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LESS IS MORE: MAKING SHAREHOLDER ACTIVISM A VALUABLE MECHANISM OF CORPORATE GOVERNANCE

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Abstract

Institutional investors have increasingly engaged in corporate governance activities, introducing proxy proposals and negotiating with management, with a goal of improving corporate performance. As shareholder activism has increased, financial economists have sought to measure its effect on performance. This paper reviews the corporate finance literature on institutional investors' activities in corporate governance and also empirically investigates the effect of confidential voting proposals on voting outcomes. It then uses the findings of the empirical literature to inform normative recommendations for the proxy process. In brief, there is an apparent paradox: Notwithstanding the development of shareholder activism and commentators' generally positive assessments of it, the empirical research indicates that such activism has little or no effect on targeted firms' performance. This implies that activist institutions ought to reassess their agenda, in order to use their resources more effectively. The paper takes a two-pronged approach to furthering this aim. First, it suggests a mechanism of internal control, whereby funds would engage in periodic review of their shareholder-activism programs to identify the most fruitful governance objectives. Second, it seeks to provide incentives to undertake such internal revaluations by advocating elimination or significant reduction of the subsidy of proposal sponsorship under the SEC rules unless a proposal achieves substantial voting support, or permitting firms' shareholders to choose what level of subsidy they wish to provide proposal sponsors. The estimated savings from eliminating the subsidy for proposals that fail to receive at least 40% of the votes ranges from $293 million to $1.9 billion.

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I. INTRODUCTION

Institutional investors have in the past decade increasingly engaged in corporate governance activities, introducing proposals under rule 14a-8, the Securities and Exchange Commission's (SEC) proxy proposal rule,[1] and privately negotiating with management of targeted firms with the stated goal of improving corporate performance. For example, since the mid-1980s, institutions have submitted shareholder proposals on corporate governance, consisting principally of proposals to eliminate defensive tactics to takeovers, to adopt confidential proxy voting, to enhance board independence, and to restrict executive compensation, to hundreds of firms. Before 1986 only a small set of individual investors engaged in such activism: from 1979-83, religious groups and between six or seven individuals, depending on the year, submitted more than half of all proposals, which ranged in the hundreds every year.[2] From 1986 until the early 1990s, five institutions (four public pension funds and the pension fund of university teachers and administrators) accounted for almost 20 percent of all proposals.[3] Since 1994, unions have overtaken public pension funds as the most active corporate governance proposal sponsors.[4] Over a dozen unions and union pension funds, including both

[1] 17 C.F.R. § 240.14a-8.

[2] *See, e.g.,* Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule,* 18 GA. L. REV. 425, 438 & n.86 (1984).

[3] *See, e.g.,* Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism,* 52 J. FIN. ECON. 293, 297 (1999) (CalPERS, CalSTERS, NYCERS, SWIB, and CREF sponsored 18% of all corporate governance proposals submitted in 1987-1993); WILLIAM F. SANDER, SHAREHOLDER VOTING ALMANAC 3 (1991 ed.) (in 1986, institutional investors began to assume "'active shareholder' stance," with five pension funds filing "a barrage of corporate governance shareholder proposals").

[4] *See, e.g.,* Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Proposals?,* 73 WASH. L. REV. 41, 51-52 & 51 n.46 (1998) and references cited

national and local level organizations, have used the proxy mechanism to sponsor such proposals.[5]

Commentators have in general commended institutional shareholder activism, at least in part from a belief that it would replicate the blockholding-based governance systems of Germany and Japan and thereby fill the void in managerial monitoring which occurred at the end of the 1980s with the decline in hostile takeovers in the United States (although the bloom now is off Germany and Japan's corporate governance systems given far superior U.S. economic performance over the past decade and the increase in hostile takeover activity in recent years).[6] In this view, more active engagement in corporate governance by institutional investors can substitute for the discipline imposed on managers from the threat of a hostile takeover.

As shareholder activism on corporate governance matters has become more pervasive, financial economists have attempted to measure the effect of such activism on targeted firms' performance. Although the finance literature focuses, among institutional investors, on proposals by public pension funds given the relatively recent appearance of union activism, because most union proposals are not substantively different from those sponsored by public pension funds, it

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therein.

[5] *See id.* at 52.

[6] *E.g.,* Bernard S. Black, *Agents Watching Agents; The Promise of Institutional Investor Voice,* 39 U.C.L.A. L. REV. 811 (1992); MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 233-53 (1994). One commentator has embraced union corporate governance activism as a mechanism for achieving organized labor-related goals of worker protection unattainable under a more conventional labor agenda. *See* Marleen A. O'Connor, *Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Capitalism,* 31 U. RICH. L. REV. 1345 (1997).

is unlikely that the findings would differ markedly for union proposals.[7] This contention is supported by the fact that the voting levels, which are an excellent proxy for the value of a proposal, for union proposals involving corporate governance do not significantly differ from those obtained for public pension fund proposals on the same subjects.[8]

This paper reviews the corporate finance literature on corporate governance activism involving shareholder proposals and uses it to inform normative recommendations concerning the proposal process. It also provides new empirical data on the impact upon voting outcomes of confidential voting proposals (proposals to adopt proxy voting practices whereby management will not know how individual shareholders voted), one of the more popular shareholder proposals, which has not been the object of previous studies. The finance literature presents an apparent paradox: Notwithstanding commentators' generally positive assessment of the

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[7] *See* text at notes 171-75 *infra* (discussing potential differential impact from union sponsorship in a signalling explanation of market reactions to shareholder activism).

[8] *See* Thomas & Martin, *supra* note 4, at 68 (no significant difference in voting outcomes). For a discussion of why voting support is a proxy for the proposal's benefit to shareholders see text and accompanying notes 190-92, *infra*. The support level is lower, but insignificantly so, when the sponsoring union is involved in a labor dispute. *Id.* at 69. It must be noted, however, that some firms follow a policy of not identifying proposal sponsors in their proxy materials, including firms with union-sponsored proposals. *See, e.g.,* Eastman Kodak proxy (Mar. 13, 1996) (sponsors not identified, indicating names and addresses will be furnished upon request). The sponsors of Kodak's 1996 proposals were two individuals and the Teamsters Union, *see* Checklist of 1996 Shareholder proposals, IRRC Corporate Governance Bulletin 27 (July-Sept. 1996). Because Thomas and Martin did not use solely proposals in proxies identifying the proponents for their analysis but instead used the afore-mentioned IRRC data source that identifies all proposal sponsors, it is possible that union proposals' support is indistinguishable from other pension funds' proposals' support only when the voting shareholders do not know the identities of the sponsors. Although Thomas and Martin's sample's mix of firms identifying and not-identifying proposal sponsors is not known, because firm policies on identifying sponsors appear to be random with respect to the proponents' identities, it is improbable that the results would differ if they had analyzed only proposals whose sponsors were identified in the proxies.

development of such shareholder activism, the empirical studies suggest that it has an insignificant effect on targeted firms' performance. Very few find evidence of a positive impact, and some even find a significant negative stock price effect from activism.

There have been two literature reviews, by Jonathan Karpoff and Bernard Black, that reach the same negative assessment of shareholder activism's impact, but they have not focused on the gulf between the empirical and normative literature.[9] Jonathan Karpoff seeks to reconcile the disparate conclusions in finance studies, which he emphasizes are due to different definitions of what counts as a success and thus are more apparent than real; his objective is not to explain the gulf between the finance literature and the legal commentary.[10] Bernard Black, who in light of the empirical finance literature shifted from an optimistic assessment of institutional investor activism to that of a "pessimist," offers a set of possible explanations for the overall insignificance of activism: that most proposals are precatory and hence can be ignored by management;[11] that the level of shareholder proposal activity is low; and that shareholders are unable to organize effectively to influence management or uninformed about what issues to

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[9] *See* Bernard Black, *Shareholder Activism and Corporate Governance in the United States,* in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (Peter Newman, ed. 1998); Jonathan M. Karpoff, Does Shareholder Activism Work? A Survey of Empirical Findings (Apr. 22, 1998) (unpublished manuscript, on file with author). In addition, Stuart Gillan and Laura Starks survey all forms of institutional investor activism and not solely shareholder proposals; they conclude that there is no empirical evidence that such activity improves performance, although in theory it is beneficial for large shareholders to become active monitors of management. *See* Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, CONTEMPORARY FINANCE DIGEST, 2, 31 (Autumn 1998).

[10] Karpoff, *supra* note 9, at 1-2.

[11] Black, *supra* note 9, at 463. The recent move to offer proposals that would require management action is discussed at text and accompanying notes 40-41, *infra*.

propose.[12]

The first two of Black's points, the precatory posture of proposals and low levels of activity, are not compelling explanations because managements often respond to precatory proposals, even those receiving less than a majority of the shares,[13] and the level of hostile takeovers, as well as that of acquisitions, is quite low compared to the number of publicly-traded firms, yet such activity produces very significant price effects.[14] Black's third point concerning shareholders' inability to organize effectively is also unpersuasive, as the institutional investors who sponsor proposals hold nontrivial blocks in many firms, and have networking organizations on corporate governance activities that largely mitigate collective action problems.

Black's related contention that shareholders have limited information concerning what proposals are efficacious is consistent with this paper's explanation that the apparent paradox is related to the substance of submitted proposals, but it is not the sole explanation of the data--fund managers might well be informed about which proposals are useful and still champion fruitless proposals, if the managers obtain private benefits from submitting such a proposal, given the absence of strong incentives of boards of public funds to monitor their staff. The fact that in

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[12] Black, *supra* note 9, at 463.

[13] For example, in this paper's sample of firms adopting confidential voting for the proxy process, only four proposals received a majority of votes. *See* part B.2.d *infra*.

[14] For example, in 1986, only 40 out of 3,300 takeovers were hostile offers (an all time high), *see* Michael C. Jensen, *Takeovers: Their Causes and Consequences,* 2 J. ECON. PERSPECTIVES, Winter 1998, at 21, 22, and the premiums in hostile takeovers, averaging 30% or 50% depending on the time period, *id.*, are incorporated in the stock price immediately upon the announcement of the bid, often with significant run-up (averaging 40% of the eventual premium) prior to the announcement, *see* Gregg A. Jarrell & Annette B. Poulsen, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?,* 5 J. L. ECON. & ORG. 225, 226-27, 244 (1989).

contrast to public pension funds, private pension and mutual funds do not engage in activism has been explained by the competitive nature of the industry, or more pejoratively, as cost-conscious private funds' free-riding on the expenditures of activist public funds.[15] I would emphasize a further, complementary explanation, that such institutions' managers are less likely to obtain private benefits from engaging in shareholder activism than public and union fund managers.[16] Both explanations are supported by survey data indicating that private fund managers perceive the costs and benefits of shareholder activism differently from public pension fund managers.[17]

This paper provides an alternative explanation of the apparent paradox in the literature that is preferable to Black's conjectures, because it can rationalize the disparate findings of insignificance and significance in the empirical studies as well as the finding that management is often responsive to shareholder activism despite its precatory form. Namely, financial economists have not been able to identify a positive performance effect of shareholder activism because much of that activism is, in fact, misdirected. I reach this conclusion by relating the studies of shareholder activism to the studies of the underlying corporate governance devices that are the object of that activity. In short, for a large proportion of the governance structures that are the focus of shareholder activism, such as independent boards of directors or limits on executive compensation, there is a paucity or utter absence of data that demonstrate that such devices improve performance. Hence, it is not surprising that shareholder activism directed at

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[15] *See, e.g.,* Robert C. Pozen, *Institutional Investors: The Reluctant Activists,* HARV. BUS. REV., Jan./Feb. 1994, at 140, 144; Black, *supra* note 9, at 460.

[16] *See* text and accompanying notes 19, 210-11, *infra* (discussing possible private benefits).

[17] *See* GILE R. DOWNES, JR., EHUD HOUMINER & R.GLENN HUBBARD, INSTITUTIONAL INVESTORS AND CORPORATE BEHAVIOR 32-34 (1999).

reforming those governance structures does not produce positive results. In fact, it is to be expected. Accordingly, were institutional investors to refocus more carefully their activities on substantive reforms that are known to positively affect performance, their actions would have a higher likelihood of having a significant impact on firms, in accord with commentators' expectations. In sum, commentators' intuition concerning the potentially beneficial effect from investor activism could well be correct were institutional shareholder activism more intelligently pursued.

Negotiated agreements between institutional investors and management, after which a proposal is withdrawn, often produce positive price effects. The paper provides a signalling interpretation of this distinctive result compared to that for submitted proposals: given that the substance of the proposals in the two forms of activism are identical, the withdrawn proposal induces a positive price effect because it signals management quality otherwise obscured by the firm's poor performance (that is, it signals that the managers desire to be responsive to investor concerns and will not seek to entrench themselves and prevent shareholders from taking actions, such as accepting a takeover bid, that improve firm value). This explanation is preferable to a more straightforward explanation of the empirical results, that when management negotiates with a shareholder and the proposal is withdrawn it is because it is a value-maximizing proposal, and when it does not negotiate, it is because the proposal is not value-maximizing. The value-maximizing explanation is unsatisfactory because there does not appear to be sufficient heterogeneity among proposal targets to explain why the same type of proposal would be value-maximizing for some firms (where it is withdrawn) and not others, which is required by this explanation given that the empirical results are indistinguishable by proposal type.

One prevalent type of shareholder proposal does not entail substantive corporate governance changes, proposals to adopt confidential voting practices. Proponents of confidential voting believe that some shareholders (such as money managers, who in addition to holding a firm's shares in their portfolio for other investors, could manage the firm's own employee pension fund) have conflicts of interest that prevent them from voting against management when to do so would maximize share value.[18] They therefore conjecture that shareholders with such conflicts will not feel constrained to vote with management if management was not able to ascertain how they voted. There has been no prior empirical research on confidential voting and this paper measures its efficacy by examining whether the adoption of confidential voting has had an impact on voting outcomes, as contemplated by its proponents.

As with the studies of other shareholder proposals, there is a discrepancy between expectations and reality: confidential voting has no significant impact on voting outcomes. Of shareholder proposals, only support for proposals to rescind defensive tactics increases after the adoption of confidential voting but this effect is due to a trend over time of increased support for such proposals rather than to the voting procedure change. In addition, support for management-sponsored proposals significantly increases after the adoption of confidential voting, but again, this effect disappears controlling for a time trend. Nor is there any performance improvement after the adoption of the procedure, or upon announcement of its adoption. We therefore cannot conclude that confidential voting proposals are a valuable use of institutional investor resources.

The wide gulf between the priors of many commentators and some pension fund

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[18] *See, e.g.,* John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight,* 20 J. FIN. ECON. 237 (1988); Black, *supra* note 6; LTV Corp., Proxy 24 (Mar. 3, 1995) (available in Lexis COMPNY library, Proxy file) (proposal proponent's supporting statement).

managers and the reality suggested by the data conveys a perplexing picture: why are time and effort being devoted to apparently fruitless or marginal activities? This paper does not answer this question directly, although one could develop plausible explanations other than value-maximization of the firms in their portfolios for proposal proponents, who are not private sector fund managers. There is also evidence substantiating this conjecture.[19] This paper instead takes as a given problematic motivational issues and seeks instead to recommend control devices that will provide fund managers with incentives that will minimize the effect of possible agency problems on portfolio performance.

The paper takes a two-pronged approach to the problem of ineffective shareholder activism. First, the paper recommends adoption of a mechanism of internal control, something akin to a good management practice, whereby funds would engage in periodic comprehensive review of their shareholder-activism programs to identify the most fruitful governance objectives. Such evaluations would improve the quality of decision-making and thereby aid in ensuring that funds' proxy activities are directed at maximizing portfolio firms' value. This should increase the benefit from activism to the beneficiaries of the funds, and is accordingly an appropriate policy from the perspective of the fiduciary obligations of fund managers. To provide an impetus for individual compliance, the paper recommends that industry associations

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[19] *See, e.g.,* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered,* 93 COLUM. L.REV. 795, 822 (1993) (example of political ambition for election to higher office affecting decision of New York City public pension fund manager); Thomas & Martin, *supra* note 4, at 61-62 (examples of union funds targeting firms where there were on-going contract negotiations). In the public pension fund activism article I suggested structural changes to align public fund managers' interests with beneficiaries, and hence I do not pursue that route here but instead focus on more incremental changes related to addressing the immediate problem, ineffective use of the shareholder proposal process.

should adopt good practice standards for activism programs that will furnish guidelines for individual funds. It also suggests requiring funds to have independent third parties, such as public accounting firms, certify that funds' activism programs meet those good practice standards. However, it would be difficult to implement a certification requirement expeditiously because it requires action by multiple regulatory institutions given the diversity in identity of institutional shareholder proposal sponsors--the 50 state legislatures and District of Columbia, which are responsible for public pension funds, the Department of Labor, which oversees union and private pension funds, and potentially the SEC, which regulates mutual funds, institutional investors with the capacity to engage in activism but which have not done so.

Given the precatory nature of the internal review proposal without a readily mandated certification requirement, the paper also advocates changing the SEC proxy proposal rules, to reduce the current subsidy of proposal sponsorship unless a proposal achieves substantial voting success, or to permit firms to opt out, in whole or in part, of the current subsidized proposal regime.[20] This second reform proposal will create incentives for funds to undertake comprehensive internal revaluations of their shareholder proposal programs, because unsuccessful policies (those that do not garner substantial support) will become more expensive

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[20] Other commentators have advocated repealing rule 14a-8, emphasizing that shareholders should not have to subsidize a proxy proposal process dominated by individual gadflies whose proposals obtained at most trivial support. *See, e.g.,* Liebeler, *supra* note 2; George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure,* 30 N.Y.L. SCH. L. REV. 1 (1985) [hereinafter Dent, *Study*]. As discussed in part III-B *infra*, the introduction of institutional investors with higher levels of ownership and whose proposals attain higher support levels does not alter the cost-benefit conclusion, that subsidizing the proposal process is inefficacious. *See also* George W. Dent Jr., *Response: Proxy Regulation in Search of a propose: A Reply to Professor Ryan*, 23 GA. L. REV. 815, 822 (1989) [hereinafter Dent, *Response*] (in light of institutional activism, shifting from advocacy of repeal of rule 14a-8 in prior article to suggesting SEC require proposal sponsors to post a bond, recoverable if voting support is "respectable").

to pursue. For example, the estimated present value of the cost of the current regime, compared to one of the proposed reforms, subsidization of only shareholder proposals obtaining 40% of the votes cast, ranges between $293 million to $1.9 billion.

The first proposal concerning the adoption of periodic internal evaluations of governance programs would have a higher probability of being voluntarily implemented in the absence of a certification requirement if the second proposal, eliminating the SEC's mandatory subsidized proposal regime, were enacted into law. This is because requiring proposal proponents to absorb the cost (in whole or in part) of their activity where there is minimal support for their objective among shareholders would increase the incentive for fund managers to sponsor proposals that truly enhance shareholder welfare and correspondingly enhance the value of reviewing the activist program to identify such proposals. It would also better track the state law approach to the reimbursement of expenses of proxy fights, which are not covered by the SEC shareholder proposal rule, in which successful challengers can recover their costs.[21] In contrast to shareholder proposals, proxy fights are not typically waged over marginal matters and the empirical literature has consistently found significant positive wealth effects from this activity.[22]

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[21] *See, e.g.,* Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955). To obtain reimbursement, the proxy fight must be over policy and not personal issues, *id.*, but it is not terribly difficult to characterize personal disputes as policy disagreements.

[22] *See, e.g.,* J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth,* 47 J. FIN. ECON. 279 (1998); David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications,* 66 J. BUS. 405 (1993); Lisa Borstadt & Thomas Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance,* FIN. MGMT., Autumn 1992, at 22; Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations,* 23 J. FIN. ECON. 29 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests,* 11 J. FIN. ECON. 401 (1983).

Admittedly, a proposal to eliminate or greatly reduce the subsidization of shareholder proposals will be politically difficult to implement: it is improbable that politically well-connected institutions (public pension funds and unions) which have been obtaining access to the proxy process for free will voluntarily agree to begin paying for it. Indeed, institutional investors have opposed even minor changes that could limit their free access to the proxy process, such as an increase in the minimum threshold of votes required for a proposal's resubmission in a subsequent year.[23] It is hoped that this paper's marshaling of the evidence and analysis of the dismal ineffectiveness of the shareholder activism agenda will alter institutional investors' (or at least nonactivist institutional investors') view of the proposal process such that they will recognize, and support, the need for meaningful reform.

II. Explaining the Negligible Impact of Shareholder Activism on Performance

This section reconciles the seeming disparity between the goals of pension fund activism--shareholder proposals and private negotiations with management--with the empirical literature that finds that such activism has, at best, minimal impact on corporate performance. It does so by relating the empirical research on the effect of pension fund corporate governance activism on firm performance to the empirical research on the performance effects of the underlying governance objectives of shareholder activists. It begins, however, by sketching which firms are targeted, in order to establish that shareholder proposals should, in fact, be evaluated by their impact on corporate performance.

A. *What firms do institutional investors target?*

[23] *See SEC Finalizes Changes to Shareholder Proposal Rules,* 64 Aspen Law & Business Corporation No. 13, at 1 (Jul. 1, 1998).

To ensure that it is appropriate to evaluate the efficacy of institutional investors' activism by whether there is an impact on corporate performance, it is necessary to identify which firms activist pension funds target. Namely, are they targeting poorly performing firms? For if pension funds' efforts at improving corporate governance are not related to concerns over corporate performance, then using improvement in performance as a benchmark for evaluating funds' behavior would be inappropriate. In particular, we would not expect to find significant performance effects from shareholder proposals if targeted firms were among the top-tier performers, for such firms would be less able to improve their performance significantly. As there may be a number of firms in a fund's portfolio with subpar performance, in considering the impact of activism on performance it is also necessary to ascertain whether funds follow target selection strategies that can be considered rational: namely, do they select firms for which they have a higher probability of success, on the assumption that a successful campaign is essential for performance improvements.

1. *Targets of shareholder activism are poor performers*

Several studies find that firms that are the targets of shareholder activism are, indeed, poor performers (compared to the market or industry-peers) on a variety of stock and accounting measures: abnormal stock returns, growth in operating income, return on assets, operating return on sales, sales growth, and market-to-book ratio.[24] However, not all studies find significant

[24] *See* James M. Forjan, *The Wealth Effects of Shareholder-Sponsored Proposals*, 8 REV. FIN. ECON. 61 (1999) (stock returns 4-1/2 month period preceding proposal); Jonathan Karpoff, Paul Malatesta, & Ralph Walkling, *Corporate Governance and Shareholder Initiatives: Empirical Evidence,* 42 J. FIN. ECON. 365 (1996) (market-to-book ratio, operating return on sales, sales growth; stock returns only in univariate tests); Deon Strickland, Kenneth Wiles, & Marc Zenner, *A Requiem for the USA: Is Small Shareholder Monitoring Effective,* 40 J. FIN. ECON. 319 (1996) (stock returns); Sunil Wahal, *Pension Fund Activism and Firm Performance,* 31 J. FIN. &

differences on all measures.[25] In part, differences among studies are a function of the selection criteria of the activist institutions. Since 1988, for instance, the California Public Employees' Retirement System (CalPERS) has explicitly chosen its targets from among the poor performers in its portfolio, whereas the Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF) uses firms' corporate governance characteristics rather than a performance criterion.[26] Not surprisingly, the one study focusing solely on TIAA-CREF's initiatives did not find the targets to have been poor performers.[27] But even TIAA-CREF's objectives are explicitly couched in the ideal of improving performance.[28] Union funds do not

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QUANT. ANALYSIS 1 (1996) (stock returns, return on assets); John M. Bizjak & Christopher J. Marquette, *Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills*, 33 J. FIN. & QUANT. ANALYSIS 499 (1998) (market-to-book ratio, growth in operating income); Marilyn F. Johnson & Margaret B. Shackell, Shareholder Proposals on Executive Compensation (June 1997) (unpublished manuscript, on file with author) (sales growth); Kose John & April Klein, Shareholder Proposals and Corporate Governance (1995) (unpublished manuscript, on file with author) (stock returns, income); Tim Opler & Jonathan Sokobin, Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors, (Working Paper No. 95-5, Charles A. Dice Center for Research in Financial Economics, Fischer College of Business, Ohio State Univ.) (1995) (stock returns, return on assets).

[25] For a comparison across studies see Karpoff, *supra* note 9, at 20-21.

[26] *See* Michael Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS,* 51 J. FIN. 227, 232 (1996) (describing CalPERS policy); Willard T. Carleton, James M. Nelson & Michael S. Weisbach, *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF,* 53 J. FIN. 1335, 1338-40 (1998) (describing TIAA-CREF policy). TIAA-CREF is the pension fund for university educators at private institutions and some state systems.

[27] *See* Carleton et al., *supra* note 26, at 1356.

[28] TIAA-CREF selects targets by their failure to follow corporate governance procedures that it has endorsed. *See id.* at 1339. It believes those procedures improve performance or otherwise enhance firm value. TIAA-CREF's chairman and chief executive officer, in explaining its corporate governance activities, asserted that "sound practices of corporate governance will make a difference in the future performance of companies." *See* John Biggs, *Why TIAA-CREF Is Active*

appear to target on performance criteria, but only a subset of their proposals are directed at firms that are the subject of collective bargaining disputes or organizing efforts.[29] In any event, the finding of target firms' subpar performance across a variety of samples of institutional investor activism is consistent with the notion that the appropriate benchmark for measuring the value of corporate governance shareholder proposals is their impact upon corporate performance.

2. *Targets have high institutional and low insider shareholdings*

There are also considerable data that institutional investors select their targets strategically to increase the probability of success--that is, they consider the composition of the firm's shareholder voting pool, and not simply performance, in choosing proposal targets. Several studies find a negative relation between the receipt of shareholder proposals and insider ownership, and a positive relation between proposal receipt and institutional ownership.[30] In

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in Corporate Governance, PARTICIPANT, Nov. 1995, at 2. CalPERS is even more explicit concerning its motivation: "At CalPERS, corporate governance is about making money..." *See* Karpoff, *supra* note 9, at 7, n.2 (quoting CalPERS' 1998 GLOBAL CORPORATE GOVERNANCE PRINCIPLES).

[29] *See* Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions,* 96 MICH. L. REV. 1018, 1025-29, 1033-34 (1998).

[30] *See* Bizjak & Marquette, *supra* note 24 (low insider ownership); Carleton et al., *supra* note 26 (same); Bizjak & Marquette, *supra* note 24 (institutional ownership high); Carleton et al., *supra* note 26 (same); Karpoff et al., *supra* note 24 (same); Smith, *supra* note 26 (same). A few studies do not find such significant relations. *See* Karpoff et al., *supra* note 24 (difference in inside ownership insignificant); Smith, *supra* note 26 (same); Johnson & Shackell, *supra* note 24 (institutional ownership low). Of these studies, it should be noted, however, that the Johnson & Shackell study, the only one finding targets have fewer institutional investors than nontargeted firms, examines solely executive compensation proposals, which, in contrast to the governance proposals examined in the other studies, tend more commonly to be offered by individual investors than pension funds. *See, e.g.,* James E. Heard, *Executive Compensation: Perspective of the Institutional Investor,* 63 U. CIN. L. REV. 749, 760 (1995).

fact, TIAA-CREF expressly uses institutional ownership as a criterion for target selection.[31] This strategic behavior is consistent with the selection of targets for which the probability of success is high. Insiders, of course, are not expected to vote for proposals restricting their discretion or otherwise requiring them to establish governance structures that they have not voluntarily adopted. Institutional shareholders, who have far greater incentives to engage in informed voting compared to individual shareholders because of the size and extent of their holdings, are hypothesized to vote for proposals enhancing shareholders' ability to monitor management with greater frequency than other outside investors. And indeed, that is precisely the way such investors vote: the percentage of votes cast for shareholder proposals is negatively related to insider ownership and positively related to institutional ownership.[32]

It is reassuring that studies find a positive correlation between proposal submission and institutional shareholdings, as it suggests that pension funds that are corporate governance activists are, in fact, concerned with the success of their undertakings. But it should be noted that the studies all involved the targets of public pension fund activism, so it is not known whether union funds follow a similar strategy. The one empirical study of labor fund activism

[31] *See* Carleton et al., *supra* note 26, at 1339. Mark Huson suggests institutional ownership is also a criterion for CalPERS. *See* Mark Huson, Does Governance Matter? Evidence from CalPERS Interventions 4 (Institute for Financial Research, Faculty of Business, Univ. of Alberta Working Paper No. 3-97, July 1997) (firms with low institutional ownership excluded from targeting).

[32] *See* Lilli A. Gordon & John Pound, *Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance Proposals,* 48 J. FIN. 697, 713 (1993) (percentage of votes cast for shareholder proposals negatively related to inside ownership and positively related to high percentages of institutional ownership); Stuart L. Gillan & Laura T. Starks, Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors 18 (Feb. 2000) (unpublished manuscript, on file with author) (percentage of votes cast for shareholder proposals positively related to institutional ownership).

investigated solely whether the percentage of voting support varied with the identity of the proposal sponsor[33] We can, nevertheless, conclude that public pension funds sponsoring corporate governance proposals are not engaged in symbolic politics, as appears to be true of sponsors of social responsibility proposals (proposals addressing social issues and corporate social policy, such as, doing business in Northern Ireland or animal testing), which receive far more limited support than corporate governance proposals. For example, in 1994, social responsibility proposals rarely received more than 20% of the vote while corporate governance proposals at times received 40%,[34] and in 1991-92, 51 of 169 corporate governance proposals received more than 33% of the vote compared to only 1 of 165 social responsibility proposals.[35] In addition, although no social responsibility proposal has ever passed, from 1986-90, 25 corporate governance proposals received a majority of the votes,[36] and the number of corporate governance proposals obtaining a majority has continued to increase dramatically in the 1990s,

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[33] Thomas & Martin, *supra* note 4. Unfortunately, the authors do not report any information on the ownership of the firms which the unions targeted.

