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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, Jeremy Kutner, Mark Roe, George Triantis, and Ed Yacobucci for helpful suggestions. 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 to it.

Abstract

This paper argues for a reallocation of power between shareholders and management in publicly traded companies. Whereas US corporate law has long precluded shareholders from directly intervening in any major corporate decisions, direct shareholder intervention is allowed under the laws of other common law countries. I argue that the case for denying shareholders the power to initiate and make major corporate decisions is far from compelling, and I put forward the case for a regime in which shareholders have such intervention power. Granting shareholders such power, I argue, can significantly address important corporate governance problems that have long occupied the attention of corporate law scholars and financial economists. In particular, providing shareholders with power to make "game-ending" decisions—to merge, sell all assets, or dissolve—would address managers' excessive tendency to retain their independence. Permitting shareholders 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. Finally, shareholder power to make "rules-of-the-game decisions"— to amend the corporate charter or change the state of incorporation—would produce better corporate arrangements. I also analyze how a regime permitting shareholder intervention could be best designed and implemented. Such a regime, I conclude, is an attractive option that could greatly improve corporate governance.

Keywords: corporate law, corporate governance, investors, shareholders, managers, directors, boards, stakeholders, agency costs, mergers, takeovers, acquisitions, proxy contest, corporate charters, charter amendments, regulatory competition, Delaware, state competition, dividends, distributions, free cash-flow, empire-building, myopia, short-termism.
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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."[1]

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

Recent events have intensified concerns about how directors and executives of publicly traded companies use the expansive powers they have. This might be thus as good a time as any to reexamine the powers long granted to management under American corporate law. Carrying out such an examination, this paper questions the basic legal rules that deny shareholders the power to intervene directly in the making of major corporate decisions. It presents the case for empowering shareholders by enabling them to initiate, and make certain, such decisions. Granting such power to intervene, I argue, would address the agency problems that have long afflicted publicly traded companies and would considerably improve corporate governance.

A central and well-settled principle of US corporate law is that all major corporate decisions require a decision, or at least initiation, 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.[2] This feature of US 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 UK do not share, is far from being an inherent corollary of the modern, large corporation. Indeed, I argue, the case for tying shareholders' hands 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) "game-ending" decisions to merge, sell all assets, or dissolve; (ii) "scaling-down decisions" to contract the size of the company's assets by ordering a cash or in-kind distribution; and (iii) "rules-of-the-game decisions" to amend the corporate charter or change the company's state of incorporation. These three

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[1] Adolf A. Berle, Jr. and Gardiner C. Means, The Modern Corporation and Private Property," (The Macmillan Company, New York, 1932), at 139.

[2] See Robert Charles Clark, Corporate Law (1986), Ch 1 & 3; and infra section II.A.

types of decisions are those for which shareholder power to intervene is worthwhile examining.

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

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 US 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.[4] 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 much from them.

Part II also describes the different approach taken by the corporate laws of the UK and several other common law countries. These countries have similar legal traditions to those of the US and, like the US, 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.

Part III explains why the powers to elect directors and to veto fundamental corporate changes are insufficient to ensure that shareholders generally have their way. To begin, shareholders might be pleased with management's general performance but still wish to make a certain decision differently than the management wishes to do. Suppose that shareholders

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[3] For an account of the current division of power, see Clark (1986) and infra section II.A.

[4] "While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to mange 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.

would like both to have management continue running the company and have the charter amended, but management does not wish to have the desired amendment. If a competing management team were to run a proxy contest promising to initiate a 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 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, say, a charter amendment without winning not one election but rather two consecutive elections, separated by a year in which the board has 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 that shareholders have to veto fundamental corporate changes does not enable them to have their way. To begin with, such power would not enable shareholders to get a fundamental change to happen – be it a dissolution, a merger, or a charter amendment – when the board prefers staying with 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 the outcome within this set that they most prefer. 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.

Having seen that shareholders' power to intervene could make a difference for corporate outcomes, Part IV discusses the potential benefits that could flow from granting such power. The discussion in this Part is organized around the three categories of major corporate decisions for which intervention power is proposed. While I think that intervention power is desirable with respect to each of these three categories, the choice is not limited to having intervention power for all of them or for none of them;

readers can 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. [5]

One category of decisions is that of "game-ending decisions" – decisions to merge, sell all assets, or dissolve. In the absence of shareholder intervention power, management might have an excessive tendency to reject attractive opportunities to merge, sell, or dissolve because termination will bring to an 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.

A second category of decisions is that of "scaling-down decisions" – decisions to contract the scale of assets under the managers' control by ordering a cash or in-kind distribution. With an intervention power, shareholders would be able to remove excess cash or assets and to 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

[5] In presenting the case for an alternative regime with broad powers of intervention for shareholders, I build on some earlier papers written by myself and by others. These papers endorsed or raised the possibility of permitting shareholders to intervene in some particular matters, but they did not attempt to put fully examine the broad range of considerations for and against shareholder power to intervene in a broad set of cases. 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, 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).

would address these problems more effectively and with lower costs than debt could.

The third category of decisions that I will discuss as possible candidates for intervention power is that of "rules-of-the game decisions" – decisions to amend the corporate charter or to reincorporate in another jurisdiction. These are "constitutional decisions" which 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, substantial improvement in the quality of corporate governance arrangements over time.

Part IV also discusses how intervention power can be best 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 having such power would be 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 in fact much exercised. It is also possible to design a regime with 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 I identify as ones 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, so the argument goes, would also produce substantial costs that would make it overall undesirable. On this view, shareholders would be better off if their hands were tied.

For one thing, 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 this would be desirable *notwithstanding* directors' superior information. Thus, denying shareholders the power to intervene implies that, instead of letting shareholders decide whether to defer to management, deference would be 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, and in such situations it would be undesirable to compel them to defer to management.

Second, it can be argued that consistency in decision-making requires that shareholders leave all decisions to management for the same reason that counsel against back-seat driving. This argument, however, is inapplicable to game-ending decisions; those should be analogized not to back-seat driving but rather to decisions to sell the car and terminate the driver's hold on the wheel. Furthermore, decisions in the rule-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 also with respect to these two categories of corporate decisions. In any event, giving shareholder the power to intervene just implies that these considerations would get whatever weight shareholders would find appropriate.

