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## THE CASE FOR INCREASING SHAREHOLDER POWER

Lucian Bebchuk

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## ARTICLES

## THE CASE FOR INCREASING SHAREHOLDER POWER

*Lucian Arye Bebchuk*

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## THE CASE FOR INCREASING SHAREHOLDER POWER

Lucian Arye Bebchuk\*

*This Article reconsiders the basic allocation of power between boards and shareholders in publicly traded companies with dispersed ownership. U.S. corporate law has long precluded shareholders from initiating any changes in the company's basic governance arrangements. Professor Bebchuk's analysis and his empirical evidence indicate that shareholders' existing power to replace directors is insufficient to secure the adoption of value-increasing governance arrangements that management disfavors. He puts forward an alternative regime that would allow shareholders to initiate and adopt rules-of-the-game decisions to change the company's charter or state of incorporation. Providing shareholders with such power would operate over time to improve all corporate governance arrangements.*

*Furthermore, Professor Bebchuk argues that, as part of their power to amend governance arrangements, shareholders should be able to adopt provisions that would give them subsequently a specified power to intervene in additional corporate decisions. Power to intervene in game-ending decisions (to merge, sell all assets, or dissolve) could address management's bias in favor of the company's continued existence. Power to intervene in scaling-down decisions (to make cash or in-kind distributions) could address management's tendency to retain excessive funds and engage in empire-building. Shareholders' ability to adopt, when necessary, provisions that give themselves a specified additional power to intervene could thus produce benefits in many companies.*

*A regime with shareholder power to intervene, Professor Bebchuk shows, would address governance problems that have long troubled legal scholars and financial economists. These benefits would result largely from inducing management to act in shareholder interests without shareholders having to exercise their power to intervene. Professor Bebchuk also discusses how such a regime could best be designed to address concerns that supporters of management insulation could raise; for example, shareholder-initiated changes in governance arrangements could be adopted only if they enjoy shareholder support in two consecutive annual meetings. Finally, examining a wide range of possible objections, Professor Bebchuk concludes that they do not provide a good basis for opposing the proposed increase in shareholder power.*

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Directors are . . . supreme during their time. . . . [D]irectors, while in office, have almost complete discretion in management; and most of the general corporation acts in terms so provide.<sup>1</sup>

## I. INTRODUCTION: RECONSIDERING THE ALLOCATION OF POWER BETWEEN MANAGEMENT AND SHAREHOLDERS

This Article questions the basic allocation of power between boards and shareholders under U.S. corporate law. I present the case for allowing shareholders to initiate and vote to adopt changes in the company's basic corporate governance arrangements. Shareholder power to adopt governance arrangements should include the power to adopt provisions that would allow shareholders, down the road, to initiate and vote on proposals regarding specific corporate decisions. Increasing shareholder power to intervene, I argue, would improve corporate governance and enhance shareholder value by addressing important agency problems that have long afflicted publicly traded companies.

Much attention has been recently given to the possibility of making it easier for shareholders to replace directors. In particular, a heated debate has taken place over an SEC proposal to provide shareholders with the power to place director candidates on the corporate ballot in some circumstances.<sup>2</sup> While I support making shareholder power to replace directors more viable, I argue that it is important to increase shareholder power with respect to other issues as well.

A central and well-settled principle of U.S. corporate law is that all major corporate decisions must be initiated by the board. Shareholders may not initiate any such decisions. The only way in which shareholders can attempt to introduce a new corporate decision is by replacing incumbent directors with a new team that is expected to make such a change.<sup>3</sup> This feature of U.S. corporate law, which has profound implications for corporate governance, is often taken for granted. Yet it is far from being an inherent corollary of the modern public corporation.

The corporate decisions for which I consider shareholder intervention power can be grouped into two categories. First, there are "rules-

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<sup>1</sup> ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 139-40 (1933).

<sup>2</sup> See Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). For a collection presenting the range of views on this subject, see *SHAREHOLDER ACCESS TO THE CORPORATE BALLOT* (Lucian Bebchuk ed., forthcoming 2005).

<sup>3</sup> See ROBERT CHARLES CLARK, *CORPORATE LAW* 21-24, 93-140 (1986); *infra* section II.A.

of-the-game” decisions to amend the corporate charter or to change the company’s state of incorporation. Such decisions, which affect a general class of situations, will be the focus of my analysis. Second, there are specific business decisions of substantial importance; in this category, the two types of decisions to which I will devote the most attention are “game-ending” decisions, which are decisions to merge, sell all assets, or dissolve the company, and “scaling-down” decisions, which involve reducing the company’s size by ordering a cash or in-kind distribution.

Part II describes the absence of intervention power under the current, longstanding corporate law principles that grant boards control over all major corporate decisions.<sup>4</sup> Although rules-of-the-game decisions and game-ending decisions generally require a vote of shareholder approval, only the board can initiate such a vote. Shareholders also may not make scaling-down decisions or any other types of specific business decisions. After discussing the U.S. system, Part II goes on to describe the U.K. system, which does give shareholders some power to intervene in corporate decisions.

To be sure, shareholders in the American public corporation have the right to vote on the election of directors. The U.S. corporation can be regarded as a “representative democracy” in which the members of the polity can act only through their representatives and never directly.<sup>5</sup> The underlying view is that, as long as shareholders have the power to replace the directors, corporate decisions can be expected to serve shareholder interests.

Part III presents the case for giving shareholders the power not only to elect and replace directors, but also to initiate and adopt rules-of-the-game decisions to amend the corporate charter or to reincorporate in another jurisdiction. Management, I argue, should not have control over “constitutional” decisions that affect the basic corporate governance arrangements to which the company is subject.

In theory, incumbents who fail to initiate a change that shareholders view as value-increasing will be ousted in a proxy contest by a team promising to make the value-enhancing change. Because challengers considering launching a contest face considerable impediments, however, contests are rare even against underperforming incumbents.

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<sup>4</sup> For an account of the current division of power, see CLARK, *supra* note 3, at 93–140; and *infra* section II.A.

<sup>5</sup> See *TW Servs. v. SWT Acquisition Corp.*, Nos. CIV.A.10427, 10298, 1989 WL 20290, at \*8 n.14 (Del. Ch. Mar. 2, 1989) (“While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation, subject however to a fiduciary obligation.”). Martin Lipton and Paul Rowe refer to the choice of completely representative democracy as “part of the deep design of the Delaware corporate form.” Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 28 (2002).

Furthermore, even if reforms were adopted to reduce or eliminate these impediments, a “bundling problem” would discourage contests against a board that fails to initiate a governance change that shareholders view as value-enhancing.

A vote for a challenger who promises to initiate a value-enhancing change would be a vote not only for the change, but also for a new team of directors. Shareholders might be reluctant to vote for the new team when it is viewed as inferior to the existing team with respect to other aspects of the firm’s management. Moreover, if confronted with a challenger running on a platform of adopting the value-enhancing change, management would likely be able to win by conceding and pledging to initiate the promised change (or a step in that direction). This prospect would discourage challengers from launching a proxy contest in the first place.

Part III also provides empirical evidence of management’s ability to avoid rules-of-the-game changes that are viewed as value-enhancing by a majority of shareholders. In most companies whose shareholders passed precatory (nonbinding) resolutions calling for dismantling a staggered board, which makes it harder for shareholders to replace management, management has chosen to retain the staggered board. Indeed, management has chosen to retain a staggered board even in some cases where precatory resolutions to repeal it have obtained majority support in two, three, or even four annual meetings.

As is the case with shareholder power to replace directors, shareholders’ power to veto changes in governance arrangements cannot eliminate the distortion that results from management’s monopoly over initiating such changes. To begin, veto power does not help shareholders to effect changes when the board prefers the status quo. Furthermore, when there is a set of possible changes that both management and shareholders would prefer to the status quo, shareholders’ veto power would not secure the arrangement that would best serve shareholder interests. In such circumstances, management’s preference would play a key role in determining which change within this set would be adopted.

Thus, without shareholder intervention power, management’s monopoly over the initiation of rules-of-the-game decisions might well result in inefficient corporate governance arrangements. Considering that public companies often live long lives in dynamic environments, management’s control over rules-of-the-game decisions can produce severe distortions over time. Shareholder power to make rules-of-the-game decisions would address this problem. It would ensure that corporate governance arrangements do not considerably depart from the ones that shareholders view as value-maximizing.

A reform allowing shareholders to make rules-of-the-game decisions would operate to improve over time the whole range of governance arrangements. By enabling the shareholders of public companies

to intervene and impose arrangements addressing identified governance problems and flaws, such a reform could reduce the need for outside intervention by legislators and regulators. For example, shareholders concerned about recent governance failures would be able to adopt whatever governance arrangements would best address these failures.

Part III also discusses how a regime that permits shareholders to initiate rules-of-the-game decisions can best be designed. For example, to address the concern that some shareholder-initiated proposals could be adopted because of transient interests, lapses, or distortions, the proposed regime would allow shareholder-initiated governance changes to go into effect only if they enjoy shareholder majority support in two successive annual meetings. Changes would thus be adopted only if they are viewed as value-enhancing by a stable majority of shareholders over a considerable period of time, which would provide ample opportunity for management to present its case. The proposed regime also would facilitate management counter-proposals to make it more likely that the menu offered to shareholders would include the value-maximizing option. In addition, Part III discusses how a regime with intervention power can be designed to encourage the initiation of desirable proposals and to limit potential costs from nuisance and opportunistic proposals.

A well-designed regime would commonly induce value-enhancing changes without shareholders exercising their power to intervene. The existence of such power in the background would provide management with incentives not to adopt or maintain arrangements that serve management's interests but not shareholder value. A regime with shareholder intervention power could thus commonly improve the quality of corporate governance arrangements without incurring the costs of actual votes.

Part IV examines potential objections to granting shareholders the power to make rules-of-the-game decisions. I analyze a wide range of arguments that can be made against shareholder intervention. Among other things, I consider objections based on shareholders' imperfect information, the desirability of consistency in decision-making, the risk of nuisance and opportunistic proposals, and the formation of potentially disruptive "social choice" cycles. I also address claims that such power would have little practical significance, as well as Panglossian claims that firms would adopt arrangements providing such power if the arrangements were in fact desirable. After reviewing all the arguments, I conclude that they do not, either individually or in combina-



tion, provide a good basis for maintaining management control over the initiation of rules-of-the-game decisions.<sup>6</sup>

Part V turns from rules-of-the-game decisions to specific business decisions concerning issues such as sales, dissolutions, cash or in-kind distributions, and management remuneration. I argue that, as part of their power to initiate and adopt charter provisions, shareholders should have the power to adopt charter provisions that would permit them subsequently to intervene in specific business decisions in the manner and subject to the limitations stipulated in these provisions. To show that the power to adopt such provisions can be beneficial, I discuss how shareholder intervention power with respect to two important types of specific business decisions — game-ending decisions and scaling-down decisions — can address substantial distortions and inefficiencies.

Regarding game-ending decisions, in the absence of shareholder power to intervene, management might have a tendency to reject attractive, value-enhancing opportunities to merge, sell, or dissolve, because termination would end its control over the independent company. Provisions granting shareholders the power to initiate and adopt binding resolutions regarding game-ending decisions would provide an effective mechanism for addressing this problem.<sup>7</sup> Such provisions

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<sup>6</sup> My analysis in Parts III and IV of this Article, which presents the case for permitting shareholders to make rules-of-the-game decisions, continues earlier work that I did with Allen Ferrell advocating that shareholders be allowed to initiate a switch from the takeover rules of their state of incorporation to the takeover rules of another jurisdiction. See Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001). A proposal for allowing shareholders to initiate charter amendments was made in William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1925–47 (1995). Some support for shareholder power to initiate charter amendments or reincorporations has been expressed in passing in various other works. See, e.g., Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 615 (2002); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 700–02 (1974); John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 774–77 (1987). This Article seeks to contribute to the literature by presenting a complete account of the case for shareholder power to make rules-of-the-game and specific business decisions. Among other things, my analysis demonstrates why shareholders' authority to remove directors is insufficient to induce management to initiate value-increasing changes; it identifies the various benefits that would result from shareholder power to make rules-of-the-game decisions; it addresses a wide range of possible objections to such power; it discusses how such a regime can be best designed to address these objections; and it presents a unified treatment of shareholder intervention regarding both rules-of-the-game decisions and specific corporate decisions.

<sup>7</sup> The possibility of allowing shareholders to initiate and adopt merger proposals was raised in LUCIAN BEBCHUK & OLIVER HART, TAKEOVER BIDS VS. PROXY FIGHTS IN CONTESTS FOR CORPORATE CONTROL 24 (Nat'l Bureau of Econ. Research, Working Paper No. w8633, 2001), available at <http://www.nber.org/papers/W8633>. A proposal to allow shareholders to initiate and adopt dissolutions was made in Park McGinty, *Replacing Hostile Takeovers*, 144 U. PA. L. REV. 983 (1996).

could permit shareholders to pass not only resolutions prohibiting management from blocking certain hostile bids, but also ones instructing it to accept or facilitate other types of game-ending transactions; for example, shareholders could require management to start a dissolution or an auction process or to accept a merger proposal made by an outside buyer.<sup>8</sup>

As for scaling-down decisions ordering a cash or in-kind distribution, shareholder intervention power could force management to contract the size of the company or to remove excess cash or assets. Such power would address the problems of empire-building and excessive retention of funds, which have occupied financial economists and corporate law scholars over the last two decades. Indeed, these problems have been viewed as sufficiently severe to motivate the use of highly leveraged structures that come with their own significant costs. Provisions giving shareholders the power to make scaling-down decisions could often prevent empire-building and excessive retention of funds more effectively and with lower costs than could debt.

Although I believe that intervention power with respect to specific business decisions might be beneficial in many cases, I recognize that such power presents greater difficulties and arouses greater concerns than intervention power with respect to rules-of-the-game decisions. Because of these difficulties and concerns, I do not propose that the law provide such intervention power as a mandatory or even default arrangement. Rather, I only advocate that the law accept provisions granting specified power to intervene in business decisions as permissible provisions of corporate charters. Under the proposed regime, then, shareholders would have intervention power regarding specific business decisions only if they made in advance the general judgment that their having such power down the road would likely be value-enhancing.

Finally, Part VI examines objections to increasing shareholder power that are based on the protection of stakeholders (that is, non-shareholder constituencies, such as employees or creditors). Even if one assumes that stakeholders should get some protection beyond that provided by their contracts, it does not follow that boards should be insulated from shareholder intervention. The overlap between the interests of management and those of stakeholders is hardly such that management can be relied upon to use its powers to protect stakeholders. Management is more likely to use its insulation from share-

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<sup>8</sup> Whether the board should be able to block takeover bids that have obtained a vote of shareholder support has been the subject of heated debate. For recent statements of the case for and against board veto in corporate takeovers, compare Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002), with Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

holder intervention to serve its own interests. Indeed, increased management slack might hurt both shareholders and stakeholders. Therefore, considerations of stakeholder protection might call for arrangements tailored specifically to address this concern, but they do not provide support for management insulation from shareholders.

My analysis indicates that the considerable weakness of shareholders in U.S. companies is not a necessary consequence of the dispersion of ownership. This weakness is at least in part due to the legal rules that insulate management from shareholder intervention. Even if the existing patterns of ownership were to remain unchanged, providing shareholders with the power to intervene would substantially strengthen their power vis-à-vis management.

This understanding of the sources of shareholder weakness complements Professor Mark Roe's work on how legal rules have contributed to the dispersion of ownership in publicly traded U.S. companies.<sup>9</sup> According to Roe, the dispersion of ownership, which weakens shareholders, is at least partly due to the fact that U.S. legal rules have long prohibited or discouraged financial institutions from holding large percentages of shares. My analysis indicates that, in addition to the rules that produce dispersed ownership, another set of rules plays a key role in keeping U.S. shareholders weak — the rules denying shareholders the power to intervene. Even under the existing patterns of ownership, introducing shareholder power to intervene would considerably change the balance of power between shareholders and management, producing a profound and largely beneficial impact on corporate governance.

Throughout this Article, I shall refer by "management" to the team of directors and officers who shape board decisions. Needless to say, the interests of officers and independent directors do not completely overlap, and much attention has been paid to improving corporate governance by increasing the power of the latter group vis-à-vis the former group. My focus, however, is on the allocation of decision-making power between the team of directors and officers as a whole — that is, between management as I define it — and shareholders.

Some supporters of greater shareholder power might regard increases in "shareholder voice" and "corporate democracy" as intrinsically desirable. I should therefore stress at the outset that I do not view increasing shareholder power as an end in and of itself. Rather, effective corporate governance, which enhances shareholder and firm value, is the objective underlying my analysis. From this perspective, increased shareholder power would be desirable only if it would oper-

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<sup>9</sup> See generally MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

ate to improve corporate performance and value. As the analysis below indicates, the proposed regime would in fact likely have such consequences.

Concluding that increasing shareholder power would be beneficial hardly implies that such a reform would be politically easy or even feasible. As I analyze in detail in other current work, management is a powerful interest group that can be expected to have substantial influence on lawmaking in the corporate area.<sup>10</sup> Attempts to reduce management insulation would have to overcome strong resistance by vested interests. Such reforms would take place, if at all, only if public investors and public officials were to recognize the substantial costs of such insulation. The analysis of this Article, I hope, can help improve understanding of these costs.

## II. THE EXISTING ALLOCATION OF POWER

This Part discusses the existing allocation of power between management and shareholders. Section A describes the managerial principles underlying U.S. corporate law. To highlight the extent to which these principles are not a corollary of the nature of the modern corporation, section B briefly describes the different approach of U.K. law.

The corporate laws of both the United States and the United Kingdom start with the same basic principle: Shareholders do not necessarily have the power to order the directors to follow any particular course of action. Rather, the powers of shareholders are limited to what corporate statutes specify and, to the extent permitted by these statutes, to the company's constitutional documents.<sup>11</sup> However, the corporate codes in the United States and the United Kingdom significantly differ in their treatment of shareholder intervention.

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<sup>10</sup> See Lucian Bebchuk, *Politics and Investor Protection* (Apr. 2004) (unpublished manuscript, on file with the Harvard Law School Library); Lucian Bebchuk & Zvika Neeman, *A Political Economy Model of Investor Protection* (Nov. 2004) (unpublished manuscript, on file with the Harvard Law School Library).

<sup>11</sup> See, e.g., *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (Del. 1989) (validating management's decision to proceed with a merger, using the powers given to it by state law, despite the apparent opposition of a majority of the shareholders); *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85, 87 (1880) (invalidating a stockholder action directly appointing a nondirector manager because the sole managerial power was given to directors by a state statute, subject to corporate bylaw restrictions); *Automatic Self-Cleansing Filter Syndicate Co. v. Cunningham*, [1906] 2 Ch. 34, 43 (Eng. C.A. 1906) (invalidating a vote by a majority of the shareholders to sell the company).

### A. U.S. Law

Although different states within the United States have different corporate codes, these codes have many similarities.<sup>12</sup> This section focuses on the law of Delaware — the most important corporate jurisdiction, which serves as domicile to a majority of public companies<sup>13</sup> — and on the Model Business Corporation Act (MBCA), which is followed by the corporate codes of twenty-four states.<sup>14</sup>

The basic and longstanding principle of U.S. corporate law is that the power to manage the corporation is conferred on the board of directors.<sup>15</sup> This power includes board control over three categories of decisions on which I will focus in this Article: rules-of-the-game decisions, game-ending decisions, and scaling-down decisions.

1. *Rules-of-the-Game Decisions.* — Rules-of-the-game decisions concern the choice of the rules by which corporate actors play. The basic governance arrangements of a company come from two sources: the corporate charter and the laws of the company's state of incorporation. Both the charter and the state of incorporation can be changed, but such changes generally require initiation by management.

Under the Delaware Code and the MBCA, charter amendments must be initiated and brought to a shareholder vote of approval by the board.<sup>16</sup> Regardless of how many shareholders want a given charter amendment and of how long they have supported the amendment, shareholders may not vote on it unless the board first elects to have such a vote.

Shareholders also lack the power to initiate changes to the state of incorporation. No state statute explicitly sets forth a procedure for reincorporating in another state; reincorporation is generally accomplished by merging the corporation into a shell corporation incorporated in the desired state. Since reincorporating procedurally takes the form of a merger, the rules governing merger decisions apply. As will

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<sup>12</sup> See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 731–34 (1998); see also John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 702 (1999) (“[T]he best documented finding in the empirical literature on the U.S. corporate chartering competition is that a high degree of uniformity has emerged in American corporate laws.”).

<sup>13</sup> In 2002, Delaware was the domicile of fifty-nine percent of Fortune 500 firms and fifty-eight percent of all publicly traded companies. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where To Incorporate*, 46 J.L. & ECON. 383, 391 tbl.2 (2003). Delaware's share is expected to increase in the future because Delaware has been able to attract an even larger fraction of firms going public in recent years. See Bebchuk & Hamdani, *supra* note 6, at 579–80.

<sup>14</sup> MODEL BUS. CORP. ACT, introduction at xxvii (2002).

<sup>15</sup> See DEL. CODE ANN. tit. 8, § 141(a) (2001); MODEL BUS. CORP. ACT § 8.01(b). For a similar provision in a state that does not follow the MBCA other than Delaware, see N.Y. BUS. CORP. LAW § 701 (McKinney 2003).

<sup>16</sup> See DEL. CODE ANN. tit. 8, § 242(b); MODEL BUS. CORP. ACT § 10.03; cf. N.Y. BUS. CORP. LAW § 803(a).

be discussed presently, only the board may initiate a vote on a merger proposal.<sup>17</sup>

It is worth noting that the Delaware Code and the MBCA grant shareholders the concurrent authority with the board to amend the company's bylaws, which can regulate some aspects of the company's governance.<sup>18</sup> The bylaws, however, are subordinate to the charter and cannot alter any of the charter's arrangements.<sup>19</sup> Furthermore, only the charter may opt out of various provisions of the Delaware Code and the MBCA.<sup>20</sup>

Thus, the scope of those restrictions on management that may be adopted through bylaw provisions is much more limited than the scope of those restrictions that may be adopted through charter provisions.<sup>21</sup> For example, while it is widely accepted that charters may prohibit the use of poison pills,<sup>22</sup> scholars have intensely debated whether and to what extent bylaws limiting director authority to issue poison pills are permissible.<sup>23</sup> And many participants in this debate hold the view that Delaware law does not permit such bylaws.<sup>24</sup>

As for the debate concerning the scope of permissible bylaw provisions, the analysis of this Article supports a broader scope for bylaw provisions by providing a full account of the benefits that result from shareholder power to make rules-of-the-game decisions. But given that the statutory language makes it clear that some changes in governance arrangements can be made only through charter provisions

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<sup>17</sup> See *infra* pp. 846–47.

