Shareholder Control and Corporate Boards

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Professor Lucian Bebchuk of Harvard Law School is a tireless promoter of "shareholder democracy." In an article about to be published in the Virginia Law Review, he continues his quest to paint shareholders as the helpless victims of greedy, incompetent managers by arguing that shareholders cannot control who sits on the boards of public corporations. The solution, Bebchuk argues in "The Myth of the Shareholder Franchise," is to breathe life into shareholders' voting rights by changing the rules of corporate law to allow disgruntled shareholders to vote out directors more easily.

In the same issue of the Review as well as in the spring issue of the Cato Institute's journal Regulation, I respond to Bebchuk by first conceding that shareholder voting rights in public corporations are, indeed, mostly useless. In fact, this has been true at least since 1932, when Adolph Berle and Gardiner Means observed in their famous book, The Modern Corporation and Private Property, that shareholders in the typical American public corporation are "subservient" to a board that is "a self-perpetuating body."

The important question isn't whether shareholders are powerless. The important question is why shareholders are powerless, and have been powerless since the public corporation first arose as a business form. After all, there are many myths -- vampires, alligators in the sewers of New York City -- we would not want to make real. Why assume, in the face of a century of American business history, that it is suddenly desirable to make shareholder control of the boards of public corporations a reality?

In fact, increasing shareholders' influence over corporate boards could end up harming shareholders themselves. Board governance creates the problem of "agency costs" (that is, directors doing a poor job of running the firm). At the same time, however, board governance provides at least three important economic benefits to shareholders:

- It promotes more efficient and informed decisionmaking.
- It discourages inter-shareholder infighting and opportunism.
- It encourages valuable specific investment in corporate production by executives, employees, customers, creditors, and even the local community.

There is ample reason to suspect that shareholders benefit from corporate law rules that leave control of the firm in the hands of a board of directors largely insulated from shareholders' own control. At the same time, board governance has its costs, especially when a board "falls asleep at the switch." This makes it impossible for academics like myself and Professor Bebchuk to determine, at the level of theory, whether shareholders would benefit from making it easier (or harder) for them to oust directors. We need evidence to decide.

And there exists such evidence, but it does not support Professor Bebchuk's proposal. Empirical studies of shareholder proxy contests have failed to provide any reliable evidence that those contests leave shareholders better off. In fact, there is some suggestion that when challengers succeed in replacing an incumbent board with their own candidates, corporate performance suffers. At the same time, studies also find that when firms "go public," public investors do not avoid buying, and some cases even seem to prefer, stocks of companies with weak shareholder rights. In other words, when investors are called upon to put their money where their mouths are, they prefer to invest in firms with strong board control.

Why then do so many observers -- including, but hardly limited to, Professor Bebchuk -- so vehemently argue that shareholders need more power over boards? Contemporary calls for greater "shareholder democracy" seem to have great appeal not because they are based on evidence, but because of emotion. My article traces the emotional appeal of the idea of shareholder power to at least three sources:

The common but misleading metaphor that shareholders "own" corporations;

The opportunistic calls of hedge funds and social activists seeking leverage over boards for self-interested reasons; and

The strong but unfocused sense that something (anything!) must be done in the wake of recent corporate scandals of the Enron variety.

There is danger in making policy on the basis of emotion rather than evidence. In the 1990s, despite a lack of empirical support for the change, Congress amended the tax law to encourage corporations to pay executives with stock options as a means of "incentivizing" better corporate performance. The result is now widely perceived to have been something of a disaster. We risk similar disaster if we allow the emotional appeal of "shareholder democracy" to triumph over evidence, careful analysis, and the lessons of American business history