I also examine claims that intervention power would produce costs resulting from disruptive social choice cycling, ex ante defensive actions by management, and loss of beneficial bargaining by management. I conclude that none of these claims 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 the one accorded by their contracts, I argue, 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 could be relied upon to use its powers to protect stakeholders. Management is unlikely to use its power to protect stakeholders. Therefore, those concerned about providing extra protection to

stakeholders should seek arrangements tailored to address this concern. Concerns about stakeholders 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.

Before proceeding, I should stress that my aim in this paper is not to demonstrate to readers that the case for a regime with 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 possible re-allocation 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 US 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 UK 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 US and the UK 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 power of shareholders are determined by the corporate code and the company's constitution.[6] But the US and the UK differ in the regimes supplied by their codes.

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[6] 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)

Let us start with the US, whose approach can be viewed as managerialist. While the US 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.[7] For concreteness, I shall focus below on the Code of Delaware—the most important corporate jurisdiction.

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.[8] But the board's power 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: termination decisions, rules-of-the-game decisions, and scaling down decisions.

1. *Termination Decisions*

Termination decisions will refer throughout to 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

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(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. Sala. 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).

[7] See John Coffee, *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.").

[8] 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 Dalas, The Control and Conflict of Interest Voting Systems, 71 N.C. L. Rev. 1 (1992).

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 to 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.[9] Delaware law grants shareholders no power to initiate merger transaction by submitting them to 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.[10] 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.[11]

2. Scaling-Down Decisions

Another 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.[12] 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

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[9] See Delaware General Corporation Law, §251(a), (b).

[10] See Delaware General Corporation Law, §271(a), (asset sale), §275 (dissolution). In theory, Delaware grants shareholder 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).

[11] 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.

[12] See, e.g., Delaware General Corporation Law, § 170.

fully reserved for management's business judgment, and courts are not willing to subject dividend decisions to judicial scrutiny.[13]

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 and scrutinize the decisions of management in this and, view such decisions as belonging to the core area where deference to the business judgment of management is warranted. [14]

3. Rules- of-the- Game Decisions

The third important category concerns "rules-of-the-game" decisions – decisions affecting the rules by which corporate players play. The corporate governance arrangements of a company comes 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 change is controlled 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 such 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.[15]

As to 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

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[13] Indeed, in the last century, there has not been a single case in which US 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).

[14] Kamin vs. American Express; Victor Brudney, U. Va. L. Rev..

[15] See, e.g., Delaware General Corporation Law, § 242(b); Revised Model Business Corp. Act. § 10.03; N.Y. Bus. Corp. Law § 803 (a).

law, reincorporation requires shareholder vote of approval, but only the board can initiate such a vote.[16]

Finally, it is worth noting that, under current rules, shareholders have the concurrent authority with the board to amend the company's by-laws.[17] 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.[18]

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, I seek to highlight, before I go into the policy analysis, that the managerialist approach of US corporate law is not an inevitable element of the structure of the modern corporation. While this approach is settled and little contested in the US, 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 US a common legal tradition. Furthermore, like the US, some of these countries, especially the UK and Australia, have a large number of publicly-traded companies with dispersed ownership,[19] which are the companies for which the subject under consideration is important.

Like in the US, shareholders in the UK do not have unlimited power in their company, but only the powers granted to them by law and the corporate charter.[20] But UK law provides shareholders with greater power than US law and, in particular, provides them with some power of intervention.

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[16] See supra Subsection A.1.

[17] See Delaware General Corporation Law, § 109; Revised Model Business Corp. Act. § 10.20; N.Y. Bus. Corp. Law § 601.

[18] Thus, for example, it is generally expected that, when the issue gets to the Delaware courts, they will decide that shareholders cannot though by-laws limit the powers managers have to adopt and use poison pills. See Lawrence Hamermesh, "Corporate democracy and Stockholder-Adopted By-Laws: Taking Back the Street?, 73 Tulane Law Review 409 (1998).

[19] LaPorta et al., Law and Finance, Journal of Political Economy (1998).

[20] See Automatic Self-Cleaning Filter Syndicate Co., Ltd. V, Cunninghame, (1906) 2Ch.34.

To be sure, UK companies are also generally run in the ordinary course of events by their board. The default arrangement, which is provided by model provisions of the article of association supplied by the Company Act, prescribe that the business of the company shall be managed by the directors, subject to "the provisions of the act, the memorandum and the articles and to any directions given by special resolution."[21] According to the Company Act, shareholders always have the residual right to adopt through a special resolution—which requires 75% of the votes—any change in the articles of association and any corporate decision.

Furthermore, shareholders have a common law right to propose resolutions at an annual shareholder meeting.[22] Shareholders wishing to exercise this right, are only required to give notice to shareholders of such proposals and to bear the cost of such notice.[23] The power to adopt proposed resolutions comes in addition to the power, which shareholders always retain under UK law, to replace the board at will.

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 might be amended by a special shareholder resolution.[24] Thus, shareholders can opt out from the regime under which only the board holds management powers and grant themselves greater control over the management of the corporation.[25] Furthermore, shareholders always have the inalienable right to take any corporate decisions through adopting a special resolution with the required 75% majority. Other common law countries also follow a similar approach.[26]

To be sure, these common law countries still have some preference for shareholder action through replacing the board. UK special resolutions, for example, require a majority of 75% of the vote, whereas replacing the board

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[21] Article 70, Table A, The Company Act 1985.

[22] See JOHN F. FARRAR ET AL., at 322.

[23] See Company Act 1985, § 376 & 377.

[24] Replaceable Rule 226A and Section 135(2) to the Corporations Law, 1991.

[25] Note that Section 136(3) authorizes the corporate constitution to specify additional requirements, beyond the requirement for special shareholder resolution, for its own amendments. This makes the Australian regime fully enabling.

