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### Author

Bebchuk, Lucian Arye

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# The Case for Empowering Shareholders

Lucian Arye Bebchuk\*

\* William J. Friedman Professor of Law, Economics, and Finance, Harvard Law School; Research Associate, National Bureau of Economic Research and Center for Economic Policy Research. I am indebted to Assaf Hamdani for his invaluable research assistance. I also wish to thank Jennifer Arlen, Victor Brudney, Allen Ferrell, Jesse Fried, Matteo Gatti, Marcel Kahan, Louis Kaplow, Jeremy Kutner, Mark Ramsayer, Mark Roe, Steve Shavell, Guhan Subramanian, George Triantis, Ed Iacobucci, and participants in seminars at Harvard Law School and Harvard Business School for helpful suggestions and discussions. Finally, I gratefully acknowledge the financial support of the John M. Olin Center for Law, Economics, and Business for its financial support and the University of Tel-Aviv for its hospitality during my visits.

## Abstract

This paper reconsiders the basic allocation of power between management and shareholders in publicly traded companies. U.S. corporate law, taking a different approach from that of other common law countries, has long precluded shareholders in such companies from directly intervening in any major corporate decisions. Management power and shareholder weakness in these companies is not largely an inevitable product of the dispersion of ownership, but are partly due to the legal rules that insulate management from shareholder intervention. I argue that the case for such legal rules is hardly compelling, and I put forward a regime in which shareholders have the power to initiate, and approve by vote, major corporate decisions.

Providing shareholders with the power to intervene can significantly address important governance problems that have long occupied the attention of corporate law scholars and financial economists. In particular, shareholder power to make “rules-of-the-game” decisions – to amend the corporate charter or change the state of incorporation—would ensure that corporate governance arrangements change over time in ways that serve shareholder interests. Shareholder power to make “game-ending” decisions – to merge, sell all assets, or dissolve—would address managers’ excessive tendency to retain their independence. Finally, Shareholder power to make “scaling-down” decisions – to contract the company’s size by ordering a cash or in-kind distribution—would address problems of empire building and free cash flow. A regime with shareholder power to intervene, I conclude, is an attractive option that should be seriously considered.

Keywords: corporate law, corporate governance, investors, shareholders, managers, directors, boards, stakeholders, agency costs, mergers, takeovers, acquisitions, proxy contests, corporate charters, charter amendments, regulatory competition, Delaware, state competition, dividends, distributions, free cash flow, empire-building, myopia, short-termism, corporate reform.

JEL classification: D70, G30, G32, G34, G38, K22.

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“Directors are thus 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 MANAGERS AND SHAREHOLDERS

Recent events have intensified concerns about how officers and directors of publicly traded companies use the expansive powers that they have. This might be as good a time as any to reconsider the allocation of power in such companies. This paper questions the basic rules of U.S. corporate law that deny shareholders the power to intervene directly in major corporate decisions. I argue that the considerable weakness of shareholders and power of management in companies with dispersed ownership is not all due to the dispersion of ownership; it is at partly due to the legal rules insulating management from shareholder intervention. I also present the case for granting shareholders the power to initiate, and approve by vote, major corporate decisions. Granting such power would address important agency problems that have long afflicted publicly traded companies, considerably improving corporate governance.

A central and well-settled principle of U.S. corporate law is that all major corporate decisions must be made, or at least initiated, by the board. Shareholders may not initiate any such decisions, and they can change the course of the corporation only by replacing the board with a new board that will do so.<sup>2</sup> This feature of U.S. corporate law, which has profound implications for corporate governance, is often taken for granted. However, this feature, which other common law countries such as the U.K. do not share, is far from being an inherent corollary of the modern, large corporation. Indeed, I argue, the case for restraining shareholders from directly intervening in corporate decisions is far from compelling.

The major corporate decisions for which I will consider shareholder intervention power can be usefully grouped into three categories: (i) “rules-of-the-game” decisions to amend the corporate charter or change the company’s state of incorporation; (ii) “game-ending” decisions to merge, sell

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<sup>1</sup> Adolf A. Berle, Jr. and Gardiner C. Means, “The Modern Corporation and Private Property,” (The Macmillan Company, New York, 1932), at 139.

<sup>2</sup> See Robert Charles Clark, *Corporate Law* (1986), Ch. 1 & 3, and section II.A *infra*.

all assets, or dissolve; and (iii) “scaling-down” decisions to contract the size of the company’s assets by ordering a cash or in-kind distribution. These three types of decisions are those for which shareholder power to intervene is worth examining.

Part II describes the absence of intervention power under existing and long-standing corporate law principles. Long-standing principles of U.S. corporate law grant management a decisive say with respect to all three categories of major corporate decisions.<sup>3</sup> Although rules-of-the-game decisions and game-ending decisions generally require a vote of shareholder approval, only the board can initiate such votes. As for scaling-down decisions — and the decisions with respect to the corporate distributions they involve — these are solely the prerogative of the board.

Part II also describes the different approach taken by the corporate laws of the U.K. and several other common law countries. These countries have similar legal traditions to those of the U.S. and, like the U.S., have developed capital markets and publicly traded companies with dispersed ownership. The fact that the corporate laws of these countries depart from the principles of purely representative democracy indicates that such departures are not implausible candidates for consideration.

To be sure, shareholders in the American public corporation are not powerless. Their power lies in their right to vote on the election of directors. The U.S. corporation can be regarded as a completely “representative democracy” in which the members of the polity can act only through their representatives and never directly.<sup>4</sup> The underlying view is that, as long as shareholders have the power to replace the directors, corporate decisions can be expected to be attentive to shareholders’ wishes and not to stray far from them.

Part III explains, however, why the power to elect directors and the power to veto fundamental corporate changes are insufficient to ensure that shareholders generally have their way. To begin with, shareholders might be

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<sup>3</sup> For an account of the current division of power, see Clark (1986) and *infra* section II.A.

<sup>4</sup> “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.” *TW Services, Inc. v. Crown*, 1989 WL 20290 (Del. Ch. 1989). Martin Lipton and Paul Rowe have recently referred to the choice of completely representative democracy as “part of the deep design of the Delaware corporate form.” See Martin Lipton and Paul K. Rowe, “Pills, Polls and Professors: A reply to Professor Gilson,” *Delaware Journal of Corporate Law* (2002).

pleased with management's general performance but still want to make a particular decision in opposition to management's wishes. Suppose that shareholders would like both to have management continue running the company and have the charter amended, but management does not wish to make the desired amendment. If a competing management team were to run a proxy contest promising to initiate the charter amendment, shareholders' power to replace directors would provide them with a choice between (i) having the current, preferred management team without the desired charter amendment, and (ii) having the desired amendment but with a different management team. The power to replace directors would not enable shareholders to have their most preferred outcome, which is (iii) having both the current preferred management team and the desired charter amendment.

Furthermore, using the power to replace directors in order to get the desired charter amendment would itself be hindered by the fact that, in most publicly traded companies, the board is classified, with only a third of its members changing each annual election. Confronting a classified board, a challenger team would be unable to fulfill a promise to initiate the charter amendment without winning not one election but rather two consecutive elections, separated by a year during which the board would have a dissenting minority. The common presence of staggered boards thus further widens the extent to which boards can depart from shareholders' wishes without fearing replacement.

Similarly, the power of shareholders to veto fundamental corporate changes does not enable them to have their way. To begin with, such power does not enable shareholders to effect a fundamental change – whether a dissolution, merger, or charter amendment – in cases where 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 for them their preferred outcome within this set. To the contrary, management's power to initiate a change and bring it to an up-or-down shareholder vote would enable it to get the change within this set that is most preferred by management.

After thus concluding that shareholders' power to intervene could make a difference in corporate outcomes, I turn in Part IV to discussing the potential benefits that could flow from granting such power. The discussion in Part IV is organized around the three categories of major corporate decisions for which intervention power is proposed. While I believe intervention power is desirable in each of these three categories, the choice is



not limited to having intervention power in all of them or none of them; readers may conclude that they support such power for some of these decisions but not for others. What the three categories have in common is that they all involve decisions that are sufficiently important so that shareholders might realistically wish to use their intervention power. Furthermore, granting shareholders the power to intervene in the decisions in each of these categories is likely to address substantial distortions and inefficiencies.<sup>5</sup>

One category consists of “rules-of-the game” decisions – decisions to amend the corporate charter or to reincorporate in another jurisdiction. These are “constitutional” decisions that affect the corporate governance arrangements to which the company will be subject. Without shareholder intervention power, management’s monopoly over initiating such changes might well lead to inefficient corporate governance arrangements. Giving shareholders the power to intervene in this area can produce, in one stroke, a substantial improvement in the quality of corporate governance arrangements over time.

Thus, a change in the basic rules insulating management from shareholder intervention would by itself ensure that the arrangements governing any other corporate law issue do not considerably depart from the ones desired by shareholders. A main reason for why corporate governance failures need to be addressed by corporate law reform, as recent legislation has done, is that shareholders in large, publicly traded companies lack the power to intervene and change existing arrangements. With shareholder power to intervene, desired changes can be expected to occur commonly

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<sup>5</sup> In presenting the case for an alternative regime with broad powers of intervention for shareholders, I build on some of my earlier papers that endorsed or raised the possibility of permitting shareholders to intervene in some particular matters. These papers, however, did not attempt to provide an analytic framework for assessing shareholder power to intervene in a broad set of corporate decisions. These early works include Lucian Bebchuk and Allen Ferrell, “A New Approach to Takeover Law and Regulatory Competition,” 87 *Virginia Law Review* 111-164 (2001); Lucian Bebchuk and Assaf Hamdani, “Vigorous Race of Leisurely Walk: Reconsidering the Competition Over Corporate Charters,” 112 *Yale Law Journal* 553-615 (2002); Lucian Bebchuk and Oliver Hart, “Takeover Bids vs. Proxy Fights in Contests for Corporate Control,” Harvard Olin Discussion Paper No. 336 (2001); William W. Bratton and Joseph McCahery, “Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation,” 73 *North Carolina Law Review*; Bernard S. Black, “Is Corporate Law Trivial?: A Political and Economic Analysis,” 84 *Nw. U. L. Rev.* 542 (1990); John C. Coffee, Jr. “The Future of Corporate Federalism: State Competition and the New Trend toward De Facto Minimum Standards,” 8 *Cardozo L. Rev.* 759, 774-77 (1987).

without such outside legal intervention. For example, shareholders concerned about recent governance failures would be able to effect, should they wish to do so, charter amendments that improve the process by which executive pay is set, require separation between the CEO and chair of the board positions, strengthen the independence of directors or auditors, and so forth.

A second category is composed of “game-ending” decisions – decisions to merge, sell all assets, or dissolve. In the absence of shareholder power to intervene, management might have an excessive tendency to reject attractive opportunities to merge, sell, or dissolve because termination will end its control over the independent company. Providing shareholders with the power to make such decisions would provide a clean mechanism for addressing this problem. Furthermore, this power can be designed in such a way that, while management would lack the power to block termination decisions favored by shareholders, it would still be able to engage in bargaining with potential buyers.

The third category of decisions that I will discuss as possible candidates for intervention power is composed of “scaling-down” decisions – decisions to contract the size of enterprise under the management’s control by ordering a cash or in-kind distribution. With intervention power, shareholders would be able to remove excess cash or assets and prevent excessive empire building. Such power would address the problems of free cash flow and empire building that have much occupied financial economists and corporate scholars over the last two decades. Indeed, these problems have been viewed as sufficiently severe to motivate the use of highly leveraged structures. As will be shown, shareholder intervention power would address these problems more effectively and with lower costs than debt can.

Part IV also discusses how intervention power can best be designed and why it is likely to be effective and practically important. Should such power be granted to them, shareholders can be expected to use it whenever management departs from their wishes in a sufficiently substantial way on important subjects. More importantly, the main benefits of the power would lie in discouraging management from such departures to begin with. That is, the very existence of this power can considerably improve corporate governance without the power being much exercised in fact. It is also possible to design a regime of intervention power in a way that would suffer little from nuisance and opportunistic proposals and that would facilitate counter-proposals to ensure that the best outcome is generally attained.

Part V and Part VI turn to examining potential objections to granting shareholders the power to intervene. I attempt to examine the full range of possible arguments that can be made against shareholder intervention. After reviewing all the arguments that have been made in the literature as well as others that could be made, I conclude that these arguments, either individually or in combination, are hardly compelling.

Part V examines claims that having the power to intervene would in fact hurt shareholders rather than benefit them. The existence of such power, the argument goes, would produce substantial costs that would make it overall undesirable. On this view, shareholders would be better off if their hands were tied.

To begin, it can be argued that, because management has superior information, shareholders would be better off if management always makes corporate decisions. Providing shareholders with the power to intervene, however, hardly implies that management's information would be unused. Management could still communicate its information, or at least its recommendation, to the shareholders. Shareholders would intervene only in those occasions in which they conclude that it would be desirable to do so notwithstanding directors' superior information. Denying shareholders the power to intervene implies that, instead of letting shareholders decide whether to defer to management, deference is mandated. In today's capital markets, such paternalistic "hand-tying" is unlikely to benefit shareholders. Mandated deference should not be expected to produce for shareholders better results overall than letting shareholders decide for themselves whether to defer. It therefore may well be undesirable to compel them to defer to management.

Second, it can be argued that consistency in decision-making requires that shareholders leave decisions to management for reasons similar to those that counsel against back-seat driving. This argument, however, is inapplicable to game-ending decisions. Such decisions should be analogized not to back-seat driving but rather to decisions to sell the car, terminating the driver's hold on the wheel. Furthermore, decisions in the rules-of-the-game and scaling-down categories are often separable from those concerning management of existing operating assets. As a result, considerations of consistency in decision-making have limited force with respect to these two categories of corporate decisions as well. In any event, giving shareholders the power to intervene just implies that these considerations would get whatever weight shareholders would find appropriate.

Addressing claims that intervention power would produce disruptive social choice cycling, I show that such cycles are unlikely to present a significant problem and can in any event be addressed within a regime of intervention. As for objections that companies would privately adopt such a regime if it were value-enhancing, I point out that adopting such a regime is largely precluded by the laws of most state corporate law codes, and that in any event IPO firms can hardly be expected to adopt arrangements that are unconventional and radically different from those in use. I conclude that none of the objections considered provides a basis for denying shareholders the power to intervene.

Finally, Part VI examines arguments based on the protection of non-shareholder constituencies. Even assuming that stakeholders should get some protection beyond what is accorded by their contracts, support for board control does not follow. Insulating the board from shareholder intervention would not be a good way to protect stakeholders. 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 unlikely to use its power to protect stakeholders. Therefore, those interested in stakeholder protection should seek arrangements tailored specifically to address this concern. Stakeholder concerns thus do not provide a good basis for expanding the discretionary power of management in the hope that this would somehow work to the benefit of stakeholders.

The analysis of the paper indicates that the current weakness of shareholders in U.S. companies with dispersed ownership is not a necessary product of the dispersion of ownership. The current power of management and weakness of shareholders is at least in part due to the legal rules in place that insulate management and preclude shareholders from intervening. Even given the existing patterns of ownership, 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 an influential view that views legal rules as partly responsible for the dispersed ownership in publicly traded companies.<sup>6</sup> According to this view, this dispersion of ownership, which weakened shareholders, was at least partly due to U.S. legal rules that prevented or discouraged the holdings of large blocks by financial institutions. As I show in this paper, even given

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<sup>6</sup> See Mark Roe, *Strong Managers, Weak Owners* (1994).

dispersed ownership, shareholder interests could have substantially more influence than at present. Thus, in addition to the rules that produce dispersed ownership, another set of rules plays a key role in making U.S. shareholders weak – the rules denying shareholders the power to intervene. Even with the existing patterns of ownership, introducing shareholder power to intervene would considerably change the balance of power between management and shareholders and thereby have profound and largely beneficial impact on corporate governance.