<sup>18</sup> See DEL. CODE ANN. tit. 8, § 109; MODEL BUS. CORP. ACT § 10.20; *cf.* N.Y. BUS. CORP. LAW § 601.

<sup>19</sup> The Delaware General Corporation Law limits authorized bylaws to provisions “not inconsistent with . . . the certificate of incorporation.” DEL. CODE ANN. tit. 8, § 109(b). The MBCA similarly limits bylaws to provisions “not inconsistent with . . . the articles of incorporation.” MODEL BUS. CORP. ACT § 2.06(b); *cf.* N.Y. BUS. CORP. LAW § 601(b).

<sup>20</sup> See, e.g., DEL. CODE ANN. tit. 8, §§ 102(b)(1), 141(a).

<sup>21</sup> See Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 479 (1998). The Delaware Supreme Court recently noted, “Section 141(a) requires that any limitation on the board’s authority be set out in the certificate of incorporation.” *Quickturn Design Sys. v. Shapiro*, 721 A.2d 1281, 1291 (Del. 1998).

<sup>22</sup> See, e.g., Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 87 (2001). Poison pills, also known as shareholder rights plans, are an important antitakeover device.

<sup>23</sup> 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, 613–16 (1997); Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 544–51 (1997); Hamermesh, *supra* note 21, at 437–42; Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835, 837 (1998).

<sup>24</sup> Indeed, Delaware law firms have been routinely opining that, even though Delaware courts did not explicitly address the issue, Delaware law does not authorize bylaws that limit poison pills. See Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 508 & n.51 (2001).

and not through bylaws, the benefits of letting shareholders make rules-of-the-game decisions could be fully realized only if shareholders are allowed to initiate changes in the charter. Indeed, to realize these benefits fully, we need to permit shareholders to initiate not only charter amendments but also reincorporations.

From a policy perspective, it is arguably inconsistent to allow shareholders to initiate “second-order rules” in the form of bylaw provisions while denying them the power to initiate “first-order rules” in the form of charter provisions. Some scholars contend that this seeming inconsistency supports the position that shareholder power to adopt bylaw provisions should be narrowly interpreted, curtailed, or even eliminated.<sup>25</sup> In my view, however, any such inconsistency should be resolved in the opposite direction — by allowing shareholders to initiate not only bylaw provisions but also all other rules-of-the-game decisions.

Finally, it is worth noting that existing securities laws enable shareholders to express their sentiments in favor of a given charter amendment or a reincorporation through precatory proposals.<sup>26</sup> Even shareholders with a very small stake may initiate shareholder resolutions, including resolutions that call for management to initiate a charter amendment or a reincorporation or urge that management adopt a certain policy or take a certain course of action.<sup>27</sup> But these resolutions are not binding: under state corporate law, directors have discretion whether to follow precatory proposals that receive substantial or majority support, and directors’ freedom to disregard such resolutions is protected under the business judgment rule.<sup>28</sup> As I discuss in section III.A.1, many boards have in fact used their freedom to disregard shareholder resolutions.<sup>29</sup>

2. *Specific Business Decisions.* — (a) *Game-Ending Decisions.* — Under the Delaware Code and the MBCA, mergers, consolidations, sales of all assets, and dissolutions — the various types of game-ending decisions — require approval by a majority of the outstanding shares.<sup>30</sup> But the power granted to shareholders is only a veto power;

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<sup>25</sup> See STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 45–48 (2002). Professor Bainbridge argues that shareholder power to adopt bylaws is “a historical anachronism . . . lacking either rhyme or reason,” and that shareholder-adopted bylaws restricting management discretion should be invalidated. *Id.* at 48; see also Hamermesh, *supra* note 21, at 444–52.

<sup>26</sup> See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 550–73 (4th ed. 2004).

<sup>27</sup> See SEC Regulation 14A, 17 C.F.R. § 240.14a-8(b)(1), (i) (2004).

<sup>28</sup> Cf. Spiegel v. Buntrock, 571 A.2d 767, 775–76 (Del. 1990).

<sup>29</sup> See *infra* pp. 852–55.

<sup>30</sup> See DEL. CODE ANN. tit. 8, § 251(c) (2001) (merger and consolidation); *id.* § 271(a) (asset sale); *id.* § 275(b) (dissolution); MODEL BUS. CORP. ACT § 11.04(e) (2002) (merger); *id.* § 12.02(e) (asset sale); *id.* § 14.02(e) (dissolution).

shareholders lack the power to initiate such decisions. Only the board may bring to a shareholder vote a proposal to have a merger, consolidation, sale of all assets, or dissolution.<sup>31</sup> Indeed, the Delaware Code even explicitly authorizes the board to abandon a proposed merger or sale of assets that received prior approval from the shareholders.<sup>32</sup>

(b) *Scaling-Down Decisions.* — Under state corporate law, the authority to determine distributions rests fully with the board.<sup>33</sup> Management has full authority to determine distributions either in cash or in kind (for example, in the stock of a subsidiary in the case of a spin-off), without the need to obtain shareholder approval. Thus, with regard to distribution decisions, shareholders lack not only initiative power, but also a veto power such as the one that they have over game-ending decisions.

Corporate law does not view decisions about distributions, however economically important, as involving the kind of fundamental change that calls for shareholder veto power. Rather, such decisions are viewed as part of the ordinary conduct of business delegated to the sole prerogative of management. Courts have consistently refused to review the decisions of management in this area, holding that such decisions belong to the core area in which deference to the business judgment of management is warranted.<sup>34</sup>

### B. *The Different Approach of the United Kingdom*

I now turn to the different approach of U.K. corporate law.<sup>35</sup> I do so to highlight that, at the level of doctrinal principles, shareholders' lack of power to initiate major corporate decisions is not an inevitable

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<sup>31</sup> *E.g.*, MODEL BUS. CORP. ACT. § 11.04(a) ("The plan of merger or share exchange must be adopted by the board of directors."). In theory, Delaware grants shareholders some initiation power regarding dissolution, but such initiation requires unanimous written consent, which in practice cannot be obtained in publicly traded companies. *See* DEL. CODE ANN. tit. 8, § 275(c).

<sup>32</sup> DEL. CODE ANN. tit. 8, § 271(b) (sale of assets). Section 251(c) provides that the terms of a merger agreement "may require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it." *Id.* § 251(c). Section 251(d) allows the parties to the merger agreement to authorize the board to abandon the merger notwithstanding its approval by stockholders. *Id.* § 251(d).

<sup>33</sup> *See id.* § 170(a); MODEL BUS. CORP. ACT § 6.40.

<sup>34</sup> *See, e.g.*, *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 812 (Sup. Ct. 1976); *see also* Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 104 (1980). Indeed, one scholar could not identify a single case in which a U.S. court has ordered a management-controlled, publicly traded corporation to increase its dividends. *See* MERRITT B. FOX, *FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY* 375 (1987).

<sup>35</sup> I am grateful to Brian Cheffins and Paul Davies for helpful discussions about U.K. law. For a good review of U.K. law on the subject, see chapters 4, 14, and 15 of PAUL L. DAVIES, *GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW* (7th ed. 2003); and chapters 3, 15, and 16 of ROBERT R. PENNINGTON, *COMPANY LAW* (7th ed. 1995).



element of the legal structure of the modern corporation. Although the rules precluding shareholder intervention are currently settled in the United States, different allocations of power between shareholders and management should not be ruled out as inconsistent with the basic doctrinal structure of corporate law.

The different approach of the United Kingdom is not an exception. Rather, the corporate law system of the United States is the one that stands out among the corporate law systems of developed countries in how far it goes to restrict shareholder initiative and intervention.<sup>36</sup> I focus on the United Kingdom, however, because it offers a good comparison: as in the United States, companies with dispersed ownership and without controlling shareholders — the companies for which the subject of this Article is important — are common in the United Kingdom.<sup>37</sup>

Like their U.S. counterparts, U.K. governance arrangements are set by statute and, to the extent that the statute permits, by companies' basic constitutional documents, which in the United Kingdom are called the memorandum and the articles of association. By statute, changes in the memorandum or the articles of association can be made by a "special resolution" that requires a supermajority approval of seventy-five percent of the votes cast at a shareholder meeting.<sup>38</sup> The memorandum or articles of association may not eliminate or limit the power to change these basic documents by special resolution.<sup>39</sup> While the supermajority requirement makes all changes in these constitutional documents more difficult, management does not have a monopoly or privileged position with respect to initiating such changes.

Shareholders in the United Kingdom have the power to bring to a shareholder vote special resolutions to amend the memorandum or articles of association. They have a right to propose such resolutions at the annual shareholder meeting provided that proper notice was given.<sup>40</sup> Furthermore, notwithstanding anything in the company's

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<sup>36</sup> REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW* 46–49 (2004).

<sup>37</sup> See Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 491–98 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1147 tbl.7 (1998).

<sup>38</sup> Companies Act, 1985, c. 6, §§ 9(1), 378(2) (Eng.), reprinted in 8 HALSBURY'S STATUTES OF ENGLAND AND WALES 88, 112, 432 (4th ed. 1999) [hereinafter HALSBURY'S]. The U.K. supermajority requirement of seventy-five percent of the voted shares is higher than the approval threshold under U.S. corporate law, but to a lesser extent than it would seem at first glance. Under U.S. corporate law, approval requires a majority of the shares outstanding, not shares participating in the vote, see, e.g., DEL. CODE ANN. tit. 8, § 242(b), and many shareholders do not participate in corporate votes. For example, if eighty percent of the outstanding shares participate in a vote on a charter amendment, requiring a majority of the outstanding shares is equivalent to requiring support from sixty percent of the voted shares.

<sup>39</sup> See *Malleon v. Nat'l Ins. & Guar. Corp.*, [1894] 1 Ch. 200 (1893).

<sup>40</sup> See PENNINGTON, *supra* note 35, at 821–62. A special resolution usually requires twenty-one days' notice of the meeting in which it is to be proposed. See *id.* A group of shareholders

memorandum or articles of association, shareholders holding ten percent or more of the company's shares have the power to call a special meeting and may bring a proposal to amend the memorandum or articles of association to a vote in such a special meeting.<sup>41</sup>

As for specific business decisions, U.K. companies are also run in the ordinary course of events by their boards. Under the default arrangement, which is supplied by the Companies Act's model provisions for the articles of association, "the business of the company shall be managed by the directors."<sup>42</sup> However, as a leading U.K. treatise observes in comparing U.K. law with U.S. law, "English law does not regard certain functions and powers as managerial or executive and therefore inalienable by the board."<sup>43</sup>

Under the default arrangement of U.K. law, the board is subject to "any directions given by special resolution" of the shareholders.<sup>44</sup> More importantly, the memorandum and the articles of association, which can always be amended by special resolution, may deviate from the default arrangement and establish a different division of power between the board and the shareholders.<sup>45</sup> Thus, shareholders always have the power to amend the articles of association by special resolution to grant themselves in the future a specified power of intervention in business decisions.

It should be emphasized that U.K. law gives shareholders other powers that enable them to have greater influence on the board than their U.S. counterparts commonly have without passing a special resolution requiring a supermajority. Under a mandatory feature of U.K. law, shareholders may at any time replace all the directors with a majority of the votes cast in a special meeting called for this purpose.<sup>46</sup> Furthermore, with respect to game-ending decisions concerning acquisition offers, the U.K. City Code prevents management from blocking takeover bids and thus provides shareholders with the power to decide whether to accept such bids.<sup>47</sup> For our purposes, however, what is important is that, at the conceptual level, U.K. law does not view the

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owning at least five percent of the shares may require the company to give notice of its resolutions and thus avoid having to bear on its own the costs of giving notice to other shareholders. *See id.*

<sup>41</sup> Companies Act, 1985, c. 6, § 368(1)–(2), *reprinted in* 8 HALSBURY'S, *supra* note 38, at 424.

<sup>42</sup> *Id.* app. tbl.A, art. 70, *reprinted in* HALSBURY'S, *supra* note 38, at 975.

<sup>43</sup> PENNINGTON, *supra* note 35, at 765.

<sup>44</sup> Companies Act app. at tbl. A, art. 70, *reprinted in* HALSBURY'S, *supra* note 38, at 983.

<sup>45</sup> *See* PENNINGTON, *supra* note 35, at 765 ("The board's powers can be as broad or as narrow as is desired . . .").

<sup>46</sup> *See* Companies Act, § 303, *reprinted in* HALSBURY'S, *supra* note 38, at 371.

<sup>47</sup> *See* DAVIES, *supra* note 35, at 716–19.

modern corporation as a “purely representative democracy.” U.S. law, I shall argue, should distance itself from this view as well.<sup>48</sup>

### III. LETTING SHAREHOLDERS SET THE RULES

To students of corporate law, the proposition that corporate governance arrangements matter requires little explanation. As the evidence indicates, the quality of governance arrangements affects firm performance and shareholder value.<sup>49</sup>

In publicly traded companies with dispersed ownership, the interests of management do not fully overlap with those of shareholders, and management thus cannot be automatically counted on to take actions that would serve shareholder interests. As a result, agency costs that reduce shareholder value might arise. Without adequate constraints and incentives, management might divert resources through excessive pay, self-dealing, or other means; reject beneficial acquisition offers to maintain its independence and private benefits of control; over-invest and engage in empire-building; and so forth. Adequate governance arrangements, however, can provide constraints and incentives that reduce deviations from shareholder-value maximization.

There are, of course, factors that reduce agency problems by inducing management to care about shareholder interests, from executive and director compensation schemes<sup>50</sup> to the inherent trustworthiness and integrity of directors and officers.<sup>51</sup> The influence of these factors,

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<sup>48</sup> It might be suggested that the validity of the case for increasing shareholder power can be tested by examining whether U.K. firms have higher value than U.S. firms have. However, in addition to the differences in corporate governance rules, the U.S. and the U.K. economies are different along many dimensions, and it may therefore not be possible to draw meaningful inferences from a comparison of U.S. and U.K. firms.

<sup>49</sup> See generally Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 15–16 (2000) (surveying evidence on the correlation that the strength of investor protection has with shareholder value and the development of stock markets).

<sup>50</sup> For a discussion of how executive compensation works to provide some alignment between the interests of management and those of shareholders, 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, 884 (2002). For an analysis of the limits to relying on executive compensation arrangements for addressing agency problems, see generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); and Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, J. ECON. PERSP., Summer 2003, at 71.

<sup>51</sup> For arguments that take the view that directors in the aggregate can be trusted to do what is good for shareholders, see Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 798–813 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 574–92 (2003); and Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 829–36 (2002). For an analysis of the limits to relying on directors that are insulated from shareholders to serve shareholder interests, see generally BEBCHUK & FRIED, *supra* note 50, chs. 2, 4, and 16 (2004); and Lucian Arye Bebchuk, Jesse Fried & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 764–83 (2002).

however, also depends on the quality of corporate governance arrangements in place. Corporate governance arrangements can have a substantial effect, for example, on the selection and incentives of directors.

The significance of governance provisions makes the process that selects them of critical importance. I argue below that, as an important part of this process, shareholders should have the power, subject to certain procedural requirements, to initiate and adopt rules-of-the-game decisions to amend the charter or to reincorporate in another state.<sup>52</sup>

Section A explains why shareholder power to elect and replace directors cannot ensure that management will initiate rules-of-the-game changes that increase value. Section B similarly shows that shareholders' veto power over charter amendments and reincorporations cannot effectively ensure the passage of value-increasing changes. Section C describes the benefits of permitting shareholders to make rules-of-the-game decisions. Finally, section D discusses the choices involved in designing a regime in which shareholders have such power, and puts forward a detailed proposal for such a regime.

#### *A. The Limits of Shareholder Power To Replace Directors*

A key element of the corporate structure is the shareholder franchise — shareholders' power to elect and replace directors. Corporate statutes provide shareholders with this power,<sup>53</sup> which courts view as a fundamental element of the corporate structure.<sup>54</sup>

One could argue that the power to replace directors is sufficient to ensure that value-enhancing changes in governance arrangements will occur even if shareholders lack the power to initiate them. If management does not initiate such changes, the argument goes, shareholders will replace the management team with one that will make the changes. Furthermore, because management knows that shareholders have the power to replace the board, management generally will not neglect shareholder interests to begin with, and shareholders will not need to exercise their replacement power.

Thus, on this view, although actual replacement of incumbent directors does not occur frequently, shareholders' power to replace directors can generally induce management to initiate value-increasing changes in rules, thereby making it unnecessary for shareholders to

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<sup>52</sup> Technically, to the extent that reincorporation involves a merger with a shell corporation that is incorporated in another state but otherwise is identical, shareholders would be able to initiate a binding vote instructing management to arrange for such a merger.

<sup>53</sup> See, e.g., DEL. CODE ANN. tit. 8, § 141(k) (2001).

<sup>54</sup> See, e.g., *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (noting the "central importance of the franchise to the scheme of corporate governance").

have power to make rules-of-the-game decisions. As I discuss below, however, shareholder power to replace directors cannot ensure that management would act in this way.

1. *Some Empirical Evidence.* — Before explaining why shareholder power to replace directors cannot secure rules-of-the-game decisions that would be value-increasing, it will be useful to consider some empirical evidence. The evidence put forward below shows that management often elects not to initiate rules-of-the-game decisions for which shareholders register strong support in precatory resolutions.<sup>55</sup>

Precatory resolutions to dismantle staggered boards provide a good context for examining this issue. During the past decade, investors have been using precatory resolutions to express their opposition to staggered boards. The Investor Responsibility Research Center (IRRC) has been tracking such resolutions in a large set of firms comprising the lion's share of U.S. stock market capitalization, and the analysis below is based on the IRRC data as supplemented by Georgeson Shareholder, the prominent proxy solicitation firm.<sup>56</sup>

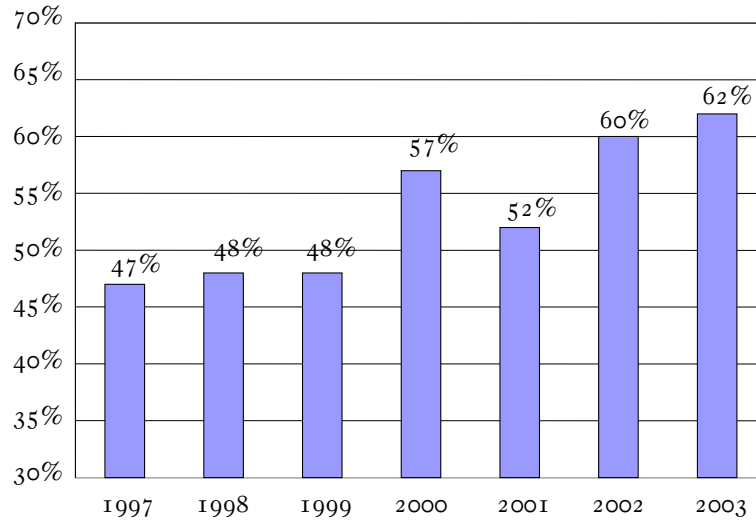
Figure 1 displays the average support level that precatory resolutions to repeal staggered boards obtained in each of the years during the period from 1997 to 2003. As the figure indicates, the average support has been substantial throughout, trending upward, and reaching average support of sixty percent of shares voted in 2002 and average support of sixty-two percent of shares voted in 2003.

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<sup>55</sup> I am grateful to Ophir Nave for his valuable help in analyzing the data and obtaining the findings reported below. In a current project, tentatively titled "How Much Do Boards Listen to Shareholders?", Ophir Nave and I are seeking to provide a fuller account of the extent to which management fails to follow majority-passed precatory resolutions.

<sup>56</sup> I am grateful to Steven Pantina and John Wilcox of Georgeson Shareholder for providing me with the data in electronic form and for helpful conversations. Much of this data appears in publications of this firm that are available on its website, <http://www.georgesonshareholder.com>.

FIGURE 1: SHAREHOLDER SUPPORT FOR  
PRECATORY RESOLUTIONS TO REPEAL STAGGERED BOARDS



Shareholders voting to repeal staggered boards had good reasons to be concerned about them. Staggered boards make it difficult to replace the board in either a proxy fight or a hostile takeover. There is evidence that having a staggered board greatly increases the likelihood that targets of hostile bids remain independent, and that it considerably reduces the returns to the target's shareholders both in the short-run and in the long-run.<sup>57</sup> There is also evidence that staggered boards are correlated with lower firm value.<sup>58</sup> Thus, the management of a company in which shareholders approve a precatory resolution to repeal a staggered board cannot claim that the shareholders' view is unreasonable or inconsistent with the available evidence.

<sup>57</sup> See LUCIAN ARYE BEBCHUK, JOHN C. COATES IV & GUHAN SUBRAMANIAN, THE POWER OF TAKEOVER DEFENSES (Harvard Law School, Working Paper, July 2003), available at <http://www.nber.org/~confer/2003/si2003/papers/cf/bebchuk.pdf>; Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 925-39 (2002) [hereinafter Bebchuk, Coates & Subramanian, *Theory, Evidence, and Policy*]. Furthermore, staggered boards do not appear to produce countervailing benefits in terms of higher premia in negotiated transactions. See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 906-08 (2002).

<sup>58</sup> See LUCIAN ARYE BEBCHUK & ALMA COHEN, THE COSTS OF ENTRENCHED BOARDS (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper Series No. 478, 2004).

