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Excerpt from:

SOME SKEPTICISM ABOUT INCREASING SHAREHOLDER POWER†

Iman Anabtawi*

This Article challenges the claim of shareholder primacists that reapportioning corporate governance power away from boards of directors and toward shareholders will benefit shareholders as a class. This claim is premised upon the assumptions that shareholders have harmonious interests and that they will pursue those interests by disciplining managers and increasing shareholder value. I argue that the pursuit of common shareholder interests is unlikely to dominate the actions of shareholders. The largest modern shareholders—those most likely to exercise shareholder power—have private interests that are both substantial and in conflict with maximizing overall shareholder value. As a result, it is misleading to assume that increasing shareholder power will benefit shareholders generally. Instead, it is more plausible that shareholders will use any incremental power conferred upon them to benefit their private interests at the expense of the firm and other shareholders. I contend that this concern poses a sufficient threat to shareholder wealth to warrant caution before implementing corporate governance reforms that would increase shareholder power.

Introduction

In the shareholder-power debate over how best to apportion corporate decision making between officers and directors, on the one hand, and shareholders, on the other hand, shareholder primacists are gaining ground. According to shareholder-primacy theory, shareholders of the modern publicly held corporation are principals, and managers are their agents in running the firm. Shareholder primacists contend that shareholders would like managers to maximize the long-term value of their shares,[1] but that managers are unlikely to do so because their interests are insufficiently aligned with those of shareholders. According to shareholder primacists, increasing shareholder power would go a long way toward solving the agency problem between managers and shareholders.[2]

On the other side of the debate are director primacists—those who argue in favor of vesting primary decision making authority in a firm's board of directors. In Stephen Bainbridge's director-primacy theory, for example, the board of directors is a mechanism for solving the organizational design problem that arises when one views the firm as a

nexus of contracts among various factors of production, each with differing interests and information.[3] The board of directors serves as an efficient, central decision maker within this scheme. Centralizing corporate decision making in a board of directors necessitates conferring upon it considerable discretion, which, in turn, implies limiting shareholder power.[4]

Margaret Blair and Lynn Stout take a different approach in justifying director primacy.[5] Their "team production" model of corporate governance argues that corporate law must address the economic problem of encouraging non-shareholder corporate constituencies, such as executives, rank-and-file employees, creditors and sometimes the local community, to make firm-specific investments in corporations. According to Blair and Stout, one way to do so is to place control of the corporation in the hands of a board of directors that is insulated from shareholder control and enjoys the freedom to take actions that improve the joint welfare of all the firm's team members.[6] Thus, the proper focus of corporate governance should, in their view, be on designing and implementing incentives for board behavior that do not involve enhancing shareholder disciplining. Instead, team production theory treats directors as "mediating hierarchs" whose job is to balance the interests of all the corporation's constituencies, thereby serving the interests of the entire firm.[7]

In this Article, I advance a third rationale for vesting primary decision making authority in the board of directors—the need for mediating the various and often conflicting interests of shareholders themselves. I claim that shareholder primacists either ignore or underplay deep rifts among the interests of large blockholders, those shareholders most likely to exercise shareholder power. Instead, they continue to regard shareholders as a monolith with a single, overriding objective—maximizing shareholder value.

This Article disputes the characterization of shareholders as having interests that are fundamentally in harmony with one another.[8] While that conception of shareholders may once have been an accurate generalization, it does not reflect the existing pattern of share ownership in U.S. public companies. Pitted against shareholders' common interest in enhancing shareholder value are significant private interests.[9] Take, for example, a hedge fund that is a shareholder in a company and that is about to raise capital for a new fund. As part of its marketing effort, it wants to show impressive returns on its prior fund. To generate such returns, the hedge fund is likely to favor policies by the firms in which its investments produce short-term gains, even if a more patient investment orientation would generate higher returns over the long term. In contrast, a pension fund or life insurance company shareholder is more likely to be

concerned about the long-term value of its investments, which will allow it to meet its future obligations. Shareholders have numerous other private interests, some of which have emerged relatively recently, and these are described in detail in Part B. of this Article. On close analysis, shareholder interests look highly fragmented.

Once we recognize that shareholders have significant private interests, it becomes apparent that they may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class. As a result, transferring power from boards to shareholders will not necessarily benefit all shareholders. Indeed, it could reduce overall shareholder welfare. This outcome, of course, is the opposite of that predicted by proponents of increasing shareholder power. …

Shareholders as a Potential Constraint on Agency Costs

Recent corporate fiascos—Enron, WorldCom, and Adelphia, to name a few—convinced many students of corporate governance that incentive pay and the corporate control market were inadequate devices for disciplining corporate managers.[10] In response, attention has shifted to revisiting the structure of corporate governance to address the agency problem between managers and shareholders.[11] Current reform efforts, often referred to as proposals for "corporate democracy," would reapportion power away from boards and toward shareholders, to some extent "reunifying" ownership and control in the modern public corporation.[12]

Indeed, the U.S. system of corporate governance leaves ample room for increasing shareholder power. Shareholders have only limited involvement in corporate decision making. The management of a firm is vested formally in its board of directors, subject only to specific shareholder voting rights.[13]

Corporate statutes typically grant shareholders the right to: (1) nominate and elect directors;[14] (2) adopt, amend and repeal bylaws;[15] (3) approve fundamental corporate changes, such as mergers,[16] sales of all or substantially all of the firm's assets,[17] dissolutions[18] and amendments to the firm's certificate of incorporation[19] and (4) request board action through shareholder resolutions included in a company's proxy statement.[20]