Before proceeding, I should stress that my aim in this paper is not to demonstrate to readers that the case for a regime of shareholder intervention is compelling. Rather, I seek only to convince them that such a regime is a plausible candidate for consideration. To this end, I aim to demonstrate the main problems with shareholder intervention, to outline an alternative regime, and to identify the potential benefits and design choices of such an alternative regime. This analysis, I hope, will provide a framework for subsequent discussion of a possible reallocation of power in publicly traded companies.

## 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 this principle is not a corollary of the nature of the modern corporation, Section B describes how the legal rules of the U.K. and some other common law countries, which also have a large number of publicly traded companies with dispersed shareholders, take a different approach.

### *A. U.S. LAW*

The corporate laws of both the U.S. and the U.K. start with the same basic principle: Even though they are the ones supplying the funds, shareholders do not necessarily have the power to order the directors to follow any particular course of action. Rather, the powers of shareholders are

determined by the corporate code and the company's constitution.<sup>7</sup> However, the U.S. and the U.K. differ in the regimes supplied by their codes.

Let us start with the U.S., whose approach can be viewed as managerialist. While the U.S. has different codes for different states, there are in fact many similarities among the different statutes, both in general and with respect to our subject in particular.<sup>8</sup> For concreteness, I shall focus below on the Code of Delaware—the most important corporate jurisdiction -- but the codes of other states have similar provisions.

The basic and long-standing principle of U.S. corporate law is that the power to manage the corporation is conferred on the board of directors.<sup>9</sup> The board's power, however, is not limited to the daily management of the corporation. The board also has significant power over major corporate decisions. In particular, this is the case with respect to three categories on which I will focus throughout this paper: rules-of-the-game decisions, game-ending decisions, and scaling down decisions. It is interesting to note that, as Section V. D will discuss in detail, the rules establishing a key role for the board in major corporate decisions are not ones from which companies are free to depart.

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<sup>7</sup> See *Automatic Self-Cleaning Filter Syndicate Co., Ltd. v. Cunninghame*, (1906) 2 Ch.34. (English case invalidating a vote by majority of the shareholders to sell the company); *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85 (1880) (New Hampshire case invalidating stockholder action directly appointing a nondirector manager); *Paramount Communications, Inc. v. Time*, 571 A. 2d 1140 (Del. 1989) (Delaware case validating actions by the board of directors despite the apparent opposition of a majority of the shareholders. For other cases holding that shareholders cannot order directors to take particular decisions, see *Continental Sec CO. V. Belmont*, 99 N.E. 138 (N.Y. 1912); *Associated Grocers of Alabama, Inc v. Willingham*, 77 F. Supp. 990 (N.D. Ala. 1948). It is also now well established that directors are free to disregard precatory shareholder resolutions that take place under the securities law. See *Speigel v. Buntrock*, 571 A. 2d 767, 775-76 (Del. 1990).

<sup>8</sup> See William J. Carney, "The Production of Corporate Law," 71 *S. CAL. L. REV.* 715 (1998); see also John C. Coffee, Jr., "The Future as History: The Prospects for Global Convergence of 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>9</sup> See Delaware General Corporation Law, § 141; Revised Model Business Corporation Act, § 8.01; California Corporation Code, § 300; New York Business Corporation Law, § 701. See Jeffrey Gordon, "Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law," 60 *U. Cin. L. Rev.* 347 (1991); Lynne Dallas, "The Control and Conflict of Interest Voting Systems," 71 *N.C. L. Rev.* 1 (1992).

## *1. Rules-of-the-Game Decisions*

“Rules-of-the-game” decisions are decisions concerning the rules by which corporate players play. The corporate 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.

The rules governing charter amendments are similar to those governing termination decisions. Such amendments require shareholder approval by a majority of the outstanding stocks, but voting can take place only on proposals brought by the board of directors. Shareholders cannot initiate charter amendment proposals and bring them to a vote.<sup>10</sup>

As for the state of incorporation, no state statute explicitly sets forth a procedure for reincorporating in other states. Reincorporation is generally accomplished by merging the corporation into a shell corporation incorporated in the desired new state of incorporation. Since state statutes allow for merger with a corporation incorporated in another state, it is possible to create a company that is identical in every respect but is simply incorporated elsewhere. As reincorporating takes procedurally the form of a merger, the rules governing merger decisions apply. Thus, under Delaware law, reincorporation requires a shareholder vote of approval, but only the board can initiate such a vote.<sup>11</sup>

Finally, it is worth noting that, under current rules, shareholders have the concurrent authority with the board to amend the company’s by-laws.<sup>12</sup> The by-laws, however, are subordinate to the charter and cannot alter any of the arrangements set in the charter. Thus, surprisingly, while shareholders have power to intervene in second-order rules, they are denied the power to intervene in high-level rules.<sup>13</sup>

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<sup>10</sup> See, e.g., Delaware General Corporation Law, § 242(b); Revised Model Business Corp. Act. § 10.03; N.Y. Bus. Corp. Law § 803 (a).

<sup>11</sup> See *supra* Subsection A.1.

<sup>12</sup> See Delaware General Corporation Law, § 109; Revised Model Business Corp. Act. § 10.20; N.Y. Bus. Corp. Law § 601.

<sup>13</sup> For example, it is generally expected that, when the issue gets to the Delaware courts, they will decide that shareholders cannot through by-laws limit the powers managers have to adopt and use poison pills. See Lawrence Hamermesh, “Corporate Democracy

## 2. Game-Ending Decisions

By “Game-ending” decisions I will refer throughout to termination decisions that will bring to an end the existence of the company and/or its business. This category thus includes merger and consolidation decisions, as well as dissolution decisions and decisions to sell all assets.

Shareholders generally have a say in termination transactions, which usually require a vote of approval by a majority of the outstanding shares. But the power granted to shareholders is only a veto power. Shareholders lack the power to *initiate* termination decisions. No matter how much they want it, shareholders cannot force management to consider a termination decision. Shareholders’ role is a passive one: they can block a termination decision initiated by management, but they cannot compel management to proceed with a termination or even to consider a termination.

Under Delaware law, the first step in a merger or consolidation transaction must be the approval of a merger agreement by the board. After such approval, the merger agreement is brought to a vote of the stockholders at an annual or special meeting and must receive approval by a majority of the outstanding stock.<sup>14</sup> Delaware law does not permit shareholders to initiate merger transactions by submitting them for approval by the board or even by a shareholder meeting. Delaware law applies similar arrangements to both liquidation decisions and decisions to sell all corporate assets.<sup>15</sup> Indeed, the Delaware code specifically authorizes the board to abandon a merger or a proposed sale of assets that received prior approval from the shareholders.<sup>16</sup>

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and Stockholder-Adopted By-Laws: Taking Back the Street?”, 73 *Tulane Law Review* 409 (1998).

<sup>14</sup> See Delaware General Corporation Law, §251(a), (b).

<sup>15</sup> See Delaware General Corporation Law, §271(a), (asset sale), §275 (dissolution). In theory, Delaware grants shareholders some initiative power regarding dissolution, but such initiation requires unanimous written consent which is of course not feasible for publicly traded companies. See Delaware General Corporation Law, § 275(c).

<sup>16</sup> See Delaware General Corporation Law, §271(b). 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.” Section 251(d) allows the parties to the merger agreement to authorize the board to abandon the merger notwithstanding its approval by stockholders.



### 3. *Scaling-Down Decisions*

A third important category includes decisions to distribute value to shareholders, thus scaling down the scope of the company. Distributions can be made in cash or in kind (for example, in the stock of a subsidiary in the case of a spin-off). Under Delaware law and the law of other states, the power to declare dividends is granted exclusively to the board, and no shareholder approval is required.<sup>17</sup> With respect to dividend decisions, shareholders lack not only initiative power concerning dividends but also the veto power they have over termination decisions. Dividend decisions are viewed as matters fully reserved for management's business judgment, and courts are not willing to subject dividend decisions to judicial scrutiny.<sup>18</sup>

The view underlying this approach is that decisions on dividend policy do not represent the kind of fundamental change that calls for shareholder veto. 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. They view such decisions as belonging to the core area where deference to the business judgment of management is warranted.<sup>19</sup>

#### *B. The Different Approach of Other Common Law Countries*

This section briefly discusses the different approach adopted by other common law countries. My aim is not to conduct an exhaustive comparative survey. Rather, before I begin the policy analysis, I seek to demonstrate that the managerialist approach of U.S. corporate law is not an inevitable element of the structure of the modern corporation. While this approach is settled and little contested in the U.S., alternative approaches to the allocation of power between shareholders and management should not be ruled out.

I will focus on the rules of English-speaking, common law countries. These countries share with the U.S. a common legal tradition. Furthermore,

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<sup>17</sup> See, e.g., Delaware General Corporation Law, § 170.

<sup>18</sup> Indeed, in the last century, there has not been a single case in which U.S. courts have ordered a management-controlled, publicly traded corporation to increase its dividends. See Merrit B. Fox, *Finance and Industrial Performance in a Dynamic Economy* 375 (1987).

<sup>19</sup> See Kamin vs. American Express; Victor A. Brudney, "Dividends, Discretion, and Disclosure," 66 *Virginia Law Review* (1980).

like the U.S., some of these countries, especially the U.K. and Australia, have a large number of publicly-traded companies with dispersed ownership,<sup>20</sup> and these are the companies for which the subject under consideration is important.

As in the U.S., shareholders in the U.K. do not have unlimited power, but only the powers granted to them by law and the corporate charter.<sup>21</sup> Still, U.K. law provides shareholders with greater power than U.S. law and, in particular, provides them with some power of intervention.

To be sure, U.K. companies are also run in the ordinary course of events by their boards. The default arrangement, which is provided by model provisions of the article of association supplied by the Companies Act, prescribes that the business of the company shall be managed by the directors. This management, by the board, however, is subject to “any directions given by special resolution” of the shareholders.<sup>22</sup> According to the Companies Act, shareholders always have the residual right to adopt through a special resolution any change in the articles of association and any corporate decision. A special resolution requires a majority of 75%, but this is a majority of 75% of the votes cast at the meeting rather than all the votes that shareholders are entitled to cast.

Shareholders have a common law right to propose resolutions at an annual shareholder meeting.<sup>23</sup> Shareholders wishing to exercise this right are only required to give notice to shareholders of such proposals and to bear the cost of notice.<sup>24</sup> Furthermore, the company must always call a special meeting when requested by shareholders holding 10% or more of the company’s shares.

The relevant statute in Australia adopts a default rule under which all management powers are given to the board subject to the constitution of the company, which may be amended by a special shareholder resolution.<sup>25</sup> Thus, shareholders can opt out of a regime under which only the board exercises management powers and grant themselves greater control over the

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<sup>20</sup> LaPorta et al., “Law and Finance,” *Journal of Political Economy* (1998).

<sup>21</sup> See *Automatic Self-Cleaning Filter Syndicate Co., Ltd. V, Cunninghame*, (1906) 2 Ch. 34.

<sup>22</sup> Article 70, Table A, The Companies Act 1985.

<sup>23</sup> See John F. Farrar et al., at 322.

<sup>24</sup> See Companies Act 1985, sections 376 & 377.

<sup>25</sup> Replaceable Rule 226A and Section 135(2) to the Corporations Law, 1991.

management of the corporation.<sup>26</sup> Furthermore, shareholders always have the inalienable right to make any corporate decisions by adopting a special resolution with the required 75% majority. Other common law countries follow a similar approach.<sup>27</sup>

To be sure, these common law countries still have some preference for shareholder action through replacing the board. U.K. special resolutions, for example, require a majority of 75% of the vote, whereas replacing the board requires only a simple majority. But all of these countries provide some power of intervention despite the fact that, unlike the case in most U.S. companies, shareholders in their companies can quickly replace all the directors. The different approach of these common law countries clearly indicates that moving away from strong board control is not inconceivable. With this in mind, I now turn to evaluating the policy arguments.

### III. THE LIMITS OF SHAREHOLDERS' EXISTING POWERS

#### *A. Preliminary Remarks on the Policy Question*

Before proceeding to examine the arguments for and against shareholder power of intervention, several preliminary observations are worth making. To begin, the starting point of my analysis is that, in publicly traded companies with dispersed ownership, management's interests do not fully overlap with those of shareholders and, as a result, agency costs might arise.<sup>28</sup> There are, of course, factors that lead management to care about shareholder interests, from executive compensation schemes to the inherent trustworthiness and integrity of directors.<sup>29</sup> And one who believes that these

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<sup>26</sup> Note that Section 136(3) authorizes the corporate constitution to specify additional requirements, beyond the requirement of a special shareholder resolution, for its own amendment. This makes the Australian regime fully enabling.

<sup>27</sup> Both Canada and New Zealand adopt a very similar approach to the Australian one. For example, Section 128(1) of the Companies Act of New Zealand states that the board shall manage the business and affairs of the company. Section 128(3), however, subjects the board's management power to any provisions found in the company's memorandum, articles of association, or constitution.

<sup>28</sup> See Michael C. Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," 3 *Journal of Financial Economics* 305 (1976).

<sup>29</sup> For a discussion of how executive compensation works to provide some alignment between management and shareholder's interests), see Marcel Khan and Edward B.

factors lead to perfect aligning of interests between management and shareholders should, of course, have no interest in shareholder power of intervention or any other measure seeking to improve corporate governance.

The assumption underlying this work, as well as much of the work in the corporate governance area, is that these factors are not sufficient to eliminate all agency problems. Given the existence of agency problems, it is desirable to have rules in place that would aim at reducing agency costs as much as possible. From this perspective, the case against shareholder intervention should not be based on ignoring agency problems. Rather, it should be made by showing that such problems are best addressed by a regime without shareholder intervention.

Second, it is worth keeping in mind that, in certain contexts, those who own assets that are managed by someone else generally have the power to intervene. If the owner of, say, a building in Seattle were to hire a manager-agent to run the property, the owner would have, under the established principles of agency law, the power to intervene from time to time, instructing the manager to take a certain course of action (or inaction).<sup>30</sup> To be sure, the building's owner might often elect not to intervene, believing that the Seattle manager is better informed. There is no question, however, that in those instances in which the owner elects to intervene and instruct the manager how to act, the manager will not be able to ignore the owner's instructions. Although the owner might make decisions that will prove regrettable, the owner has the full legal power to determine what its interests are and what course of action would further them.

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Rock, 69 *U. Chi. L. Rev.* 871 (2002). For discussion that take the view or assume that directors can be trusted to do what is good for shareholders, see Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 *Nw. L. Rev.* (2002); Stephen M. Bainbridge, "Director Primacy in Corporate Takeovers," 55 *Stanford Law Review* (2002); Mark Gordon, "Takeover Defenses Work. Is that such a Bad Thing?" 55 *Stanford Law Review* (2002).

<sup>30</sup> This principle is a long-standing one. "The agent has a duty, at all times, to obey the directions of his principal, even though the principal may have initially indicated he would not give such additional instructions" W. Sell, *Agency* 2 (1975). "[I]t is the duty of the agent to respond to the desires of the principal... even if the principal is guilty of a breach of contract by interfering, the agent will still commit a breach of duty by acting in a manner opposed to his principal's wishes." H. Reuschlein & W. Gregory, *Agency and Partnership* 11-12 (1979).