Has management then largely followed majority-passed resolutions to repeal staggered boards? To study this question, all the companies in which shareholders passed resolutions to repeal staggered boards during 1997–2003 and that are still in existence were examined to determine whether they still had a staggered board in the fall of 2004.<sup>59</sup>

Table 1 provides statistics concerning the number of resolutions in my dataset passed in each of the years since 1997. It also displays the percentage of such resolutions that were implemented by the fall of 2004. As the table indicates, more than two-thirds of the resolutions obtaining majority support during the period 1997–2003 were not implemented — that is, the company still had a staggered board — by the fall of 2004.

TABLE 1: MAJORITY-REPEALED  
RESOLUTIONS TO REPEAL STAGGERED BOARDS

Year	Number of Majority-Passed Resolutions	Number Not Implemented by Fall 2004	Percentage Not Implemented by Fall 2004
1997	8	6	75.0%
1998	7	4	57.1%
1999	11	7	63.6%
2000	13	10	76.9%
2001	27	19	70.4%
2002	32	21	65.6%
2003	33	23	69.7%
Total	131	90	68.7%

It might be suggested that companies where management did not implement majority-passed precatory resolutions to repeal a staggered board were ones that had only transient shareholder support for such a resolution. Convinced by management or changing circumstances, shareholders of these companies could have dropped their support for repealing the staggered board after the passage of the precatory resolution. The evidence indicates, however, that in many companies, man-

<sup>59</sup> This determination was made using the takeover defenses data of the IRRC as well as the data of TrueCourse, available at <http://Sharkrepellent.net>.

agement did not follow shareholder resolutions to repeal staggered boards despite the fact that such resolutions had obtained the support of a majority of the voted shares in two, three, or even four annual meetings.

Table 2 provides statistics about such cases. As the table indicates, management did not follow majority-passed resolutions to repeal staggered boards in most of the companies whose shareholders passed such resolutions twice. Management failed to follow such resolutions even in most of the companies whose shareholders passed such resolutions three or more times.

TABLE 2: COMPANIES WITH TWO OR MORE MAJORITY-PASSED RESOLUTIONS TO REPEAL STAGGERED BOARDS

	Number of Companies	Number of Companies with Staggered Board in Fall 2004	Percentage with Staggered Board in Fall 2004
Two Resolutions	22	17	77%
Three or More Resolutions	15	9	60%

Indeed, in three companies, Airborne Inc., Eastman Kodak Company, and The Kroger Company, resolutions to repeal staggered boards obtained majority support four times, but to no avail: these companies still had a staggered board in the fall of 2004. To be sure, it is still possible in such cases that management will eventually relent and follow shareholders' registered views. After all, at Bristol-Myers Squibb Company, management initiated repeal of the staggered board after precatory resolutions calling for such repeal attracted majority support in each of the six years 1997–2002. But the “happy end” of the Bristol-Myers Squibb saga does not indicate that shareholder power to make rules-of-the-game decisions would not have been helpful in this case; the company was governed by an arrangement viewed by shareholders as value-reducing for a rather long time.

Finally, it might be argued that the focus on cases in which precatory resolutions were passed drastically underestimates the magnitude of management's willingness to repeal a staggered board when shareholders view it as value-reducing. According to this conjecture, shareholders commonly make their views known to management in ways other than through passing precatory resolutions, and management is



commonly responsive to shareholders' requests. In this view, shareholders need to resort to passing precatory resolutions only in a small subset of the cases where shareholders seek a repeal of a staggered board. If this conjecture were valid, most cases in which shareholders wish to have a staggered board repealed would end up with such a repeal without the passing of a precatory resolution to this effect.

According to the IRRC/Georgeson data, the number of instances in which management initiates a repeal of a staggered board, however, has not been large at all relative to the number of cases in which resolutions to repeal staggered boards pass. Prior to 2003, the incidence of management proposals to repeal staggered boards was negligible, with three such proposals in 2001 and five in 2002. This incidence went up in 2003 and 2004, but the incidence of management proposals in those two years (sixty) hardly dwarfed the incidence of precatory resolutions to repeal staggered boards (seventy-eight), or even the incidence of such resolutions that obtained majority support (sixty-six).

Thus, the cases in which management does not follow majority-passed resolutions to repeal staggered boards are not a small island in a sea of management responsiveness to shareholder pressure to repeal staggered boards. Rather, these cases are, at a minimum, sufficiently significant in number to indicate that shareholders' existing power to remove directors is not generally sufficient to ensure that management will initiate all changes in governance arrangements that shareholders view as value-increasing.

2. *Why the Power To Replace Directors Is Insufficient.* — How can management ignore the wishes of shareholders and still remain in power? To begin, as I discuss in detail elsewhere, under current arrangements, shareholders seeking to exercise their theoretical power to replace directors face substantial impediments.<sup>60</sup> Challengers do not have the access to the corporate ballot and to the corporation's proxy machinery that incumbents enjoy. Unlike incumbents, who have their campaign costs fully borne by the company, challengers have to bear their campaign costs themselves — even though they will share the benefits from improved corporate governance with their fellow shareholders. It is therefore not surprising that, outside the hostile-takeover context, the incidence of electoral challenges to directors is negligible. In a study of such challenges during the seven-year period 1996–2002, I found that, among thousands of public companies, there were on average only eleven such challenges a year, with less than two a year for firms with market capitalization exceeding \$200 million.<sup>61</sup>

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<sup>60</sup> Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 *BUS. LAW.* 43, 44–46, 64–66 (2003).

<sup>61</sup> *See id.* at 45–46.

Substantial changes in the corporate elections process would be necessary to make shareholders' power to replace directors viable, and I support such reforms.<sup>62</sup> Such reforms would have to provide challengers with broad access to the corporate ballot as well as with some reimbursement of campaign expenses. Even with such reforms, which currently do not seem politically feasible, incumbents would continue to have an advantage over challengers because shareholders would be more uncertain about how the challengers would affect share value; replacing directors would (as it should) be far from straightforward.<sup>63</sup>

Moreover, even assuming that challengers seeking to replace directors faced no disadvantages relative to the incumbents, the viability of director replacement would still not eliminate the need for shareholder power to make rules-of-the-game decisions. A vote to replace directors with a rival team that promises to initiate a given rules-of-the-game change is a highly imperfect instrument for achieving the desired change. Such a vote to replace directors bundles together (1) the given change in rules and (2) another significant change — the replacement of incumbent directors with the rival team. This bundling problem might prevent the adoption of value-increasing rule changes that shareholders would support by themselves.<sup>64</sup>

Suppose, for example, that the shareholders of a company view the existing management team as the best team for running the company's core assets. Suppose also that, for self-serving reasons, management does not wish to initiate a given value-increasing change in rules CR (for example, having an annual election for directors). Let us assume

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<sup>62</sup> See *id.* at 44–48, 64–66; see also SEC Roundtable on Proposed Security Holder Director Nominations Rules, available at <http://www.sec.gov/spotlight/dir-nominations/transcript03102004.txt>, at 5–52 (comments of Lucian Bebchuk at the SEC Roundtable (Mar. 10, 2004)).

<sup>63</sup> See BEBCHUK & HART, *supra* note 7 (showing how imperfect information about challengers provides incumbents with a substantial advantage in contests over director elections).

<sup>64</sup> This bundling problem is different from the “standard” bundling problem in corporate law. The standard problem, which is discussed in *infra* pp. 864–65, arises when management obtains shareholder approval for a change that shareholders view as value-decreasing by bundling this change with another change desired by shareholders and bringing them to a shareholder vote as a “package.” See, e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1475 (1992) (discussing how bundling two proposals in one package might enable management to gain shareholder approval of a value-decreasing reincorporation); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 47–49 (1988) (discussing how bundling of value-decreasing dual class recapitalization with a proposal desired by shareholders might lead to approval of the recapitalization). In contrast, the bundling problem that I discuss here is that, by requiring shareholders who wish to change a rule to take the director replacement route, state corporate law bundles any attempt to obtain a rule change with a board replacement. Thus, the bundling is done not by management (as in the standard bundling problem), but rather by corporate law's ruling out of shareholder initiation of rules-of-the-game decisions. The resulting distortion is not that shareholders would approve a value-decreasing proposal by management (as in the standard bundling problem), but rather that they would be discouraged from seeking value-increasing changes.

for concreteness that CR would produce a net gain of three dollars per share (taking into account all costs of the change, including, for example, the cost of any additional compensation that might have to be paid to management if the rule change is adopted). In this case, the value-maximizing outcome would be both to keep the current management at the helm and adopt CR. If shareholders could initiate and adopt CR, the value-maximizing outcome would be attained. Without power to make rules-of-the-game decisions, however, shareholders cannot directly vote to adopt CR while retaining the current management.

To be sure, if management refrains from initiating CR, a challenger team could emerge and run a proxy fight, seeking to gain shareholder support by promising to initiate CR. Such a challenge, however, would not automatically produce the value-maximizing outcome of having both CR and the best management team. Assuming that incumbent management maintains its opposition to CR, the challenge would only offer shareholders the choice between (1) having their assets managed by the existing (best) management but not having CR, and (2) having CR, but also having their assets managed by the new team (NT). As explained below, such a challenge might well not emerge and, even if it emerges, need not result in the adoption of CR.

Suppose that, for any given rule, the cost to shareholders of having the company led by the new team NT, rather than by incumbent management, would be  $\$X$  per share.<sup>65</sup> Consider first the case in which  $\$X > \$3$ : the reduction in share value from having the company run by the new team is greater than the increase in share value that CR would produce. In this case, the bundle of the new management team and CR would have a lower value than the bundle of the current team without CR. As a result, voting for the challenger would not be in the interest of shareholders, and the challenger's promise to initiate CR would be insufficient for the challenger to win. Accordingly, in this situation, launching a contest over CR would not induce management to concede to initiate CR. Management would recognize that it would win the proxy contest and remain in office whether or not it agrees to initiate CR. Furthermore, with little chance of winning or pushing management to adopt CR, potential challengers would have little incentive to bear the costs of launching a contest in the first place.<sup>66</sup>

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<sup>65</sup> Of course, if shareholders viewed the new team as better than current management, a proxy challenge could emerge and succeed even without management's failure to initiate CR. My analysis in this section, however, focuses on the question whether shareholders' power to replace the board would induce management to initiate CR when, putting aside the issue of adopting CR, shareholders do not wish to replace management with a new team.

<sup>66</sup> In a forthcoming article, K.A.D. Camara takes issue with my analysis of the bundling problem. He argues that in the above situation, shareholders can be expected to vote to oust management in the event that it does not initiate CR, and management will adopt CR to avoid

Consider next the case in which, at least with some campaigning by a challenger to present its new team and to allay potential concerns about it,  $\$X$  is below  $\$3$ : in this scenario, the costs of having the new team manage the company's assets instead of the current team is lower than the value of having CR. In this case, management will recognize (or be told by its proxy solicitors as the contest proceeds) that, unless it makes some concessions, shareholders will vote for the challenger. In this case, assuming a challenge arises and proceeds (which, as we shall see, might well not occur), the threat of ouster will lead management to agree to initiate a rule change in the direction desired by shareholders.

To defeat the challenge, it might well be sufficient for management to initiate a change more modest than CR. Management only needs to move in the direction of CR up to the point that the challenger's promise to initiate CR would no longer be sufficient to make it worthwhile for the shareholders to replace the incumbent team with the new team and bear the loss of  $\$X$  per share. For concreteness, suppose that  $\$X = \$2$ , and suppose also that a certain modest change, which we will call CR-lite, would increase value compared with the status quo by  $\$1.5$  per share — that is, by  $\$1.5$  per share less than the increase in value that CR would produce. In this case, it would be sufficient for management to agree to initiate CR-lite to defeat a challenge based on

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such an outcome. Shareholders, Camara suggests, will wish to develop the reputation of being "tough" and committed to ousting the board in any case in which the board fails to initiate a rule change favored by shareholders. See K.A.D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2005 WIS. L. REV. \_\_ (manuscript at 23–30), *manuscript available at* <http://papers.ssrn.com/abstract=411480>. In particular, shareholders can be expected to pursue a strategy of ousting any board that fails to implement a precatory resolution receiving majority support. See *id.* at 26, 28 & n.83. If shareholders are expected to pursue such an approach, management can be expected to initiate all changes that shareholders view as value-increasing, including all changes that receive majority support in a precatory resolution. *Id.*

There are reasons to doubt, however, that this "reputational" mechanism can generally be sufficient to induce management to initiate changes that it disfavors but that shareholders favor. To begin, at the theoretical level, reputational mechanisms induce parties to "be tough" to "signal" their type. See, e.g., David M. Kreps & Robert Wilson, *Reputation and Imperfect Information*, 27 J. ECON. THEORY 253, 275–76 (1982). Such a signaling motive could emerge, however, only if the shareholders of a company remained the same, and the people making the decisions for these shareholders remained the same, over time. In such a case, those making voting decisions could try to signal their toughness. Because there is substantial turnover among shareholders, however, a certain voting decision at a given time would not provide much information about the toughness of those who will be making voting decisions several years down the road.

Moreover, putting aside whether this reputational/signaling mechanism could work in theory, the evidence indicates that shareholders cannot generally be expected to oust management that does not initiate a rule change they favor. Shareholders generally have not ousted boards that have failed, even successively, to implement precatory resolutions that obtained majority support. See *infra* p. 861. Because shareholders are in fact not expected to oust management in the event that it fails to implement majority-passed resolutions, management is not powerfully deterred from failing to do so by the fear of ouster.

a promise to initiate CR. As long as there is some “partial” concession that would be sufficient to defeat the challenger, which is likely when  $\$X$  is significant, management would not need to make the “full” concession of agreeing to initiate CR.

In any event, as long as shareholders do not wish to replace management independently of the CR issue — that is, as long as  $\$X > 0$  — management could be induced to make a partial or full concession only if a challenge were launched and were sufficiently well-designed and financed to convince shareholders that  $\$X < \$3$ . Only then would management find it in its interest to make a concession in order to defeat the challenge.

Furthermore, the prospect of management making some concession might not be sufficient to induce a potential challenger to bear the costs of launching a proxy contest. Doing so would not enable the challenger to obtain control of the board and the private benefits associated with such control. The challenger would merely serve as a stalking horse, inducing management to make a concession by agreeing to CR-lite or even CR to avoid defeat.

Note that mounting the considered proxy challenge would be more costly than initiating a proposal to adopt CR under a regime with shareholder power to initiate such proposals. If most shareholders view CR as value-increasing, as we are assuming in our hypothetical, then a proposal to adopt CR would win without substantial campaign expenses on the part of the proposing shareholders. In contrast, substantial campaign expenses might be necessary to run a proxy contest over director replacement that would apply sufficient pressure to induce management to make concessions.

In addition to stating its commitment to adopting CR, the challenger would have to communicate to shareholders information regarding its candidates for the board and their plans for the company. To pressure the board to agree to adopt CR-lite, the challenger would need to convince shareholders that the new team would not reduce value by more than  $\$3$  per share. For the pressure to be sufficient to induce the board to agree to adopt CR, the challenger would need to overcome an even bigger hurdle, that of convincing shareholders that management by the new team would not reduce value by more than  $\$1.5$  per share.

Thus, to obtain the adoption of CR through the use of a proxy contest over replacement of the board, a potential challenger may well have to bear substantial expenses. And if the campaign is successful in inducing the board to initiate CR, the challenger, which will have to bear the full costs of the campaign, will share the benefits of CR with all the other shareholders. Such a payoff structure could discourage shareholders dissatisfied with management’s failure to initiate CR from mounting a proxy fight to replace the board. And if no share-

holder mounts a proxy challenge, management would be able to continue avoiding CR without any fear of ouster.

Finally, it is worth noting that a majority of U.S. public companies currently have staggered boards,<sup>67</sup> which further exacerbate the bundling problem. In my discussion of the bundling problem thus far I have assumed that shareholders could, if they so chose, replace all the directors with a team that would initiate CR. In such a case, the success of a challenger running on a CR-based platform would provide shareholders with both CR and a new team immediately after the one vote needed to replace directors. In contrast, when a company has a staggered board, a challenger winning a contest will be able to replace only one-third of the board and thus would be able to initiate CR only after winning two contests one year apart.

Thus, when the board is staggered, a victory by the challenger in the first round would give shareholders only (1) a divided and fractious board without CR for a year, and (2) a prospect of getting the bundle of CR and a new management team in a year. Shareholders will get the package of CR and a new team firmly in control only if the challenger wins the next contest as well. The need to bear both the costs of a divided board and the risk that the challenger will not win the next round will diminish the willingness of shareholders to vote for the challenger in the first contest. As a result, having a staggered board will make it more difficult for a proxy challenge to win or to force incumbents to agree to initiate CR. Thus, in turn, having a staggered board will make it less likely that a challenge will emerge in the first place.

The evidence supports the above analysis that management can fail to initiate a rule change for which there is substantial shareholder support — as registered, for example, in a precatory resolution — without facing much risk of a proxy challenge (not to speak of defeat in such a challenge). I examined whether proxy challenges followed the ninety resolutions to repeal staggered boards that obtained majority support during the period 1997–2003 but were not implemented by management by the fall of 2004.<sup>68</sup> Proxy challenges to replace directors took place in only three of the examined companies. Thus, it seems safe to conclude that, in companies with dispersed ownership, we cannot rely on shareholders' power to replace directors to secure all value-increasing changes in rules.

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<sup>67</sup> BEBCHUK & COHEN, *supra* note 58, at Table 1.

<sup>68</sup> This examination was done using Georgeson Shareholder data on companies in which contested proxy solicitations took place during the considered period.

*B. Shareholders' Veto Power over Fundamental Changes*

Shareholders have the power to veto charter amendments and reincorporations proposed by management. One could argue that this veto power can ensure that decisions regarding basic governance arrangements will be made in the interest of shareholders. As discussed below, however, this is not the case.

1. *Cases in Which Management Prefers the Status Quo.* — The power to veto rule changes is very different from the power to initiate rule changes. Shareholders' veto power prevents the adoption of changes that would make shareholders worse off than they would be under the status quo. Veto power is thus a "negative" power that precludes any worsening of the shareholders' situation. This power, however, cannot ensure that rule changes that could increase shareholder value will take place. In particular, when management disfavors a value-increasing change for self-interested reasons, shareholders' veto power will not enable them to obtain this change.

Consider, for example, the situation of Delaware companies after Delaware's adoption of its anti-takeover statute.<sup>69</sup> The statute, which makes hostile takeovers more difficult (or less profitable), applies to all companies that have not opted out of it by adopting a charter provision to this effect. Suppose that, following the adoption of the anti-takeover statute, the shareholders of a given company viewed a charter provision opting out of this statute as value-increasing. Since management did not have any reason to change the new status quo created by the legislation, the shareholders' formal power to veto charter amendments would not enable them to obtain the desired charter provision.

2. *Cases in Which Both Management and Shareholders Prefer Change.* — Shareholders' veto power will not ensure a value-maximizing outcome even in cases in which there are potential changes that would make both shareholders and management better off relative to the status quo. In such a case, some value-increasing change will likely take place, but it may not be the change that would maximize shareholder value. Rather, within the set of value-increasing changes that would make both shareholders and management better off, the selection will be very much influenced by which change would best serve management's interests.

Consider a situation in which there are three possible charter amendments — *A*, *B*, and *C* — that would each render both shareholders and management better off compared with the status quo. Suppose further that, in terms of shareholder value, amendment *A* is

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<sup>69</sup> See DEL. CODE ANN. tit. 8, § 203 (1989); RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1359–69 (2d ed. 1995).

best, followed by *B* and then *C*, but that in terms of management interests the ranking is in the opposite order, with *C* being the best, followed by *B* and then *A*. Clearly, the veto power that shareholders have over changes does not enable them to ensure that the value-maximizing arrangement, *A*, will be selected. Indeed, *A* would not necessarily be selected even in a hypothetical case in which both management and shareholders have to agree to a change and each side can make proposals to the other. In such a situation, both sides ostensibly would be symmetrically situated, and both sides would have an equal opportunity to influence the selection. The selected arrangement in such a case might be, for example, *B*, which is the second-best choice for each of the two sides.

This hypothetical situation, however, is not equivalent to the one in place under current corporate law. In the existing corporate context, management and shareholders are not symmetrically situated. Management does not merely have the power to block a change, as shareholders do. Management also has the sole power to put proposals on the table, and shareholders have to vote up or down on these proposals without having the option to amend them.

Bargaining theory indicates that, when two parties bargain over the division of surplus from an agreement between them, a party that has the sole option to make take-it-or-leave-it offers to the other will have a substantial advantage.<sup>70</sup> When the game has a finite number of bargaining rounds, such a party will be able to capture virtually the full surplus if the other party is solely motivated by monetary considerations and does not have reputational or other mechanisms to commit itself to being “tough.” Thus, management’s monopoly over the initiation of changes and its ability to bring suggested changes to an

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<sup>70</sup> See, e.g., Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model*, 50 *ECONOMETRICA* 97, 108 (1982). To see the intuition behind this result, consider two parties,  $P_1$  and  $P_2$ , who have  $n$  rounds to bargain over the division of a hundred dollars, and suppose that, in all possible  $n$  rounds,  $P_1$  would be the only party with the ability to put offers on the table for  $P_2$  to accept or reject. If the bargaining reaches the  $n$ th round,  $P_1$  will be able to get  $P_2$  to accept an offer of a small amount. Given that this is the last round,  $P_2$  will be better off accepting a small amount — say, one dollar — rather than declining such an offer and remaining with nothing. Given that  $P_2$  is expected to accept an offer of a small amount in the last round,  $P_1$  can also be expected to accept a small offer, just slightly above the offer expected in the last round, in the round before last. Proceeding in this fashion by backward induction, one finds that  $P_2$  can be expected to accept already in the first round an offer that gives it  $P_2$  a small fraction of the hundred-dollar surplus.

While this result holds under the assumption that parties are rational and concerned only with the maximization of monetary payoffs in the game under consideration, real-world situations do not always conform to this assumption. In experiments, a party’s ability to make take-it-or-leave-it offers to the other side does not generally enable the party to extract the lion’s share of the surplus. Researchers have attributed these findings to individuals’ having a sense of fairness that leads them to resent and reject a highly unbalanced division of the surplus even if such rejection leaves them with nothing. See, e.g., Daniel Kahneman et al., *Fairness and the Assumptions of Economics*, 59 *J. BUS.* S285, S288–89 (1986).



up-or-down vote by shareholders gives it a significant advantage over shareholders.

