will likely be reflected in the company's stock price when the arrangement is adopted, and thus the short-run effect of its adoption will likely be negative as well."⁹⁴

There may well be governance provisions that are harmful to the long-term health of the corporation. But governance provisions are so open and generic that the markets are likely to correctly ascertain their long-term values. Most of these governance changes pushed by activist investors come down to one thing: reducing the insulation of directors from the market. As Bebchuk has explained, even if we adopt a long-short distinction, long-term shareholder value is not served by insulating directors from the market.⁹⁵

These considerations illustrate the broader observation that theories about investment horizon in corporate governance are implicitly theories about financial markets. To say that there is a difference between short-term price and long-term price in a particular context is to hypothesize a particular type of market efficiency. The markets may well not be perfectly efficient. But for that to translate into governance recommendations, we need to *in what ways* they are inefficient. Yet legal commentators, judges, and businesspeople do not hesitate for a moment to contrast "short-term prices" with "long-term value," even though such a statement necessarily implies a difference between the two. And to suggest that there is a difference between the two suggests a specific behavioral theory of finance.

The judges are often the most egregious violators in this regard, because they internalize the long-and-short dogma without grasping that that perspective means implicitly adopting a highly controversial theory of financial markets. In part, the problem seems to stem from basic misunderstanding of financial markets from some of the most prominent Delaware judges. Take, for example Chief Justice Strine's response to Bebchuk's claim that staggered boards reduce shareholder wealth. Strine argues in the pages of the Harvard Law Review:

"If Bebchuk is correct about staggered boards, the mutual

⁹⁴ Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 884 (2005).

⁹⁵ See generally, Bebchuk, *supra* note 7.

fund industry is also missing an obvious opportunity. They could sell ‘The Unstaggered 500’ fund comprised of those members of the S&P 500 without staggered boards. With this fund, investors could achieve diversification while achieving superior returns by avoiding companies with staggered boards.”⁹⁶

But of course Bebchuk’s claim does not imply that “obvious opportunity” at all. If unstaggered boards increase shareholder value, standard financial theory would suggest that value would already be impounded into the market price of the shares of companies without staggered boards, so there would be no “superior returns” by buying their shares, even if Bebchuk’s claim is right.

Indeed, Strine is assuming that the market is inefficient in an attempt to rebut Bebchuk’s reliance on market efficiency. Thus, in order for Strine’s argument to have any validity, he must be positing a specific type of market defect that would inhibit the market from responding positively *right now* to the adoption of a non-staggered board. He has not proposed such a theory or even engaged seriously with behavioral finance theories that might be harnessed for this purpose. This suggests that part of the long-and-short view is the failure to fully appreciate that the long-and-short distinction requires a specific behavioral theory for support.

One of the best illustrations of this fundamental misunderstanding is the way long-and-short theorists slip effortlessly between talking about short-term and long-term corporate profits and short-term and long-term stock price as if they were the same thing. To say that managers should maximize shareholder value is not the same as saying that maximizing “profits” in the accounting sense, whether short-term or long term.⁹⁷ This is evident when long-and-short theorists conflate accounting concepts with market concepts, arguing that short-term investors want to engage in gimmicks such as moving revenues to earlier periods and expenses to later periods, arguing that this will (temporarily) increase share price.⁹⁸ They claim that this is what efficient markets theorists do, but in fact that is the opposite of what the efficient markets hypothesis would suggest.⁹⁹

⁹⁶ Strine, *supra* note 47, at 1774.

⁹⁷ Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 U.C.L.A. L. REV. 277, 302-306 (1990) (explaining that maximizing “earnings” or other accounting measures of corporate performance distorts incentives in a way that is inconsistent with maximizing shareholder wealth).

⁹⁸ See, e.g., Anabtawi, *supra* note 15, at 581-582. See also Grossman, *supra* note 52, at 916-919 (discussing various accounting rules and their purported “short-term” bias on stock prices).

⁹⁹ Hu, *supra* note 97, at 336-337 (“The underlying assumption, that the stock market

The long-and short argument is aimed at certain types of corporate policies or actions that activists favor. They believe that such actions increase share price in the short term but ultimately decrease value in the long term. These policies and actions typically include increasing dividends, increasing leverage, increasing risk, and decreasing expenditures on research and development. They do not, however, point to systematic empirical evidence that these policies or institutional ownership in general is harmful to shareholder wealth. Nor could they, as such evidence does not exist, and indeed the empirical evidence is to the contrary.¹⁰⁰

Probably the most common claim asserted by long-and-short theorists is that short investor horizons will lead corporations will underinvest in research and development or other long-term projects. The argument is that if managers are compensated based on short-term metrics or that they fear a takeover if the stock price drops too much, they will shun longer-term projects and slash research and development.¹⁰¹ However, the connection between short investor horizons and underinvestment in long-term projects is not immediate, leading others to argue that it is "not entirely plausible that markets systematically undervalue long-term projects," and indeed "it is at least as likely that the opposite is true."¹⁰² Indeed, under some circumstances short-termism among managers could lead to over-investment in long-term projects such as research and development.¹⁰³ In any event, the evidence is at least as strong that exposure to the market increases research and development.¹⁰⁴

There are both theoretical reasons¹⁰⁵ and empirical evidence¹⁰⁶ to believe that the appearance of large institutional holders might cause an

focuses narrowly on current earnings and other accounting numbers, is inconsistent with the basic operative principle of the EMH itself as well as with direct evidence of market reactions to long-term activities.”)

¹⁰⁰ See, e.g., Bebchuk, *supra* note 7, at 1667-1676.

¹⁰¹ See Lucian Arye Bebchuk and Lars A. Stole, *Do Short-Term Managerial Objectives Lead to Under- or Over-investment in Long-Term Projects?*, 48 J. FIN. 719, 720-721 (1993) (describing as “commonly accepted” the notion that managers have short-term objectives for these reasons).

¹⁰² JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* 267 (2008).

¹⁰³ See Lucian Arye Bebchuk and Lars A. Stole, *Do Short-Term Managerial Objectives Lead to Under- or Over-investment in Long-Term Projects?*, 48 J. FIN. 719, 720-721 (1993) (describing the conditions under which short-term managerial perspectives could lead to over- or under- investment in long-term projects).

¹⁰⁴ See Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 993-994 (2013).

¹⁰⁵ See Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481, 2504.(2009).

¹⁰⁶ Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22 REV. FIN. STUD. 3941 (2009)

increase in research and development. Indeed, it doesn't matter whether the institutional holders are short-term or long-term, as even "short-term trading may in fact support long-term investment, as it impounds its effects into stock prices."¹⁰⁷ The point is that the mere assertion of a short investment horizon does not automatically lead underinvestment. Instead, a mechanism must be specified, such as that proffered by Bebchuk and Stole, pursuant to which underinvestment is likely when the market cannot observe the level of investment, and overinvestment is likely when the market cannot observe the productivity of long-term investment.¹⁰⁸ In other words, even if we take short-term managerial focus as a given, that focus could lead to either overinvestment or underinvestment depending on the specific type of model one adopts.

The end result of the carelessness of the long-and-short argument is that it has become so ingrained in lawyers' thinking as to not draw critical thinking. As an example, consider the report issued in 2008 by the task force of the American Bar Association's Section of Business Law Corporate Governance, Committee on Delineation of Corporate Governance Roles and Responsibilities released.¹⁰⁹ The report is infused throughout with references to long-term versus short-term objectives, and spends several consecutive pages describing the issue in detail.¹¹⁰ Yet there is no mention anywhere in the Report that markets might have some role in equalizing short-term and long-term interests, let alone that mainstream financial economics suggests there is no difference between the two. The Report does not explain why short-term prices might differ from long-term prices, and how the market imperfections that produce those differences are triggered by particular corporate policies under discussion.

The argument here is not that managers never behave in a short-term oriented manner, or that they might even do so in the belief they will thereby please the market.¹¹¹ The argument is not that the manager should operationally privilege the short term. But the manager shouldn't necessarily privilege the long term either. Long-term payoffs are not a good in themselves; indeed, the opposite is true all things being equal because of the time value of money. Instead, managers should use an optimal operational horizon, discounting longer-term payoffs to present value to make positive net present value investment decisions.

¹⁰⁷ Edmans, *supra* note 105, at 2504.

¹⁰⁸ *See id.* at 726-727.

¹⁰⁹ AM. BAR ASS'N, REPORT OF THE TASK FORCE OF THE ABA SECTION OF BUSINESS LAW CORPORATE GOVERNANCE COMMITTEE ON DELINEATION OF GOVERNANCE ROLES AND RESPONSIBILITIES (2009).

¹¹⁰ *See id.* at 141-144.

¹¹¹ Evidence in favor of this proposition is presented in Roe, *supra* note 104, at 986.