[34] *See* WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS: CASES AND MATERIALS 374 (7th ed. unabr. 1995).

[35] *See* John & Klein, *supra* note 24, at 16. In the 1980s, social responsibility proposals gained less than 3% of the votes. *See* Liebeler, *supra* note 2, at 450-52. Average support for corporate governance proposals increased throughout the 1980s and for the five highest support categories ranged from 25.8% to 42.1% by 1990. *See* SANDER, *supra* note 3 at 5. While social responsibility proposals' support has also increased, the averages for the two highest support categories were 12.4% and 9.75% in 1990. *Id.* at C-2 to C-8 (my calculation). Social responsibility proposals are not a subject of this paper because they are not advanced in order to improve corporate performance and are consequently, not compatible with the objective of U.S. corporate law, which is to maximize share value.

[36] *See* SANDER, *supra* note 3, at 86.

with 30 passing in 1999 alone.[37]

Of course, a proposal that passes does not mean that it will be adopted--to be submissible under the SEC rules, proposals involving ordinary business decisions must be precatory because corporate law delegates such decision-making to the board.[38] Although many boards respond even to unsuccessful proposals, boards can and, on occasion do, disregard majority votes, particularly on takeover defense rescissions.[39] Recent shareholder proposals have sought to prevent the possibility of such an outcome by phrasing the proposal as a bylaw amendment (which, if passed, would mandate board action). Whether such a legal strategy is permissible has not yet been adjudicated in Delaware, but an Oklahoma court upheld the inclusion of this type of proposal under the SEC proposal rules as a proper subject for shareholder action, under a state statute similar to Delaware's.[40] The issue has also been the subject of extensive commentary, most of which advocates permitting such bylaw proposals, or some subset of them.[41]

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[37] *See* IRRC Corporate Governance Bulletin, April-June 1999, at 4 (in 1999, 41 shareholder corporate governance proposals received more than 50% of the votes cast and, based on the company's voting requirements, 30 of these passed, all but two of which involved elimination of takeover defenses). The vast majority of firms' annual meetings are held in the first half of the year (March-May), so the IRRC reports a year's proxy season results in June.

[38] *See* 17 C.F.R. § 240.14a-8(i). Proposals involving matters that are subject to shareholder action are submissible in non-precatory form.

[39] *See* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?,* 73 TUL. L. REV. 409, 421-22 (1998) (describing example of such conduct by Fleming Companies, Inc.)

[40] *See* International Bhd. of Teamsters Gen. Fund v. Fleming Companies, Inc., No. CIV-96-1650-A, 1997 U.S. Dist. LEXIS 2980 (W.D. Okla. Jan 24, 1997). The issue is whether poison pills are a proper subject for shareholder action (i.e., bylaw amendments) or ordinary business matters that are within the authority of the board.

[41] *See, e.g.,* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests,* 51 U. MIAMI L. REV. 605, 613-15 (1997) (suggesting several

Notwithstanding the still open question whether an intransigent management can be required to adopt the policies that are the subject of a successful (majority-supported) shareholder proposal, given the data on firm targeting, we can conclude that institutional sponsors of corporate governance proposals are attempting to use their resources effectively in their choice of targets.

B. *What is the relation between activism and performance?*

Shareholder proposals have no significant effect on firm performance, but private negotiations over proposals in advance of the shareholders' meeting often have a short-term positive impact.[42] This section reviews and reconciles these seeming inconsistent data. The most plausible explanation of the absence of a positive effect of shareholder proposals on performance is that the proposed governance reforms are typically not mechanisms that demonstrably improve corporate performance. When successful private negotiations produce a positive price effect, the market reaction is best understood as educing information concerning management quality, that the targeted firm's management desires to be responsive to its institutional shareholders, in contrast to a management that does not successfully negotiate with its investors and instead receives a proposal. The price effect is not, then, a measure of the value of the subject of the

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"bright line" rules to identify permissible bylaw proposals); Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 Cardozo L.Rev. 511, 544-49 (1997) (distinguishing permissible bylaws as those involving shareholders' residual governance power); Hamermesh, *supra* note 39, at 425-44, 453, 463-67 (questioning validity and advisability of bylaw proposals); Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw,* 26 HOFSTRA L. REV. 835, 864-69 (1998) (advocating validity of bylaw proposals). A further open question is whether boards can subsequently repeal shareholder-passed bylaws. For differing positions on this issue see Coffee, *supra*, at 616-18 (suggesting that board might be able to repeal such a bylaw but that by careful crafting shareholders can limit board's ability to do so); Hamermesh, *supra* note 39, at 469-75 (maintaining boards can amend shareholder-adopted bylaws under Delaware law).

[42] Karpoff, *supra* note 9, at 23.

negotiations (which is typically precisely the same as that of proposals that produce insignificant price reactions). Thus, even a management seeking to be attentive to shareholder concerns will not increase shareholder wealth if those concerns are not directed at reforms that improve performance.

1. *Studies of proxy proposals*

Despite the apparent rationality of public pension funds' targeting--targeted firms tend to be poor performers with a shareholder pool that is predisposed to vote for corporate governance proposals--there is an absence of evidence that such activism has any discernible positive impact on corporate performance. Across the most comprehensive studies of shareholder proposals, there is a uniform finding of no significant relation between proposal submissions and target firm performance.[43] Although the overall conclusion is that proposals do not affect performance, in

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[43] *See* Wahal, *supra* note 24 (247 proposals at 146 firms, sponsored by 9 activist funds, over 1987-93); Karpoff et al., *supra* note 24 (522 proposals at 269 firms, sponsored by both individual and institutional investors, over 1986-90); Del Guercio & Hawkins, *supra* note 3 (266 proposals at 125 firms, sponsored by 5 activist funds, over 1987-93); Gillan & Starks, *supra* note 32 (2042 proposals at 452 firms, sponsored by individual and institutional investors, over 1987-94); Catherine M. Daily, Jonathan L. Johnson, Alan E. Ellstrand & Dan R. Dalton, Institutional Investor Activism; Follow the Leaders? 30 (1996) (unpublished manuscript, on file with author) (random sample of 200 *Fortune 500* firms, performance and proposals examined over 1990-93; finding number of shareholder proposals unrelated to firm performance). Because the Daily et al. study does not provide information on the proposals' content, which is the focus of this paper's analysis, it will not be discussed further.

One study found a significant long-term positive valuation effect of shareholder activism, *see* Aigbe Akhigbe, Jeff Madura & Alan L. Tucker, *Long-term Valuation Effects of Shareholder Activism*, 7 APPLIED FIN. ECON. 567, 570 (1997) (144 firms, average abnormal stock returns of 23% by three years after activism), but it combined shareholder proposals with proxy fights. It is obvious that the results are driven by the proxy fights in the sample, *see* text and note 22 *supra* and text and accompanying notes 183-85, *infra*, and are not evidence that shareholder proposals increase long-term performance. The authors did not classify their sample by activism form (i.e., individuals seeking a block of board seats are not differentiated from proposals to add independent directors to the board) but did classify by activist type: institutional investor, each of the comprehensive studies of shareholder proposals there are subsamples that have significantly positive or negative effects.

Sunil Wahal, for example, finds no significant improvement in the long-term stock or accounting performance in the targets of public pension fund activism, both for submitted proxy proposals and nonproxy contact (sending a letter to management expressing concern about performance without subsequently introducing a proxy proposal).[44] But Wahal does find a significant short-term stock price effect for the nonproxy contacts around the announcement of their targeting, in contrast to the proxy proposals. Jonathan Karpoff, Paul Malatesta and Ralph Walkling also find no significant stock price reaction to proxy proposals and no operating performance improvements over one to three years following the shareholder proposal (for all firms and for the subset of firms where the proposal was offered by CalPERS).[45] But for a subset

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individual and groups of large shareholders (the two latter groups essentially comprise the proxy fights in the sample as the individuals were well known for takeovers, such as Carl Icahn, Harold Simmons and Robert Bass, and the examples of individual and group activity are examples of proxy contests, whereas the examples of institutional activity are standard shareholder proposals). *Id.* at 569. They find the individual and group variables are positive and marginally significant at the 10% level related to the size of the abnormal return, *id.* at 572, which is entirely consistent with the straightforward explanation of the data, that it is measuring the value of proxy fights and not shareholder proposals.

[44] Wahal, *supra* note 24.

[45] *See* Karpoff et al., *supra* note 24, at 380-83, 390-91. When the performance measure is the short term stock price reaction to a particular "event," such as the announcement of submission of a shareholder proposal or the initiation of negotiation over a proposal, the econometric methodology used to determine the performance effect is called an event study. Event studies investigate the impact of new information upon expected stock returns, which are estimated by an asset pricing model that most commonly depends on the return on the market; the residual of the linear regression of the stock return of event firms on the market return during the event interval is the abnormal return or performance measure due to the event, as it represents the change in stock return beyond the model’s predicted return in the absence of the event. *See, e.g.*, Stephen Brown & Jerold B. Warner, *Using Daily Stock Returns: The Case of Event Studies*, 14 J.

of proposals--those involving executive compensation--the stock price reaction to the proposal was significantly negative.[46]

Stuart Gillan and Laura Starks similarly find no significant stock price reaction to proxy proposals offered by institutional investors, but a significant negative stock price reaction to the subset of proposals seeking rescission of poison pills.[47] Diane Del Guercio and Jennifer Hawkins also find no significant stock price effect from proxy proposals around the announcement date or in the long term (measured over three years after the proposal) and no significant improvements in long-term operating performance.[48] In addition, in contrast to Wahal, they do not find any difference in announcement date returns when their sample is divided into proxy proposals and nonproxy (negotiated outcome) firms. But they do find a significant positive stock price effect for proposals offered by the State of Wisconsin Investment Board (SWIB) around the outcome

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FIN. ECON. 205 (1985). Karpoff et al.'s sample includes proposals by both public pension funds and other investors; the stock price effects are insignificant whether the proposals are separately grouped by type of proponent (such as by a pension fund or an individual investor) or aggregated together. Although the returns were significantly negative for the full sample on the day after the proxy mailing date, *see* Karpoff et al., *supra* note 24, at 381 (table 4), they do not explicitly report this result and instead report the insignificance of the negative cumulative returns.

[46] However, a multivariate regression did not confirm a significant difference between compensation-related and other proposals. Karpoff et al., *supra* note 24, at 382. As discussed in part II.B.2.c. *infra*, and as evident in the Karpoff et al. data, executive compensation proposals are a small fraction of the proposals offered by institutional investors, and this undoubtedly contributes to the difference between their result and the absence of negative price effects in the aggregate data of the other studies, which do not separately examine this proposal category.

[47] Gillan & Starks, *supra* note 32, at 23-24. When the identity of the proposal sponsor is interacted with proposal type, poison pill proposals sponsored by individual investors do not produce significant negative returns, in contrast to those sponsored by institutional investors. *Id.* at 44 (table 11). In contrast to the results in Karpoff et al., *supra* note 24, they further find a small positive stock price reaction (.2%) to the full set of individually-sponsored proposals. Gillan & Starks, *supra* note 32, at 23.

[48] *See* Del Guercio & Hawkins, *supra* note 3, at 322-26 (table 8).

date (the annual meeting date or the news date of a withdrawn proposal), and marginally significant (10% level) negative returns on the announcement date for proposals relating to antitakeover defenses and board composition or structure.[49]

Finally, James Forjan, whose sample of proposals is not limited to institutional investor activism, finds a significantly negative stock price reaction on the proxy mailing date for firms subject to a shareholder proposal in the 1978-91 proxy seasons; the abnormal return is not significant when cumulated over one and two day intervals before and after the mailing date.[50] Whether the finding would persist were the sample restricted to proposals by institutional sponsors as in the previously-discussed studies is unknown. Disaggregated by proposal type, the significant negative returns occur solely for proposals to repeal staggered boards and to ban greenmail or golden parachutes.[51] Forjan further finds that for a subset of 27 firms where management reached an early agreement with the proposal sponsor or where the proposal passed

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[49] *See id.* (table 8). Two other findings of significant positive returns in Del Guercio and Hawkins' study are, in my judgment, problematic and are therefore not relied upon in this paper's analysis. They find significant positive returns on the outcome dates for the sample of proposals sponsored by CalPERS but the significance of this subsample is driven by one firm with a confounding event--at the same time as the outcome date for CalPERS' proposal to rescind Avon Products' poison pill, newspapers reported that a noted corporate raider had acquired a 10% block of Avon stock and intended to make a hostile takeover bid. *See* Karpoff et al., *supra* note 24, at 384. When the Avon observation is eliminated from the CalPERS subsample, the returns are no longer significant. *See* Del Guercio & Hawkins, *supra* note 3, at 325. They also find marginally positive significant returns (10% level) for board-related proposals cumulated over one month before the announcement date through one month after the outcome date. *Id.* The length of the period--several months--and the absence of significant returns over the shorter intervals around either event date counsels against attributing the statistical finding to the funds' activism.

[50] *See* Forjan, *supra* note 24, at 67 (467 firms receiving 1,076 proposals).

[51] *Id.*

with a majority vote, the announcement effect is significantly positive.[52]

A more narrowly-gauged study by Michael Smith, focused solely on proposals sponsored by CalPERS, the largest activist public pension fund, reports similar results to those of the broader-based studies.[53] Smith finds no significant stock price effect and no long-term effect on the firms' operating performance from CalPERS' activism, but a positive stock price effect for the subset of CalPERS' proposals that succeeded. However, what Smith classifies as successful proposals partially overlaps with Wahal's nonproxy category, as they are described as instances where the targeted firm either adopted the shareholder resolution or reached a settlement with

[52] *Id.* at 69. He does not, however, indicate the breakdown of the 27 cases into negotiated and passing proposals, nor does he provide information concerning the subject matter of these proposals.

[53] Smith, *supra* note 26 (CalPERS-sponsored proposals over 1987-93). An additional study which focused on CalPERS, by Stephen Nesbitt, is not discussed in the text because it uses an idiosyncratic and unreliable calculation of the performance measure. Stephen L. Nesbitt, *Long-term Rewards from Shareholder Activism: A Study of the "CalPERS Effect",* J. APPLIED CORP. FIN., Winter 1994, at 75 (CalPERS-sponsored proposals over 1987-92). Nesbitt finds that half of the firms CalPERS targeted with proxy proposals experienced positive returns above the S&P 500 index over a five-year period after the date of CalPERS' first letter to the firm. He does not, however, provide any statistical tests of his data. Moreover, in contrast to the Del Guercio and Hawkins, Smith, and Wahal studies, Nesbitt does not adjust for the firms' market risk in evaluating performance, which renders his results less reliable (if the targeted firms were riskier than the market, higher than market returns would be expected). Compounding the problem with interpreting his results, the number of firms in his sample declines dramatically over time, which increases the likelihood that there is selection bias in the data. Finally, he is examining stock prices over several years, which introduces considerable noise, making it difficult to attribute with confidence any price effect to CalPERS' targeting. In fact, Del Guercio and Hawkins find that the higher returns of targeted firms over the S&P 500 index is not statistically significant, and a control sample of non-targeted firms, comparable in performance, size and industry to the targeted firms, has a similar increase in returns compared to the market. They thus conclude that the improved performance Nesbitt attributes to CalPERS is due to some other factor, such as mean reversion. *See* Del Guercio & Hawkins, *supra* note 3, at 326. Consequently, in my judgment, Nesbitt's results are not reliable, compared to all of the other studies that do not identify long-term positive performance effects from activism.

CalPERS which resulted in the proposal's withdrawal. In addition, he finds a negative stock price effect upon the targeting event for the subsample of proposals offered in 1987-88, the sample years when CalPERS was selecting targets by the presence of antitakeover defenses rather than financial performance, and during which none of its efforts succeeded, in contrast to the later years' corporate governance proposals.

2. *Why do proposals have insignificant performance effects?*

The consistent findings of statistical insignificance for shareholder proposals, as well as the subsamples with non-zero performance effects, are most plausibly a function of the value of the corporate governance mechanism that is the object of the proposals. For instance, three of the four governance mechanisms of greatest interest to shareholder activists--board reforms, takeover defenses, and executive compensation--have been extensively researched. The types of board and compensation reforms advocated by proposal sponsors have not been found to be value-enhancing corporate governance devices, and the results of the empirical research on antitakeover devices are mixed, with only some findings of a negative impact from some of the tactics that shareholder proposals seek to rescind. The impact of the remaining most frequently sponsored shareholder proposal on corporate governance, implementation of confidential voting, is examined empirically in this section.

a. *Boards of directors*

A focus of shareholder proposals that is typically commended by commentators entails altering board composition and structure to enhance its independence from management.[54]

[54] *See, e.g.,* Ira M. Millstein & Paul W. MacAvoy, *Essay: The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1291-92 (1998). Advocacy of independent boards has a long intellectual tradition in the legal literature,

Proposals of such board reforms range from 9% to 16% of the total corporate governance proposals in the shareholder activism studies.[55] However, firms whose boards have a majority of independent directors do not perform significantly better than those whose boards are controlled by insiders,[56] nor do firms which split the function of board chairmen and chief

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with the classic statement presented before such boards were commonplace. *See* MELVIN EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 170-77 (1976).

[55] *See* Wahal, *supra* note 24, at 9 (board independence issues comprise 16% of proposals); Smith, *supra* note 26, at 234 (board independence proposals comprise 9% of identifiable proposals); Gillan & Starks, *supra* note 32 (table 3) (board and committee independence proposals comprise 3% of proposals and 9% of institutions' proposals); Del Guercio & Hawkins, *supra* note 3, at 298 (board independence issues comprise 9% of proposals). Karpoff et al. do not report any board independence proposals in their identification of proposals' content. *See* Karpoff et al., *supra* note 24, at 372.

[56] For a literature review see Roberta Romano, *Corporate Law and Corporate Governance,* 5 INDUS. & CORP. CHANGE 277, 284-90 (1996) (detailing extensive research finding no performance effects). There have been two large-scale studies of board composition and performance subsequent to my literature review. The first study, consonant with the prior research, finds no significant performance effect of independent boards, and some evidence of a negative correlation (when there is a super-majority of independent directors). *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance,* 54 BUS. LAW. 921, 944-49 (1999). The second study, which is the only study to find a positive relation between performance and board independence, does not use the composition of the board to measure independence, nor does it use standard stock price and accounting measures of performance. *See* Millstein & MacAvoy, *supra* note 54. The Millstein and MacAvoy study instead uses as its measure of board independence, the grade assigned to a company by CalPERS, based on the firm's response to a survey requesting a report on compliance with the guidelines for boards created by General Motors (GM); its performance measure is a variant of a popular practitioner measure of firm value known as EVA, representing the difference between earnings and the firm's return on capital. Both of these variables raise difficult measurement issues that makes reliance on this study's findings for policy conclusions concerning board independence problematic: the independence measure poses severe selection bias, as firms self-reported their compliance levels. Presumably firms that felt they would not provide CalPERS with the responses it was seeking did not complete the survey, and the endogeneity of guideline adoption means that a test will be unable to distinguish whether good performers adopt the GM guidelines or whether the guidelines result in improved performance. In addition, the key component of EVA, return on capital, is extremely difficult to measure, making this a less desirable performance measure to use than stock and earnings measures. Given

executive officer compared to firms that do not split these positions,[57] the board reforms on which shareholder proposals focus.

Although independent boards do not affect performance, and hence cannot be said to perform a strong monitoring function, they may provide an episodic monitoring function, by benefiting shareholders in extraordinary or crisis situations.[58] For example, Michael Weisbach found that there is a higher probability of CEO turnover after significant poor performance when outsiders control the board compared to insider-controlled boards, although this finding is not

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the unusual board independence measure that the Millstein and MacAvoy study employs, a better study design would have examined conventional performance measures as well as the EVA construct, in order to make the study comparable to other research and to demonstrate the robustness of its distinctive finding.

[57] Of six studies of the split in office, four find no difference or improved performance in the firms where the positions are not split and two find improved performance in firms where the positions are split, with one paper in each result category being industry-restricted; the text follows the weight of the evidence, and in particular, the fact that the most comprehensive and sophisticated study, which is also the most recent, finds either no or improved performance for the non-split board structure, and not a decrease in performance. *See* James A. Brickley, Jeffrey L. Coles, & Gregg Jarrell, *Leadership Structure: Separating the CEO and Chairman of the Board,* 3 J. CORP. FIN. 189 (1997) (no difference or improved performance for firms where the positions are not separated, using stock price and accounting measures of performance); B. Ram Baliga, R. Charles Moyer & Ramesh S. Rao, *CEO Duality and Firm Performance: What's the Fuss?*, 17 STRATEGIC MGMT J. 41 (1996) (no significant announcement stock price or long-term accounting operating performance effects); Rajeswararao S. Chaganti, Vijay Mahajan & Subhash Sharma, *Corporate Board Size, Composition and Corporate Failures in Retailing Industry*, 22 J. MGMT. STUD. 400 (1985) (no difference in failure rate in retail industry); S.V. Berg & S.K. Smith, *CEO and Board Chairman: A Quantitative Study of Dual vs. Unitary Board Leadership,* 3 DIRECTORS & BOARDS 34-37 (1978) (reporting mixed and inconclusive results using several financial indices and concluding no significant difference); L. Pi & S.G. Timme, *Corporate Control and Bank Efficiency,* 17 J. BANKING & FIN. 515 (1993) (banks with non-chairman CEOs and with higher stock ownership level of such chairmen have higher returns on assets); Paula L. Rechner & Dan R. Dalton, *CEO Duality and Organizational Performance: A Longitudinal Analysis,* 12 STRATEGIC MGMT. J. 155 (1991) (better accounting performance measures in split position firms).

[58] *See* Romano, *supra* note 56, at 290-91.

uncontroverted, as Wayne Mikkelson and Megan Partch find no correlation between board composition, CEO turnover and performance.[59] The research on the effect of outside boards for takeover targets is also ambiguous: one study found that board composition does not affect the likelihood of a takeover or the size of the premium,[60] while another found that shareholder premiums were higher for targets with outsider-dominated boards, particularly when the firm resisted the bid, but board composition did not affect the success of a bid and the mean total takeover gain was not significantly different for outsider board firms (i.e., the greater gains to target shareholders with independent boards came from lower bidder returns).[61] Finally, management-led buyouts of firms with outsider boards have higher abnormal returns than those with insider boards;[62] and takeover bidders with outsider boards experience less negative

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[59] *Compare* Michael Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988) *with* Wayne H. Mikkelson & M. Megan Partch, *The Decline of Takeovers and Disciplinary Managerial Turnover,* 44 J. FIN. ECON. 205 (1997).

[60] Anil Shivdasani, *Board Composition, Ownership Structure, and Hostile Takeovers*, 16 J. ACCT. & ECON. 167 (1993).

[61] James F. Cotter, Anil Shivdasani & Marc Zenner, *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers,* 43 J. FIN. ECON. 195 (1997)

[62] Chun Lee, Stuart Rosenstein, Nanda Rangan & Wallace N. Davidson, *Board Composition and Shareholder Wealth: The Case of Management Buyouts*, 21 FIN. MGMT. 58 (1992). Independent boards may also have a positive impact on divestitures: one study found that the size of selling firms' abnormal stock returns was significantly positively related to a variable interacting the presence of a positive total gain on the sale and the proportion of outside directors, albeit significantly negatively related to the proportion of outside directors; however, when abnormal returns for only firms whose sales produced a positive total gain are examined, board composition is not significant. *See* Robert C. Hanson & Moon H. Song, *Managerial Ownership, Board Structure, and the Division of Gains in Divestitures,* 6 J. CORP. FIN. 55, 67-68 (2000).

abnormal returns on the announcement of their bids than those with insider boards.[63]

Because the vast majority of firms will not be involved in hostile takeovers or management-buyouts, the expected benefit from increasing board independence for the average firm is quite low, particularly as there are no data indicating that the frequency of these acquisitive events is higher for firms with independent boards. Moreover, the probability of CEO turnover after poor performance, although it may well be higher for independent boards, is still extremely low and, of course, the board's independent composition did not avert the poor performance. It is therefore fair to conclude that the benefit to shareholders from an independent board's performance in certain extraordinary situations is sufficiently limited to render more decisive, for assessing the significance of board composition reform, the overwhelming evidence that independent boards do not produce performance improvements. This point has even more force because the finding of a positive impact on decision-making of independent boards in extraordinary circumstances is itself not uniformly identified in the literature. Hence, the occasional identification of behavioral differences by scholars of independent boards in specific atypical settings that benefit shareholders does not alter the conclusion that the failure to find performance effects from shareholder proposals to enhance board independence is due to the fact that greater independence does not significantly improve performance.

One explanation for the failure to find performance improvements with independent boards is that the optimal board structure may vary across firms. Because the choice of board structure is endogenous to management, if firms with different requirements select differing

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[63] John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids,* 32 J. FIN. ECON. 195 (1992).

proportions of outside directors, then we would not expect to find significant performance effects in a cross-sectional study of boards. Shareholder proposals to change board structure, accordingly, will not enhance firm value where management has already optimized on the board's independence dimension; they will enhance value only if management has made a mistake. The failure to document positive price effects from shareholder proposals on board composition thus suggests that pension funds do not possess superior information regarding optimal board structure and, correlatively, that activism is not functioning to improve a suboptimal board composition decision. Supporting this inference is the fact that firms that are targeted for shareholder proposals typically already have a majority of outside directors,[64] and they may well have a higher proportion of outsiders than non-targeted firms.[65]

A study by Anup Agrawal and Charles Knoeber, that attempts to control statistically for the problem of the endogeneity of corporate governance devices provides further evidence that is at odds with the belief of proponents of independent boards. They find a negative impact on performance from board independence after controlling for other governance devices, and thus contend that firms are currently suboptimizing board composition by nominating too many outside directors.[66]

In a subsequent paper, Agrawal and Knoeber examined board composition more closely

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[64] *See* John & Klein, *supra* note 24.

[65] *See* Smith, *supra* note 26, at 240 (targets have fewer insider directors than control sample firms, but difference not statistically significant).

[66] Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders,* 31 J. FIN. & QUANT. ANALYSIS 377 (1996).

and identified a subset of "political" outside directors, whose career experience is conjectured to aid firms' governmental interactions, that is, directors with political experience or law degrees (such as former high-level government and military officials serving on aerospace and defense firms' boards).[67] They suggest that the negative correlation between performance and board composition identified in their earlier article may be spurious, in that, firms subject to political interference are poor performers and also have more outside directors, particularly of the political variety.[68] Consequently, board composition choices may not be suboptimal, as they initially concluded. Regardless of whether corporate boards have the optimal amount of outside directors or too many, Agrawal and Knoeber's research implies that the market will not positively value shareholder proposals seeking to move boards any further along the independence dimension.

b. *Takeover defenses*

The most popular type of proposal sponsored by institutional investors (between 36% to 48% of their proposals) involves elimination of takeover defenses, and of these, proposals to rescind poison pills are the overwhelming majority.[69] The empirical literature on the price effects

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[67] Anup Agrawal and Charles R. Knoeber, Outside Directors, Politics, and Firm Performance (Apr. 1998) (unpublished manuscript, on file with author).

[68] *Id.* at 22.

[69] *See* Del Guercio & Hawkins, *supra* note 3, at 298 (41% of proposals involved defensive tactics and of these 75% are poison pill proposals); Gillan & Starks, *supra* note 32 (table 3) (48% of institutional investor proposals involved defensive tactics and of these 76% are poison pill proposals); Wahal, *supra* note 24, at 9 (36% of proposals involved defensive tactics and of these 81% are poison pill proposals) Smith, *supra* note 26, at 234 (45% of identifiable, and 38% of total proposals, involved defensive tactics and 77% of these are poison pill proposals). The proportion in the Karpoff et al. study is not accurately identifiable: the category, "external corporate control market issues," which comprises 49% of identifiable institutional investor proposals (breakdown by type not provided), excludes several defensive tactic proposals, such as eliminating a staggered board, which are instead included in the category "internal corporate

of the adoption of poison pills is, however, inconclusive. The initial studies reported a significant negative price effect on the adoption of a poison pill,[70] but the results of subsequent research are mixed, with one study still finding a negative effect but several studies reporting no significant price effect for pills adopted after 1984.[71] More important, one study found a positive

governance issues," along with a variety of proposals that are not takeover-related, such as confidential voting. *See* Karpoff et al., *supra* note 24, at 372.

[70] Gregg Jarrell & Michael Ryngaert, Office of Chief Economist of the Securities and Exchange Commission, The Effects of Poison Pills on the Wealth of Target Shareholders (Oct. 23, 1986) (firms subject to takeover speculation without confounding effects had negative returns); Gregg Jarrell and Annette B. Poulsen, *Shark Repellents and Poison Pills: Stockholder Protection-From the Good Guys or the Bad Guys?*, 4 MIDLAND CORP. FIN. J. 39 (1986) (firms without confounding events and firms subject to takeover speculation had negative returns); Paul H. Malatesta & Ralph A. Walkling, *Poison Pill Securities: Stockholder Wealth, Profitability and Ownership Structure,* 20 J. FIN. ECON. 347 (1988) (full sample had negative returns as well as firms without confounding effects); Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth,* 20 J. FIN. ECON. 377 (1988) (firms subject to takeover speculation as well as firms without confounding events had negative returns). But even these studies had either full or subsamples of firms with insignificant price effects.