In the example under consideration, management might be able to get arrangement *C*, which is most favored by management but least value-increasing for shareholders. If management proposes arrangement *C*, shareholders might approve *C* rather than vote it down and thereby incur the risk of staying with the inferior status quo. Moreover, shareholders may face uncertainty as to whether management prefers any arrangement other than *C* over the status quo, and thus whether management would be willing to propose any other charter amendments if *C* is voted down. Such uncertainty will increase shareholders' willingness to approve *C*.

Management's agenda-setting power has the same effect on reincorporation decisions as it has on charter amendment decisions.<sup>71</sup> Suppose that a company is incorporated in its home state *H* and that two states, *F* and *G*, are trying to attract reincorporations from state *H*'s companies. Suppose also that, compared with *H*, both *F* and *G* offer a set of rules that are better for both shareholders and management, and that, compared with *G*, *F* offers rules providing excessive private benefits to management that shareholders disfavor and management favors. In this scenario, the company might well be more likely to end up moving to *F* than to *G*. If management brings a proposal to reincorporate to *F* to a shareholder vote, the shareholders — having on the table a choice only between *F* and the status quo *H* — might well approve the move.

3. *Bundling a Change with Something Else.* — In the situations discussed thus far, shareholders' veto power over charter amendments and reincorporations, though ineffective at securing value-increasing changes, could at least prevent value-decreasing changes. But management's agenda-setting power under existing arrangements also enables it to obtain shareholder approval for changes that, by themselves, reduce shareholder value.<sup>72</sup> Management can do so by bundling a value-decreasing rule change favored by management with a move that is value-increasing by itself, such as a profitable merger or consolidation.

Consider a charter amendment that shareholders would reject as value-decreasing if the change were brought to a shareholder vote by

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<sup>71</sup> For a formal model that fully develops this point and its implications, see OREN BAR-GILL, MICHAL BARZUZA & LUCIAN BEBCHUK, *THE MARKET FOR CORPORATE LAW* 10–13 (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper Series No. 377, 2002), available at [http://papers.ssrn.com/abstract\\_id=275452](http://papers.ssrn.com/abstract_id=275452).

<sup>72</sup> See Bebchuk, *supra* note 64, at 1475; Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1836–40 (1989) [hereinafter Bebchuk, *Limiting Contractual Freedom in Corporate Law*]; Gordon, *supra* note 64, at 47–49.

itself. Management could wait until it had an opportunity to initiate a merger transaction that would increase shareholder value. Then, management could include the charter amendment as an element of the proposed merger. If the benefits to shareholders of the merger transaction by itself exceed the reduction in shareholder value caused by the charter amendment, shareholders will approve the proposal brought to them, and management will get the value-decreasing change in rules it desires. Management could use a similar strategy to pass a value-decreasing reincorporation.

*C. The Benefits of Letting Shareholders Set the Rules*

Under the regime that I advocate, shareholders would be able to initiate and adopt any rules-of-the-game decisions. In particular, they would be able to initiate and approve by vote both changes in the corporate charter and changes in the company's state of incorporation. Identifying the optimal contours of this shareholder power presents difficult questions, and I discuss some of the design choices and issues in the next section. Before considering these questions, however, I wish first to describe how providing shareholders with such power would eliminate substantial distortions and thus produce substantial benefits.

*1. Corporate Charters.* — Corporations operate in a dynamic environment. Thus, the optimal set of corporate governance arrangements is likely to change over time as new problems arise, as new tools and arrangements are developed to address both old and new problems, and as more evidence about problems and solutions is gathered. Accordingly, from time to time, shareholders may well benefit from appropriate changes in the corporate charter.<sup>73</sup>

Management's control over charter amendments, as we have seen, distorts the evolution of charter provisions in management's favor. Changes that could increase shareholder value will not be adopted if they make management worse off. When a change could make both shareholders and management better off, the change that will be selected could well be the one that best serves management rather than the one that best serves shareholders. Moreover, from time to time, management may even take advantage of a merger or some other value-increasing transaction to obtain a value-reducing change that it favors.

The fact that public companies have a long lifespan exacerbates the problem of pro-management bias in the evolution of corporate char-

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<sup>73</sup> The need to update the charter will further increase if corporate law adopts the strategy of sunset provisions in which some insider-favoring arrangements are valid after a certain period only if ratified by a shareholder vote.

ters. Table 3 below displays summary statistics regarding the age distribution of companies included in the S&P 500 in 2003.<sup>74</sup> As the table indicates, about four-fifths of these companies went public more than twenty years ago — that is, before the development of modern take-over defenses and the legal rules governing them. Moreover, almost half of these companies (comprising slightly more than half of the total market capitalization of these companies) went public more than forty years ago.

TABLE 3: AGE DISTRIBUTION OF S&P 500 COMPANIES

Years since going public	Percentage of firms	Percentage of total stock market capitalization
0-20	21.1%	18.2%
21-30	6.0%	5.3%
31-40	27.4%	26.1%
41-50	21.8%	15.2%
More than 50	23.7%	35.2%
	100.0%	100.0%

If a publicly traded company went public, say, fifty years ago, its charter is now composed of the provisions it contained when it went public as amended over the years. Clearly, over the past fifty years, corporate circumstances and needs have changed markedly, as have the available governance tools and technologies and the state of knowledge about governance problems and solutions. Thus, the IPO charter is highly unlikely to have offered the set of provisions that shareholders would view as value-maximizing in 2004. Given that the process of adjustment over time has suffered from a pro-management bias, there is substantial ground for concern that the company's 2004 charter significantly deviates from the value-maximizing set of provisions.

The problem of pro-management distortions in the charter amendment process has led me to suggest in earlier work that corporate law be designed in a way that counters these distortions. In an

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<sup>74</sup> I am grateful to Alma Cohen for her help in producing the summary statistics reported in this table. In preparing this table, Standard & Poor's data about the firms included in the S&P 500 was used. To calculate the age of any given firm, the first year for which stock-price information about the firm is available on the standard CRSP (Center for Research in Security Prices) database was identified and served as a proxy for the year in which the firm went public.

article about the limits of contractual freedom in corporate law, I argued that the existing pro-management bias in the charter amendments process provides an important reason for using mandatory rules. Such mandatory rules could make up for shareholders' inability to rely on the charter amendment process to produce value-maximizing charter amendments in midstream companies.<sup>75</sup>

In a more recent article about the choice of default rules in corporate law, Assaf Hamdani and I argued that, as new circumstances arise, our choice of default corporate law rules should follow a "reversible defaults" approach.<sup>76</sup> Under this approach, the choice of default rules should err on the side of arrangements less favorable to management because of the difficulty of opting out of arrangements favored by management. Given management's control over the initiation of charter amendments, a default chosen by public officials but that turns out to reduce shareholder value will likely be reversed if management disfavors the default, but not if management favors it.<sup>77</sup>

Mandatory legal rules and reversible defaults are indeed desirable, taking as given the existing distortions in the charter amendment process. But mandatory rules and reversible defaults hardly eliminate the costs of these distortions. Rules chosen by public officials, whether mandatory or default, inevitably suffer from the problem that "one size does not fit all." Public officials have neither the information nor the resources to tailor different arrangements to the particular features of different companies.

Thus, although mandatory legal rules and the reversible defaults approach can reduce the adverse consequences of the pro-management bias in the charter amendment process, it would be desirable to eliminate or at least reduce the bias itself. Providing shareholders with the power to intervene in rules-of-the-game decisions would do so. When shareholders are able to initiate charter amendments, they will be able to effect value-increasing changes that management does not favor for its own, private reasons. Shareholders will no longer find themselves stuck with charter arrangements that they view as inferior, but that they are powerless to change without management initiation.

2. *Reincorporation Decisions and State Law Rules.* — Management's current control over reincorporation decisions also distorts the choice among the arrangements provided by state corporate law. A reincorporation will not take place unless management favors it. And

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<sup>75</sup> See Bebchuk, *Limiting Contractual Freedom in Corporate Law*, *supra* note 72, at 1820–25; see also Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1577–80 (1989).

<sup>76</sup> See generally Lucian Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002).

<sup>77</sup> See *id.* at 492–93, 500–05.

when reincorporation in several different states could make both shareholders and management better off, the reincorporation might take place in the state most favored by management.

The data presented earlier concerning the longevity of publicly traded companies are as relevant to reincorporation choices as they are to charter provisions. A substantial fraction of total market capitalization is in companies whose state of incorporation is a product of (1) the IPO choice made a long time ago, and (2) subsequent decisions whether or not to reincorporate that have been initiated by management. There is little reason to assume that the states where these companies are now incorporated correspond to the states of incorporation that shareholders would prefer if they were given the choice.

The distortions that should concern us are not limited to firms' incorporation choices taking state law rules as given. The distortion of reincorporation decisions also affects the state law rules themselves. It provides adverse incentives to states that seek to attract incorporations. Management's key role in reincorporation decisions induces such states to provide rules favored by management.<sup>78</sup>

For questions of corporate law with regards to which the interests of shareholders and management sufficiently overlap, states' incentives to provide rules that management prefers are acceptable. However, with respect to rules that have a substantial effect on management's private benefits of control, such incentives might lead states to offer value-reducing rules that are excessively favorable to management. For example, states could elect to offer incumbents more protection from hostile takeovers than would be optimal for shareholders. Indeed, recent evidence indicates that adopting anti-takeover statutes makes states much more successful in the market for incorporations.<sup>79</sup>

Granting shareholders the power to intervene in rules-of-the-game decisions would improve incorporation choices, moving companies to jurisdictions with value-increasing rules. In addition, and perhaps even more importantly, granting shareholders such power would improve the corporate law rules of the states among which companies may choose to incorporate. If shareholders had the power to make re-

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<sup>78</sup> For an account of the ways in which management's control over reincorporation decisions distorts the incentives of states seeking to attract incorporation, see Bebchuk, *supra* note 64. This account is further developed, with special focus on takeover law, in Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race To Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999). Bar-Gill, Barzuza, and Bebchuk offer a formal model further developing the analysis of these distortions. See BAR-GILL, BARZUZA & BEBCHUK, *supra* note 71.

<sup>79</sup> See Bebchuk & Cohen, *supra* note 13, at 404-20; Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1808-18 (2002); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2002).

incorporation decisions, the best strategy for a state seeking to attract incorporations would be to adopt rules that would best serve shareholders. The resulting changes in the quality of state corporate law rules would considerably improve the arrangements governing publicly traded companies.

3. *One Rule Change To Improve All Governance Arrangements.* — There is an attractive feature of allowing shareholders to initiate and adopt rules-of-the-game decisions that is worth stressing: making this one basic change in existing corporate governance arrangements would improve the whole set of corporate law arrangements over time. With respect to many issues in corporate law, deciding which arrangement is optimal is highly contestable. Furthermore, one size does not fit all: an arrangement that might be optimal for some companies might not be optimal for others. For this reason, many corporate law scholars have long wanted to leave the choice of governance arrangements to private ordering, to “the market.”<sup>80</sup> On this view, it would not be optimal to have all companies abide by a general arrangement chosen by public officials. Rather, it would be desirable to allow private parties, armed with the best information about their particular needs and the best incentives to choose and tailor the most fitting arrangement, to make the relevant choices.

Unfortunately, however, the private choices that companies make among alternative governance arrangements have been thus far distorted by the legal rules governing how these choices must be made. Management’s control and the tying of shareholders’ hands have distorted companies’ choices. This process cannot be expected to produce value-maximizing arrangements, as supporters of private ordering have hoped. Instead, this process can be expected, over time, to produce governance arrangements that substantially deviate from value-maximization in a direction that favors management.

A regime in which shareholders have the power to initiate and adopt rules-of-the-game decisions would improve the key process by which choices among governance arrangements are made. The private choices produced by this improved process would be more likely to be value-maximizing. This improved process would therefore enable greater reliance on private ordering to produce beneficial governance arrangements.

A reform that provides shareholders with the power to make rules-of-the-game decisions thus would lessen the need for other corporate law reforms. Without this “constitutional” reform, evidence that exist-

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<sup>80</sup> See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, ch. 1 (1991); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

ing arrangements fail to provide adequate checks necessarily calls for intervention by “outsiders” — be they legislators, SEC officials, courts, or exchanges — as shareholders do not have the power to adopt the necessary changes. Once this “constitutional” change is made, however, shareholders will have “self-help” tools to address governance flaws, and public officials will have less need to intervene.

With this constitutional change, shareholder interventions — and, more importantly, the rule changes initiated by management to avoid shareholder interventions and the changes in law made by states seeking to avoid shareholder-initiated reincorporations — could considerably contribute to addressing governance problems as they emerge. Thus, the considered constitutional change would operate over time to improve the full array of arrangements governing publicly traded companies, and it would provide a sounder foundation for relying on private ordering in the corporate arena.

#### *D. Design*

The above analysis thus far indicates that management should not have a monopoly over the initiation of rules-of-the-game decisions. We should reform the state of affairs under which a shareholder-initiated change is ruled out no matter how widespread the support for it or how long-standing this support has been. This conclusion, however, still leaves it necessary to answer the important questions regarding the precise conditions and circumstances under which a shareholder-initiated change in rules could be brought and would be adopted.

As is often the case with decision rules and procedures, identifying the optimal procedural requirements is difficult, if not impossible. My main aim in this Article is to persuade readers that a regime under which shareholders have initiation power is generally desirable, not to sign them on a particular full blueprint for the desirable regime. In this section, however, I outline some of the issues and choices that arise in designing such a regime. In addition, to provide concreteness for a debate over the merits of a regime with shareholder intervention power, I put forward a set of choices that seem plausible and capable of forming a proposal for such a regime. I also note alternative choices that readers might want to consider.

*1. Submission of Proposals. — (a) For Vote in Any Annual Meeting.* — In setting up a regime of shareholder intervention power, we need to specify when and how often shareholders should be able to initiate proposals for rules-of-the-game decisions. Under the proposal that I would like to put on the table, shareholders would be able to submit such proposals for consideration in any annual meeting. Alternatively, one could allow submission of such proposals not only in annual meetings, but also in special meetings that might be held between annual elections, as is possible in the United Kingdom.

In addition, if one believes that management should be given a significant period during which it does not have to worry about shareholder intervention,<sup>81</sup> another alternative would allow shareholders to initiate rules-of-the-game decisions less often than once a year — say, every other year or once in every three years. These alternatives are all options about which individuals may reasonably disagree. Although different answers can reasonably be offered to the question of “How often should shareholders be able to initiate rules-of-the-game decisions?,” the answer definitely should not be “Never.”

(b) *Holding and Ownership Requirements.* — Under my suggested regime, only shareholders, or groups of shareholders, that satisfy some minimum ownership and holding requirements should be permitted to submit proposals. In my view, these threshold requirements can be modest, though not as low as the de minimis threshold requirements for the initiation of precatory resolutions. As long as we have the other safeguards discussed below — in particular, the safeguard of having changes occur only if approved by a majority of outstanding shares in two successive annual meetings — shareholders and management could safely ignore proposals they view as ill-advised and unlikely to attract broad support. Accordingly, imposing threshold requirements that would likely prevent some good proposals would be counterproductive.

While I would impose only modest ownership and holding threshold requirements, others might prefer to have more demanding requirements. What is unacceptable, however, is the current state of affairs under which no group of shareholders, however large its total holding of shares, and regardless of how long it has held shares in the company, may bring a proposal for a rules-of-the-game decision to a shareholder vote.

(c) *Limits on Resubmission of Proposals.* — The proposed regime would not permit the submission of a proposal to a shareholder vote when an equivalent proposal was strongly defeated (for example, by a majority of seventy-five percent or more of the votes cast) in the recent past (for example, in the last annual election or in one of the last two elections). Such a requirement would preclude proposals that are extremely unlikely to pass. While individuals may reasonably disagree on defining the scope of proposals that were “strongly defeated,” what should be unacceptable is the current state of affairs under which shareholders may not even initiate proposals that would be extremely likely to pass according to the expression of shareholder preferences in a recent vote on a precatory resolution.

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<sup>81</sup> See, e.g., William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1100 (2002).



(d) *Management Counter-Proposals.* — When shareholders submit a proposal to amend the charter or reincorporate, the suggested regime would allow the submission of counter-proposals. Such proposals would expand shareholders' set of choices and thus could increase the chances that the most value-increasing change in rules will be chosen. In particular, it seems plausible to give management the prerogative of the "last proposal" — that is, the right to add, after the passage of the deadline for the submission of proposals by shareholders to be voted on in a given meeting, a new proposal to be voted on at the same meeting. As I will discuss in section IV.E, facilitating management counter-proposals can address certain potential "social choice" problems. While giving management the right of "last proposal" could be justified, what cannot be justified is blocking any proposals by anyone other than management.

2. *Adoption of Proposals.* — (a) *By Approval in Two Successive Meetings.* — Under existing rules, a management-initiated proposal will be adopted if and only if it wins a majority vote in one meeting. If one takes the reasonable position that management-initiated and shareholder-initiated proposals should be placed on completely equal footing, as is done in the United Kingdom, an approval in one meeting would also suffice for shareholder-initiated proposals. However, to allay concerns about shareholder power to intervene, the requirements for approval of shareholder-initiated changes could be designed to ensure that a proposal not only attains (possibly short-lived) shareholder support at some given time but that it has stable, lasting shareholder support.

Accordingly, under the regime that I am putting forward, a proposal would be adopted only if it obtains shareholder approval in two subsequent annual meetings (or in two shareholder meetings that are apart by, for example, one year). Formally, the vote in the first meeting might be regarded as a vote to schedule a decisive shareholder vote in the subsequent meeting. A requirement of passage in two successive votes has been used in other contexts; interestingly, Delaware requires its legislature to pass votes in two successive sessions to amend its state constitution.<sup>82</sup>

Alternatively, the suggested regime could stipulate that a proposal approved in an annual meeting would come into effect after the subsequent annual meeting, but only if no decision to reverse the earlier decision is approved in that meeting. Under this version of the regime, following the approval of a shareholder-initiated proposal, management will bring to the subsequent annual meeting a proposal to reverse

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<sup>82</sup> DEL. CONST. art. XVI, § 1. I am grateful to Leo Strine for bringing the Delaware constitution example to my attention.

the earlier decision if it believes that, in light of changing circumstances or management efforts at persuasion, the decision no longer enjoys majority support. While this version would not actually require two votes, it would ensure that proposals go into effect only when they enjoy stable shareholder support over a period that contains two annual elections.

As will be discussed in the next Part, a two-meeting requirement would address two types of concerns that might be raised by critics of shareholder intervention power. Such a requirement would reduce potential costs from nuisance proposals. With such a requirement, management would be little distracted by proposals that are unlikely to gain massive shareholder support; management would recognize that, if the proposal somehow were to pass, it would have a full year to present its position to shareholders. Furthermore, a two-meeting requirement would address concerns over rule changes motivated by the short-term interests or preferences of some shareholders. With such a requirement, shareholder-initiated proposals would be approved only if they enjoyed shareholder support over a significant period of time.

(b) *By Majority of the Outstanding Shares.* — Under the default arrangements of state corporate law, a management-initiated change in rules needs support from a majority of the outstanding shares to be adopted. Under the suggested regime, the same threshold would be used for shareholder-initiated proposals. Requiring a higher majority for shareholder-initiated proposals seems unwarranted, especially if one adopts a two-meeting requirement for shareholder-initiated proposals. Note that, because of the significant incidence of shareholder nonvoting, a proposal will receive support from a majority of the outstanding shares only if it receives a much higher majority of the votes cast. For example, if eighty percent of the shareholders participate in a vote on a charter amendment, the amendment will pass only if 62.5% of the shares vote to support it.<sup>83</sup>

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<sup>83</sup> The passage of the amendment will require an even higher majority among the nonmanagement shareholders who will vote. Suppose, for example, that management holds or can influence the voting of ten percent of the company's shares. Also suppose that eighty percent of the nonmanagement shareholders vote. In such a case, the amendment will pass only if it gains support from about seventy percent of the nonmanagement shares voted.

A related issue that requires consideration is that of broker votes. Under NYSE rule 452, when management proposes a charter amendment or a reincorporation, brokers may vote shares whose beneficial owners do not provide voting instructions. Because brokers tend to vote with management, this rule facilitates the passage of management-initiated changes in governance arrangements. In votes on contested proposals, however, brokers may not vote uninstructed shares. For a detailed discussion of the NYSE arrangement, and for evidence of its significant role in facilitating management-initiated proposals, see Jennifer Bethel & Stuart Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29 (2002). If the proposed regime is adopted, it will be desirable to reconsider the arrangement governing broker

(c) *Financing of Expenses.* — It would be desirable to require firms to reimburse reasonable expenses to shareholders initiating proposals that pass a certain threshold of success (such as attracting a certain percentage of the company's shares or of the shares voted).<sup>84</sup> Such a requirement would alleviate "public good" problems, which might discourage shareholders from bringing desirable proposals when the initiating shareholder must bear the full costs but capture only a (possibly small) part of the benefits. At the same time, by limiting reimbursement to proposals that end up receiving substantial shareholder support, this requirement would facilitate desirable proposals without encouraging frivolous proposals.

3. *Adoption of the Proposed Regime.* — (a) *State Law or Federal Intervention.* — My focus in this Article is on identifying which regime is substantively desirable, not on the political feasibility of getting the regime adopted. As the allocation of power is now regulated by state law, my analysis supports a reform in state corporate law. The very forces that have shaped state corporate law in a managerialist direction, however, might also prevent state law from changing course and adopting such a reform. Indeed, as I discussed earlier, the control over reincorporations that management has under states' corporate laws is in itself a key factor that discourages states from making rule changes that management disfavors.

To the extent that state law will continue to provide management with control over rules-of-the-game decisions, my analysis will provide a basis for federal intervention. Such federal intervention could directly provide shareholders with the power to make rules-of-the-game decisions or could alternatively require states to modify their corporate laws so as to grant shareholders such power. The importance of providing shareholders with such power will warrant federal intervention if states do not act by themselves. In addition to facilitating the improvement of corporate charters over time, such federal intervention would improve firms' selections among any given menu of state law choices. Moreover, such intervention would improve the menu of state law choices by providing states with an incentive to change their rules in ways that would serve shareholders.