In practice, however, the foregoing rights give shareholders little power over corporate decision making. To begin with, the right of shareholders to nominate and elect directors is restricted by their inability to call special shareholder meetings.[21] Shareholders must wait until the next regular annual meeting to present and vote on a proposal to

replace the company's existing board of directors, by which time it may be too late to implement any policy supported by the shareholders. Moreover, if a board of directors is staggered, it could take shareholders more than one annual election cycle to replace a majority of the board.[22] Dissident shareholders contemplating putting forward their own director slate must also incur significant costs to do so.[23] Waging an expensive proxy contest for control of the board is, therefore, unlikely except with respect to the most significant business decisions.

Similarly, shareholders' power over bylaws is weaker than it appears. While corporate statutes that grant shareholders the right to amend bylaws permit those bylaws to address business decisions—so long as such bylaws are consistent with state law and a corporation's charter[24]—those statutes also vest authority to manage the corporation in the board.[25] In attempting to accommodate the foregoing provisions, courts have resisted attempts by shareholders to use bylaws to mandate directors' business decisions.[26]

With respect to the right of shareholders to approve fundamental board decisions, it is important to note that this is merely a veto power—shareholders cannot initiate such decisions.[27] Thus, shareholders can block extraordinary board actions, but they cannot initiate any. In addition, very few business decisions fall into this category.[28]

Finally, because shareholder resolutions are merely precatory if they do not relate to a proper subject for action by shareholders under applicable state law, boards are entitled to disregard them.[29] To be sure, resolutions that garner substantial shareholder support are likely to get management's attention. Still, boards commonly decline to implement precatory resolutions that obtain support from even a majority of shares.[30]

These limitations on the effectiveness of shareholder participation in corporate decision making suggest that shareholders presently have the potential to operate as only a weak constraint on managers. Proponents of increasing shareholder power claim that doing so would reduce agency costs and enhance shareholder value.[31] They recommend implementing dramatic measures that would fundamentally reapportion the current balance of corporate decision making power between managers and shareholders. These reforms include allowing shareholders to vote (1) to amend a corporation's charter and change the state in which it is incorporated and (2) to grant themselves through charter provisions the power to initiate and adopt binding resolutions with respect to specific business decisions.[32] A corporate governance regime that incorporated the foregoing features would recast dramatically the role of

shareholders in corporate governance. It is far from certain, however, that increasing shareholder power would, as its proponents claim, reduce agency costs and increase shareholder value.

Three basic assumptions underlie the case for increasing shareholder power. The first is that the proper role of the corporation is to serve shareholders rather than stakeholders generally.[33] Second, the case for increasing shareholder power assumes that shareholders would overcome collective action problems to make use of the power being transferred to them.[34] Third, it assumes that shareholders would use their incremental power to discipline managers, thereby benefiting shareholders as a class, as opposed to furthering their private interests.[35] If any of these assumptions is not satisfied, then shifting corporate governance power from boards to shareholders may be undesirable.[36]

A. Shareholder Action Under Conditions of Divergent Interests

Shareholders can influence management not only to enhance common shareholder value but also to obtain private benefits. This possibility arises whenever shareholders have private interests that diverge from the interests of shareholders generally. In these circumstances, shareholders have an incentive to act in the common interests of all shareholders only when two conditions are satisfied. A shareholder will undertake the costs of disciplining management if its proportionate share of the expected collective benefits from its actions exceeds its expected costs. In addition, the shareholder's stake in the firm must align that shareholder's interests with the interests of other shareholders more than its private interests conflict with the interests of those shareholders. In the absence of either condition, (1) there will be no single maximand with respect to which shareholders as a class desire managers to run the firm and (2) it might be rational for any given shareholder to deploy its power to promote its private interests at the expense of common shareholder interests.

Rent Seeking

When shareholders do not agree on a common objective in managing the firm, it may be privately rational for them to engage in rent-seeking activities. "Rent-seeking" is the socially costly attempt to obtain wealth transfers.[37] Such behavior can reduce shareholder value.

Transferring power to shareholders likely will exacerbate rent-seeking behavior. The reason for this is that any meaningful expansion of shareholder power would increase the expected benefits to shareholders with private interests of undertaking a given

level of activism. As shareholders step up the pursuit of their private interests, interest costs would rise as corporate managers—weakened by shareholder-empowerment measures—increasingly satisfy those interests. In addition, increased efforts to obtain private benefits (or to counteract the efforts of other shareholders to capture them) would raise total squabbling costs.[38]

Thus, increasing shareholder power when shareholders have private interests could both reduce the size of the shareholder pie and increase the resources spent competing over how to share it. Part B. shows that there are, indeed, deep rifts among the interests of modern shareholders. These divisions, in turn, imply that increasing shareholder power carries with it the real risk of reducing shareholder value.

B. Divergent Interests Among Shareholders

Shareholders, to paraphrase William Chandler III, come in different flavors.[39] Most observers of corporate governance law, nevertheless, regard divergences in the interests of shareholders as either insignificant[40] or checked by the corporate law voting principle of majority rule.[41] This part catalogues five schisms among modern shareholders,[42] which then turns to the likelihood that these divisions will cause shareholders to promote their private interests at the expense of their common shareholder interests.