D. A Fundamental Contradiction

The simultaneous hostility to the efficient market thesis and affinity for long-term shareholding leads the long-and-short commentators into an interesting tension. As adherents to the belief that short-term strategies undermine corporate effectiveness, the long-and-short commentators naturally praise the buy-and-hold approach as a normative matter. But they do more than that, praising the strategy as economically rational. As Chief Justice Strine wrote, "it is nearly impossible to pursue an active trading strategy that will beat the market over time."¹¹² Similarly, Lynn Stout has described trading as a "self-defeating" strategy of pursuing "the statistically futile hope of beating the market."¹¹³ In many cases, the long-and-short commentators praise for the index funds for this reason, which by their nature are long term investors.¹¹⁴

The irony is that this is exactly that strategy that efficient markets have endorsed on the basis of the efficient markets hypothesis. Indeed, the efficient market hypothesis has been one of the prime reasons for recommending the buy-and-hold approach,¹¹⁵ If short-term stock prices differ wildly and predictably from long term stock prices, it is not at all "nearly impossible" to "beat the market over time." In such cases, those who buy and hold would be greatly disadvantaged.

The tension is further illustrated by the rather pedestrian observation that yesterday's long-term price is today's short-term price. Long-and-short theorists regularly make internally inconsistent claims such as "short-term share prices deviate from their fundamental values for extended periods of time."¹¹⁶ The implication is that eventually prices will draw closer to their fundamental values. But who is to say that the "short-term" price fluctuations of the present deviate more from fundamental value than will the "short-term" price fluctuations of the future? Every long-term shareholder buys in a short-term market and sells in a short-term market, together with whatever imperfections that short-term market has, regardless of his her own holding period. The point of the efficient markets hypothesis

¹¹² Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 4 (2007)

¹¹³ Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 711 (1995).

¹¹⁴ Strine, *supra* note 112, at 4. Index funds by their nature need to hold shares in the whole market or some identified subset of the whole market.

¹¹⁵ See generally BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (1990).

¹¹⁶ Anabtawi, *supra* note 15, at 567.

is exactly that the long-term shareholder need not worry about such imperfections, because they are relatively minor and do not last long.

Moreover, at the same time as the long-and short approach questions the ability of sophisticated market participants to get the price right, the approach is absurdly overly optimistic about the ability of managers to predict long-term share price. As Homstrom and Kaplan argue:

Markets also have a distinct advantage over corporations when it comes to evaluating and rewarding future performance. U.S. capital markets have often been accused of short-termism (for example, Porter, 1992), but insofar as these accusations suggest that investments should not be evaluated on an ongoing basis in the light of current events, the accusations are largely misplaced. Especially in a time of technological transition, quick reassessments of where capital should be reallocated are a rational response to greater uncertainty. Large swings in stock prices arise precisely because the market takes a long view of growth expectations. Also, while stock prices are highly imperfect, they have one unmatched virtue: they have integrity, because markets are asking people to put their money where their mouth is.¹¹⁷

Indeed, for a manager to believe he or she has superior insight to that of the market on the long-term price of the stock borders on pathological arrogance. The market consists of tens or hundreds of thousands of highly sophisticated market participants with a laser-like focus on one thing: buying underpriced stocks and selling overpriced stocks, both of which push the stock price toward the best estimate of its long-term value. The idea that a team of managers could systematically make better predictions, in the absence of private information, strains credulity. This is especially true considering that 25-50% of the risk of any security is systematic risk,¹¹⁸ into which managers have no special insight. By its very nature, systemic risk is not affected by any one company's decision to take a particular action or governance reform, further constraining the scope in which the long-and-short argument could conceivably work.

E. Predictive Errors of the Long-and-Short Perspective

¹¹⁷ Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 138 (2001).

¹¹⁸ See MOYER, R. CHARLES MOYER, JAMES R. MCGUIGAN, RAMESH P. RAO & WILLIAM J. KRETLOW, *CONTEMPORARY FINANCIAL MANAGEMENT* 294 (2012).

The long-and-short argument is not new,¹¹⁹ but rather waxes and wanes with the fortunes of the markets. The long-and-short scholars argue that stock prices vary in the short term in predictable ways from the long term. This leads them to make predictions that, ironically, turn out themselves to be shortsighted.

As an example, consider the long-and-short writing in the wake of the “dot-com” collapse. One such article, as evidence that the dot-com bubble “rivals the famous Dutch Tulip Bulb Craze of 1637,” derisively cites an account that in 1999 Amazon.com was valued at seven times the value of “its two gigantic and highly-profitable ‘bricks-and-mortar’ competitors, Borders and Barnes and Noble.”¹²⁰ The same account mocked eBay as a company that “runs online auctions of such objects as Beanie-babies, for which it collects small fees.”¹²¹ Of course, today Amazon is not valued at seven times the brick-and-mortar stores; it is *valued at over 100 times* the value of those companies combined (one of them went bankrupt). If you had invested \$100 a value weighted portfolio of these two companies when they were in their 1999 “bubble,” you would now have over \$300.

Another article, actually published earlier, proved more prescient in predicting the “long-term” even though it accorded reliability to “short-term” prices.¹²² That article credited “market information” in evaluating performance, and identified Amazon and Ebay as companies whose “potential value would probably have been overlooked” by managers in a corporate hierarchy.¹²³ Indeed, the irony is that to the extent there was an error in the Internet bubble, it was arguably because of the market placing too much value on the long term.¹²⁴

The long-and-short theorists also put great weight on market crashes and macroeconomic trends, even though none of these is relevant to the microeconomic questions of corporate governance. More than a decade earlier there was a similar flurry of long-and-short thinking in the wake of the 1987 stock market collapse. In the late 1980s early 1990s, the long-and-short theorists lauded the “patient capital” approach of Japan and Germany.¹²⁵ Lipton and Rosenblum, in a cringe-worthy prediction, wrote:

¹¹⁹ Indeed, Mark Roe describes it as “perhaps corporate law’s longest running modern refrain.” Roe, *supra* note 104, at 982.

¹²⁰ Stout, *supra* note 61, at 636 & n.8.

¹²¹ SHLEIFER, *supra* note 72, at 154.

¹²² Holmstrom and Kaplan, *supra* note 117, at 138-139.

¹²³ *Id.*

¹²⁴ See Roe, *supra* note 104, at 580 (“[T]he dot.com bubble of a decade ago suggests that the markets can over-value the long term”).

¹²⁵ Lipton and Rosenblum, *supra* note 69, at 218-222; Michael T. Jacobs, *SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA* (1991) (attributing short-term thinking as the cause of American decline relative to Germany and Japan);

The healthy economies of Japan and Germany result in large part from effective, stable management and long-term capital investment. Unless the corporate governance systems of the United States and the United Kingdom can engender a similar long-term orientation, the relative health of American and British corporations, and the relative wealth of their stockholders, will inevitably erode.¹²⁶

Of course, Japan and Germany experienced stagnation throughout most of the period of the nineties after that, and not surprisingly these favorable references seemed to wane during the “lost decade” that followed immediately after in Japan.

The point here is not that one economist could pick stocks better than another or more accurately forecast macroeconomic calamity based on corporate governance regimes. Indeed, that is exactly the point; future stock prices are not predictable in systematic ways. This is the value of the capital markets. To see the stock market reaction to stockholder activism as a bubble is much like seeing Amazon as a bubble in 1999. The irony of these stories that the long-and-short theorists typically point to short-term (and recent) market declines as evidence of their theory. The long-and-short theorists are the ones who are afflicted with the “representativeness bias” and “think they see patterns in truly random sequences.”¹²⁷ The new long-and-short theorists of today are making exactly the same arguments they made in the early nineties, that America’s short-term orientation will cause it to lose out in competition with other countries.¹²⁸

F. Summary

There is no doubt that a stakeholder who happens to be a shareholder may face conflicts of interests with other shareholders. The argument in this Part is that shareholders qua shareholders do not face such conflicts of interest with respect to investment horizon. To have a credible argument, the long-and-short theorists would need to connect short investment horizons of investors to short investment horizons of managers. Indeed, it is

Richard R. Ellsworth, *Capital Markets and Competitive Decline*, HARV. BUS. REV., Sept.-Oct. 1985, at 171 (“Strategies designed to shore up short-term returns to shareholders erode the company’s international competitiveness and thus its ability to provide long-term returns to all constituents: shareholders, employees, customers, suppliers, and society.”)

¹²⁶ Lipton and Rosenblum, *supra* note 69, at 218.

¹²⁷ SHLEIFER, *supra* note 72, at 113.

¹²⁸ See *supra* note 2, at 1649.

possible that the managers' pay packages they set for themselves may in fact have a shorter duration than that of the typical institutional investor.¹²⁹ It is not enough to claim that markets are inefficient; one would need to specify how they are inefficient. In the absence of such a theory, as Mark Roe has persuasively argued, the "short-term" argument should be given "no weight" in developing corporate law.¹³⁰

In the next part, this Article explores the implications for corporate law that would follow from a recognition of different interests based on investment horizon. These implications would eviscerate much of the present structure of corporate law, particularly the business judgment rule.