In the case of corporate managers, however, the law has chosen to take a different approach.<sup>31</sup> Unlike the owner of the Seattle building, shareholders cannot instruct managers to sell the assets (they can only veto an initiative of management to sell the assets) or distribute the cash produced by the assets rather than reinvest it. The question, then, is whether taking such a different approach in the case of corporate managers is warranted. Thus, in examining below the arguments for management control, it will be helpful to consider whether they have greater force in the corporate context than in other contexts in which assets are managed by someone other than their owner.

Third, it is worth noting at the outset that shareholder nonintervention is not required in order to obtain the benefits of centralized management. As Dean Clark stressed in his classic text on corporate law, centralized management is a beneficial feature of the modern public corporation.<sup>32</sup> Dispersed public shareholders would be better off remaining largely passive and having the company run by the management. However, granting shareholders the power to intervene is not proposed in order to replace centralized management with shareholder management. Rather, the suggestion is to supplement centralized management with a power to intervene that can be expected to be used, at most, occasionally and to remain in the background most of the time.

As will be discussed, the case for shareholder intervention is based on the value to shareholders of having this “weapon of last resort” which could benefit them both in the rare instances in which it would be actually used and, more importantly, in the instances in which its mere existence would induce management to act in shareholders’ interests. Thus, given that shareholders will not constantly use the power to intervene should it be granted, proponents of nonintervention must explain why shareholders should be absolutely deprived of the power to ever intervene.

With these preliminary observations in the background, let us now turn to a policy evaluation of the power to intervene. The decisions with respect to which such power might be worth considering are those that are of relatively substantial importance to shareholders. It is only with respect to

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<sup>31</sup> As Dean Clark remarks: “[T]he relationship between shareholders and directors is not well described as being between principals and agents.” Robert Charles Clark, *Corporate Law* (1986), at 22.

<sup>32</sup> See Clark, *Corporate Law*, at 21-24.

such matters that shareholders can plausibly be expected to have sufficient incentive to initiate and vote over management's opposition.

The subsequent Sections of this Part consider arguments that, at least with respect to such key decisions, shareholder power to intervene is not necessary to ensure that they are made in accordance with shareholder preferences. Whenever shareholders have a clear preference for a certain important corporate decision, the argument goes, the existing powers of shareholders are sufficient to ensure that management will make the decision favored by shareholders. On this view, management cannot be expected to stray from shareholders' wishes because such straying would be prevented by shareholders' powers to replace directors and veto fundamental corporate changes. Below, I consider each of these two basic powers in turn, and I explain why they are insufficient (separately as well as in combination) to ensure that shareholders generally have their way on issues of importance to them.

## *B. The Power to Replace Directors*

### *1. Elections and Decisions*

The strongest and most important mechanism that arguably could ensure that shareholder interests are served is the shareholder franchise—the power of shareholders to elect the directors. This fundamental power is one that corporate statutes provide<sup>33</sup> and that courts strongly protect.<sup>34</sup>

The shareholder franchise undoubtedly pushes management in the direction of serving shareholder interests. And it might be argued that the power to replace directors can indeed ensure that shareholders have their way with respect to all matters that are significant to them and on which they have clear preferences. If management does not follow shareholder preferences with respect to such matters, the argument goes, then shareholders will replace the management team with one that will do so. Furthermore, shareholders' power to replace management will ensure that management generally heeds shareholders' preferences to begin with, making replacement unnecessary. Thus, on this view, even if actual replacement of the current directors happens infrequently, the power of shareholders to

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<sup>33</sup> See, e.g., Delaware General Corporations Law, Sections 211-212.

<sup>34</sup> See, e.g., *Blasius Industries v. Atlas Corp.*, 564 A. 2d 651 (Del. Ch. 1988).

cause such replacement will have a forceful effect on management and generally induce it to follow shareholders' preferences.

According to the above argument, the power to replace management will have an effect with respect to all issues of importance to shareholders—the very issues for which intervention power is a meaningful possibility. On such matters, it is argued, a management team straying from shareholder interests would meaningfully increase its chances of ouster, which would strongly discourage such straying. Thus, even if the power to replace management cannot guarantee that shareholder interests will be served on issues of little significance for shareholders, this power can be expected to ensure that shareholder interests will be served on those matters for which allowing direct action is a serious alternative. This expected outcome, the argument concludes, makes shareholder intervention power wholly unnecessary.

In considering this argument, it is first worth noting that it is equally applicable to other contexts in which owners of assets do have the power to direct management's decisions. In the example of the Seattle building, the owner might well have the right to replace the building manager, but the law still provides the owner with the residual power to intervene, and contracts made by owners with managers are not expected to limit this power. The law presumably does not view the owner's power to replace the manager (or threat to do so) as making the power to intervene wholly redundant. As explained below, the power of public investors to replace managers in the corporate context may be especially insufficient to ensure that shareholders' preferences guide all important corporate decisions.

## *2. The Problem of Bundling*

To start with, owners in general—and the shareholders of a publicly-traded company in particular—might wish not to have management replaced, but rather to have management act differently with respect to a particular issue. In the Seattle building example, the owner might be generally pleased with the performance of the building manager but wish to have the manager act differently on a certain matter—say, to pass on the accumulated rents to the owner rather than invest them in a large renovation project or in purchasing neighboring properties. In such a case, the owner's power to replace the agent might be a cumbersome and possibly ineffective way for the owner to get its way. Because the owner does not wish to replace the

manager, using the replacement threat to induce the manager to act as the owner wishes might be ineffective (lacking in credibility) or counterproductive (leading to actual replacement). The owner's power to intervene and order a certain action might provide the most straightforward and effective way for getting the manager to send the accumulated funds rather than invest them.

Such bundling situations clearly arise also in the corporate context.<sup>35</sup> Suppose that the shareholders of a company view existing management as the best team for running the company's core assets, believing it can produce \$X more in expected revenues than rival teams with uncertain quality and less experience. Suppose also that the shareholders further believe that, for self-serving reasons, the managers do not wish to take a certain action A (say, initiate a given value-increasing charter amendment or effect a certain value-increasing spin-off of a division) that would produce a benefit of \$Y. In this case, the shareholders' most preferred outcome would be to have both current management at the helm and the action A taken. And if shareholders could order management to take action A, they would immediately attain their preferred outcome.

In contrast, without a power to intervene, it is far less certain that shareholders could ensure that A be taken. To be sure, if management refrains from taking action A, there is the possibility – but not the certainty – that a challenger team might emerge and run a proxy fight, seeking to gain shareholder support by promising to take action A if it gains control of the board. Such a proxy contest will not automatically provide the shareholders with the option they most prefer. It will provide shareholders only with the choice between (i) having their assets managed by the existing (best) management but not having action A, and (ii) having action A taken but having their assets managed by the (inferior) new management.

Suppose first that the benefits from action A are viewed by the shareholders as lower than the advantage of having current management run the company's core units. In this case, a challenger's promise to take action A will not be sufficient to induce the shareholders to vote for the challenger. Assuming that management recognizes this to be the case, the threat of a proxy contest or even the launching of such contest will not be sufficient to

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<sup>35</sup> Cf. Gordon, "Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice," 76 *California Law Review* 3 (1989) (examining how bundling can lead to undesirable mid-stream adoption of dual-class).



push management to take action A. Management will refrain from taking action A, because management will know it will be able to remain in office even without taking this action.

Suppose next that the benefit from action A is viewed by shareholders as larger than the advantage of current management remaining in charge. In such a case, if the existing management does not recognize the intensity of shareholder preferences, a proxy contest will be able to succeed and the challenger team promising to take action A will gain control. In this case, the shareholders will again not secure their most preferred outcome—they will get action A but without their preferred management team.

There remains the case in which action A is sufficiently important to induce voting for a challenger and in which management recognizes the danger. In this case, the threat of ouster might lead management to change its ways. Nonetheless, even in this case, the outcome most preferred to shareholders might well not be attained. Suppose that the action A is “divisible” in that a more “moderate” version of it can be undertaken. In this case, management will be induced to go in the direction of A up to a point that would be sufficient to make shareholders prefer to stay with current management. Because shareholders prefer to have the assets managed by the current management rather than by the challenger team, management would not need to fully match the challenger’s promise to adopt A—going part way might be sufficient to win the contest. Thus, even in this case, shareholders’ power to replace management, although inducing management to move in the direction desired by shareholders, would not be sufficient to secure the outcome most preferred by shareholders.

### *3. The Chrysler Example*

To emphasize the potential problems produced by the bundling of decisions and management teams, it might be useful to illustrate them with a concrete example. To this end, let us consider Kirk Kerkorian’s well-known campaign to get Chrysler to distribute its cash hoard to shareholders.<sup>36</sup> In

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<sup>36</sup> The account below is based on various Wall Street Journal articles: “York May Try a proxy Fight for Chrysler,” *WSJ*, Sep 12, 1995, at A3. “Playing the Odds; Why Kirk Kerkorian Has a (Slim) Chance to Win over Chrysler,” *WSJ*, Sep. 15, 1995, at A1; “Kerkorian’s Deals Have Often Drawn Fire,” *WSJ*, Octo. 26, 1995, at C1; “Chrysler Boosts Quarterly Payout; Move Could Mute Kerkorian’s Criticism,” *WSJ*, Dec 8, 1995, at A4; “Chrysler Board Seat is Non-negotiable to Avert Proxy Fight from Kerkorian,” *WSJ*, Jan

1995, Kerkorian held (through a company named Tracinda) approximately 14% of Chrysler's shares. At the time, Chrysler had a cash hoard of approximately \$7 billion. Management favored maintaining such large reserves, claiming that the company needed to maintain them in order to be prepared for the next economic downturn. Kerkorian tried to push management to distribute the cash reserves to shareholders and started a proxy contest for this purpose.

According to media accounts from that period, most market participants believed that distributing all or most of these reserves would be value-maximizing. The widespread support among shareholders for distributing the cash reserves, however, did not guarantee Kerkorian a victory in the proxy contest event because of a bundling problem. The proxy contest was not expected to present shareholders with a "pure" choice between having and not having the cash distributed. It would have bundled this choice with the choice between having the existing team or Kerkorian's team manage the company's assets.

According to newspaper accounts, Chrysler's management was generally regarded as having had done a very good job running the company and making it a "financial and operational success."<sup>37</sup> In contrast, Kerkorian's past record—one money manger referred to him as "the most self-serving guy ever to happen on the scene"<sup>38</sup>—made some shareholders rather uneasy about having him in control of the company's operations. A shareholder who viewed Chrysler's management as sufficiently superior operationally to Kerkorian's team could have been expected to vote against Kerkorian even if the shareholder wished to have the cash hoard distributed.

The problem was that many shareholders appeared to favor (i) the existing team in terms of operational management, but also (ii) Kerkorian's

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13, 1996, at B3; "Accord Gives Investor Board Representation, Bars Takeover Moves," *WSJ*, February 9, 1996, at A3;" Chrysler Declares 2-for-1 Stock Split and Increases its Dividend by 17%," *WSJ*, May 17, 1996, at B3.

<sup>37</sup> "Why Kirk Kerkorian Has a (Slim) Chance to Win over Chrysler," *WSJ*, Sep. 15, 1995, at A1; "Kerkorian's Deals Have Often Drawn Fire," *WSJ*, Oct. 26, 1995, at C1. Indeed, even Jerome York, Kirk Kerkorian's chief strategist, conceded that Chrysler was "well run operationally" but that there was "untapped value there." See York May Try a Proxy Fight for Chrysler, *WSJ*, Sep 12, 1995, at A3.

<sup>38</sup> "Kerkorian's Deals Have Often Drawn Fire," *WSJ*, Oct. 26, 1995, at C1.

proposal regarding the single issue of distributing cash to shareholders.<sup>39</sup> Such shareholders would have been happy to vote for distributing funds, if they could do so without supporting Kerkorian's management of the remaining operations. But this was not an option that the proxy fight provided.

Indeed, even though Kerkorian had a significant amount of stock himself, and even though he championed a course of action that was seemingly favored by many shareholders, his chances of winning a proxy contest were viewed by observers as "slim."<sup>40</sup> Eventually, after a protracted process, and facing an uphill battle in the proxy fight, Kerkorian reached a compromise with Chrysler's management. Under the accord reached between Kerkorian and Chrysler, Kerkorian withdrew the proxy challenge and Chrysler increased its annual share repurchase program significantly—moving in the direction advocated by Kerkorian but to an extent that fell substantially short of what Kerkorian sought.<sup>41</sup>

For the purposes of the present analysis, it is not necessary to form a judgment on whether the distribution of the cash hoard sought by Kerkorian was value-maximizing and favored by most shareholders. What is important is just to recognize that, assuming this had been the case, the possibility of running a proxy contest might well have been insufficient to secure such an outcome. Certainly Kerkorian himself thought this was the case since otherwise he would not have compromised. The story of Kerkorian and Chrysler thus illustrates how, due to the bundling of desired management decisions with the choice of management team, the threat of a proxy fight is

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<sup>39</sup> See "Why Kirk Kerkorian Has a (Slim) Chance to Win over Chrysler," *WSJ*, Sept. 15, 1995, at A1. This was, for example, the view of a representative of the Vanguard group, which held approximately 4% of Chrysler's stock, who spoke with the *WSJ*.

<sup>40</sup> "Why Kirk Kerkorian Has a (Slim) Chance to Win over Chrysler," *WSJ*, Sept. 15, 1995, at A1.

<sup>41</sup> See "Accord Gives Investor Board Representation, Bars Takeover Moves," *WSJ*, February 9, 1996, at A3; "Chrysler Declares 2-for-1 Stock Split and Increases its Dividend by 17%," *WSJ*, May 17, 1996, at B3. The accord that Chrysler reached with Kerkorian and which led to the withdrawal of Kerkorian's challenge was described as "accommodating several of [Kerkorian's] claims." In particular, Chrysler said it would double its 1996 share-repurchase and committed to buy back another \$1 billion in 1997. Kerkorian's camp conceded that it failed to win Chrysler's agreement to make annual repurchases of \$2 billion for the foreseeable future.

hardly sufficient to secure fully the corporate decisions that are most favored by shareholders.<sup>42</sup>

#### *4. Impediments to Replacing Directors*

In the corporate context there is an additional limitation, absent in the ordinary case of assets not managed by their owners, on the ability to use the power to replace management to induce it to take the decisions desired by shareholders. In the Seattle building example, the default arrangement would permit the owner to replace the manager at will. To be sure, the owner might be contractually obligated to compensate the fired manager. Still, should the manager refuse to carry out some action desired by the owner, the owner would be able to quickly replace the manager with someone who would do so. In publicly-traded companies, however, the arrangement governing board elections often precludes shareholders from replacing management without much delay.

Indeed, in the corporate context, shareholders very often cannot vote to replace directors immediately. This would be possible only in those companies in which shareholders have the power to call a special meeting or act by written consent and in which the board is not staggered. When shareholders do not have the power to call a special meeting or to act by written consent, they will have to wait at least until the next meeting and, if the board is staggered, at least until the annual meeting after next, which might be two years down the road. Indeed, most U.S. companies have

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<sup>42</sup> Another example of bundling, also with respect to “scaling-down” decisions, is that involving Carl Ichan and USX and discussed by Jeffrey Gordon. See Jeffrey Gordon, “Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law,” 60 *U. Cin. L. Rev.* 347 (1991). In 1990, Ichan had 13% of the shares of USX and was trying to prod it into separating its oil and steel business by spinning off the steel company or most of its shares. Ichan undertook a proxy fight on the basis of this plan 1991 and ended it after reaching a compromise arrangement with management under which the steel unit would not be spun off but would be a separate subsidiary with a separate class of USX stock. In that case, where Ichan’s view did not seem to have majority support, the non-binding shareholder resolution he proposed was narrowly defeated. The important point, however, is that even if Ichan’s position in favor of a spin-off had been supported by a majority of the shareholders, this would not have guaranteed his victory in a proxy fight. Shareholders who wished to have a spin-off might have still been reluctant to have Ichan run the remaining oil business.

charters that would force shareholders to wait a significant period of time before they can vote management out.<sup>43</sup>

Whether it is desirable to limit substantially the power to replace managers is a question beyond the scope of this paper, and I leave it for another occasion. For our purposes, what is important is that, as long as this remains true for a large fraction of U.S. companies, it will substantially limit the extent to which shareholders' power to elect directors will enable them to have their preferences followed.