Short-term Versus Long-term Shareholders

One axis of division among shareholders is the time horizon over which they expect to hold their shares. Heterogeneity among shareholders with respect to their expected holding periods can lead to differences in shareholder preferences over corporate decision making. This conflict focuses on whether managers should make decisions for long-term or immediate profits.[43] A short-term shareholder is viewed as one who seeks to buy and sell stocks with high frequency in an endeavor to profit from market movements.[44] By contrast, a long-term investor is seen as buying and holding stocks, usually without regard to short-term developments.[45] Short-term shareholders prefer managers to maximize short-run share price, while long-term shareholders prefer to forego immediate gains in favor of maximizing long-run shareholder value. Thus, the distinction between a short-term and a long-term shareholder turns mainly on whether the shareholder seeks to profit from fluctuations in stock price, without regard to whether those fluctuations will become permanent.

The contention that differences in the time horizons of shareholders can lead to divergent preferences for how a corporation is managed calls for elaboration. According to the

efficient capital markets hypothesis (ECMH), the price of a firm's stock at any given time accurately reflects all available information about the company.[46] If the ECMH accurately described stock prices, then short-term stock prices would reflect investors' fully-informed mean estimates of the fundamental, or long-term, value of securities. The maximization of short-term value would then be consistent with long-term value maximization. Thus, in an efficient stock market, the time horizon of a shareholder should not affect how that shareholder would like to see the firm managed.

The ECMH, however, is no longer regarded as an accurate description of the real world.[47] Although there is still believed to be some relationship between short-term stock prices and fundamental value, that relationship is now understood to be extremely loose.[48] In other words, short-term stock prices may deviate from fundamental values for extended periods of time.[49]

This recognition presents the possibility of conflicts of interest among shareholders with divergent time horizons. For example, shareholders with a short timeframe will favor the inflation of current share prices at the expense of long-run value. On the other hand, long-term investors will be willing to sacrifice immediate profits for future appreciation. One example of why short-term stock prices might deviate from their long-term values involves the valuation of a company's earnings. Numerous studies have shown that the stock market places a disproportionately high value on a company's near-term earnings by placing an excessively high discount rate on its future expected earnings.[50] Short-term investors will, therefore, have a bias for increasing current earnings at the expense of future earnings. This result can be achieved by, for example, moving expenses from the current year to the future or by moving revenues from future years to the current year.[51] Such actions can enhance (or avoid depressing) a company's current share price but reduce long-run shareholder value.[52]

Diversified Versus Undiversified Shareholders

Another fault line separating shareholders is the extent to which their portfolios are diversified. James Hawley and Andrew Williams have advanced the argument that the institutionalization of U.S. shareholdings created a new category of shareholders, "universal owners," who are characterized by their holdings across a wide spectrum of the stock market.[53] Because their investment portfolios are so diversified, universal owners are thought of as "owning the economy."[54] As Hawley and Williams point out, "the quintessential universal owners are the largest of the public and private pension funds," which have investment portfolios that consist of a broad cross-section of the economy.[55] Universal owners can be contrasted with undiversified shareholders, such

as inside shareholders[56] and founding-family shareholders,[57] who have their wealth disproportionately invested in a given company.

The interests of diversified and undiversified shareholders are likely to conflict in two arenas—risk preferences and concern over externalities. First, the investment opportunities that a firm has available to it vary with respect to risk characteristics. For example, a pharmaceutical company may be faced with the choice of making a significant investment in one of two competing projects: Project A and Project B. Suppose that Project A will yield a steady return of 5 percent a year. Project B, on the other hand, has a 50 percent chance of generating a 40 percent annual return and a 50 percent chance of generating no return. Which project a shareholder may prefer the firm to choose depends on that shareholder's risk profile.

Inside Versus Outside Shareholders

One of the most frequently noted conflicts of interest over the management of a firm arises between inside and outside shareholders.[58] Inside shareholders are shareholders who are firm employees—either senior executives or rank-and-file workers. Insiders possess firm-specific human capital and therefore have heavy exposure to firm-specific risk. As a result, in making project-selection decisions, for example, insiders seek to minimize firm-specific risk, which they (unlike outside shareholders) cannot diversify away, by under-investing in projects that increase firm risk and over-investing in risk-reducing activities.[59] In contrast, outside shareholders invest in the firm only externally.

Conventional wisdom holds that insider equity ownership can mitigate the agency problem of insiders pursuing their own interests at the expense of outside shareholders.[60] Even when an insider's interests are tied to those of outside shareholders through equity holdings, the insider may still find it beneficial to pursue his private interests at the expense of shareholder value. Such incentives exist whenever the benefit (or cost) to the insider, as a shareholder, of pursuing the superior (or inferior) project is outweighed by the cost (or benefit) to the insider, as an employee, of pursuing the project.

Insiders also have conflicts of interest with outside shareholders in the acquisition context. Specifically, insiders may frustrate or reject attractive acquisition offers that would increase shareholder value but possibly cost them their jobs. In addition, they might be motivated to entrench themselves by adopting (or resisting the repeal of) anti-takeover provisions, such as poison pills. Conversely, top executive insiders may

have golden parachutes in place. If these benefits are sufficiently large, they may encourage managers to support an acquisition that is not in the best interests of outside shareholders.