(b) *Allowing Opt-Outs.* — My analysis indicates that a regime in which shareholders are allowed to adopt rules-of-the-game changes

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votes; otherwise, the conditions for approval of shareholder-initiated proposals would be significantly more demanding than those for approval of management-initiated proposals.

<sup>84</sup> A general case for reimbursing expenses to shareholders that initiate proxy contests and gain sufficient shareholder support is made in Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1085–87 (1990). I recently stressed the importance of providing such reimbursement to challengers in contests over the election of directors in Bebchuk, *supra* note 60, at 64–65.

should be, at the minimum, the default corporate law arrangement. The question is whether this arrangement should be mandatory or one from which companies are free to opt out by adopting charter provisions to this effect. In the United Kingdom, shareholders always have the right to adopt changes in the charter by special resolution, and firms cannot limit this power.

The question of contractual freedom has been extensively debated elsewhere<sup>85</sup> and is beyond the scope of this paper. In my own view, there are good reasons for limiting contractual freedom in corporate law.<sup>86</sup> Some scholars, however, advocate complete or very broad contractual freedom.<sup>87</sup> For readers who are persuaded that allowing shareholders to adopt charter amendments and reincorporations is desirable, whether companies should be allowed to opt out of this regime should depend on one's position on the general question of the appropriate scope of the freedom to opt out in the corporate area. An intermediate position would be to allow opting out through sunset charter provisions, that is, provisions that expire after a certain period of time unless ratified again by shareholders.<sup>88</sup>

#### IV. OBJECTIONS TO LETTING SHAREHOLDERS SET THE RULES

This Part considers and responds to a wide range of possible objections to giving shareholders the power to initiate and approve changes in basic governance arrangements. I conclude that these objections do not, either individually or collectively, provide a good basis for tying shareholders' hands.

##### A. *Rare Adoption of Shareholder-Initiated Changes*

One possible objection to providing shareholders with the power to initiate changes in basic rules is that this power would rarely result in the adoption of shareholder-initiated changes. In particular, one could argue that (1) shareholders will not have an incentive to initiate such proposals, and that (2) proposals that are initiated would be unlikely to

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<sup>85</sup> See generally Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989). For an overview of the debate, see Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395-1415 (1989).

<sup>86</sup> I discuss reasons for constraining contractual freedom by midstream companies in Bebchuk, *Limiting Contractual Freedom in Corporate Law*, *supra* note 72. I examine reasons for constraining contractual freedom by IPO firms in LUCIAN ARYE BEBCHUK, FREEDOM OF CONTRACT AND THE CORPORATION: AN ESSAY ON THE MANDATORY ROLE OF CORPORATE LAW (John M. Olin Ctr. for Law, Econ. and Bus., Harvard Law Sch., Discussion Paper No. 46, 1988); Bebchuk, *supra* note 85, at 1404-08; and Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003).

<sup>87</sup> See, e.g., EASTERBROOK & FISCHER, *supra* note 80, ch. 1.

<sup>88</sup> For a discussion of sunset provisions and the reason for using them, see Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, *supra* note 86, at 751-52.

obtain majority approval. But neither of these propositions is warranted. Furthermore, granting shareholders the power to intervene would likely produce most of its benefits by inducing management to initiate desirable changes, and these benefits thus should not be measured by the frequency with which shareholder-initiated proposals would actually be adopted.

1. *Will Shareholders Have Incentives To Bring Proposals?* — Let us begin with the objection that shareholders would not have sufficient incentives to initiate proposals.<sup>89</sup> Unlike winners in proxy contests over the election of directors, winners in “issue contests” cannot expect to obtain private benefits from control. In addition, because winners of “issue contests” will not gain control of the board, they will not be in a position to use the board power under existing rules to authorize reimbursement for the costs of running proxy contests.<sup>90</sup> Furthermore, some institutional investors, such as mutual funds, are generally reluctant to take the initiative in corporate governance matters.<sup>91</sup> Thus, one might be concerned that shareholders will have little incentive to initiate rules-of-the-game proposals.

There are reasons to expect, however, that shareholders, if given the power, would initiate value-increasing rule changes when management fails to initiate them. For one thing, in the case of many proposals, especially the ones that would be most likely to gain approval, the costs of initiating a potentially successful proposal would be limited. When the issues involve general, familiar corporate governance questions, shareholders will be able to initiate a proposal with little campaigning. The incentive to initiate a proposal would be strongest for changes that would enjoy large shareholder support and therefore would have a high chance of adoption — which are precisely the changes that would be most desirable for shareholders to initiate.

It is worth noting that even though precatory shareholder resolutions initiated under current SEC proxy rules have no binding force and are regularly ignored if passed, many such resolutions are nonetheless initiated. In 2003, 427 precatory resolutions took place, with an

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<sup>89</sup> A similar objection was raised with respect to the recent SEC proposal to provide shareholders with access to the corporate ballot. *See, e.g.*, Letter from Robert Todd Lang & Charles Nathan, Co-Chairs, Task Force on Shareholder Proposals, ABA Section of Business Law, to the SEC Division of Corporate Finance (June 13, 2003) [hereinafter ABA Letter] (“New mechanisms to increase on a routine basis shareholder participation in director selection will not be worth their costs because they will not likely result in significant numbers of shareholder-nominated directors being elected.”), available at <http://www.sec.gov/rules/other/s71003/abao61303.htm>.

<sup>90</sup> For an analysis of the difference between the incentives of shareholders to mount issue contests and their incentives to mount contests over directors, see Bebchuk & Kahan, *supra* note 84, at 1126–29.

<sup>91</sup> Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.–Feb. 1994, at 140, 140 (arguing that mutual funds are at most “reluctant activists”).

average participation rate of more than eighty percent of all outstanding shares.<sup>92</sup> This pattern suggests that a significant number of proposals can be expected in a regime under which shareholder-initiated proposals are binding.

Moreover, once intervention power is introduced, it would be desirable to strengthen incentives for bringing good proposals (ones with meaningful chances of adoption) by installing appropriate reimbursement rules. Specifically, when a proposal is approved by a shareholder vote, or perhaps even when it passes a specified threshold of substantial support (say, one-third of the vote), it would be desirable to reimburse costs to shareholders initiating the proposal. Such financing rules would encourage only those proposals that enjoy substantial shareholder support.

2. *Will Shareholders Vote Against Management?* — It might also be argued that shareholder intervention power could have little beneficial effect because shareholder-initiated proposals would be unlikely to pass. On this view, most shareholders, including institutional investors, can usually be expected to defer to management rather than to vote against it.

The tendency of institutional investors to vote with management might result from rational deference to a party that institutions believe is better informed. It might also be reinforced by the desire of institutional investors to be on good terms with management. Shareholder voting thus can be expected to tilt in favor of management's position. There is no reason, however, to assume that shareholders will generally vote with management when it opposes a value-increasing change in governance arrangements.

In 2003, while some types of precatory resolutions systematically failed to gain majority support, four types of resolutions did obtain such support: proposals to repeal classified boards obtained on average sixty-two percent of the shares voted; proposals calling for the elimination of supermajority provisions obtained on average sixty percent of the shares voted; proposals calling for rescission of poison pills obtained on average fifty-nine percent of the shares voted; and proposals for shareholder approval of future golden parachutes obtained on average fifty-three percent of the shares voted.<sup>93</sup> Shareholders' willingness to vote for these types of shareholder-initiated proposals would likely be even greater in a regime in which such proposals are binding.

In sum, shareholders' tendency to defer to management does not provide a basis for denying shareholders the power to intervene. It re-

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<sup>92</sup> See GEORGESON SHAREHOLDER, ANNUAL CORPORATE GOVERNANCE REVIEW: SHAREHOLDER PROPOSALS AND PROXY CONTESTS 6–7 (2003) [hereinafter GEORGESON SHAREHOLDER], available at <http://www.georgesonshareholder.com/pdf/2003%20a.wrapup.pdf>.

<sup>93</sup> *Id.* at 7.

duces, but hardly eliminates, the range of issues on which shareholders can be expected to vote for proposals opposed by management. And when shareholder-initiated proposals will pass despite the tendency of many shareholders to defer to management, the proposals will likely be ones that are clearly and strongly in shareholders' interest.

3. *It's the Indirect Benefits, Stupid.* — Finally, it should be emphasized that the benefits of shareholder intervention power should not be measured solely, or even primarily, by the rate of actual shareholder intervention. Indeed, a large fraction of the benefits would be indirect. Introducing the power to intervene would induce management to act differently in order to avoid shareholder intervention. Thus, even if a regime of intervention did not lead to the adoption of many shareholder-initiated proposals, it would not imply that the power is not working as hoped; on the contrary, lack of shareholder-initiated proposals could well mean that the power is working rather well.

To illustrate, consider the existing power of shareholders to veto fundamental changes. Despite the fact that shareholders generally approve proposals for fundamental changes submitted by management, shareholders' veto power does impose a valuable constraint on management's choice of fundamental changes. Management does not pursue those changes that it favors but that it does not expect to obtain shareholder approval. The main benefit of this approval requirement, then, is that it discourages management from bringing these value-decreasing changes to a vote in the first place.

Shareholder power to intervene would similarly produce its benefits in large part by influencing management's behavior rather than by leading to actual interventions. Incumbents prefer not to lose votes. Therefore, whenever they expect a proposal to have sufficiently strong support, they will seek to avoid defeat in a vote by initiating the change themselves. Thus, for example, if repealing a staggered board enjoys clear support among a majority of the shareholders of a given company, the adoption of a regime with shareholder intervention would induce the company's management to initiate a proposal for de-staggering the board either without any initiation of a shareholder proposal or, at least, once a shareholder proposal is initiated and seems likely to be adopted.

#### *B. The Costs of Contests over Nuisance Proposals*

I have argued above that, in many of the cases in which shareholder intervention power would encourage value-increasing changes, it would do so not through a costly contest but rather by inducing management to initiate changes itself. It might still be argued, however, that granting shareholders the power to intervene would result in the initiation of many proposals that would have little chance of being adopted but that would impose costs on companies and their shareholders. According to this view, many shareholders might bring pro-

posals that are unlikely to obtain majority support because they are farfetched, ill-considered, or motivated by considerations other than shareholder wealth. Although these proposals would ultimately be defeated, dealing with them would be costly: shareholders would be burdened by the need to vote against the proposals, and management would have to devote time, attention, and company resources to campaign against them.<sup>94</sup>

The design of the proposed intervention regime, however, would keep the costs of contests over “nuisance proposals” to an acceptable minimum. To begin, some threshold ownership requirements for proposal submission by a shareholder or a group of shareholders would screen out proposals that are frivolous or that lack any meaningful support among shareholders. The proposed regime would provide additional screening by precluding proposals from being brought to a shareholder vote when a similar proposal failed to obtain a specified threshold of shareholder support in the preceding year.<sup>95</sup>

Moreover, proposals that satisfy the requirements for submission but that have limited support among shareholders are unlikely to cause significant inconvenience for either shareholders or management. Inconvenience to shareholders will be avoided as long as shareholder-initiated proposals require approval by a majority of outstanding shares, as opposed to a majority of the shares that participate in a vote. Under such a rule, abstaining from voting on a proposal will be equivalent to voting against it. As a result, shareholders who do not support a proposal will not have to bother voting against it.

Nuisance proposals with little chance of attracting majority support will also be unlikely to have a significant adverse effect on the company’s management. To be sure, one could argue that, even when a proposal seems unlikely to gain majority approval, management would not want to bear even a small risk of passage, and thus would feel compelled to lobby against the proposal. To the extent that this

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<sup>94</sup> This concern is similar to the one expressed by supporters of management insulation with respect to the shareholder access proposal. See, e.g., John J. Castellani & Amy L. Goodman, *The Case Against the SEC Director Election Proposal*, in SHAREHOLDER ACCESS TO THE CORPORATE BALLOT, *supra* note 2; Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003).

<sup>95</sup> Requirements of this sort are already used in connection with the initiation of votes on precatory resolutions. See, e.g., LOSS & SELIGMAN, *supra* note 26, at 569–72. However, because the goal of votes on precatory resolutions is to air issues rather than produce binding outcomes, current securities laws allow resubmission of resolutions as long as they exceed some very low threshold of support in preceding votes. In contrast, because the proposed regime seeks to facilitate actual rule changes when desirable, there would be little point in allowing a revote on a proposal that, for example, received five percent of the votes in the preceding annual election.

Finally, it is worth noting that if it is desirable to further reduce the extent to which management and shareholders might be distracted, this objective can be served by concentrating all voting on shareholder-initiated proposals at the annual meeting.



problem is viewed as a serious concern, it can be fully addressed by requiring that shareholder-initiated changes be approved only when passed by a majority in two successive meetings. With such a requirement, management will have a safety net. In the unlikely event that the proposal wins one vote, management will have another opportunity, and ample time, to campaign against the proposal's adoption. Accordingly, management will not have to devote significant attention, effort, or resources to fighting proposals that it views as unlikely to enjoy majority support.

### C. Shareholders Will Make the Wrong Decisions

I have thus far argued that shareholder intervention power would have a meaningful effect on governance arrangements, producing changes that shareholders view to be value-increasing, without incurring substantial costs from many contested votes. It might be argued, however, that the fact that shareholders view a change as value-increasing does not imply that the change would be in fact value-increasing. In this view, shareholders might support a change that is detrimental to long-term share value because (1) they are imperfectly informed, (2) their interventions might produce costly inconsistencies with decisions made by management, or (3) they might be influenced by short-term considerations and special interests.

1. *Imperfect Information.* — The most common argument against expansions in shareholder voting rights is based on the informational disadvantage that shareholders are likely to have vis-à-vis management.<sup>96</sup> Unlike management, shareholders do not have access to inside, private information. Moreover, shareholders might have insufficient incentives to obtain and fully assess all available public information.<sup>97</sup> Corporate law has long accepted the view that management might sometimes have superior information.<sup>98</sup> Because management is better informed about the company, the argument goes, it is in a better position to determine which governance arrangements would most enhance shareholder value. In this view, having rules-of-

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<sup>96</sup> See, e.g., CLARK, *supra* note 3, at 24, 94–95. Indeed, Clark takes the view that the main benefit stemming from the voting rights of dispersed shareholders lies not in each shareholder's use of such rights while the company has dispersed ownership, but rather in the rights' collective function in a takeover, where a buyer purchases a controlling block to use the voting rights coming with it to displace management. See *id.* at 95.

<sup>97</sup> Shareholders bear the costs of obtaining and assessing information, but do not capture the full benefits that result from more informed voting decisions. See Bebchuk, *Limiting Contractual Freedom in Corporate Law*, *supra* note 72, at 1836–40.

<sup>98</sup> See, e.g., *Paramount Communications, Inc. v. Time, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 94,514, 93,277 (Del. Ch. 1989) (“No one, after all, has access to more information concerning the corporation's present and future condition [than managers].”).

the-game decisions made by management protects shareholders from making some poor, erroneous decisions.<sup>99</sup>

However, rules-of-the-game decisions typically do not turn on inside, company-specific information. Consider, for example, the decisions whether to amend the charter to remove a staggered board or whether to reincorporate the company in Delaware. Institutional investors encounter these questions in many companies, and the answers to such questions depend largely on judgments regarding issues that arise in a wide range of companies. Although individuals may reasonably disagree on how to answer these questions, the answers to them are unlikely to depend on inside information that management has but that shareholders lack.

Moreover, even if it were the case that management sometimes is better informed than shareholders about which rules-of-the-game decision would best serve shareholder interests, management would not have the best incentives for making the right decision. Management might prefer to avoid a charter amendment that would enhance shareholder value but that would also restrict its freedom or reduce its private benefits. Thus, without shareholder intervention power, decision-making is left to a party that, even if better informed, is likely to have worse incentives. This concern is real and significant because the claim that management has superior information can always be raised and is difficult to disprove.<sup>100</sup>

Importantly, granting shareholders the power to intervene hardly implies that whatever superior information management might have will not influence the choice of governance arrangements. Management will be able to use the information as a basis for its recommendations to shareholders. Shareholders will then decide how much deference to give to management's recommendation, taking into account both that management might be better informed and that it might have self-serving reasons for opposing a value-enhancing proposal.

After balancing the considerations for and against deference, rational shareholders might often conclude that deference would be best on an expected-value basis. Other times, however, they might reach the opposite conclusion. Although shareholders cannot be expected to get it right in every case, it is their money that is on the line, and they

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<sup>99</sup> See, e.g., Jeffrey N. Gordon, *Shareholder Initiative and Delegation: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 353-55 (1991); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 115-16 (1979).

<sup>100</sup> See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293, 327 (Del. Ch. 2000) (noting that "it is important to recognize that substantive coercion can be invoked by a corporate board in almost every situation").

thus naturally have incentives to reach decisions that would best serve their interests.<sup>101</sup>

In contrast, in a regime in which shareholders are precluded from initiating rule changes, deference to management is mandated as a general rule. The choice of regime, then, does not depend on whether shareholders are better informed than management, but rather on whether shareholders should be free to decide the degree of deference that will be given to management's recommendations. There is little basis for believing that shareholder decision-making on when to defer would be so flawed that tying shareholders' hands and mandating general deference to management would better serve shareholder value.

2. *The Consistency Argument Against Back-Seat Driving.* — Another concern about shareholder intervention power is that shareholders' decisions would lack coherence with management's corporate decisions. There is much value, so the argument goes, in corporate decisions' having sufficient internal consistency to create a coherent and well-integrated corporate strategy. The question of how a certain corporate governance issue is decided, one could argue, should not be answered in isolation from how other corporate decisions are made.<sup>102</sup>

Proponents of this argument can appeal to the intuitions and experiences that caution us against back-seat driving or having one dish prepared by two chefs. Shareholders should sit calmly in the back seat, the argument goes, and not try to instruct the person at the wheel; intervening might lead to accidents or at least to a nerve-racking trip. Alternatively stated, shareholders should stay out of the kitchen; giving directions to the chef is hardly a recipe for a tasty meal.

The consistency argument, however, does not provide a good basis for opposing shareholder power to make rules-of-the-game decisions. In many cases, alternative governance rules would be consistent with management's business policy, and in those circumstances there is no reason to give management a veto over the choice of governance rule. Management's choice of business strategy does not require that its choice be decisive with respect to questions such as whether all directors should stand up for elections annually or whether stock options should be expensed.

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<sup>101</sup> Note that in deciding whether to defer, shareholders will be in the same situation as many parties who must decide whether to defer to an agent who has greater expertise but worse incentives. Because we expect self-interested individuals to have incentives to balance the costs and benefits of deference, we generally believe that such parties would be better off if they were permitted to decide for themselves instead of being required to defer to the expert agent. Few would support mandating that clients defer to the recommendation of their lawyers when deciding whether to accept a settlement offer.

<sup>102</sup> Cf. CLARK, *supra* note 3, app. A at 801–03 (arguing that a central locus of power facilitates coordination and reduces the overload on an organization's communication network).

In addition, the argument against back-seat driving suffers from the same problem as the argument about imperfect information: the shareholders themselves could and should decide how much weight to give to the consistency consideration. Granting shareholders the power to initiate rules-of-the-game changes does not imply that they will constantly use it. They might defer to management if they believe that such deference is desirable for consistency in decision-making. Shareholders will use their intervention power only when they see reasons for interference that are sufficiently strong to outweigh whatever adverse effects the intervention might have regarding consistency in the company's decision-making.

Thus, mere recognition that back-seat driving might sometimes be counter-productive is hardly sufficient to mandate general deference to management. Such mandated deference would follow only if one assumes that shareholders are so irrational or undisciplined that they cannot be trusted to decide for themselves whether deference would best serve their interests. In today's capital markets, where institutional investors have a dominant presence, such paternalistic hand-tying is hardly warranted.

3. *Special Interests and Short-Term Horizons.* — Supporters of management insulation might also worry that shareholder-initiated proposals might be motivated by considerations other than the enhancement of long-term share value. Some shareholders, it might be argued, have special interests or a social agenda, and might consequently favor changes that serve their own agenda but not long-term shareholder value.<sup>103</sup> Further, some shareholders, such as financial institutions with high turnover strategies, might focus on short-term stock prices and consequently might produce changes that would be detrimental to long-term value and long-term shareholders.<sup>104</sup>

These concerns, however, are unwarranted. To begin, changes in governance provisions initiated by shareholders will not be adopted without support by a majority of the outstanding shares. A proposal that seeks to advance special interests or an activist agenda at the expense of shareholder value would have no meaningful chance of obtaining majority support. Moreover, considering the tendency of most money managers to support management and to focus on shareholder value, such a proposal would be unlikely to attract their votes.

Past experience with shareholder precatory resolutions supports this prediction. The only resolutions that systematically obtain majority support are ones calling for changes that are viewed as value-

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<sup>103</sup> See, e.g., Lipton & Rosenblum, *supra* note 94, at 82–83 (arguing that proposals to increase the frequency of shareholder voting would result in the nomination and election of special interest directors).

<sup>104</sup> See, e.g., *id.* at 78–79.

enhancing by a wide range of financial institutions — such as de-staggering the board or rescinding poison pills.<sup>105</sup> In contrast, proposals that focus on social or special interest issues uniformly fall far short of a majority. For example, in 2003, while precatory resolutions to expense options obtained an average of forty-six percent support, precatory resolutions to abolish stock options obtained an average of only six percent, and precatory resolutions seeking to highlight the ratio of highest to lowest compensation paid by the company obtained an average of only twelve percent.<sup>106</sup>

We still need to consider the potential costs that might be caused by shareholders with short horizons, such as institutional investors and traders that follow high-turnover strategies. It is far from clear that the governance provisions favored by such shareholders would commonly deviate from those favored by long-term shareholders. If a governance arrangement is widely viewed as detrimental to long-term share value, its long-run effect will likely be reflected in the company's stock price when the arrangement is adopted, and thus the short-run effect of its adoption will likely be negative as well.

