The 'Corporate Democracy' Oxymoron

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Henry G. Manne
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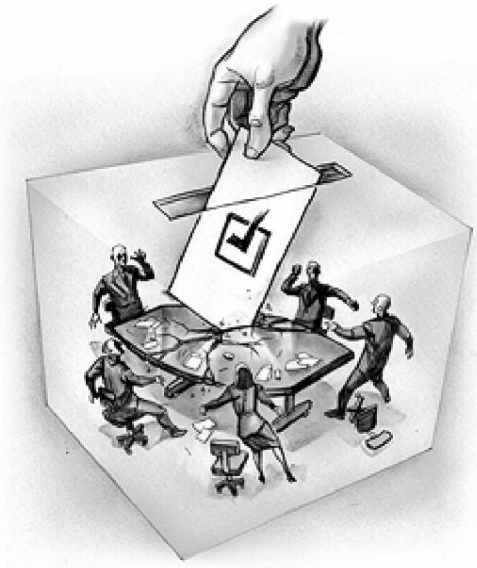
They're back! Every 20 or 30 years shareholder democracy ideas come back in vogue, and their time seems to have arrived again -- with a vengeance.

The SEC is huddling on whether to facilitate direct shareholder nomination of directors through a new interpretation of its shareholder proposal rule. A prominent professor at Harvard Law School, Lucian Bebchuk, proposes, among other democratizing moves, amending state corporation laws to encourage contested elections for board members. There is ongoing controversy about whether mutual funds are making sufficient disclosure to investors of how they vote on various portfolio corporate matters. And European corporate governance circles are in a dither because the EU failed in a recent directive to qualify the usual one-share-one-vote rule with something approaching one-shareholder-one-vote. The list could be expanded considerably.

There is absolutely nothing new in any of this discussion. The real world has not changed in any significant way, and our knowledge of corporate governance has not been revolutionized by some intellectual breakthrough. Furthermore, the provenance of the "corporate democracy" oxymoron has long been understood. The idea results from the inappropriate conflation of political ideals with market institutions. Its persistence can only be attributed to the intelligentsia's far greater comfort and familiarity with political models and events than with knowledge and appreciation of how markets function.


David Klein

But, as has been demonstrated time and again, the modern corporation is a market creation, not a political one. Hardly any aspect of "capitalism's greatest invention" cannot be explained by reference to the market forces that caused it to evolve as it has. Indeed, there is probably no aspect of modern state corporation laws, including limited liability, "personhood" and perpetual existence, that could not have evolved (albeit a bit more expensively) in a purely contractual, common law milieu. So it is with the selection of managers.

Multi-owner businesses with no single controlling shareholder have always had to select managers (here including the board of directors) to avoid the prohibitive costs and inconveniences of personal consultation and group decision making by large numbers of equity owners. Some sort of voting mechanism to select the central management was the most obvious and the cheapest solution, though other devices were feasible. Consideration of how a non-voting device might operate helps to reveal the practical essence of corporate voting and its radical difference from political voting.

Suppose, hypothetically, that all shares or interests in a new corporate venture were, in current parlance, non-voting. A provision in the charter or bylaws would then have to provide for some external mechanism -- perhaps a court, an independent trustee or a private commission of some sort -- to canvas all shareholders and determine who had sufficient shares to allow them to control the company and thus eventually to name the managers.

There would not be a vote. Rather the requisite number of share owners would simply "prove" to the outside agency their right to control the business. That shareholder or group of shareholders could then use any system they wanted to make the personal selection of managers after their control was certified. Of course, in practice it would be more efficient for the shareowners to designate their candidates in advance and use an election model to determine the outcome. But that is not crucial to this illustration. The critical determination is not the identification of the managers but rather of the holders of the controlling number of shares. From time to time, depending on the period or conditions established by the incorporators or applicable laws, this certification process would be conducted anew.