III. THE LONG-AND-SHORT THEORY IN CORPORATE LAW

This Part examines the legal implications of recognizing a distinction between the interests of short-term and long term investors and finds that such a recognition would dramatically alter existing corporate law. This is because the entire foundation of fiduciary duty in the corporation is built around the fungibility of shares of the same class. Yet among the stockholders of a public company there may be thousands of shareholders, each with a different investment horizon. And because virtually every officer and director is also a shareholder with his or her own investment horizon, he or she would also have conflicting interests with those shareholders who have different horizons. And because a conflict of interest of a majority of the board rebuts the business judgment rule, the long-and-short agenda would effectively eliminate the business judgment rule *for most business decisions*.

A. *The Fiduciary Proposal*

The long-and-short contention that shareholders have different economic interests in corporate governance based on investment horizon leads naturally to questions about fiduciary duty. In general, those in control of a corporation, such as its officers, directors, and controlling shareholders, owe fiduciary duties to the corporation and other shareholders. In most routine decisions that affect stock price the law does not consider these fiduciaries to have conflicting interests with other shareholders. The reason is that they own stock just like other shareholders and the stock is considered to be fungible, therefore the fiduciaries experience benefit or harm proportionately to the same extent as all other shareholders. This basic underpinning of the business judgment rule is what makes daily corporate

¹²⁹ Roe, *supra* note 104, at 980; 997-998.

¹³⁰ *Id.*

life manageable; fiduciaries cannot be second-guessed as to the wisdom of each and every judgment they make, so long as they do not have a conflict of interest in the decision being made.

Once the long-and-short perspective intrudes into the analysis, all of a sudden each shareholder has different interests from each other shareholder, at least to some extent. Some investors have a desire to “pump up” the price of shares temporarily even if that may harm longer-term shareholders, while others are willing to endure years or decades of depressed stock price for an eventual higher return. Thus, directors serving at the behest of short-term shareholders may have conflicts over many business decisions. And to the extent that shareholders exercise effective control over the corporation, they might use this control to favor their short-term interests over the long-term interests of other shareholders. This resembles a duty of loyalty violation of a majority shareholder, which is established in corporate law.¹³¹

In general, fiduciary duties do not arise in the context of shareholder activism because activist shareholders typically do not have “control” of the corporation and therefore do not assume the fiduciary duties of corporate directors. Some long-and-short commentators see this as a problem, because even though activist shareholders may not have control, they can wield significant power.¹³² Accordingly, one prominent solution to the perceived problem of institutional shareholder influence is the imposition of fiduciary duties on such activist investors. There are two parts to the proposal. The first is to treat activist shareholders like controlling shareholders. The second part is to recognize long-term interests and short-term interests as having a conflict within the meaning of fiduciary duty law.

The idea of imposing fiduciary duties on institutional is the natural culmination of the long-and-short perspective, and is not entirely new.¹³³ If the interests of short-term and long-term shareholders conflict, then to the extent one of the groups is able to dictate corporate actions that favor that group over the other then arguably duty of loyalty should be triggered. Although treating activism as the equivalent of control would be a fairly

¹³¹ See, e.g., *Jones v. HF Ahmanson & Co.*, 460 P. 2d 464 (Cal. 1969).

¹³² See, e.g., Strine, *supra* note 112, at 15; Anabtawi, *supra* note 15, at 593 n. 171 (stating that in general the shareholders’ “relationship with the corporations in which they hold shares is therefore unpoliced by fiduciary duty law. In other words, they are free to trade off overall shareholder value for private gain.”)

¹³³ See, e.g., Karmel, *supra* note 51, at __ (“If favored institutions begin to nominate and cause the election of directors in opposition to the selection by an existing board, such institutions should, in appropriate cases, be held to the same kind of duties that are imposed on controlling shareholders.”); See, e.g., Boyer, Allen D. Boyer, *Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons From the Robber Barons*, 50 WASH. & LEE L. REV. 977, 1037 (1993) (arguing that the law should either limit the influence of institutional shareholders or impose fiduciary duties on them).

radical departure from the status quo, that change alone would not be sufficient to trigger fiduciary scrutiny in most cases because of the second part—the fungibility of shares—which means no conflict of interest exists.

This is especially true for the types of transactions that activist shareholders tend to propose, which are not self-dealing but rather corporate governance oriented. Among the common initiatives that worry the long-and-short commentators are selling the company, declaring dividends, repurchasing stock, or cutting research and development.¹³⁴ Such actions have never been considered self-dealing provided that they treat all shareholder equally, even when influenced by an actual majority shareholder. Therefore, the proposal would require not merely applying fiduciary duties to activist shareholders, but redefining the nature of fiduciary duties themselves.

The long-and-short redefinition of fiduciary duties would be accomplished by recognizing different interests among investors with different investment horizons. To the extent the interests differ, short-term investors might make decisions that favor the short-term stock price over the long-term stock price. If this distinction were recognized in corporate law, it would expand the universe of conflicts of interest.¹³⁵ But the business judgment rule has as its basic underpinning the absence of material conflicts of interests between the decision makers (officers, directors, and controlling shareholders) and the other investors. As the realm of conflict of interests expands, the realm of the business judgment rule contracts.

Existing Delaware precedent rejects the long-and-short argument in the form of the *Sinclair Oil Corp. v. Levien*¹³⁶ case. In *Sinclair Oil*, the plaintiff challenged the parent corporation’s causing the subsidiary to pay “excessive dividends,” among other things.¹³⁷ The court held that because “a proportionate share of this money was received by the minority shareholders of Sinven,” “Sinclair received nothing from Sinven to the exclusion of its minority stockholders,” and therefore “these dividends were not self-dealing.”¹³⁸ This is despite the fact that the Court accepted the Chancery Court’s conclusion that “[t]he excessive dividends paid by Sinven resulted in so great a cash drain as to effectively deny to Sinven any ability to expand.”¹³⁹ Because the majority shareholder didn’t use the dividend

¹³⁴ Anabtawi and Stout, *supra* note 5, at 1291-1292.

¹³⁵ The long-and-short theorists sometimes acknowledge this. *See id.* at 1299 (explaining that their approach would mean “expanding the notion of shareholder conflicts of interest).

¹³⁶ 280 A.2d 717 (1971).

¹³⁷ *Id.* at 720.

¹³⁸ *Id.* at 721-722

¹³⁹ *Id.* at 722.

policy to divert opportunities to itself, there was no self-dealing, and therefore the business judgment rule applied.¹⁴⁰

The bottom line is that because of *Sinclair Oil*, “In general, courts treat business and strategic decisions that even-handedly affect the controlling and non-controlling shareholders essentially as business judgments.”¹⁴¹ It is only the “core self-dealing” where “the controlling shareholder appears to benefit at the expense of the controlled corporation” that the intrinsic fairness standard is applied.¹⁴² The stakes could not be higher, because the distinction is between the deferential business judgment rule and intrinsic fairness, which is “the most rigorous in corporate law jurisprudence.”¹⁴³

The facts and legal holding in *Sinclair* are a stark rejection of the long-and-short perspective. Declaring “excessive” dividends is, in a sense, the ultimate “short-term” strategy as resources are being drained from the corporation making further investment impossible. And despite the fact that the payment of “excessive” dividends prevented *Sinven* from expanding and limited *Sinven*’s long-term growth, the Court had no problem concluding that there was no conflict of interest between the proponent of the dividends and the minority shareholders.

Anabtawi and Stout would like to remove business judgment rule protection from short-term strategies that a plaintiff alleges would impair long-term value. They acknowledge that it may be difficult to show a “material benefit” to short-term shareholders that is not shared by long-term shareholders.¹⁴⁴ However, the authors seem to concede only that it would be difficult as an evidentiary matter, not that it would radically alter corporate law:

To show that an activist investor was subject to such a conflict, a plaintiff would have to show that the investor had either already sold its interest, or intended to sell it in the very near future. The plaintiff would also have to show that the stock price increase resulting from the activist’s efforts was only temporary, and so did not equally benefit long-term shareholders. We acknowledge that it will be difficult to make such a showing in most cases, as the temporary nature of the price increase will become apparent only after some time, and then any decline could be attributed to other causes.¹⁴⁵

¹⁴⁰ *Id.* at 722.

¹⁴¹ Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 790 (2003)

¹⁴² *Id.* at 791.

¹⁴³ *Id.*

¹⁴⁴ Anabtawi and Stout, *supra* note 5, at 1301.

¹⁴⁵ *Id.* (explaining that “The plaintiff would also have to show that the stock price increase resulting from the activist’s efforts was only temporary, and so did not equally

These types of showings, however, are all factual in nature, which means that a plaintiff can walk into court with mere allegations of a difference between short- and long-term value and survive a motion to dismiss. This would be true for almost any corporate action, as described in more detail below.¹⁴⁶

Oddly, the Anabtawi and Stout cite *Sinclair Oil* as being “particularly” consistent with their approach, when in fact it is completely inconsistent. They cite the fact that *Sinclair Oil* found a loyalty issue with the majority causing the subsidiary to sell petroleum products to the majority stockholder.¹⁴⁷ That is true, but irrelevant, as that is a direct form of self-dealing, not one based on investment horizon. Much more relevant is the fact that *Sinclair Oil* found the allegedly “excessive dividends”¹⁴⁸ did not raise a loyalty issue. Considering that “excessive dividends” is one of the classic examples of “short-termism” cited by the long-and-short theorists, the attempt to invoke *Sinclair Oil* for its exact opposite falls short.