Suppose again that decision A is desired by shareholders but would not serve management's private interests. And, to put aside the problem of bundling, suppose that current management is viewed by shareholders as only marginally superior to a rival team. Would the power of shareholders to vote on the election of directors ensure that management is induced to adopt decision A right away? If the company has a staggered board, management would not be much threatened by a proxy fight by a challenger promising to adopt A. To begin with, shareholders might be discouraged from voting for the challenger by the knowledge that a victory by the challenger would involve some disharmony on the board for two years.

Furthermore, the challenger might not persevere for two elections. In any event, why would management capitulate to the challenger's demand now instead of waiting a while? Given that the issue might become moot or otherwise goes away in the meantime, waiting might well be management's preferred strategy. And the anticipation that a challenger might not win in the end if the issue becomes moot or goes way, and that at the minimum it would have to persevere for a long period, might discourage the initiation of a proxy contest to begin with.

### C. *Shareholders' Veto Power Over Fundamental Changes*

Another power that shareholders have is to veto fundamental corporate changes. Fundamental corporate changes—mergers, sales of all assets, charter amendments, and dissolutions—require a shareholder vote of approval. This veto power, it might be argued, can ensure that at least all

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<sup>43</sup> See Robert Daines and Michael Klausner, "Do IPO Charters Maximize Firm Value?: Antitakeover Protections in IPOs," 17 *J. L., Econ., & Org.* 83 (2001); John Coates, "Explaining Variation in Takeover Defenses: Blame the Lawyers," 89 *Cal L. Rev.* 1301 (2001); Laura Casares Field and Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, J. Fin. (Oct 2002).

decisions regarding fundamental corporate changes 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*

Shareholders have the power to *veto* fundamental changes rather than the power to direct that they be made. There is considerable difference between these two powers. Veto power ensures that there will be no fundamental changes that would make shareholders worse off compared with the status quo. This is a “negative” power to prevent any worsening of the shareholders’ situation. But this power cannot ensure that fundamental changes that would be superior to the status quo for shareholders would indeed take place. In particular, when such a change is desired by the shareholders but management prefers the status quo, shareholders’ veto power will not enable them to obtain their desired fundamental change.

Consider, for example, a Delaware company following the adoption of Delaware’s anti-takeover statute. The statute made it more difficult (or less profitable) for hostile takeovers to take place. The statute applied to all companies, unless they opted out by charter amendment. Suppose that, following the adoption of the act, the shareholders of a given company would have preferred a charter provision opting out of the antitakeover statute. Since the managers 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 have enabled them to obtain the desired charter provision.

### *2. Cases in which Management and Shareholders Prefer Change*

Let us now turn to cases in which both shareholders and managers prefer to make a fundamental change in the status quo. In such a case, a fundamental change that provides some benefits to shareholders might well take place, but it might not take the form that would best maximize shareholder value. Rather, from the set of possible improvements over the status quo, the selected choice will be very much influenced by the preferences of management. Indeed, if there is a set of possible changes that would be preferable to the status quo for both shareholders and managers, there is reason to expect that the one that will be selected will be the one most preferred by managers and *not* the one most preferred by shareholders.

Consider a situation in which there are three possible charter amendments – A, B, and C – and that each of these amendments is preferred over the status quo by both managers and shareholders. Suppose further that shareholders prefer A to B and B to C, and that management has the opposite ranking, preferring C to B and B to A. Clearly, the veto power that shareholders have over changes does not enable them to choose the identity of the charter amendment and to ensure that the one they prefer the most, A, will be selected.

Indeed, shareholders' preferences would have less influence than managers' preferences even in a case in which both management and shareholders had to accept a change and each side could make proposals to the other. In such a situation, both sides ostensibly would be symmetrically situated, and the preferences of both sides would possibly affect the selection of the particular arrangement to the same extent. In such a situation, the selected arrangement might be, for example, B – which is the second-best choice, not the best but not the worst – for each of the two sides.

In this case, the shareholders' effect on selection would be weaker than management's because the parties are in fact *not* symmetrically situated. In addition to having a veto power as shareholders do, management has the sole power to put proposals on the table that shareholders can only vote up or down without being able to amend them in any way. This power enables management to have a decisive say over the selection of an arrangement within the set of changes that both management and shareholders prefer. In the example under consideration, management might well be able to secure arrangement C, which is most favored by management and least favored by shareholders. If management proposes arrangement C, shareholders – facing a choice only between C and the status quo, which is inferior to C – can be expected to approve C.

It would be worthwhile to situate this point within the standard theory of bargaining. When the consent of both parties is needed, and when they both can make an offer to each other, it can be expected that they will both share in the surplus created by their joint consent. However, if one of the parties has the sole power to make take-it-or-leave-it offers to the other, the party with the power to make offers can be expected to capture all or most of the surplus produced by the parties' joint consent. In the context under consideration, the ability to capture most of the surplus is translated into the ability to choose among the set A, B, and C the arrangement most preferable to the side with agenda control. Given this understanding of bargaining and

surplus division, management and shareholders are not equal partners in the adoption of fundamental corporate changes. Management's control over the agenda makes it the much stronger partner and enables it to select which outcome would be chosen among the constraint of the set of outcomes that improve upon the status quo.

An example can illustrate the potential significance for corporate governance of management's agenda-setting power. Suppose that a company is incorporated in its home state H and that two states, A and B, are trying to attract incorporations from H-state companies. And suppose that, compared with the rules of H, both A and B offer a set of rules that are better for both shareholders and management. Suppose also that, compared with the rules of A, B's rules are favored by management and disfavored by shareholders because B offers certain "managerial" rules that enable some inefficient extraction of private benefits by management. In this case, the company can be expected to move to B rather than A. If management brings a proposal to move to B to a shareholder vote, the shareholders—recognizing that a move to B is still better than the status quo and that a move to A is not on the table—will approve the move. Furthermore, because management is able to secure reincorporation to the state offering the managerial rule, states interested in attracting reincorporations have an incentive to adopt this rule.<sup>44</sup>

### *3. Cases in which Shareholders Lack Veto Power*

For completeness, it should be noted that, while shareholders have veto power over game-ending decisions and rules-of-the-game decisions, U.S. corporate law does not grant them veto power over scaling-down decisions. The decision whether to make distributions in cash or in-kind are solely the prerogative of the board, which is free to make them without any need for shareholder approval.

This absence of veto power, however, is not a source of concern for shareholders in practice. Given that incumbents have an incentive to keep assets inside the company and not reduce the size of the empire, it seems plausible to assume that in cases in which even incumbents would choose to distribute assets, shareholders would not wish to oppose the distribution. This management tilt against distributions indicates that the problem for

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<sup>44</sup> See Oren Bar-Gill, Michal Barzuza, and Lucian Bebchuk, "The Market for Corporate Law," Harvard Olin Discussion Paper No. 377 (2002).



shareholders is not in the distributions that management elects to do but in those that it avoids. Thus, while this tilt suggests that shareholder veto power over distributions would not be of practical significance for shareholders, it also indicates that the power to initiate distribution could have such significance.

#### IV. THE POTENTIAL BENEFITS OF SHAREHOLDER POWER TO INTERVENE

The preceding Part has shown that shareholders' existing powers do not ensure that their preferences govern and thus do not make the power to intervene redundant. This Part discusses the potential benefits of intervention power in the context of the three categories of important corporate decisions for which this power is proposed. Sections A–C will discuss, in turn, rules-of-the-game decisions, game-ending decisions, and scaling-down decisions. Serious agency problems afflict each of these three sets of decisions. I show that granting intervention power can address each of these agency problems. Section D discusses the potential practical significance of the proposed regime and how it could be designed to operate most effectively by, among other things, inducing good proposals and minimizing the potential costs from nuisance and opportunistic proposals.

##### *A. Rules-of-the-Game Decisions*

###### *1. Issues Covered*

Rules-of-the-game decisions involve the choice of corporate governance arrangements to which a company will be subject. Such arrangements come from two main sources. First, some of these arrangements are provided by law, especially the corporate law of the state in which the company is incorporated. Second, some of these arrangements come from the company's charter. A corporation can change both types of arrangements -- by reincorporating in another state or by amending the company's charter. Under a regime of shareholder intervention, shareholders would be able to initiate, and approve by vote, both types of changes.<sup>45</sup>

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<sup>45</sup> As long as reincorporation requires merger with a shell corporation incorporated in another state, a proposal for reincorporation could take the form of a merger proposal.

## *2. Improving Corporate Arrangements*

With respect to rules-of-the-game decisions, the existing powers of shareholders to replace the board are especially ineffective. Although replacing the board is generally an uphill battle, it is conceivable that shareholders might be sufficiently interested in a termination or a scaling down that they would be willing to replace incumbent management with a new team in order to achieve such a result. However, while changes in rules of the game may be significant, in light of the bundling phenomenon they are unlikely to be of sufficient weight to enable a challenger to win a proxy contest on that basis alone. When shareholders view the incumbent team as generally doing a good job, it is unlikely that they would vote for a challenger team solely because of its promise to initiate some given charter amendment or reincorporation. For this reason, shareholder power to intervene in rules-of-the-game decisions can significantly improve corporate arrangements.

### *(a) Corporate Charters*

Corporations live in a dynamic environment. They need to adapt to changing conditions. Thus, the optimal set of corporate governance arrangements is likely to change over time. Accordingly, from time to time, shareholders may well be served by appropriate adjustments in the corporate charters.

Management's current control over charter amendments agenda distorts the evolution of charter provisions in favor of management. Changes that could increase shareholder value can be expected to be adopted if and only if they management also favors them. If a value-increasing change benefits management, it will be initiated by management and subsequently adopted. In contrast, if a value-increasing change would not benefit management, it will not be initiated.

The problem is of course more severe for mature companies that went public a long time ago. If a publicly traded company went public, say, 40 years ago, its charter is now composed of the provisions it contained when it went public, as amended over the years. Given that corporate circumstances and needs have changed markedly over the last 40 years (for example, due to the advent of institutional investors and the development of the takeover market), and that the process of adjustment over time is distorted as

discussed above, the current charter is unlikely to be the one most preferred by shareholders.

The above problems have led to suggestions that corporate law be designed in a way that counters the above distortion of the charter amendment process. First, it has been suggested that mandatory rules are desirable.<sup>46</sup> Second, short of adopting mandatory rules, it has been suggested that, as new circumstances arise, default corporate law should err on the side of arrangements less favorable to management because of the difficulty of opting out of arrangements favored by management. With management having control over charter amendments, if shareholders would like to reverse a default chosen by public officials, such reversal can be expected if management disfavors the default but not if management favors it.<sup>47</sup>

Taking as given the existing distortion in the charter amendment process, it is desirable for corporate law to follow the above approaches. But it might be better yet for corporate law to address the underlying problem by eliminating the underlying distortion in favor of management. Providing shareholders the power to intervene in rules-of-the-game decisions would do this. 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. They will no longer find themselves stuck with arrangements that they view as inferior but which they are powerless to change without management initiation. Plus, against this background, management will be more likely to initiate value-increasing amendments itself.

*(b) 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 when reincorporation in several different states could make both shareholders and management better off, the reincorporation will take place in the state most favored by management.

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<sup>46</sup> Lucian Bebchuk, "Limiting Contractual Freedom in Corporate Law: the Desirable Constraints on Charter Amendments," 102 *Harvard Law Review* 1820-1860 (1989); Jeffrey Gordon, "The Mandatory Structure of Corporate Law," *Columbia Law Review* (1989).

<sup>47</sup> Lucian Bebchuk and Assaf Hamdani, "Optimal Defaults for Corporate Law Evolution," 96 *Northwestern Law Review* 489-520 (2002).

The problem for shareholders is not limited to the actual decision whether to reincorporate, taking state law rules as given. The problem is that the distortion of reincorporation decisions provides adverse incentives to states seeking to attract incorporations.<sup>48</sup> Because management plays such a key role in reincorporation decisions, states have an incentive to provide rules that management prefers.

In some questions of corporate law, where the interests of shareholders and management sufficiently overlap, this incentive of states does not adversely affect shareholders. However, with respect to rules that have a substantial effect on management's private benefits of control, the incentive might lead states to offer rules that are excessively favorable to management. For example, the incentive might lead states to offer incumbents more protection from hostile takeovers than is optimal for shareholders. Indeed, recent evidence shows that adopting antitakeover statutes enables states to be more successful in the market for incorporations.<sup>49</sup> States therefore have an incentive to adopt such statutes.

Granting shareholders the power to intervene in rules-of-the-game decisions thus will not only improve reincorporation decisions but, perhaps more importantly, it will work to improve the corporate law rules of the states among which a state of incorporation is chosen. With shareholders having the power to make reincorporation decisions, the best strategy for a state seeking to attract incorporations will be to offer the rules that best serve shareholders. As a result, states will have incentives to focus on shareholders' interests. The resulting improvement in the quality of state corporate law rules will considerably improve the arrangements governing publicly traded companies.

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<sup>48</sup> See Lucian Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law," 105 *Harvard Law Review* 1435-1510 (1992); Lucian Bebchuk and Allen Ferrell, "Federalism and Takeover Law: The Race to Protect Managers from Takeovers," 99 *Columbia Law Review* 1168-1199 (1999); Lucian Bebchuk, Oren Bar-Gill and Michal Barzuza, "The Market for Corporate Law," Harvard Olin Discussion Paper No.377 (2002).

<sup>49</sup> See, e.g., Lucian Bebchuk and Alma Cohen, "Firms' Decisions Where to Incorporate," Harvard Olin Discussion Paper No. 351 (2002), forthcoming in *Journal of Law and Economics* (2003); Guhan Subramanian, "The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the 'Race' Debate and Antitakeover Overreaching," *University of Pennsylvania Law Review* (2002).

## B. Game-Ending Decisions

### 1. Issues Covered

There are several decisions that could terminate the existence of a company's business. A regime of shareholder intervention could permit shareholders to initiate and bring to a shareholder vote a proposal to (i) have a merger or consolidation with another company, (ii) sell all of the assets to a certain buyer, or (iii) dissolve the company. The initiative for a shareholder vote would not have to come from the board as is required by existing rules. Once a proposal is brought to a shareholder vote and is approved by the required majority, it would have the same force and would be binding in the same way as proposals that are approved under current rules.

Without intervention power, shareholders are only able to get an acquisition offer accepted over the objection of management by accepting a tender offer. Management has long sought to block unsolicited tender offers, and courts and lawmakers have permitted them to engage in defensive tactics and, in particular, to maintain a poison pill. In earlier work, I have argued that defensive tactics are acceptable only as an instrument of protecting shareholders from being pressured into tendering.<sup>50</sup> On this view, in the face of a tender offer, it would be desirable both to provide shareholders with voting power and to require management to redeem the poison pill in the event that the offer gains sufficient support.

Establishing shareholder power to initiate a vote to approve an acquisition offer would be a simple and clean way to accomplish a similar result. The initiated vote would express shareholders' undistorted choice on whether acceptance of the offer is in their collective interest. Thus, providing shareholders with the power to initiate proposals to accept acquisition offers would be a good way to resolve the long-standing debate on defensive tactics.