In any event, if one remains concerned about proposals that would have positive short-term effects but negative long-term effects, it is possible to design a regime of shareholder intervention power in a way that would address this concern. In particular, a shareholder intervention regime could be designed to enable shareholder-initiated proposals to become valid only after a significant time from when they are brought. Under the regime proposed in section III.D, for example, a proposal will not become valid until after the passage of two shareholder meetings, held at least one year apart. With such a requirement, shareholders will initiate and adopt an arrangement only if they believe that it would have beneficial effects in the longer term.

#### *D. Opportunistic Proposals*

Another possible concern is that allowing shareholder intervention would enable some shareholders to bring (or to threaten to bring) proposals simply in an effort to extract some private benefits from management. Thus, it might be argued, union pension funds may leverage their initiation power to extract concessions for labor.<sup>107</sup> Similarly, one could argue, some other large shareholders might use their initiation

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<sup>105</sup> See GEORGESON SHAREHOLDER, *supra* note 92.

<sup>106</sup> See *id.* at 7, 22.

<sup>107</sup> See John J. Castellani & Amy L. Goodman, *The Case Against the SEC Director Election Proposal*, in SHAREHOLDER ACCESS TO THE CORPORATE BALLOT, *supra* note 2 (manuscript at 9–10, 18–19, on file with the Harvard Law School Library) (expressing concern that an increase in shareholder power may enable state and labor union pension funds to advance their collateral agenda).

power to gain financial or other benefits from management.<sup>108</sup> Such opportunism would not produce changes in rules, but it would enable some shareholders to obtain benefits for themselves at the expense of their fellow investors.

This concern about potential “blackmail,” however, does not appear significant. To begin, management would not be particularly worried about a threat to bring a proposal for a change that would likely be value-decreasing. Given the tendency of shareholders to defer to management, there is no assurance that even a value-increasing proposal opposed by management would be adopted. Thus, a shareholder-initiated proposal for a change that would likely be value-decreasing would be highly unlikely to obtain majority support. Accordingly, a threat to bring such a proposal would not enable a shareholder to blackmail management.

It is still necessary to consider the possibility of shareholders’ blackmailing management by threatening to bring a proposal that management recognizes to be value-increasing and thus likely to gain majority support. The potential for blackmail in such a case would be limited by the fact that striking a deal with the blackmailer would not prevent the proposal from being initiated. If de-staggering the board is likely to enjoy widespread shareholder support, for example, granting labor concessions to appease a union that threatens to bring a de-staggering proposal would not prevent the initiation of such a proposal: such a proposal would likely be brought before too long by another shareholder interested in increasing share value.

It is worth noting that a blackmail argument can be made not only against increasing shareholders’ power, but also against maintaining the power that shareholders currently have. After all, shareholders can already threaten to vote against management in director elections, on fundamental changes proposed by management, and on the approval of stock option plans. But the blackmail concern has not produced calls for the elimination or reduction of these powers. This concern should similarly play little role in assessing whether shareholders should have the power to make rules-of-the-game decisions.

### *E. Disruptive Cycles*

In an article seeking to provide a basis for the lack of shareholder intervention power, Jeffrey Gordon argues that giving shareholders the power to intervene in any given corporate decision would produce “so-

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<sup>108</sup> See Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 987 (2001) (expressing concern that large block shareholders may act opportunistically and “threaten to initiate a campaign to shift to [a regime that reduces overall share value] unless management ‘pays off’ the block shareholder”); Gordon, *supra* note 99, at 383–84 (expressing a similar concern).

cial choice” problems. In particular, he contends that shareholder power to initiate proposals would lead to “cycles” that could disrupt or even paralyze corporate decision-making.<sup>109</sup>

To illustrate the possible cycling problem, consider a hypothetical scenario in which a potential charter provision *A* is favored by a majority of the shareholders over another potential provision *B*. Suppose also that *B* is favored by (another) majority of shareholders over potential provision *C*, and that, finally, *C* is favored by yet another majority over *A*. As a result, no provision will be “stable” — any regime could be defeated by some other provision in a vote. Thus, shareholder decision-making would confront a “cycle.”<sup>110</sup> In this case, the argument goes, allowing shareholders to initiate proposals would lead to a cycle in which the company will move in each annual meeting to another provision, and will do so with no final destination: *A* would be replaced in a vote by *C*, which in turn would be replaced next time by *B*, which would itself be replaced by *A*, and so forth and so on.

Note that in this situation none of the three provisions *A*, *B*, or *C* can be viewed as inferior to the two others. The one outcome that would be clearly inferior is the outcome of perpetual change.<sup>111</sup> This negative outcome, Gordon argues, can be avoided by management control.<sup>112</sup> Such control would enable management to determine by fiat one of the three possible arrangements, providing stability and avoiding disruptive cycling.

The desire to avoid disruptive cycles, however, does not provide a basis for opposing shareholder initiation. To begin, the above analysis ignores the concern that management control could lead to the selection of an option that would be inferior to all the choices in the top set. Suppose that a company is now governed by a provision *D* that is viewed by all shareholders as worse than any of the provisions *A*, *B*, or *C*. Without shareholder power to intervene, if management prefers *D* to *A*, *B*, and *C*, shareholders might be “stuck” with an arrangement that is inferior to all of the top choices. Similarly, if management prefers *D* to *A*, *B*, and *C*, management control might enable it to get shareholders to approve *D* if the company is now governed by an arrangement that shareholders view as inferior to *D*. In contrast, shareholder power to intervene will ensure that the company will not end up with an arrangement like *D* that is outside the set of top choices.

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<sup>109</sup> See Gordon, *supra* note 99.

<sup>110</sup> The recognition that group decision-making can give rise to cycles goes back to Condorcet. For general treatments of the problem of cycles, see DUNCAN BLACK, *THE THEORY OF COMMITTEES AND ELECTIONS* 39–51 (1958); and AMARTYA K. SEN, *COLLECTIVE CHOICE AND SOCIAL WELFARE* (1970).

<sup>111</sup> See Gordon, *supra* note 99, at 381.

<sup>112</sup> See *id.*

Furthermore, and most importantly, assuming that a cycle of top choices arises, addressing this problem does not require denying shareholders the power to intervene. The cycling problem could be fully addressed merely by permitting management to accompany shareholder initiatives with management counter-proposals.<sup>113</sup>

Suppose that we are in the hypothetical case in which *A*, *B*, and *C* form a cycle. Suppose also that management prefers *A*, and that the status quo is *A*. If some shareholders initiate a vote on *C* in a given shareholder meeting, management can immediately put on the agenda for the meeting subsequent votes on *B* and then on *A*, which would lead to *A* continuing to govern. Indeed, in this case, permitting management to make counter-proposals and schedule the votes would discourage the initiation of *B* and *C* in the first place. Either way, the company would remain with a stable outcome of *A*. With management counter-proposals, shareholders will initiate a proposal only if they identify an arrangement that is superior (and viewed as superior by most shareholders) to *A*, *B*, and *C*, and if the initiation of such a proposal increases shareholder value and does not produce a cycle.

Thus, concerns about cycling at most require providing management with the power to place counter-proposals on the agenda. Such power would be sufficient to enable management to break any cycles that might arise. But concerns about cycling do not warrant denying shareholders the power to bring proposals to a shareholder vote. Such power is necessary to ensure that governance arrangements do not fall outside the set of top choices for shareholders.<sup>114</sup>

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<sup>113</sup> Earlier work suggests that the cycling problem raised by Gordon can be addressed by not scheduling incompatible proposals for a vote in the same meeting. Bratton and McCahery suggest that if two inconsistent proposals are submitted to an annual meeting, only the first should be placed on the ballot. See Bratton & McCahery, *supra* note 6, at 1945–46. Similarly, Royce de R. Barondes argues that separation in time between votes on incompatible proposals would make cycling much less likely. See Royce de R. Barondes, *Dynamic Economic Analyses of Selected Provisions of Corporate Law: The Absolute Delegation Rule, Disclosure of Intermediate Estimates and IPO Pricing*, 7 DEPAUL BUS. L.J. 97, 112–14 (1994). But separation in time would not eliminate cycles; it would only slow them down. If *A*, *B*, and *C* constitute a cycle in terms of shareholder preference, then *A* might be adopted in one annual meeting, *B* could be adopted in the subsequent annual meeting, *C* could be adopted in the annual meeting after that, and then the cycle would go back to *A*. In contrast, the method I describe below solves the cycling problem completely and immediately.

<sup>114</sup> Gordon notes the possibility of allowing shareholders to initiate proposals while letting management schedule the votes, but he argues that providing management with such agenda-setting power effectively nullifies the shareholders' power to initiate proposals. The power to schedule votes, Gordon suggests, is equivalent to the power to control fully the agenda and the outcome. See Gordon, *supra* note 99, at 359–60 (“[A] party with control over the agenda and with knowledge of the preferences of the other parties can generate virtually any outcome he wishes despite a majority voting process.”). As the above discussion indicates, however, this claim is correct only if, as Gordon assumes, the only available options are ones that belong to the set of top choices (*A*, *B*, and *C* in my example). In this case, either the power to make the choice or the power to schedule votes would be sufficient to ensure the outcome preferred by management.



### F. Panglossian Claims

Discussions of corporate law reforms usually cannot proceed without having to address what might be referred to as the “Panglossian argument.” According to this argument, we live in the best of all possible worlds because the market ensures that the best arrangements are always adopted. If a given arrangement were beneficial to shareholders, it would have emerged already because founders taking companies public would have an incentive to adopt this arrangement in the company’s IPO charter. While this type of argument suffers from general problems that I discuss elsewhere,<sup>115</sup> it is especially weak in the case of the reforms under consideration.

To begin, under U.S. corporate law, charter provisions that establish a regime in which the shareholder meeting has the power to make rules-of-the-game decisions are either impermissible or of uncertain validity. Although U.S. corporate law follows a clear and consistent “enabling” approach — allowing incorporators to opt out of many state law provisions and design their own tailored governance provisions<sup>116</sup> — with respect to a wide range of issues, it does not follow this approach with respect to opting out of the principles of managerial insulation from shareholder intervention.

The MBCA explicitly prohibits public companies from providing shareholders with intervention power. Section 7.32 of the MBCA authorizes shareholder agreements that are set forth in the articles of incorporation or bylaws to shift managerial power to shareholders.<sup>117</sup> Section 7.32(d), however, provides that such agreements “cease to be effective when shares of [a] corporation are listed on a national securities exchange.”<sup>118</sup> Moreover, once a company becomes public, if the agreement is contained or referred to in the corporate charter, the board is authorized to amend the charter without shareholder approval to delete from the charter the agreement as well as any references to the agreement.<sup>119</sup>

Although Delaware is especially known for its enabling philosophy, its law hardly welcomes opting out of the basic provisions establishing managerial insulation.<sup>120</sup> Many sections of the Delaware Code explic-

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But if management most prefers option *D*, which shareholders view as inferior to *A*, *B*, and *C*, then management control could enable management to enjoy *D*, while the power to sequence votes would not.

<sup>115</sup> For a detailed discussion of the general problems with making Panglossian inferences from IPO decisions, see Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, *supra* note 86.

<sup>116</sup> See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 1 (1993).

<sup>117</sup> See MODEL BUS. CORP. ACT § 7.32 (2002).

<sup>118</sup> *Id.* § 7.32(d).

<sup>119</sup> *Id.*

<sup>120</sup> I am grateful to Bill Allen, Larry Hamermesh, and Leo Strine for helpful conversations about Delaware’s law on this issue.

itly indicate that the arrangement specified in them holds only if the charter does not specify otherwise.<sup>121</sup> But the sections in the Code that govern charter amendments, mergers, consolidations, dissolutions, and distributions do not include such a qualification.

It might be argued that opting out of the statutory allocation of power is still permitted under the general provision of section 141(a).<sup>122</sup> This section allows companies to adopt charter provisions that confer the powers granted to the board on other “person or persons as shall be provided in the certificate of incorporation.”<sup>123</sup> A close look at the Delaware Code, however, suggests that it does not permit arrangements under which the general meeting may adopt a change in the charter (or a merger proposal or distribution decision) without board involvement.

Under section 141(a), if a charter provision provides that certain decisions will be made not by the directors but by some other group of persons, who may be referred to as “the substitute directors,” these persons will have the same powers and duties that the Code confers or imposes on the directors in connection with making the relevant decisions.<sup>124</sup> Among other things, substitute directors making decisions have the power, as well as the fiduciary duty, to review the inside information relevant to those decisions. Under Delaware law, directors are supposed to perform a screening function, and the powers conferred and the duties imposed on them are supposed to enable them to perform their screening function well. While section 141(a) permits the performance of the screening function by some substitute directors, rather than by the board members, it does not permit the elimination of this screening function — only its delegation to substitute directors. In particular, this section does not seem to contemplate a state of affairs in which, following a proposal by outside shareholders who lack access to the company’s internal information and are not subject to the duties and liabilities of directors, the general meeting of shareholders may adopt some decisions without any screening by directors or substitute directors.<sup>125</sup>

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<sup>121</sup> For examples of provisions that include this qualification, see DEL. CODE ANN. tit. 8, § 223(a), (d) (2001) (permitting vacancies and newly created directorships to be filled by a majority of the current directors unless otherwise specified in the charter or bylaws); and *id.* § 228(a), (b) (permitting actions required by the Code to be taken at shareholder meetings to be made by written consent of stockholders unless otherwise specified in the charter). *Cf.* MODEL BUS. CORP. ACT § 6.26(a) (permitting directors to authorize shares without certificates unless otherwise specified in the articles of incorporation or bylaws).

<sup>122</sup> See Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 669 (2003).

<sup>123</sup> DEL. CODE ANN. tit. 8, § 141(a).

<sup>124</sup> *Id.*

<sup>125</sup> Support for the view that the statute does not permit an arrangement that confers initiative power on shareholders can be found in section 351 of the Delaware Code. See DEL. CODE ANN.

Panglossians might still claim that, because Delaware law is not absolutely clear as to the permissibility of shareholder power to intervene, companies would seek some ways to provide such power if it were beneficial. In the case under consideration, however, IPO firms face substantial impediments to adopting unconventional opting-out provisions. As is now well recognized, the adoption of legal arrangements by companies is influenced by “network externalities.”<sup>126</sup> It is advantageous for a company to offer an arrangement that is familiar to institutional investors, that facilitates pricing relative to other companies, that is backed by a developed body of precedents and judges familiar with the arrangement. Conversely, companies are discouraged from adopting arrangements that are unconventional and radically different from those in other companies. In cases in which, as here, the legal validity of an unconventional governance arrangement is uncertain, companies are especially likely to be reluctant to adopt it.

Thus, opposition to shareholder power to intervene cannot be based on company founders’ not making efforts to adopt a regime of shareholder intervention through private action. We need to focus directly, as I have been doing, on the possible merits of such a regime.<sup>127</sup>

### G. Comparison to Political Referenda

A final objection, based on analogizing shareholder initiatives to political referenda, is worth briefly discussing. Many political systems do not permit voters to initiate and adopt directly general or specific legislation, while other political systems allow ballot initiatives that enable voters to adopt legislation directly. Substantial debate exists as

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tit. 8, § 351. This section — governing only close corporations — explicitly permits shareholders, if the charter so provides, to intervene directly in management decisions. *See id.* The limitation of this provision to close corporations supports the view that the charters of publicly traded companies may not confer board powers on shareholders.

To look at another jurisdiction, consider New York. Section 620(b) of the New York Business Corporation Law permits charter provisions that confer management power on shareholders. *See* N.Y. BUS. CORP. LAW § 620(b) (McKinney 2003). Section 620(c), however, provides that such charter provisions would be valid only “so long as no shares of the corporation are listed on a national securities exchange or regularly quoted in an over-the-counter market by . . . a national . . . securities association.” *Id.* § 620(c).

<sup>126</sup> *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 763, 772–73 (1995) (discussing the importance of network externalities for corporate arrangements and how such externalities can discourage companies from choosing an unfamiliar arrangement).

<sup>127</sup> There is another Panglossian argument that is worth noting: it might be argued that, if the legal reforms I advocate were indeed efficient, investors would have already pushed for them and convinced legislators to adopt them. But although many scholars believe that individuals’ market choices produce efficient outcomes, few believe that political choices, which are partly shaped by interest groups, can be generally expected to produce efficient legislation. In current work, I analyze the factors that enable management to have considerable influence on corporate law rules. *See* Bebchuk, *supra* note 10; Bebchuk & Neeman, *supra* note 10.

to the merits of allowing such referenda.<sup>128</sup> Some critics of increased shareholder power equate it with voter initiatives in political systems and assume that the former arouses all the problems associated with the latter.<sup>129</sup>

Opposition to political referenda, however, does not imply support for managerial insulation from shareholder intervention. Even if direct referenda are not desirable in politics, their analog might work well in the corporate context. Indeed, some of the main problems of direct referenda are not present — or are present to a lesser extent — in the corporate context.

Even accepting that shareholders might be imperfectly informed, they are likely to be better informed than voters in a state referendum. A shareholder vote is likely to be decided by a much smaller number of voters — the institutional investors holding shares in the company. And these voters will be relatively sophisticated and well-informed on the corporate governance issues involved.

Furthermore, shareholders are much more homogenous in their interests than are the voters in most political systems. In political systems, representative processes might be necessary to produce compromises that balance the divergent interests of various groups. In contrast, direct legislation can lead to majority-takes-all outcomes on each issue coming to a vote, precluding the log-rolling that is possible in the legislature. These concerns are much less relevant in the corporate context in which the interests of voting shareholders are more homogeneous than the interests of a political system's voters. In the corporate context, the issue is commonly not deciding whose interests to serve, but rather identifying which decision serves the common interest of shareholders in enhancing share value.

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<sup>128</sup> See generally THOMAS E. CRONIN, *DIRECT DEMOCRACY: THE POLITICS OF INITIATIVE, REFERENDUM, AND RECALL* (1989) (examining the history of direct democracy in America and taking a generally favorable view of its impact on the political system); C.H. HOEBEKE, *THE ROAD TO MASS DEMOCRACY: ORIGINAL INTENT AND THE SEVENTEENTH AMENDMENT* (1995) (discussing the dangers of direct democracy); Marci A. Hamilton, *Power, Responsibility, and Republican Democracy*, 93 MICH. L. REV. 1539 (1995) (discussing the relative merits of representative and direct democracy).

<sup>129</sup> See, e.g., John Castellani, Remarks at Harvard Law School Symposium on Corporate Elections Panel on the Board/Management Perspective (Oct. 3, 2003), in Symposium on Corporate Elections, at 36 (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Papers Series No. 448, Lucian Bebchuk ed., 2003) (stating that those examining possible corporate reforms should learn from the experience of states where voter referenda had undesirable consequences).

## V. GAME-ENDING, SCALING-DOWN, AND OTHER SPECIFIC BUSINESS DECISIONS

I have thus far discussed how giving shareholders the power to make rules-of-the-game decisions would improve corporate governance and increase shareholder value. I now turn to examining shareholder intervention with respect to specific business decisions.

Although I believe that giving shareholders intervention power with respect to some important types of specific business decisions would be beneficial for most public companies, I recognize that the case for such power faces more significant objections than the case for shareholder power to intervene in rules-of-the-game decisions. I therefore stress in section A that recognizing the potential benefits of shareholder power to intervene in some types of specific business decisions does not require adopting legal rules that provide such power as the default arrangement of corporate law.

Instead of providing such power as the default arrangement, it is possible to permit shareholders, as part of their power to make rules-of-the-game decisions, to adopt charter provisions that would give them power to intervene in some specific business decisions. Under this approach, intervention power with respect to specific business decisions would be introduced only when shareholders made — in advance — the general rules-of-the-game decision to allocate such power to themselves. This approach should be acceptable to anyone who agrees that intervention power with respect to specific business decisions might be beneficial for some public companies, even if not necessarily for most of them.

To demonstrate the importance of permitting shareholders to adopt charter provisions that grant them the power to make specific business decisions, sections B and C discuss two types of specific business decisions for which shareholder intervention power could well be beneficial in many cases: section B deals with game-ending decisions, and section C focuses on scaling-down decisions. I show that shareholder power to make such decisions could address important agency problems and produce considerable benefits.

### *A. Leaving Shareholders the Choice Whether To Have a Choice*

In presentations of drafts of this Article, I have commonly encountered greater skepticism about intervention in game-ending decisions, and even more so about intervention in scaling-down decisions, than about intervention in rules-of-the-game decisions. This skepticism arises because of concerns about shareholder power to intervene that appear to have more weight in the context of specific business decisions than in rules-of-the-game decisions.

1. *Management's Informational Advantage.* — One main concern with shareholder power to intervene in specific business decisions is

that management's informational advantage over shareholders is likely to be more substantial with respect to such decisions than with respect to rules-of-the-game decisions. Making a decision as to whether a given governance provision is desirable commonly does not require inside information. While individuals might disagree on whether having annual elections for all directors is desirable for a given company, their answer to this question is unlikely to depend on aspects of the company that are known only to management. In contrast, management's private information concerning the company's investment, growth opportunities, and expected long-term value might be quite relevant to, for example, decisions whether to make a given distribution to shareholders or whether to accept a particular acquisition offer.

That management's informational advantage is larger with respect to some decisions, however, does not imply that shareholder deference to management should be mandated. As discussed in section IV.C, giving shareholders the power to intervene would not imply that choices would generally be initiated by them rather than by management; it would only imply that shareholders would be permitted to decide for themselves to what extent to defer to management.

When management views a shareholder proposal with respect to a game-ending or scaling-down decision as value-decreasing, management will likely communicate to shareholders its reasons for opposing the proposal. Of course, in some circumstances, management might be unable to communicate the information underlying its position because business considerations require secrecy<sup>130</sup> or because the information is difficult to disclose credibly.<sup>131</sup> But in such cases, management can still communicate to the shareholders its recommendation and the general reason for it.

Faced with such communications from management, rational shareholders can be expected to balance two considerations. On the one hand, they will recognize that management might be better informed, which would weigh in favor of deferring to management. On the other hand, shareholders will take into account that management might have self-serving reasons for opposing game-ending or scaling-down decisions. Shareholders also will recognize that the directors and executives might make mistakes and suffer from a cognitive-

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<sup>130</sup> See, e.g., *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989). In *Shamrock Holdings*, the target's largest asset was a patent litigation claim, and the court accepted the argument that disclosures about this claim might compromise the target's bargaining position in the litigation. See *id.* at 288–90.