B. Gutting the Business Judgment Rule for Directors

The business judgment rule is the centerpiece of judicial review of actions taken by directors and other fiduciaries in the corporation. In general, courts often define the rule as “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹⁴⁹ This allows managers to make decisions about corporate policy without after-the-fact scrutiny of the wisdom of those decisions by courts.

In the vast majority of decisions made by a board, the business judgment rule applies, preventing substantive scrutiny into the decision made by the board. The presumption is “rebutted” however, when a majority of the directors have a conflict of interest in the transaction at hand. In most cases the business judgment rule will not be rebutted, because most decisions relating to corporate policy affect all shareholders proportionately and equally, meaning there is no conflict of interest or self-dealing.¹⁵⁰

benefit long-term shareholders. We acknowledge that it will be difficult to make such a showing in most cases, as the temporary nature of the price increase will become apparent only after some time, and then any decline could be attributed to other causes.”)

¹⁴⁶ See *infra* Part B.

¹⁴⁷ Anabtawi and Stout, *supra* note 5, at 1299.

¹⁴⁸ *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720.

¹⁴⁹ See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)

¹⁵⁰ In the language of Aronson, the benefit of such actions “devolves upon the

The situation changes entirely for corporate directors once one recognizes investment horizon as a potential conflict of interest. If long-term shareholders and short-term shareholders have different interests in ordinary corporate decisions, then every shareholder has a potential conflict with every other shareholder with a different investment horizon. But virtually every officer and director is a shareholder, whether long-term or short-term, so under the long-and-short approach every decision that has the potential to divide long-term and short-term shareholders is one in which the board of directors has a conflict of interest. Take the dividend in *Sinclair Oil*, for example. Perhaps short-term and long-term shareholders have different preferences in declaring the dividend versus expanding the business, and suppose directors have a shorter weighted-average investment horizon than many shareholders. A plaintiff could make a strong case under the long-and-short approach that the board had a conflict of interest. In a sense, this would be treating long-term shareholders as holding a different class of stock from short-term shareholders.

This complication has gone unappreciated by the long-and-short theorists, most of whom are defenders of managerial prerogatives vis-à-vis shareholders. In an ironic twist, the argument about the “long-term” best interests of the corporation and its shareholders, which has long been used as a shield for managers in corporate litigation, now becomes a sword plaintiffs could use against them. The fiduciary duty proposal makes the long-term/short-term distinction introduce conflicts of interest into ordinary corporate decisions, that laying the predicate for duty of loyalty violations of the board.

The long-and-short theorists would likely argue that they are not proposing additional duties for directors—and they probably did not intend to. But because directors and officers are almost always shareholders—and probably short-term shareholders in many cases—they have a personal financial interest that differs from that of certain other shareholders in any decision that implicates the short-term/long-term distinction. Thus, the business judgment rule would be a dead letter under the proposal.

Indeed, the implications become even worse for corporate managers when examined more closely. Not only would the officers and directors of the company be conflicted on virtually every issue, but they could not even rely on “independent” directors. Any director who held stock would not be independent because he or she would have conflicts of interest with other shareholders who had different investment horizons. Moreover, to the extent that Delaware Section 144(a)(2) requires disinterestedness of shareholders,¹⁵¹ none of them exist either, because every shareholder has an

corporation or all stockholders generally.” *Id.* At 812.

¹⁵¹ The terms of Delaware Section 144(a)(2) does not explicitly require

investment horizon that differs. Thus, the prospects for using the business judgment rule to rid the board of plaintiffs' lawsuits becomes very challenging.¹⁵² This would effectively unravel much of corporate law as it exists today.

C. Horizon in Judicial Decisions

Perhaps because of the insurmountable problems identified above, the long-and-short perspective in scholarly commentary and extrajudicial writings of Delaware judges has not explicitly penetrated into the case law in Delaware.¹⁵³ Although the long-and-short doctrine is already embedded in the case law implicitly every time a distinction is made between long-term and short-term shareholders, the judges have largely refrained from relying on the distinction in holdings. Indeed, even judges who have been the most strident in their criticism of short-term shareholders often keep the long versus short distinction from explicitly entering into the reasoning of their opinions.¹⁵⁴

A particularly illustrative example is the case of *Paramount v. Time*,¹⁵⁵ which is near the pinnacle of pro-incumbent decisions. It was so pro-management, indeed, that the Delaware courts deferred to the board even though "an objective observer would likely conclude that the Time board's decision was, in fact, crazy."¹⁵⁶ Yet in that case the Chancery Court upheld the board's decision to throw away a deal that offered higher value for shareholders in part to preserve the "culture" of the company.¹⁵⁷ The Supreme Court in that case essentially endorsed the Chancery Court's view

"disinterestedness" of stockholders approving the transaction, but a number of courts have read it that way. *See, e.g.*, Blake Rohrbacher, John Mark Zeberkiewicz, & Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 731-732 (2008).

¹⁵² Indeed, it is difficult to see how any litigation could be dismissed, as it would seem the question of whether long-term and short-term interests differed would be one of fact that would require a trial.

¹⁵³ *See* Roe, *supra* note 104, at 983 (explaining that no Delaware judge "has articulated this broad view in judicial decisions, but rather has offered the power of the short-termist view in off-the-bench writings, with the judicial attention to short-term horizons narrower and more transactional.")

¹⁵⁴ *See, e.g.*, *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A. 2d 786, 814-815 (2007). In that case, then Vice Chancellor Strine explained that he was "reluctant to premise an injunction on the notion that some stockholders are 'good' and others are 'bad short-termers.'" *Id.* Although he saw public policy reasons for distinguishing between short-and long-term shareholders, the judiciary was not the best route for making such distinctions, at least at the preliminary injunction stage. *See id.*

¹⁵⁵ 571 A.2d 1140 (1989)

¹⁵⁶ Black & Kraakman, *supra* note 12, at 528.

¹⁵⁷ *See Time*, 571 A.2d at 1151-1152.

that investors are myopic, they cause management to act myopically, and that directors judge value better than the market.¹⁵⁸

Yet even this case the court distanced itself from making the explicit distinction between short-term and long-term value made by the Chancery Court.¹⁵⁹ The Supreme Court wrote, “we think it unwise to place undue emphasis upon long-term versus short-term corporate strategy,”¹⁶⁰ explaining that the “question of ‘long-term’ versus ‘short-term’ values is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interest without regard to a fixed investment horizon.”¹⁶¹ On one hand, it seems that the Supreme Court simply avoided the issue.

On the other hand, however, if one takes the Court seriously its approach actually establishes far more than meets the eye. The only way that it is possible for directors to “chart a course for a corporation which is in its best interest without regard to a fixed investment horizon” is if there indeed is such a course. There will only be such a course if one of two things is true: (1) long-term and short-term values are equivalent, or (2) shareholder value itself is irrelevant and the corporation has some “best interest” that is different from shareholder value. Thus, although in a sense “the law actually purports to be agnostic as to investment horizons,”¹⁶² there is a sense in which its statements are only coherent if the law rejects a distinction between short-term and long-term value, or perhaps a rejection of shareholder value altogether. The second possibility leads to the next section, because this is really what much of the long-and-short argument is all about.

IV. UNMASKING THE LONG-AND-SHORT MOVEMENT

The long-and-short literature largely speaks the language of shareholder value—that is, “long-term” shareholder value—which is assumed to be true and “durable” wealth.¹⁶³ But digging a little deeper quickly reveals that the

¹⁵⁸ See Hu, *supra* note 97, at 313.

¹⁵⁹ The Chancery Court had stated “‘directors, when acting deliberately, in an informed way, and in the good faith pursuit of corporate interests, may follow a course designed to achieve long-term value even at the cost of immediate value maximization.’” *Paramount Communications, Inc. v. Time, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277 (Del. Ch. 1989), *aff’d*, 571 A.2d 1140 (Del. 1990).

¹⁶⁰ 571 A.2d 1140, 1150.

¹⁶¹ *Id.*

¹⁶² Julian Velasco, *Taking Shareholder Rights Seriously*, 41 U.C. DAVIS L. REV. 605, 637 (2007).

¹⁶³ See, e.g., Strine, *supra* note 44, at 2 (proposing that the “basic purpose” of corporations is “the generation of durable wealth for its stockholders.”)

concerns of many of the long-and-short theorists are not about shareholder value at all. This Part reveals the open secret in corporate law that the “long-term” interests of the corporation are largely a euphemism for sacrificing shareholder interests (long term and short term) for interests of other corporate stakeholders, as well as increasing director discretion.