Note that the ability to vote on an acquisition proposal would offer some flexibility that tender offers do not currently offer. In particular, the unsolicited tender offers that now provide the only way to accomplish a transaction without management support do not always allow full realization of the potential savings to shareholders from having the transaction structured as a tax-free reorganization. Permitting shareholders to bring

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<sup>50</sup> Lucian Bebchuk, "The Case Against Board Veto in Corporate Takeovers," 69 *U of Chicago L. Rev.* 973-1035 (2002).

acquisition offers to a shareholder vote would enable the full realization of tax benefits that are now possible only with merger agreements supported by management.

One question worth considering is whether shareholders should have not only the power to sell the company to a particular buyer, but also the possibility to direct that the company be sold through a specified auction procedure. Whether or not a particular buyer has already expressed interest in the company, shareholders might wish to have an auction that would sell the company to the highest bidder. Under current rules, only management can start such a process. In a regime of shareholder intervention, however, it might be worth permitting shareholders to begin such a process as well.<sup>51</sup>

## *2. Addressing the Managerial Bias Toward Retaining Control*

### *(a) Ex Post Effects*

One of the problems that has for long occupied legal scholars and financial economists concerns the bias of management in favor of continuing the existence of their firm. Because management enjoys significant private benefits that will be terminated if the company ceases to exist, termination might not serve management's interests. For this reason, one must worry that 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 might be a range of cases in which the interests of shareholders and management diverge. To use the language of *Unocal*, termination decisions confront us with "the omnipresent specter that a board may be acting primarily in its own interests."<sup>52</sup>

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<sup>51</sup> Another question worth considering is who should carry out a termination decision that is initiated by shareholders and subsequently approved in a vote. Although the adoption of a termination decision would signal that the end of the company is in sight, it might be necessary in the meantime to have people be in charge of carrying out the decision. One possibility is to leave this to existing management and rely on its fiduciary duties to induce it to carry out the termination in the best way possible. Another possibility is to allow shareholders to include as part of a proposed termination the appointment of a new team to carry out the termination.

<sup>52</sup> *Unocal*, 493 A2d at 954.

The empirical evidence on acquisition offers indicates that management decisions in this area produce significant agency costs. For example, studies indicate that, when directors of target companies use their veto power to defeat offers, shareholders on average experience a significant stock market loss. For example, Cotter and Zenner found that when offers are defeated shareholders suffer a 21% decline in their stock price.<sup>53</sup> In a recent empirical study on staggered boards, Coates, Subramanian, and I studied how the rejection of bids affects shareholders when evaluated from a long-term perspective.<sup>54</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.

Additional evidence of the agency problem is provided by studies examining the circumstances in which incumbents are likely to resist bids. An early study by Walkling and 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>55</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>56</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 might 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 Hartzell, Ofek, and Yermack found that target CEO's 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>57</sup> Another study indicates that, in merger

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<sup>53</sup> See James F. Cotter and Marc Zenner, "How Managerial Wealth Affects the Tender Offer Process," 35 *J. Fin. Econ.* 63, 86 (1994).

<sup>54</sup> See Lucian Bebchuk, John Coates IV, and Guhan Subramanian, "The Anti-Takeover Power of Classified Boards: Theory, Evidence and Policy," 54 *Stan. L. Rev.* (2002), at Section IV.C.

<sup>55</sup> See Ralph A. Walkling and Michael Long, "Agency Theory, Managerial Welfare, and Takeover Bid Resistance," 15 *Rand. J. Econ.* 54, 67 (1984).

<sup>56</sup> See Cotter and Zenner.

<sup>57</sup> See Jay Hartzell, Eli Ofek, and David Yermack, "What's in It for Me?: Personal Benefits Obtained by CEOs Whose Firms Are Acquired at 21," working paper (2000), available online at <<http://papers.ssrn.com/id=236094>>.

negotiations, CEO's are willing to trade higher acquisition premia in exchange for better managerial positions in the merged firm.<sup>58</sup>

*(b) Ex Ante Effects*

The control that management currently has over termination decisions also produces agency costs ex ante, before any 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 continued independent existence of the company. This possibility would provide management with incentives to serve shareholders. Better performance by management would make it less likely that shareholders would intervene to make a termination decision.

Permitting shareholder intervention would thus eliminate or 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, consumption of private benefits, empire building, and other actions that are beneficial or convenient for managers but costly to shareholders. Studies by Bertrand and Mullinathan and by Garvey and Hanka found that stronger protection from antitakeover statutes causes increases in managerial slack.<sup>59</sup> Gompers, Ishii, and Metrick 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

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<sup>58</sup> See Julie Wulf, "Do CEOs in Mergers Trade Power for Premium?: Evidence from 'Mergers of Equals'," working paper (2001), available online at [http://knowledge.wharton.upenn.edu/show\\_paper.cfm?id=1009](http://knowledge.wharton.upenn.edu/show_paper.cfm?id=1009).

<sup>59</sup> See Marianne Bertrand and Sendhil Mullinathan, "Is There Discretion in Wage Setting? A Test Using Takeover Legislation," 30 *Rand J Econ* 535 (1999) (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs); Gerald T. Garvey and 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").



operating performance—including lower profit margins, return on equity, and sales growth.<sup>60</sup>

There is also evidence that insulation from takeover threats results in greater consumption of private benefits by managers. Borokhovich, Brunarski, and Parrino found that managers with stronger antitakeover defenses enjoy higher compensation levels.<sup>61</sup> Bertrand and Mullinathan obtained similar findings for managers that are more protected due to antitakeover statutes.<sup>62</sup> Finally, Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire building.<sup>63</sup>

### *C. Scaling-Down Decisions*

#### *1. Issues Covered*

At present, all decisions concerning distributions are in management's hands. Management may decide to distribute to shareholders a cash dividend or an in-kind dividend (say, in 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.

Under a regime of shareholder intervention, shareholders themselves would be able to initiate and approve distributions. Shareholders, for example, would be able to order the payment of a \$2 billion dividend at the end of the year. Such a decision would specify the amount of the dividend to be paid, the future record date (to determine which shareholders have a dividend entitlement), and the payment date. Once a distribution decision passes by vote, the company would be obligated to pay the dividend, just as if the board had made the decision. Thus, in the example of Chrysler and Kerkorian discussed earlier, the existence of shareholder intervention power

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<sup>60</sup> See Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," NBER Working Paper No 8449 (2001), available online at <<http://papers.nber.org/papers/w8449.pdf>>.

<sup>61</sup> See Kenneth A. Borokhovich, Kelly R. Brunarski, and Robert Parrino, "CEO Contracting and Antitakeover Amendments," 52 *J. Fin.* 1495, 1515 (1997).

<sup>62</sup> See Marianne Bertrand and Sendhil Mullinathan, "Executive Compensation and Incentives: The Impact of Takeover Legislation," NBER Working Paper No 6830 (1999), available online at <<http://papers.nber.org/papers/W6830>>.

<sup>63</sup> See Gompers, Ishii, and Metrick, at 31–32.

would have enabled Kerkorian to bring to a shareholder vote his proposal to distribute the company's cash hoard.

Under an intervention regime, shareholders would also be able to order in-kind distributions, forcing the company to distribute, for example, its shares in a subsidiary. These decisions, too, would reduce the scale of the enterprise governed by management and would remove some shareholder value from management control.

One question worth considering is whether shareholders, in deciding to make a distribution, should be able to order a distribution of newly-issued securities or to mandate future dividends whose amounts are as yet uncertain. For example, shareholders might be granted the power to order a distribution of new debt securities that, once distributed, might compel management to start liquidating assets to satisfy the claims of the new securities. Shareholders might also be given the power to order the company to pay in the future dividends equal to, say, 50% of annual earnings.

It should be clear that an intervention regime would not weaken the protection currently accorded to creditors. Creditors have statutory protection – and often also contractual protections – limiting the amounts that the company may distribute to its shareholders.<sup>64</sup> Management may not elect to make distributions to shareholders that violate these constraints. Under a regime of shareholder intervention power, shareholder decisions concerning distributions would be similarly subject to these constraints. The only difference would be that, within these constraints, not only management but also shareholders would be able to make distribution decisions. What is contemplated is a rearrangement of power between management and shareholders, not a renegotiation of rights between shareholders and creditors.

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<sup>64</sup> It was observed long ago that “the principal objective of dividends law has therefore been the preservation of a minimum assets as a safeguard in assuring the payment of creditors’ claims ...” D. Kehl, *Corporate Dividends* 14-15 (1941). Corporate law casebooks and textbooks discuss dividends largely in terms of the upper legal limits on management’s distributions. See e.g., William L. Cary & Melvin Aron Eisenberg, *Corporations: Cases and Materials* (7th edition, 1996); Robert Charles Clark, *Corporate Law* (1986).

## 2. *Addressing Empire-Building and Free-Cash-Flow Problems*

### *(a) Empire-Building and Free-Cash-Flow Problems*

One of the agency problems that has received a great deal of attention from financial economists and corporate law scholars concerns the tendency of managers to avoid distributing cash or assets to shareholders.<sup>65</sup> A company might have cash reserves whose distribution to shareholders would be value-maximizing because the company currently has poor internal investment opportunities. A company might also have assets that would be better managed separately, and it thus would be value-maximizing to spin off these assets or sell them to a third party and then distribute the cash proceeds to shareholders. In such circumstances, management might, for self-serving reasons, refrain from taking actions that would reduce the size of the empire under its control.

Management might prefer not to reduce the size of its empire because it derives larger private benefits, in both pecuniary and non-pecuniary terms, from running a larger firm. 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 increases its freedom to pursue expansion plans. Indeed, some scholars have viewed these problems as the most significant agency problems that large public companies face.<sup>66</sup>

### *(b) Superiority to the Use of Debt*

The problem of management’s tendency to engage in empire building and excessive cash flow retention has received considerable attention from financial economists. They suggest that a main reason for the use of debt capital, including the use of highly leveraged structures, is an attempt to address this problem. On this view, the advantage of debt is that it forces management to distribute to those who contributed capital to the firm more

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<sup>65</sup> The standard reference is to Jensen, “Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,” 76 *American Economic Review* 323 (1986).

<sup>66</sup> See e.g., Henry Hansmann, *Ownership of Enterprise* (1995); Michael Jensen, “Eclipse of the Public Corporation,” *Harvard Business Review* (1989). See also Margaret Blair and Martha Schary, “Industry-Level Indicators of Free Cash Flow,” in *The Deal Decade* (M. Blair, ed.) (empirical evidence indicates that the US corporate sector was caught in the 80’s by “an epidemic of free cash flow”).

cash than they would be otherwise inclined to distribute. Because management can avoid making dividend payments but not making interest payments to creditors, raising capital in the form of debt rather than equity reduces the discretion 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 bonding is an important motivation for the use of debt has gained much support among financial economists.<sup>67</sup> Indeed, commentators have viewed the bonding benefits as an important motivation for the 1980's wave of leveraged acquisitions and buyouts. The belief that leveraged structures are desirable in order to mitigate problems of empire building and free cash flow underscores how seriously these problems are taken by financial economists.

There is no question, however, that debt financing is an highly imperfect remedy. To begin with, high leverage produces its own inefficiency distortions.<sup>68</sup> Furthermore, leverage is a rather inflexible and costly mechanism. When the level of debt is set, there is uncertainty about how much excess cash flow the company will have in the future and what the company's investment needs will be. Accordingly, any level set might turn out to be too low and thus insufficient check on inefficient empire building, or too high and thus a costly burden on the company.

Suppose that a company is expected to generate future cash flow with an expected value of \$200 million a year, that it will not have beneficial investment opportunities, and that it will be efficient to remove whatever cash flow the company will have. Could a leveraged capital structure that requires making interest payments of \$200 million a year ensure an efficient outcome? Not if the \$200 million in expected value stands for either \$100 million or \$300 million with equal likelihood. In such a case, a commitment to

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<sup>67</sup> See e.g., Michael Jensen, "Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers," 76 *American Economic Review*, 2 (May 1986); Milton Harris and Arthur Raviv, "Capital Structure and the Informational Role of Debt," 45 *Journal of Finance* 321 (1990); Rene M. Stulz, "Managerial Discretion and Optimal Financing Policies," 26 *Journal of Financial Economics* 3 (1990).

<sup>68</sup> See e.g., Michael C. Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," 3 *Journal of Financial Economics* 305 (1976). One important distortion is that high leverage provides incentives to make high-risk gambles and investment choices even if they are inefficient.

pay out \$200 million annually would either put the company into costly (if annual profits turn out to be \$100 million a year) or would turn out to be insufficient to remove fully the unnecessary cash flow (if annual profits turn out to be \$300 million a year).

Compared with the introduction of a substantial level of debt, having shareholder power of intervention provides a flexible mechanism for dealing with the problems of empire building and excessive cash flow. In the example above, once uncertainty about the company's cash flows is realized, shareholders would be able to use their intervention power to remove from company control an appropriate amount. Thus, intervention power would deal with the problems under consideration in a way that would be more finely tuned to circumstances than the inflexible mechanism of debt.

*(c) Superiority to Stricter Judicial Review*

The problems of empire building and excessive cash retention have concerned not only financial economists but also legal scholars. Some of these commentators have proposed to reconsider the current deference to managers' business judgment on such matters.<sup>69</sup> On their view, given management's bias against distributions, courts should be prepared to scrutinize the merits of management's decisions in this area.

Even assuming that higher scrutiny by courts would be beneficial in the absence of other ways of addressing the problems, it would undoubtedly be a highly imperfect remedy.<sup>70</sup> Courts are ill-equipped to make business decisions. In this respect, the proposed shareholder power to intervene provides a superior alternative. Instead of having judges guess as to what distribution decisions would likely benefit shareholders, we would let shareholders themselves make the decision as to what they prefer.<sup>71</sup>

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<sup>69</sup> For the strongest appeal for greater judicial intervention in dividend decisions see Victor A. Brudney, "Dividends, Discretion, and Disclosure," 66 *Va. L. Rev.* (1980).

<sup>70</sup> See Zohar Goshen, "Shareholder Dividend Options," 104 *Yale Law Journal* 881 (1995).

<sup>71</sup> Another noteworthy proposal in the legal literature was made by Zohar Goshen, "Shareholder Dividend Options," 104 *Yale Law Journal* 881 (1995). Goshen proposed that each shareholder would receive an option every year to withdraw the shareholder's fraction of the company's earnings and would be able to choose how the option is exercised. Any amount not withdrawn would essentially constitute a reinvestment of funds in the company. My proposal in the present paper may be superior to Goshen's mechanism in two ways. First, as Goshen himself recognizes, under the existing tax rules, the mechanism he proposed would require shareholders to pay taxes in all the

We can thus conclude that shareholder intervention power would provide the best and most effective way for dealing with the problems of empire building and free cash flow. Ex post, when a company has more cash than what beneficial investment opportunities can absorb, the shareholders would be able to intervene to remove whatever funds would be desirable to distribute. Better yet, the very existence of intervention power would induce management to make such a distribution itself. Ex ante, if the problems of empire building and free cash flow are expected to be addressed, it will become easier and less expensive to raise equity capital.

#### *D. Effectiveness and Design*

##### *1. Will Proposals be Initiated?*

It might be argued that shareholders would not have sufficient incentives to initiate proposals. Without a willingness to initiate proposals, the shareholder power to intervene would not have substantial impact.

The concern may be grounded in the observation that the current incentives to run a proxy contest over an “issue” are much lower than the incentive to run a proxy contest for control. In the latter case, if the challenger wins the contest, the challenger will gain control of the board and capture the associated private benefits of control. Furthermore, the challenger will be able to authorize its own reimbursement for the costs of running the proxy contest. In contrast, when a party runs a proxy contest over an issue (e.g., opposition to a management proposal), victory will bring neither private benefits of control nor a reimbursement of costs.