<sup>131</sup> In some cases, management has argued that information cannot be passed on effectively to shareholders because they would have difficulty comprehending it. See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293, 332 (Del. Ch. 2000) (discussing the target board's concern over "the risk of stockholder confusion").

dissonance tendency to view favorably both their own past performance and the course of action that serves their interests.<sup>132</sup>

In balancing these considerations, shareholders will consider various aspects of the particular case facing them. These aspects might include shareholders' own judgment concerning the benefits of accepting the proposal (for example, if they view as marginal the case for accepting, the risk from deferring to management is small); how likely management is to have private information of substantial importance for the question at hand (which in turn might depend on the nature of the company's business); and the estimated divergence between management's and shareholders' interests (the more shares management holds, for example, the smaller the likely divergence of interests).<sup>133</sup>

In any event, after balancing the considerations for and against deferring to the directors, rational shareholders might often conclude that deference would be best on an expected-value basis. When shareholders reach the opposite conclusion, however, letting them overrule management might well be the best approach to maximizing expected shareholder value. Given that it is their money that is on the line, shareholders naturally would have incentives to make the decision that would best serve their interests.<sup>134</sup> Thus, a significant informational advantage on the part of management does not imply that it is desirable to tie shareholders' hands and preclude any shareholder intervention in specific business decisions.

2. *Let Shareholders Decide.* — A regime in which shareholders may make rules-of-the-game decisions to adopt charter provisions that would subsequently grant shareholders the power to intervene in specific business decisions would provide a way of dealing with concerns about such shareholder power to intervene. Under this approach, the default arrangement of corporate law would remain that shareholders

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<sup>132</sup> As Chancellor William Allen insightfully observed in *City Capital Associates v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988), "human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial." *Id.* at 796 (emphasis added).

<sup>133</sup> It is worth noting that, in a regime of intervention power, if management opposes a termination decision, it could credibly signal that its recommendation is based on its genuine estimate that the target's independent value is high. For example, managers could so signal by committing themselves, in the event the proposal fails, to spend some of their own funds to purchase from the company at a high price (for example, the payoff per share that termination is expected to bring) some specified number of shares and hold them for a specified period of time. Because such an investment would be profitable only if shareholders would be better off were termination rejected, a commitment to make such an investment would provide a credible signal that managers genuinely view the rejection of the termination proposal as being in shareholders' interests. Under a regime of shareholder nonintervention, management has control over game-ending decisions and thus does not need to make such commitments.

<sup>134</sup> As discussed earlier, in deciding whether to defer, shareholders' situation will be similar to that of parties in other contexts who are free to choose whether to defer to an agent with greater expertise. *See supra* note 101.

do not have the power to intervene in specific business decisions. As part of their power to adopt rules-of-the-game decisions, however, shareholders would have the power to adopt charter provisions that would allow them in the future to intervene regarding specific business decisions in the manner and subject to the limitations specified in these provisions.

Note that, if shareholder adoption of governance arrangements would require approval of the arrangement in two annual meetings, a shareholder adoption of the power to intervene with respect to some specific business decisions would likely be based on general considerations. When shareholders initiate such an arrangement, they will do so knowing that, if ultimately adopted, significant time will pass before it becomes effective. Thus, the shareholders' decision would be a true "rules-of-the-game" choice rather than a response to some time-specific, transient circumstances.

Permitting shareholders to make such a choice would also give shareholders the ability to tailor both the substantive scope and the procedural requirements of the arrangement granting them intervention power. Shareholders would have the power to intervene in specified ways in some specific business decisions only to the extent that they elected, in advance, to have such power. For example, shareholders could adopt an arrangement that requires a specified supermajority and a specified passage of time for interventions in some types of specific business decisions. As long as shareholder power to intervene in specific business decisions might be desirable in some cases, anyone who agrees that shareholders should have the power to make rules-of-the-game decisions subject to procedural safeguards should also be willing to accept shareholder choices to adopt arrangements granting themselves power to intervene in specific business decisions.

Finally, this approach implies that, in principle, there is no reason to rule out categorically shareholder intervention power with respect to any type of specific business decision. If shareholders choose to initiate and adopt a provision that down the road gives them, for example, the power to set aspects of the CEO's compensation, we should not prohibit their adopting such a provision. That said, I focus in the next two sections on shareholder intervention power with respect to game-ending decisions and scaling-down decisions. I do so because, by addressing certain agency costs that have long been a source of concern, power with respect to these two types of decisions could well provide considerable benefits for a significant number of companies.

### *B. Game-Ending Decisions*

1. *Arrangements with Shareholder Intervention Power.* — There are several decisions that could terminate the existence of a company's business, including decisions to dissolve the company, to sell all assets, and to merge or consolidate with another company. An arrangement



under which shareholders have the power to intervene with respect to such transactions could provide shareholders with the power to make (subject to whatever procedural safeguards it specifies) binding resolutions with respect to some or all such transactions. Such an arrangement, for example, could give shareholders the power to adopt in the future binding resolutions instructing management to put the assets of the company (or the company as a whole) on the auction block, to begin a process of dissolution, or to accept certain merger or consolidation proposals submitted by a particular buyer.

Under existing rules, shareholders may decide to accept acquisition offers opposed by management only when the buyer makes a tender offer. Further, management has long sought to block hostile tender offers, and courts and lawmakers have permitted it to use poison pills to do so.<sup>135</sup> Under the view to which I subscribe, however, defensive tactics are acceptable only to protect shareholders from being pressured into tendering.<sup>136</sup> On this view, in the face of a tender offer, management should be required to redeem the poison pill if the offer gains sufficient support in a shareholder vote.

An arrangement that grants shareholders the power to pass binding resolutions with respect to game-ending decisions would be a simple and effective way to accomplish a substantively equivalent result. A shareholder resolution in favor of the offer made under the agreement would express shareholders' undistorted view that acceptance of the offer is in their collective interest. Anyone who supports a ban on defensive tactics should be willing to support charter provisions (or at least shareholders' power to adopt charter provisions) that give shareholders the power to adopt binding resolutions instructing management not to block a particular tender offer.

Those who support shareholder power to vote in favor of tender offers should presumably also endorse arrangements that permit shareholders to make binding resolutions in favor of other forms of acquisition offers. Such arrangements would offer some flexibility that a mere ban on takeover defenses would not provide. In particular, tender offers are not always the most efficient form of acquisition transaction; for example, another acquisition form might be more tax advantageous. An arrangement allowing shareholders to make binding resolutions in favor of acquisition offers in general, and not only tender offers, would address this problem. Under such an arrangement, when a buyer makes a merger proposal that management opposes, a shareholder group (or the buyer itself if it owns enough shares in the com-

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<sup>135</sup> See, e.g., WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION (2003).

<sup>136</sup> See generally Bebchuk, *supra* note 8 (putting forward the case for such limits on defensive tactics).

pany) would be able to bring to a vote a binding resolution instructing management to accept the proposal (or accept it only in the event that the buyer meets certain specified conditions).

Note also that, in votes on acquisition offers, allowing management to make counter-proposals would be important. When confronted with a tender offer, shareholders' current inability to make a counter-offer might put them at a bargaining disadvantage. This disadvantage can be viewed by opponents of shareholder intervention as a justification for giving management the power to block the acquisition offer so that management will be able to make a counter-offer to the buyer. But some of the advantages of management counter-offers can be retained under the considered arrangement.

Suppose that a buyer puts on the table an acquisition offer of \$100 per share, which management opposes, and that the buyer or an independent shareholder group subsequently initiates a resolution instructing management not to block the offer (if it is in the form of an acquisition offer) or to accept it (if it is in the form of a merger proposal). Management could submit for a vote a counter-proposal instructing acceptance of the offer if and only if the acquisition consideration is raised to \$130 per share. If shareholders approve management's proposal, the company would practically make a counter-offer of \$130 per share to the acquirer. The acquirer will know that, should it raise its offer to this level, management would be bound to accept the offer.

Under current rules, shareholders may not initiate an auction of the company or of its assets or a process of dissolution. Under the proposed regime, however, shareholders will have the option to adopt arrangements that will give them the power to initiate such processes. Boards now may decide to auction the company rather than try to negotiate a sale with a particular buyer. Shareholders may conclude that they will benefit from having in the future the ability to do so as well. Indeed, given that management might have an advantage in soliciting particular bids, the power to initiate an auction might be especially beneficial for shareholders. When a sale of the company seems to be value-maximizing, shareholders' initiation of a resolution to begin an auction, or even the mere existence of shareholders' power to do so, might induce management to look for a particular buyer.

2. *Addressing the Managerial Bias Toward Retaining Control.* —  
(a) *Ex Post Benefits.* — One of the problems that have long occupied legal scholars and financial economists concerns management's bias against transactions that terminate the company's existence. Because termination would mean that management will no longer enjoy the significant private benefits associated with control, termination has an adverse effect on management's private interests. Thus, management might reject opportunities to terminate — via merger, sale, or dissolution — even if pursuing them would serve the interests of shareholders.

To be sure, when termination would sufficiently benefit shareholders, executives' stock options might make it worthwhile for management to facilitate termination. But there is a range of cases in which the interests of shareholders and management diverge. To use the language of *Unocal*, game-ending decisions confront us with "the omnipresent specter that a board may be acting primarily in its own interests."<sup>137</sup>

The empirical evidence on acquisition offers indicates that management's control over decisions in this area produces significant agency costs. Studies show that when directors of target companies use their veto power to defeat offers, shareholders on average experience a significant stock market loss. For example, James Cotter and Marc Zenner found that when offers are defeated, shareholders suffer on average a twenty-one percent decline in their stock price.<sup>138</sup>

In a more recent study, John Coates, Guhan Subramanian, and I studied how the rejection of bids affects shareholders when evaluated from a long-term perspective.<sup>139</sup> We found that thirty months after the bid's announcement, the shareholders of targets remaining independent were on average substantially worse off when compared with a scenario in which the bid would have been accepted.<sup>140</sup> This evidence is inconsistent with the view that management blocks offers when its private information indicates that the offer falls short of the target's long-term value.

Studies examining the circumstances in which incumbents are likely to resist bids provide additional evidence of agency problems. An early study by Ralph Walkling and Michael Long indicated that the probability of a hostile reaction by incumbents is inversely related to the effect of the acquisition on managers' financial interests.<sup>141</sup> Subsequently, Cotter and Zenner found that managers are more likely to resist offers when they have smaller holdings (and their interests thus overlap less with shareholder interests).<sup>142</sup>

Finally, even when management agrees to a termination, the end-period nature of the situation might lead management to seek some private payoff that could come at the expense of shareholders. Indeed, there is evidence that management might be willing to trade premia to shareholders for personal benefits. A recent study by Jay Hartzell, Eli

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<sup>137</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

<sup>138</sup> James F. Cotter & Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J. FIN. ECON. 63, 86 (1994).

<sup>139</sup> See Bebchuk, Coates & Subramanian, *Theory, Evidence, and Policy*, *supra* note 57, at 932–36.

<sup>140</sup> *Id.* at 932–33.

<sup>141</sup> Ralph A. Walkling & Michael S. Long, *Agency Theory, Managerial Welfare, and Takeover Bid Resistance*, 15 RAND J. ECON. 54, 67 (1984).

<sup>142</sup> Cotter & Zenner, *supra* note 138, at 76.

Ofek, and David Yermack finds that target CEOs are willing to accept lower acquisition premia in transactions that involve extraordinary personal treatment (such as special payments to the CEO at the time of the acquisition or a high-ranking managerial post in the acquirer).<sup>143</sup> Another study by Julie Wolf indicates that in merger negotiations CEOs are willing to trade higher acquisition premia in exchange for better managerial positions in the merged firm.<sup>144</sup>

(b) *Ex Ante Benefits*. — The control that management currently has over game-ending decisions also produces agency costs ex ante, before opportunities to terminate arise. Under a regime of shareholder intervention, management would always act against the background possibility that shareholders might decide to accept an acquisition offer or even dissolve the company if they prefer termination to the continued independent existence of the company. This possibility would provide management with incentives to serve shareholder interests. Better performance by management, in turn, would make it less likely that shareholders would intervene to make a termination decision.

Permitting shareholder intervention would thus reduce the agency costs that now exist in the majority of publicly traded companies whose management is protected in one way or another from the discipline of a takeover threat. As the empirical evidence confirms, such insulation weakens incentives to avoid managerial slack. Two studies found that stronger protection from antitakeover statutes causes increases in managerial slack.<sup>145</sup> Another study found that companies whose managers enjoy more protection from takeovers (as measured by a governance index taking into account both corporate arrangements and state antitakeover provisions) are associated with poorer operating performance — including lower profit margins, return on equity, and sales growth.<sup>146</sup> This study also found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire-building.<sup>147</sup>

There is also evidence that insulation from takeover threats results in greater consumption of private benefits by executives. Kenneth

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<sup>143</sup> See Jay C. Hartzell et al., *What's in It for Me? CEOs Whose Firms Are Acquired*, 17 REV. FIN. STUD. 37, 57 (2004).

<sup>144</sup> See Julie Wulf, *Do CEOs in Mergers Trade Power for Premium? Evidence from "Mergers of Equals"*, 20 J.L. ECON. & ORG. 60, 87 (2004).

<sup>145</sup> See Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535, 545 (1999) (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519, 520 (1999) (concluding that antitakeover statutes "allow managers to pursue goals other than maximizing shareholder wealth").

<sup>146</sup> See Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 111, 129 (2003).

<sup>147</sup> See *id.* at 136–37.

Borokhovich, Kelly Brunarski, and Robert Parrino found that executives with stronger antitakeover defenses enjoy higher compensation levels.<sup>148</sup> Marianne Bertrand and Sendhil Mullainathan obtained similar findings for executives who are more protected due to antitakeover statutes.<sup>149</sup>

Finally, there is evidence of a correlation between anti-takeover protections and lower firm value. This evidence indicates that the aggregate effect of management insulation on shareholder value is negative. In a recent study, Alma Cohen and I find that staggered boards, with the substantial antitakeover protection they provide, are correlated with an economically significant reduction in firm value.<sup>150</sup> A subsequent study by Alma Cohen, Allen Ferrell, and me finds that firm value is negatively correlated not only with staggered boards, but also with several other provisions associated with greater takeover protection, as well as with an entrenchment index based on these provisions.<sup>151</sup>

Before concluding the discussion of potential ex ante benefits, it is worth noting that shareholder power to intervene in game-ending decisions might also have some adverse ex ante consequences. In particular, fear of shareholder intervention could lead management to focus excessively on short-term results.<sup>152</sup> Furthermore, such fear might in-

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<sup>148</sup> See Kenneth A. Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495, 1515 (1997).

<sup>149</sup> See MARIANNE BERTRAND & SENDHIL MULLAINATHAN, EXECUTIVE COMPENSATION AND INCENTIVES: THE IMPACT OF TAKEOVER LEGISLATION 4 (Nat'l Bureau of Econ. Research, Working Paper No. 6830, 1998), available at <http://papers.nber.org/papers/W6830>.

<sup>150</sup> BEBCHUK & COHEN, *supra* note 58, at 2. The study investigates the connection between firm value and staggered boards during the period from 1995 to 2002 and uses Tobin's Q, a standard measure used by financial economists, as a proxy for firm value.

<sup>151</sup> See LUCIAN BEBCHUK ET AL., WHAT MATTERS IN CORPORATE GOVERNANCE (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper No. 491, 2004). This study also finds that these "entrenching provisions" and the "entrenchment index" based on them were negatively correlated with stock returns during the period from 1990 to 2003. Further, the provisions in the entrenchment index drive the correlation that Paul Gompers, Joy Ishii, and Andrew Metrick identified between a broader index of management-favoring provisions and firm values as well as stock returns during the 1990s. See Gompers et al., *supra* note 146.

<sup>152</sup> Supporters of insulating management from hostile takeovers have argued that the threat of hostile takeovers forces managers to focus on short-term results and thereby discourages investments that would bear fruit only in the longer run, such as investments in research and development. See Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 115-16 (1979); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205-14, 218-22 (1991). For theoretical models analyzing the possibility and direction of ex ante distortions, see Lucian Arye Bebchuk & Lars A. Stole, *Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects?*, 48 J. FIN. 719 (1993); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989); and Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988).

duce management to seek to create “embedded defenses” against a sale or dissolution — features of the company’s business arrangements and contracts that would make it difficult or costly for shareholders to intervene.<sup>153</sup>

While such ex ante distortions are possible, there is empirical evidence suggesting that these distortions are not of sufficient magnitude to make shareholder power to intervene undesirable overall. Empirical studies could not find any significant systematic correlation between the degree of board insulation and under-investment in long-term research and development.<sup>154</sup> More importantly, as discussed above, there is evidence that, overall, a higher degree of insulation from acquisition offers is correlated with a reduction in firm value.<sup>155</sup> Thus, even if management insulation has some positive ex ante effects on shareholder value, these effects are apparently outweighed in most companies by the negative effects of management insulation.

### C. Scaling-Down Decisions

1. *Arrangements with Shareholder Intervention Power.* — At present, all decisions concerning distributions are in management’s hands. Management decides whether to distribute to shareholders a cash or an in-kind dividend (which could involve, for example, shares of a subsidiary). Such decisions transfer assets from company control into shareholder hands, in effect reducing the size of the empire under management’s control.

Consider how a charter provision allowing shareholders to make scaling-down decisions could operate. Such a provision could, for example, permit shareholders to initiate and pass binding resolutions regarding dividends. Such a resolution could instruct the board to pay a dividend with a specified amount, record date, and payment date; alternatively, such a resolution might specify only some of these details, leaving others to be determined and implemented by the board.

The considered provision might also allow shareholders to pass binding resolutions with respect to in-kind distributions. Under such a provision, shareholders would be able, for example, to instruct the

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<sup>153</sup> For a comprehensive analysis of how absence of insulation from acquisitions might lead to such defenses, see Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003). Management might, for example, include in the company’s contracts with business partners or with creditors provisions that would make it difficult or costly to sell the company or make distributions.

<sup>154</sup> See Mark S. Johnson & Ramesh P. Rao, *The Impact of Antitakeover Amendments on Corporate Financial Performance*, 32 FIN. REV. 659, 677–79, 681 (1997); Lisa K. Meulbroek et al., *Shark Repellents and Managerial Myopia: An Empirical Test*, 98 J. POL. ECON. 1108, 1110–16 (1990); William N. Pugh et al., *Antitakeover Charter Amendments: Effects on Corporate Decisions*, 15 J. FIN. RESEARCH 57, 62–67 (1992).

<sup>155</sup> See studies cited in *supra* notes 150 & 151.

board to distribute the company's shares in a subsidiary. Such resolutions, too, would reduce the scale of the enterprise governed by management and would remove some shareholder value from management's control.

In addition, the considered arrangement might provide shareholders with the power to pass resolutions that would force management to make distributions further down the road. For example, shareholders may be allowed to pass resolutions instructing the board to distribute newly issued securities. Shareholders may use such power to order a distribution to themselves of new debt securities that, once distributed, would compel management to pay out cash in the future to satisfy the claims of the new securities. Also, shareholders could be allowed to pass resolutions that would instruct management to follow a certain dividend policy in the future, such as paying each year a certain dividend amount or a dividend equal to a certain fraction of earnings.

Charter provisions that give shareholders the power to make scaling-down decisions would not weaken the protection currently accorded to creditors. Creditors have statutory protection — and often also contractual protection — limiting the amounts that the company may distribute to its shareholders.<sup>156</sup> Management may not elect to make distributions to shareholders that violate these constraints. Under a provision establishing shareholder intervention power, shareholder decisions concerning distributions would be similarly subject to statutory and contractual constraints. The considered provision would involve a change in the allocation of power between the board and the shareholders, not a renegotiation of the rights that creditors have.

As with shareholder power to make rules-of-the-game decisions, it should be stressed that provisions permitting shareholders to make scaling-down decisions could well have an effect even without shareholder intervention actually taking place. The presence of such a provision could induce a board to effect a distribution when the board would otherwise prefer to retain excessive funds to expand or at least maintain the size of its empire. With shareholder power to make scaling-down decisions, the board might decide to have such a distribution in order to avoid a shareholder resolution requiring a similar, or an even larger, distribution.

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<sup>156</sup> It was observed long ago that “the principal objective of dividend law has therefore been the preservation of a minimum of assets as a safeguard in assuring the payment of creditors’ claims.” DONALD KEHL, *CORPORATE DIVIDENDS: LEGAL AND ACCOUNTING PROBLEMS PERTAINING TO CORPORATE DISTRIBUTIONS* 15 (1941). Corporate law casebooks and textbooks have long discussed dividends largely in terms of the upper legal limits on management’s distributions. See, e.g., WILLIAM L. CARY & MELVIN ARON EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 1332–82 (7th ed. 1995); CLARK, *supra* note 3, at 593–625.

2. *Addressing Empire-Building and Free-Cash-Flow Problems.* —  
(a) *The Problems.* — One of the agency problems that have received a great deal of attention from financial economists and corporate law scholars concerns management's tendency to avoid distributing cash or assets to shareholders.<sup>157</sup> A company might have excessive cash reserves (relative to the amounts needed for the profitable investment opportunities it faces) whose distribution to shareholders would be value-increasing. A company might also have assets that would be better managed separately, in which case it would be value-increasing to spin off these assets or to sell them to a third party and then distribute the cash proceeds to shareholders. In such circumstances, however, management might refrain from taking actions that would reduce the size of the empire under its control.