A. The Effects of a “Long-Term” Perspective

The long-term perspective on shareholder value has some rather serious limitations for evaluating corporate effectiveness. The long-and-short viewpoint suggests that “short-term” stock prices are unreliable guides. But “[w]ithout the measuring stick of share prices, the long-term effects of management actions would become much harder to assess.”¹⁶⁴ But the “long-term” impact on prices will not be known for more than a decade, as many long-and-short commentators define the “long term.” Thus, the “patient capital” approach suggests that shareholders should wait out a CEO’s entire tenure before letting the market speak on his or her performance.¹⁶⁵

Such a perspective on the “long-term” performance of boards and CEOs is unworkable because without “short-term” stock prices it is impossible to evaluate management in time to make a change. Thus, the single largest effect of focusing on long-term over short-term is to provide managers with more discretion, and less accountability. This is not merely discretion about how to pursue the objective of maximizing shareholder wealth, but *whether* to pursue that objective. Accordingly, the long-and-short theorists always seem to come out in favor of more board power.¹⁶⁶

The increased discretion the board has does not concern the long-and-short theorists because they believe that directors can be trusted.¹⁶⁷ In contrast to rational-choice economic approaches to modeling behavior, the long-and-short theorists believe that concepts such as “altruism”¹⁶⁸ and

¹⁶⁴ Holmstrom & Kaplan, *supra* note 117, at 138.

¹⁶⁵ The average tenure of a CEO is now approximately seven years. *See* Roe, *supra* note 104, at 980.

¹⁶⁶ *See* Anabtawi, *supra* note 15, at 598.

¹⁶⁷ Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 8–9 (2003) (asserting that directors “mostly live up to our trust.”); Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 749-752 (2007) (labeling as a “myth” the notion that directors and officers act in their own self-interest rather than as faithful fiduciaries); Lipton and Rosenblum, *supra* note 69, at 195-196 (arguing that the model of management as self-interested is “unfounded”).

¹⁶⁸ Stout, *supra* note 167, at 1 (arguing that “the corporate board is premised on the expectation, and the experience, of director altruism”).

“intrinsic trustworthiness”¹⁶⁹ are not just normatively but descriptively accurate accounts of the directors’ motivations. The long-and-short theorists liken corporate directors to “Platonic guardians”—the “philosopher kings” of the firm.¹⁷⁰ It is easy to see why directors would like to be described this way—who wouldn’t like being called a “philosopher king”?—but what about the rest of us who are a bit less optimistic about the “intrinsic trustworthiness” of corporate management?

There is little doubt that distinguishing between short-term value and long-term value is intended to provide the board with more discretion. Most long-and-short theorists believe the board can be trusted with this discretion, but even if their intrinsic trustworthiness fails, Delaware’s fiduciary duty law or other accountability mechanisms can be trusted to constrain directors.¹⁷¹ Market discipline is not necessary, and would actually be counterproductive. The motivation of the insulation of boards and directors is explored in the next Part.

B. The True Motivation of the Long-and-Short Movement

The common thread that unites the long-and-short theorists is the idea that corporate governance and management performance should not be measured by the market price of the stock, but instead of “other measures of corporate performance.”¹⁷² One would think that the primary “other measure of corporate performance” would be earnings, but focus on these is lamented by long-and-short theorists too.¹⁷³ So what are the “other measures” that long-and-short theorists believe should be used to evaluate corporate performance? The details are never made explicit.

The reason that they aren’t made explicit is because in large measure the arguments of long-and-short theorists in corporate law are not really about short-term shareholder value versus long-term shareholder value. Indeed, these debates are not about shareholder value at all. The “long-term” is, and always has been, a code word for giving management the discretion to trade off benefits of many conflicting constituencies in the corporation. Indeed,

¹⁶⁹ Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403, 441-443 (2001).

¹⁷⁰ Stephen M. Bainbridge, *Director Primacy: The Ends and Means of Corporate Governance*, 97 NW. U.L. REV. 547, 550-551 & n. 21 (2003).

¹⁷¹ Lipton & Savitt, *supra* note 167, at 752-752 (labeling as a “myth” the claim that directors are insufficiently constrained by accountability mechanisms); Lipton and Rosenblum, *supra* note 69, at 196-197. *But see* Stout, *supra* note 167, at 5-9 (arguing that duties of care and loyalty are inadequate constraints to ensure faithfulness of directors).

¹⁷² Karmel, *supra* note 51, at 19.

¹⁷³ *Id.*, at 9 (complaining of “[p]ressures by institutional investors for ever higher quarterly earnings”).

even a former Delaware judge has conceded that the law has “papered over” the conflict between various constituencies (labor, customers, creditors, communities, etc.) by introducing the “murky distinction between long-term profit maximization and short-term profit maximization.”¹⁷⁴

Therefore, it is not a coincidence that virtually all of those who believe there are problems with short termism also reject the shareholder wealth maximization norm to a significant extent,¹⁷⁵ although there are (a few) exceptions.¹⁷⁶ Most do not completely abandon the idea of shareholder value, but instead they caution that “shareholders should not achieve wealth through disregard for the impact of corporate decision making on stakeholders,” creating a need to deviate “to some degree from the standard shareholder wealth maximization conception.”¹⁷⁷

The debate about constituencies and stakeholders in the corporation is far from new, as prominent arguments on both sides date back at least 80 years.¹⁷⁸ The problem with the “stakeholder” approach (among other things) is that “a stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own.”¹⁷⁹ A requirement to consider all

¹⁷⁴ William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 272-273 (1992).

¹⁷⁵ See, e.g., Blair & Stout, *supra* note 169, at 406 (“[S]hareholder primacy is both positively and normatively incorrect, at least in the extreme rhetorical form in which it is most commonly expressed. Corporate law does not - nor should it - require directors to maximize the value of the company's common stock.”)

¹⁷⁶ An intermediate position is that of Professor Stephen Bainbridge, who argues that shareholder wealth maximization is the appropriate normative principle to guide board action, and does not seem overly focused on short-term versus long-term distinctions. See STEPHEN BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 57-72 (2008). Although Professor Bainbridge has for many years included language in his articles that suggests sympathy to the short-term long-term distinction, he has not made this distinction a significant part of his argument for director primacy. See, e.g., Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1054-1055 (1993) (“Most shareholders presumably come to the corporation with profitmaking as their principal goal. Their investment time horizons, however, are likely to vary widely from short-term speculation to long-term buy-and-hold strategies. These differences in turn are likely to result in disagreements about corporate strategy.”).

¹⁷⁷ Virginia Harper Ho, “*Enlightened Shareholder Value*”: *Corporate Governance Beyond the Shareholder-Stakeholder Divide*, J. CORP. L. 1, 62 (2010).

¹⁷⁸ Adolf A. Berle, Jr., *For Whom Are Corporate Managers Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932) with E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147-48 (1932).

¹⁷⁹ Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001).

constituencies "is essentially vacuous, because it allows management to justify almost any action on the grounds that it benefits some group."¹⁸⁰ But at least with the constituency model, management could conceivably take some action that is harmful to every constituency and be condemned.

With this in mind, it is not surprising that managers often express sympathetic views toward social responsibility of business and other constituencies. Indeed, Chancellor Allen described the "social entity view" of the corporation where no one constituency should be privileged as "the dominant view among business leaders for at least the last fifty years."¹⁸¹ Students are often surprised that business leaders would have such a view, but it's actually fairly straightforward. Many people would prefer a mandate to balance a nebulous list of factors rather than pursuing well-defined objectives. If a manager has responsibilities to shareholders, creditors, labor, suppliers, customers, and the public at large, with no particular weighting scheme as to how to order or weight the priorities, who is to say when the manager has violated a duty to any one of those constituencies? Thus, managers become largely free from constraint, to indulge their own personal objectives.¹⁸²

The very same thing is true of the long-term and short-term distinction, without the polarizing political dimension. The short-term versus long-term distinction is simply a way to adopt this "other constituency" perspective without explicitly rejecting shareholder value as the objective of the corporation. The reason for this is twofold. First, the long-and-short argument provides a means to exaggerate the conflicts among shareholders. This has the result of making stakeholder theory seem inevitable. After all, if there are already conflicts among the shareholders of the corporation, then there is nothing particularly special about the shareholders qua shareholders. Even if we wanted to maximize shareholder value, there would be no means of doing so.

The second reason is that the long-term approach does not require theorists to face up to the tradeoffs that the capital market approach does. Long-and-short commentators can argue that in the long term, shareholder and stakeholder interests are aligned,¹⁸³ or that a long-term perspective

¹⁸⁰ Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO L.J. 299, 303 (1993). See also, Easterbrook & Fischel, *supra* note 24, at 1192 ("A manager responsible to two conflicting interests is in fact answerable to neither.")

¹⁸¹ See Allen, *supra* note 174, at 272.

¹⁸² A writer sympathetic to management and stakeholder interests wrote that "it may be that other constituency statutes are merely descriptive of how management behaves anyway." See Richard A. Booth, *Stockholders, Stakeholders, and Bagholders: (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 432, 436 (1998).

¹⁸³ See, e.g., Grossman, *supra* note 52, at 951-959.

