# Texas Law Review
# *See Also*

Response


## How Embattled Are U.S. CEOs?


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### I. Introduction

One of the more prominent debates in recent corporate law scholarship has focused on the question of whether U.S. managers are too powerful. Lucian Bebchuk has famously argued that they are[1] and has therefore suggested various reforms to increase the influence of shareholders.[2] Other voices have defended the central position the law accords to managers as being in the best interest of shareholders.[3] What both sides agree upon, though, is that U.S. managers *are* in fact quite powerful, especially by international standards.[4]

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1. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 913–14 (2005) (asserting that management has too much control over the evolution of corporate governance arrangements and that increasing the power of shareholders would "benefit shareholders and improve corporate performance").

2. *See id.* at 836 (suggesting that shareholders should be allowed to initiate and adopt changes to the basic governance arrangements of their corporation).

3. *See* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1758 (2006) (concluding that the substantial benefits of the existing system justify retaining it at least as a default rule); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1769–70 (2006) (arguing that the capital markets have not indicated a need for substantial change in corporate governance).

4. *Cf.* Bainbridge, *supra* note 3, at 1735 (noting that much of corporate law serves to limit the influence of shareholders and referring to this phenomenon as "director primacy"); Bebchuk, *supra* note 1, at 848 (pointing out that U.S. corporate law is exceptional among the corporate law systems of developed countries in how strongly it limits the power of shareholders); Strine, *supra* note 3, at 1762 (noting that Delaware law invests corporate managers with "a great deal" of authority). *But see* Florence Shu-Acquaye, *The Independent Board of Directors and Governance in the United States: Where Is This Heading?*, 27 WHITTIER L. REV. 725, 735 (2006) (asking, though ultimately leaving open the question, "whether the days of the . . . 'imperial CEO' are over").

In their well-reasoned and important article *Embattled CEOs*, Professors Marcel Kahan and Edward Rock offer a fresh perspective on the situation of American CEOs.[5] They advance two main claims. First, they assert that CEOs of publicly traded corporations in the United States are losing power vis-à-vis shareholders and boards.[6] Second, they argue that this is not just a temporary phenomenon but rather a long-term trend that will continue in the future.[7]

Much of their argument is persuasive. In particular, it seems at the very least highly plausible to argue that the last few years have seen a decline in managerial power. However, some caution is appropriate. To begin, power is both complex and hard to measure. As a result, sweeping statements about managerial power or the decline thereof are inherently problematic. Furthermore, Kahan and Rock probably overestimate the impact of statutory as well as privately adopted rules, leading them to overstate the decrease in CEO power. Finally, the case for a long-term trend does not seem as clear as Kahan and Rock suggest. In the following Parts of this Response, I will address these concerns in turn.

## II. The Fundamental Obstacles to Generalizations About Managerial Power

Any attempt to gauge the power of managers necessarily has to face a number of fundamental obstacles.

### *A. The Complex Nature of Power*

To begin, as the authors more or less concede, power is a complex, multidimensional phenomenon.[8] Managers can become more powerful in one respect, while at the same time losing power in other dimensions.[9] Accordingly, any generalized statement to the effect that managers have become more or less powerful should be taken with a grain of salt. Moreover, the complex, multidimensional nature makes it substantially more difficult to interpret some of the developments that Kahan and Rock adduce as evidence of a decline in managerial power.

For example, as part of their case that CEOs have become less powerful, Kahan and Rock point to increased activism on the part of mutual funds.[10] Mutual funds, they note, "have shown an increased willingness to oppose acquisition of their portfolio companies by private equity firms or large

5. Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEXAS L. REV. 987 (2010).

6. *Id.* at 989.

7. *Id.*

8. *See id.* (noting that power is conceptually "complex").

9. *See id.* at 992–95 (measuring CEO power over three dimensions and explaining that it "has changed over some of these dimensions more than over others").

10. *Id.* at 1001–04.

family owners"—despite the fact that the relevant acquisitions had the blessing of the companies' CEOs.[11] The intuitive appeal of this argument is obvious: A CEO who, by giving his blessing to a buyout, can silence critics of that transaction is more powerful than a CEO whose recommendation will be ignored.