[71] *See* Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures,* 39 J. FIN. ECON. 3, 21 (1995) (no significant effect); Sudip Datta & Mai Iskandar-Datta, *Takeover Defenses and Wealth Effects on Securityholders: The Case of Poison Pill Adoptions,* 20 J. BANKING & FIN. 1231, 1242-43 (1996) (insignificant for full sample but significantly negative for a small subset of firms (9) that were subject to a takeover); Dana J. Johnson & Nancy L. Meade, *Shareholder Wealth Effects of Poison Pills in the Presence of Anti-Takeover Amendments,* 12 J. APPLIED BUS. RES. 10 (1996) (insignificant effect); James M. Mahoney, Chamu Sundaramurthy & Joseph T. Mahoney, *The Differential Impact on Shareholder Wealth of Various Antitakeover Provisions,* 17 MANAGERIAL & DECISION ECON. 531 (negative price effect for pills adopted 1984-88). It should be noted that there is an interpretation of the insignificant effects of pills in later year event studies that is consistent with their having a negative impact on shareholder wealth: the adoption of poison pills after the tactic was upheld by the Delaware Supreme Court in 1985 could have been anticipated by shareholders and thus the negative impact was already impounded in the stock price at the pill announcement date. In this interpretation, the appropriate event for determining the impact of poison pills is the 1985 judicial decision.

price effect for pill adoptions where the board consists of a majority of outsiders.[72]

The finding of one study of a positive impact of board composition on market reactions to pills suggests that investors view independent boards as having a higher probability of using a pill to run an auction and raise the premium received rather than to deter a control transfer, and that, under such circumstances, they prefer to trade off a decreased probability of a bid for an increased probability of an auction (should a bid occur). Indeed, Brickley et al. found that bids for firms with pills and independent boards resulted in significantly more auctions than firms with pills but without independent boards.[73] This is consistent with the finding that independent boards generate higher target shareholder gains but not a higher rate of successful bids--a higher frequency of auctions provides an explanation for these data. This finding also suggests another difficulty in interpreting the empirical literature which may explain the disparate empirical results: a pill adoption may provide new information to investors concerning a firm's probability of a takeover, or management's level of resistance to a bid, and hence price effects may be a function of the market's assessment of that information (that is, a signalling effect) rather than the value attributed to the pill itself. The explanation of the findings that pill adoptions provide new information is plausible, particularly because by the time of the later empirical studies, which were undertaken after Delaware courts had upheld a variety of poison pills, in almost all cases a firm without a rights plan is able to adopt one even after a hostile takeover has commenced, and

[72] James A. Brickley, Jeffrey L. Coles & Rory L. Terry, *Outside Directors and the Adoption of Poison Pills,* 35 J. FIN. ECON. 371, 379 (1994). The price effect is negative when the board is an insider board. *Id.* The sample period was 1984-86, which includes the year (1984) during which other studies have found negative price effects. *Id.* at 375; Comment & Schwert, *supra* note 71, at 21.

[73] Brickley et al., *supra* note 72, at 386-87.

hence investors understand that "pill-less" firms have implicit pills.

Further complicating the interpretation of the impact of poison pill adoptions, the efficacy of a pill's defensive effect, and hence the market reaction, may be related to other defenses already in place. While this contention is theoretically plausible, the few studies examining the price effect of pill adoptions in conjunction with antitakeover charter amendments have disparate results: they find either no difference or a more positive return for firms with a prior antitakeover amendment.[74] It must be noted, however, that the results of studies of the adoption of antitakeover charter amendments are also mixed, with the most frequent result, statistically insignificant price effects.[75] This is not of itself surprising since shareholders must approve the

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[74] *See* Ryngaert, *supra* note 70 (no significant differences in abnormal returns for firms with or without classified board amendments and fair price or supermajority amendments); Johnson & Meade, *supra* note 71, at 15-16 (firms that did not have any antitakeover charter amendments had insignificant negative abnormal returns while firms with fair price or supermajority amendments had insignificant positive abnormal returns, and the difference in mean abnormal return for the two groups is significant at .10; when the antitakeover amendment firms are subdivided by type, the returns to the firms with fair price provisions in place are significantly positive, and significantly different from the firms with no amendments, but not from the firms with supermajority amendments). The Johnson and Meade data thus would appear to indicate that shareholder wealth effects from pills are lower for firms with no prior defenses. *Id.* at 15.

[75] *E.g.,* Harry DeAngelo & Edward M. Rice, *Antitakeover Charter Amendments and Shareholder Wealth,* 11 J. FIN. ECON. 329 (1983) (insignificant effect); Scott C. Linn & John J. McConnell, *An Empirical Investigation of the Impact of 'Antitakeover' Amendments on Common Stock Prices,* 11 J. FIN. ECON. 361 (1983) (positive or insignificant effect); Gregg Jarrell & Annette Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980,* 19 J. FIN. ECON. 127 (1987) (insignificant effect for fair price amendments, the majority of sample); James A. Brickley, Ronald C. Lease & Clifford W. Smith, Jr., *Ownership Structure and Voting on Antitakeover Amendments,* 20 J. FIN. ECON. 267 (1988) (insignificant effect). But as in the poison pill case, there are studies that find significant negative price effects. *E.g.,* Mahoney, Sundaramurthy & Mahoney, *supra* note 71 (negative effect for full sample and some but not all subsamples); Jarrell & Poulsen, *supra* (negative effect for full sample and for supermajority amendment subsample); Victoria B. McWilliams & Nilanjan Sen, *Board Monitoring and Antitakeover Amendments,* 32 J. FIN. & QUANT. ANALYSIS 491, 497 (1997) (insignificant effect for firms with independent boards and negative effect for firms with insider

amendments, and we would not expect them to vote for provisions that are contrary to their interest.[76] Moreover, in contrast to the poison pill studies, there is a more negative stock price reaction to charter amendments when the board is outsider-dominated.[77] Thus, the benefits to shareholders from independent board composition with regard to defensive tactics are, again, uncertain. The studies of the interaction of poison pills and charter amendments are not, however, the best test of the thesis that the efficacy of a poison pill depends on firms' other defenses because the most prevalent amendment in the study samples, a fair price provision, has little impact on a pill's defensive potency. A more informative test would be to examine the most effective defense in conjunction with a pill, a staggered board, rather than aggregated data on antitakeover charter amendments.

The ambiguous results concerning the wealth effects of poison pills parallel the disagreement among commentators over the efficacy of takeover auctions,[78] as a pill's principal impact, by providing management with time to find a preferred bidder, is to foster an auction

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boards).

[76] Indeed, Anup Agrawal and Gershon Mandelkar find a positive relation between the wealth effect of an antitakeover charter amendment proposal and the firm's institutional ownership (presumably the firm's most informed voters). Anup Agrawal & Gershon N. Mandelker, *Large Shareholders and the Monitoring of Managers: The Case of Antitakeover Charter Amendments,* 25 J. FIN. & QUANT. ANALYSIS 143, 159 (1990).

[77] Chamu Sundaramurthy, James M. Mahoney & Joseph T. Mahoney, *Board Structure, Antitakeover Provisions, and Stockholder Wealth,* 18 STRATEGIC MGMT. J. 231, 237 (1997).

[78] *Compare* Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers,* 35 STAN. L. REV. 1 (1982) *with* Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense,* 35 STAN. L. REV. 51 (1982).

rather than to end preclusively a bid.[79] It is therefore not a complete surprise that shareholder proposals to rescind poison pills have not produced positive stock price effects. Rescission would be expected to improve performance only if pill adoption were more unequivocally a value-decreasing event.

The discussion of the corporate finance literature on takeover defenses has focused on poison pills not only because they are the subject of the most prevalent shareholder proposal on defensive tactics' repeal, but also because some studies have found significant performance effects for subsets of proposals containing poison pill rescissions. Before discussing those results in relation to the finance literature, it must be noted that the defenses besides poison pills that are the most common subject of shareholder proposals, cumulative voting, staggered boards and golden parachutes, have not been as intensively empirically investigated as poison pills. The wealth effects reported in the small number of studies examining such defenses are not uniformly negative but are also positive or insignificant, calling into question the efficacy of proposals to rescind them, similar to the inference drawn from the research on poison pills. For example, although the one study of board-sponsored amendments to eliminate cumulative voting found a negative price effect,[80] the one study of the adoption of golden parachutes found positive price

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[79] Studies showing that firms with poison pills are not subject to fewer successful takeover bids than firms without such defenses include Comment & Schwert, *supra* note 71, and Jamil Aboumeri, *Poison Pills and Shareholder Value/1992-96,* 68 ASPEN LAW AND BUSINESS CORPORATION No. 24, at 1 (Dec. 15, 1997) (study by Georgeson & Company, also available at http://georgeson.com).

[80] Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights,* 27 J. L. & ECON. 339 (1984). The one study of charter amendments that separated out cumulative voting reductions from the other amendments also found a significant negative effect, but the sample size is small (21 proposals). *See* Mahoney, Sundaramurthy & Mahoney, *supra* note 71, at 537.

effects,[81] and the two charter amendment studies that separated out proposals to classify the board found no significant effect.[82] These findings suggest that only proposals to restore cumulative voting might produce a beneficial wealth effect for shareholders, but the only shareholder activism study that separately reported the impact of this type of proposal found no significant effect.[83] It should further be noted that the same study found a negative price effect for proposals to rescind golden parachutes and staggered boards, defenses which have been found to have positive or insignificant price effects, a combination of findings consistent with the conclusion that such proposals are misguided from the perspective of shareholder wealth-maximization.

Smith's finding of a significant negative price effect for the CalPERS' proposals in 1987-88 which focused on takeover defenses and were largely poison pill proposals, Gillan and Starks' similar finding for institutional investors' poison pill proposals (and all such proposals before 1992), and Del Guercio and Hawkins' finding of a marginally significant negative price effect for antitakeover and board proposals (the bulk of the proposals in the group are antitakeover proposals, and poison pill rescissions predominate among these proposals),[84] are consistent with the studies finding that poison pills do not decrease shareholder wealth and may, on occasion,

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[81] Richard Lambert & Donald Larckner, *Golden Parachutes, Executive Decision-making and Shareholder Wealth,* 7 J. ACCT. & ECON. 179 (1985).

[82] *See* Mahoney, Sundaramurthy & Mahoney, *supra* note 71; Jarrell & Poulsen, *supra* note 75.

[83] *See* Forjan, *supra* note 24, at 67 (207 proposals).

[84] Antitakeover provisions comprised 110 of 140 proposals in Del Guercio and Hawkins' grouping, with the most frequent (83) being rescission of a poison pill. *See* Del Guercio & Hawkins, *supra* note 3, at 298 (calculated from table 1). Pills are the subject of virtually all of the proposals submitted in 1987-88 in Smith's sample (15 of 17). *See* Smith, *supra* note 26, at 234 (table 1).

increase it.[85] This interpretation of the literature is supported by a study of poison pill shareholder proposals that found targeted firms more frequently revise their poison pills than nontargeted firms.[86] If such revisions, undertaken by management's being responsive to shareholder actions, weaken a pill's effectiveness, a negative market response anticipating such an effect explains the shareholder proposal data.

However, complicating the analysis is the finding of Del Guercio and Hawkins that virtually all of the SWIB proposals that had a positive price effect at the time of the outcome date (the annual meeting date or the news date of a withdrawn proposal) were proposals to rescind poison pills.[87] One explanation for this perplexing result given that all of the other significant results involving poison pill proposals produced negative effects, might be market anticipation of a subsequent acquisition given knowledge of the level of shareholder support for pill rescission, as the date is after the vote. But Del Guercio and Hawkins report that SWIB's targets were not significantly more likely to be subject to a takeover attempt than other sample firms, although targets receiving antitakeover proposals were.[88] An alternative explanation is that the result is

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[85] An alternative interpretation of the negative stock price effect of poison pill proposals as a signal of management quality rather than an assessment of the value of a pill, will be discussed in the next section, because it is dependent on the finding of positive price effects from private negotiations with management concerning poison pill rescissions. *See* Part II-B-3, *infra*.

[86] Bizjak & Marquette, *supra* note 24.

[87] Del Guercio & Hawkins, *supra* note 3, at 298 (20 of 22 SWIB proposals were poison pill rescissions).

[88] *Id.* at 318-19. The insignificance of the dummy variable for SWIB in their regressions of control activity may be due to multicollinearity with the antitakeover proposal dummy variable: One-third of the SWIB targets subsequently experienced takeover activity compared to 16% of the full sample, and a majority of the targets experiencing takeover activity had received antitakeover proposals. *Id.* However, CalPERS targets experienced an even greater frequency of control activity (37%) and a dummy variable for CalPERS was significant in their regressions of

spurious (that is, due to some other factor) because of the event date selected, shareholder meeting dates, in contrast to the event dates in the studies that identified negative effects, proxy mailing dates: random samples of annual meeting dates produce positive returns, in contrast to those using proxy mailing dates.[89] A plausible explanation of the event date finding, offered by the author of the study uncovering the effect, James Brickley, is that annual meeting dates are known in advance and often contain important management announcements (such as earnings forecasts), which can produce abnormal returns because "risk and expected returns can increase around predictable events likely to contain information."[90] Brickley's results argue for care in interpreting returns around meeting dates, as opposed to proxy mailing dates.

Another factor militating against concluding that shareholder activism involving takeover defenses is non-value-maximizing is that proposals to eliminate takeover defenses obtain the highest level of voting support of all corporate governance proposals.[91] This suggests a third possible means of squaring the SWIB finding with the other defensive tactic proposal findings. SWIB, as an active stock-picking fund, is well-informed concerning its specified targets and focuses on antitakeover issues, in contrast to other activist institutions that are more heavily

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control activity. But because CalPERS sponsored numerous types of proposals (only half of its proposals involved takeover defenses), its indicator variable would not be as highly correlated with the antitakeover proposal dummy variable as the SWIB indicator.

[89] *See* James A. Brickley, *Interpreting Common Stock Returns around Proxy Statement Disclosures and Annual Shareholder Meetings,* 21 J. FIN. & QUANT. ANALYSIS 343, 346-47 (1986).

[90] *Id.* at 347-48.

[91] *See, e.g.,* John & Klein, *supra* note 24, at 16; SANDER, *supra* note 3, at 5.

indexed and hence less informed about the particulars of their portfolio firms.[92] SWIB might therefore be better able to identify firms where pill rescissions do maximize share value than other proponents of such measures, whose proposals, along with SWIB's, are included in the studies finding negative price effects. Accordingly, firm-specific information (such as board composition), which appears in the finance literature to effect significantly the impact of poison pills on firms, may also affect the efficacy of shareholder proposals to repeal such defenses.

c. *Executive compensation*

Proposals concerning executive compensation, which typically seek reductions in the level of pay, are a much smaller proportion of corporate governance proposals than the antitakeover proposals. In the Karpoff et al. study, they were approximately 10% (42 of 408 identified proposals), and none were sponsored by pension funds.[93] Although there are also no compensation proposals in Del Guercio and Hawkins' study of pension fund activism,[94] public pension funds do sponsor this type of proposal, while at a far lower rate than proposals on defensive tactics (less than 10% of their proposals).[95]

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[92] *See* Del Guercio & Hawkins, *supra* note 3, at 301, 305-306 (SWIB stresses its antitakeover issues focus and how its target selection is based on detailed knowledge of companies, compared to the indexed NYCERS's deliberate decision not to sponsor poison pill proposals because they "require too much company-specific knowledge.")

[93] *See* Karpoff et al., *supra* note 24, at 372.

[94] Del Guercio & Hawkins, *supra* note 3, at 297-98 (no compensation proposals, including proposals to cap executive pay, sponsored by funds in sample).

[95] *See* Wahal, *supra* note 24, at 9 (compensation proposals are 4% of proposals); Smith, *supra* note 26, at 234 (compensation proposals are 8% of identifiable proposals and .6% of total proposals). Smith does not report separate performance results for this proposal category, presumably because of the small sample size. Wahal does not examine performance effects by proposal category.

This category of proposals was the subset producing negative price effects in the Karpoff et al. study. The substance of the proposals may explain this fact: Proposals calling for limits on executive compensation are at odds with the empirical literature that finds that compensation and performance are positively correlated.[96] A majority of the compensation-related shareholder proposals in the Karpoff et al. study called for limits on executive pay or requirements that directors own stock.[97] While directors' compensation in stock might function as an incentive-aligning device that improves performance, in fact, studies investigating the relation between performance and directors' stock ownership have not documented a significant positive relation.[98]

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[96] *See, e.g.,* Kevin Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis,* 7 J. ACCT. & ECON. 11 (1985) (positive relation between performance and total compensation); Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance,* 38 J. FIN. ECON. 163 (1995) (positive relation between performance and portion of total compensation paid in stock).

[97] *See* Karpoff et al., *supra* note 24, at 371.

[98] *Compare* Mehran, *supra* note 96, at 180 (no relation) *with* Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Corporate Performance: An Empirical Analysis,* 20 J. FIN. ECON. 293 (1988) (nonlinear relation). One study finds a positive relation between past performance and director stock ownership. *See* Sanjai Bhagat, Dennis C. Carey & Charles M. Elson, *Director Ownership, Corporate Performance and Management Turnover*, 54 BUS. LAW. 885, 907 (1999) (1991-1992 performance positively related to directors' stockholdings in 1993). Unfortunately, this is not a useful test of the efficacy of director stock compensation: the authors should have examined the firms' performance over the years after they measured stock ownership, to determine whether incentive compensation for directors improves performance. They did find that a dummy variable indicating whether directors were given stock options in 1992 and 1993 was significantly related to stock returns in 1994, a promising result, but there was no relation between grants and stock returns in any of the other sample years. *Id.* at 899 (table 4, panel B). They also find that CEO turnover appears to be more frequent with higher stock ownership by directors, given poor performance, *id.* at 909, a result consistent with Weisbach's finding of higher CEO turnover in poor performers with independent boards, *see* Weisbach, *supra* note 59, but this result on director equity ownership and CEO turnover is not robust across all of the regression models, *see* Bhagat et al., *supra*, at 910. Thus, Bhagat et al.'s results are best viewed as consistent with the previously cited studies that do not find a significant relation between equity compensation for directors and improved performance.

It should also be noted that all five of the CalPERS-sponsored executive compensation proposals in Smith's study were proposals to reduce top management's compensation, and it is important to add that, despite the small number, these proposals were 15% of the proposals Smith identified as successful, the same success rate achieved by the takeover defense proposals in his sample.[99]

Two studies have focused solely on the impact of executive compensation proposals. The initial study of the effect on firm compensation policy of shareholder proposals involving executive compensation, by Marilyn Johnson, Susan Porter and Margaret Shackell, found that both compensation levels and sensitivity of pay to performance decreased for firms targeted by CalPERS, but there was no significant effect on compensation from the submission of a shareholder proposal in general.[100] Although their study does not indicate whether CalPERS' activism was directed at compensation issues for all of the targeted sample firms, it does provide anecdotal evidence of instances of management agreeing to reduce executive pay after meetings with CalPERS.[101] Their anecdotes are consistent with Smith's reported high success rate of CalPERS' executive compensation proposals (80%).[102] Given the literature detailing the positive impact of total compensation, as well as incentive (equity) compensation, on performance, to the extent CalPERS' activism results in lower compensation that is less sensitive to performance, it is

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[99] *See* Smith, *supra* note 26, at 234.

[100] Marilyn F. Johnson, Susan Porter & Margaret B. Shackell, Stakeholder Pressure and the Structure of Executive Compensation 20 (May 1997) (unpublished manuscript, on file with author) (sample of 186 firms, 26 with proposals and 4 targeted by CalPERS; compensation levels and sensitivity to performance unaffected by shareholder proposal but negatively affected by identification as a target of CalPERS).

[101] *Id.*

[102] Smith, *supra* note 26, at 234 (4 of 5 proposals to reduce executive compensation successful).

not beneficial to targeted firms' shareholders.

The second study, by Randall Thomas and Kenneth Martin, found that the compensation of targeted firms' CEOs did not increase as rapidly as that of non-targeted firms' CEOs after targeting, but the decrease was not statistically significant.[103] This corroborates the results of Johnson et al.'s study concerning the absence of an impact of compensation proposals. Prior to targeting, Thomas and Martin find that the targeted firms' managers had higher compensation than the average compensation of managers in similarly-sized firms in their industry, and received more of their compensation in the form of incentive pay (stock options) than non-targeted firm managers, but only the cash salary component is statistically different.[104] The higher than industry-average compensation level persisted after the proposal, despite the lower rate of increase in pay.[105] After targeting, the targeted firms' CEOs' compensation packages shifted more toward cash than to long-term incentive compensation (that is, stock options, not cash salaries were reduced).[106] Although this difference was also not statistically significant, it is

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[103] Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1065-66 (1999) (168 proposals submitted to 145 firms in 1993-97).

[104] *Id.* at 1063.

[105] *Id.* at 1065. These authors use a different year than Johnson et al. for post-proposal compensation, which, besides the difference in sample composition, may explain the slight difference in results. When they examine compensation two years after the proposal, they find the decrease in incentive pay is significant, as well as the increase in salary. *Id.* at 1067. While this result is favorable to this paper's thesis, given the time lag before significance shows up, particularly given the choice of a later year chosen as year one compared to the choice of Johnson et al., the two-year result is less reliably attributed to the submission of a proposal than the one-year result, and thus I do not rely on it in my analysis.

[106] *Id.* at 1065-66. In fact, one of the results that the authors state they cannot explain, that the CEO's industry-adjusted compensation level post-proposal is higher for individual rather than union sponsors, *id.* at 1069, can be explained when considered in conjunction with Johnson et

a result, similar to that of the Johnson et al. study, that suggests that executive compensation proposals do not benefit shareholders because they reduce, rather than promote, the use of the compensation form that best aligns shareholder and manager interests, incentive stock options.[107]

The conclusion that shareholder activism involving compensation issues is non-value-maximizing is further supported by the finding of Andrew Prevost and John Wagster that firms on CalPERS' 1990 and 1991 "hit list"--the firms CalPERS was publicly targeting under its shareholder activism program in those years--experienced a negative stock price effect to two events in 1992: Congressional hearings on a bill to permit shareholder resolutions on executive compensation and increase proxy disclosure on compensation; and an SEC proposal thereafter to increase the shareholder votes required on executive compensation issues and to adopt a new method of valuing stock options in proxy statements.[108] Prevost and Wagster interpret these data as indicating that facilitating corporate governance directed at executive compensation by increased disclosure rules does not benefit shareholders because the disclosure, equally available to stakeholders with interests other than value-maximization, such as unions, political activists and the press, as it is to investors, will encourage stakeholder pressure on boards to weaken the "pay-for-performance" sensitivity of management compensation.[109] Their explanation of the data

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al.'s findings: institutional investors exercise more influence on compensation committees than individuals.

[107] For the classic statement of the optimal incentive compensation package for an agent see Bengt Holmstrom, *Moral Hazard and Observability,* 13 BELL J. ECON. 324 (1979).

[108] Andrew K. Prevost & John D. Wagster, Impact of the 1992 Changes in the SEC Proxy Rules and Executive Compensation Reporting Requirements 18-20 (Sept. 1999) (unpublished manuscript, on file with author). A control firm of non-targeted firms matched by size and industry did not experience negative returns on the event dates. *Id.* at 21.

[109] *Id.* at 6.

is corroborated by the studies of executive compensation proposals: a negative stock price reaction to the SEC disclosure rule indicates an expectation that firms will be pressured to diminish incentive compensation plans, and this expectation is borne out, as the performance sensitivity of the pay of executives at CalPERS-targeted firms decreased significantly, and at union-targeted firms decreased, albeit insignificantly, after being targeted subsequent to the SEC rule change.

Given the content of many compensation proposals--to limit pay and restrict incentive compensation practices--it is not a surprise that shareholder activism, when compensation is the object, has not been found to improve performance. The perverse effects that would accompany the adoption of such proposals--decreased incentives for managers to increase share value--in all likelihood explains the negative stock price reaction to CalPERS' activism in connection with such proposals, as there is a higher probability that boards will respond to CalPERS' compensation demands (and indeed they have done so), than to the individual shareholders who more typically sponsor compensation proposals. It must also be noted that other shareholders appear to be aware of the problematic value of the proposals. Compensation proposals receive less voting support than other corporate governance proposals, typically not much more than 10% compared to over 30% for proposals involving defensive tactics.[110] The lower level of

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[110] *Compare* Thomas & Martin, *supra* note 103, at 61-62 (11.3% average support for compensation proposals) *with* Del Guercio & Hawkins, *supra* note 3, at 296 (34% average support for corporate governance proposals which did not include any compensation proposals); *see* Gordon & Pound, *supra* note 32, at 704-05 (table II) (compensation-related proposals dominate list of proposals receiving lowest percentage of votes--less than 7%--and none are in list of proposals with highest proportion of votes--over 40%--which are dominated by poison pill and confidential voting proposals); SANDER, *supra* note 3, at 78 (table shows compensation-related proposals' average voting support is lower than that of other proposals). Similarly, in my sample of firms with confidential voting analyzed in part II.B.2.d *infra*, executive compensation

support for compensation proposals may also be a function of imprecise targeting: the data suggest that executive compensation at firms receiving compensation-related proposals is not significantly higher than that at other firms.[111]

Finally, an increasingly common form of executive compensation proposal, preventing the resetting of executive stock option contracts (or subjecting resetting to shareholder approval), needs to be discussed. If options are not repriced after stock price declines, the executive receiving them will be unable to profit from that form of incentive compensation (the option exercise price will be above the stock price at expiration). Shareholders opposed to repricing contend that it simply rewards poor performance, in contrast to repricing firms' contentions that it is necessary to retain valuable employees whose compensation has otherwise declined.[112] This category of proposal has, unfortunately, not been empirically studied, as it is a recent object of activism. Repricing opponents' position appears to resonate with investors as proposals to ban repricing have received a much higher level of support than other executive compensation proposals, but the number of such proposals is far too small to draw any definitive inferences.[113]

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proposals averaged 11.6% of the votes, defensive tactic proposals averaged 33%, and the average for all shareholder proposals is 26.6% (table 2).

[111] *See* John & Klein, *supra* note 24, at 33; Johnson & Shackell, *supra* note 24, at 18. Thomas and Martin's finding that targeted firms' executives earned above-industry average compensation was not statistically significant except for the cash compensation part, yet the executives' greatest salary component was in options and long-term incentive pay. *See* Thomas & Martin, *supra* note 103, at 1063.

[112] *See, e.g.,* Adam Bryant, *Stock Options that Raise Investors' Ire,* N.Y. TIMES, Mar. 27, 1998, at D1.

[113] In 1998, three proposals to ban repricing underwater stock options averaged 27.6%, whereas 15 proposals to restrict executive compensation averaged 9.5% and 9 proposals to disclose executive compensation averaged 5.5%. *See Voting on U.S. Governance Shareholder Resolutions*, IRRC Corporate Governance Bulletin, April-June 1999, at 3. Repricing also appears

While little empirical research has been undertaken on the efficacy of stock option resetting,[114] and none on shareholder proposals to prevent it, the optimality of such behavior has been formally modelled. Viral Acharya, Kose John and Rangarajan Sundaram find that where realistic limits on the form of contingent compensation exists (such as the use of at-the money stock options, which is a tax-law qualifying limitation for compensation plans), then resetting may benefit shareholders (increase firm value) compared to a compensation policy that precommits to never resetting.[115] This model suggests that empirical tests involving the most recent type of compensation proposal, repricing prohibitions, will not alter the inference drawn from the prior literature, that the objects of shareholder initiatives regarding executive compensation do not enhance firm value and may lower it. Accordingly, such proposals will not be likely to positively affect firm performance when placed on the proxy agenda.

d. *Confidential voting*

In contrast to the other categories of shareholder proposals, which are substantively directed, proposals for confidential voting seek to alter shareholder voting patterns and thereby

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to increase the number of votes cast against management proposals regarding stock option plans, although dilution may be a more consistently significant factor in explaining the level of opposition. *See* Randall S. Thomas & Kenneth J. Martin, The Determinants of Shareholder Voting on Stock Option Plans 43, 71, 55, 64, 67 (unpublished manuscript, Nov. 30, 1999).

[114] Two studies have found that the impact on shareholders of option repricing is insignificant, although the impact on the executives whose options are repriced is great. *See* Don M. Chance, Raman Kumar & Rebecca B. Todd, "The 'Repricing' of Executive Stock Options" (unpublished manuscript Aug. 13, 1999); Menachem Brenner, Rangarajan K. Sundaram & David Yermack, "Altering the Terms of Executive Stock Options," New York University Center for Law and Business Working Paper #CLB-98-001 (Oct. 9, 1998).