This little mental exercise illustrates that the selection of managers in corporations is ultimately a function of majority shareholding, not of any political-type shareholder election process. It should also demonstrate the fatuousness of any ideal of shareholder democracy. It was probably most nearly approximated by the pre-New Deal era of "banker control" of corporations, which, by all accounts, worked fairly well. And it is the de facto system in any corporation which has a control block of shares held by a single shareholder or cohesive group.

Public voting in corporations, which has so confused the public on the issue, is merely a cheap way of determining who holds the requisite number of shares and only incidentally who shall be the managers. If we had never used the word "voting" in corporation law, there is a good chance that many critics would never have thought up the idea of shareholder democracy on their own, since the principal overt evidence of an overlap with the political process would then be missing.

Corporate voting is not about reallocating resources, as is inevitably involved in political elections, nor is it about making actual managerial decisions, as in New England town meetings. There is no room in this scenario for contested elections or nominations to be made willy-nilly by the shareholders. Both of these ideas are part and parcel of the political version of elections. It is hard not to agree with Professor Stephen Bainbridge of UCLA Law School that, if either of these ideas had any real merit, we would have seen them tried and adopted in the real corporate world. We do not.

Also it now becomes clear why an unfettered market in corporate control (with whatever private provisions for managing changes of control are prescribed in the articles or bylaws) is so desirable in a large corporate system. This is actually a market for votes, since votes are the indicia used for control, and the votes and control move into the hands of those who, because they are best able to profit from them, are willing to pay the most for them. That is how efficient markets function. Thus the system of buying and selling votes, including the payment of premium prices for voting shares needed for control, works very well to settle the election issue.

It ill behooves corporate democrats like Professor Bebchuk to deride this system as not satisfactorily monitoring managers when he knows full well that regulatory interferences are mainly responsible for poor performance in the market for corporate control and, for that matter, for much of the steep escalation in executive compensation in recent years. That they would then propose intricate regulatory provisions for more shareholder democracy is evidence of the mindset that causes the problems. (No matter though; the hedge funds -- if we can just leave them alone -- have found ways around those market restraints, even to the point of creating a separate market for votes.)

Corporate voting, as an integral part of the control designation process, is premised on the not-illogical view that shareholders are interested exclusively in maximizing their return on investment and not in social causes, political movements or the reallocation of wealth. Some shareholders may put these interests above profit maximization -- but the laws of corporate governance should not countenance interference by those activists with the contractually established expectations of the vast number of investors.

Why do they always concern themselves with successful businesses instead of founding their own? Perhaps many of the advocates of shareholder democracy actually have a hidden agenda, most usually either a greater degree of government control over private enterprises, or more power to unions via their control of pension funds. Neither has proved beneficial to the investing public or is consistent with a vigorous and innovative public economy.

The hidden agenda of many corporate democrats is even more apparent when they argue that large corporations are indeed like small republics and should, therefore, like all governments, be democratized or constitutionalized. This is usually no more than an assertion that the large size of an otherwise private enterprise is sufficient to convert what would otherwise be a private ordering into something suffused with a public interest -- in other words, an argument for more socialism. The very success of a private concern becomes the reason for destroying its privateness -- a neat rhetorical trick if it was not so patently absurd.

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Sometimes this argument is made a bit more logical by saying that large size necessarily means that external costs will be visited on the rest of society. This is the basis for the currently popular claim that so-called "stakeholders" should have a real voice in how the corporation conducts its affairs. But even if there are occasional costly externalities associated with corporate activities, rearranging corporate governance, which is obviously functioning adequately for investors now, is an irresponsible and costly way to solve that real political problem.

We need corporate activists today more than ever, but we need them to lobby and argue for repeal of our many costly and ill-serving bits of corporate regulation. They might start with Sarbanes-Oxley, then go back in time to cover the Williams Act and state anti-takeover provisions, the Investment Company Act of 1940, the Securities and Exchange Act of 1934 and the Securities Act of 1933. I know this is pie-in-the-sky idealism, but it does not change the fact that, on balance, the world would be a far better place without these laws or anything like them.