Public and Union Pension Funds Versus Economic Shareholders

Sometimes, shareholders have targeted, non-economic, interests. The most influential shareholders in this category are public pension funds and labor-union pension funds.[61] These groups have incentives to consider objectives apart from shareholder value in exercising their influence as shareholders.

Like public pension funds, labor-union pension funds have become increasingly significant shareholders.[62] These funds are private pension plans that pool the pension fund money of union members for investment.[63] Union pension funds are subject to the Taft-Hartley Act,[64] which mandates the joint management of union pension funds by trustees appointed by both corporate managers and unions.[65] While the Taft-Hartley Act imposes a fiduciary duty on plan trustees, mandating that all payments be held in trust for the "sole and exclusive benefit of the employees . . . and their families and dependents,"[66] it does not directly regulate the investment activities of pension funds.

Union pension fund trustees are also subject to the fiduciary duties of the Employee Retirement Income Security Act of 1974 (ERISA),[67] which requires "diligence . . . that [would be used] in the conduct of an enterprise of a like character and with like aims,"[68] and requires trustees to diversify, unless it is clearly prudent not to do so.[69] The Department of Labor has given union pension funds leeway in pursuing socially or economically targeted investments. Thus, as Stewart Schwab and Randall Thomas have stated, "within bounds, ERISA—and certainly Taft-Hartley—allows union pension funds to invest in projects that benefit workers, so long as the risk and return is similar to other projects."[70]

As with other investors with private interests, the preferences of union pension funds parallel those of investors generally in many circumstances.[71] Schwab and Thomas, for example, have emphasized those goals of union shareholder activity that benefit all shareholders, such as attacks on poison pills and excessive executive compensation.[72] Union pension funds, however, often also have an interest in furthering the special labor interests of union members, even at the expense of shareholder wealth. For example, a union pension fund might be seeking union recognition[73] or desire concessions in collective-bargaining negotiations. The latter scenario unfolded last year in connection with a strike by the United Food and Commercial Workers (UFCW),

one of California's most powerful private-sector unions, against Safeway, Inc. The strike began when the UFCW and Safeway could not agree on terms for a new contract.[74] At the time, the California Public Employees' Retirement System (CalPERS) owned over $75 million in Safeway stock.[75] CalPERS is a public pension fund overseen by a board of trustees, the former president of which was also the UFCW's regional executive director. CalPERS exerted pressure on Safeway to accede to union demands while the strike was in progress.[76] After the strike was over, CalPERS announced that it would withhold support for the board reelection of Safeway CEO Steven Burd. Although CalPERS justified its opposition to Burd by a desire to enhance overall shareholder value, many observers concluded that it was designed to respond to Burd's hardline stance in his negotiations with the UFCW.[77]

Hedged Versus Unhedged Shareholders

Continuing innovation in the financial products market is giving rise to yet another tension among shareholders. There are now numerous techniques, including the use of equity derivatives and other financial contracts, that allow shareholders to alter the economic characteristics of their ownership interest in a firm's shares relative to pure shareholders (shareholders that have not engaged in any derivative transactions with respect to their shares). The result is that shareholders can effectively decouple their voting rights in a firm from their economic exposure to the firm's performance.[78]

Consider a shareholder that purchases one share of a firm's stock at the market price of $10 per share and simultaneously purchases an at-the-money put option on the stock. The put option entitles the shareholder to sell, or "put," the stock to the option counterparty at $10 per share for a designated period of time. As a result, during the term of the option contract, the shareholder is insulated from the risk that the firm's share price will decline. If the share price falls to $9, the value of the share that the shareholder owns goes down by $1, but the shareholder has the right to sell one share to the put-contract counterparty at $10. Because this latter right is worth $1, the shareholder has insulated itself, or hedged, against the economic consequences of a decline in the firm's stock price.

As a result of entering into the put contract, the shareholder in the foregoing example does not have the same economic interests as a pure shareholder. Specifically, until the option agreement expires, the shareholder will be indifferent to a decline in the value of the firm's shares. Indeed, if the shareholder purchased additional put options, its profits would increase directly with decreases in the firm's stock price. The economic impact of share price movements on the hedged shareholder would be in direct conflict with that on a pure shareholder, whose interest is to maximize share price.

Despite the fact that the hedged shareholder in the above example has altered the economic incentives associated with pure share ownership, that shareholder retains the right to vote its shares.[79] The default rule of shareholder voting allocates one vote to each common share.[80] The "one-share/one-vote" rule is not affected by hedging transactions in which a shareholder engages.[81] Thus, shareholders can exercise voting rights with respect to shares in which they have a positive, zero or negative net economic interest.

Increasing Shareholder Power When Shareholders Have Private Interests

The rationale for shareholder activism is grounded in the desire to constrain the interest costs that arise from the separation of ownership and control in the large corporation. The rise of institutional shareholdings offered incentives for shareholders to discipline corporate managers. In Part A., I identified the conditions under which shareholders with private interests would rationally sacrifice overall shareholder value for private gain: Whenever shareholders expect to earn greater returns from advancing their private interests than it costs them as shareholders to do so, they will derive net benefits from using their shareholder power opportunistically. Part B. set forth numerous divisions among the interests of shareholders. Whether such interests will drive the actions of shareholders, however, depends in large part on the constraints on shareholders of pursuing self-serving behavior.[82]