However, upon closer examination, the situation proves to be more difficult to judge. After all, the willingness of mutual funds to challenge buyout attempts by large family shareholders or private equity firms is an example of one group of large shareholders policing the conduct of another group of large shareholders. And especially in the buyout context, where corporations are taken private,[12] such policing likely benefits CEOs in at least one important respect: Any effort on the part of mutual funds to challenge firms will, at the margin, reduce the likelihood of such buyouts and hence increase the chance that the firm will remain publicly traded. To the CEO, this matters for two reasons. First, avoiding a buyout means that the CEO is more likely to retain her position. After all, buyouts by large family shareholders or private equity firms often go hand in hand with a change in management.[13] And second, even if the CEO could hang on to her position in case of a buyout, it has to be kept in mind that CEOs typically enjoy more independence at the helm of a publicly traded company than at the helm of a company that has been taken private.[14] In other words, the increased activism of mutual funds in the context of buyouts proves to be a double-edged sword with respect to CEO power. On the one hand, such activism reduces the power of a CEO to help stage such buyouts and to obtain possible pecuniary gains that such deals may yield for the CEO.[15] On the other hand, activism of this type increases her power to remain the CEO of a publicly traded firm.

### *B. The Difficulties in Observing Power*

Even setting aside the multidimensional nature of power, the issue remains that CEO power is hard to observe and hence difficult to measure.

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11. *Id.* at 1001–02.

12. *See* Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 80 (2008) (explaining that "leveraged buyout funds—often in concert with existing management—generally purchase sufficient securities of a target so as to take it private").

13. *See id.* at 83 (referring to a study according to which 74% of top managers in buyout targets eventually lost their jobs).

14. *See id.* at 46, 79–80 (noting that influence over corporate management is the key ingredient that distinguishes the investment strategy of private equity fund managers from that of corporate managers and institutional investors and pointing out that taking companies private is one way of establishing such influence).

15. For example, the buyout may trigger a golden parachute agreement.

Kahan and Rock admit as much,[16] but the problem would seem to be more daunting than they concede.

For example, as one important indicator of greater board independence (and hence reduced CEO power), Kahan and Rock point to the fact that CEO tenure is declining.[17] For example, according to one study, annual CEO turnover has increased by 59% between 1995 and 2006, and performance-related turnover has increased by 318% during the same period.[18] There is no doubt that such data is highly relevant to the question of CEO power. Indeed, many scholars would presumably agree that the CEO's ability to hang on to her job is a central indicator of CEO power.[19] However, the relevant data has to be seen in context. Two other factors seem particularly pertinent.

First, executive compensation has also risen dramatically in the relevant period. According to the data provided by Kahan and Rock, median total compensation of S&P 500 CEOs rose from $2.6 million in 1995 to $6.9 million in 2006.[20] In other words, the typical 1995 CEO may have had a greater ability to hang on to her job, but—in terms of compensation—it was a very different job.

Another source of uncertainty in interpreting tenure data results from the proliferation of so-called golden parachutes. Despite unfavorable tax treatment[21] and considerable opposition from shareholders,[22] golden parachute agreements are very common. One recent study of 137 large U.S. corporations found that 82% of these firms provide their CEOs with golden

16. *See* Kahan & Rock, *supra* note 5, at 989 (noting that power is difficult to observe).

17. *Id.* at 1030–32.

18. *Id.* at 1031.

19. *Cf., e.g.*, Jeffrey N. Gordon, *Executive Compensation: If There's A Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis*,*"* 30 J. CORP. L. 675, 683 (2005) (arguing that Bebchuk and Fried's account of managerial compensation being explained in considerable part by managerial power "fits uncomfortably with the increased rate of CEO turnover and the shortening of average CEO tenure").

20. Kahan & Rock, *supra* note 5, at 1037 tbl.8.

21. *See* I.R.C. § 162(m)(1), (4)(F) (setting the level of non-excessive parachute payments at $1,000,000 for publicly traded corporations); *id.* § 280G(a) (2006) (precluding deductibility of "excess" parachute payments); *id.* § 4999(a) (imposing an excise tax of 20% on excess parachute payments).

22. *Cf.* Yonca Ertimur, Fabrizio Ferri & Stephen R. Stubben, *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53, 70 app.A (2010) (documenting growing support between 1997 and 2004 for shareholder proposals calling for golden parachutes to be subject to shareholder approval); Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 378, 379 tbl.3 (2007) (documenting that the number of shareholder proposals on golden parachutes in 2003 and 2004 exceeded those in 2002). *Cf. also* Phred Dvorak, *Proxy Firm Targets Practice of Paying Executives' Tax Bills*, WALL ST. J., Nov. 24, 2008, at B4 (describing RiskMetrics Group's opposition to the payment of taxes owed by executives for golden parachutes).

parachutes and that the median worth is $29 million.[23] Of course, golden parachutes are by no means a new phenomenon. They have been widely used since at least the 1980s.[24] But it is at the very least conceivable that golden parachutes in 2006 were substantially more generous than in 1995. And if that were true, the average 2006 CEO may simply have fought less hard to remain in office than the average 1995 CEO. Accordingly, shorter tenure may at least in part be explained not by a loss in power but by the availability of an attractive way out.