Still, there are reasons to expect that, when changes could produce significant improvement, they will be initiated in a regime of shareholder intervention. For example, it can be expected that “issue” proposals will be brought by shareholders with significant holdings—or by groups of shareholders that together hold a significant block—on the prospect of a

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instances in which they elect to withdraw no dividends but rather “reinvest” all earnings in the company. Second, and importantly, there might be cases in which (i) each shareholders would prefer that all shareholders not withdraw their funds from the company, but that (ii) taking as given what others are going to do, each shareholder prefers to have its own funds withdrawn. In such a case, the individual option would lead to withdrawal of funds by all shareholders, whereas shareholder power to intervene would lead to the outcome that is in shareholders’ collective interest.

significant appreciation in the value of their shares. The incentive to initiate a proposal would be strongest in those instances in which there will be a meaningful chance of the proposal's adoption, which is exactly when it would be desirable to have the proposal brought.

Note that in the case of some proposals there would not be much need for campaigning since the issues will be sufficiently familiar to shareholders. This would be the case for most rules-of-the-game proposals, since these will focus on general governance issues. Note also that, even though shareholder resolutions currently initiated under the proxy rules of the securities laws have no binding force and are regularly ignored if passed, many such resolutions, including ones that end up gathering substantial votes of support, are nonetheless initiated. This pattern suggests that, in a regime in which shareholder-initiated proposals are binding and can produce a termination, scaling-back, or rule-changing decision, a significant number of proposals can be expected.

Moreover, once intervention power is introduced, it would be possible and indeed desirable to strengthen incentives to bring good proposals with meaningful chances of adoption by installing appropriate reimbursement rules. Specifically, when a proposal is adopted in a vote, or perhaps even when it passes a specified threshold of support (e.g., 30% of the vote), it would be desirable to reimburse the costs of the shareholders initiating the proposal. Indeed, if further strengthening of incentives to bring proposals with potential significant support is viewed as desirable, the proponents of successful proposals might be granted some multiple of their costs. Such financing rules would encourage the bringing of exactly those proposals, and only those proposals, which enjoy substantial shareholder support and thus are worth encouraging.

## *2. Will Shareholders Vote against Management?*

It might be argued that shareholder intervention power would have little effect for a second reason. Even if proposals are initiated, the argument goes, they will not be adopted because shareholders will not have sufficient incentives to participate in the vote or, even if they participate, they can be expected to defer to management rather than vote against it.

Shareholders have only weak incentives to participate in voting because of a “rational apathy” problem.<sup>72</sup> Still, the costs of voting are rather small, and the incidence of corporate voting is rather substantial, even on non-binding shareholder resolutions.<sup>73</sup> For one thing, institutional investors buy and large vote their shares. Thus, the question is only whether they can be expected to vote against management’s recommendation.

The tendency of institutional investors to vote with management might result from rational deference to a party that institutions believe is better informed on the question at hand. It might also be reinforced by the desire of institutional investors to be on good terms with management in order to receive information and in some cases also to obtain business. For this reason, voting can be expected to be somewhat tilted in favor of management’s position. But there is no reason to assume that shareholders will always vote with management.

There might well be instances in which, given the presence of clear agency problems on management’s part and the importance and appeal of the proposal on the table, rational shareholders will have sufficient confidence in their judgment to vote against management. This possibility is clearly indicated by the fact that in recent times, many proposals for de-classifying boards have attracted a majority among voting shareholders even though they are merely advisory in nature.<sup>74</sup> The incentive of institutions to vote for such proposals would only increase in a regime in which they are binding.

Institutional investors’ bias in favor of voting with management does not at all indicate that shareholders should be denied the power to intervene. When a majority of shareholders will in fact be prepared to vote for a shareholder-initiated proposal, there will be no reason to block them from doing so. To the contrary, if shareholders actually choose to intervene, despite their tendency not to vote against management, such a vote would suggest that the proposal is strongly in the shareholder interest.

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<sup>72</sup> See Clark, *Corporate Law*, at 390-392.

<sup>73</sup> See Georgeson & Co., *Annual Corporate Governance Review; Shareholders Proposals and Proxy Contests* (2002), available at <http://www.georgesonshareholder.com>.

<sup>74</sup> Such proposals obtained average support of 60% in 2002. See Georgeson & Co., *Annual Corporate Governance Review; Shareholders Proposals and Proxy Contests* (2002), available at <http://www.georgesonshareholder.com>.



### *3. It's the Indirect Benefits, Stupid*

Finally, and perhaps most importantly, it should be emphasized that the benefits of a regime of intervention should not be measured by the number of times that shareholders would in fact intervene and adopt shareholder-initiated proposals. Rather, the primary benefits would be indirect ones. Introducing the power to intervene would induce management to act differently in order to avoid the power to intervene. Thus, if a regime of intervention does not produce many adoptions of proposals, this would not imply that the power is not working as hoped; rather, it might well mean that the power is working better than expected.

To illustrate, consider the existing power of shareholders to veto fundamental changes, which is generally viewed as valuable. Shareholders almost always approve proposals for fundamental changes submitted by management. But this hardly means that the existence of the approval requirement does not serve an important purpose. Management's choice of fundamental changes is likely influenced by the need for a shareholder vote of approval. Management does not pursue those changes that could favor it but that could not be expected to obtain shareholder approval. In a regime without an approval requirement, such changes would take place. The approval requirement prevents such changes - not by actual veto when proposed but rather by discouraging management from bringing them to a vote to begin with.

Shareholder power to intervene would similarly produce its benefits primarily by influencing management's behavior rather than by actual interventions. If the prospect of distributing Chrysler's cash hoard enjoys widespread support among shareholders, it will happen under a regime of intervention power without Kerkorian winning a vote on the matter. Management will in all likelihood elect to make such a distribution to begin with or at least once it gauges shareholder sentiment.

### *4. Nuisance Proposals*

One might be concerned that shareholders would bring nuisance proposals. One shareholder, who has an idea that is far-fetched or motivated by considerations other than shareholder wealth, would be able to impose a cost on the system. The bringing of nuisance proposals, the argument goes, would burden shareholders with the need to vote against them, and

management with the need to lobby against them. An appropriate design of the intervention regime, however, could keep the costs of such nuisance proposals to an acceptable minimum.

First of all, some threshold requirements for submitting a proposal could screen out the proposals that are completely frivolous or have no meaningful support among shareholders. For example, submission of proposals might be conditioned on their being co-sponsored by shareholders having together more than a threshold fraction (say, 5% or 10%) of the company's shares. Such threshold requirements are already used in state law rules and charter provisions that allow shareholders to call a special meeting. In addition, it would be possible to disallow the submission of proposals when a similar proposal was voted on in the preceding year and failed to get a certain threshold of shareholder support (say, 15%). Requirements of this sort, though perhaps not demanding enough in their specifics, are used already in connection with the initiation of votes on advisory resolutions under the proxy rules of the securities laws.<sup>75</sup>

Second, proposals that satisfy the requirements for submission but have limited support among shareholders are unlikely to cause any significant inconvenience for either shareholders or management. This can be ensured, for example, by requiring that adopted proposals gain support of a majority of outstanding shares (and not just shares that are voted). Under such a rule, abstaining from voting on a proposal is equivalent to voting against it. As a result, shareholders that do not support a proposal do not have to bother to vote against it.

For a proposal to be adopted, it would need such strong support that holders of a majority of outstanding shares would affirmatively support it. Given that getting support from a majority of outstanding shares is somewhat demanding, management would have to pay attention only to proposals that appear to have support among a significant fraction of the shares. Thus, management would not have to pay costly attention to proposals other than

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<sup>75</sup> See e.g., Clark, *Corporate Law*, at 374-383. If one wishes to further discourage proposals that can be expected to gain little support, it would be possible to do so with financial incentives. In the same way that those shareholders who initiate proposals that are successful in attracting support can be granted a reimbursement of costs, those that initiate proposals that fail to attract any significant amount of support can be required to reimburse the company's resulting costs or pay some penalty.

those with significant shareholder support, which is precisely the desirable state of affairs.<sup>76</sup>

### *5. Opportunistic Proposals*

Concerns might also be expressed that allowing shareholder intervention would enable some large shareholders to try to initiate proposals in order to extract benefits from management.<sup>77</sup> This concern focuses on large shareholders that are not in control and whose ability to extract preferential treatment from managers depends on their power vis-à-vis managers. The ability to initiate and push for proposals, it might be feared, will lead such large shareholders to threaten to initiate value-decreasing proposals unless they are paid off by management.

This concern does not appear to be a significant one. While introducing the power to intervene would likely increase the incidence of shareholder voting, there are already shareholder votes that take place which are vulnerable to the considered concern. Large shareholders can already threaten to vote against management in the annual election of directors and in votes on fundamental changes (such as charter amendments) proposed by management. I am unaware of any substantial evidence that large outside shareholders are able to extract significant benefits from management as a result, nor do I know of any argument that such a concern makes it worthwhile to eliminate any of these votes.

A threat by a large shareholder to bring a value-decreasing proposal is unlikely to be particularly worrisome for managers. If the move is significantly shareholder value-decreasing, it is highly doubtful that the large shareholder will be able to get support from a majority of shareholders. As discussed, given the tendency of shareholders to vote with management, there is even no assurance that a value-increasing proposal opposed by management would be adopted at all. Gaining support from holders of a majority of the outstanding shares would thus be quite unlikely when a proposal would not benefit shareholders but instead considerably harm them.

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<sup>76</sup> Finally, it is worth noting that if it is desirable to even further reduce the extent to which management and shareholders might be distracted, this can be accomplished by concentrating all voting on shareholder-initiated proposals at the annual meeting will attain this goal.

<sup>77</sup> See, e.g., Stephen Choi and Andrew Guzman, "Choice and Federal Intervention in Corporate Law," 87 *Va. L. Rev.* 961 (2001).

Furthermore, there are credibility problems with a threat to bring a value-decreasing proposal, as carrying out the threat would not be in the interest of the large shareholder.

#### *6. Management Counter-Proposals*

It is worth noting that, when a proposal is initiated, it would be possible to make counter-proposals. Such proposals could be made either by other shareholder groups or by management. Management counter-proposals, in particular, can serve an important role in a regime of intervention power.

Suppose that, in the Chrysler example, shareholders prefer distributing the \$7 billion cash hoard to having no distribution at all, but that the outcome most preferred by most shareholders is to distribute only part of the cash hoard. In such a case, if Kerkorian submits a proposal for distributing the whole cash hoard, it can be expected that management, fearing adoption of the proposal if shareholders face a choice only between it and the status quo, will make a counter-proposal to distribute only part of the cash hoard. This counter-proposal would be adopted, further improving the outcome for shareholders.

A counter-proposal, by management or another shareholder group, might thus lead to an outcome that is superior to the one that an initial proposal would produce. A counter-proposal that would make matters worse off as compared with an initial proposal would be unlikely to win majority support. For this reason, it would be perfectly acceptable, and even desirable, to facilitate the submission of counter-proposals to the same meeting at which an initial proposal will be considered.

### V. CLAIMS THAT INTERVENTION POWER WOULD HURT SHAREHOLDERS

This Part considers claims that, even if shareholder power to intervene would produce some beneficial outcomes for shareholders, it would also impose on them costs that would make having such power overall undesirable for shareholders. Because of these costs, the argument goes, shareholders are best off when their hands are tied and they cannot intervene. Below I consider several claims in turn and conclude that they do not provide a good basis for tying shareholders' hands.

### A. Imperfect Information

The most commonly used argument against expansions in shareholder voting rights is based on the informational disadvantage that they are likely to have vis-à-vis management.<sup>78</sup> Management, the argument goes, is better informed about the company and is thus in a better position to evaluate which decision would most enhance shareholder value. That management might sometimes have superior information has been long accepted by corporate law.<sup>79</sup> If shareholders were allowed to make decisions themselves, the argument proceeds, they would make poorer decisions than management would. Therefore, shareholders are made better off by being denied the power to intervene. Having decisions made by management or at least initiated by management prevents shareholders from making some poor, erroneous decisions.<sup>80</sup>

Shareholders' possibly inferior information, however, does not warrant denying them the power to intervene. To begin with, some of the decisions in the categories under consideration are ones with respect to which shareholders have perfectly adequate information. Rules-of-the-game decisions are especially likely to be ones for which shareholders commonly have perfectly adequate information to make a good decision. Consider decisions on whether to have a staggered board charter provision and on

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<sup>78</sup> See Robert Charles Clark, *Corporate Law* (1986), 1.2.4 and 3.1.1. Indeed, Clark takes the view that the main benefit stemming from the voting rights of dispersed shareholders does not lie in each shareholder's use of such rights while the company has dispersed ownership. Rather, the benefit lies in the rights' collective function in a takeover, where a buyer purchases a controlling block to use the voting rights inherent in the shares to displace management. *Id.* At sec. 3.1.1.

<sup>79</sup> For example, the Delaware courts have viewed as plausible and legitimate directors' concern that shareholders might mistakenly view as adequate an offer that, according to the directors' superior information, is in fact, inadequate. See *Paramount Communications, Inc v. Time Inc*, 1989 Del Ch LEXIS 77, \*56 (Allen) ("No one, after all, has access to more information concerning the corporation's present and future condition [than managers]"). See also *Moore v. Wallace Computer*, 907 F Supp 1545, 1557 (D Del 1995); *Unitrin v. American General Corp*, 651 A2d 1384, 1385 (Del 1994); *Paramount Communications, Inc v. Time Inc*, 571 A2d 1140, 1153 (Del 1989). In each of these cases, the court expressed concern about shareholders' decisions being affected by their "ignorance or mistaken belief" as to the target's intrinsic value.

<sup>80</sup> See e.g., Jeffrey N. Gordon, "Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law," 60 *U. Cin. L. Rev.* 347 (1991); Martin Lipton, "Takeover Bids in the Target's Boardroom," 35 *Business Lawyer* 101, 115 (1979).

whether or not to be incorporated in Delaware. These are questions that institutional investors encounter in many companies, questions to which the answer is unlikely to depend on private information about the company known only to management. Shareholders might make the wrong decisions on such questions, of course, but such mistaken decisions will not be due to shareholders' lacking some special information about the company that only management possesses.

I do agree, however, that there are some decisions for which intervention power is proposed for which management's private information might be useful. Management often has private information, both hard and soft, that public investors do not possess. Management also might have devoted more time and effort to assessing the body of information about the company that is publicly available. Thus, management might have the best information about the company's independent value and about the company's investment and growth opportunities, which are relevant for end-of-the-game decisions and scaling-down decisions. Clearly, denying shareholders the power to intervene cannot be grounded in the possibility that management's private information indicates that the company's independent value and investment opportunities are poorer than shareholders believe. Might opposition to intervention power be grounded in the possibility that such private information is positive, meaning that the company's value and investment opportunities are much better than shareholders believe? As I explain below, the answer is no.

To start, note that, even accepting that management sometimes has better information than shareholders, management does not have the *best incentives* for making the right decision. Thus, with no intervention power, decision-making is fully left to a party that might be better informed but also has worse incentives.

Management might use its power over corporate decision-making not (or not only) for the intended purpose of stopping shareholders from making erroneous decisions but also to avoid some decisions – to terminate, scale back, or change rules of the game -- that would be beneficial to shareholders. This concern is real and significant because the claim that management has superior information is one that management can always raise and that

would be hard to falsify, whenever management prefers the status quo.<sup>81</sup> In contrast, if shareholders had intervention power and used it in some cases, their decisions might sometimes be less informed but would generally be based on their judgment of what would best serve their interests.