[115] Viral Acharya, Kose John & Rangarajan Sundaram, Contract Renegotiation and the Optimality of Resetting Executive Stock Options (Dec. 7, 1998) (unpublished manuscript, New York University Stern School of Business, on file with author).

recalibrate the internal dynamics of the firm with the expectation that this will improve performance. Contemporary proponents of confidential voting believe that conflicts of interest prevent certain shareholders from voting against management where to do so would maximize share value.[116] In particular, they contend that money managers aspire to do business with the firm whose shares they hold, such as to manage the firm's pension fund, and such business prospects would be jeopardized by voting against management.[117] Correspondingly, advocates of confidential voting expect that shareholders in such a predicament will not feel constrained to vote with management when it is against their interest as shareholders, were management unable to ascertain how they voted (that is, they believe that confidential voting will eliminate institutional investors' conflicts of interest in proxy voting).[118] Because several activist institutions subscribe to this position, proposals to adopt confidential voting are second only to proposals to eliminate defensive tactics in frequency of institutional sponsorship, ranging from 18% to 44% of the proposals in studies of institutional investor activism.[119]

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[116] *E.g.,* Pound, *supra* note 18. The initial call for confidential voting emerged, however, from different concerns regarding management resolicitation of votes. Social activist investors thought that management, "knowing in advance of the annual meeting how institutional investors had voted" [on social issue shareholder proposals, would] "resolicit large shareholders to try to get them to change their votes or abstain." *See* PATRICK MCGURN, CONFIDENTIAL PROXY VOTING 14 (1989).

[117] *See, e.g.,* Pound, *supra* note 18; Black, *supra* note 6; LTV Corp., Proxy 24 (Mar. 3, 1995) (available in Lexis COMPNY library, Proxy file) (proposal proponent's supporting statement).

[118] See sources cited in note 117, *supra*.

[119] *See* Wahal, *supra* note 24, at 9 (confidential voting proposals comprise 41% of proposals); Smith, *supra* note 26, at 234 (confidential voting proposals comprise 18% of identifiable proposals and 15% of all proposals); Gillan & Starks, *supra* note 32 (table 3) (confidential voting proposals comprise 12% of proposals and 31% of institutions' proposals); Del Guercio & Hawkins, *supra* note 3, at 298 (confidential voting proposals comprise 44% of proposals; over 70% of these proposals were sponsored by one fund, NYCERS). Confidential voting proposals in

It is intuitively plausible to expect voting institutions to affect outcomes: in the U.S. election context, for instance, the adoption of "Australian" ballots--state-prepared and administered ballots that are secret, in contrast to the party ballot system--was associated with an increase in ticket-splitting, although the change in ballot form (organized by office rather than party) appears to have had a more significant effect than the confidentiality of the ballot.[120] However, it is also quite possible that the main effect of the Australian ballot was not to alter voting outcomes but rather, to reduce party expenditures on election campaigns, as it eliminated the bribes parties were paying voters under the open ballot system because they no longer could be assured of the bribes' desired outcome.[121] Under this alternative hypothesis, the procedural reform was adopted because it was in the interest of the major political parties, and not simply due to effective reformist agitation. The analogy in the proxy context is that confidential voting is adopted by managers because they do not expect it to affect voting outcomes adversely to their

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the Karpoff et al. study are included in the "internal corporate governance issues" category (51% of identifiable institutional investors' proposals), which contains a variety of other proposals, including some more properly classified as defensive tactics, such as eliminating a staggered board. *See* Karpoff et al., *supra* note 24, at 372.

[120] Jerrold G. Rusk, *The Effect of the Australian Ballot Reform on Split Ticket Voting: 1876-1908,* 64 AM. POL. SCI. REV. 1220 (1970).

[121] *See* Alan Gerber, The Adoption of the Secret Ballot (June 1993) (unpublished manuscript, on file with author) (modelling when political parties would prefer secret to open ballot to reduce bribery, and suggesting conditions under which U.S. states switched to the Australian ballot in the late 19th century--increasingly competitive elections--are consistent with model predictions). In support of this hypothesis, in a history of the reform, L.E. Fredman states that over time, several observers pointed out that the Australian ballot checked obvious bribery abuses but did not seriously weaken the power of political machines. L.E. FREDMAN, THE AUSTRALIAN BALLOT: THE STORY OF AN AMERICAN REFORM 85 (1968).

interest.[122]

There has been no prior empirical research on the effect of confidential shareholder voting. This section therefore seeks to answer the question whether confidential voting affects voting outcomes. In particular, it examines whether management proposals obtain lower, and shareholder proposals higher, levels of support when a firm has instituted confidential voting. In doing so it seeks to ascertain whether this procedural focus of investor proposals is worth the effort, paralleling the discussion concerning shareholder proposals substantively directed at improving corporate governance by reforming board composition, repealing takeover defenses and altering executive compensation.

i. *Formulating a hypothesis test*

There is no simple test of the proposition that confidential voting alters proxy proposal voting results, such as comparing votes cast across firms with confidential voting and firms without such a practice, because confidential voting is an endogenous procedural choice. Of the firms that have adopted a policy of confidential voting, several have done so in response to prodding by shareholders, although adoption is not typically in reaction to approval of a shareholder proposal on the subject.[123] This suggests that firms with confidential voting may

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[122] Ian Ayres and Jeremy Bulow note that some commentators contend that the Australian ballot was adopted to weaken mass political activism, particularly by the labor movement. *See* Ian Ayres & Jeremy Bulow, *The Donation Booth: Mandating Donor Anonymity to Disrupt the Market for Political Influence,* 50 STAN. L. REV. 837, 840 n.9 (1998). Whatever the accuracy of that hypothesis in the political arena, it is not relevant for the proxy context because union funds support pension funds' confidential voting proposals and the success of such proposals is perceived to be helpful for furthering the agenda of shareholder activists.

[123] *See e.g.,* First Bank System Inc., Proxy (Mar. 22, 1993) (indicating that Board of Directors passed resolution providing for confidential balloting and shareholder who had submitted a stockholder proposal relating to confidential balloting therefore agreed to withdraw the proposal)

have different shareholder pools from firms without it, a difference which may impact upon voting outcomes more generally. Not only may firms' decisions on confidential voting be connected to expected voting support levels, but more important for empirical testing, firms with shareholder pools likely to support confidential voting may experience higher support for other shareholder proposals as well (independent of the firm's voting policy). Moreover, because no confidential voting proposal was ever proffered at close to two-thirds of the firms in this paper's sample, there may also be endogenous differences in the management of firms which adopt confidential voting that affects the types of management, as well as shareholder, proposals that are presented at these firms.

To control for the potentially confounding impact of the endogeneity of voting policy that would occur in a cross-sectional analysis of firms that vary according to whether they have confidential voting, this paper examines instead differences in mean voting outcomes for firms that enacted a confidential voting policy between 1988 and 1997 by paired-comparison tests of differences in mean support levels of proposals sponsored at the sample firms before and after their adoption of the procedure. Such an approach controls for the endogeneity of confidential voting adoption, since only firms that adopted the policy are examined, and post-adoption voting outcomes are compared with each firm's prior voting outcomes as its own benchmark.

(available in Lexis COMPNY library, Proxy file). Only four of the 102 confidential voting proposals in this paper's sample obtained a majority vote, and a majority of the sample firms did not receive any such proposal.

A further potential analytical difficulty for empirical testing is that the procedure followed under confidential voting varies across firms. In a few instances, corporate employees rather than independent agents count the ballots. Even for this small number of firms, the practice is not consistent throughout the sample period: most typically, employees were still used to count ballots when confidential voting was initiated and some years later independent agents were employed, but the firm considered there to be no difference in the confidentiality of its voting policy throughout the entire sample period. Although firms using employees assert in their proxy materials that confidentiality of votes is maintained despite the identity of the ballot tabulators, shareholders might well be skeptical of such claims and consider the process equivalent to a nonconfidential voting procedure. For an even smaller number of firms, confidential voting was offered as an option that shareholders checked off when completing their ballots, rather than automatically applied.

Differences in the form of the confidential voting procedure are not controlled for in this study for technical convenience because aggregation does not pose significant problems. First, the number of firms without independent tabulators or using the optional procedure is extremely small. Second, the average support for proposals by type post-adoption do not reveal significant outliers across the sample firms that could suggest a need to control for voting procedures. Finally, the vast majority of shareholders are apparently satisfied with the confidential voting procedures adopted by their firms: only eight proposals on confidential voting were offered subsequent to its adoption, compared to 94 proposals prior to adoption, and all of the eight firms with post-adoption proposals used independent tabulators and automatically applied confidentiality to the ballots.[124]

ii. *Sample construction and characteristics*

A sample of 118 firms with confidential voting was constructed from a list of 174 firms identified by the Investor Responsibility Research Center (IRRC), a non-profit research group serving institutional investors, as all firms that have adopted the practice. Only firms whose confidential voting adoption date was identifiable in the firm's proxy statements and which date fell within the years in which proposal voting outcomes are available, 1986-1998, were included in the sample.[125] The first criterion, notification in the proxy that votes would be kept

[124] Of the eight proposals offered post-adoption, seven were submitted in the same proxy as the firm announced its implementation of a new confidential voting policy; the eighth proposal, which was submitted three years after the firm's adoption of confidential voting, was not submitted under the SEC shareholder proposal rule and hence was not included in the firm's proxy; it was a direct union solicitation governed by a different SEC rule. The union used the direct solicitation rule, rule 14a-4, 17 C.F.R. § 240.14a-4. Use of this rule avoids the requirement of the proxy proposal rule of continuous ownership of a specified number of shares for one year prior to the submission of a proposal, 17 C.F.R. § 240.14a-8(b); presumably disqualification under the ownership criterion was the reason for the union's use of rule 14a-4. Rule 14a-4 also avoids the proxy proposal rule's various exclusions, 17 C.F.R. § 240.14a-8(i), but these exclusions are not at issue with respect to a confidential voting proposal. While there are these advantages to using rule 14a-4 for a proposal compared to use of the shareholder proposal process established by rule 14a-8, there is a major disadvantage. In contrast to the proxy proposal rule, under rule 14a-4, the proposal sponsor has to pay for the proposal's solicitation costs (it undertakes its own direct solicitation of votes). In the seven rule 14a-8 proposals, either the company announced that it had adopted a confidential voting policy that was equivalent to that requested in the submitted proposal, or there was a divergence between the proposal and the firm's adopted procedure on one or both of the following two dimensions: the firm's confidential voting procedure excluded proxy contests, which the proposal proponent wanted covered by confidential voting; or the firm had not codified the policy in its charter or bylaws, which the proposal sponsor desired in order to prevent the possibility that the procedure could be rescinded by the board at a future time. None of these proposals received a majority of the votes and the practices that were challenged--a proxy contest exemption and failure to place the policy in the corporate constitutional documents--are common to virtually all of the sample firms.

[125] The IRRC did not identify an adoption year for 37 firms. Eight of these firms had confidential voting in place throughout the entire sample period and were consequently

confidential, was used to insure that shareholders knew the policy existed and could therefore factor it into their voting decision. This ensures a clean statistical test. The second criterion assured that a paired-comparison test was possible, that is, that the firm could have proposals offered both before and after confidential voting was adopted. These two criteria eliminated 41 firms, as indicated in table 1. In addition, 12 firms experiencing proxy fights were eliminated to maintain consistency in management proposal policy over the entire sample period as well as in shareholder voting, out of concern that firms experiencing proxy fights are apt to be qualitatively different from those that do not and that the experience could in an unknown but systematic manner alter how those firms' shareholders vote on subsequent proposals, which would pose difficulties for the aggregated statistical tests. The set of firms used for the paired comparison tests of voting outcomes is smaller than the total sample of 118 firms because only 98 firms reported voting on a management proposal, and 54 firms on a shareholder proposal, both before

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eliminated from the sample; another ten were eliminated because they had confidential voting in place in all of their available proxies, although the initial proxy year occurred in the middle of the sample period. For twelve firms, however, I was able to identify a year from the firm's proxy statements that fell within the sample period, and these firms were included in the sample. Where I found discrepancies in the adoption year between the IRRC's data and the firms' proxies, I used the firm's proxy year. The principal reason for a discrepancy (22 of 26 firms) was that the policy was adopted after the annual meeting held during the IRRC's adoption year and thus implemented at the next year's annual meeting, which is the relevant year for the statistical analysis. The years for which voting data are available, 1986-98, are the years over which the IRRC has collected and published voting data in its corporate governance publication series, which is the source for the proposal votes analyzed in this paper. The IRRC publication containing voting results has varied over time: 1986 voting results were published in CORPORATE GOVERNANCE AND SHAREHOLDER RIGHTS; from 1987-1989, voting results were published in annual volumes under the title VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE [YEAR] PROXY SEASON; the results for 1990 were published in a hard-bound almanac, SANDER, *supra* note 3; and after 1990, voting results have been published in the IRRC's loose-leaf service, Corporate Governance Bulletin. My data end in 1998 because 1999 results were not available at the time the study was conducted.

and after adoption of confidential voting. This does not pose any problem of selection bias because voting outcomes are indistinguishable across the full sample and the reduced sample of firms used for the statistical tests (see table 2).

There is evidence of an impact of explicit shareholder activism on the adoption of voting policy in the sample firms (and hence that the concern over endogeneity that led to the chosen sample was a valid one). Somewhat over one-third of the sample firms experienced a vote on a confidential voting proposal prior to their adoption of the policy (44 of 118), and half of those firms received such a proposal at least twice in the three years prior to the year of adoption. Only four of the proposals obtained a majority vote, and in all four cases, management instituted confidential voting for the next annual meeting (that is, it was in place the year after the proposal passed). There is also evidence that management responds to confidential voting proposals as support for the proposal increases. The average support for 36 confidential voting proposals submitted in the year before management adopted the practice was 39.6% (37.2% excluding the four proposals that obtained a majority vote), whereas the average level of support for 22 confidential voting proposals received two years before adoption was 32.7%, and the average support for 19 confidential voting proposals received three years before adoption was 26.7%. For the 19 firms where a confidential voting proposal was submitted two years in a row before the proposal was adopted by management, the difference in the mean support level the proposal received across the two years before adoption, at 7.8%, is significantly positive (significant at .001).[126] Management responsiveness to the level of support a confidential voting proposal

[126] Of the 14 firms for which confidential voting proposals were submitted three years in a row before the proposal was adopted, the difference in mean support level received between proposals submitted two and three years before adoption, although smaller in magnitude at 4.2%,

obtains parallels Thomas and Martin's finding of a significant relation between voting support for executive compensation proposals and a subsequent decrease in targeted firms' executives' annual compensation.[127]

There were 812 management-sponsored proposals and 693 shareholder-sponsored proposals voted on by the sample firms' shareholders during the sample period, 1986-98.[128] Descriptive information concerning proposal type and aggregate voting outcomes is provided in table 2. The breakdown of shareholder proposals by category in this sample, which does not consist solely of institution-sponsored proposals, is virtually identical to that of Gillan and Starks' full sample, indicating that the adoption of confidential voting does not alter shareholders'

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was also significantly positive (significant at .0048). But because the key statistic, the difference in differences, which is the increase in voting support between one and two years before the adoption year, compared to the increase in voting support between two and three years prior to the adoption year, is not significant (mean difference in difference of 1.3% is significant at only .5068) for the 13 firms where confidential voting proposals were submitted three years in a row before adoption, we cannot conclusively attribute the decision to respond to the proposal in a given year as a function of significantly increasing support levels.

[127] Thomas & Martin, *supra* note 103, at 1068. The relation, although in the right direction, was not significant for the changes in the other compensation variables that they examine.

[128] Three proposals included in the sample were offered at shareholder meetings held in the fall of 1985, because the annual meeting period covered in the IRRC's 1986 voting data ran from September 1985 through July 1986.

selection of proposals.[129]

As table 2 indicates, voting outcomes vary widely by proposal type: for example, management proposals obtain greater support than shareholder proposals;[130] management proposals on executive compensation plans obtain greater support than management proposals to construct defenses to takeovers; and shareholder proposals to repeal or modify defensive tactics

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[129] The proposal proportion comparisons are:

Proposal type	Gillan & Starks' full sample+	this paper's full sample (matches only in parentheses)
Confidential voting	12%	15% (12%)
Board independence	3%	4% (4%)
Executive compensation	11%	11% (11%)
Defensive tactics*	49%	53% (55%)
Poison pills (as a % of defenses)*	25%	23% (21%)

* Gillan and Starks consider cumulative voting proposals as a separate category from defensive tactic proposals and I include them in the defensive tactic proposals; the table follows my approach in the calculations. +Gillan & Starks, *supra* note 32 (table 3).

[130]Jennifer Bethel and Stuart Gillan contend that greater support for management proposals is a function of management's ability to manipulate the proxy process, particularly, by their structuring proposals as "routine" to permit broker voting of shares or their bundling of proposals. *See* Jennifer E. Bethel & Stuart L. Gillan, Does Managerial Control of the Proxy Process Disenfranchise Shareholders? (unpublished manuscript Mar. 2000). Their data do not, however, provide convincing support for the contention: the broker votes on routine proposals are small (less than 1%), and on nonroutine proposals, even subtracting those votes from the outcome, the level of support for management proposals is still far greater than that for shareholder proposals: using their table 6 data, management proposals still average 45% higher voting support, 65% compared to 20%, than shareholder proposals. Even recharacterizing routine proposals as nonroutine and subtracting the average broker votes, the "routine" proposals are still estimated to receive between 71 and 84% of the votes. *Id.* at 20. In addition, bundling occurred in very few proposals (27, or less than 10%) and it was not significant in explaining votes. *Id.* (tables 8 and 9). It is therefore, in my view, highly improbable that management manipulation of the proxy process is more likely to explain voting outcomes than shareholders' rational assessment of the impact of the proposals on their wealth.

obtain greater support than shareholder proposals on executive compensation. The variability in voting across proposals requires conducting statistical tests that control for proposal type to minimize potentially spurious findings: for instance, a finding of an increase in votes for shareholder proposals with confidential voting in place is not likely to be due to the procedural change if the subject matter of the proposals simultaneously changes from executive compensation to defensive tactics. Therefore paired-comparison t-tests for firms voting on proposals of the same type both before and after confidential voting adoption were performed.

One question concerning the validity of paired-comparison tests is that they do not control explicitly for firm characteristics that appear to affect shareholder proposal voting outcomes, such as institutional ownership and performance. As earlier discussed, there is a positive correlation among shareholder proposals, voting outcomes and institutional ownership and a negative correlation among proposals, voting outcomes and performance.[131] The sample firms' institutional ownership averaged 59.1% in the year that confidential voting was adopted, which is similar to the average institutional ownership percentage of firms receiving shareholder proposals.[132] Institutional ownership is quite stable for the sample firms over the sample period,

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[131] *See, e.g.,* Gordon & Pound, *supra* note 32, at 713 (percentage of votes cast for shareholder proposals negatively related to insider ownership and positively related to high percentages of institutional ownership); Gillan & Starks, *supra* note 32, at 18 (percentage of votes cast for shareholder proposals positively related to institutional ownership and negatively related to performance); Bizjak & Marquette, *supra* note 24, at 508 (institutional ownership high for proposal firms; support for poison pill resolutions increases with poor performance in prior years). Although these studies have not specifically examined confidential voting proposals, there is no reason to assume that the results would differ for confidential voting proposals.

[132] *See, e.g.,* Bizjak & Marquette, *supra* note 24, at 506 (mean institutional ownership of sample firms .593, compared to .523 for control firms with no proposals); Karpoff, et al., *supra* note 24, at 377 (mean institutional ownership of sample firms .521, compared to .418 for control firms with no proposals); and Smith, *supra* note 26, at 238-39 (mean institutional ownership of

averaging 56.6% in 1988 and 60.5% in 1998.[133] The differences in mean institutional ownership (using a paired-comparison t-test matching ownership before and after for each firm) from 1988 to the confidential voting adoption year, from the confidential voting adoption year to 1998, and from 1988 to 1999, are all insignificantly different from zero. The Pearson correlations are, respectively .45, .65 and .26, all statistically significant.[134] Accordingly, the absence of controls for institutional ownership over time should have no effect on the voting comparison tests.

Changes in performance of sample firms also does not appear to be an important factor: the long run stock performance of the sample firms before and after the adoption of confidential

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sample firms .6422 compared to .5383 for combined sample and control firms). I obtained institutional ownership for the confidential voting year from the STANDARD & POOR'S SECURITY OWNERS' STOCK GUIDES and outstanding shares from the firm's proxies.

[133] Three observations of institutional ownership were obtained for each sample firm: the year in which confidential voting was adopted, the last year of the sample, 1998, and the first year with a significant number of shareholder proposals and available firm data, 1988. For a few firms, 1998 data were unavailable and 1997 data were used. For the sample firms which adopted confidential voting in 1988, 1987 data were used. In addition, for three firms not publicly traded in 1988, the first year of available data, ranging from 1990-1992, was used in the 1988 calculation. Because in each of the three observation years, data on holdings for one or two firms were not available, the statistical tests are based on only 115 firms. For the 1988 and 1998 calculations, institutional holdings were obtained from the STANDARD & POOR'S SECURITY OWNERS' STOCK GUIDES, and outstanding shares were obtained from the firms' proxy statements or, where not available, the MOODY'S INDUSTRIAL MANUAL or other Moody's volume in which the firm appeared.

[134] The lower correlation of institutional ownership from the beginning to end of the sample period, compared to the correlation between each endpoint and the year of confidential voting adoption, is most probably a function of the increase in institutional ownership in the stock market over this time period. For example, institutional investors owned 46.6% of the top 1000 firms in 1987 compared to 57.2% in 1995. *See* CAROLYN K. BRANCATO, INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 19-20 (1997). It could also well be additional support for the concern, discussed at text and accompanying notes 138-43, *infra*, that increases in voting outcomes identified by the paired-comparison tests are due to a time trend rather than the voting procedure change (see table 7).

voting, while increasingly negative, is not significant. In particular, long run stock performance was computed as the market-adjusted return on a buy-and-hold investment in the sample firms, using daily return data from the University of Chicago Center for Research in Security Prices (CRSP) data, over three- and one-years before and after adoption.[135] The portfolio of sample firms' abnormal performance is not significantly different from zero over any of these periods.[136]

iii. *Results*

The aggregate data suggest that confidential voting increases support for all proposals. As indicated in table 3, the mean votes supporting proposals before confidential voting adoption

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[135] *See, e.g.*, Brad M. Barber & John D. Lyon, *Detecting Long-run Abnormal Stock Returns: The Empirical Power and Specification of Test Statistics*, 43 J. FIN. ECON. 341, 344 (1997). The market proxy used to adjust the firm returns to measure abnormal performance is the return on a buy-and-hold investment in the equal-weighted CRSP portfolio I use the equal-weighted portfolio as the market proxy, following the literature, because my test portfolio is equal-weighted. The calculation of the buy-and-hold abnormal return, (BHAR), is: $BHAR_{i\tau} = \prod_{\tau} [1+R_{i\tau}] - \prod_{\tau} [1+R_{m\tau}]$. Of the sample firms, 109 firms have returns data over the full 7-year period. Although a market-adjusted model is not as robust methodologically as the use of a control firm sample for long-term buy-and-hold returns, *see id.* at 364-66, construction of a paired sample is extremely difficult because for many sample firms, all comparably sized industry peers have confidential voting or there is no comparably sized industry peer. In addition, the endogeneity of the adoption of confidential voting is apt to undermine the efficacy of using a matched sample as a performance control, as unknown characteristics affecting the choice of such a procedural reform may also systematically affect performance.

[136] The one and three-year BHARs and t-statistics for significance are:

Interval	Buy-and-hold Abnormal Return	t-statistic
-3 years	-1.1227	-.0457
-1 year	-0.1507	-.0248
+1 year	-0.2751	-.0359
+3 years	-0.9996	-.0442

If the value-weighted CRSP portfolio is used as the market proxy instead, the sign of the BHARs is positive and decreasing, and insignificant in all four intervals.

are lower than the mean votes supporting proposals afterward, whether the proposal is offered by management or shareholders. But only the difference in management proposal support level is statistically significant. Namely, the statistical tests (pairwise-comparisons by firm), presented in table 4, show that management proposals, on average, obtained 9% more support, and shareholder proposals 3% more support, after confidential voting was in place, but only the difference for management proposals is significant at conventionally accepted confidence levels (significant at .05 or less). Because it is management, and not shareholder proposals, which gain in votes at a level beyond the borderline of statistical significance, the voting procedure does not appear to alter outcomes as its proponents' anticipated. This result tracks the contention in the American politics literature that the major political parties supported, and benefitted from, the institution of secret ballots, notwithstanding its advocacy by reformers: in the corporate context, management agrees to adopt confidential voting because it does not expect the procedure to affect voting outcomes.

The increase in support for management proposals is inconsistent with the prediction that management support should decline with voter anonymity. One possible explanation of the finding of increased support for management proposals more favorable to confidential voting advocates' position is that management strategically alters the proposals it submits for a vote after confidential voting is in place, sponsoring only proposals that it expects to receive higher levels of support. If this were true, confidential voting would actually have had a beneficial effect for shareholders, despite the increased voting support for management proposals. One means of testing this proposition is to disaggregate the data and undertake pairwise-comparisons of differences in mean voting support by proposal category: because such matches imply a continuation, as opposed to reversal, of management's proxy agenda (the same type of proposal is being introduced before and after confidential voting is instituted), the hypothesis of an altered strategy would be rejected if voter support did not decline in the matched proposal subsamples.

The altered proposal selection strategy explanation is not supported by the data. As indicated in table 4, over 2/3 of the sample firms' agendas appear to be unaltered by the procedural change (that is, they have matched proposals). Paralleling the aggregate data, in the two management proposal categories for which there are enough pairs to test for statistically significant differences--proposals to increase the authorized common stock and proposals to adopt or amend executive and director compensation plans--still have significantly higher voting support levels after adoption (7% and 3% increases in support level, respectively, both significant at less than 5%). This is, however, an imprecise test of the altered strategy proposition, because matching by category may conceal subtle changes in the content of proposals (that is, whether a proposed amendment to an executive compensation plan involves an innocuous change concerning the plan’s terms or a change investors would find objectionable, such as option repricing or significant dilution).

There are no matched pairs of management-sponsored defensive tactics, as all but one of these proposals were offered prior to the adoption of confidential voting (that one proposal, in fact, received more votes than the average votes obtained by the pre-adoption defensive tactic proposals). It could be contended that the reduced frequency of proposals involving takeover defenses is evidence of a selection effect caused by confidential voting. But such a claim is not supported by the data: the peak period during which firms adopted confidential voting was the 1990s (see table 5), well after the peak period of management takeover defense proposals. In other words, the explanation for the absence of such proposals post-confidential voting adoption is that the sample firms' defensive tactics were already in place by 1988, when they began instituting confidential voting. Indeed, the prominence of shareholder proposals to repeal defensive tactics after the adoption of confidential voting underscores the timing explanation--that defenses were already intact--rather than the alternative explanation--a revision in management's proposal selection subsequent to the voting procedure change. For if management altered its proxy agenda strategy and ceased to propose takeover defenses in response to the implementation of confidential voting, rather than having already had such defenses in place, the shareholder proposals calling to rescind defensive tactics would not have been necessary for the sample firms.

Although the results for shareholder proposals are also disappointing for proponents of confidential voting, disaggregating the proposals by type appears to provide better support for the hypothesis that confidential voting increases the voting support for shareholder initiatives disfavored by management. As indicated in table 4, the mean voting support for shareholder proposals seeking to repeal defensive tactics increased significantly after confidential voting. This is true when the defensive tactic proposals are grouped to include all defenses (a 10.5% difference in mean increase in voting support, significant at less than 1%), as well as when they are more specifically matched for defensive proposal type (poison pills, staggered boards, or cumulative voting), although the specific defensive tactic matches contain very few observations (less than a dozen) and therefore do not provide as reliable statistics as do the aggregated data.

The defensive tactics subsample arguably provides the best test of the efficacy of confidential voting because management typically vigorously resists repealing the use of defensive tactics and the fact that shareholders benefit from takeover bid premiums, which may be thwarted by defenses, is well-known.[137] It is also the only subsample of shareholder proposals that can be analyzed with confidence, as it is the only category whose sample size is sufficiently large to conduct reliable statistical tests. Even if, as noted earlier in the discussion of poison pill proposals, the contention that defensive tactics harm shareholders (that is, that they reduce the rate of successful bids) is a controverted empirical claim, if shareholders believe that defensive tactics are not in their interest, then the expectation that institutional investors would have a higher likelihood to vote against management under conditions of anonymity would be best tested by this subsample of vote comparisons.

Moreover, the principal difference between the full sample of shareholder proposals and the defensive tactic proposals is the inclusion of proposals on board composition and executive compensation (the confidential voting proposals constitute a slightly smaller part of the difference). Those proposals involve substantive governance changes that, as discussed earlier, have had no discernible effect on corporate performance.[138] If the institutional investors whose votes are in question (private money managers who might have business relations with management) do not believe that the implementation of proposals involving independent boards and compensation limits improves performance, consistent with the empirical literature reviewed earlier, but regard more favorably the rescission of takeover defenses (a plausible assumption

[137] *See, e.g.,* Jensen, *supra* note 14, at 22 (depending on the time period, takeover premiums averaged 30% and 50% above the market price); Easterbrook & Fischel, *supra* note 78 (shareholders lose from defenses that foster auctions because this reduces the initial probability of receiving a bid).

[138] *See* parts II.B.2.a and II.B.2.c, *supra*.

given the inconclusive empirical results on defenses), then we would not expect such investors to change their vote and support the former proposals when their votes become anonymous.