### *C. The Relative Nature of Any Reduction in CEO Power*

It must also be kept in mind that any claim about CEO power is highly relative: Even assuming a decline in CEO power, American CEOs remain very powerful. This is fairly obvious by international standards. For example, in the United States, precatory shareholder resolutions may be given increasing weight by corporate boards,[25] but the resulting balance of power between shareholders and managers still does not come anywhere near the U.K. system where the shareholders are at liberty to adopt shareholder resolutions giving binding instructions to the board.[26]

Accordingly, any finding that U.S. CEOs are now less powerful than they used to be has to be handled with care in legal policy discussions. For example, even if CEOs are now less powerful than they were some years ago, they may still have too much power vis-à-vis shareholders, and critics of regulatory competition may still worry that such competition has made Delaware law excessively management friendly. Of course, none of this diminishes the importance of the article by Kahan and Rock. However, future scholarship building on the claim that managers are now less powerful than they used to be should be cautious not to disregard that claim's inherent limitations.

## III. The Claim That Managers Are Losing Power

Next, let me address the descriptive question of whether managers are, in fact, losing power. As previously indicated, I am sympathetic to the claim

23. *See* Eliezer M. Fich, Anh L. Tran & Ralph A. Walkling, *On the Importance of Golden Parachutes* 4 (4th Annual Conf. on Empirical Legal Studies, Working Paper, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1425211 (citing a relevant study by Equilar Inc.).

24. *See, e.g.*, Gordon, *supra* note 19, at 688 n.31 (remarking that golden parachutes increased in the 1980s in response to a favorable tax law change).

25. *See* Ertimur, Ferri & Stubben, *supra* note 22, at 54 (finding that more shareholder proposals are getting majority support than in the past and that boards are being more responsive to shareholder proposals that obtain a majority).

26. *See, e.g.*, Bebchuk, *supra* note 1, at 849 (stating that under U.K. law, the default arrangement is for the board to be subject to directions given by special resolution of the shareholders).

that they are. However, some of the evidence is more ambiguous than it may seem at first glance.

### *A. Reasons for the Decline in Managerial Power*

Many, if not all, of the causes that may explain the loss of power experienced by CEOs can be divided into three main groups: (1) changes in ownership structures; (2) changes in the law governing corporations; and (3) privately adopted rules.

The most convincing explanation for a decline in CEO power relates to the change in ownership structures: It does appear that the era of highly dispersed ownership lies in the past.[27] And given that it is easier for large shareholders than for small shareholders to monitor managers,[28] more concentrated ownership generally translates into less autonomy for the firm's managers.[29]

The practical relevance of the various changes in the law that Kahan and Rock describe are harder to assess. The main problem here is that corporate CEOs may well find ways to adapt to the relevant changes in a way that blunts their impact.[30] As is well-known, the fierce takeover wave of the 1980s that led about one-third of Fortune 500 companies to become takeover targets within a single decade[31] eventually produced the development of defensive strategies such as the poison pill,[32] which, in combination with a staggered board, is a fairly effective way of preventing hostile takeovers.[33]

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27. *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1379 (2009) (concluding that "most public corporations in the United States have large-percentage shareholders, and the ownership concentration of U.S. corporations is similar to the ownership concentration of corporations elsewhere").

28. *See, e.g.*, Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 J. CORP. L. 681, 684 (2008) (indicating that large shareholders are more effective monitors of managers than small shareholders because they experience fewer collective action problems).

29. *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 331 (2004) (noting that dispersed ownership tends to result in greater managerial autonomy).

30. In earlier scholarship, Marcel Kahan and Edward Rock have stressed the importance of such adaptive reactions. *See* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 872 (2002) (noting that market participants faced with law they do not like "can try to change the law, opt out of the law, or work around the law").

31. Gerald F. Davis & Suzanne K. Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980–1990*, 37 ADMIN. SCI. Q. 605, 608 (1992).

32. *See, e.g.*, Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 U. CHI. L. REV. 917, 917 (2002) (relating that in response to the 1980s' takeover wave, managers developed "strategies to fend off unwanted bidders and retain control of their firms," including the poison pill).

33. *See, e.g.*, Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, 2004 COLUM. BUS. L. REV. 21, 39 (arguing that the combination of the poison pill and a staggered board is "an effective defense" to a hostile takeover).