“transcends the shareholder-stakeholder divide,”¹⁸⁴ and there is no way to evaluate that claim. Any such tradeoffs, even if they reduce stock prices in the “short term,” can be described as consistent with “long-term shareholder wealth.”¹⁸⁵ Indeed, Chief Justice Strine goes so far as to equate the interest of “society” with those of “long-term investors,” as opposed to “short-term investors.”¹⁸⁶ The claim is that long-term shareholder interest somehow automatically conduces to the benefit of all stakeholders, and even all of society, and that managers who do not realize this are simply not “enlightened.”¹⁸⁷

In moments of candor, the long-and-short theorists occasionally recognize the accountability problem themselves. One article concedes that, “[b]ecause uncertainties multiply as the time horizon lengthens, shareholder primacy becomes more and more meaningless as it stretches from short to long.”¹⁸⁸ Or even more clearly, speaking of the takeover context, “[w]hen observers speak in terms of interests other than short-term wealth maximization, they are referring to these non-shareholder constituencies.”¹⁸⁹ But instead of using these contradictions as reasons to reject the long-and-short approach, they tend to use them as reasons to reject the norm of shareholder wealth maximization.

The underlying theme of implicit rejection of the shareholder value criterion through “long-term” rhetoric has deeply influenced Delaware law. As three former Delaware judges candidly wrote, Delaware law is “ambivalent” about the question of whether “the purpose of the corporation” is to “facilitate shareholder economic welfare” or to also accomplish other goals.¹⁹⁰ They further acknowledge the connection between the long-and-short argument and the stakeholder/constituency model of the corporation, arguing that the former is just a “weaker form” of the latter.¹⁹¹ Another former Delaware judge writes that the short-term long-term distinction is used to provide “some judicial protection to shareholders, while affording substantial room to the multi-constituency, social entity conception to operate.”¹⁹²

Thus, the long-and-short argument has provided the logical undergirding to the “social entity conception” of the firm, where “[t]he

¹⁸⁴ Ho, *supra* note 177, at 62.

¹⁸⁵ *See id.*

¹⁸⁶ *Id.*

¹⁸⁷ *See generally, id.*

¹⁸⁸ Hayden & Bodie, *supra* note 33, at 493.

¹⁸⁹ Hazen, *supra* note 36, at 142.

¹⁹⁰ *See* Allen, Jacobs & Strine, *supra* note 40, at 1067-1068 (three current and former Delaware judges).

¹⁹¹ *Id.* at 1076.

¹⁹² Allen, *supra* note 174, at 274.

board of directors' duties extend beyond assuring investors a fair return, to include a duty of loyalty, in some sense, to all those interested in or affected by the corporation."¹⁹³ Thus, the long-and-short approach effectively empowers corporate managers, rather than the capital, labor, and other markets, with the authority to mediate among the various economic interests in society. Indeed, Professors Blair and Stout see directors as “mediating hierarchs’ charged with balancing the sometimes competing interests of a variety of groups that participate in public corporations.”¹⁹⁴ This is a turn away from the notion that the stakeholders of the corporation should strike their own deals with the corporation, and toward the idea that part of management’s role is to trade off shareholder value to other constituencies.

However, the rhetoric about short-term shareholders having different interests *as shareholders* actually harms long-term shareholders by distracting from real conflicts of institutions that *happen to be shareholders* but have interests not widely shared by other shareholders. Public employee pension funds, in particular, have engaged in shareholder activism for many years,¹⁹⁵ despite the fact that their interests on some issues may not align with those of other shareholders. These institutions may try to use their shareholdings to influence decisions as part of “rent seeking” behavior that is inconsistent with the interests of other shareholders.¹⁹⁶ Moreover, these types of institutional investors may well be subject to political pressure that negatively affects the firms in which they invest.¹⁹⁷ Indeed, in recent years, there has been an increasing agitation in favor of “social proposals” through the shareholder proposal process.¹⁹⁸

The fact that activism by such institutions probably does not align with the interests of other shareholders is front and center in some of the long-and-short accounts.¹⁹⁹ But they lump together “short-term” shareholders with those holding “non-financial objectives,”²⁰⁰ when the two are completely different. The long-and-short argument is not about these types

¹⁹³ Allen, *supra* note 174, at 265.

¹⁹⁴ Blair & Stout, *supra* note 169, at 408.

¹⁹⁵ See, e.g., Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795, 797-798 (1993) (describing pension funds’ activism in the late 1980s and early 1990s).

¹⁹⁶ See Anabtawi, *supra* note 15, at 575-577.

¹⁹⁷ See generally Romano, *supra* note 195.

¹⁹⁸ Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53, 72 (2008), 88-89.

¹⁹⁹ See Anabtawi & Stout, *supra* note 5; Anabtawi, *supra* note 15, at 588-590.

²⁰⁰ 33 Corp. L. 1, 7 (“Most corporate law scholars have not burdened their minds with the fact that undifferentiated empowerment of these so-called stockholders may disproportionately strengthen the hand of activist institutions that have short-term or non-financial objectives that are at odds with the interests of individual index fund investors.”)

of rather banal conflicts among shareholders,²⁰¹ or more novel ones such as shareholders who are economically short but vote nonetheless.²⁰² These situations do not present conflicts of interest between shareholders *as shareholders*, but conflicts between institutions who *happen to be* shareholders. In the pension fund case, the fact of shareholding would actually temper the conflicting ideological or pecuniary interests these institutions would push for, but does not change their interests as shareholders. Although some long-and-short theorists acknowledge this distinction,²⁰³ the very same commentators praise these conflicted institutions as examples of “long-term” shareholders.²⁰⁴

The irony is that by hamstringing institutional investors whose investment horizon is “short term,” the long-and-short approach would empower other interests whose interests are truly adverse to those of the shareholders. Yet the very same long-and-short commentators want to impose fiduciary duties on activist shareholders to act in the “long term” best interests. Thus, the long-and-short theorists are really arguing that activist shareholders have fiduciary duties to stakeholders, something that Delaware does not even impose on the *board*.

This does not trouble the long-and-short theorists, because the majority of them take the position that the shareholders don’t own the corporation. This is repeatedly and categorically asserted in the long-and-short literature, as if it were a clearly established fact.²⁰⁵ Indeed, the long-and-short

²⁰¹ All of these conflicts of interest are addressed and disputed in a recent article See George W. Dent, *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 Del. J. Corp. L. 97, 105-116 (2010). The other common situation that does implicate conflicts of interests *as shareholders* is the distinction between diversified shareholders and undiversified shareholders. This is because diversified investors have different risk preferences from non-diversified investors. However, shareholders can simply diversify this risk away, whereas no diversification can compensate for lower expected returns that might come from a risk averse corporate policy. Thus, the purported conflict here is more apparent than real. See Anabtawi, *supra* note 15, at 583-585. Not all agree. See, Richard A. Booth, *Stockholders, Stakeholders, and Bagholders: (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 432 (1998) (arguing that managers should have duties to the corporation, which is best measured by undiversified stockholders).

²⁰² Anabtawi & Stout, *supra* note 5, at 1287. Hard to see how other shareholders are going to vote for these policies. So you would have to hold a huge block of votes. But that would subject you to Section 16(c), which they never mention.

²⁰³ Some of the long-and-short articles distinguish between these two types of interests. See Anabtawi, *supra* note 15, at 578 n. 76 (distinguishing between interests that are “external” to the ownership of shares and interests that are “internal” to the ownership of shares, but arguing that both types of interests generate conflict of interests).

²⁰⁴ *Id.* at 580 (arguing that pension funds’ long-term orientation means they “have greater incentives to pursue the long-term prospects of the companies in which they invest.”)

²⁰⁵ See, e.g., Lipton & Savitt, *supra* note 167, at 754 (labeling the notion of shareholder

literature asserts that nobody owns the corporation, and therefore the shareholders have no more right to control of the corporation than does any other stakeholder.²⁰⁶

The notion that the shareholders do not own the corporation is, to say the least, not uncontroversial.²⁰⁷ The Delaware Supreme Court has repeatedly asserted over many, many years that shareholders are owners of the corporation.²⁰⁸ What the shareholders do not directly own is the assets of the corporation. But there is a difference between saying the shareholders do not directly own the assets of the corporation and saying the shareholders don't own the corporation, a distinction that commentators often fail to make.²⁰⁹

The idea that shareholders do not own the corporation has been repeated over and over even though it is belied by common sense and basic notions of accounting, tax, and regulatory environment.²¹⁰ The long-and-short theorists loathe the concept that the corporation is the "property" of the shareholders is often associated with the idea that "the function of directors, as agents of the owners, is faithfully to advance the financial interests of the owners."²¹¹ To see where the notion of an organization without owners will take us, one need look no farther than the abuses in the

ownership of corporations a "myth"); Lipton and Rosenblum, *supra* note 69, at 191-195 (arguing that the corporation is not ordinary private property and the shareholder is not an owner in the ordinary property sense); Karmel, *supra* note 51, at 1.

²⁰⁶ Lipton & Rosenblum, *supra* note 38, at 72

²⁰⁷ See, e.g., Julian Velasco, *Shareholder Ownership and Primacy*, U. ILL. L. REV. 897, 898 (2010) ("According to the traditional view, the shareholders own the corporation.")