The paired-comparison test of shareholder proposals on defensive tactics is confirmatory of the hypothesized benefit of confidential voting, as support significantly increases after the procedural change (mean support difference of 10.5%, significant at less that 1%). There is a problem, however, with concluding from these results that confidential voting facilitates voting against management: the higher voting support for proposals submitted after the adoption of confidential voting could also be a function of the widely-reported fact that voting support for shareholder proposals has increased over time, and not of the confidentiality of the votes. The IRRC, for instance, in its annual reports on shareholder voting reports a trend of increasing support for shareholder proposals,[139] and the proxy soliciting firm, Georgeson & Company, reports an upward trend in particular for votes in favor of poison pill rescissions.[140] As indicated

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[139] *See, e.g.,* "Voting on U.S. Governance Shareholder Resolutions," IRRC Corporate Governance Bulletin 3 (Apr.-June 1998) (indicating increasing support levels for poison pill and staggered board proposals, as well as board independence proposals in 1998 compared to 1997 proxy votes but decreases in executive compensation and cumulative voting proposal support levels); "Average voting results on major corporate governance shareholder proposals," IRRC Corporate Governance Bulletin 20 (July-Sept. 1995) (table indicating an increase (decrease) in average votes from 1994 to 1995 of over 3% for 8 (2) shareholder proposal categories, and an increase (decrease) of less than 1% in 1 (3) categories, and none of the categories with decreases involved defensive tactics); SANDER, *supra* note 3, at 4-5 (average support for almost all types of shareholder proposals increased over five years 1986-90, and noting three categories experienced over 10 point increases, two of which involved defensive tactics). Gillan and Starks also report that voting support for shareholder proposals has increased over time, finding an increase in mean support in the latter half of their sample (after 1990). Gillan & Starks, *supra* note 32, at 13.

[140] Georgeson & Company, Inc., 1998 Annual Meeting Season Wrap-Up Corporate Governance 7 (1998) (graph of votes for poison pill proposals from 1987 through 1999, shows steady increase in support from 20% to 45%) (1998) (also available at their website, www.georgeson.com).

in tables 5 and 6, the sample mean voting outcomes reveal a positive time trend, although the trend is not constant for all types of proposals and actually appears less pronounced for shareholder, than for management, proposals.

To test the alternative hypothesis that the significant increase in support for shareholder proposals involving defensive tactics is due to a positive time trend in votes against management and not the institution of confidential voting, voting outcomes were regressed on a variable indexed for proposal year (the first sample proposal year is 1), a dummy indicator variable for whether the proposal was submitted after confidential voting was adopted (1 indicates submission post-adoption), and past stock return, as other researchers have found that votes for shareholder proposals are significantly negatively correlated with past performance.[141] Because for the first three sample years all proposals are all pre-adoption for all firms and for the last four sample years all proposals are all post-adoption for all firms, the variables indexing proposal year and post-adoption are indistinguishable for these observations, which renders impossible any attempt to separate out the effect of time from that of the voting procedure upon voting outcomes for proposals submitted in those seven years. As a consequence, the regressions were estimated eliminating the observations from those seven years. As indicated in table 7, the post-adoption dummy variable is not significant for the shareholder proposals, either in the aggregate or for the defensive tactics; the year dummy is significant in both cases. Table 7 indicates that the same is

[141] *See* Gillan & Starks, *supra* note 32, at 18 (significant negative correlation). Stock returns were calculated using the buy-and-hold methodology discussed in note 136, *supra* for monthly rather than daily data, for both the year ended before the meeting and one year before that ("year minus one"). Both raw and adjusted returns, using the equal-weighted CRSP portfolio, were calculated. I use in the regressions the return that had the highest significant correlation with the voting outcomes, which is the raw return of year minus one for the aggregate shareholder proposals and the market-adjusted return of year minus one for the defensive tactic proposals.

true for management proposals: only the time trend variable is significant.[142] Hence the increase in support for submitted proposals is not a function of the voting procedure.

The regression in table 7 indicates that voting support increases at slightly under 1% per year over the sample period for the management and aggregate shareholder proposals, and at 1.8% per year for the shareholder defensive tactic proposals. The latter estimate confirms the time trend explanation of the increase in voting for shareholder defensive tactic proposals in the sample firms because it closely tracks the increase in support identified in the literature for all poison pill rescission proposals.[143]

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[142] There are no stock returns in the management proposal regression because there was no significant correlation between any of the four stock return variables and the voting outcomes of the management proposals. This is not surprising: there is no straightforward theoretical link between voting support for management proposals and past performance; if anything, we would expect the relation to vary with the substance of the proposal. For instance, while we might expect support to drop with poor performance, if management submits proposals that are expected to improve lagging performance, then support would rise with poor performance. In fact, one study found, to the authors' surprise, that support for management proposals on executive compensation increased with prior poor performance, even in the face of unfavorable plan terms that otherwise decreased voting support. *See* Thomas & Martin, *supra* note 113, at 50. In addition, all three regressions were also estimated using a tobit model, which takes into account the fact that the dependent variable's range is restricted between 0 and 100. *See* TAKESHI AMEMIYA, ADVANCED ECONOMETRICS 360-64 (1985). The tobit results were identical to those of the ordinary least squares (OLS) regressions and given that tobit coefficients are less transparent to interpret than OLS coefficients they are not reported. The identity of results is most likely due to the absence of any censored observations. Therefore, an additional model specification was estimated, following conventional econometric techniques, that logistically transformed the values of the dependent variable: $y = \log\{(y/100) \div (1-(y/100))\}$. Because the results using the transformed dependent variable are the same as those of the untransformed dependent variable regressions for the management proposals, for the shareholder defensive tactic proposals except as discussed in note 144, *infra*, and for the aggregate shareholder proposals except that for the model in table 7, only the performance variable is significant, these results are not reported for the same reason as the tobit results, less interpretable coefficients.

[143] *See* Georgeson & Company, *supra* note 140 (25% increase over 13 years); SANDER, *supra* note 3 (12% increase over 5 years); "Voting on U.S. Governance Shareholder Resolutions," *supra* note 139, at 3 (1.8% increase in support from 1997 to 1998).

Two additional models were estimated to consider whether the time trend is nonlinear (whether voting support increases at a diminishing rate over time): in the first model, a squared time trend term was added; in the second, in addition to the squared time trend term, an interaction term between the time trend and the post-adoption dummy variable was added. For the shareholder defensive tactic proposals, in the first nonlinear specification, all of the variables, including the simple time trend, are statistically insignificant. In the second, the interaction term is marginally positively significant (9 percent); all other variables are insignificant.[144] Although I do not have an explanation for this odd result, because this regression does not have significantly more explanatory power than the simpler regression reported in table 7 (adjusted R^2 of .1045), the conclusion to draw from these data is that more sophisticated models do not improve upon the analysis of the voting for shareholder defensive tactic proposals provided by the simpler model. The result of the pairwise comparisons in table 4 indicating higher support after the adoption of confidential voting is evidently a function of voting support for rescinding defensive tactics increasing over time, and not of the change in voting procedure.

For the aggregate shareholder proposals, the squared time trend term, as well as the simple time trend and performance variables, are statistically significant and the sign of the squared term is negative. This indicates that the increase in support diminishes over time. However, the effect is small: the coefficient on the nonlinear term is much smaller (.7) than the coefficient on the time trend (11). For the management proposals, when only the nonlinear time trend variable is added, as in the shareholder defensive tactic regression, all of the variables

[144] Running the same two regressions using the log transformation of the voting dependent variable described in note 142, *supra,* no variables are significant in either nonlinear estimation.

become insignificant. When both nonlinear terms are added, the post-adoption dummy variable and the interaction term are significant (positive and negative, respectively), while the two time trend variables are insignificant; the signs on the nonlinear terms are negative. Although the disparate finding (insignificant simple time trend and significant post-adoption dummy variable) in this specification compared to all the other models is puzzling, the most coherent explanation, viewing all of the models together, is that support for proposals is not significantly affected by the adoption of confidential voting.

In sum, the regression results indicate that the effect of a time trend is more important than the institution of confidential voting for explaining the increased support for shareholder and management proposals in the sample firms (although neither variable explains most of the variation in votes, given the low values of the statistic measuring that effect, the regressions' adjusted R^2s). Thus one can conclude that confidential voting has no significant impact on voting outcomes. An event study of the stock price effects of the announcement of adoption of confidential voting, which measures investors' assessment of the wealth effect of such voting procedures, is consistent with this interpretation.[145] There is no significant stock price effect upon the announcement date or cumulated around intervals between 1 and 20 days before and

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[145] For a brief discussion of the event study methodology, *see* note 45, *supra*. I used a standard beta-adjusted market model (with the CRSP equal-weighted stock return portfolio as the market portfolio) to compute abnormal returns for the portfolio, over 200 days before the month of the event. *See id.* The event is the mailing date of the proxy in which the adoption of confidential voting was first announced (for firms with no explicit mailing date in the proxy, the date of the proxy was used because the date is identical for 80% of the firms providing both dates). For 38 sample firms, there was a press release or other news report of the adoption of confidential voting; the results were no different for this subsample of announcement dates.

after the announcement.[146] Finally, as earlier reported, there is no significant improvement in stock price performance over one to three years after the adoption of confidential voting.[147] In fact, a paired-comparison test of the difference in mean market-adjusted abnormal performance indicates a significant decrease over years -1 and +1 using an equal-weighted portfolio as the market proxy; the difference is not significant over years -3 and +3, or if a value-weighted portfolio is the market proxy. Of course, if, as this paper contends, the subject of the vast majority of shareholder proposals does not improve performance, than changing the voting procedures to enhance the probability of such proposals' adoption will not improve performance either.

The insignificant impact of confidential voting on voting outcomes plausibly explains why many firms voluntarily adopt the procedure: it doesn't matter.[148] The conclusion concerning

[146] The abnormal returns for the event date and cumulated over selected intervals are:

Interval	Abnormal returns	t-statistic
Day 0	-.0052	1.078
Day +1	.0007	.4036
Days 0 through +1	-.0012	-.2384
Days -5 through +5	-.0143	-.2291
Days -20 through +20	-.0139	-.0301

[147] *See* note 136, *supra*. In fact, the portfolio difference in mean market-adjusted buy-and-hold returns over year -1 and year +1 (paired-comparison by firm), of -0.1244, is significantly negative (t-statistic of -3.77); that is, relative performance declined after the adoption of confidential voting. The difference in mean BHAR over 3 years before and over 3 years after confidential voting adoption, of -0.1231, is not significant (t-statistic of -0.96).

[148] To check whether there is a sample selection bias–that is, whether only the firms where confidential voting will not matter adopt the procedure, which would be firms whose shares are not held by the private institutional investors which are posited to have conflicting interests under non-anonymous voting, *see* text and accompanying note 117, *supra*, the portfolios of the

the import of the time trend corroborates the results from the aggregate sample pairwise-comparison tests that are inconsistent with the hypothesis that support for shareholder proposals should increase, and support for management proposals decline, with the adoption of confidential voting. Thus, the interpretation to draw from the data on confidential voting is consistent with the general conclusion drawn from the extant empirical literature regarding the three other principal categories of shareholder proposals: the benefit of promoting such proposals is, at best, marginal, because the procedure has no discernable behavioral effect.

3. *Private negotiation effects as signals*

In contrast to submitted proposals, institutional investors' private negotiation governance strategies produce significant positive stock price effects. Findings of significance are uniform across the five studies of such activities, although not over all time intervals investigated. These results are consistent with, as previously reported, Wahal's finding distinguishing between submitted proxy proposals and successful private negotiations that obviated the need for a proposal, Smith's finding of a positive effect for successful targeting (assuming this subsample is dominated by instances of nonproxy rather than proxy activism), and Forjan's finding of a positive announcement effect for successful negotiations (assuming that the cases of negotiations dominate those of the proposals that passed in his 27-firm sample combining the two cases).

Willard Carleton, James Nelson and Michael Weisbach examined the impact of the

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largest private equity mutual fund managers and managers of pension accounts (as identified in *Pensions and Investments* as the top institutional managers) were examined. There is no evidence of such a bias: these funds held significantly more positions in the 118 sample firms with confidential voting than in a random sample of 118 firms that did not confidential voting, which was obtained from the population of firms experiencing either a management or shareholder proposal in 1994 according to the IRRC reports.

corporate governance activities of TIAA-CREF, which seeks to negotiate privately with firms it has targeted and typically reaches an agreement with management that results in its not having to submit a proposal.[149] Carleton et al. found no significant changes in accounting measures of long-term performance from TIAA-CREF's activism, but the stock price effect of the initial targeting was significant, depending on the substantive content of the negotiations. It was significantly positive for targeting with the goal of restricting poison pills, significantly negative for targeting seeking to increase the diversity of the composition of the board of directors, and insignificant for targeting to institute confidential voting.[150]

Another positive finding concerning "behind the scenes" activism involves firms targeted by the United Shareholders Association (USA), a non-profit shareholder advocacy organization which was founded by T. Boone Pickens, a prominent hostile takeover bidder during the 1980s, and whose members were primarily small shareholders. Deon Strickland, Kenneth Wiles and Marc Zenner examined negotiated settlements with the group.[151] When management agreed to USA's requested changes prior to the proxy proposal submission deadline, the targeted firms experienced positive stock price effects, but there were no significant price effects when USA presented a proxy proposal. The negotiated agreements involved takeover defenses (subdivided into poison pill and golden parachute removal proposals), board composition and confidential

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[149] Carleton et al., *supra* note 26, at 1356 (agreements reached with 32 of 45 firms without issue coming to a shareholder vote).

[150] *Id.* at 1351. The stock price effects around the time in which the firms publicly announced their action to comply with TIAA-CREF's demands were generally not statistically significant, but these were not robust tests because very few firms publicly announced these actions (number of observations ranged from 1-11 firms, depending on the subsample). *Id.*

[151] Strickland et al., *supra* note 24 (53 negotiated agreements over 1992-93).

voting; in contrast to the proxy proposal and TIAA-CREF studies, there was no difference in the sign and significance of the price effects across USA's three types of proposals.[152]

Tim Opler and Jonathan Sokobin examined the returns of firms on the Council of Institutional Investors' (CII) "focus-list" of poor performers.[153] The CII is an organization of public and private pension funds that serves as a clearinghouse for the funds' corporate governance activities. Opler and Sokobin find that the targeted firms experience better market and operating performance than the market as a whole and other benchmark portfolios in the year subsequent to their inclusion on the CII list. They infer from this result that coordinated investor action that takes place behind the scenes ("quiet activism") is effective in improving firm performance, in contrast to the proxy proposal route, which often involves campaigns by one investor, and for which studies do not find positive effects.[154] This conclusion is only an inference because we do not know whether all of the firms on the focus-list were indeed the targets of such shareholder activism. But it is consistent with the findings of Carleton et al., Smith, Strickland et al. and Wahal concerning privately negotiated (nonproposal) activism by institutional investors.

Claire Crutchley, Carl Hudson and Marlin Jensen investigate targeting activities by CalPERS by examining the stock price reaction to a firm's initial placement on the fund's publicly announced list of targets.[155] They find a short run positive price effect that disappears

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[152] *Id.* at 12.

[153] Opler & Sokobin, *supra* note 24 (117 firms on lists over 1991-94).

[154] *Id.* at 6-8, 19.

[155] Claire E. Crutchley, Carl D. Hudson, & Marlin R.H. Jensen, *The Shareholder Wealth Effects of CalPERS' Activism*, 7 FIN. SERVICES REV. (forthcoming).

over a year after the announcement and conclude that for the full sample there is no lasting impact on performance.[156] They then divide their sample in two, the early years, 1992-94, when Dale Hanson was the fund's CEO and CalPERS' activist corporate governance campaign was quite visible, and the later years, 1995-97, when, under Hanson's successors, it came to play what they term a "quieter" (that is, a less visible, behind-the-scene) role. Crutchley et al. find that over the year after targeting, the early years subsample has a significantly positive cumulative return, whereas the later years subsample's cumulative return is negative, compared to the return on the S&P 500 index.[157] As restructuring actions taken by the targeted firms after targeting do not affect the size of the abnormal return, their conclusion is, in contrast to Opler and Sokobin's, that visible or aggressive public activism, and not quiet activism, increases shareholder wealth.[158]

Finally, N.K. Chidambaran and Tracie Woidtke studied the shareholder proposals that were withdrawn from 1985-1995.[159] They find that the characteristics of firms where proposals are withdrawn have changed over time, particularly after the adoption in 1992 by the SEC of changes in the proxy process to facilitate shareholder communication. In contrast to the other four studies evaluating negotiations over proposals, their measure of firm value is the change over the proposal year in Tobin's Q, the ratio of the firm's market to book value. A Tobin's Q greater than 1 indicates the market values the firm's assets above their book value, which

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[156] *Id.* at (table 4-ms. p. 9).

[157] *Id.* at (ms. p. 10)

[158] *Id.* at (table 5, ms. 10-12).

[159] N.K. Chidambaran & Tracie Woidtke, The Role of Negotiations in Corporate Governance: Evidence from Withdrawn Shareholder-Initiated Proposals (unpublished manuscript, Dec. 1999).

indicates the firm has significant intangible asset value, and hence the ratio is considered to be an indicia of good performance. Although for the whole sample of withdrawn proposals there is no significant performance effect, for the set of proposals withdrawn post-1992 whose sponsors were public or union funds, there is a negative valuation effect (a statistically significant decrease in Tobin's Q), in contrast to proposals withdrawn before 1992, where the valuation effect (change in Tobin's Q) was positive albeit not significant.[160]

Chidambaran and Woidtke interpret these data as indicating that the 1992 proxy reforms provided institutional investors with excessive bargaining power such that they are able to pressure managers to accept non-value-maximizing proposals, because the firms whose proposals were withdrawn after 1992 also have lower levels of management stock ownership than the firms whose proposals were withdrawn before 1992, and such pressure will be more easily accomplished when management does not have significant voting power.[161] Hence, they also reach a diametrically opposite conclusion from Opler and Sokobin concerning behind-the-scenes activism by institutional investors, that it is not a shareholder wealth-enhancing activity.

The seeming paradoxical finding of significant positive performance effects, at least in the earlier years under empirical study, from negotiated agreements (private activism), largely

[160] *Id.* at 16-17 and 28 (table 6).

[161] *Id*. at 3, 19. These data suggest that before 1992 manager-shareholder negotiated compromises were more likely to occur when proposals were value-maximizing propositions than post-1992. They buttress this contention with an examination of the subset of proposals for which they can classify whether management adopted the withdrawn proposal as is or whether the parties reached a compromise on the proposal's substance; they find that post-1992, proposals accepted as is had a significant negative impact on firm value, and before 1992, compromises had a significant positive effect, *id*. at 18-19, but they do not indicate how representative, or what percentage, of the full sample, this subsample is.

independent of subject matter, and insignificant effects from shareholder proposals on the same issues, can be reconciled by a signalling explanation of management behavior. From this perspective, the positive price effects from private activism are not indicia of a positive assessment of the subject matter of that activism but rather, indicate investors' assessment of management's quality, that it will be responsive and not resistant to shareholders' efforts to improve firm value.

In other words, the difference in stock price reaction is a function of learning--informational updating concerning management quality by the market from the occurrence of shareholder activism--rather than the market's assessment of the value of the underlying activism's objectives. The market views nonproxy (negotiated settlement) activism as a positive signal (that is, a signal that management quality is actually high): because management was sufficiently responsive to the institutional investor's concern that the investor was willing to withdraw its proposal, investors update their evaluation of management quality as less prone to self-entrenchment and more apt to improve performance. In contrast, the failure to negotiate does not provide new information as the market had already perceived the management of targeted firms to be of low quality, and hence, we would not expect studies to report consistently a negative stock price effect upon proposal submissions.

The information concerning management's response to shareholder activism is informative in this scenario, for it enables investors to screen, from among poorly performing firms, those with lower quality management (that is, the signal reveals information because it would be more expensive for low, than high, quality managers to be responsive). This is an equilibrium story only if it is costly for lower quality managers to mimic higher quality managers by negotiating proposal withdrawals. The signal provided by a successful negotiation will clearly be a more costly strategy for lower-quality managers to undertake compared to higher-quality managers when the subject is a proposal to eliminate a defensive tactic: the former type of managers are more likely to be the target of a hostile bid and replaced. This factor makes the signal not easily mimicked by poor quality management even for proposal categories where the impact will not be as clearly disparate across managerial quality: since most firms do not experience only one type of proposal,[162] if lower-quality managers negotiate over one proposal and then refuse to negotiate over takeover defenses, their type will be revealed.

An alternative explanation of the discrepancy between the results in the studies of successful negotiations over proposals and submitted proposals is that, in contrast to submitted proposals, withdrawn proposals are value-maximizing proposals, and thus when managers accept the proposal, shareholders bid the price up in anticipation of the proposal's implementation. In this view, the proposals that are submitted are proposals that management recognizes are non-value-maximizing and hence proposals over which it does not negotiate withdrawal; there is no market reaction to a submission because the proposal is negatively assessed but not expected to pass. The problem with this explanation, compared to the signalling explanation, is that the stock price results for proposal negotiations are independent of proposal type, except for the Carleton et al. study of TIAA-CREF's activism, and as already discussed, most of the proposals are not directed at value-maximizing reforms. The results should not differ by proposal type if the value-maximizing proposal explanation is correct.

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[162] For example, in the confidential voting firm sample of this paper, 2/3 of the firms receiving a proposal to eliminate a defensive tactic received another type of proposal at the same meeting.

The findings of negative valuation effects from negotiated activity in later subsample time periods (the studies by Crutchley et al. and Chidambaran and Woidtke) are obviously inconsistent with the simple value-maximization explanation. While these findings also appear to contradict the signalling explanation, there is a means of reconciling that theory with these data. If the subsample firms experiencing negative valuation effects had been targets of proposal negotiations previously, the negative effect could be explained as a downward revision of prior beliefs regarding managerial quality because shareholders had to come back with additional proposals. Under this line of reasoning, the negative valuation findings are not at odds with the signalling explanation.

The downward revision hypothesis differentiating the signalling and value-maximizing explanations with regard to the studies finding negative valuation effects is supported by a further study of proxy proposals by Andrew Prevost and Ramesh Rao, which subdivided firms between those receiving proposals sponsored by institutional investors known to engage in pre-submission negotiations, such as CalPERS, and other public fund investors, and then subdivided the activist investor targets between those receiving proposals over more than one year and those receiving proposals only once.[163] Not only do Prevost and Rao find a significant negative price effect for the 32 proposals submitted by the activist funds and no significant effect for the overall sample, but they also find that the negative wealth effects last for much wider event intervals for the 10 multiple year proposal firms than for the 22 single proposal firms.[164] Admittedly, the

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[163] Andrew K. Prevost & Ramesh P. Rao, *Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?* J. BUS. (forthcoming).

[164] *Id.* at 18, 28.

study's sample size is small. But the findings are entirely consistent with a signalling explanation because the returns are significant only for proposals submitted by institutions whose pre-proposal activism is highly visible, and hence for situations in which the proposal's appearance on the proxy is evidence to the market that management was not responsive to the investor, with the information effect magnified for firms receiving multiple proposals. These data imply that in instances of multiple submissions, investors update their beliefs concerning management quality, concluding that a persistently unresponsive management will be unwilling or unable to undertake necessary steps to improve firm value (that is, investors learn that the targets are firms with potential agency problems as the managers have not learned from their "first exposure" to institutions' proposals how to avert future submissions).[165]

All of Prevost and Rao's findings of negative significance are independent of proposal category, further corroborating the signalling hypothesis. Moreover, the expectation of poor performance due to low management quality (that is, the identification of an agency problem more severe than first expected) offered as the interpretation of the more negative statistical results for multiple proposal firms is a rational expectation: that is, it is in fact borne out by subsequent data. Both long-run stock returns and accounting measures of long-term performance decline significantly for the multiple proposal firms, but not for the single proposal firms.[166] In short, management that does not respond to institutional investors' concerns--managers of firms where proposals are actually submitted for a vote--are conjectured by investors to be managers of low quality, and that assessment is confirmed when a second proposal is submitted. Moreover,

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[165] *Id.* at 19.

[166] *Id.* at 22-23.

the signal is accurate: the longer term subsequent performance of firms with such managers is worse.

The signalling explanation of the impact of private activism is also consistent with the finding of Gillan and Starks that the magnitude of the price reaction to a shareholder proposal is negatively related to the identity of the sponsor as an institutional investor.[167] Firms negotiate with institutional shareholders and not with the individual shareholders who sponsor proposals before the final proxy statement because institutions have larger shareholdings and consequently their support is more important to management. Thus, in contrast to proposals submitted by individuals, institutions' proposals have a higher probability of being withdrawn before the proxy is mailed due to negotiated agreements with management. Accordingly, revelation of a submitted proposal sponsored by an institution provides information concerning management's quality (that is, of its responsiveness to investor concerns) that is not revealed by one sponsored by an individual investor--institutions' submitted proposals reveal failed negotiations.[168] Of course, if institutional investors are pressing non-value-maximizing proposals, their greater propensity to influence management would have the opposite effect, the results of the Chidambaran and Woidtke study, as well as the executive compensation proposal studies.

Finally, where the Carleton et al. study's results of significance differ from those of the shareholder proposal studies,[169] a signalling explanation seems especially apt at reconciling the

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[167] *See* Gillan & Starks, *supra* note 32, at 26.

[168] *See, e.g., id.* at 20 (withdrawn proposals predominantly institution-sponsored proposals).

[169] Carleton et al.'s varying findings of statistical significance based on the content of TIAA-CREF's activism can be reconciled with the empirical literature on the underlying governance devices. The finding that TIAA-CREF's efforts to increase board diversity has a negative impact

differences. Carleton et al. found that private negotiations involving restrictions on poison pills had a positive impact, compared to the negative impact of antitakeover proposals (which were primarily poison pill rescission proposals) in the Smith and Gillan and Starks studies, and the marginally significant negative result in the Del Guercio and Hawkins study. Although Carleton et al.'s result is consistent with the initial empirical studies that found a negative wealth effect of poison pills, it is also consistent with a management quality signalling explanation: Smith, Gillan and Starks, and Del Guercio and Hawkins, who do not find positive price effects, are examining submitted proposals whereas Carleton et al., who find positive effects, are not. Thus the management of the firms in Carleton et al.'s study could have been perceived as more responsive to investor concerns and thus less prone to entrenchment in the use of a poison pill defense, than those in the other three studies.

The signalling explanation for the difference across the studies of shareholder activism concerning poison pills is especially compelling because Carleton et al.'s sample of negotiations all occurred after 1992, the period in which poison pill adoptions appear no longer to have a

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on performance is consistent with one study that identified value-maximizing boards (boards chosen by leveraged buyout firms going public) as having fewer female directors than the average board. *See* Robert Gertner & Steven N. Kaplan, The Value Maximizing Board (Dec. 1996) (unpublished manuscript, on file with author). The studies relating board composition to performance do not examine directors' personal attributes of gender and race, the object of TIAA-CREF's proposal, but the failure to find a positive effect on performance in the more general board studies of director independence is consistent with the finding that TIAA-CREF's board proposals do not increase target firm value, because increasing director diversity typically would be achieved by the addition of independent directors under TIAA-CREF's policy. The finding of insignificance for confidential voting adoptions is consistent with this paper's finding that the practice does not significantly affect voting outcomes. And the finding of a positive impact for negotiations on poison pills is consistent with the results of the earliest empirical studies of negative price reactions to pill adoptions, as well as with a signalling explanation, which is discussed in the text.

negative price effect.[170] Finally, the signalling explanation reconciles most of the disparities across the entire set of shareholder activism studies--that is, it explains why a proposal may have a price effect when privately raised with management yet not when appearing in a proxy, but at the same time why targeted firms' long-term performance does not significantly improve, whatever the form of activism.

It should be noted that managements at first did not enter into private negotiations with union funds, compared to other pension funds, a fact which, in all likelihood, explains the unions' increasing share of submitted proposals. More recently, they have begun to negotiate with union proposal sponsors.[171] There is little reason to expect different performance or price effects from union than pension fund activism as regards proposals with the same substantive objectives, and there previously would have been no signalling effect from union proposal submissions, as is the case for proposals by individual investors, given the historical absence of private contacts.

But it is not self-evident whether the same price reaction would occur as occurs for public pension fund proposal submissions when union sponsorship also carries an information effect. It is possible that a similarly negative response would occur, but the interpretation of such a signal could be different from that offered for the other pension funds' proposals. For instance, the targeting of union activists after failed negotiations could provide the market with new information concerning firms' labor relations. This would be true if the market believed that

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[170] *See* text and note 71 *supra*.

[171] *See, e.g.*, IRRC, *Update on Union Funds*, 11 Corporate Governance Highlights 17 (Feb.4, 2000) (building trades unions continue to negotiate with company management over proposals); Vineeta Anand, *Labor Learns Lesson Well Unions Use Activism as Tool against Target Companies,* PENSIONS & INVESTMENTS, Apr. 3, 1995, at 24 (quoting Teamsters' official stating "there's a lot more negotiations going on").

there was a correlation between the outcomes of proxy proposal negotiations with a union fund and the outcomes of firms' labor negotiations in general. Such a scenario would produce a negative stock price effect, although it is not the same perception of what renders the management "low" quality as the signal when the failed negotiator is a public pension fund. However, such a scenario--updating concerning a firm's labor relations from independent negotiations over proxy proposals--is highly improbable because firms' labor disputes are widely-publicized events and firms' poor labor relations are well known to market analysts.[172] It would thus seem more probable that the interpretation of a submitted proposal as a negative signal regarding management quality would be the same for union and pension fund proposals.