[26] 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.

requires a simple majority. But all of them provide some power of intervention despite the fact that, unlike the case in most US companies, shareholders in their companies can always quickly replace all the directors. But 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 will 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, it is worth making several preliminary observations. To begin, any discussion of the subject should start from the recognition that, in publicly traded companies with dispersed ownership, management's interests might not fully overlap with those of shareholders and, as a result, agency costs might arise.[27] Because of this agency problem, it is desirable to have rules in place that would aim at reducing agency costs as much as possible. The case against shareholder intervention thus cannot be made by assuming away the existence of an agency problem. This case can be made only by showing that this problem can be 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).[28] To be sure, the building's owner might often elect not to intervene, believing that

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[27] 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).

[28] This principle is a long-standing one. "The agent has a duty, at all time, 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).

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. The owner has the legal power to determine, however erroneously this might turn out to be, what its interests are and what course of action would further them.

In the case of corporate managers, however, the law has chosen to take a different approach.[29] 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 to distribute to them the cash produced by the assets rather than reinvest it. The question, then, is whether taking such a different approach for the case of corporate mangers is warranted. Thus, in examining below arguments for management control, it will be helpful to examine for each of them whether they have greater force in the corporate context than in other contexts in which assets are managed by someone other than their owners.

Thirdly, 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.[30] 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 management by the shareholders. 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, granting that shareholders cannot be expected to use constantly the power to intervene should such a power be granted,

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[29] 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.

[30] See Clark, Corporate Law, at 21-24.

proponents of shareholder nonintervention have to 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 such matters that shareholders could be plausibly expected to have sufficient incentive to initiate and participate in voting over management's opposition. This Part considers arguments that, at least with respect to such key decisions, shareholder power to intervene is not at all necessary to ensure that they are made in accordance with shareholder preferences.

Whenever shareholders have a clear preference for a certain important corporate decision, so the argument goes, the existing powers of shareholders are sufficient to ensure that management 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 the powers that shareholders have to replace directors and to veto fundamental corporate changes. Below I therefore consider in turn each of these two basic powers, 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 could arguably ensure that shareholder interests are served is the shareholder franchise—the power of shareholders to elect the directors. This fundamental power to elect directors is one that corporate statutes provide[31] and that courts strongly protect.[32]

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

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[31] See, e.g., Delaware General Corporations Law, Sections 211-212.

[32] See, e.g., Blasisu Industries v. Atlas Corp., 564 A. 2d 651 (Del. Ch. 1988).

have clear preferences. If management does not follow shareholder preferences with respect to such matters, so 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 it generally heed shareholders' preferences to begin with, making replacement unnecessary. Thus, even if actual replacement of the current directors happens infrequently, so the argument concludes, the power of shareholders to cause such replacement will have a forceful effect on management and generally induce it to follow shareholders' preferences.

According to the considered argument, the power to replace management will have such 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, so the argument goes, a management team not acting in 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 be served on some issues of little significance for shareholders, this power can be expected to ensure that shareholder interests be served on those matters for which allowing direct action could be seriously considered. And 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 threaten to do so) as making the power to intervene wholly redundant. As explained below, in the corporate context, the power of public investors to replace managers is similarly, if not 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 the manager replaced, but rather wish the manager to 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, 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 provide 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 sometimes be ineffective (lacking credibility) and might sometimes be 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.[33] Suppose that the shareholders of a company view existing management as likely the best team for running the company's core assets, and that 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 certain value-increasing charter amendment or effect a certain value-increasing spin-off for a certain 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 directly provide shareholders only with the choice between (i) having their assets managed by the existing (best)

[33] 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).

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 push management to take action A. Management will refrain from action A itself, because management will know that it will be able to remain in office even without doing so.

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 it 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 illustrate 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.[34] In 1995, Kerkorian held (through a company named Tracinda) approximately %14 of Chrysler's shares. Chrysler had, at the time, 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 have been 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."[35] Furthermore, Kerkorian's past record—one money manger referred to him as "the most self-serving guy ever to happen on the scene"[36]—made some shareholders rather uneasy about having him in control of the company's operations. A shareholders who viewed Chrysler's management as sufficiently superior

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[34] 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 20%; Move Could Mute Kerkorian's Criticism," WSJ, Dec 8, 1995, at A4; "Chrysler Board Seat is Non-negotiable to Avert Proxy Fight form Kerkorian," WSJ, Jan 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.

[35] "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.Indeed, even Jerome York, Kirk Kerkorian's chief strategist, conceded that Chrysler was "well run operationally" but that there was "untapped value there" (the $7 billion cash hoard). See York May Try a Proxy Fight for Chrysler, WSJ, Sep 12, 1995, at A3.

[36] "Kerkorian's Deals Have Often Drawn Fire," WSJ, Octo. 26, 1995, at C1.

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 proposal regarding the single issue of distributing cash to shareholders. [37] 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 could have 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 in the view of some observers, his chances of winning a proxy contest were viewed by the same observers as "slim."[38] 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.[39]

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 not been sufficient to secure such an outcome. Certainly Kerkorian himself thought this was the case since

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[37] See "Why Kirk Kerkorian Has a (Slim) Chance to Win over Chrysler," WSJ, Sep. 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.

[38] "Why Kirk Kerkorian Has a (Slim) Chance to Win over Chrysler," WSJ, Sep. 15, 1995, at A1.

[39] 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 agreement to make annual repurchases of $2 billion for the foreseeable future as it had sought.

otherwise he would not have compromised. The story of Kerkorian and Chrysler thus illustrates well how, because of the bundling of desired management decisions with the choice of management team, the threat of a proxy fight is hardly sufficient to secure fully the corporate decisions that are most favored by shareholders. [40]

4. Impediments to Replacing the Directors

In the corporate context there is an additional limitation, not present in the ordinary case of assets managed by someone other than their owner, on the ability to use the power to replace management to induce it to generally take the decisions desired by shareholders. In the Seattle building example, the default and standard 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. However, should the manager refuse to carry out some refuse 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 preclude shareholders from replacing management without much delay.