The main objection to the argument that large shareholders are likely to use their power opportunistically is that their ability to do so is checked by the shareholder voting principle of majority rule.[83] In this regard, proponents of increasing shareholder power contend that shareholders will not be able to pursue successfully their private agendas to the detriment of shareholders generally because they will be unable to obtain majority support for such initiatives. According to this view, the only proposals that will succeed are those that increase shareholder value because this objective is the only one that shareholders have in common. Schwab and Thomas have noted, for example, that union-shareholder activity encompasses both initiatives aimed at enhancing shareholder value generally and initiatives designed to further unions' traditional organizing and collective-bargaining goals.[84] They argue, however, that because other shareholders will be skeptical of proposals that favor the special interests of labor, union-shareholders will have difficulty forming coalitions with them.[85]

When shareholders have private interests, however, a simple majority voting rule, in which shareholders vote in a binary "yes" or "no" fashion on issues, cannot be relied upon to produce only shareholder value-increasing outcomes. …

There is evidence indicating that shareholders use direct negotiations with corporate management to bargain for their private interests. In a study of direct negotiations between the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), a fund that manages pension money for teachers and other employees of tax-exempt organizations, and companies at which TIAA-CREF made shareholder proposals, 71 percent of the companies reached a negotiated settlement with TIAA-CREF prior to the vote on the shareholder proposal.[86] More generally, Institutional Shareholder Services, a consulting firm that advises institutional investors on corporate governance issues, stated recently that constructive dialogue between shareholders and corporations has replaced confrontation, with communications taking place "off stage, the results out of the limelight."[87]

Thus, we cannot rely on majority voting to ensure that only shareholder value-enhancing initiatives will succeed. Large shareholders may form coalitions that further their private interests but reduce overall shareholder value. They may also engage in negotiations with corporate management to achieve their own objectives. These possibilities cast doubt on the view that if shareholders are given increased power, then they will use that power to increase shareholder value.

Conclusion

Should we rely on shareholders to act as effective monitors of management? Others have put forth persuasive arguments for director primacy—a board-centered model for the management of public companies—arguing that we should not. In Stephen Bainbridge's director-primacy theory, the board of directors "is a *sui generis* body—a sort of Platonic guardian—serving as the nexus for the various contracts comprising the corporation."[88] Increasing director accountability to shareholders necessarily involves constraining board discretion.[89] From the director-primacy perspective, however, increasing shareholder power undermines the very raison d'etre of boards—to establish a central corporate decision maker with authority to contract for the corporation in the context of differing interests and information among the corporation's various factors of production.[90] In these circumstances, consensus-based decision making, the alternative to board primacy, is inefficient.[91]

Margaret Blair and Lynn Stout have taken a different approach to justifying the broad discretion vested in boards. Their "team production" view of corporate governance argues that the ex ante wealth of both shareholders and other corporate constituencies is maximized by rules that give directors freedom to consider the interests of all the groups that make specific investments in the corporation.[92] Thus, the proper focus

of corporate governance should, in their view, be on designing and implementing incentives for board behavior that do not involve strengthening shareholders. Instead, team production theory treats directors as "mediating hierarchs," whose job it is to balance the interests of all the corporation's constituents, not just shareholders, in serving the interests of the entire firm.[93]

This article sheds additional light on the shareholder-primacy versus director-primacy debate in that it suggests a further rationale for vesting primary decision making authority in the board of directors. It contends that shareholders have widely divergent interests that may give them incentives to pursue their private objectives at the expense of overall shareholder value. In contrast, directors, who owe fiduciary duties to all shareholders, are more likely to be able to mediate shareholder conflicts and make decisions on behalf of shareholders as a class.

Endnotes

†Excerpt from the full article "Some Skepticism About Increasing Shareholder Power," UCLA L. Rev. 561 (2006).

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1 *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 842 (2005) ("[E]ffective corporate governance, which enhances shareholder and firm value, is the objective underlying my analysis."). Later in the article, Professor Bebchuk refers only to the enhancement of shareholder value as his metric for effective corporate governance. *Id.* at 892 ("I have thus far discussed how giving shareholders the power to make rules-of-the-game decisions would improve corporate governance and increase shareholder value."); *see also id.* at 908 ("I have argued that making shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value.").

I refer to this objective as maximizing "shareholder value" or "shareholder wealth." This is a narrower objective than that of maximizing "firm value," which incorporates the preferences of nonshareholder constituencies of the firm, such as lenders. *See* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 Iowa J. Corp. L. (forthcoming 2006) (observing that although "empirical scholars have largely equated firm value with shareholder value, the two concepts are not identical"). For a general discussion of possible corporate finance objectives, see Aswath Damodaran, Corporate Finance: Theory and Practice 11–14 (2d ed. 2001).

2 *See generally* Bebchuk, *supra* note 1, at 833 (arguing that shareholder intervention would reduce agency costs between managers and shareholders); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811 (1992) (setting forth a favorable account of shareholder oversight); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. Rev. 895 (1992) (advancing arguments for greater institutional voice); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991) (discussing the benefits of increasing board of director accountability to shareholders).

3 *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. Rev. 601 (2006) (emphasizing the value of authority-based decisionmaking structures in large organizations).

4 *See id.* at 604 ; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 Harv. L. Rev. 1735 (2006) (replying to Bebchuk, *supra* note 1); *see also* Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. Pa. L. Rev. 577 (2003) (contending that managers have available to them means of evading shareholder oversight in the takeover context through unregulable or unobservable actions and that such behavior could destroy shareholder value to a greater extent than shareholder oversight enhances it).