A different potential concern regarding management-union private negotiations over corporate governance proposals is that management might, in exchange for termination of a corporate governance campaign, capitulate to employment-related demands that it would otherwise reject. In such a scenario, a failed negotiation would indicate to the market that management had opted not to engage in compromising tactics, and a submitted proposal could produce a positive price effect. For if management was entering into a hypothesized deal, then the union proposal would be withdrawn; hence proposal withdrawal, not proposal submission, would be the negative information-inducing signal for union activism.[173] To the extent that

[172] *See, e.g.,* Keith Bradsher, *Big 3 Copy One Another Except in Labor Relations,* N.Y. TIMES, June 18, 1998, at D3 (discussing automakers' longstanding, contrasting labor approaches).

[173] A test of such a signal would run in the opposite direction of the analysis in Prevost and Rao--a negative signal concerning management quality with the corroborated expectation of deteriorating subsequent performance would occur for firms with multiple proposal withdrawals from union funds, rather than with multiple submissions. *See* Prevost & Rao, *supra* note 163, at 19, 22-23.

unions make up a larger percentage of the sponsors of the withdrawn proposals in the post-1992 subsample in the Chidamaran and Woidtke study, this is a possible explanation of their finding of a negative valuation effect from proposal withdrawals. This explanation would enable the signalling explanation to reconcile all of the activism studies' disparate performance effects.

There is, in fact, evidence that some unions have undertaken corporate governance campaigns to further collective bargaining goals, and while there is no systematic research that indicates that managements have altered their labor strategies in response to union-shareholder activism, there is anecdotal evidence that prolonged union campaigns are on occasion successful in obtaining management accommodation.[174] Perhaps consistent with the anecdotes, a confrontational approach does not appear to be the typical reaction to union proposals: only a handful of firms, in their opposition statements to union proposals in the proxy materials, raise as an issue the possibility that the proponent is not concerned with enhancing shareholder wealth but has an ulterior motive, to further the union's agenda; but these few firms were involved at the time in labor disputes.[175] But it is not evident that such an approach influences shareholders to

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[174] *See, e.g.,* Schwab & Thomas, *supra* note 29, at 1033 (Amalgamated Clothing and Textile Workers Union's corporate campaign against J.P. Stevens, which was part of its efforts to organize the company's workforce, succeeded in getting firm to bargain with union, as evidenced by settlement term in which union promised not to engage in further corporate campaign tactics).

[175] In reviewing the proxies of all firms with union-sponsored proposals as identified by the IRRC in its corporate governance bulletins from 1993-1997 available on Lexis, I found that only a handful of firms raised such an issue in their proxy materials, and as noted in the text, these firms were all involved in labor disputes at the time. *See* Albertson's Inc. Proxy (Mar. 29, 1996) ("This stockholder proposal was submitted to the Company by the International Brotherhood of Teamsters (the 'International'). The Company is regularly engaged in negotiating labor agreements with various Teamsters local unions, and management believes this proposals reflects an attempt by the International to gain leverage over the Company for use in labor negotiations with the Company"); Yellow Corp. Proxy (Mar. 17, 1994) ("The proponent is a road driver for the Company's principal operating subsidiary and a member of the International Brotherhood of

alter how they would otherwise vote on the merits of the proposal. For example, Randall Thomas and Kenneth Martin found that union proposals sponsored during labor disputes obtained statistically insignificantly lower voting support than similar proposals sponsored by pension funds.[176] In any event, most firms do not adopt such a confrontational posture because most union proposals are not sponsored in the context of labor disputes. However, the relation between the use of the shareholder process to further corporate governance as well as a labor agenda, and its impact on management's response, is clearly an area in which further empirical research would be informative.

4. *Structural changes following shareholder activism*

In addition to examining the impact of activism on performance, some studies investigate whether firms engage in corporate restructurings or other governance reforms after they have been targeted by institutional investors. The rationale is that the undertaking of significant structural change by firms after a proxy targeting is an alternative means by which to gauge the success of shareholder activism. The assumption is that such changes will eventually improve

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Teamsters, with which this operating subsidiary is currently engaged in contract negotiations. Moreover, the proponent has indicated that a union official from the Teamsters' general headquarters in Washington, DC is acting as his representative with respect to this proposal"); *cf.* Caterpillar proxy (Feb. 22, 1995) ("last year the proponent [Northern Nevada Carpenters Pension Fund] designated a member of the International Union, United Automobile Aerospace and Agricultural Implement Workers of America ("UAW") to present the proposal. A majority of that presentation was dedicated to that union's agenda. The Company invites the proponent to respect the integrity of the stockholder proposal process this year by not permitting the proposal to be used again as a sounding board for the UAW"). There are also instances where management has publicly called on Congress and the SEC to investigate, and prevent, unions' use of the proxy process and other forms of management harassment during union disputes and organizing drives. *See* Schwab & Thomas, *supra* note 29, at 1033-34 (describing trucking association complaint).

[176] Thomas & Martin, *supra* note 4, at 69.

performance. This scenario would provide a concrete basis for the signalling explanation of the positive returns to nonproxy activism: The market expects a more responsive management to adopt policies that will increase shareholder wealth, and the anticipation of such action explains the positive returns.

There is considerable divergence across studies concerning whether targeted firms make significant structural changes, such as fire the CEO or sell substantial assets. The differences appear to be related to the studies' variation in findings concerning stock price performance. Karpoff et al., who found no stock price effects, find little evidence of policy changes in direct response to the proxy vote, and, in particular, that CEO turnover is not related to receipt of a shareholder proposal.[177] The studies finding subsample positive stock price effects, however, tend to find an increase in the level of asset divestitures of the targeting firms. For instance, Smith finds no significant difference in CEO turnover in targeted firms compared to industry and performance control groups, but significantly higher sales of assets by the targeted firms.[178] And Opler and Sokobin find a decrease in CEO turnover but an increase in asset sales after activist targeting.[179] The fit is less exact with the results in Del Guercio and Hawkins, as they find significantly more newspaper reports of restructuring activity and increased employee, but not increased CEO, turnover in targeted firms compared to an industry and performance control group, a result that holds for the subsamples of CalPERS and CalSTERS targets, and increased CEO and employee turnover for the board proposal subsample, subsamples which did not have

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[177] *See* Karpoff et al., *supra* note 24, at 388.

[178] *See* Smith, *supra* note 26, at 241, 248.

[179] *See* Opler & Sokobin, *supra* note 24, at 17-18.

significant positive returns.[180] Mark Huson also finds that CalPERS targets engage in more asset divestitures than a set of control firms over three years subsequent to the targeting, although the control group is quite imprecise (the control firms are either smaller or better performers than the CalPERS targets); he does not, however, investigate the price effects of the targeting.[181]

Finally it should be noted that while TIAA-CREF's activism was successful--Carleton et al. find that virtually all of the firms targeted by TIAA-CREF adapted their governance structures to accommodate the fund's objective[182]--the changes in TIAA-CREF-targeted firms reported by Carleton et al. are less substantial than the structural changes examined in other studies, such as CEO turnover and asset dispositions. The responses to TIAA-CREF's activism consist of refinements to poison pill plans, establishment of confidential voting, and commitments to increase minority and female representation on boards. It is improbable that these modest adjustments to corporate policy affect performance by leading to the more substantive responses

180 *See* Del Guercio & Hawkins, *supra* note 3, at 308-313. As discussed in note 48 *supra*, the positive returns for the CalPERS subsample disappear when Avon Products, a takeover target, is excluded, and hence I do not consider this a truly positive return subsample.

181 Huson, *supra* note 31, at 13 (18 firms targeted by CalPERS over 1990-92). Huson finds that there is a more significant price effect of the announcement of divestitures and other events, such as acquisitions and joint venture agreements, for the shareholder-proposal targets than the control firms, and in particular, that the effects were negative for such events announced before the CalPERS targeting and positive for those announced after the targeting. *Id.* at 15-18. He concludes that these data evince that CalPERS' activism improves firm decisionmaking. *Id.* at 19. This conclusion is quite tenuous. In addition to the difficulty of attributing events occurring over a three year period after targeting to that targeting, it would be useful to obtain specific comparative information concerning the divestitures that produced a negative effect three years prior to targeting compared to the divestitures producing the positive effect after targeting, before attributing the difference to CalPERS' intervention.

182 *See* Carleton et al., *supra* note 26, at 1336, 1343 (agreements reached over 95% of the time; targets complied with TIAA-CREF's request in over 85% of the agreements).

found in the other studies, a conclusion supported by the absence of positive significance for most of the TIAA-CREF negotiated settlements. The sole positive price effects subsample, the poison pill negotiations, raise the prospect of potential premiums, or future CEO change or asset sales if no bid is forthcoming, after a pill's relaxation. Unfortunately, this hypothesis cannot be tested because Carleton et al. do not investigate whether the TIAA-CREF-targeted firms subsequently experienced any restructurings.

The three-way association among positive price effects, some forms of shareholder activism, and subsequent structural changes is consistent with the research examining the impact on performance of the most substantial form of investor activism: proxy fights for control. Studies of proxy contests consistently find more favorable effects from this form of investor activism than do the studies of shareholder proposals. The stock price reactions to proxy fights are significantly positive (whether or not the dissidents actually win).[183] Moreover, the contests have significant firm-level consequences: firms that are the subject of proxy fights for control typically experience top management turnover regardless of outcome and they are often sold or liquidated shortly thereafter.[184] This result--the high frequency of subsequent acquisition, restructuring or CEO change--most probably accounts for the increase in value created by the initiation of a proxy fight compared to a proxy proposal. In fact, the most recent and most comprehensive study of proxy fights finds that most of the positive price effects of proxy contests are driven by firms that are acquired soon after the contest; when there is no acquisition, the gains in shareholder wealth from the proxy fight are sustained only by firms whose CEO is

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[183] *See* note 22, *supra* (collecting references).

[184] *See* DeAngelo & DeAngelo, *supra* note 22.

replaced.[185] And, of course, the literature is replete with the positive effect on target shareholder wealth from acquisitions.[186]

From a cost-benefit perspective, it is not surprising that more restructuring occurs after proxy fights than after shareholder proposals, and that, accordingly, the performance effect of proxy fights is greater than that of proxy proposals, because proxy fights are a far more expensive form of shareholder activism than shareholder proposals and restructuring is typically the contestants' objective. As Bernard Black noted, the general insignificant effect on performance of shareholder proposals relates to the low level efforts of the investors--institutions get what they pay for, "not much".[187] The thrust of the explanation advanced in this paper, though not at odds with Black's observation, is somewhat different. While it is true that proxy proposal activism is inexpensive compared to proxy contests, the insignificant performance results are predictable given the objectives: independent boards, compensation limits, confidential voting, and albeit more ambiguously, poison pill rescissions, are not corporate

[185] Mulherin & Poulsen, *supra* note 22, at 280, 299, 303. DeAngelo and DeAngelo also concluded that the bulk of the gains were from subsequent acquisitions. *See* DeAngelo & DeAngelo, *supra* note 22.

[186] *See, e.g.,* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation,* 9 YALE J. REG. 119, 122 (1992) (summarizing literature on target returns).

[187] *See* the abstract to the pre-publication version of Black, *supra* note 9, (unpublished manuscript version of Nov. 1997, on file with author, and available electronically at http://papers.ssrn.com/paper.taf?abstract_id=45100); *cf.* Carleton et al., *supra* note 26, at 1357 (concluding shareholder activism is not a substitute for takeovers but "a way that institutions spend more limited resources to accomplish much more modest goals").

governance devices that increase share value.

III. IMPROVING THE IMPACT OF CORPORATE GOVERNANCE ACTIVISM

The absence of evidence that shareholder activism improves targeted firms' performance raises the core question whether institutions should reassess their shareholder proposal agenda, in order to manage their resources more effectively. This paper takes a two-pronged approach to the issue. First, it suggests a mechanism of internal control, whereby fund boards would engage in periodic review of their staff's shareholder-activism programs to identify the most fruitful governance objectives. Second, it advocates increasing the incentive to undertake such internal revaluations by proposing elimination or substantial reduction of the subsidy of proxy proposal sponsorship unless a proposal achieves substantial voting support.

A. *Internal controls: Refocusing activist programs*

One means of reducing the likelihood that shareholder activism is a negative net present value undertaking is to improve the quality of decision-making by institutional investors by encouraging implementation of comprehensive internal reviews of corporate governance programs. Such reviews should include an evaluation of the empirical research relating to the objective of contemplated proposals or private negotiations, as well as the voting outcome of previously submitted proposals. The review should be forwarded to the fund board and not simply the officers or employees supervising activism programs. This would enable a fund board to identify better what activity is worthwhile, facilitating the fulfillment of their fiduciary obligations to fund beneficiaries. A formal mechanism of reporting on a fund’s activities and their effectiveness would put fund trustees and fund managers on a more equal footing and thus lessen the possibility that better-informed managers could rationalize an agenda to a board in terms of good corporate governance practices that consists, in fact, of non-value-enhancing reform proposals.

The required written review of corporate governance activities should also be incorporated in the fund's annual report or statement sent to beneficiaries or holders of fund shares. As a publicly available document, it will be of use to fund participants willing to expend the effort to monitor fund managers' efforts at enhancing the value of their portfolio. In addition, legislators and taxpayers who finance public pensions will also be better able to identify inappropriate expenditures that could affect the funding of plan assets for which they are ultimately responsible.

What should be a fund's response to the proposed review? At minimum, proxy proposals that will not have a positive impact upon performance given the literature on corporate governance devices, such as those involving executive compensation limits and independent board demands, ought to be scrapped, in favor of those whose effect is at least arguably ambiguous, such as, proposals to relax takeover defenses. Such a policy will also require the fund's staff to develop firm-specific knowledge to engage in activism: just as the empirical literature finds that the stock price effect of takeover defenses varies with firm characteristics, such as board composition and firm size,[188] proposals to eliminate those defenses would, accordingly, be more beneficial for some firms than others.[189] If a fund does not possess

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[188] *See* Brickley et al., *supra* note 72 (negative effect for firms with insider boards); M. Andrew Fields & Janet M. Todd, *Firm Size, Antitakeover Charter Amendments, and the Effect of State Antitakeover Legislation,* 21 MANAGERIAL FIN. 35 (1995) (negative effect for small firms).

[189] As discussed at text and note 92 *supra*, some institutional investors are aware of this issue and have adapted their governance activities accordingly.

adequate firm-specific knowledge, proposals whose impact is likely to be highly firm-specific, such as takeover defense rescissions, ought to be avoided.

Similarly, proxy proposals that receive little support from other investors (which not surprisingly tend to be those whose substantive objectives produce the least positive impact on firm value) should be reevaluated, with an eye to their elimination. The reasoning for such a criterion is that support levels are a good proxy for the judgment of other informed investors that the proposal is in their interest. Hence, proposals that obtain a higher level of voting support have a higher probability of being those that maximize share value.[190] This may not, however, always be the case. If shareholder beliefs are biased concerning the valuation effects of a particular proposal, then the level of support will not be an accurate proxy for the proposal's impact on performance. For instance, Jamil Aboumeri notes that it is surprising that shareholders vote in large numbers to rescind poison pills despite his research showing substantial benefits from those defenses.[191]

But notwithstanding Aboumeri's claim, voting in support of defensive tactic rescission proposals is not likely to be an example of biased errors in judgment. The literature on the impact of poison pills on takeovers is ambiguous, and, in particular, the effect appears to vary considerably with firm characteristics.[192] It is therefore reasonable for investors to believe that the removal of a pill will be beneficial for some firms. In addition, given the large number and

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[190] *Cf.* Schwab & Thomas, *supra* note 29, at 1082-83 (other shareholders more likely to support union-sponsored proposals that have potential to improve performance than those concerned with labor-related interests).

[191] Aboumeri, *supra* note 79, at 5.

[192] *See, e.g.,* text and accompanying note 73, *supra*.

diversity of institutional investors and their information sources, systematic errors across investors over proposal valuation effects is simply not a plausible scenario. The more plausible assumption is that shareholder mistakes on the value of a particular governance device are randomly distributed. In such a scenario, with a large number of voting shareholders, investor errors will cancel out and the proportion of yes votes will be the best estimate of the proposal's value.

Periodic program review is also important because shareholder activism in the proxy process is not costless, even though it is certainly inexpensive compared to activism involving control changes. For example, CalPERS estimates the annual cost of its activism program at $500,000 (which is .002% of the fund's domestic holdings).[193] Del Guercio and Hawkins indicate that the activist pension funds in their study similarly spent less than half of a basis point per year on their corporate governance programs (with an expenditure range from $50,000 to $1 million).[194] They also state that TIAA-CREF spends annually $1 million or .002% of assets on its corporate governance program.[195] Other corporate governance strategies, such as voting against management proposals and board nominees of poorly-performing firms, are far cheaper to implement than an activist agenda; for instance, one estimate of the annual cost of a "just vote no" program is $100,000.[196]

Given the cost differential between active and passive mechanisms of monitoring

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[193] *See* Smith, *supra* note 26, at 245.

[194] *See* Del Guercio & Hawkins, *supra* note 3, at 328.

[195] *Id.* at 328 n.4.

[196] *See* Joseph Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians inside the Gates,* 45 STAN. L. REV. 857, 911 (1993).

management and the overall ineffectiveness of shareholder activism at improving corporate performance, from a fiduciary standpoint, fund managers should have to justify program expenditures to their boards. Identifying which corporate structures or processes enhance share value by reference to readily available data, rather than wishful thinking concerning their effects, will improve the quality of decision-making and should produce corporate governance programs which are consonant with the funds' fiduciary obligations. Although the expected decline in proposals due to adoption of such a review process could reduce the beneficial information concerning management quality signalled by a proposal submission indicating failed negotiation, the effect could equally well be heightened--funds will shift to proposals that are more likely to have a performance impact (proposals more likely to obtain higher voting support), such as defensive tactic rescissions, and hence ones more costly for low quality managers to negotiate over.

The details of an appropriately enhanced system of internal control for a shareholder activism program have, admittedly, not been minutely specified. The reason is two-fold. First, because the benefit of some corporate governance mechanisms vary with firm-specific characteristics, too-minutely specified criteria might freeze a fund's ability to respond differentially to particular situations. Second, the benefits of corporate governance, more generally, are amorphous. In particular, it has been difficult for researchers to identify corporate governance mechanisms that improve firm value, apart from control changes and major restructurings, such as management-led buyouts.[197] Less intrusive governance devices than

[197] For a review of performance improvements from management changes in takeovers and management-led buyouts see Romano, *supra* note 186, at 130-133.

control changes, such as independent directors or directors' stock ownership, which are thought to impact positively performance, have typically not been identified to have any effect.[198] The absence of identifiable governance devices that improve performance renders problematic efforts by investors to redirect the management of poorly performing firms through governance reforms rather than through turnover in executive personnel. But given the evolution of the corporate form and accompanying governance devices, it would be premature to advocate the termination of all corporate governance activism because of the inability to find a statistically significant positive impact. Instead, as an initial step, a filter mechanism, narrowing the number of proposals, ought to be implemented that takes account of the extant empirical literature, but which is sufficiently fluid to be able to adapt to new findings and circumstances.

Pension fund boards should find implementation of the proposed review process sufficiently desirable to adopt it voluntarily as a good management practice. But it might well be difficult for boards to evaluate their programs' efficacy, as they are not likely to possess corporate governance expertise, and this might lead to hesitancy in adopting the proposal or implementing it effectively. There are, however, a number of avenues for achieving widespread adoption of adequate internal control practices, the most prominent being the promulgation of good practice standards by industry associations. If the Government Finance Officers Association (GFOA) or the Investment Company Institute (ICI), the trade groups for public pension fund officials and private mutual funds, respectively, for example, were to adopt good practice guidelines that included comprehensive evaluations of shareholder activism programs, this would have a

[198] See the sources collected in Romano, *supra* note 56 (board composition); and in note 98 *supra* (stock ownership).

salutary impact on individual fund practices. The CII and national union organizations such as the AFL-CIO, which have been active promoters and coordinators of the corporate governance movement, could also perform such a function. Finally, private organizations, including business trade organizations such as the Business Roundtable, the National Association of Corporate Directors and the Conference Board, the corporate bar, stock exchanges and public accounting firms, have already been involved in devising recommendations for corporate governance standards for boards of directors and audit committees,[199] and they could as well be recruited to formulate standards for shareholder activism programs.

An alternative route, with a greater likelihood of influencing individual fund behavior because of its mandatory feature, is a certification requirement: funds could be required to obtain a letter from an independent third party, such as the firm's auditor, certifying that the institution has undertaken a periodic comprehensive review of its activism program and has acceptable activism practices.[200] Certification of such procedures is not a far-fetched idea and is, in fact, in

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[199] Ira Millstein and Paul MacAvoy list the business and bar organizations that have produced corporate governance standards for boards. *See* Millstein & MacAvoy, *supra* note 54, at 1288-89 & nn. 21-22. The New York Stock Exchange and National Association for Securities Dealers, in response to SEC concerns, created the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which issued a report in February 1999 with recommendations for improving audit committees, and accounting firms have followed up with statements of audit committee standards. *See, e.g.,* PRICEWATERHOUSECOOPERS, AUDIT COMMITTEES: BEST PRACTICES FOR PROTECTING SHAREHOLDER INTERESTS (1999); KPMG, SHAPING THE AUDIT COMMITTEE AGENDA (1999).

[200] To the extent that there is concern that such work could compromise the independence of the auditor, use of a different public accounting firm could be required. But this work would not appear to create a significant independence issue as it does not constitute self-review of the auditing function as do other appraisal and valuation services. *See, e.g., ISB Gives Guidance to Auditors on Derivatives Accounting,* Fed. Sec. L. Rep. (CCH) No. 1919, at 3 (Apr. 17, 2000) (discussing interpretation of Independence Standards Board regarding auditors' provision of assistance on the implementation of FAS 133, the new standard for accounting for derivatives as

accord with present day trends in auditing. It is entirely consonant with the contemporary movement in auditing to certify processes rather than transactions or outputs, items that are verifiable quantitatively and hence the substance of traditional audits.[201] More important, accounting firms in recent years have been required to review a variety of qualitative information concerning firms' internal controls, including issues such as year 2k compliance,[202] and they have been marketing their auditing services as "assurance services," through which they express a willingness to certify matters beyond financial accounting data during an audit.[203] In addition, a special committee of the American Institute of Certified Public Accountants (AICPA) created in 1994 to report on the "current state and future" of audit and assurance services, defined "assurance services" as "independent professional services that improve the quality of information, or its content, for decision makers," and proposed examples of such services that

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hedges).

[201] *See, e.g.,* KPMG, THE FINANCIAL STATEMENT AUDIT 9 (1999); Anita Dennis, *Becoming a Business Partner: Involvement of Internal Audit Departments in Business Management,* 183 J. ACCT. 72, 74 (1997) ("We used to analyze transactions; now we analyze the processes," quoting Robert Brewer, director of Audits at Praxair, a $4 billion supplier of industrial gases).

[202] *See Official Releases, Auditing Interpretation...Statements of Position 98-4, 98-5 and 98-6 7-98*, J. ACCT. 95 (July 1998) (auditors' responsibilities regarding year 2000 issues).

[203] The websites of some accounting firms refer to their provision of "assurance services" in conjunction with traditional auditing services. *See, e.g.,* Pricewaterhouse Coopers Health Care Practice, Assurance and Business Advisory Service, at http://www.pwchealth.com/ services/business.html ("PwC provides traditional auditing services, as well as assurance on financial information, internal controls, compliance, operating and performance information, and information systems") (visited Oct. 15, 1999); KPMG International Services, Assurance at http://www.kpmg.com/ services/Default.asp ("Optimising the benefits of audit for our clients is a major priority. We provide opinions in accordance with national statutory requirements and in compliance with all relevant national and international regulations. . . .Additional services include IT risk, security and continuity services (Information Risk Management) and internal audit services (Management Assurance Services) (visited Oct. 15, 1999).

comport with the proposed use: assurance regarding compliance with company policies and assurance regarding investment managers' conformity with performance presentation standards.[204] Quite clearly, evaluation of the effectiveness of corporate governance programs is no less certifiable by an auditor than the other nonfinancial matters that auditing firms have undertaken in recent years. Indeed, auditors' experience in such areas makes them better suited to provide a certifying function for funds' corporate governance programs than other professionals with expertise in the proxy process, such as lawyers and consulting firms.

If certification of activism programs was required by regulators, then institutional investors plainly would have to undertake the necessary evaluative reviews.[205] But the varied identity of proposal sponsors and potential sponsors renders implementation of a uniform certification requirement difficult. Public pension funds are regulated by state legislatures, union pension funds are regulated by the Department of Labor (DoL),[206] and mutual funds, which have not been involved in corporate governance activism but have been encouraged to do so,[207] are

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[204] *See* AICPA, Report of the Special Committee on Assurance Services, available at the website of the AICPA:http//www.aicpa.org/assurance/scas (site visited Feb. 19, 2000).

[205] Accounting regulatory bodies, such as the Government Accounting Standards Board (GASB) and Financial Accounting Standards Board (FASB), are not the appropriate locus of authority for such certification, as their mandates are directed at disclosures of the costs and revenues of firm output.

[206] The DoL's authority over union funds comes from its administration of ERISA, the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1000 et seq., and the Taft-Hartley Act, 29 U.S.C. § 186(c)(5) (multiemployer plans).

[207] *See* Robert McGough & Pui-Wing Tam, *Bogle Urges Role in Corporate Governance*, WALL ST. J., Oct. 21, 1999, at C23 (John Bogle, founder of the Vanguard Group called on mutual funds to "live up to their responsibility of corporate citizenship" and promote better corporate governance and wield their voting power to oppose management on issues harmful to shareholders, such as excessive stock options).

regulated by the SEC.[208] Certification requirements for activism programs would be more readily adopted by state legislatures were they already implemented as an industry standard for good management practices by umbrella organizations such as the GFOA or ICI, or by the business law sections of the local or national bar associations, whose expertise would provide state legislatures with guidance. In the interim, accounting firms should be encouraged to make available assurance services regarding activism programs to funds desiring such certification. Again, demand for such a service would in all likelihood increase were industry associations to take the lead and formulate good practice guidelines or standards for activism.

B. *External controls: Shifting the financial burden of shareholder proposals*

Internal controls in the form of enhanced review at the board level of fund activism may not have much bite in the absence of a certification requirement. Because the most active funds are public pension funds, which are defined benefit plans, their beneficiaries' payouts are independent of the funds' endowment; hence fund managers will not have incentives to adopt comprehensive evaluations even if some funds do, for fear of adverse signalling, since their beneficiaries are not as actively monitoring fund performance as are mutual fund shareholders. Politicians are also not likely to target fund activism out of concern about taxpayer expense as the expenditures on such activities are relatively small and some non-value-maximizing populist forms of activism may actually provide political benefits: executive compensation has, for instance, been a focus of Congressional attention.[209] Consequently, another mechanism is

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[208] The SEC's regulatory authority over mutual funds is derived from the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq.

[209] *See* I.R.C. § 162(m) (eliminating tax deductibility of executive compensation over $1 million unless performance-based and performance goals set by compensation committee with

necessary to incentivize public pension fund managers.

One means of providing such an incentive is to eliminate the subsidy of losing proposals under the SEC's proxy proposal rules. If funds incur the cost of a losing proposal, then the fund managers will have to scrutinize, on a continuing basis, the fund's corporate governance program, to determine which proposals are most likely to attract voting support, because their cash position will decline if they do not. If they persist in offering losing proposals the outflows for reimbursement will reduce funds available for other expenditures. Admittedly, the incentive created by this reform is low-powered, as fund beneficiaries are not very likely to be able to monitor fund outflows or budget reallocations due to a poorly performing corporate governance program. But over time the expenses from losing proposal reimbursements will build up and start affecting fund performance, and at that point, the fund board will have incentives to intervene, action that is in the fund manager's interest to avoid, and which will make the manager, anticipating the possibility of such future action, adjust its behavior regarding shareholder proposals from the outset of the reform.

1. *Should shareholder proposals be subsidized?*

It is elementary economic learning that parties bearing the full cost of their actions make better decisions than those that do not. When a party does not bear the full cost of its activity, it will engage in more of the activity, for in equating the marginal benefits and costs of the enterprise, a lower level of benefit from the activity suffices to meet the reduced cost. But under the shareholder proposal regime, this analysis is thought to be overridden by collective action concerns. Namely, if the cost of action by an individual shareholder is greater than the

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two independent directors and approved by shareholders).

shareholder's pro rata benefit albeit less than the aggregate gain to all shareholders, the activity will be under-, rather than over-supplied. The proxy proposal regime assumes that this is the proper calculation of the costs and benefits of shareholder proposals. But where there are private benefits from the shareholder's action, that is, benefits that accrue solely to the proposal sponsor and that are not proportionately shared by all shareholders as is the case with an increase in firm value, then matching pro rated costs and benefits will not produce the optimal level of activity. This is because when costs are allocated across all shareholders, small private benefits will induce individual action that does not benefit the shareholders in the aggregate.[210]

It is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. The disparity in identity of sponsors--the predominance of public and union funds, which, in contrast to private sector funds, are not in competition for investor dollars--is strongly suggestive of their presence. Examples of potential benefits which would be disproportionately of interest to proposal sponsors are enhanced political reputations for public pension fund managers or progress on labor rights desired by union fund managers.[211] A further potential private benefit concerns personal employment, the "revolving door" issue common to

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[210] For a discussion of the divergence between private and social gains and the allocation of costs in proxy contests see Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy towards Proxy Contests,* 78 CALIF. L. REV. 1073, 1092-95 (1990).