The corporate context is indeed one in which shareholders very often cannot vote immediately to replace the mangers. 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

[40] 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 the lion's share of its shares. Ichan undertook a proxy fight on the basis of this plan 1991 and ended it after reaching with management a compromise arrangement 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, Ichan's view did not seem to have majority support, a nonbonding 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.

might be two years down the road. Indeed, most US companies have charters that would force shareholders to wait a significant period of time before they can vote management out. [41]

Whether it is desirable to limit substantially the power to replace managers is a question beyond the scope of this paper, and I discuss it elsewhere. For our purposes, what is important is that, as long as this is the case for a large fraction of US 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 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 necessarily much threatened by a proxy fight by a challenger promising to adopt A. To begin, 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. And, in any event, why capitulate to the challenger's demand now rather than wait for a while and capitulate, if the issue does not in the meantime become moot or otherwise go away, much later on.

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 shareholder vote of approval. This veto power, it might be argued, can ensure that at least all

[41] 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. [42]

1. Cases in which Management Prefers the Status Quo

Shareholders have the power to *veto* fundamental changes rather than the power to decide to have them. 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' situations. 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 changes.

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

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[42] For an earlier discussion of some limitations of shareholders' veto power on fundamental changes, see Lucian Bebchuk, "Limiting Contractual Freedom in Corporate Law: the Desirable Constraints on Charter Amendments," 102 Harvard Law Review 1820-1860 (1989) (discussing some limitations of shareholders' veto power on charter amendments); Lucian Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law," 105 Harvard Law Review 1435-1510 (1992) (discussing some limitations of shareholders' veto power on reincorporations).

take place, but it might well 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 preferable to the status quo by both managers and shareholders over. 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 secure that the one they prefer the most, A, would be selected.

Indeed, the 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 would be in a way 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 the situation under consideration, the shareholders' effect on selection would likely be even weaker because the parties are 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 have then to 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 adopted 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 that is inferior to — 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 that is most preferable to the side with agenda control. Given this received understanding of bargaining and surplus division, management and shareholders are not equal power partners in the adoption of fundamental corporate changes. Thus, management's control over the agenda makes it the far stronger partner and enables it to shape the outcome subject to the constraint that it limits its choice to 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 shareholder vote, the shareholders—recognizing that a move to A 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. [43]

3. Cases in which Shareholders Lack Veto Power

For completeness, it should be noted that, whereas shareholders have veto power over game-ending decisions and rules-of-the-game decisions, US 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

[43] See Oren Bar-Gill, Michal Barzuza, and Lucian Bebchuk, "The Market for Corporate Law," Harvard Olin Discussion Paper No. 377 (2002).

prerogative of the board, which is free to make them without any need for shareholder approval.

This absence of veto power, however, is not practically a source of concern for shareholders. 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 choose to distribute assets, shareholders would not wish to oppose the distribution. This management tilt against distributions indicates that the problem for shareholders is not in the distributions that management elects to do but in those that it does not do. 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 this 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 termination decisions, rules-of-the-game decisions, and scaling-down decisions. Serious agency problems afflict each of these three sets of decisions, and I show that granting intervention power can address each of the agency problems afflicting these categories of important corporate decisions. 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, minimizing the potential costs from nuisance and opportunistic proposals.

A. Game-Ending Decisions

1. Issues Covered

There are several decisions that could terminate the existence of the target'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 it required by existing rules. Once a proposal is brought to a shareholder vote and is approved by the required majority, it will have the same force and will 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. On this view, on the face of a tender offer, it would be desirable to provide shareholders with an access to a vote 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 on approving an acquisition offer would be an alternative and simple way to accomplish a similar result. The initiated vote would express shareholders' undistorted choice on whether acceptance of the offer would be in the shareholders' 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 offer the only way to accomplish a transaction without management's support do not always enable a full realization of the potential savings to shareholders from having the transaction structured so as to be recognized as tax-free reorganization. Permitting shareholders to bring 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 that is worth considering is whether shareholders should have not only the possibility of not selling the company to a particular buyer, but also the possibility of ordering 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 have a preference for starting an auction for selling the company to the highest bidder. Under current rules, only management can start such a process (which will bring it

into the *Revlon* zone). In a regime with shareholder intervention, however, it might be worth enabling also shareholders to begin such a process.[44]

Another question that is worth considering is whether shareholders would be able to vote on a sale of some substantial part of the assets—say, a certain subsidiary or a division of the company. It might be argued that a sale of a substantial division might be something that shareholders would wish to do even over the objection of management.

2. *Addressing the Managerial Bias toward Retaining Control*

(a) Ex Post Benefits

One of the problems that has 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 might be terminated if the company ceases to exist, termination might not serve management's interests. For this reason, one has to worry that they might reject opportunities to terminate—via merger, sale, or dissolution—even if carrying them out would serve the interests of shareholders. To be sure, when termination is sufficiently beneficial for shareholders, the stock options of executives might still make it worthwhile for them to facilitate such 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."[45]

The empirical evidence on acquisition offers indicates that management's decisions in this area produce significant agency costs. To start with, the evidence indicates that, in the event that incumbents use their veto power to defeat bids, shareholders end up worse off compared with the scenario in which the bid would have been accepted. Studies indicate that,

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[44] 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 might signal that the end of the company is in sight, it might be necessary to have in the meantime some people in charge of carrying out the decision. One possibility is to leave this to the existing management and rely on its fiduciary duties to induce it to carry out the binding termination decision in the best way possible. Another possibility is to give shareholders at least the option of incorporating in the termination decision the appointment of a new team to carry it out.

[45] Unocal, 493 A2d at 954.

when target managers 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 percent decline in their stock price.[46]

It might be objected, however, that incumbents' resistance should be evaluated by its effects on shareholders' wealth in the long term rather than short term. In a recent empirical study on staggered boards, Coates, Subramanian, and I therefore studied how the defeat of bids affected shareholders when evaluated from a long-term perspective.[47] We examined hostile bid cases during the period 1996–2000 in which targets remained independent. We found that, evaluated thirty months after the bid's announcement, the shareholders of targets remaining independent were on average substantially worse off when compared with the scenario in which the bid would have been accepted. To illustrate, during the period that we studied, we estimated that the average return to target shareholders during the thirty months following the offer was 54 percent higher for targets that were acquired than for targets that remained independent.