5 *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law,* 85 Va. L. Rev. 247, 286 (1999) (emphasizing the role of a firm's board of directors as mediating conflicts among the firm's various "team members"); *see also* Reinier Kraakman et al., The Anatomy of Corporate Law: A Comparative and Functional Approach 18 (2004) ("As a normative matter, the overall objective of corporate law—as of any branch of law—is presumably to serve the interests of society as a whole."); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of*

Directors, 58 U. Chi. L. Rev. 187, 205 (1991) (endorsing a model of the corporation in which the interests of "stockholders, managers, and other constituencies" are relevant).

6 *See* Blair & Stout, *supra* note 5, at 288.

7 *Id.* at 291.

8 Corporate law recognizes that "controlling" shareholders have incentives to engage in self-dealing and thus imposes fiduciary duties on them to minority shareholders. *See* Zahn v. Transamerica Corp., 162 F.2d 36, 44 (3d Cir. 1947). Noncontrolling shareholders, on the other hand, are presumed to be unable to exercise their power to advance their private interests. *See, e.g.*, Weinstein Enters., Inc. v. Orloff, 870 A.2d 499, 507 (Del. 2005); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989); Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del. Ch. 1984), *aff'd*, 575 A.2d 1131 (Del. 1990). The leading exceptions in the academic literature to the foregoing generalization are the explorations by Jeffrey Gordon and Edward Rock into the possibility that noncontrolling shareholders will assert their influence in a self-serving manner. *See* Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. Cin. L. Rev. 347 (1991); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 Cardozo L. Rev. 987 (1994).

9 By "private" interests, I mean those interests of a shareholder that are not shared by shareholders generally. *See infra* note 42.

10 *See, e.g.*, Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. Chi. L. Rev. 1233, 1246–47 (2002); *cf.* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid*," 57 Bus. Law. 1403 (2002).

11 *See infra* notes 31–32 and accompanying text.

12 Although the phrase "corporate democracy" has been associated with a variety of meanings, I use it here to refer to a greater role for equity investors in corporate governance and more management accountability to shareholders. *See* Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 Ala. L. Rev. 879, 900 (1994).

13 *See* Del. Code Ann. tit. 8, § 141(a) (2001). The typical corporate statutes discussed subsequently in the text above are based on the Delaware General Corporation Law, which applies to the majority of U.S. publicly traded companies. *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & Econ. 383, 391 tbl.2 (2003).

14 tit. 8, § 141(k).

15 § 109(a).

16 § 251(c).

17 § 271(a).

18 § 275(b).

19 § 242(b).

20 17 C.F.R. § 240.14a-8 (2005).

21 tit. 8, § 211(d).

22 *See* Robert Charles Clark, Corporate Law § 13.6, at 576 (1986).

23 Because a corporation's board of directors generally has discretion over whether to pay for the campaign costs of dissident shareholders, shareholders challenging incumbent directors are likely to be reimbursed for their expenses only if they succeed in gaining control over the board of directors. *See* Lucian Ayre Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1071, 1106–10 (1990).

24 tit. 8, § 109(b).

25 § 141(a).

26 *See* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. Miami L. Rev. 605, 608 (1997).

27 *See* Bebchuk, *supra* note 1, at 846–47.

28 *See supra* notes 15–18 and accompanying text.

29 17 C.F.R. § 240.14a-8(i)(1) (2005).

30 *See* Randall S. Thomas & James F. Cotter, *Shareholder Proposals Post-Enron: What's Changed, What's the Same?* 14–18 (Sept. 2, 2005) (unpublished manuscript, on file with author).

31 *See, e.g.*, Bebchuk, *supra* note 1, at 908 ("[M]aking shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value."); *see also Donaldson Assures Leading House Democrats About Shareholder Access Proposal*, 22 Corp. Secretary's Guide: Corp. Directions 65 (2005) (reporting Congressional sentiment that the "lack of accountability on the part of boards of directors remains one of the most glaring deficiencies in corporate governance today"). *See generally* Bernard S. Black, *Institutional Investors and Corporate Governance*: *The Case for Institutional Voice*, 5 J. Applied Corp. Fin. 19 (1992) (describing the potential benefits of invigorating institutional monitoring of corporate managers).

32 Bebchuk, *supra* note 1, at 865–75, 892–98. More limited measures to increase shareholder power that have been advanced recently include: (1) granting shareholders the right to have their director nominees placed on the company's proxy statement and ballot under certain circumstances (Security Holder Director Nominations, Exchange Act Release No. 34-48626, Investment Company Act Release No. 26206 (proposed Oct. 14, 2003)), *available at* http://www.sec.gov/rules/proposed/34-48626.htm (last visited Dec. 14, 2005); (2) electing directors by majority, rather than plurality vote, *see* James J. Hanks, Jr., *It's All in the Numbers—"Majority Voting" for Directors*, Insights, Mar. 2005, at 2; (3) eliminating staggered boards, *see* Steven Syre, *Directors Feel the Heat*, Boston Globe, Dec. 23, 2004, at C1; and (4) requiring shareholder approval of poison pills, *see A New Corporate Governance World: From Confrontation to Constructive Dialogue*, 2004 Postseason Report 7–8 (Institutional S'holder Servs., Rockville, Md.), *available at* http://www.issproxy.com/pdf/2004ISSPSR.pdf.