Importantly, granting shareholders the power to intervene hardly implies that management's superior information will go unused. It can be expected that, most of the time, shareholders will defer to management's judgment. Even when a shareholder initiative offers up a decision for shareholder vote, management's superior information would not necessarily be wasted. Management would be prevented from blocking the proposal, but management would be able to use the information as a basis for its communications and recommendations to shareholders.

When confronted with a proposal that seems to have a meaningful chance of being accepted, management is likely to communicate to shareholders its reason for opposing it, and they might back up such communication with new information and, if appropriate, an investment banker's opinion. Such communications might close or significantly reduce whatever information gap existed between management and public investors prior to the offer. Of course, in some circumstances, management might be unable to communicate the information underlying their position because business considerations require secrecy<sup>82</sup> or because the information is difficult to disclose credibly.<sup>83</sup> In such cases, management can still communicate to the shareholders its recommendation and the general reason for it.

In the face of such a communication from management, rational shareholders can be expected to balance two considerations. On the one hand, they will recognize that management might be better informed. That shareholders are imperfectly informed about the company's value or

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<sup>81</sup> Cf. *Chesapeake Corp v. Shore*, 771 A2d 293, 327 (Del Ch 2000) ("It is important to recognize that [superior information claims] can be invoked by a corporate board in almost every situation.")

<sup>82</sup> See, for example, *Shamrock Holdings, Inc v. Polaroid Corp*, 559 A2d 278 (Del Ch 1989). In this case, the target's largest asset was a patent litigation claim. The court accepted the argument that disclosures about this claim might compromise the target's bargaining position in the litigation. *Id* at 290.

<sup>83</sup> In some cases, managers have argued that information cannot be passed on effectively to shareholders because they would have difficulty comprehending it or would get confused. See, for example, *Chesapeake*, 771 A2d at 332 (discussing the concern expressed by Shorewood with respect to "the risk of shareholder confusion").

investment opportunities does not imply that they are unaware that this is the case. This consideration would weigh in shareholders' decision-making in favor of deferring to management.

On the other hand, shareholders will also take into account whatever considerations might weigh against deferring to management. First, as discussed earlier, management might have self-serving reasons for opposing termination, scaling-back decisions, or rule-changing decisions. Furthermore, like other humans, the directors might make mistakes and might suffer from a cognitive-dissonance tendency to view favorably both their own past performance and the course of action serving their interests.<sup>84</sup>

In balancing these considerations, shareholders will consider various facets of the particular case facing them. Among other things, shareholders might take into account the following factors: their own judgment concerning the benefits of accepting the proposal (e.g., if they view the case for it as marginal, the risk from deferring to management is small); how likely management is to have private information of substantial import for the question at hand (which in turn might depend on the nature of the company's business); and the estimated magnitude of management's divergence of interest (the more shares the managers hold, for example, the smaller the likely divergence of management's and shareholders' interests).<sup>85</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. Other times, however, they might reach the opposite conclusion. Of course, shareholders might not always get it right. But given that it is their money that is on the line,

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<sup>84</sup> As Chancellor William Allen wisely remarked in *Interco*: "[H]uman nature may incline even one acting in subjective good faith to rationalize as right that which is merely personally beneficial." *City Capital Associates Partnership v. Interco*, 551 A2d 787, 796 (Del Ch 1988).

<sup>85</sup> It is worth noting that in a regime with intervention power, management opposing a termination decision 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 that the proposal fails, to spend some of their own funds to purchase from the company at a high price (say, the payoff per share that termination is expected to bring) some specified number of shares and hold them for a specified period of time. Such an investment would be profitable only if shareholders would be better off if termination is rejected. Accordingly, 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 nonintervention, management does not need to make such a commitment.



shareholders naturally would have incentives to make the decision that would best serve their interests.<sup>86</sup>

In contrast, in a regime of nonintervention, deference to management is mandated as a general rule. A regime without intervention power and a regime with such power would produce different outcomes only in those cases in which shareholders would elect not to defer if the decision were in their hands. Thus, to block any and all shareholder intervention, one would have to believe that—due to ignorance, imperfect information, irrationality, or hubris—shareholders would be making the wrong choice in most of those cases. That is, one would have to believe that shareholders’ decision-making on whether to defer would be so flawed that tying shareholders’ hands and mandating general deference to management would make shareholders better off.

Although shareholders are often less informed than management, there is little reason to view shareholders as unaware of this state of affairs or as likely to ignore it out of hubris, irrationality, or otherwise. Target shareholders do not seem to be a group for which paternalistic hands-tying is warranted. As the United States Supreme Court stated in *Basic, Inc v. Levinson*, management should not “attribute to investors a child-like simplicity.”<sup>87</sup>

The substantial presence of institutional investors makes paternalistic mandating of deference especially unwarranted. Institutions are likely to be aware of the informational advantage of management, and they appear capable of making reasonable decisions on whether deferring to management would be best overall. Some institutional investors conduct their own analysis, and some rely on proxy-advisory firms such as Institutional Shareholder Services (ISS), which researches questions put to a shareholder vote and recommends how client institutions should vote.<sup>88</sup> There is little reason to believe that the decisions of institutional investors on whether to

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<sup>86</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. Because we expect such parties to have incentives to balance well the costs and benefits of deference, we generally believe that such parties would be better off if they were allowed to make the decision rather than be required to defer to the expert agent.

<sup>87</sup> *Basic, Inc. v. Levinson*, 485 US 224, 234 (1988), quoting *Flamm v. Eberstadt*, 814 F2d 1169, 1175 (7th Cir 1987).

<sup>88</sup> See, for example, “Northrop Grumman Gains ISS Endorsement for TRW Special Meeting,” PR Newswire (Apr 18, 2002) (reporting that ISS, the “nation’s leading independent proxy advisory firm, endorsed a vote in favor of allowing Northrop Grumman’s bid for TRW to proceed”).

defer would be so poor that mandating deference would be preferable to letting them make such decisions.<sup>89</sup>

Finally, voting shareholders can hardly be regarded as a group that is excessively reluctant to defer to management. Indeed, the normal patterns of corporate voting indicate that shareholders, including institutions, commonly display a great deal of deference to management's views. Thus, if anything, there are grounds for concern that voting shareholders might be excessively deferential.<sup>90</sup> But this is not a reason to mandate deference. When circumstances would make shareholders sufficiently confident to overcome the tendency to defer to management, imposing deference on them would be unlikely to be beneficial.<sup>91</sup>

In conclusion, let us reflect briefly on the Seattle building example. The building manager in that example might well have superior information with respect to possible termination and scaling-back decisions. Nonetheless, neither law nor contracting practice in such cases deprive the owner from the power to order that the building be sold or that funds be sent back to the owner. The owner is free to seek the manager's recommendation on such

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<sup>89</sup> In *Chesapeake*, 771 A2d at 328, Vice Chancellor Strine asks rhetorically, "If stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded them?" Paraphrasing the Vice-Chancellor's question, one might ask: "If stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide whether to defer to directors' recommendations on major corporate decisions?"

<sup>90</sup> This concern is discussed in *supra* Section IV.D.2.

<sup>91</sup> It is worth noting that the case against mandated deference is supported by the existing evidence on the effects of mandated deference in takeover situations. When incumbents use defensive tactics to defeat offers, shareholders experience on average a significant decline in stock value. See James F. Cotter and Marc Zenner, "How Managerial Wealth Affects the Tender Offer Process," 35 *J Fin Econ* 63, 86 (1994). This pattern that is consistent with the proposition that mandating deference makes shareholders worse off. To be sure, supporters of mandated deference can rightly object that this evidence does not fully respond to their claim because short-term declines in stock price following defeat of an offer do not rule out the possibility that the defeat of offers by management ultimately pays off in the long run. In a study of staggered boards, however, Coates, Subramanian, and I examined long-term returns and found no long-term payoff. To the contrary, we found that thirty months after the bid announcement, the shareholders of targets that remained independent obtained on average a significantly lower value than they would have obtained had the board agreed to an acquisition. See Lucian Bebchuk, John Coates IV and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards" 54 *Stan. L. Rev.* (2002).

matters, and might defer to it as long as the owner finds deference to be optimal. Similarly, for the reasons discussed in this Section, shareholders should have the freedom to decide for themselves whether to defer to the better informed management or to view a case as sufficiently exceptional that deference is no longer warranted.

### *B. The Consistency Argument Against Back-Seat Driving*

A related objection to shareholder intervention is that shareholders would likely make bad decisions not so much for lack of particular pieces of information, but because their decisions would not cohere as well as management's would with other corporate decisions. There is much value, the argument goes, to corporate decisions having sufficient internal consistency to add up to a coherent and well-integrated whole. The question of how a certain issue should be decided, it is argued, cannot be well answered in isolation from how other issues are expected to be resolved.<sup>92</sup>

Proponents of this argument can accompany it with an appeal to our intuitions (or experience) cautioning us against back-seat driving or letting two or more people prepare one dish. Shareholders should sit calmly in their back seats, the argument goes, and not try to instruct the person at the wheel how to drive; intervening might lead to accidents or at least a nerve-racking trip. And, as long as they do not plan on replacing the chief chef, shareholders should stay out of the kitchen and let management prepare its dish without direction from shareholders what ingredients to include; intervention is hardly a recipe for a tasty meal.

This argument, however, is unpersuasive. To begin with, the issues for which intervention power is proposed are hardly ones for which consistency with other corporate decisions is a key element of a good decision. Game-ending decisions can best be analogized not to back-seat driving but rather to decisions to sell the car. Scaling-down decisions can be best analogized not to adding ingredients to a chef's dish but rather to asking the chef for the remainder of the funds you gave her to buy ingredients for the meal when

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<sup>92</sup> Although this argument seems to be "in the air," I have not been able to identify any paper making it explicitly. It has some relationship, but is not identical to, Dean Clark's argument that having a central locus of power facilitates coordination and reduces the overload on an organization's communication network. See Robert Charles Clark, *Corporate Law* (1986), Appendix A.

you do not wish the chef to invest remaining funds in preparing another meal which you are not interested in having.

Furthermore, the argument against back-seat driving suffers from the same problems as the argument about imperfect information: why not let the shareholders themselves decide how much weight to give to the consistency consideration? Granting shareholders the power to intervene does not imply that they will constantly use it. They might commonly defer to management, guided by their recognition that management might have superior information or that consistency in decision-making is sometimes valuable. It seems a safe bet that money managers taking cabs to the airport do not engage in much back-seat driving. They might intervene only in those rare occasions when they see that the driver is heading to Newark whereas their flight leaves from LaGuardia, and in such cases the intervention will be in their interest.

Similarly, shareholders will use their power to intervene only in those cases in which they see strong signs that call for such intervention and that outweigh the considerations of consistency and deference to management. Mere recognition that back-seat driving might sometimes have costs is hardly sufficient to mandate general deference to management. Such mandated deference would follow only if shareholders were assumed to be sufficiently irrational or undisciplined that they could not be trusted to make the deference decision themselves. Again, in today's capital markets, where institutional investors have a dominant presence, such paternalistic hand-tying is hardly warranted.

### *C. Disruptive Cycles*

In an interesting article, Jeff Gordon argued that giving shareholders the power to intervene in any given corporate decision would produce "social choice" problems.<sup>93</sup> In particular, he argued that shareholder power to initiate proposals would lead to "cycles" that would disrupt or even paralyze corporate decision-making.

To illustrate the potential 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*, that *B* is favored by

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<sup>93</sup> Jeffrey N. Gordon, "Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law," 60 *U. Cin. L. Rev.* 347 (1991).

(another) majority of shareholders over potential provision C, and that, finally, C is favored by (yet another) majority over A. As a result, there might fail to be one provision that would be “stable” in that it could not be defeated in a vote by some other provision. Instead, shareholder decision-making would confront a “cycle.”<sup>94</sup> In this case, the argument goes, allowing shareholder initiation might lead to a cycle in which each year the company will move to another provision 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 later by A, and so forth and so on.

Note that in this situation none of the three provisions A, B, and C can be viewed as “the best” for shareholders. Each one of them would do just as well as another, in a sense. The one outcome that would be clearly inferior is the outcome of perpetual change. This negative outcome, Gordon argues, can be avoided by management control. Such control enables management to determine by fiat one of the three possible arrangements, providing stability and avoiding disruptive cycling.

This argument, again, does not provide a basis for opposing shareholder intervention. First, there are reasons to doubt that the phenomenon of cycling is likely to arise in the corporate context. Shareholder interests are likely to be far more homogenous, given the common shareholder interest in maximizing share value, than the preferences of populations in which cycling might be an important phenomenon.<sup>95</sup>

Second, the important problem for corporate governance is not the possibility that the set of top choices will lend itself to cycling, but rather the more realistic possibility that there will exist choices that are inferior to all the choices in the top set. Suppose that potential provision D is viewed by all shareholders as worse than any of the provisions A, B, and C. Without shareholder power to intervene, if D is for some reason preferred by management to the other possible provisions, shareholders might be “stuck”

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<sup>94</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* (1958); Amartya Sen, *Collective Action and Social Welfare* (1970).

<sup>95</sup> There is substantial literature on the conditions that would guarantee shareholder unanimity. See e.g., Harry DeAngelo, “Competition and Unanimity,” 71 *Am. Econ. Rev.* 18 (1981). Gordon points out correctly that these conditions are unlikely to be generally satisfied. Jeffrey N. Gordon, “Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law,” 60 *U. Cin. L. Rev.* 347, 368-370 (1991). However, the conditions for absence of cycles are much weaker than those for unanimity. Single-peaked preferences are sufficient to ensure that majority voting would not lead to cycles.

with an arrangement that is inferior to all of the top choices. The power to intervene ensures that the company will not end up with any arrangement outside the set of top choices.

Third, assuming that a cycle of top choices arises, addressing this problem does not make it necessary to eliminate the power to intervene, which is needed to rule out D and other inferior arrangements. The problem could be addressed by merely permitting management to accompany any shareholder initiative with management counter-proposals. Suppose that we are in the hypothetical case with A, B, and C forming a cycle. Suppose further that management prefers A, and that the status quo is A. If some shareholders initiate a vote on C, management can immediately put on the agenda subsequent immediate votes on B, and then on A, which would lead to an outcome of A being adopted. Indeed, permitting management to schedule the votes would discourage the initiation of a proposal to begin with. Either way, the company would remain with a stable outcome of A.

Thus, whatever problem of cycles exists, this at most calls for providing management with the power to schedule votes on counter-proposals, thereby allowing management to be the tiebreaker among choices that all belong to the top set. The cycling problem does not call for denying shareholders the power to initiate votes. This power is necessary to ensure that choices made by companies are always within the set of top choices for shareholders.<sup>96</sup>

#### *D. Panglossian Claims*

No discussion of corporate law reform can conclude without addressing what might be referred to as the “Panglossian argument.”

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<sup>96</sup> It should be noted that Gordon notes the possibility of letting shareholders initiate and letting managers set the agenda. He argues, however, that with the agenda setting power, the managers effectively nullify the power of shareholder initiation. The power to set the agenda of votes, he says, is equivalent to the power to fully control the agenda. See Jeffrey N. Gordon, “Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law,” 60 *U. Cin. L. Rev.* 347 (1991). As the above discussion makes clear, however, this claim overlooks the problems of choices outside this set of top options. It is correct if the only options are A, B, and C (which is what Gordon assumes). In this case, either the power to make the choice or the power to set the agenda would be sufficient to ensure for management the outcome preferred by it. But if management most prefers an option D which is dominated by A, B, and C but favored by management, then management control will enable management to get D but the agenda-setting power to sequence votes would not.