[211] *See, e.g,* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism,* 79 GEO. L.J. 445, 479-81 (1991) (discussing political entrepreneurism of public and private pension fund managers active in corporate governance); Romano, *supra* note 19, at 801-19, 822 (discussing political interests of, benefits to, and pressures on, public pension fund managers); Schwab & Thomas, *supra* note 29, at 1032-34 (discussing labor's corporate campaigns); and Paul Jarley & Cheryl L. Maranto, *Union Corporate Campaigns: An Assessment,* 43 INDUS. & LAB. REL. REV. 505 (1990) (discussing relation between use of corporate campaigns and accomplishment of traditional union goals).

government employees. For example, a top official involved in CalPERS' corporate governance program, Richard Koppes, left the fund and joined a law firm that advises management on takeover defenses.

Such private benefits have a higher likelihood of being present in certain classes of proposals than others. For example, proposals to limit executive compensation and increase board diversity are more likely to enhance political reputations for fund managers than confidential voting or takeover defense rescission proposals. There is far greater media publicity surrounding executive compensation and minority representation issues, and these proposals implicate the kinds of social issues on which political reputations are established, in contrast to other corporate governance devices.[212] This conjecture has plausibility given the far lower level of voting support for executive compensation and board proposals compared to confidential voting and defensive tactic proposals by those who have a financial stake in firms.

A broader set of proposals--all those making managers' life more uncomfortable--may provide private benefits to union fund managers seeking a more accommodating management; these include proposals rescinding takeover tactics as well as proposals to limit executive pay and enhance board independence. But the takeover defense proposals may also be offered strategically, to gain support and good will from other investors that is hoped will carry over to future issues of greater importance to labor. Although such a carryover is a "private" benefit to

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[212] *See, e.g.,* Elizabeth Holtzman, *When Management Falls Down on the Job; Pension Funds Can Put Independent Directors on the Board*, Wash. Post, May 26, 1992, at A17 (New York City controller and trustee for New York City Employees' Retirement Funds, when running for the Democratic party nomination for U.S. Senate, highlighted her fund's sponsorship of proposals for independent directors, in order to obtain "more accountable management," including elimination of "fat executive compensation plans").

the union , it is not a "private" benefit in the strict sense in that any gain from the specific proposal--such as an increase in stock value from rescission of a poison pill--is not unequally shared.

Although it may have had relevance historically, the rationale advanced for the shareholder proposal rule's subsidization of sponsors' costs, a collective action problem, has little relevance for contemporary capital markets, in which a majority of shares is held by institutional investors.[213] Institutional investors own large blocks of stock and often cannot sell shares in a poorly-managed firm because their fund is indexed to a portfolio including that firm. Consequently, they experience far less of a free rider problem than the individual shareholder whose hypothesized dilemma has motivated adoption of a cost-subsidization regime. In addition, there are a number of organizations, such as the CII, the IRRC and the Institutional Shareholders Service (ISS),[214] that collect and disseminate information to institutional investors concerning corporate governance issues, which further reduces the need for a regulatory solution to the collective action problem. The AFL-CIO has also published a detailed set of voting guidelines for union funds[215] and the possibilities of inexpensive and widespread dissemination of information through the internet are already present and potentially enormous. Besides the websites of the AFL-CIO, CalPERS, CII and other organizations that detail their corporate

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[213] *See* BRANCATO, *supra* note 134, at 19-20 (in 1995, institutional investors held 50% of total U.S. equity, including 57.2% of the largest 1,000 firms).

[214] The ISS is a private consulting firm that provides advice on proxy voting and other voting services to institutional investors.

[215] *See AFL-CIO Proxy Voting Guidelines Could Form Unions into Formidable Voting Bloc,* XVI IRRC CORPORATE GOVERNANCE BULLETIN 21 (July-Oct. 1998).

governance activities, some small activist funds are posting on their websites how they have voted their proxies and are encouraging use of their sites to facilitate individual shareholder participation in an activist agenda.[216]

2. Proposed reform of the proposal process

Subsidization is not necessary for active use of the proxy process by investors and, in fact, it has created perverse incentives for institutional investors, such that fund managers may not be using the proposal process in the best interest of their beneficiaries.[217] This paper accordingly advocates revising the present regime to reduce such incentives. It offers three alternative approaches that would all have the salutary effect of reducing the subsidy: (i) adoption of a vote cutoff below which the sponsor must fully reimburse the firm for the cost of submitting the proposal; (ii) use of a sliding scale of reimbursement depending on the level of votes obtained; and (iii) shareholder selection of the extent of subsidization of proposals. The third option is my preferred approach, but in contrast to the other two proposals, it is at odds with the mandatory structure of SEC rules.

Advocating that shareholders finance their proposals is not a novel position; over the years, others have advanced similar proposals.[218] Commentators writing in the 1980s critiqued

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[216] *See New Websites Post Proxy Voting Activity*, 10 IRRC CORPORATE GOVERNANCE HIGHLIGHTS 65 (Apr. 16, 1999) (Domini Social Investments, a socially responsible investment fund, is posting how its Equity Fund has voted shares in its 400 firms as well as adding an investor activism center with information on social issue proxy proposals and permitting email to CEOs of targeted firms).

[217] Individual investors may, of course, also misuse the process if they obtain consumption, rather than investment, benefits from offering proposals that are not in the interest of the other shareholders.

[218] *E.g.,* Dent, *Response, supra* note 20, at 823.

the shareholder proposal subsidy, contending that the mismatched incentives for individual shareholders arising from the subsidy were greater than the benefits from reducing free rider problems.[219] But they did not have access to the contemporary corporate finance literature that powerfully bolsters the case for altering the policy of free access to the proxy machinery. In particular, the commentators emphasized the extremely low voting support for the proposals and the small number of "professional gadfly" individual sponsors. Their position is equally apt today in the quite different landscape of institutions' higher-support-generating proposals, as the corporate finance literature indicates that proposal sponsors are frequently not pursuing a value-maximizing agenda.

The essential incentive mismatch of the rule identified by earlier critiques is, then, as relevant for institutional as it is for individual investors, given the probability that fund managers can obtain private benefits from proposal sponsorship, while the free rider problem is mitigated for institutions given their larger ownership positions and their participation in trade organizations that assemble detailed information on governance issues. Moreover, if proposal sponsors obtain private benefits, then not only is there even less cause for other shareholders to subsidize such activity, but also, special cause for concern in the institutional setting, as such benefits accrue to the fund manager and not the fund beneficiaries, who are in a similar position to that of the other shareholders, as they benefit solely from proposals producing performance improvements.

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[219] *See, e.g.,* Liebeler, *supra* note 2, at 447-57; Dent, *Study, supra* note 20, at 4-8, 14-16; Dent, *Response, supra* note 20, at 819, 821 (distinguishing traditional from antitakeover proposals as not cost-justified); Daniel R. Fischel, *The Corporate Governance Movement,* 35 VAND. L. REV. 1259, 1279 (1982) (criticizing rule for cost subsidization).

Earlier critics, such as Susan Liebeler and George Dent, advocated repeal of the entire SEC rule governing proxy proposals.[220] Complete repeal may well be a worthy idea, as voting rules are analytically more properly issues of state corporate law than federal securities law,[221] and securities regulation would be better served by a competitive state regime rather than the current federal regulatory monopoly.[222] But such a reform goes well beyond the specific requirement of solving the problem at hand, which is to improve proposal sponsors', and more specifically, fund managers' incentives to increase the efficacy of their corporate governance activities within the contours of the existing shareholder proposal regime. This paper, having such a limited goal, focuses on the one piece of the regime that if altered would have the greatest impact on institutional activism because it has the greatest potential incentive effect, the regime's subsidization of shareholder proposals.

Apart from repeal of the entire federal proxy apparatus, two other proposals that would indirectly work to reduce the subsidy have been more recently advanced in conjunction with proposals advocating an expansion of the SEC's proxy proposal regime and thus should be discussed. The first proposal, proffered by John Coffee in the context of advocating an

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[220] *See* Liebeler, *supra* note 2, at 453 (advocating repeal of rule); Dent, *Study, supra* note 20 (same).

[221] *See, e.g.,* Business Roundtable v. SEC, 905 F.2d 406 (D.C.Cir. 1990) (SEC regulation of corporate voting rules beyond its authority because a subject matter of state law).

[222] *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation,* 107 YALE L.J. 2359 (1998) (advocating comprehensive reform of the federal securities law by permitting issuers to choose their securities regime, analogous to the choice of corporate charter, from among the 50 states as well as the SEC or other nations). The present paper underscores the merit of such an approach: the SEC has not formulated proxy proposal rules that ensure institutional investors have appropriate incentives in using the process to improve the value of the targeted firm.

expansive view of what employment issues should be includable proposals under the SEC rules, would increase the rule's minimum ownership requirements for proposal sponsors.[223] This proposal indirectly reduces the rule's subsidy by limiting who is eligible to receive it. Coffee justified it as a means of avoiding the risk of misuse of his proposed expansion of access under the rule by "zealot shareholders with no real economic stake," whose many proposals would so "clutter" the proxy as to obscure essential information.[224]

The second proposal would limit the number of includable proposals per firm, and was advanced by Alan Palmiter in the context of advocating an expansion of the shareholder proposal rule by eliminating the SEC's arbitration of what proposals are included under its rules requiring proposals to be proper subjects for shareholder action and to not involve ordinary business matters.[225] This proposal also has the effect of indirectly reducing the cost subsidy by restricting its availability. Where more proposals are submitted than permissible under the cap, Palmiter proposed an allocative rule according to the size of the sponsor's stock holdings. Again, the justification for the subsidy limitation is that access expansion might produce abuse of the process by "social/political gadflies".[226]

Neither the Coffee nor the Palmiter approach to the cost subsidization issue, however,

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[223] *See* John C. Coffee, *Blocking Bias Via Proxy*, WALL ST. J., Feb. 2, 1993, at A14 (recommending minimum ownership of 1% or $100,000 in stock value). The current threshold is the lesser of 1% or $2,000 in stock value. 17 C.F.R. § 240.14a-8(b)(1).

[224] Coffee, *supra* note 223, at A14.

[225] *See* Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation,* 45 ALA. L. REV. 879, 918-19, 923-24 (1994) (numerical cap of seven proposals per firm).

[226] *Id.* Palmiter noted that his proposed limit was in recognition of others' concerns over abuse by "gadflies," concerns which he did not share.

would resolve the core problem of concern in this paper, the absence of incentives to fund managers to adopt value-maximizing corporate governance programs, and, of course, they were not meant to do so. Activist funds often have sizeable ownership blocks so that an ownership requirement excluding them from the process would exclude virtually all shareholders, and the paper's goal, in any event, is not to exclude institutions from proposal sponsorship but rather to promote cost-effective sponsorship. Numerical limits on proposals per firm also would not affect fund manager incentives, particularly when based on stockholdings, as such a rationing system would favor institutional investors. If the allocation system was based on the substantive content of the proposal, this might affect institutional investors' incentives (to the extent they wanted their proposals submitted and rationing appeared likely for a particular firm). But it would be extremely difficult for the SEC to implement a merit-ranking system, and more important, it is not at all apparent that the SEC would do a better job than the funds in determining which proposals have a greater likelihood of enhancing share value.

The proponents of repeal of the entire shareholder proposal regime, Liebeler and Dent, also offered less demanding solutions. Liebeler proposed that corporations should adopt bylaws imposing minimum ownership requirements in order to bring proposals before the annual meeting that were greater than the SEC's minimal threshold requirement, as well as bylaws requiring reimbursement of the cost of proposals, as second-best measures to protect corporate interests while the SEC rule remained on the books.[227] Dent modified his initial position on repeal of the rule in a subsequent article, given the increasing role of institutional investor activism on takeover issues, to require instead the posting of a bond to cover corporate costs if

[227] Liebeler, *supra* note 2, at 462, 464.

the proposal did not garner a sufficient level of support.[228] Although Dent does not specify a numeric criterion for his proposal, he notes a possible minimum of 20%.[229] This paper's first two proposals, elimination or reduction of the subsidy, are closest to Dent's revised position; the third proposal, shareholder choice of the regime, is most similar to Liebeler's fallback position.

The first proposal is elimination of the subsidy, unless the proposal gains substantial support, which I define as 40% of the voting shares. Such an approach is consistent with the state law approach to the collective action problem: Proxy contestants must pay their own expenses, although shareholders may approve successful challengers' expenditures *ex post*.[230] The strongest source of support for such a reform is the fact that the state law approach to cost recovery has been more successful than the federal proxy regime in aligning more closely individual shareholders' incentives with the aggregate interest. In contrast to the shareholder proposal regime, proxy fights are not devoted to social issues tangentially related to corporate governance or to inconsequential structural reforms that have no relation to the profitability of corporate operations. More importantly, they result in significant improvements in firm performance while shareholder proposals do not. The superior outcome from the operation of

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[228] Dent, *Response, supra* note 20, at 823. The bond proposal is analogous to the security-for-expenses statutes in many states which require the shareholder-plaintiff in a derivative suit to post a bond to cover the corporation's expenses should the plaintiff lose. *E.g.,* CAL. CORP. CODE § 800(c) (corporation can move court to require posting of security-for-expenses up to $50,000); N.Y. BUS. CORP. LAW § 627 (corporation may require posting of security-for-expenses unless plaintiffs own at least 5%).

[229] Dent, *Response, supra* note 20, at 823.

[230] *See* Rosenfeld v. Fairchild Engine, 309 N.Y. 168, 128 N.E.2d 291 (1955). The shareholder proposal rule is not applicable to proxy fights. *See* Rule 14a-8(c)(8) & (9), 17 C.F.R. § 240.14a-8(c)(8) & (9) (proposals relating to an election to office and proposals counter to a management proposal excludable).

state law should not be surprising: the competition across states for corporate charters produces laws that tend to enhance shareholder welfare, and the absence of competition in the federal securities regime renders it considerably less responsive to investors' concerns, and therefore less likely to produce wealth-maximizing rules.[231]

Absolute success (50%), the state law proxy expense reimbursement standard, ought not to be the standard for retention of full subsidization of the proposal. Rather, an appropriate benchmark for success is 40%, by analogy to success in the takeover process. Hostile takeovers made for any or all shares at substantial premiums, for example, rarely obtain 100% of outstanding shares, but rather, more typically obtain 75%, as there are inevitably shareholders who cannot or do not tender their shares in time; the number of tendered shares rises to over 85% when the bidder's pre-offer shareholdings are included.[232] A 40% success rate for proxy proposal reimbursement is therefore roughly equivalent to the tendering rate in the average successful takeover (that is, it is 80% of 50%).

Using the takeover bidder success rate as the benchmark for proxy proposal success is appropriate because the vagaries of the extent of nonvoting shareholders would seem to be even greater than that of nontendering shareholders, given the greater publicity attending takeover bids, as well as the clearer financial payoff. There are two additional reasons for selecting a

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[231] For a discussion of the efficacy of state competition compared to federal law see ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); for a more specific analysis concerning the proxy process see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 81-84 (1991) (federal proxy rules likely to be inferior to rules firms would adopt themselves under state law).

[232] *See* Robert Comment & Gregg A. Jarrell, *Two-Tier and Negotiated Tender Offers, The Imprisonment of the Free-riding Shareholder,* 19 J. FIN. ECON. 283, 301 (1987) (hostile tender offers for any or all shares obtain on average 75.1% of outstanding shares, for a total of 87.7% when average bidder pre-offer holdings are included).

percentage less than a majority for full reimbursement. First, in practice, management often responds to proposals that obtain a significant level of support. In this paper's confidential voting sample, for instance, management adopted the practice when the support level approached 40% (a factor also guiding the specific cutoff choice). Indeed, management often responds to the initiatives of single institutional investors, such as TIAA-CREF or CalPERS, before a vote is held, as well as to proposals obtaining lower levels than 40%. Although such a response not only varies across companies, but also typically varies across proposal types (management is more likely to respond to non-majority votes on confidential voting than on takeover defense rescissions), the 40% proposal does not distinguish across proposal types because the rationale for management's responsiveness--the appropriateness of following the desires of a substantial set of shareholders–should not vary with the proposal's substantive content. This is because it is improbable that such a large percentage of shares would be voted for a non-value-maximizing proposal.

Second, it is conceivable that the mere possibility of the submission of a shareholder proposal, rather than voting success, has a deterrent effect on managers to act in shareholders' interest. The probability of any significant deterrent effect is, however, remote, given the absence of a performance effect from the act of proposal submission and the infrequency of management change or corporate restructuring following proposal submissions. But because we cannot empirically accurately measure a potential deterrent effect, it is prudent to maintain the subsidy for proposals that receive substantial support, albeit less than an absolute majority.

The first approach of a 40% support cut-off level for reimbursement is advanced as a reference point for discussion, with the caveat that too low a reimbursement threshold will discourage institutions' scrutiny of the efficacy of their activism, leaving too much room for the sponsorship of proposals whose private benefits outweigh aggregate gains.[233] An alternative approach that could work as well is a sliding scale of proportional reimbursement: the successful proponent is fully reimbursed, and thereafter, the reimbursement rate is proportionate to the votes received in relation to the votes necessary for success. Thus, the sponsor whose proposal obtains a 40% vote share, does not have free access but rather, pays 20% of the proposal's costs (that is, the reimbursement is 40% of 50%). However, the sliding scale approach could also incorporate the 40% level of the first (cut-off) approach as the measure of "success" for free access, and proportionately reduce the subsidy for vote levels below 40%. Under this second approach, a proposal sponsor will always obtains some cost subsidization (the subsidy is reduced, but not eliminated).

A relaxed standard of success for proposal reimbursement (less than 40% or the sliding scale approach) would be appropriate despite the higher threshold at state law for proxy fight expenditures, if the potential private benefits to proponents of shareholder proposals are far lower than the private benefits realizable to proxy fight contestants. In such a scenario, the adverse incentive effect of subsidization due to a divergence in private and social benefits would be reduced. For example, if private benefits are nonexistent, the proposals offered would uniformly be expected to increase share value (but we would also expect such proposals to receive high levels of support).

[233] Bebchuk and Kahan would retain the actual success rule for proxy fights, but suggest, without specifying a concrete number, that a lower threshold may be appropriate for proxy fights over issues as opposed to board seats. *See* Bebchuk & Kahan, *supra* note 210, at 1122, 1128. They are not, of course, discussing shareholder proposals, where the costs of the action are much lower and the private benefits, given the parties involved, qualitatively different.

There is, however, no compelling reason to expect private benefits to be zero in the shareholder proposal context, particularly given institutions' continued pursuit of particular reform proposals despite an absence of proven performance effects, the glaring disparity across private and public institutional investor types concerning who engages in such activity, and the failure of many proposals to receive even close to a majority of the votes. Accordingly, setting a meaningful threshold for proposal subsidization is desirable. In addition, to the extent that the social benefits of the proposal are significant compared to private benefits, more shareholders can be expected to vote for the proposal. In this regard, establishing a sufficiently high voting threshold is a means of ensuring the right private-social benefit calculation by the proposal sponsor, as the costs of a corporate governance proposal are not likely to vary with the substance of the proposal, but the private benefits may well do so.

The first two approaches to reduce the shareholder proposal subsidy (whether achieved by a specified cut-off for obtaining any reimbursement or through a sliding scale reduction in reimbursement amount) have the all-or-nothing approach of all SEC rules: they are mandatory regulations applicable to all issuers. But a third approach, which I find more preferable, is to permit firms, by shareholder vote, to choose, their proxy proposal regime, opting from among full, partial, or no subsidy regimes, for all or some proposals or proposal sponsors. Such an optional approach would, in fact, mesh neatly with the enabling feature of state corporate law, and in this respect is a more fitting approach for proxy procedures than a mandatory rule, because the proxy process (voting) is integrally related to a corporation's internal affairs, the subject matter of state law, which recognizes the necessity for firms to tailor governance devices to their particular needs.[234]

The optional approach to proposal subsidization is similar to Liebeler's fallback position that corporations should amend their bylaws to require reimbursement for losing proposals, but it is not self-evident that her proposal is the regime that will emerge as the most common across issuers.[235] Institutional investors who engage in corporate activism will not be predisposed to opt for a regime that eliminates the current subsidy of their activity. However, as activist shareholders do not hold a majority of any corporation's stock, they will need the support of other shareholders to maintain a full subsidization regime. Hence, the benefit of an optional approach to the proxy process is that the decision to subsidize proposals will be voluntarily rendered by the firm's shareholders as a group, rather than imposed upon them by SEC fiat. But there is a downside to such an outcome: although the firm's other shareholders may be willing to subsidize all proposals (because they can vote against ones they determine are non-value-maximizing and may not find it worthwhile to decide *ex ante* which to exclude as required in a partial subsidization regime, in effect, free-riding on the institutions' corporate governance programs), they may be imposing a cost on fund beneficiaries who cannot vote on the proposal regime yet who, under a full subsidization regime, obtain no improvement in the incentives of their fund

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[234] *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C.Cir. 1990) (SEC imposition of corporate voting rule as exchange listing requirement beyond agency's authority).

[235] By choosing a bylaw for the reimbursement rule, in contrast to this paper's proposal, Liebeler's proposal would permit management to eliminate the subsidy without shareholder approval, as managers typically can amend bylaws on their own. *See, e.g.,* DEL. CODE ANN. tit. 8, § 109 (1998) (corporate charter may confer power to adopt, amend or repeal by-laws on directors). It should be noted that none of the proposals in this paper suggest requiring management to reimburse the corporation for shareholder proposals it opposes that are adopted. This is because, although reimbursement would effect a symmetrical policy outcome, it is impossible to implement and police effectively since such expenses are easily covered by increased compensation to the managers.

managers to reevaluate their activist agendas so as to engage in value-maximizing behavior.

3. *Would reducing the shareholder proposal subsidy be effective?*

Would a shift in the cost of the shareholder proposal regime create an incentive for institutional investors to engage in a comprehensive evaluation of their activism programs? The data on corporate expenditures on shareholder proposals are sketchy and imprecise, but the best available estimate suggests that eliminating the subsidy would have a salutary incentive effect. The data source of the best estimate is the SEC. In a 1998 release regarding proposed reforms of the proxy proposal rule, the SEC indicated that respondents to a 1997 agency-administered questionnaire reported an average (median) expenditure of approximately $50,000 ($10,000) on printing, distribution and tabulation costs for including a shareholder proposal, and $37,000 ($10,000) on the determination whether to include a proposal.[236]

The mean estimates submitted to the SEC imply that eliminating the subsidization of shareholder proposals would add almost 20% to CalPERS' current expenditures on its activist

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[236] *See* Amendments to Rules on Shareholder Proposals, Release No. 34-40,018, 17 C.F.R. Part 240, 63 Fed. Reg. 29,106, 29,114 (May 28, 1998) (80 firms reporting on proposal inclusion determination costs and 67 reporting on printing and other direct costs). The SEC noted that it was unclear whether the responses it received accounted for more than one proposal. *Id.* This estimate was one of only three estimates that I could find. The second estimate was in response to a request for information on the cost of compliance with the shareholder proposal rules in 1976: the SEC received one estimate, from a firm which reported it spent $22,450 per included proposal, and $3,740 per excluded proposal, for a total expenditure of over $150,000 on 16 proposals. *See* Proposed Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Securities Exchange Act Release No. 34-19,135, 47 Fed. Reg. 47,420, 47,424 n.17 (Oct. 14, 1982). Given the absence of a basis to judge the representativeness of this firm, this estimate is useless. The third estimate I found is in Susan Liebeler's article proposing repeal of the rule, from an informal survey conducted by the American Society of Corporate Secretaries (ASCS) in response to proposed changes in the shareholder proposal rule in 1982: the ASCS reported an average cost of $94,775 per company or $10,275 per proposal. *See* Liebeler, *supra* note 2, at 454 n.157. Even adjusting for inflation, the 1997 SEC survey cost estimate is much higher (five times) than the 1982 ASCS estimate.

program with just one proposal failure. Such an effect should provide an impetus to the CalPERS staff to fine-tune its program. Using the median cost estimate of $20,000 instead of the average estimate of $87,000, incentives for the staff to be more selective regarding proposal sponsorship would be more attenuated, as it would require CalPERS to incur at least four defeats under a full subsidy elimination regime to approach the 20% mark. Using the first approach's 40% cutoff for reimbursement, in actual practice, the impact of the reform on a fund like CalPERS would be quite variable because its success record varies considerably: in 1998 CalPERS sponsored four proposals, only one of which obtained more than 40% of the votes, whereas in 1995 it sponsored only two proposals, both of which met the 40% test.[237] Thus, under this proposed reform, CalPERS' 1998 activism would have cost between 12% to 52% of its activism budget, depending on whether the median or mean SEC estimate is used as the reimbursement benchmark, while its 1995 agenda would have had no cost impact. Under the partial reimbursement of the second proposed approach, the cost of CalPERS' activism would obviously be less, and hence the incentive to review that activity seriously would be that much weaker.

Clearly the incentive provided by the proposed reform will depend on the cost that a losing proposal sponsor must pay, as well as the extent of the investor's activism program. But

[237] *See* "Checklist of 1998 U.S. Corporate Governance Shareholder Proposals," IRRC Corporate Governance Bulletin, *supra* note 139, at 27-32; "Checklist of 1995 Shareholder Proposals," IRRC Corporate Governance Bulletin 24-33 (July-Sept. 1995). In recent years CalPERS has significantly cut back on the number of proposals it has submitted for a vote, although it still targets a dozen firms. *See* Paul Sweeney, *Clash by Proxy,* ACROSS THE BOARD, May 1996, at 21, 25 (CalPERS general counsel notes in 1995 fund pushed for vote on only 2 proposals of 10 firms contacted with resolutions, and expects to file proposals at only 3 or 4 meetings in 1996). Elimination of the cost subsidization rule undoubtedly will reinforce this trend.

unless the investor's demand for activism is inelastic, a dubious proposition, it will result in its sponsoring fewer proposals, or retaining the same number but being more selective concerning which proposals are submitted, as either approach (full or partial reimbursement) will raise the cost of activism that does not have broad support across shareholders.[238] Either adjustment in fund behavior will have a similar outcome: there will be fewer instances of low-vote-attracting proposals.

For a more global perspective on the costs of the shareholder proposal process of the proposed reforms, it is useful to estimate what effect the proposed subsidy reduction would have had in aggregate for shareholder proposals submitted in 1997 and 1998. The IRRC reported the voting results for 254 of 255 shareholder proposals on corporate governance submitted to 175 firms in 1998, and for 283 proposals submitted to 179 firms in 1997.[239] The absolute number of proposals receiving over 50% of the votes cast is about the same in the two years, 32 and 31, respectively, and an additional 26 (28) proposals in 1998 (1997) received at least 40% of the votes, the proposed cutoff for sponsors' full reimbursement. Thus, a 40% cutoff would result in reimbursement of 23% of the 1998 submitted proposals (21% of 1997 proposals). The average level of support was 26% in 1998 and 24% in 1997, an increase of 2%, paralleling the time trend estimate of the annual increase in support for shareholder proposals on defensive tactics presented in table 7 and noted in other sources collecting voting data, referred to earlier, such as

[238] As discussed in the text at pages 99-100, *supra,* agency problems within institutional investors could delay the proposed reform’s having an immediate impact on activist behavior, but even in such a scenario, eventually a steady stream of cash outflows to reimburse the cost of losing proposals will come to a fund board’s attention and result in a change in proposal activity, and at such a juncture, in fund manager as well.

[239] IRRC, Corporate Governance Service, Voting Results 1997 (1998); IRRC, Corporate Governance Service, Voting Results 1998 (1999).

the IRRC and the proxy solicitation firm, Georgeson & Company.[240] The medians reveal a similar increase, 20.3% in 1997 compared to 23% in 1998, and thus Dent's suggested 20% cutoff would reimburse half of the proposals submitted in these two years. The bottom quartile of the distribution of votes on shareholder proposals in 1998 (1997) consists of proposals with less than 10% (9%) of the votes cast.

The cost of the shareholder proposal regime, using the SEC estimates for the 1998 data, is indicated in table 8 in the 0% cutoff row in the table, as the current regime subsidizes all proposals, as is the cost of a reformed regime under a variety of vote cutoff levels.[241] As the table indicates, the cost is non-trivial from the point of view of individual proposal sponsors who would otherwise be paying these sums, but not when compared to the aggregate market value of publicly traded firms. To determine the subsidy for proposals not attracting a majority, the 50% cutoff row estimates are subtracted from those in the 0% cutoff row; this provides an estimate of $22 million in 1997 and $19 million in 1998, using the SEC's mean estimate of $87,000 in corporate expenditures per proposal, for an average over the two years of nearly $21 million. Averaging over the two years, the subsidy ranges from $18 million to $7 million, for a vote cutoff of 40% and 10% respectively (which approximate the top and lower quartiles of the distribution of votes cast). Another way to state this is that elimination of the subsidy for

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[240] *See* notes 139-40, *supra*.

[241] The table uses votes as a percentage of votes cast to classify proposals. For less than 10% of the corporate governance proposals reported in the data sources cited in note 239, *supra*, the company specified a different voting requirement in its proxy statement. As a result, the cutoff assigned in table 8 to 21 corporate governance proposals in 1997 and 22 in 1998 would be lower, using the firms' vote tally. Thus, the figures in the text underestimate the cost of the regime if one were to use as the cutoff percentage, the vote necessary for a proposal's passage, rather than the percentage of votes cast.

proposals that fail to obtain 40% of the votes would save targeted firms $18 million annually.