²⁰⁸ See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("[D]irectors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."); *Seinfeld v. Verizon Communs., Inc.*, 909 A.2d 117, 119 (2006) ("The legal responsibility to manage the business of the corporation for the benefit of the stockholder owners is conferred on the board of directors by statute."); *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998) ("The board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners.")

²⁰⁹ See Velasco, *supra* note 207, at 908 (explaining how commentators often fail to make the distinction between owning the corporation and owning the corporation's assets). One commentator actually makes the distinction between the two but still argues that non-ownership of the assets suggest that shareholders are not owners of the corporation. See Karmel, *supra* note 51, at 1.

²¹⁰ If shareholders are just another claim on the corporation then why are payments to shareholders (dividends) not deductible by the corporation when payments to creditors (interest) are? Why does the corporation recognize a gain or loss on extinguishment of debt but not of stock? These are the basic business concepts that are elusive to academics, but well known to those in the business world.

²¹¹ Allen, *supra* note 174, at 264-265.

nonprofit sector.²¹²

It should be noted that upon closer scrutiny the rhetoric about ownership of the corporation actually does not automatically entail support for the long-and-short adoption of the stakeholder model. One can accept the idea that shareholders do not “own” the corporation without rejecting the shareholder wealth maximization criterion.²¹³ Indeed, the claim that ownership of the corporation is irrelevant has, from the beginning, been espoused by the most forceful advocates of shareholder wealth maximization.²¹⁴ Still, in most cases the long-and-short argument is merely one component of a larger cluster of beliefs, that include (1) increased board discretion, (2) rejection of the capital market valuations of stocks, (3) the stakeholder model of corporate governance, and (4) the absence of an “owner” of the corporation.

C. Summary

The long-and-short commentators and even some judges are turning the corporate fiction into a corporate farce. The long-and-short movement allows the Delaware courts to avoid choosing between the “property conception” and the “social entity conception” of the firm, just as it did in the 1980s.²¹⁵ To some extent, this judicial dithering does not pose any concrete problems. But the growing willingness to accept a distinction between short-term and long-term shareholder value would create a corporate entity that lost its polestar of fidelity to shareholder interests. An allegiance to many conflicting interests would effectively insulate directors from accountability, and ultimately threaten the value of the corporate form. The next Part explains why this conflict is unlikely to end in the stalemate that resulted from the hostile takeover wars of the late 1980s and early 1990s.

V. LOOKING OVER THE INVESTMENT HORIZON

There are reasons to believe that the long-and-short debate is likely to trigger a confrontation in the coming decade. On the one hand, it is true that the long-and-short literature of today is largely a reincarnation of the

²¹² See generally, George W. Dent, Jr. *Corporate Governance Without Shareholders, A Cautionary Lesson From Non-Profit Organizations*, 39 DEL. J. CORP. L. 93 (2014) (arguing that ownerless non-profit organizations lead to organizational ineffectiveness).

²¹³ See Stephen Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH & LEE L. REV. 1423, 1427-1428 (1993).

²¹⁴

²¹⁵ Allen, *supra* note 174, at 272-273.

artificial crisis of the early 1990s, in which hostile takeovers forced a confrontation over the “meaning of corporate existence.”²¹⁶ The current long-and-short theorists, like those of the early 1990s, yearn for the idyllic days before the 1980s,²¹⁷ when “managers of the large public corporations little reason to focus on shareholder concerns.”²¹⁸ The managers could focus on long-term projects of interest to them, building sprawling conglomerate empires, keeping a stable of tame directors, and generally living life without accountability to an atomistic, apathetic, faceless mass of shareholders. The long-and-short theorists largely won the battle in the early nineties, when the Delaware courts capitulated to management prerogatives.

But there are two key differences in the current debate that will lead to a confrontation, rather than the fizzle of the early 1990s. First, the judiciary in Delaware appears to be explicitly signing onto the long-and-short agenda, at least in extrajudicial writings, potentially signaling willingness to force the issue. Second, the institutions are no longer passive because of the growth in institutional ownership, the rise of hedge funds, and the coordination of proxy voting. Finally, changes in the proxy rules have made and will make voting on directors more meaningful. Thus, this Part argues that the days of managerial supremacy that prevailed before the 1980s are fading, and if Delaware continues on its present course, it may become a relic as well.

A. Institutional Shareholdings

The anxiety about institutional shareholding is nothing new in America. The populist suspicion of institutions and political movements to curb their influence have held sway in this country since before the Great Depression.²¹⁹ Over many years, the “popular mistrust of powerful institutions” has led to many of the impediments to corporate governance by institutions.²²⁰ The institutions that have come to prominence in recent years, however, have created alarm in different quarters.

Over the course of the 1980s, the proportion of stock held by institutions increased immensely.²²¹ Already in 1992 there had been a “phenomenal rise of the institutional shareholder” marked by a “dramatic increase” in

²¹⁶ Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 867-868 (1990).

²¹⁷ See Karmel, *supra* note 51, at 2, (lamenting that (“In the 1980s and 1990s, equity came to trump all other corporate constituencies.”).

²¹⁸ Holmstrom and Kaplan, *supra* note 117, at 123.

²¹⁹ See MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 28-32 (1994).

²²⁰ *Id.* at 197.

²²¹ Institutional ownership increased from 38% in 1981 to 45% in 1986 to 53% in 1990. See Black, *supra* note 18, at 827.

institutional holdings and increased governance activism.²²² By 2011, institutional ownership in the largest 1000 publicly traded companies reached 70%.²²³ Institutional investors now control a majority of the equity value of publicly traded companies,²²⁴ and roughly three-fourths of the value of the largest publicly traded companies.²²⁵ For a variety of reasons, the United States equity markets have transitioned to ones dominated by institutions over the last few decades.²²⁶

The growth of institutional investor ownership was not enough to bring about the revolution in governance that the long-and-short theorists decry. For a variety of reasons, including what Gilson and Gordon call the “agency costs of agency capitalism,”²²⁷ institutional ownership by traditional, “reticent” institutions is insufficient to overcome agency problems in portfolio companies. What was needed was the rise of activist investors who specialize in monitoring management and proposing policies and governance reforms to other institutional investors.²²⁸ These activists, a “species of hedge funds,” are able to present alternatives to other institutional investors in a way that overcomes those traditional institutions’ “rationally reticent” stance toward portfolio companies.²²⁹

The long-and-short theorists agree that the rise of hedge funds,²³⁰ together with several other changes, contributed to turning the growth in institutional ownership into an activist institutional ownership.²³¹ These included the liberalization of the SEC’s proxy rules in 1992, opened the door for a new avenues of institutional voice and coordination.²³² The emergence of Institutional Shareholder Services helps to coordinate institutions’ voting.²³³

²²² John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1354-1358 (1992)

²²³ See Gilson and Gordon, *supra* note 29, at 865.

²²⁴ MATTEO TONELLO & STEPHAN RABIMOV, THE CONFERENCE BD., THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 22 (2010).

²²⁵ *Id.* at 27.

²²⁶ See Gilson and Gordon, *supra* note 29, 874-888 (providing a detailed explanation of the reasons for the rise in institutional investor ownership).

²²⁷ See generally *id.*

²²⁸ *Id.* at 896-902.

²²⁹ *Id.* at 867.

²³⁰ Most institutional investors are subject to regulation that prevents them from taking large stakes in firms. See generally, Roe, *supra* note 23. But hedge funds are largely able to function freely of these restrictions, which is why the long-and-short commentators dislike them.

²³¹ See Anabtawi and Stout, *supra* note 5, at 1275-1283.

²³² *Id.* at 1276-1277.

²³³ *Id.* at 1277-1278.

B. Broker Voting and Majority Voting

The advocates of shareholder voice have long held hope for replacing members of the board. But proxy contests are costly and largely ineffective at disciplining directors.²³⁴ As a result, governance activists' interest turned to proxy access, which would give large shareholders the opportunity to place candidates' names on the corporate ballot.²³⁵ Proxy access has hit a roadblock with the D.C. Circuit's invalidation of the SEC's proposal. However, the dynamics of director elections are changing in important ways that make proxy access less important. Today the institutions do not need to mount a proxy contest, as they did less than a decade ago when plurality voting was universal, and directors were effectively guaranteed reelection.²³⁶ Indeed, replacement of directors is not necessary.

The reason is the fall of broker voting and the rise of majority voting. Broker voting was the practice of brokers of voting proxies (really, voting instruction forms) that their clients had not voted. These votes were usually cast for incumbent management, placing a heavy thumb on the scale in favor of incumbents in a stock with a significant retail ownership.²³⁷ The Dodd-Frank Act, however, prohibited broker voting in director elections, removing the artificial "boost" for incumbent directors and making their vote totals more precarious.