33 *See* Bebchuk, *supra* note 1, at 842.

34 *See id.* at 842 ("My analysis indicates that the considerable weakness of shareholders in U.S. companies is not a necessary consequence of the dispersion of ownership. This weakness is at least in part due to the legal rules that insulate management form shareholder intervention.").

35 *See id.* at 908 ("I have argued that making shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value.").

36 This Article does not address the first assumption above—the debate over whose interests the corporation should serve. Not only has that subject been discussed thoroughly, *see supra* notes 4–5, it also seems clear that if one believes that stakeholder interests are entitled to weight in corporate governance, then shifting power to shareholders is per se undesirable. Instead, the primary aim of this Article is to explore whether shareholders are likely to make use of any incremental power conferred upon them, and, if so, to what end they will deploy that power.

37 *See generally* Robert D. Tollison, *Rent Seeking, in* Perspectives on Public Choice: A Handbook 506 (Dennis C. Mueller ed., 1997) (discussing the development of the theory of rent seeking).

[38] Albert O. Hirschman remarked that dissatisfied members of an organization face a choice between promoting their interests (voice) and deserting the enterprise (exit). Albert O. Hirschman, Exit, Voice, and Loyalty 30–31 (1970). In effect, increasing shareholder power subsidizes voice, thereby encouraging shareholders to use more of it before exercising their exit option.

[39] William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors,* 67 U. Cin. L. Rev. 1083, 1092 (1999).

[40] To the extent attention has been given to investor conflicts of interest, it has addressed *intra*shareholder conflicts of interest within institutional shareholders; that is, the second-order agency problem between the managers of institutional shareholders and their beneficiaries. These conflicts diminish the disciplining role of institutional shareholders because the managers of institutional investors often face incentives to side with corporate managers, on whom they may rely for business, against the interests of the institutional shareholders' beneficiaries. Consequently, intrashareholder conflicts of interest raise a separate source of concern about the efficacy of relying on shareholders to discipline corporate managers. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990). 595–608; John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277, 1321–28 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 Geo. L.J. 445, 469–76 (1991). *But see* Gordon, *supra* note 8 (raising concerns about opportunistic shareholder behavior); Rock, *supra* note 8 (same).

[41] *See, e.g.*, Bebchuk, *supra* note 1, at 883–84; Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 Mich. L. Rev. 1018, 1082–84 (1998). *But see* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 557–58 & 558 n.53 (2003) (pointing out that, under conditions of uncertainty, shareholder opinions are likely to diverge over how best to maximize the company's share value); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation,* 81 Va. L. Rev. 611 (1995) (arguing that investor disagreement is an important and powerful force that explains many business phenomena and should be taken into account by policymakers).

[42] Shareholders' private interests fall into two, sometimes overlapping, categories. First, certain shareholder private interests are separate from, or "external" to, the shareholder's investment interest in its shares. In other words, such interests are not related to share value. An example of such an external interest is a union pension fund's interest in organizing workers or influencing collective-bargaining negotiations. While a shareholder in the union pension fund may have an interest in how a firm deals with these matters, that interest is external to its interest as a pure shareholder. *See infra* text accompanying notes 73–77.

The second category of shareholder division involves differences of opinion over how to maximize shareholder value given an investor's peculiar characteristics, such as its investment horizon or tax status. Such private interests are "internal" to a shareholder's investment interest in its shares in that even if the shareholder had no external interests, its peculiar characteristics would still affect how it desired the firm to be run. Thus, a diversified shareholder would want the firm to undertake riskier projects than would a shareholder with a disproportionately high investment in the firm.

Both types of shareholder division have the potential to generate interest costs and squabbling costs. Shareholders with external or internal private interests may generate interest costs vis-à-vis all other shareholders who do not share such interests to the extent they successfully distort firm decisionmaking toward their own interests. The likelihood that internal private interests will generate interest costs is mitigated, however, by the clientele effect—the notion that investors with similar preferences are attracted to similar types of stocks. *See* Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance,* 79 Cal. L. Rev. 1053, 1065–66 (1991) (noting that "[a]lthough the taxation of dividends is commonly used to illustrate the clientele effect, it is not the only factor that may attract a particular investor to a particular stock"). When shareholders expend resources to further their external

or internal private interests, or to counteract those of other shareholders, they also incur squabbling costs.

43 *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

44 Hart v. Comm'r, 73 T.C.M. (CCH) 1684 (1997).

45 Purvis v. Comm'r, 530 F.2d 1332, 1334 (9th Cir. 1976) (per curiam) (quoting Chiang Hsiao Liang v. Comm'r, 23 T.C. 1040, 1043 (1955)).

46 For a full elaboration of the efficient capital markets hypothesis, see Eugene Fama's seminal article on the subject, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383 (1970). *See also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 554–58 (1984).

47 *See* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. Corp. L. 635, 667 (2003).

48 *See, e.g.*, Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J. Econ. Lit. 1583, 1616 (1989) (citing evidence that large discrepancies between price and fundamental value regularly occur).

49 *See id.*

50 *See id.*

51 Michael C. Jensen, *Paying People to Lie: The Truth About the Budgeting Process*, 9 Eur. Fin. Mgmt. 379, 387 (2003).

52 *See* Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law,* 70 N.C. L. Rev. 137, 181–82 (1991).