Similar adaptive techniques are conceivable with respect to the recent changes in statutory law that seem to make CEOs less powerful. For example, it has been suggested that rules requiring the disclosure of executive compensation may simply prompt managers to resort to hidden forms of compensation that are equally expensive to the company but less offensive to shareholders.[34] Similarly, faced with the requirement to have a majority of independent directors,[35] management may well become more and more adept at finding directors who appear to meet the requirements for independence but are nonetheless sympathetic to management.

Even more skepticism seems appropriate with respect to those rules that corporations adopt voluntarily. As Kahan and Rock rightly note, an increasing number of large corporations have recently begun to adopt regimes that serve to increase the power of shareholders—such as majority voting for directors[36] or say on pay.[37] However, compared to changes in statutory law, voluntarily adopted changes give rise to three additional concerns.

To the extent that corporate boards adopt the relevant rules by amending the corporation's bylaws, these bylaws do not really impose much of a legal constraint on the board. After all, the board can easily repeal the relevant amendments without shareholder approval.[38] Accordingly, the board may go along with the relevant rules as long as the burden they impose is limited. But once the new rules become a real threat to the board, the board may well decide to get rid of them.

This issue is particularly conspicuous where the board adopts a bylaw provision according to which the election of directors requires a majority rather than a mere plurality of the vote. The board may be happy to apply the relevant bylaw provision as long as only the fate of individual directors is at stake. But who is to say that the board will not amend the bylaw in question

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34. *See, e.g.*, Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 476 (2007) (arguing that "the *form* of compensation, rather than the *level*, may shift in response to disclosure").

35. NASDAQ OMX GROUP, INC., NASDAQ STOCK MARKET RULES § 5605(b)(1) (2009), *available at* http://nasdaq.cchwallstreet.com/ (mandating companies listed on the Nasdaq to have a majority of independent directors); NYSE, INC., LISTED COMPANY MANUAL § 303A.01 (2009), *available at* http://nysemanual.nyse.com/LCM/Sections/ (requiring companies listed on the NYSE to have a majority of independent directors).

36. Kahan & Rock, *supra* note 5, at 1010–11.

37. *Id.* at 1034–36.

38. Under the legal default rule, the board of a Delaware corporation does not have the power to amend the bylaws. DEL. CODE ANN. tit. 8, § 109(a) (2008). However, as a practical matter, the articles of incorporation of large corporations usually grant the board that power. L. John Bird, Comment, *Stockholder and Corporate Board Bylaw Battles: Delaware Law and the Ability of a Corporate Board to Change or Overrule Stockholder Bylaw Amendments*, 11 U. PA. J. BUS. L. 217, 225 (2008).

as soon as shareholders attempt to use it to affect major changes?[39] Kahan and Rock claim that such a reaction is "both unlikely and ultimately ineffective [because] even under a plurality-vote regime, a director who receives a majority of withhold votes faces enormous pressures to resign."[40] Yet that argument reinforces rather than quells doubts regarding the relevance of majority-vote bylaws: After all, if the true reason for the resignation of a director who receives a majority of "withhold" votes lies in the pressure exerted by the shareholders, and if that same pressure will be exerted even under a plurality regime, then it is unclear why a majority requirement contained in the bylaws should make much of a difference.

Moreover, corporations that voluntarily adopt rules increasing shareholder power are self-selected. Accordingly, such rules may disproportionately be adopted by those corporations that believe their impact to be limited.

Finally, and perhaps most importantly, voluntarily adopted rules that sacrifice board power in one dimension may serve to preserve or enhance such power in other dimensions. For example, a board faced with shareholder outrage over a steep increase in executive compensation may voluntarily adopt a say-on-pay regime rather than assuage shareholders by making substantial cuts in executive compensation. Admittedly, the fact that the board feels the need to make any such concession in the first place proves that management is not almighty. But once one recognizes that say-on-pay bylaws and similar privately adopted rules are ways of managing the board's relations with the shareholders, their adoption no longer can be equated with a loss of power. It hardly seems convincing to argue that a board that consciously decides to give shareholders say-on-pay rather than make substantive pay cuts is less powerful than a board that makes the opposite choice.

### *B. Indicators of Change: Executive Compensation and Tenure*

Finally, it is worth adding a few words about executive compensation and tenure. For those trying to assess whether CEOs have become more or less powerful, it is certainly plausible to look to compensation and tenure as two obvious indicators.