This development, combined with majority voting, has turned sleepy director elections into potentially significant events. Majority voting can be implemented in several ways, but in general it requires directors to receive a majority of the "for" vote to continue to serve. Majority voting standards have become the norm over the last decade.²³⁸ Recently Apple, Inc. one of the most visible companies agreed to majority voting after a multi-year struggle by shareholders.²³⁹ They are enough to apply pressure to management. To the extent the goal is to discipline directors they are motivated by avoiding their own removal from the board, not from the

²³⁴ 118 Harv. L. Rev. 833, 856 (arguing that the costs and regulatory burdens of proxy contests make them insufficient to secure faithfulness from managers.)

²³⁵ For a general discussion of proxy access, see Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 *Bus. Law.* 361 (2010).

²³⁶ See Fairfax, *supra* note 198, at 63-64 (explaining that under plurality voting, even if 99% of the votes were withheld from a director's election, the director could still win with a single vote "for").

²³⁷ Institutions, as opposed to retail shareholders, already tended to vote their shares, so broker voting had limited effect on companies with substantial institutional ownership.

²³⁸ *Id.* at 64-70.

²³⁹ See <http://blog.issgovernance.com/gov/2012/02/apple-agrees-to-adopt-majority-voting.html>.

installation of new members. Thus, majority voting, if taken seriously by institutional investors, can exercise as much discipline over the board as a proxy fight, and at low cost.

C. Delaware's Demise?

These changes in corporate governance have swung the pendulum much farther in the direction of institutional shareholder control over the machinery of corporate governance. This leads to the question: why would so many Delaware judges openly disparage institutional shareholders? As mentioned above, the institutions own a majority of the voting power in publicly traded companies, and the overwhelming majority in large publicly traded companies. Yet Delaware depends on incorporation business for a substantial portion of its budget, and that revenue could be jeopardized by taking sides in the gathering storm over activist investors.

One answer is that Delaware's judiciary is simply beholden to corporate management interests to try to adapt to the new institutional governance. The judges may reason that institutional ownership alone is not enough to generate activism, after all, Germany and Japan have huge institutional ownership but weak monitoring.²⁴⁰ It is true that shareholders cannot initiate corporate changes and reincorporation in another state is no exception.²⁴¹ The board and the shareholders both have to approve a reincorporation.²⁴² Thus, when the board likes the status quo, value-increasing change becomes very difficult.²⁴³

On the other hand, institutional shareholders are not likely to significantly decrease their ownership stakes or their activism in the near future. The stage is set, therefore, for a collision that has the potential to redefine the stakes in corporate law. In some ways, the looming collision may seem like simply a replay of the battles over short-term versus long-term values in takeovers that dominated corporate law in the 1980s.²⁴⁴ In those years, Delaware faced the foundational corporate law question of whether managers should have the power to block takeovers to defend their

²⁴⁰ See Shleifer, *supra* note 16, at 761.

²⁴¹ Bebchuk, *supra* note 94, at 844-845.

²⁴² Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125, 140-141 (2009).

²⁴³ Bebchuk, *supra* note 94, at 852.

²⁴⁴ Indeed, the long-and-short theorists have explicitly linked the two. See Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 188-189 (1991) (arguing that hostile takeovers and institutional investor corporate governance "dominance" lead to "inordinate focus on short-term results and a dangerous overleveraging of the American and British economies, the ill effects of which are only beginning to emerge.")

“long-term” strategies²⁴⁵ or whether shareholders should have the right to sell their shares to a hostile bidder for a “short-term” premium.²⁴⁶ The battles resulted in a resounding victory for management.²⁴⁷ Courts decided that directors could “just say no” to hostile takeovers, ignoring the capital market’s influence over governance,²⁴⁸ and effectively blocking a solution based on a market for corporate control.²⁴⁹

Delaware weathered that storm without losing its edge in incorporations. There is a key difference, however, between the battles of the 1980s and those occurring now in the “governance wars” of recent years. In the 1980s, the focus was at least nominally on protecting shareholders as a whole from outsiders—the corporate raiders. The theory was that managers had better information about the “hidden value” of the corporation, and shareholders as a whole needed their protection from raiders who would try to acquire that hidden value at too low a price.²⁵⁰ If the market price is not a reliable indicator of the value of the company, then it is possible for the outsider to “steal” value from shareholders by buying their shares too cheaply.

The long-and-short perspective that has developed in the last two decades is different in a key respect, however. This approach envisions short-term shareholders not as wards in need of protection, but as enemies

²⁴⁵ For an early exposition of this view, see Martin Lipton, *Takeover Bids in the Target’s Boardroom*, 35 BUS. LAW. 101 (1979).

²⁴⁶ For a now classic defense of the right of shareholders to decide, see Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

²⁴⁷ See, e.g., Joseph Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 858 (1993) (opining that “[t]he takeover wars are over. Management won.”)

²⁴⁸ *Id.* at 862 (“With the demise of the hostile takeover, shareholders can no longer expect much help from the capital markets in disciplining or removing inefficient managers.”) Interestingly, the courts arguably took an approach that neither the directors nor the shareholders would have the power to decide, but rather the courts would determine whether resisting a takeover was “proportionate.” See Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 496 (2001).

²⁴⁹ The idea of a “market for corporate control” as a corporate governance mechanism that would inure to the benefit of shareholders by ousting inefficient management was developed in a seminal article by Henry Manne. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). Manne argued that only takeovers, rather than courts or regulatory agencies, could “provide[] some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders.” *Id.* at 113. See also Easterbrook & Fischel, *supra* note 24, at 1173-1174.

²⁵⁰ See Bernard Black and Reinier Kraakman, *Delaware’s Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U.L. REV. 521 (2002) (describing the “hidden value” of the target, a value unknown by the target’s shareholders, that target management was guarding for the shareholders’ benefit in blocking takeovers).

of long-term shareholders. The termers view the institutional shareholders as using a corporate governance agenda to *intentionally* create an artificial and temporary increase in the stock price. The institutional shareholders would share in the increase just like everyone else, after which they proceed to dump the shares and the price will decline. Thus, in their conception, the enemy is within—the shareholders themselves. Once one accepts this premise, the call to impose fiduciary duties of loyalty on activist shareholders is a natural step.

The irony is that Delaware created the class of activist corporate governance investors through its decisions in the 1980s.²⁵¹ There is truth in the long-and-short theorists' arguments that shareholder democracy is cumbersome, clumsy, costly, and inefficient—in a word, suboptimal. Those who favor market solutions generally agree with this;²⁵² It would be far better to allow markets to deal with agency costs. If Delaware had allowed the market for corporate control to function, the waves of corporate governance activism of the last decade would have been greatly muted.

The current standoff could end in reincorporations to states other than Delaware. Although management must propose such a reincorporation, that has not posed an obstacle in the case of classified boards, where activists have routed their opponents. Even if there is no immediate and obvious state to reincorporate to, Delaware faces competition because such a state could quickly materialize (just as Delaware did in competition with New Jersey) and the constant looming threat to federalize aspects of corporate law.²⁵³ The next decade will tell whether the Delaware judiciary has enough of an interest in self-preservation to relent in this standoff.

CONCLUSION

The long-and-short paradigm threatens the very underpinnings of corporate law. If courts entertain arguments that shareholders have different interests according to their investment horizons in ordinary corporate events then virtually every corporate action becomes a potential duty of loyalty case, eviscerating the business judgment rule. This Article argues that there is no reason to eviscerate the business judgment rule because Delaware law, financial theory, and common sense already dictate that shares of the same class of a corporation are identical in their economic interest, regardless of investment horizon. Indeed, the capital markets are actually the reason for

²⁵¹ See, e.g., Gilson, *supra* note 248, at 500-501 (arguing that Delaware's Unocal decision effectively blocked the tender offer and left elections as the only feasible route to a takeover).

²⁵² See *id.* at 502-505.

²⁵³ See Roe, *supra* note 242, at 142-151.

the identity of the two sets of interests.

The question, therefore, is whether Delaware's judiciary will embrace the new institutional governance or double down on managerialism. One way or another, Delaware will have to back away from the long-and-short approach, because the current path will lead to a confrontation with institutional investors.²⁵⁴ Intensifying institutional activism, pro-shareholder changes in corporate governance, and growth in institutional investors' market share has passed the tipping point of managerial monopoly. This means that if Delaware does not step back from the precipice, institutional investors will have the ability, and possibly the willingness, to dethrone Delaware as the dominant jurisdiction for publicly traded companies.

The institutions themselves are not likely to back off of the hard-fought corporate governance influence they have garnered in the last two decades, so a collision is likely in corporate law. Thus, corporate law will need to grapple with one of its most important enduring tensions, the connection between investment horizon and governance horizon in the modern corporation.

²⁵⁴ The judiciary has in the past gone astray and been called back by the Delaware legislature. In *Smith v. Van Gorkom*, 488 A.2d 858 (Del 1985), the Delaware Supreme Court rendered what one commentator has called "one of the worst decisions in the history of corporate law". Daniel R. Fischel, *The Business Judgment Rule and the TransUnion Case*, 40 BUS. LAW. 1437, 1455 (1985). The Delaware legislature, along with those of many other states, enacted legislative provisions to "effectively overturn" the Supreme Court's decision. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 618 (2003).