Having a larger empire serves management's private interests. Management can derive greater private benefits, in both pecuniary and nonpecuniary terms, from running a large firm. In addition, retaining undistributed liquid funds ("free cash flow") or assets that can be turned into such funds increases the autonomy of management vis-à-vis the capital markets and bolsters its freedom to pursue expansion plans. Indeed, some scholars have viewed these concerns as the most significant agency problems that large public companies face.<sup>158</sup>

This view receives support from evidence that management's decisions might be distorted by its inclination to favor excessive expansion of its company and excessive retention of free cash flow. In a recent empirical study of investment decisions, for example, Christopher Hennessy and Amnon Levy find evidence of empire-building.<sup>159</sup> Another recent study reports that firms that substantially increase capital investments subsequently achieve negative benchmark-adjusted returns, with the negative abnormal returns stronger for firms that have

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<sup>157</sup> See Sanford J. Grossman & Oliver D. Hart, *Corporate Financial Structure and Managerial Incentives*, in *THE ECONOMICS OF INFORMATION AND UNCERTAINTY* 107-40 (John J. McCall ed., 1982); Oliver Hart & John Moore, *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management*, 85 *AM. ECON. REV.* 567, 568-69 (1995); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 *AM. ECON. REV.* 323, 323 (1986).

<sup>158</sup> See, e.g., HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 38 (1996); Michael C. Jensen, *Eclipse of the Public Corporation*, *HARV. BUS. REV.*, Sept.-Oct. 1989, at 61, 66; see also Margaret M. Blair & Martha A. Schary, *Industry-Level Indicators of Free Cash Flow*, in *THE DEAL DECADE* 128 (Margaret M. Blair ed., 1993) (noting that empirical evidence indicates that the U.S. corporate sector was caught in the 1980s by "an epidemic of free cash flow").

<sup>159</sup> CHRISTOPHER A. HENNESSY & AMNON LEVY, *A UNIFIED MODEL OF DISTORTED INVESTMENT: THEORY AND EVIDENCE* 2-3 (Am. Fin. Ass'n, Working Paper, 2002), available at <http://ssrn.com/abstract=334742>.



greater investment discretion.<sup>160</sup> And a study by Jarrad Harford finds that, among cash-rich firms, the decision to spend the cash on an acquisition (rather than to pay it out) is strongly related to factors associated with greater agency problems (such as a lower level of share ownership by management).<sup>161</sup> This study also found that the availability of cash that can be spent on acquisitions is correlated with firms' pursuit of diversifying acquisitions and targets that are less attractive to other potential acquirers.<sup>162</sup>

(b) *Comparison with the Use of Debt.* — Financial economists have suggested that a main reason for the use of debt capital, including highly leveraged structures, is to address the problem of management's tendency to engage in empire-building and excessive cash flow retention.<sup>163</sup> On this view, the advantage of debt is that it forces management to distribute more cash to those who contributed capital to the firm than management would be otherwise inclined to disburse. Because management can avoid distributing dividends to shareholders, but would face severe repercussions if it were to stop making interest payments to creditors, raising capital in the form of debt rather than equity reduces the discretion that management has over the allocation of free cash flow. Thus, having debt in a company's capital structure serves a beneficial bonding role, committing management to pay out some of the company's cash flow.

The view that such bonding is an important motivation for the use of debt enjoys much support among financial economists.<sup>164</sup> Indeed, researchers have argued that bonding benefits were an important motivation for the wave of leveraged acquisitions and buyouts during the 1980s. The belief that highly leveraged structures are often introduced to mitigate problems of empire-building and free cash flow underscores how seriously financial economists take these problems.

Debt financing, however, is a highly imperfect remedy for the considered problems. To begin with, high leverage produces its own inefficiency distortions.<sup>165</sup> For example, high leverage induces manage-

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<sup>160</sup> SHERIDAN TITMAN ET AL., CAPITAL INVESTMENTS AND STOCK RETURNS 1–3 (Nat'l Bureau of Econ. Research, Working Paper No. 9951, 2003), available at <http://www.nber.org/papers/w9951>.

<sup>161</sup> See Jarrad Harford, *Corporate Cash Reserves and Acquisitions*, 54 J. FIN. 1969, 1970, 1995 (1999).

<sup>162</sup> *Id.*

<sup>163</sup> See, e.g., Jensen, *supra* note 157.

<sup>164</sup> See, e.g., Milton Harris & Artur Raviv, *Capital Structure and the Informational Role of Debt*, 45 J. FIN. 321, 321 (1990); Jensen, *supra* note 157, at 324; René M. Stulz, *Managerial Discretion and Optimal Financing Policies*, 26 J. FIN. ECON. 3, 3–4 (1990).

<sup>165</sup> See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 333–37 (1976).

ment whose wealth is tied to equity value to take excessive risks. The greater the leverage, the larger the costs of distortions arising from it.

Furthermore, leverage is a rather inflexible mechanism that cannot be expected to induce optimal distribution decisions for most public companies that have been in existence for a long period of time. When the level of debt is set at the time a company goes public or through a leveraged restructuring, there is uncertainty about the company's future excess cash flow and investment needs. Accordingly, any level set at that time might turn out to be too low, and thus an insufficient check on inefficient empire-building, or too high, and thus a costly burden on the company.

Suppose that a company that goes public is expected to generate future cash flows with an expected value of \$200 million a year, with equal likelihood of either \$100 million or \$300 million. Suppose also that the company will not have beneficial investment opportunities and that it will be efficient to remove whatever cash flows the company will have. In such a case, a leveraged capital structure that requires making interest payments of \$200 million a year would not work too well. A commitment to pay out \$200 million annually would either put the company into costly financial distress (if cash flows turn out to be \$100 million a year) or prove insufficient to remove fully the unnecessary cash flow (if cash flows turn out to be \$300 million a year).

Of course, companies may (and do) adjust their debt levels over time. But when the management of a publicly traded company with dispersed ownership decides in midstream how to adjust the debt level, it does not have the incentives to make the decision that will reduce management's own future agency costs in the most cost-effective way. Thus, for companies in which the debt level is not largely the product of an IPO or a leveraged restructuring, debt cannot be expected to provide an effective remedy for the problems of empire-building and excessive cash flow retention.

In contrast, shareholder power to make distribution decisions can provide a mechanism for dealing with empire-building and excessive cash flow in a way that would be tailored to the circumstances that the shareholders of midstream companies face. In the example above, once uncertainty about the company's cash flow is resolved, shareholders would be able to use their intervention power to instruct management to distribute then or over a certain period of time amounts that would seem appropriate in light of the realization of uncertainty about cash flows. Thus, intervention power would deal with the problems under consideration in a manner more finely tuned to changing circumstances than the mechanism of debt.

(c) *Comparison with Other Proposals for Legal Changes.* — The problems of empire-building and excessive cash retention have concerned not only financial economists but also legal scholars. Some le-

gal scholars have proposed reconsidering the current judicial deference to management's business judgment on such matters.<sup>166</sup> In their view, given management's bias against distributions, courts should be prepared to review the merits of management decisions in this area.

As a remedy for the problems of empire-building and excessive retention of cash flow, however, judicial scrutiny would have substantial limitations. Courts are both ill-equipped and naturally reluctant to evaluate business decisions. Shareholder power to intervene appears to be a superior alternative: instead of having judges guess which distribution decisions would benefit shareholders, shareholder power to intervene allows shareholders themselves to make the decision.

Zohar Goshen makes another noteworthy proposal for dealing with management's tendency to engage in excessive expansion and retention of cash flow.<sup>167</sup> He proposes requiring companies to give each shareholder an option every year to withdraw his or her fraction of the company's earnings. Any amount not withdrawn by a given shareholder would essentially constitute a reinvestment of funds in the company. Goshen's proposal would provide shareholders with power to withdraw excess funds, but this power would be given to each shareholder individually rather than collectively through a decision adopted by a majority vote.

Giving shareholders the power to make scaling-down decisions collectively may be superior to Goshen's dividend options mechanism in two ways. First, under the existing tax rules, Goshen's mechanism would require shareholders to pay taxes in all the instances in which they elect not to withdraw funds from the company (that is, to reinvest the dividends they are entitled to withdraw). Second, there may well be cases in which (1) each shareholder would prefer that all shareholders not withdraw their funds from the company, but in which (2) taking other shareholders' withdrawal decisions as given, each shareholder prefers to have his or her own funds withdrawn. Under these circumstances, individual dividend options would lead to the inferior outcome of withdrawal of funds by all shareholders, whereas shareholder power to intervene would lead to the outcome that is in shareholders' collective interest.

*(d) Potential Distortions and Overall Desirability.* — An assessment of alternative strategies for dealing with the problems of empire-building and free cash flow suggests that, taking as given the amounts that companies have to distribute, shareholder-intervention power could well be the most effective solution to these problems. This

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<sup>166</sup> For a vigorous appeal for greater judicial intervention in dividend decisions, see Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85 (1980).

<sup>167</sup> See Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881 (1995)

power would enable shareholders (rather than courts) to make collectively (rather than individually) a decision that would be tailored to the circumstances at hand about the constraints that should be imposed on management's distribution decisions. The ongoing debt-level decisions of longstanding companies, which are the product of management decisions, cannot be expected to provide such constraints.

To be sure, shareholders contemplating whether to adopt a provision permitting intervention in scaling-down decisions will have to consider the possibility that such a provision would produce distortions resulting from management's attempts to protect its discretion from shareholder intervention. Thus, one might be concerned that management will take steps to reduce the amounts that the company may distribute. Management might do so by hurrying to invest any cash received by the company or by including clauses in existing debt contracts that prohibit or severely limit the amounts of dividends that may be distributed.

This concern might deter shareholders who would otherwise be inclined to support a provision permitting intervention in scaling-down decisions from adopting such a provision. But it also might not. Instead, when this concern seems significant, shareholders may choose to adopt a resolution instructing management to distribute a certain amount or fraction of earnings over a period of time, which would force management not to invest any cash that comes its way. And shareholders may also adopt a resolution instructing management not to adopt any contractual clauses that constrain distributions more tightly than certain limits specified by the resolution.

There is little basis for believing that the costs of provisions allowing scaling-down decisions would exceed their benefits for all companies at all times. The law thus should not preclude shareholders from deciding that such a provision is overall beneficial for their company. The recognized significance of the problems of empire-building and excessive cash flow retention, and the inability of debt to provide a general solution to these problems, suggest that such provisions could be adopted by shareholders, and might produce considerable benefits, in many companies.

## VI. MANAGEMENT INSULATION AND STAKEHOLDER INTERESTS

I have argued that making shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value. I now turn to objections to increasing shareholder power that are based on the potential harm that

it could cause to corporate stakeholders — nonshareholder constituencies such as employees, suppliers, or debtholders.<sup>168</sup> Limits on shareholder power, one could argue, are necessary to prevent shareholders from making decisions that would take away value from stakeholders. Indeed, some economists and legal scholars have argued that, to induce stakeholders to make investments in the success of an enterprise, it is in the ex ante interest of shareholders themselves to tie their own hands and let boards make decisions that will take into account the interests of stakeholders.<sup>169</sup>

The argument that stakeholder interests justify management control has played an important role in the debate over takeover defenses. Supporters of management insulation have used claims about stakeholder interests in the political arena, in the courts, and in the world of public opinion. And a majority of states have enacted statutes allowing management to take into account the interests of stakeholders when responding to a takeover bid.<sup>170</sup>

As explained below, stakeholder interests do not provide a good reason for the current insulation of management from shareholders. Management protection should not be mistaken for stakeholder protection.

#### A. *The Puzzling Scope of the Stakeholder Interests Claim*

What is puzzling about the claim under consideration is that its proponents do not seek to limit the power of capital providers in large firms in general. They seek to do so only for publicly traded firms with dispersed ownership.

Consider a large firm operating in a certain industry that has a controlling shareholder; the firm might be either closely held or publicly traded. Suppose that it is desirable to limit the influence of shareholders on corporate decision-making in publicly traded firms with dispersed ownership that operate in this industry. In such a case, there seems to be no reason not also to limit the influence of the shareholders of the firm with a controlling shareholder. Even under a regime that increases the power of dispersed shareholders, the share-

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<sup>168</sup> See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 (1999); Lipton, *supra* note 152; Lipton & Rosenblum, *supra* note 94, at 72–73.

<sup>169</sup> See Blair & Stout, *supra* note 168, at 304–05; John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435, 446–47; Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 37–41 (Alan J. Auerbach ed., 1988); cf. John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 23–24 (1986).

<sup>170</sup> See INVESTOR RESPONSIBILITY RESEARCH CTR., STATE TAKEOVER LAWS §§ A-6 to A-7 (2003).

holders would not influence corporate decision-making more, and might well influence it less, than the controlling shareholder under current arrangements.

Thus, if supporters of limits on shareholder power in firms with dispersed ownership base their position on the need to protect stakeholders, they should equally support limiting the intervention power of controlling shareholders. Similarly, if management insulation serves the shareholders of companies with dispersed ownership by inducing stakeholders to make firm-specific investments, such insulation should be similarly beneficial for the shareholders of firms in the same industry that have a controlling shareholder. Indeed, in such a case, in the absence of legal rules that limit controllers' power to intervene, controllers should be expected to make contractual arrangements that would limit their power to intervene (by, for example, entering into contracts with professional managers that insulate the managers from ex post intervention by the controller).

A substantial fraction of large firms in the United States, and most large firms around the world, have a controlling shareholder (or shareholder group). These controlling shareholders have practically more power to influence corporate decisions than dispersed shareholders would have under the reforms that I advocate. Neither legal rules, nor the charters or contracts of these firms, attempt to provide management of these firms a degree of insulation from shareholders that is even close to that currently enjoyed by management in publicly traded companies. At the outset, this observation suggests some skepticism for claims that management insulation from shareholders is desirable for companies with dispersed shareholders.

### *B. Do Weak Shareholders Benefit Stakeholders?*

I now turn to examining directly whether management insulation in companies with dispersed ownership operates to the benefit of stakeholders. In considering this question, it is worth noting first that some of the decisions for which intervention power is proposed are ones that are unlikely to affect stakeholders. This is the case for many rules-of-the-game decisions that affect the relationship between shareholders and management and among shareholders. This might also be the case for some scaling-down decisions: the distribution of excess cash would prevent managers from expanding the size of the firm and bringing in additional stakeholders, but might not adversely affect existing employees and other stakeholders.

Some corporate decisions might of course have an effect on existing stakeholders. Game-ending decisions, even when they involve a merger or sale rather than a dissolution, might sometimes adversely affect the interests of stakeholders. Employees might be laid off, creditors' debt might become riskier, suppliers might be denied a valuable business partner, and communities might lose a corporate headquarters

or corporate operations. In addition, some scaling-down decisions might require management to liquidate operating assets and thereby might have adverse effects on stakeholders.

Some commentators argue that, even though full or partial termination can theoretically impose losses on stakeholders, the evidence indicates that such losses are not very common and, relative to shareholders' gains, are small in magnitude when they do occur.<sup>171</sup> One could also argue that the law generally should not provide protection to stakeholders beyond what is called for by their contracts with the corporation. Under this view, protection of stakeholder interests should be left to contracts between them and the corporation or to nonlegal sanctions.<sup>172</sup>

In any event, even assuming that (1) termination, scaling-down, and rules-of-the-game decisions can often impose significant negative externalities on stakeholders (possibly employees in particular), and that (2) contractual and other protections would not be sufficient to protect stakeholders adequately, the case against shareholder power to intervene does not follow. Indeed, management control is a rather poor way of protecting stakeholders.

For one thing, there is no assurance that management will use increased insulation from shareholders to serve stakeholder interests. In theory, one could consider requiring management to maximize the overall welfare of all corporate constituencies. Courts, however, would be unable to enforce effectively compliance with such a principle. Indeed, courts are reluctant to review whether management decisions serve even the narrower and well-defined interests of shareholders. As Oliver Hart observes, a prescription to management to take the interests of all constituencies into account "is essentially vacuous, because it allows management to justify almost any action on the grounds that it benefits some group."<sup>173</sup>

Supporters of management control do not even suggest that management should be required to use its power in ways that protect stakeholders and that courts should sanction the use of such power for other purposes. Lest there be any misunderstanding that courts are expected to ensure that directors take stakeholders' interests into account, the drafters of state constituency statutes have used, in all cases but one, language that authorizes directors, but does not require them,

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<sup>171</sup> For a review of the evidence, see Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 U. TORONTO L.J. 315, 317-25 (1993); and Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 133-43 (1992).

<sup>172</sup> An excellent discussion of this view can be found in Daniels, *supra* note 171, at 340-49.

<sup>173</sup> Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO L.J. 299, 303 (1993).

to take into account the interests of nonshareholder constituencies.<sup>174</sup> Supporters of management control merely express the hope that management will use its discretion to protect stakeholder interests. In considering how likely management is to use its discretion in this way, one should examine whether the interests of management are likely to overlap with the interests of stakeholders.

If anything, management's interests are likely to be aligned with stakeholders' interests to an even lower degree than with shareholders' interests. Whereas managers usually have a significant fraction of their wealth in the form of shares and options, they do not usually have much of their wealth tied to bondholder or employee wealth. Thus, if we expect management to be an imperfect agent for shareholders, we can expect management to be an even less reliable agent for stakeholders.

The actual practices of boards and executives hardly reflect a conception of management as an agent for stakeholders. Standard schemes of compensating officers and directors tie such compensation to shareholder wealth but not to stakeholder wealth. While option plans, restricted stock, and bonus plans based on financial performance are common, I know of no company that links the compensation of executives or directors to measures of stakeholders' interests such as the average or total compensation paid to employees.

To be sure, some correlation between the interests of management and stakeholders might arise when game-ending decisions pose a threat to managers (who might lose private benefits of control) and also to employees (who might lose their jobs) or creditors (who might be harmed by increased leverage). But this correlation of interests is likely to be limited; management and stakeholder interests can be expected to overlap occasionally but not in general.

Furthermore, management, for self-serving reasons, may actually disfavor decisions that would benefit stakeholders — for instance, selling to a large and rich buyer that would improve opportunities for employees while displacing current management. Conversely, management, if offered a sufficiently good deal, may actually favor an acquisition that would hurt stakeholders. Finally, in cases in which an acquisition is likely to occur, management might use whatever veto power it has to bargain for better terms, not for stakeholders, but for itself. In sum, given the limited overlap between management and stakeholder interests, there is no basis for expecting management control to translate into effective protection of stakeholders.<sup>175</sup>

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<sup>174</sup> See Comm. on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2261–63 (1990).

<sup>175</sup> Interestingly, the push for constituency statutes seems to have come from those seeking to enhance management power. Although acquisitions and their effects on stakeholders have been



### C. *Management Protection in Stakeholder Clothes*

I have discussed in detail stakeholder-based arguments because of their potential importance for the case in favor of management power. Once stakeholders are brought into the debate, shareholders no longer have a central claim on what management should do; they become one constituency among several constituencies whose interests should be protected. Defenders of management power can cast opposition to shareholder intervention as a rejection of the view that only shareholders count and an endorsement of the view that stakeholders, especially employees, also count.

Defenders of management power would like us to accept that if stakeholders are to count, shareholders must be held at bay. By casting management as the champion of stakeholders, defenders of management insulation can boost significantly its perceived legitimacy and appeal. Support for such insulation is no longer a self-serving position on the part of management. Rather, it represents a noble fight against a narrow, shareholder-centered view of the corporation and in favor of a broad, inclusive view.<sup>176</sup>

The arguments made in this Part question this account of what is at stake in the debate over shareholders' power vis-à-vis management. Management is unlikely to be an effective agent for stakeholders. Limits on shareholder power should be viewed not as supporting the interests of employees and other stakeholders, but rather as enhancing the power of management relative to shareholders. The resulting increase in management slack might well operate to the detriment of both shareholders and stakeholders.

The debate over management power does not confront us with a choice between shareholders and stakeholders, with management as the champion of the latter. Rather, the choice is between shareholders and management, with stakeholders as bystanders.

## VII. CONCLUSION

This Article has reconsidered a long-standing, basic feature of American corporate law — the preclusion of shareholders from inter-

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part of the corporate landscape for a long time, such statutes came into being only after the rise of hostile bids created a threat to management power. Furthermore, the majority of state constituency statutes were adopted as part of a larger wave of antitakeover statutes aimed at impeding hostile acquisitions. An examination of the data on state antitakeover statutes indicates that, out of the thirty-one states that have a constituency statute, all but four also have another type of second-generation antitakeover statute. See INVESTOR RESPONSIBILITY RESEARCH CTR., *supra* note 170, §§ A-1 to A-5.

<sup>176</sup> See Allen et al., *supra* note 81, at 1076–77 (viewing the debate over shareholder choice in takeovers as partly involving choice between a shareholder-centered view of the corporation and a broader, “entity” perspective that incorporates the interests of stakeholders).

vening to adopt changes in the company's basic governance arrangements or to make major business decisions. This basic feature has a profound influence on the governance of U.S. companies with dispersed ownership. The legal rules that tie shareholders' hands and insulate management from shareholder intervention partly account for the power of management and the weakness of shareholders in such companies.

The case for management insulation from shareholder intervention does not follow from informational advantages that management has over shareholders or from the requirements of centralized management. Nor is it justified by fears that shareholders would use their powers too little, too much, or in the wrong ways. Furthermore, reducing management insulation can significantly contribute to addressing major problems of corporate governance that have long troubled financial economists and legal scholars.

This Article has argued for granting shareholders the power to initiate and adopt rules-of-the-game decisions to change the corporate charter or state of incorporation. In the absence of such power, the evolution of governance arrangements — which are in part designed to constrain and regulate management — has been for too long left to a process controlled by management. Introducing shareholder power to make rules-of-the-game decisions would operate over time to improve a wide range of corporate governance arrangements. It would provide a mechanism that could, without further regulatory intervention, address existing governance flaws as well as new governance problems that arise in the future.

Shareholder power to adopt rules-of-the-game decisions should be defined broadly enough to allow shareholders to adopt charter provisions that would give them a specified power to adopt binding resolutions regarding business issues, such as game-ending or scaling-down decisions. The adoption of such provisions could considerably reduce agency costs and produce substantial benefits in many companies. In particular, provisions introducing shareholder power to make game-ending decisions could counter management's tendency to favor continuation of the company, and provisions granting shareholders power to make scaling-back decisions could counter management's tendency to retain excessive funds or engage in empire-building.

This Article, I hope, will contribute to the recognition that the allocation of power between management and shareholders merits careful reconsideration. Increasing shareholder power would much benefit shareholders and improve corporate performance.