As regards tenure, I am generally sympathetic to the claim that the increased turnover for CEOs suggests that CEOs are less powerful—

39. Section 216 of the Delaware General Corporation Law contains a special rule regarding the modification of bylaws governing the number of votes necessary for the election of directors: To the extent that such bylaws are adopted by the shareholders, they cannot be amended or repealed by the board of directors. DEL. CODE ANN. tit. 8, § 216 (West 2010). However, this section does not prevent the board from repealing a bylaw on majority voting as long as it was the board that adopted the bylaw in the first place. *Id.*

40. Kahan & Rock, *supra* note 5, at 1042.

although, as pointed out above, it is difficult to interpret the meaning of higher CEO turnover unless one also takes into account executive compensation and golden parachutes.

By contrast, executive compensation presents the more difficult puzzle. Kahan and Rock compare numbers regarding the median and average total compensation for the CEOs of S&P 500 companies. Yet their numbers hardly support a lasting trend towards loss of power. Median compensation in 2008 ($5.9 million) was slightly *higher* than in 2000 and substantially higher than it had been even ten years earlier in 1998 ($4.3 million).[41] Hence, it may be true that CEO compensation "has come to a halt."[42] But if CEOs had truly lost power, one would expect salaries to decline rather than simply to fail to continue to rise.

## IV. The Long-Term Trend

According to Kahan and Rock, the loss of power that managers experience is not just a temporary phenomenon but rather a long-term trend that will continue in the future.[43] Their prognosis may well turn out to be accurate. However, as pointed out above, CEOs may find ways to adapt to the new rules and thereby regain some of the power that they have lost. Moreover, two additional factors suggest that a further reduction in managerial power should not be taken for granted.

Much of the shift in power from managers and shareholders can be explained as a result of changing ownership patterns:[44] More concentrated ownership means less powerful managers.[45] But it is difficult to predict whether ownership will continue to become more concentrated. After all, concentrated ownership has costs as well as benefits,[46] and it is exceedingly difficult to foretell at what point the former will outweigh the latter, especially since the costs and benefits of concentrated ownership may vary across corporations.[47] If the trend towards more concentrated ownership comes to an end, so may the decline in CEO power.

Furthermore, it is difficult to predict whether institutional investors will continue to grow more active. After all, hedge funds are responsible for a substantial portion of the new activism, and hedge funds are still a young

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41. Kahan & Rock, *supra* note 5, at 1037 tbl.8.

42. *Id.* at 1037.

43. *See supra* note 7 and accompanying text.

44. *See* Kahan & Rock, *supra* note 5, at 998 (noting that "activist hedge funds have emerged as critical new players in both corporate governance and corporate control").

45. *See supra* text accompanying notes 27–29.

46. *See, e.g.*, Dammann, *supra* note 28, at 684–85 (indicating that while controlling shareholders can more effectively monitor managers and reduce transaction costs incurred in contractual dealings between it and the corporation, such shareholders also can abuse their power and profit at the expense of other shareholders).

47. *Id.* at 705.

industry with an uncertain future.[48] In particular, it is yet uncertain to what extent hedge funds will be subjected to regulation[49] and what impact such regulation will have on hedge fund activism. It has been suggested, for example, that hedge funds will eventually become more like traditional institutional investors.[50] In other words, as the hedge funds industry matures, it might also show less activism in matters of corporate governance.

## V. Conclusion

Kahan and Rock have made a comprehensive, well-reasoned, and persuasive case that CEO power has declined in recent years and may decline further in the future.

However, it is important to note this claim is subject to various limitations: Because power is a complex, multidimensional phenomenon, generalizations about managerial power necessarily have to be somewhat simplistic. Moreover, it is well worth remembering that, decline or not, U.S. CEOs remain very powerful by international standards. And, most importantly, because actual power is hard to observe, any claims about managerial power must be somewhat speculative.

Of course, none of this diminishes the importance of the analysis offered by Kahan and Rock—an analysis that both contributes to existing scholarship and will very likely start a significant scholarly discussion of its own.

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48. It is commonly thought that the first hedge fund was founded by Alfred Winslow Jones in 1949. *E.g.*, J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 802 (2007). However, it was much more recently that the hedge fund industry started to explode. *See, e.g.*, René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. ECON. PERSP. 175, 176 (2007) (noting that the amount of assets invested in hedge funds increased from less than $50 billion in 1990 to more than $1 trillion in 2006).

49. *See* Stulz, *supra* note 48, at 192 (stating that the activism of hedge funds, along with other practices, sometimes leads to demands for hedge fund regulation).

50. *See id.* (arguing that as hedge funds evolve, "they will behave more like financial institutions").