53 *See* James P. Hawley & Andrew T. Williams, The Rise of Fiduciary Capitalism 3 (2000); *see also* Simon Deakin, *The Coming Transformation of Shareholder Value*, 13 Corp. Governance 11, 16 (2005).

54 Hawley & Williams, *supra* note 53, at 21.

55 *Id.*

56 *See generally* Chamu Sundaramurthy & Douglas W. Lyon, *Shareholder Governance Proposals and Conflicts of Interests Between Inside and Outside Shareholders,* 10 J. Managerial Issues 30 (1998) (exploring the conflict of interest between internal and external shareholders within the context of shareholder-sponsored proposals to repeal antitakeover provisions). For a more detailed discussion of the private interests that characterize insiders, see *infra* text accompanying notes 58–60.

57 *See generally* Ronald C. Anderson & David M. Reeb, *Board Composition: Balancing Family Influence in S&P 500 Firms*, 49 Admin. Sci. Q. 209 (2004) (examining the influence of founding families on firm performance). Anderson and Reeb note that "founding families have substantial stakes in roughly one-third of the largest U.S. companies." *Id.* at 209.

58 *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); *see also* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & Econ. 327 (1983); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301 (1983). For the classic exposition of the agency problem in the law literature, see Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991).

59 *See* Michael C. Jensen, A Theory of the Firm: Governance, Residual Claims, and Organizational Forms 144-45 (2000).

[60] *See id.* at 140.

[61] *See* Thomas & Cotter, *supra* note 30, at 16–17 (comparing levels of shareholder support according to type of shareholder proponent).

[62] *See* Schwab & Thomas, *supra* note 41, at 1019.

[63] *See* Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 Comp. Lab. L. & Pol'y J. 97, 110 n.21 (2000).

[64] Labor-Management Relations (Taft-Hartley) Act, Pub. L. No. 80-101, 61 Stat. 136 (1947) (codified as amended at 29 U.S.C. §§ 141–196 (2000)); *see also* O'Connor, *supra* note 63, at 110 n.21.

[65] 29 U.S.C. § 186(c)(5)(B).

[66] *Id.* § 186(c)(5).

[67] ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. §§ 1001–1461 and in several sections of 26 U.S.C. (tax code)).

[68] 29 U.S.C. § 1104(a)(1)(B).

[69] *Id.* § 1104(a)(1)(C).

[70] *See* Schwab & Thomas, *supra* note 41, at 1080.

[71] *Id.* at 1035.

[72] *Id.*

[73] *See* O'Connor, *supra* note 63, at 114.

[74] *See* Nancy Cleeland & James F. Peltz, *2-Tier Plan Is Crucial to Grocery Pact,* L.A. Times, Feb. 28, 2004, at A1.

[75] *See* Jonathan Weil & Joann S. Lublin, *Gadfly Activism at Calpers Leads to Possible Ouster of President,* Wall. St. J., Dec. 1, 2004, at A1.

[76] *Id.*

[77] *See* Louis Lavelle, *CalPERS: Too Fierce?*, Bus. Wk., June 7, 2004, at 114.

[78] *See* Shaun P. Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775, 778–79; Henry T.C. Hu & Bernard Black, Empty and Hidden Voting: Shareholder Voting Rights and Coupled Assets 6–9 (2005) (unpublished manuscript, on file with author).

[79] *See* Martin & Partnoy, *supra* note 78, at 778.

[80] *Id.* at 780–86.

[81] *See id.* at 777–78.

[82] Shareholders are not presumed generally to have fiduciary duties to one another. *See supra* note 8. Shareholders acquire fiduciary duties only when they exert a sufficient level of control over the corporation. *See* Weinstein Enters., Inc. v. Orloff, 870 A.2d 499, 507 (Del. 2005). The point at which a shareholder becomes a controlling shareholder varies with the facts and circumstances of each case. There is, for example, no minimum percentage ownership requirement that confers controlling status on a shareholder. Rather, a shareholder is deemed controlling and becomes a fiduciary with respect to other shareholders when that shareholder "steps out of [its] role as a stockholder and begins to usurp the functions of director in the management of corporate affairs." *See* Gottesman v. General Motors, 279 F. Supp. 361, 383–84 (S.D.N.Y. 1967); *see also Weinstein*, 870 A.2d at 507 (holding that a minority shareholder must have "*actual exercise* of control over the corporation's conduct" in order to acquire fiduciary obligations). In other words, a controlling shareholder is one that can dictate corporate policy. While special interest shareholders employ a variety of means to influence corporate policy, they are typically not in a position to set firm policy. Their relationship with the corporations in which they hold shares is therefore

unpoliced by fiduciary duty law. In other words, they are free to trade off overall shareholder value for private gain.

83 *See, e.g.*, Bebchuk, *supra* note 1, at 883–84; Schwab & Thomas, *supra* note 41, at 1082–84.

84 *See* Schwab & Thomas, *supra* note 41, at 1023.

85 *Id.* at 1082–83.

86 *See* Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, 2 CONTEMP. FIN. DIG. 10, 20 (1998), (citing study).

87 *See A New Corporate Governance World*, *supra* note 32, at 3.

88 Bainbridge, *supra* note 41, at 550–51 (footnote omitted).

89 *See id.* at 573.

90 *See id.* at 572–73.

91 *See id.* at 558–59.

92 *See* Blair & Stout, *supra* note 5, at 288.

93 *See id.* at 291–92.