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 negatively related to the effect of the acquisition on managers' financial interests.[48] 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 those of the shareholders).[49]

Finally, even when management agrees to a termination, the end-period nature of the situation might lead management to seek some private

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[46] See James F. Cotter and Marc Zenner, "How Managerial Wealth Affects the Tender Offer Process," 35 J Fin Econ 63, 86 (1994).

[47] 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. Note that this evidence indicates that, even compared with a state of affairs in which all these companies would have been acquired, the instances of bid rejection and remaining independent produced on average significant losses to shareholders. The losses produced by defeating bids might have been even greater in comparison to a state of affairs in which shareholders would have made choices whether to reject the offer. To the extent that shareholders would have rejected some bids in this state of affairs, those bids that were relatively less attractive would have been more likely to be rejected.

[48] See Ralph A. Walkling and Michael Long, "Agency Theory, Managerial Welfare, and Takeover Bid Resistance," 15 Rand J Econ 54, 67 (1984).

[49] See Cotter and Zenner.

payoff that might come at the expense of the payoff to shareholders from the termination. There is indeed evidence that management might be willing to trade off premia to shareholders for personal benefits. A recent study by Hartzell, Ofek, and Yermack found that target CEOs are willing to accept lower acquisition premia in transactions that involve an extraordinary personal treatment (such as special payments to the CEO at the time of the acquisition or high-ranking managerial post in the buyer).[50] Another study by Wulf indicated that, in merger negotiations, CEOs are willing to trade off higher acquisition premia in exchange for better managerial positions in the merged firm.[51]

(b)Ex Ante Benefits

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 be acting against the background of the possibility that shareholders would decide to accept an acquisition offer or even dissolve the company, if they prefer such 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

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[50] 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>.

[51] 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. Some of the famous takeover cases nicely illustrate the weight that CEOs give in takeover negotiations to their managerial position in the merged firm. In Paramount Communications, Inc v Time Inc, 571 A2d 1140 (Del 1989), one of the sticking points in the negotiations was which managerial team would be more dominant following the combination of Time and Warner. See id at 1144 (recounting how, before the merger, the consensus among Time's board members was that "a merger of Time and Warner was feasible, but only if Time controlled the board of the resulting corporation"). In QVC v Paramount, 635 A2d 1245 (Del Ch 1993), Herb Wachtell argued for QVC that, in seeking to facilitate an acquisition by Viacom, Paramount's CEO was motivated by his desire to become CEO of Paramount/QVC. See id at 1248 (noting "Mr. Davis's insistence that he become CEO").

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.[52] 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 operating performance—including lower profit margins, return on equity, and sales growth.[53]

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.[54] Bertrand and Mullinathan obtained similar findings for managers that are more protected due to antitakeover statutes.[55] Finally, Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire-building.[56]

B. Scaling-Down Decisions

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[52] 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").

[53] 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>.

[54] See Kenneth A. Borokhovich, Kelly R. Brunarski, and Robert Parrino, CEO Contracting and Antitakeover Amendments, 52 J Fin 1495, 1515 (1997).

[55] 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>.

[56] See Gompers, Ishii, and Metrick, at 31–32.

1. Issues Covered

At present the decision to distribute and contract the size of the assets of the company is in the hands of management. Management can decide to distribute to shareholders a cash dividend. In appropriate cases, it may distribute to shareholders the shares the company holds in a subsidiary, thus effecting a spin-off. Such decisions remove assets from the company into the hands of shareholders, thus reducing the size of the empire run by management.

Under a regime with shareholder intervention, shareholders could be empowered to initiate and approve decisions that would require the corporation to make certain distributions to them. 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 as well as the future dates to serve as the record date (for determining who held shares at the date giving rise to the dividend entitlement) and the payment date. Once such a decision to pay dividend is passed, the company will become obligated to pay that dividend in the same way as if the board made the decision. Thus, in the example of Chrysler and Kerkorian discussed earlier, the existence of shareholder intervention power would have enabled Kerkorian to bring a proposal to distribute the company's cash hoard to a shareholder vote.

Under the considered regime, shareholders would also be able to order also in-kind distributions. They would be able to order that the company distribute to them its shares in some subsidiary. Such decisions for cash or in-kind dividends would of course reduce the scale of the enterprise governance by management and would take off the table, so to speak, some of the value shareholders have under management's control.

One question that I wish to put on the table for consideration is whether shareholders, to compel management to go in the direction of value distribution, should be able to order distribution of new securities to be issued or to order the distribution of amounts that are still indeterminate at the time of the decision. It is possible to grant shareholders the power to order the company to distribute to them certain debt securities, which once distributed would compel management to start liquidating assets to satisfy the demand of these new securities. It is also possible to give shareholders the power to order the company to pay in the future dividends equal to, say, 50% of annual earnings.

It should be made clear that the considered regime would not involve any weakening of the protection accorded to creditors. Creditors have statutory protection – and often additional contractual protections – limiting the amounts that the company can distribute to its shareholders. [57] Management currently may not elect to make distributions to shareholders that violate the constraints established to protect creditors. Similarly, under a regime with shareholder intervention power, shareholder decisions concerning distributions would be also subject to these constraints. The only difference would be that, within these constraints, not only management but also shareholders be able to make decisions. What is contemplated is just rearrangement of power between management and shareholders, not a renegotiation of rights between shareholders and creditors.

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 their shareholders.[58] A company might have cash reserves whose distribution to shareholders would be value-maximizing because the company does not currently have good 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 to sell the assets to a third party and then possibly to distribute the received cash to the shareholders. In such circumstances, management might still, for its self-serving reasons, refrain from taking such actions that would reduce the size of the empire under management's control.

Management might prefer not to reduce the size of its empire because management might derive larger private benefits, in both pecuniary and non-

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[57] 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 devote the discussion of dividend largely to 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).