The estimate of the cost of the shareholder proposal regime is greater when social responsibility proposals are included in the calculation: although fewer in number than corporate governance proposals, these proposals receive far lower levels of support. The second panel in table 8 contains a parallel calculation of the cost of the subsidy for social responsibility proposals submitted in 1997 and 1998.[242] As no such proposal received a majority of the votes, the subsidy for proposals not attracting a majority is simply the estimate in the 0% cutoff row, $9.1 million in 1998 and $8.3 million in 1997, respectively, using, as before, the SEC's mean proposal expenditure estimate of $87,000. Combining the estimated cost of these proposals with that of the corporate governance proposals, using a voting cutoff of either 40% or 10% and averaging the cost over the two years, results in an estimated cost savings that ranges from $27 million to $15 million (since no social responsibility proposals received more than 40% of the votes in these two years, there is no cost difference between the two voting cutoffs for such proposals).

The average cost per firm in 1998 of corporate governance proposals is approximately $126,000 ($110,000 and $97,000 excluding proposals obtaining 50% and 40% of the votes, respectively), and in 1997, $140,000 ($123,000 and $109,000 respectively). But as two-thirds of

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[242] Voting results on social responsibility proposals were obtained from IRRC, SOCIAL POLICY SHAREHOLDER RESOLUTIONS IN 1997: ISSUES, VOTES AND VIEWS OF INSTITUTIONAL INVESTORS (Jan. 1998) (hereafter IRRC SOCIAL 1997) and IRRC, SOCIAL POLICY SHAREHOLDER RESOLUTIONS IN 1998: ISSUES, VOTES AND VIEWS OF INSTITUTIONAL INVESTORS (Jan. 1999). Where a proposal is an overlap–that is, where it is tracked by both IRRC services--it is counted as a corporate governance proposal (there were 20 overlaps in 1997, and 17 in 1998). The withdrawal and omission rate for the social responsibility proposals is high: including overlapping proposals, by my count, of 299 initial social responsibility proposals in 1997, 115 came to a vote, and in 1998, 121 of 293 tracked proposals came to a vote.

the firms received only one corporate governance proposal in each year, their estimated expenditure was $87,000. To consider the robustness of these figures, we need to consider the distribution of proposals obtaining a majority of the votes, as these proposals should be subsidized by the regime. Of the firms receiving only one corporate governance proposal, in both years, 13 firms' proposals obtained a majority of the votes cast. Of the firms experiencing multiple corporate governance proposals, over the two years, the proposals of only three firms all obtained over 50% of the votes (eight proposals). For most of the firms receiving more than one proposal, no proposal obtained 50% of the votes (55 of 67 such firms in 1997 and 39 of 55 in 1998). This means that the cost of the regime to multiple proposal firms is much higher than the aggregate average, reaching as high as $435,000, for the two firms in 1998 with five proposals, and $348,000 for two firms with four proposals in 1997, none of which obtained 50% of the votes.[243]

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[243] The distribution of proposals across firms is as follows (where 50% indicates firms with proposals obtaining at least 50% of the votes cast and 40% indicates firms with proposals obtaining between 40-49% of the votes cast):

Number of proposals	No. of firms 1997	No. firms with 50% (40%) proposals, 1997	No. of firms 1998	No. firms with 50% (40%) proposals, 1998
1	112	13 (14)	120	13 (9)
2	40	4 (7)	38	14 (8)*
3	21	6 (1)*	11	1 (5)
4	2	1 (3)	4	1 (1)
5	4	1 (0)	2	0 (0)

* indicates firm counted more than once because it received both a 50% and 40% proposal. Calculated from sources cited in note 239, *supra*. The paper does not undertake a similar calculation for social responsibility proposals because they are not the focus of concern of this paper and they appear to be slightly less clustered across target firms than corporate governance proposals. For example, in 1997, of 74 firms voting on such proposals, 55 or 74% voted on only

The distribution pattern is similar if the vote cutoff is 40%: while nine (14) more single proposal and 13 (11) multiple proposal firms more meet this criterion in 1998 (1997), again, most of the additional multiple proposal firms had only one proposal that obtained over 40% of the votes (10 in 1998 and nine in 1997). Of course, none of the estimates, whether by firm or in the aggregate, include the resources expended by firms on omitted proposals (proposals excluded for failing to meet the SEC's criteria for submission), nor withdrawn proposals (proposals for which the firm and sponsor negotiated an agreement resulting in the proposal's withdrawal), the number of which would have received a substantial proportion of votes is not known.[244] Yet the resources spent on omitted proposals are close to half of the expenditure on those that are included.[245] From this perspective, all of the cost figures presented underestimate the cost of the regime.

The cost estimates in table 8, even if refined to reflect the actual distribution of proposals across firms, do not appear to impose a crushing burden on shareholders who are subsidizing proposal sponsors and voting against the proposals. But even low annual expenditures add up: the present value of the cost of the regime is, at a minimum, $315 million, using the historical market risk premium of 9.2% as the capitalization rate.[246] This is a minimum estimate because

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one proposal, and only two (3%) voted on more than two proposals. IRRC SOCIAL 1997, *supra* note 242, at 77-84.

[244] While we would expect management to reach a negotiated settlement over proposals it deems likely to obtain a high level of support, the negative performance results following such compromises in recent years reported by Chidambaran and Woidtke, *see* text and notes 159-61 *supra*, caution that this may not be the case.

[245] *See* text and accompanying note 236, *supra*.

[246] *See, e.g.*, STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY F. JAFFE, CORPORATE FINANCE 227-28 (5th ed. 1999) (equity risk premium averaged 9.2% from 1926 to 1997). The

there is considerable debate over whether the equity risk premium is accurately estimated at this rate: it was significantly lower in the nineteenth century and beginning of the twentieth century,[247] and many financial economists predict a lower premium in the future.[248] Using, for example, the average risk premium from either 1802-1870 or 1871-1925, 1.4% and 4.4% respectively, or the overall average premium of 5.1% from 1802-1997,[249] as the capitalization rate, the subsidy of shareholder proposals under the current regime is $2.1 billion, $659 million or $569 million. The savings to firms from eliminating the subsidy for shareholder proposals that fail to receive at least 40% of the votes ranges, across the differing historical capitalization rates, from $1.9 billion to $293 million. None of these sums are trivial.

Some might contend that because the cost estimates are extremely modest compared to, say, the market value of publicly-traded firms, it is unnecessary to propose a concerted remedy. Such a claim might have some traction if there was no basis for the concern regarding private benefits from public funds' proposal sponsorship: then the problem of institutions' sponsoring non-value-maximizing proposals might be largely self-correcting, as informed funds could be expected to revise their strategies in the face of the new learning of the finance literature. The

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present value of a perpetuity is the annual cash flow divided by the capitalization rate. *Id*. at 120. The numerator used for this calculation is the average over 1997 and 1998 of the cost of corporate governance and social responsibility proposals that did not obtain a majority of votes (the estimates in the 50% cutoff row subtracted from those in the 0% cutoff row in table 8), or $29 million. If the proposed 40% cutoff for full reimbursement were adopted, the numerator would be $27 million.

[247] *Id.* at 228 (risk premium averaged 1.4% from 1802-1870 and 4.4% from 1871-1925).

[248] *See, e.g.*, BRADFORD CORNELL, THE EQUITY RISK PREMIUM 200 (1999) (reasonable forward-looking range for risk premium of 5% to 7%). The capitalized cost using this rate range is from $580 million to $414 million.

[249] ROSS, WESTERFIELD & JAFFE, *supra* note 246, at 228.

contention is that because the annual expenditure is modest, it is better for shareholders to bear that cost during such an adjustment period than for them to operate under a reformed regime that reduced the subsidy, for two reasons. First, it could undermine whatever deterrent effect is provided by shareholder proposals, and second, it could reduce the extent of governance innovations that arise from institutional investors' experimentation with governance reforms through proposal sponsorship, as they would no longer be able to offer, at no cost to themselves, proposals that take several years of submission before they achieve substantial support.

These objections to the need for a regime change are not, however, persuasive. As already noted, a significant deterrent effect is not likely.[250] In addition, the experimentation aspect of shareholder proposals is attenuated: the governance proposals offered by institutional investors have not been directed at novel devices for which there have been no empirical research on performance effects.[251] Moreover, experimentation over governance reforms will not be eliminated by a reduction in the subsidy–it will simply require a more informed basis for action. Most important, the disparity in proposal sponsorship across public and private fund managers strongly suggests that there is an agency problem, so that the regime will not, in fact, be subject to self-correction. The current regime provides no incentive to mitigate an agency problem in institutional proposal sponsorship. Instead, it encourages the submission of proposals that have private benefits and hence may not be value-maximizing, by allocating proposal costs across all

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[250] *See* page 111, *supra.*

[251] For example, the drive to propose independent directors in the 1990s occurred after most firms' boards had a majority of outside directors and substantial research had been undertaken regarding their impact, and the defensive tactics that were the object of the initiation of shareholder proposals had been the subject of empirical study. In the latter case, the performance effect of defenses has been found to differ over time, which has changed the calculus concerning the efficacy of shareholder targeting of them.

shareholders. Accordingly, the more compelling response to the current regime's relatively low annual cost compared to market capitalization than viewing it as a justification for the regime's continuance, is to recognize that it is a contributing factor to the tolerance of a wasteful regime.

It should finally be noted that, as indicated in table 8, the proposed elimination or reduction of the subsidy of shareholder proposals would have a much greater impact on social responsibility proposals than corporate governance proposals because such proposals receive much lower levels of support. But this would be a felicitous outcome from the viewpoint of corporate law as social responsibility proposals are not directed at improving corporate performance, which is the aim of corporate law and organization. Indeed, the SEC's approach to such shareholder proposals stands corporate law on its head, because it permits a minority of shareholders to dictate the expenditure of corporate funds for non-profit-maximizing uses when corporate law requires unanimity for waste of assets, and prohibits reimbursement of proxy expenses for contests undertaken for personal reasons.[252] An attractive benefit of the third reform option, shareholder selection of the proposal regime, is that it returns the proxy process to the corporate law decision-making norm, whereby the minority is bound by the majority,[253] as a majority of the shareholders would choose the extent of the subsidization of shareholder proposals. In short, it, as well as the other proposed reforms, would put an end to an obvious misuse of the proxy process.

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[252] *See, e.g.,* Schreiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978) (majority cannot ratify waste of assets); Rosenfeld v. Fairchild Engine, 309 N.Y. 168, 128 N.E.2d 291 (1955) (limitation of proxy fight expenditure reimbursement).

[253] For example, fundamental changes to the corporate form require the vote of at least a majority of the shareholders. E.g., DEL. CODE ANN. tit. §§ 242, 251, 271 (majority stockholder vote required for charter amendment, merger, and sale of assets).

IV. Conclusion

Shareholder proposals, although an increasingly prominent feature of institutional investor corporate governance activism since the mid-1980s, have not had a significant impact on firm performance. The most plausible explanation for the absence of a discernible positive effect has been large scale misdirection in the form that such activism has taken: many proposals have focused on reforming board composition and structure and limiting executive compensation, yet empirical studies by financial economists of such reforms consistently indicate that they do not improve performance. In addition, this paper has further shown that proposals to implement confidential voting are also of marginal benefit because the procedural change does not significantly alter voting outcomes. Finally, proposals to remove takeover defenses need to be directed at firms where they will do the most good, such as those with insider-controlled boards, yet proposal sponsors often lack the knowledge of specific firm characteristics to engage in precision targeting, diminishing the likelihood that the proposal will improve performance.

Although submitting a proposal is not as expensive as other forms of shareholder activism, such as waging a proxy fight, the lackluster results of such activity suggest that institutional investors should implement greater internal controls to monitor their corporate governance programs, redirecting the resources expended on activism to their highest valued use. Adoption of industry-wide good practice standards and third-party certification requirements that include comprehensive corporate governance program evaluations would spur individual funds to engage in such reviews.

Fund managers' incentives to undertake ongoing scrutiny of their governance programs would further be enhanced were the federal rules for shareholder proposals revised to require proposal sponsors either to incur the full cost of a losing proposal or a substantial part of the cost, or, better still, to permit firms by a shareholder vote to select their own proposal subsidization regime. By increasing the probability that institutional efforts at corporate governance activism will improve targeted firms' share values, these recommendations will not only benefit all targeted firm shareholders but will also encourage fund boards to perform more attentively their fiduciary obligations to fund beneficiaries.

Table 1. Confidential Voting Firm Sample Construction

Firms identified by IRRC	174
Firms adopting policy by 1986	12
Firms with no verifiable adoption year	17
Firms with no proxy reference to policy	9
Firms with no recent proxy reference to policy	3
Firms with proxy fights	12
Firms with misc. identification problems	3
Total Firms in Sample:	118

Table 2. Mean Voting Outcomes by Proposal Type (number of proposals in parentheses)

A. Management Proposals

Type	% Yes (all)	% Yes (matches)
All	80.6 (812)	80.5 (736)
Blank Check Preferred	61.3 (16)	60.5 (13)
Defensive Tactics	62.1 (67)	61.6 (60)
Ex. & Dir. Compensation	86.8 (399)	86.8 (370)
Increase/auth. Com. Stk.	77.0 (114)	76.8 (106)
Liability & Indemn.	79.8 (116)	78.5 (97)
Repeal/Modify Defensive Tactics	82.3 (11)	81.3 (10)

B. Shareholder Proposals

Type	% Yes (all)	% Yes (matches)
All	26.6 (693)	26.7 (556)
Board Matters	14.4 (29)	14.3 (20)
Confidential Voting	33.2 (102)	34.5 (65)
Defensive Tactics	33.0 (364)	33.2 (303)
Director Matters	16.4 (71)	16.3 (62)
Ex. Compensation	11.6 (74)	12.0 (64)
Proxy Process	8.6 (16)	9.0 (14)
Sell Co./Division	16.2 (16)	16.7 (13)

C. Shareholder Proposals - Defensive Tactics

Type	% Yes (all)	% Yes (matches)
Cumulative voting	23.8 (91)	23.0 (69)
Golden parachutes	28.7 (34)	28.0 (27)
Poison pills	41.1 (82)	41.9 (64)
Staggered boards	36.7 (119)	36.8 (110)
Supermajority provisions	29.3 (6)	29.3 (6)
Takeover statutes	24.0 (8)	23.3 (7)
Targeted share placements	39.5 (9)	38.8 (8)

Table 3. Mean Yes Votes in Relation to Confidential Voting Adoption by Proposal Type

A. Management Proposals

Type	Before Adoption	After Adoption
All Proposals		
Full sample	77.5 (485)	85.2 (327)
Matches sample	77.0 (430)	85.3 (306)
Blank Check Preferred		
Full	61.3 (16)	none
Matches	60.5 (13)	none
Defensive Tactics		
Full	62.0 (66)	66.3 (1)
Matches	61.5 (59)	66.3 (1)
Ex. & Dir. Compensation		
Full	86.1 (172)	87.4 (227)
Matches	85.7 (156)	87.5 (214)
Increase/auth. Com. Stk.		
Full	74.4 (68)	81.0 (46)
Matches	73.8 (63)	81.3 (43)
Liability & Indemn.		
Full	79.9 (114)	76.6 (2)
Matches	78.6 (95)	76.6 (2)
Repeal/Modify Defensive Tactics		
Full	77.8 (2)	83.2 (9)
Matches	77.8 (2)	82.1 (8)

B. Shareholder Proposals

Type	Before Adoption	After Adoption
All Proposals		
Full sample	25.5 (335)	27.7 (358)
Matches sample	24.4 (262)	28.7 (294)
Board Matters		
Full	17.9 (6)	13.4 (23)
Matches	18.5 (5)	12.9 (15)
Confidential Voting		
Full	33.1 (94)	34.5 (8)
Matches	34.5 (60)	33.6 (5)
Defensive Tactics		
Full	27.5 (166)	37.6 (198)
Matches	26.5 (132)	38.3 (171)
Director Matters		
Full	11.4 (27)	19.5 (44)
Matches	11.4 (27)	20.1 (35)
Exec. Compensation		
Full	12.9 (22)	11.0 (52)
Matches	12.9 (21)	11.6 (43)
Proxy Process		
Full	8.3 (10)	8.9 (6)
Matches	9.0 (8)	8.9 (6)
Sell Co./Division		
Full	10.5 (2)	17.1 (14)
Matches	10.5 (2)	17.8 (11)

Table 3.Mean Yes Votes in Relation to Confidential Voting Adoption by Proposal Type (continued)

C. Shareholder Proposals - Defensive Tactics

Type	Before Adoption	After Adoption
Cumulative voting		
Full sample	18.7 (35)	27.0 (56)
Matches sample	19.0 (30)	26.1 (39)
Golden parachutes		
Full	28.2 (16)	29.1 (18)
Matches	27.3 (11)	28.5 (16)
Poison pills		
Full	37.0 (45)	46.1 (37)
Matches	37.1 (33)	47.1 (31)
Staggered boards		
Full	26.1 (44)	43.0 (75)
Matches	24.5 (36)	42.8 (74)
Supermajority provisions		
Full	23.4 (5)	58.4 (1)
Matches	23.4 (5)	58.4 (1)
Takeover statutes		
Full	23.7 (7)	26.3 (1)
Matches	22.8 (6)	26.3 (1)
Targeted share placements		
Full	48.9 (1)	38.3 (8)
Matches	48.9 (1)	37.3 (7)

Table 4. Paired-Comparison T Tests, Difference in Mean Outcomes Before and After Confidential Voting Adoption (no. firms in parentheses)

A. Management Proposals

Type (#)	Mean Diff	Std. Error	T-stat.	Prob. > |T|
All (98)	9.037	1.009	8.954	0.0001
Ex&Dir Comp (all 68)	3.039	1.513	2.009	0.0486
Ex&Dir Comp (mix 36)	2.954	2.445	1.208	0.2352
Ex&Dir Comp (solo 7)	-3.233	3.089	-1.0465	0.3357
Ex Comp (59)	3.915	1.671	2.344	0.0225
Dir Comp (4)	7.800	5.039	1.548	0.2194
Inc Com (15)	7.218	2.908	2.483	0.0263

B. Shareholder Proposals

Type (#)	Mean Diff	Std. Error	T-stat.	Prob. > |T|
All (54)	2.819	1.596	1.766	0.0831
Def Tactics (all 39)	10.513	2.030	5.180	0.0001
Def Tactics (mix 34)	10.876	2.315	4.699	0.0001
Def Tactics (solo 11)	8.967	4.296	2.087	0.0634
Stag Bd (11)	19.701	5.024	3.922	0.0029
Pois Pill (8)	12.494	4.425	2.823	0.0257
Cum Vot (8)	5.685	0.795	7.148	0.0002
Gold Par (5)	4.367	4.172	1.047	0.3543
Dir Mtrs (7)	9.176	4.672	1.964	0.0971
Ex Comp (5)	-0.388	1.569	-0.247	0.8168
Con Vot (4)	3.642	2.308	1.578	0.2127

Table 5. Mean Voting Outcomes by Proposal Type and Year (matches only)

A. Management Proposals

Year*	Def. Tactics	BlnkChk Pfd	Inc/Ath ComStk	Liab &Indem	ExDir Comp	Repeal DefTac
1985 (0)			68.2 (2)			
1986 (0)	58.9 (33)	61.5 (4)	74.2 (15)	74.2 (2)		
1987 (0)	66.9 (10)	59.2 (2)	73.9 (17)	79.0 (71)		
1988 (5)	64.1 (10)	60.1 (2)	71.3 (9)	77.4 (19)	85.8 (42)	
1989 (3)	62.3 (6)	69.9 (1)	83.3 (3)	75.4 (2)	83.7 (39)	
1990 (9)	66.3 (1)	59.0 (2)	71.6 (11)	76.7 (2)	85.2 (36)	85.8 (1)
1991 (16)		56.7 (2)	76.0 (7)		87.3 (41)	68.1 (1)
1994 (18)			80.6 (11)	82.2 (1)	86.2 (82)	85.0 (3)
1997 (3)			84.1 (16)		89.1 (79)	85.2 (3)
1998 (0)			79.5 (15)		88.3 (51)	74.2 (2)

* Number of full sample firms with first meeting with confidential voting in year in parentheses

Table 5. Mean Voting Outcomes by Proposal Type and Year (matches only) (continued)

B. Shareholder Proposals

Year*	Bd Matters	Confid Voting	Dir Matters	Def Tactics	Exec Comp	Sr Pxy Process	Sell Co/Div
1985 (0)				12.3 (2)			
1986 (0)			12.4 (1)	12.3 (4)	3.3 (1)		
1987 (0)		10.7 (1)		22.2 (17)	7.7 (1)		
1988 (5)		26.6 (2)	9.2 (8)	24.8 (17)	6.8 (2)	14.5 (5)	
1989 (3)		29.1 (15)	9.1 (3)	24.6 (21)	6.1 (2)	5.4 (2)	
1990 (9)		32.5 (15)	11.1 (5)	28.1 (35)	5.1 (1)	22.6 (1)	
1991 (16)	25.9 (1)	34.7 (10)	12.4 (3)	31.5 (35)	3.9 (1)		12.1 (1)
1992 (16)	10.9 (2)	37.1 (12)	13.4 (5)	30.2 (25)	8.2 (1)		8.8 (1)
1993 (27)	21.2 (3)	49.8 (5)	13.0 (4)	33.4 (24)	15.7 (16)		
1994 (18)	9.7 (3)	48.2 (3)	27.1 (6)	38.6 (20)	12.6 (11)	9.4 (4)	
1995 (18)	12.5 (4)	33.6 (2)	20.7 (15)	40.3 (30)	16.9 (5)		8.8 (1)
1996 (3)	12.3 (2)		33.4 (7)	37.4 (26)	14.2 (8)		17.0 (4)
1997 (3)	11.5 (4)		13.4 (3)	41.7 (22)	9.4 (7)		23.7 (3)
1998 (0)	25.0 (1)		20.5 (2)	45.5 (25)	7.5 (8)	3.6 (2)	15.8 (3)

* Number of full sample firms with first meeting with confidential voting in year in parentheses

Table 5. Mean Voting Outcomes by Proposal Type and Year (matches only) (continued)

C. Shareholder Proposals - Defensive Tactics

Year*	Cum. Voting	Gold. Parachute	Poison Pill	Stag. Board	Takeover Statute
1985 (0)				11.8 (1)	
1986 (0)				14.1 (1)	
1987 (0)	14.0 (1)	16.4 (1)	26.9 (7)	18.3 (4)	
1988 (5)	16.1 (4)		36.1 (4)	21.1 (6)	
1989 (3)	15.2 (6)		38.6 (4)	25.7 (7)	17.7 (2)
1990 (9)	19.1 (9)	21.2 (4)	40.0 (11)	26.2 (7)	26.2 (3)
1991 (16)	20.0 (8)	32.8 (7)	45.9 (9)	26.1 (7)	24.5 (2)
1992 (16)	20.9 (6)	21.5 (5)	41.5 (6)	32.2 (7)	
1993 (27)	24.3 (5)	30.5 (4)	38.8 (4)	37.2 (10)	
1994 (18)	30.2 (5)		49.9 (3)	39.9 (10)	
1995 (18)	28.5 (6)	35.2 (3)	52.3 (4)	43.3 (15)	
1996 (3)	26.5 (7)	40.6 (1)	41.1 (4)	41.6 (13)	
1997 (3)	28.4 (6)		47.5 (4)	46.3 (12)	
1998 (0)	26.9 (6)	24.9 (2)	56.7 (4)	53.3 (10)	

* Number of full sample firms with first meeting with confidential voting in year in parentheses

Table 6. Mean Voting Outcomes by Year (number of proposals in parentheses, matches only)

A. Management Proposals

Year	%Yes Votes	%Yes before CV	%Yes after CV
1985	68.2 (2)	(none)	68.2 (2)
1986	64.4 (58)	(none)	64.4 (58)
1987	75.9 (111)	(none)	75.9 (111)
1988	78.4 (90)	77.9 (85)	87.4 (5)
1989	79.8 (59)	79.8 (56)	78.7 (3)
1990	80.0 (59)	80.1 (50)	78.9 (9)
1991	83.5 (55)	82.7 (36)	85.2 (19)
1994	83.4 (113)	86.2 (32)	82.2 (81)
1997	88.2 (105)	88.2 (105)	(none)
1998	85.5 (84)	85.5 (84)	(none)

B. Shareholder Proposals

Year	%Yes Votes	%Yes before CV	%Yes after CV
1985	12.3 (2)	(none)	12.3 (2)
1986	10.8 (6)	(none)	10.8 (6)
1987	20.3 (20)	(none)	20.3 (20)
1988	17.9 (34)	18.0 (33)	15.9 (1)
1989	23.1 (44)	23.0 (41)	24.4 (3)
1990	27.0 (58)	27.1 (50)	26.6 (8)
1991	29.6 (52)	28.2 (40)	34.0 (12)
1992	27.9 (47)	28.7 (32)	26.1 (15)
1993	26.8 (53)	26.8 (23)	26.8 (30)
1994	24.9 (48)	23.1 (15)	25.7 (33)
1995	29.6 (60)	29.6 (60)	(none)
1996	29.0 (49)	29.0 (49)	(none)
1997	27.7 (42)	27.7 (42)	(none)
1998	32.2 (41)	32.2 (41)	(none)

Table 6. Mean Voting Outcomes by Year (number of proposals in parentheses, matches only) (continued)

C. Shareholder Proposals - Defensive Tactics

Year	%Yes Votes	%Yes before CV	%Yes after CV
1985	12.3 (2)	(none)	12.3 (2)
1986	12.3 (4)	(none)	12.3 (4)
1987	22.2 (17)	(none)	22.2 (17)
1988	24.8 (17)	25.3 (16)	15.9 (1)
1989	24.6 (21)	24.7 (18)	24.4 (3)
1990	28.1 (35)	28.3 (29)	27.2 (6)
1991	31.5 (35)	30.2 (23)	34.0 (12)
1992	30.2 (25)	30.7 (14)	29.6 (11)
1993	33.4 (24)	28.4 (6)	35.0 (18)
1994	38.6 (20)	27.5 (3)	40.6 (17)
1995	40.3 (30)	40.3 (30)	(none)
1996	37.4 (26)	37.4 (26)	(none)
1997	41.7 (22)	41.7 (22)	(none)
1998	45.5 (25)	45.5 (25)	(none)

Table 7. Regressions Examining Time Trends in the Voting Data

A. Management Proposals

Dependent variable= % Vote in Support of Proposal

Regressor	Coefficient	Std. Error	T-stat.	Prob. > |T|
Intercept	75.6	2.1	35.5	0.000
Year	0.8	0.3	2.4	0.017
Post-adoption	-0.3	1.7	-0.1	0.885

Adjusted R^2 =.0168
No. Obs. = 370

B. Shareholder Proposals

Dependent variable= % Vote in Support of Proposal

Regressor	Coefficient	Std. Error	T-stat.	Prob. > |T|
Intercept	30.1	4.4	6.9	0.000
Year	0.9	0.4	2.1	0.036
Post-adoption	0.2	1.8	0.1	0.913
Stock returns	-9.7	2.9	-3.3	0.001

Adjusted R^2 = .0363
No. Obs. = 336

C. Shareholder Proposals-Defensive Tactics

Dependent variable= % Vote in Support of Proposal

Regressor	Coefficient	Std. Error	T-stat.	Prob. > |T|
Intercept	17.1	3.8	4.5	0.000
Year	1.8	0.6	3.1	0.002
Post-adoption	2.3	2.1	1.1	0.271
Stock returns	-2.1	3.7	-0.6	0.571

Adjusted R^2 = .0987
No. Obs. = 177

Table 8. Estimated Cost of Shareholder Proposal Regime, 1997-98.

A. Corporate Governance Proposals

Vote Cutoff for subsidy	No. proposals in 1997	No. proposals in 1998	Subsidy extent ($mill.) 1997	Subsidy Extent ($mill.) 1998
50%	31	32	$2.7 ($.6)	$2.8 ($.6)
40%	59	58	$5 ($1.2)	$5 ($1.2)
30%	94	91	$8.2 ($1.9)	$7.9 ($1.8)
20%	142	141	$12.4 ($2.8)	$12.3 ($2.8)
10%	196	188	$17.1 ($3.9)	$16.4 ($3.8)
0%	283	254	$24.6 ($5.7)	$22.1 ($5.1)

B. Social Responsibility Proposals

Vote Cutoff for subsidy	No. proposals in 1997	No. proposals in 1998	Subsidy extent ($mill.) 1997	Subsidy Extent ($mill.) 1998
50%	0	0	0	0
40%	0	0	0	0
30%	0	1	0	$.09 ($.02)
20%	0	2	0	$.2 ($.04)
10%	14	16	$1.2 ($0.3)	$1.4 ($0.3)
0%	95	104	$8.3 ($1.9)	$9.1 ($2.1)

Data Sources: IRRC Corporate Governance Service, Voting Results 1997 (1998); IRRC Corporate Governance Service, Voting Results 1998 (1999); IRRC Social Policy Shareholder Resolutions in 1997: Issues, Votes and Views of Institutional Investors (Jan. 1998); and IRRC Social Policy Shareholder Resolutions in 1998: Issues, Votes and Views of Institutional Investors (Jan. 1999). Proposals covered by both IRRC services included in panel A, corporate governance proposals. Average cost estimate per proposal of $87,000 (median cost estimate per proposal of $20,000) obtained from a survey of issuers by the Securities and Exchange Commission, reported in Amendments to Rules on Shareholder Proposals, Release No. 34-40,018, 63 Fed. Reg. 29,106, 29,114 (May 28, 1998).

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