According to this argument, we live in the best of all possible worlds because the market ensures that this is so.<sup>97</sup> According to the Panglossian view, 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. Although there are some general problems with this type of argument,<sup>98</sup> the Panglossian argument, however, is especially weak in the case of the reforms under consideration.

To start with, U.S. corporate law does not enable companies to opt into a regime with shareholder intervention. Consider first the provisions of the Revised Model Business Corporation Act (RMBCA), which has been adopted by many states. The RMBCA explicitly prohibits public companies from providing shareholders with intervention power. Section 7.32(a) of the RMBCA authorizes shareholder agreements to shift managerial power to shareholders. 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. Moreover, once the company becomes public, the board is authorized to delete any references to such an agreement in the charter .

Delaware is known for its enabling approach.<sup>99</sup> An examination of the Delaware code, however, indicates that it does not permit arrangements that give shareholders the power to intervene. Importantly, the sections in the code that govern mergers and charter amendments do not include the specification, appearing in many other sections of the Delaware code, that they hold only if the charter does not specify otherwise.

It might be argued that opting out of the statutory allocation of power is permitted under the general provision of Section 141(a), which allows companies to confer the powers granted to the board on other "person or persons as shall be provided in the certificate of incorporation."<sup>100</sup> A close look at the code indicates, however, that Section 141(a) does not enable

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<sup>97</sup> Panglossians are not necessarily wide-eyed optimists. As the old saying goes, optimists believe that we live in the best of all possible worlds, while pessimists are afraid this is true.

<sup>98</sup> For discussion of the problems with making Panglossian inferences from IPO decisions, see Lucian Bebchuk, "Why Firms Adopt Antitakeover Arrangements," *University of Pennsylvania Law Review* \_ (2003).

<sup>99</sup> See Romano, *The Genius of American Corporate Law*.

<sup>100</sup> See Stout, "The Shareholder as Ulysses: An Empirical Exploration of Why Public Corporations are Controlled by Boards of Directors," *U. Penn. L. Rev*, forthcoming 2003.

arrangements under which a group of shareholders can initiate a binding shareholder vote on a charter amendment or a merger.<sup>101</sup> To begin with, while Section 141(a) may be used to delegate some of the powers conferred on the board by Section 141 itself, it cannot be used to take from the board the powers conferred on it by the other specific sections of the statute concerning mergers and charter amendments.<sup>102</sup>

Moreover, the code requires that, in the event that any powers are transferred to some other persons under Section 141(a), the fiduciary duties of directors shall be imposed on these persons. Thus, the transferred contemplated by this Section is to a specified group of persons that would have the duty to become fully informed about the decision. Whatever opting out is permitted, it does not include conferring power on a group of, say, 5% of the shareholders that would band together for the sole purpose of supporting a proposal and that would not have a duty of care to obtain and assess all reasonably available information.

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. This section—governing only close corporations—explicitly permits shareholders, if the charter so provides, to intervene directly in management decisions. The limitation of this provision to close corporations indicates that the charter of other companies – and, in particular, publicly traded companies – may not confer board powers on shareholders.<sup>103</sup>

Panglossians, however, might claim that, because Delaware law’s prohibition on shareholder power to intervene is not unambiguously clear, one would expect companies to seek 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.

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<sup>101</sup> I am grateful to Bill Allen and Larry Hamermesh for discussing with me the interpretation of Delaware law provided below.

<sup>102</sup> See, e.g., Charles R.T. O’Kelley & Robert B. Thompson, *Corporations and Other Business Associations*, 175 (1999) (italicization added) (reading Section 141(a) to authorize the charter to “give shareholders a right to control, or participate in the control of, *ordinary business matters*.”)

<sup>103</sup> To look at yet another jurisdiction, consider New York State. Section 620(b) of the New York Business Corporation Law permits charter provisions that confer management power on shareholders. 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.”



It is now well recognized that the adoption of legal arrangements by companies is influenced by “network externalities,” externalities that arise “where purchasers find a good more valuable as additional purchasers buy the same good.”<sup>104</sup> It is advantageous for a company to offer an arrangement that is familiar to institutional investors, that facilitates pricing relative to other companies, and that is supported by a developed body of precedents and by judges familiar with it. Conversely, companies are discouraged from adopting arrangements that are unconventional and radically different from those in other companies. This is all the more the case when, as here, the legal validity of the arrangement is rather uncertain.

Thus, it is not possible to infer that shareholder power to intervene is undesirable from the fact that company founders have not been making efforts to adopt a regime of shareholder intervention through private action. Accordingly, if one concludes that such power is beneficial, one has every reason to establish it at least as a default arrangement. In such a case, whether companies should be free to opt out of this default arrangement would depend on one’s view of the general question of contractual freedom in corporate law, a question on which readers might well hold different views.<sup>105</sup>

## VI. OBJECTIONS BASED ON STAKEHOLDER INTERESTS

I finally turn to objections to shareholder intervention that are based on its potential harm to corporate stakeholders—nonshareholder constituencies such as employees, suppliers, or debtholders.<sup>106</sup> It might be argued that it is desirable to prevent shareholders from making decisions that would transfer value from stakeholders. Indeed, it has been argued that, in order to induce ex ante investments by stakeholders in the success of an enterprise, it is ex ante in the interest of shareholders to tie their own hands and let later

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<sup>104</sup> Michael Klausner, “Corporations, Corporate Law, and Networks of Contracts,” 81 *Va. L. Rev.* 757, 842 (1995). Mark A. Lemley & David McGowan, “Legal Implications of Network Economic Effects,” 86 *Cal. L. Rev.* 479, 483 (1998); see also Michael L. Katz & Carl Shapiro, “Network Externalities, Competition, and Compatibility,” 75 *Am. Econ. Rev.* 424, 424 (1985).

<sup>105</sup> My own views on the subject are expressed in several earlier works including, most recently, Lucian Bebchuk, “Why Firms Adopt Antitakeover Arrangements,” *University of Pennsylvania Law Review* \_ (2003).

<sup>106</sup> See, for example, Margaret M. Blair and Lynn A. Stout, “A Team Production Theory of Corporate Law,” 85 *Va. L. Rev.* 247, 253 (1999); Martin Lipton, “Takeover Bids in the Target’s Boardroom,” 35 *Bus. Law.* 101, 130–31 (1979).

decisions be made by a board that will take into account the interests of both stakeholders and shareholders.<sup>107</sup>

The argument that stakeholder interests justify management control has played a role in the politics of takeovers. A majority of states has enacted statutes allowing managers responding to a takeover bid to take into account the interests of stakeholders.<sup>108</sup> In the debate on takeover defenses, supporters of management control have used claims about stakeholder interests in the political arena, in the courts, and in the court of public opinion.

As explained below, stakeholder interests do not provide a good reason for limiting the powers of shareholders. Managerialism 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 closely held or it might be publicly traded. If it is desirable to limit the power of capital providers in publicly traded firms with dispersed ownership that operate in this industry, there is no reason not to have such limits in the case of the firm with the controlling shareholder as well. Dispersed shareholders with power to intervene would not intervene in decision-making more, and might well intervene less, than the controlling shareholder under current arrangements.

If the elimination of intervention power in firms with dispersed ownership is intended to attain a social goal of stakeholder protection, the

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<sup>107</sup> See Margaret M. Blair and Lynn A. Stout, "A Team Production Theory of Corporate Law," 85 *Va. L. Rev.* 247, 304-05 (1999); Andrei Shleifer and Lawrence H. Summers, "Breach of Trust in Hostile Takeovers," in Alan J. Auerbach, ed., *Corporate Takeovers: Causes and Consequences* 33 (Chicago 1988); John C. Coffee, Jr., "The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders, and Bust-Ups," 1988 *Wisc. L. Rev.* 435; John C. Coffee, Jr., "Shareholders versus Managers: The Strain in the Corporate Web," 85 *Mich L Rev* 1 (1986).

<sup>108</sup> See Gartman, State Takeover Laws §§ A-6 to A-7, *supra* note 7. The committee drafting the RMBCA, however, decided that directing directors to consider the interests of nonshareholder constituencies is undesirable. See "Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion," 45 *Bus Law* 2253, 2270-71 (1990).

goal should equally call for limiting the intervention power of the controlling shareholder. Similarly, if the absence of intervention power serves the dispersed shareholders by inducing stakeholders to make firm-specific investments, this consideration should be equally applicable to firms in the same industry that have a controller. In the absence of legal rules that limit the controllers' power to intervene, controller should be expected to make contractual arrangements that would limit their power to intervene (by, say, signing contracts with professional managers that provide the managers with insulation from ex post intervention by the controller).

A substantial fraction of large firms in the U.S., and most large firms around the world, have a controlling shareholder or family. In many such cases, the firm has a professional manager. Still, neither legal rules nor the charters or contracts of these firms attempt to block the controller's power to intervene. At the outset, this observation suggests some skepticism is warranted for the claim that such management insulation is called for in companies with dispersed shareholders.

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

Turning to examine whether denying dispersed shareholders the power to intervene operates to the benefit of stakeholders, it is first worth noting that some of the decisions for which intervention power is proposed are ones which are unlikely to affect stakeholders. This is the case for rules-of-the-game decisions that affect mainly the relationship among shareholders and between shareholders and management. This might be the case also for scaling-down decisions. The distribution of a cash hoard would prevent managers from expanding the size of the firm and bringing in additional stakeholders but might well not adversely affect existing employees and other stakeholders.

Some decisions might of course have an effect on existing stakeholders. Termination decisions, even when they involve a merger or sale rather than 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, communities might lose a corporate headquarters or corporate operations, and so forth. In addition, some scaling-down decisions might require management to liquidate operating assets and thereby cause partial termination with possibly adverse effects on stakeholders.

Some commentators have argued that, although full or partial termination in theory can impose such harm on stakeholders, the evidence indicates that such losses are not very common and, furthermore, are small in magnitude relative to shareholders' gains when they do occur.<sup>109</sup> It can also be argued that the law generally should not provide protection to stakeholders beyond what is called for by their contracts with the corporation. On this view, protection of stakeholder interests should be left to contracts between them and the corporation or to nonlegal sanctions.<sup>110</sup>

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

To begin with, it is worth observing that there is no assurance that power given to management will be exercised to protect stakeholders. In theory, one could consider requiring management to maximize the overall welfare of all corporate constituencies. Courts, however, would be unable or at least unwilling to enforce 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 observed, 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>111</sup>

Supporters of management control indeed do not assert that management should be required to use its power in ways that would protect stakeholders, or that courts should sanction the use of such power for other

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<sup>109</sup> For a review of the evidence, see Ronald Daniels, "Stakeholders and Takeovers: Can Contractarianism Be Compassionate?," 43 *U Toronto L J* 297, 317-25 (1993); Roberta Romano, "A Guide to Takeovers: Theory, Evidence, and Regulation," 9 *Yale J Reg* 119, 133-43 (1992).

<sup>110</sup> An excellent discussion of this view can be found in Ronald Daniels, "Stakeholders and Takeovers: Can Contractarianism Be Compassionate?," 43 *U Toronto L J* 297, 340-49 (1993).

<sup>111</sup> Oliver Hart, "An Economist's View of Fiduciary Duties," 43 *U Toronto L J* 299, 303 (1993).

purposes. Indeed, 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 (rather than requires) directors to take into account the interests of other constituencies.<sup>112</sup> Supporters of management control wish to give management *discretion* with the hope that it would use its discretion to protect stakeholder interests. In considering how likely this is to happen, we should examine whether the interests of management are likely to overlap with the interests of the stakeholders that are supposed to benefit from this discretion.

Do we have good reasons for expecting management to be a good agent for stakeholders? If anything, management's interests are more likely to be aligned with those of shareholders rather than stakeholders. 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, this is all the more true with respect to stakeholders.

The practices of boards and executives hardly reflect the proposed conception of management as partly an agent for stakeholders. To the extent that executive compensation and the compensation of directors include incentives, those are solely incentives to increase shareholder 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, say, the average or total compensation paid to employees.

To be sure, some correlation between the interests of management and those of stakeholders might arise because some termination decisions might be 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 rather limited; management and stakeholder interests can be expected to overlap occasionally but not in general.

There might well be decisions that would be beneficial to stakeholders—say, when an acquisition by a large and rich buyer would improve opportunities for employees—but that management would disfavor

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<sup>112</sup> See "Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion," 45 *Bus Law* 2253, 2261–63 (1990).

for self-serving reasons. Conversely, there might well be (full or partial) termination decisions that would hurt stakeholders but that management, at least if it is offered a sufficiently good deal, would favor. 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 rather for itself. In sum, given the limited overlap between management and stakeholder interests, there is no basis for expecting management control to translate into an effective protection of stakeholders.<sup>113</sup>

### *C. Managerialism in Stakeholder Cloths*

I have discussed in detail the arguments based on stakeholder interests because of their importance in public debates about management and shareholder power. Stakeholder arguments have been an important card used by defenders of managerial power. Once stakeholders are brought into the debate, shareholders no longer have a central claim on what management should do, but rather become one constituency of several whose interests should be protected.

Thus, opposition to shareholder intervention can be cast as a rejection of the view that only shareholders count, and as arising from a 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, managerialism can boost significantly its perceived legitimacy and appeal. It is no longer a self-serving position on the part of management. Rather it is a noble fight against a narrow, shareholder-centered view of the corporation and in favor of a broad, inclusive view.<sup>114</sup>

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<sup>113</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 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 constituencies statute, all but four also have another type of second-generation antitakeover statute. See Gartman, *State Takeover Laws*, Appendix B.

<sup>114</sup> Cf. Allen, Jacobs, and Strine, *69 U Chi L Rev* (2002) (viewing the debate over shareholder choice in takeovers as partly involving choice between a shareholder-

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 a good agent for stakeholders. Limits on shareholder power should not be viewed as supporting the interests of employees and stakeholders but rather as support for enhancing the power of management relative to shareholders. 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. This is what is at stake in the debate on managerialism.

## VII. CONCLUSION

This paper has reconsidered a well-settled and basic feature of American corporate law – that shareholders do not have the power to intervene and make major corporate decisions. This basic feature, which is not shared by the corporate law systems of other common law countries, has a profound influence on the governance of U.S. companies with dispersed ownership. The power of management and the weakness of shareholders in such companies is not largely an inevitable product of the dispersion of ownership. They are in part due to the legal rules that tie shareholder hands and insulate management from shareholder intervention.

The analysis has shown that the case for maintaining management's insulation from shareholder intervention is far from compelling. It does not follow from the imperfect information that shareholders have or from the requirements of centralized management. Furthermore, this feature of corporate law is at least partly responsible for some long-standing problems of corporate governance. Indeed, providing shareholders the power to intervene can substantially alleviate the agency problems that have for long occupied legal scholars and financial economists.

The paper has identified three categories of major corporate decisions as ones for which shareholder power to intervene should be seriously considered. Shareholder power to make rules-of-the-game decisions could do much to improve the contractual and legal arrangements governing corporations and to address concerns that management control produces an

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centered view of the corporation and a broader, "entity" perspective that incorporates the interests of stakeholders.

inefficient tilt of such arrangements in favor of management. Shareholder power to make game-ending decisions could do much to counter the tendency of management to favor continuation of the company and thus their private benefits of control. And shareholders power to make Scaling-back decisions could do much to address the problems of free cash flow and empire building. The paper has also analyzed how such a regime could best be designed to make it work most effectively.

More work remains to be done before the consequences of shareholder power to intervene can be fully assessed. The analysis of this paper can serve as a starting point for such work. The allocation of power between management and shareholders is a subject that warrants a careful reconsideration by all those interested in improving corporate governance.