[58] The standard reference is to Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," 76 American Economic Review 323 (1986).

pecuniary terms, from running a larger firm. Having undistributed liquid funds ("free cash flow"), or assets that could be turned into such funds, increases the autonomy of management vis-à-vis the capital markets and will increase its future freedom to pursue expansion plans. Indeed, the problem of free cash flow has been regarded by some as the most significant of the agency problems that large public companies face.[59]

(b) Superiority to the use of debt

The problem of management's tendency to engage in empire-building and the retaining of excessive cash flow has received considerable attention from financial economists. They suggested that a main reason for the use of debt, including the use of highly leveraged structure, 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 cash than they would be otherwise inclined to do. Because management has discretion to make dividend payments but not to refuse 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, on this view, having debt in a company's capital structure serves a beneficial bonding role, committing management to pay out some of the company's cash flow.

The view that such bonding is an important motivation for the use of debt has gained much support among financial economists.[60] Indeed, commentators have viewed the bonding benefits resulting form more leveraged capital structures as an important motivation for the 80's wave of leveraged acquisitions and buyouts. The belief that leveraged structure are desirable to mitigate problems of empire building and excess free cash flow

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[59] See e.g., Henry Hansman, 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.) (the empirical evidence indicates that the US corporate sector has been caught in the 80's by "an epidemic of free cash flow").

[60]See e.g., Michael Jensen, Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers, *American Economic Review, Vol. 76, No. 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).

underscores the seriousness with which financial economists have taken these problems.

There is no question, however, that debt financing is a highly imperfect and costly remedy to these problems. To begin, high leverage produces its own inefficiency distortions.[61] Furthermore, leverage provides a highly inflexible mechanism, and this inflexibility is likely to be quite costly. 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 setting of the level of debt 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 in the future a cash flow with an expected value of $200 million a year and that it will not have beneficial investment opportunities and that it will be efficient to remove whatever cash flow the company will have. Could an efficient outcome be secured by having in the capita structure debt that requires making interest payments of $200 million a year? 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 pay out $200 million annually would either put the company into insolvency with its deadweight costs (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 considered example, shareholders' intervention power would be able to ensure that the amount of excess cash flow that the company will have – neither less nor more – will be removed the company. Thus, the intervention power would enable dealing with the problems under consideration in a way that would be more flexible and finely tuned to circumstances than is the inflexible mechanism of debt.

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[61] See e.g., Michael Jensen, Journal of Financial Economics (1976). One important distortion is that high leverage provides incentives to make high-risk gambles and investment choices even if they are inefficient.

(c) Superiority to Stricter Judicial Review

The problem of empirical-building and excessive retention of cash has been a concern not only to financial economists but also to legal scholars. And some of these commentators have proposed to reconsider the business judgment deference to managers' decisions on such matters.[62] On their view, given management's bias against distributions, courts should be prepared to scrutinize the merits of management's decisions on these matters.

Even assuming that higher scrutiny by courts could be beneficial in the absence of any other way of addressing the problems under consideration, it would undoubtedly be a highly imperfect remedy for these problems.[63] Courts are ill equipped to make business decisions. In this respect, the proposed shareholder power to intervene provides 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.[64]

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

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[62] For the strongest appeal for greater judicial intervention in dividend decision see Victor A. Brudney, "Dividends, Discretion, and Disclosure," 66 Va. L, Rev. (1980).

[63] See Zohar Goshen, Shareholder Dividend Options, 104 Yale Law Journal 881 (1995).

[64] It is also worth noting another suggestion that was made in the legal literature by Zohar Goshen for dealing with the free cash flow problem. See Zohar Gohsen, Shareholder Dividend Options, 104 Yale Law Journal 881 (1995). Goshen made an interesting proposal under which each shareholders would get each year an option to withdraw his fraction of the company's earnings and would be able to choose the extent to which the shareholder will exercise this option. Any amount not so withdrawn will essentially constitute a reinvestment of funds in the company by the shareholder. The proposal made in this paper is 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 also in all those instances in which they elect to withdraw no dividends (but rather "reinvest" all earnings in the company). Second, …

C. Rules-of-the-Game Decisions

1. Issues covered

Rules-of-the-game decisions concern the choice of the corporate governance arrangements to which the 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 to another state or by amending the company's charter.

Under a regime with shareholder power to intervene, shareholders would be able to initiate and approve by vote both types of changes. First, shareholders would be able to initiate and approve a charter amendment. Second, shareholders will be able to initiate and approve by vote a reincorporation to another state of incorporation. [65]

2. Improving Corporate Arrangements

It is worth noting that, with respect to rules-of-the-game decisions, the existing powers that they now have to replace the board are especially ineffective. Although replacing the board is generally an uphill battle, it is conceivable that shareholders would be willing to replace the incumbent management team with a new team in order to have the company acquired. In contrast, while changes in rules-of-the-game are significant, they are generally unlikely to be of sufficient weight to enable a challenger to win a proxy contest on their basis. When shareholders view the incumbent team as doing a good job, it is rather unlikely that they would vote for a challenger team 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.

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[65] As long as reincorporation requires a merger with a dummy corporation created I another state, a proposal could take the form of a proposal for such a merger.

(a) Corporate Charters

Corporations live in a dynamic and ever-changing environment. They need to adapt to changing circumstances and conditions. In particular, it is desirable for shareholders to change from time to time the arrangements contained in their charters. For this reason, the optimal set of charter provisions for shareholders changes from time to time and the charter needs to be adjusted and evolve.

Management's current control over the 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 are also favored by management. 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. When a publicly traded company went public, say, 40 years ago, its charter is made of the provisions in the charter it had when it went public forty years ago as amended and adjusted over the years. Given that corporate circumstances and needs have changed markedly over the last forty years (for example, because of 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 this problem makes mandatory rules desirable.[66] Even short of adopting mandatory rules, it has been suggested that, as new circumstances arise, corporate law generally by default erred on the side of arrangements less favorable to management because of the difficulty of opting out of arrangements favored by management – only defaults disfavoring management can be expected to change if they are not what shareholders prefer.[67]

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[66] Lucian Bebchuk, "Limiting Contractual Freedom in Corporate Law: the Desirable Constraints on Charter Amendments," 102 Harvard Law Review 1820-1860 (1989); Gordon, The Mandatory Structure of Corporate Law, Columbia Law Review (1989).

[67] Lucian Bebchuk and Assaf Hamdani, "Optimal Defaults for Corporate Law Evolution," 96 Northwestern Law Review 489-520 (2002).

Taking as given the existing distortion in the charter amendment process, it is desirable for corporate law to follow the above approaches. But it would be better yet for corporate law to address the underlying problem by eliminating the distortion in favor of management. Providing shareholders the power to intervene in rules-of-the-game decisions would do so. With shareholders able to initiate charter amendments whenever the charter as is does not best serve their interests, which will often push management to initiate itself value-increasing amendments, the arrangements in corporate charters will become more aligned with those that best serve shareholders.

(b) Reincorporation decisions and State Law Rules

Management's current control over reincorporation decisions also distorts the choice among those arrangement provided by state corporate law. A reincorporation will not take place unless it is favored by management. And when reincorporation to several different states could make both shareholders and management better off, the reincorporation will take place to the state most favored by management.

The problem for shareholders is not limited to the actual decisions whether to reincorporate taking state law rules as given. The problem is that the distortion of reincorporation decisions provides adverse incentives to state seeking to attract incorporations. [68] Because management plays such a key role in reincorporation decisions, such 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, this incentive might lead states to offer rules that are excessively favorable to management. For example, this 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

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[68] 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).

more successful in the market for incorporations, which provides them with 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, 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.

D. Effectiveness and Design

1.Will Proposals be Initiated?

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

The concern might 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.[69] In the latter case, if the challenger wins the contest, the challenger will gain control of the board and capture the private benfits of control associated with it. Furthermore, in such a case, the challenger would be able to authorize a reimbursement to itself of the costs of running the proxy contest to itself. In contrast, when a party runs a proxy contest over an issue (e.g., opposition to a management proposal brought by management), 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 with shareholder intervention. They can be expected to be brought by shareholders with some significant holdings -- or by groups of shareholders that together hold a

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[69] See Lucian Bebchuk and Marcel Kahan, "A Framework for Analyzing Legal Policy Toward Proxy Contests," 78 California Law Review 1071-1136 (1990).

significant block – that would be motivated by the prospect of a significant the appreciation of the value of their holdings. Their incentive to initiate a proposal would be stronger in those instances in which there will be a meaningful chance of the proposals being adopted, 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 those 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 initiated. This pattern suggests that, in a regime in which shareholder-initiated proposals are binding and can produce a termination, a scaling back, or a 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 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. The described 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 another reason. Even if proposals are initiated, so 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 display deference to management and are reluctant to vote against it.

Shareholders have only weak incentives to participate in voting because of a "rational apathy" problem.[70] Still, the costs of voting are rather small, and the incidence of voting in corporate vote is rather substantial, even on non-binding shareholder resolutions. For one thing, institutional investors by and large vote their shares. Thus, the question is only whether they can be expected to ever 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.[71] But there is no reason to assume that shareholders are bound to always vote with management.

There might well be instances in which, given the presence of clear agency problem on management's part and the importance and appeal of the proposal on the table, rational shareholders will have sufficient confidence in their judgment and be sufficiently motivated to vote against management. This is clearly indicated by the fact that in recent times proposals for de-classifying boards have been receiving support from a majority of voting shareholders even though they are advisory. The incentive of institutions to vote for such proposals would further increase in a regime in which they can be made 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 elect to intervene and adopt a proposal by vote, despite the problems that depress voting against management (or voting at all), such a vote would suggest that the proposal would likely be strongly in the interests of shareholders.

3. It's the Indirect Benefits, Stupid

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[70] See Clark, Corporate Law, at 390-392.

[71] See Lucian Arye Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harv. L. Rev. 1820 (1989).

Finally, and perhaps most importantly, it should be emphasized that the benefits of a regime with the power to intervene should not be measured by the number of times that shareholders would in fact intervene and adopt by shareholder-initiated proposals. Rather, the primary benefits would be indirect ones. Introducing the power to intervene would induce management to act and decide differently in order to avoid the power to intervene. Thus, if a regime with power to intervene 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 very well indeed.

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 presumably does not pursue changes that could favor it when it expects that the changes would fail to get shareholder approval. In a regime without an approval requirement, such changes would take place. The approval requirement prevents such changes – but does so not by vetoing them when proposed but rather by discouraging management form bringing them to a vote to begin with.

Shareholder power to intervene would similarly produce its benefits primarily without the need for adopting by vote of a shareholder-initiated proposal. If distribution of Chrysler's cash hoard enjoys widespread support among shareholders, it will happen under a regime with intervention power without Kerkorian winning a vote on the matter. Management would in all likelihood elect to make such distribution to begin with or at least once it learns about Kerkorian's plans.

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, so 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 power regime, however, could keep the costs of such nuisance proposals to an easily acceptable minimum.

To begin, some threshold requirements for submitting a proposal can screen out the proposals that are completely frivolous or have no meaningful support among shareholders. Thus, 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 now used by those state law rules and charter provisions that allow shareholders to call for a special meeting. In addition, it is 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%). Such requirements are now used, though are arguably not demanding enough, in connection with the initiation of votes on advisory resolutions under the proxy rules of the securities laws. [72]

Second, proposals that satisfy the requirements for submission but have limited support among shareholders are unlikely to cause any significant disruption and inconvenience for either shareholders or management. This can be secured, 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 but only need to lend their support to it. Adopted proposals would be only those that have such strong support that holders of a majority of outstanding shares have affirmatively supported them.

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 or to be gathering support among a significant fraction of the shares. Thus, management would have to pay costly attention to those proposals – and only those proposals -- with significant shareholder support, which would be a desirable state of affairs.

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[72] See e.g., Clark, Corporate Law, at 374-383. If one wishes to further discourage proposals that can be expected to gain small amount of support, it is possible to do so with financial incentives. In the same way that those that initiate proposals that are successful in attracting support can be granted a reimbursement of their costs, those that initiate proposals that fail to attract any significant amount of support can be required to the company a reimbursement of the company's resulting costs or some "penalty."

Finally, it is worth noting that if it is further reducing the extent to which management and shareholders might be distracted is desirable, concentrating all voting on shareholder-initiated proposals at the annual meeting will attain this goal.

5. Opportunistic Proposals

Concerns might also be expressed that allowing shareholder intervention might enable some large shareholders to try to initiate proposals in order to extract benefits from management.[73] 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 increase the incidence and importance of shareholder voting, here are already important shareholder votes that take place. Large shareholders can now threaten to vote against management in the annual election of directors and in votes on fundamental changes (such as on charter amendments) proposed by management. I am unaware of any substantial evidence that large outside shareholders are able to extract significant benefits from management due to the existence of such votes or 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 proposals 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 for the move from a majority of shareholders. As discussed, given the tendency of shareholders to vote with management, there is even no assurance that value-increasing proposal opposed by management would all be adopted. Gaining support from holders of a majority of the outstanding shares would thus be quite unlikely when a proposal would not benefit shareholders but rather would considerably harm them. Furthermore, there are credibility problems with a

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[73] See Stephen Choi and Andrew Guzman, Choice and Federal Intervention in Corporate Law, 87 Va. L. Rev. 961 (2001).

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 should 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 with intervention power.

Suppose that, in the Chrysler example, shareholders prefer distributing the $10 billion cash hoard to having no distribution at all, but that the outcome most preferred by most shareholders is to distribute part of the cash hoard and not all of it. In such a case, if Kerkorian submits a proposal for distributing all the cash hoard, it can be expected that management, fearing correctly that the proposal be adopted in the event that shareholders face a choice only between Kerkorian's proposal and the status quo, would bring to a vote a counter-proposal to distribute only part of the cash hoard. This counter-proposal would be then adopted, further improving the outcome for shareholders.

Counter-proposals, by management or other shareholder groups, can thus lead to an outcome that is superior to the one that adoption of the initial proposal would produce. And counter-proposals that would make matters worse off compared with the initial proposals would be unlikely to defeat it. For this reason, it would be perfectly acceptable, and if anything desirable, to have a counter-proposal submitted to the same annual meeting to which an initial proposal is submitted.

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, so the argument goes, shareholders are best off when their hands are tied and they are thereby prevented from intervening. Below I consider in turn several claims and conclude that they do not provide a good basis for tying shareholders' hands.

A. Imperfect Information

The most commonly used argument against any expansion in the voting rights of shareholders is based on the informational disadvantage that they are likely to have vis-à-vis management.[74] Management, so the argument goes, is better informed about the company and thus in a better position to evaluate which decision would best enhance shareholder value. That management might sometimes be better informed has been long accepted by corporate law.[75] If shareholders are allowed to make decisions themselves, the argument proceeds, they would make poorer decisions than management would. Accordingly, the argument concludes, shareholders themselves are better off if their hands are tied from having the power to intervene. Having decisions made by management or at least initiated by management prevents shareholders from making some poor, erroneous decisions.[76]

Shareholders' possibly inferior information, however, does not warrant denying them the power to intervene. To begin, 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 are likely to have perfectly adequate information to make a good decision. Consider decisions on whether to have a staggered board charter provision and on whether or not to be incorporated in Delaware. These are questions that

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[74] See Robert Charles Clark, Corporate Law (1986), 1.2.4 and 3.1.1. Indeed, Clark takes the view that the main benefit form the voting rights that dispersed shareholders is not in the actual use of such rights in the hands of these shareholders but rather in their making possible a takeover in which a buyer would purchase a controlling block and then use the voting rights coming with the shares to displace management. Id. At sec. 3.1.1

[75] For example, the Delaware courts have viewed as plausible and legitimate directors' concern that shareholders might mistakenly view as adequate an offer that is, in fact, inadequate according to directors' superior information. 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.

[76] 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).

institutional investors encounter in many companies, questions to which the answer is unlikely to depend on some private information about the company known only to management. Shareholders might make the wrong decisions on such questions, of course, but if they do so it will not be because they lack some special information about the company possessed only by management.

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 in turn 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 target's independent value and investment opportunities are poorer than shareholders believe. But might opposition to intervention power be grounded in the possibility that such private information will be positive and the company's value and investment opportunities will be much better than shareholders appreciate? As I explain below, the answer is no.

To begin, 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 game rules -- 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 generally raise, and that would be hard to falsify, whenever management prefers the status quo.[77] In contrast, if shareholders had intervention power

[77] As was observed by Vice Chancellor Strine: "It is important to recognize that substantive coercion can be invoked by a corporate board in almost every situation." Chesapeake Corp v Shore, 771 A2d 293, 327 (Del Ch 2000). Note that the raising of a false claim cannot be discouraged by fears that even if the claim is not demonstrably false when made, it will become so down the road. Suppose that managers block an

and used it in some cases, their decisions might sometimes be less informed but would generally be based on their judgment of what would serve shareholders best.

Furthermore, and importantly, granting shareholders the power to intervene would hardly imply that management's superior information would go totally unused. It can be expected that, most of the time, deference to management's judgment would be such that shareholder initiatives would not be made. And even when a shareholder initiative would put a decision on the table for a shareholder vote, management's superior information would not be necessarily wasted. Management would only be precluded from ruling the proposal as out of order. But such information could and would likely be used as a basis for management's 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[78] or because the information is difficult to disclose credibly.[79] In such cases, management can still communicate to the shareholders its recommendation and the general reason for it.

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offer of $100 per share on grounds that the target's independent value is $120 per share, and suppose that the market price three years down the road will be $90 per share. Managers still will be able to defend their earlier estimate: The $120 per share estimate was accurate at the time it was made, they will argue, but it was an expected-value estimate; the price after three years has fallen below this expected value because uncertainty has been resolved unfavorably.

[78] 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 that disclosures about this claim might compromise the target's bargaining position in the litigation. Id at 290.

[79] 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").

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 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.[80]

In balancing these considerations, shareholders will consider various circumstances of the particular case facing them. Among other things, shareholders might take into account the following factors: their own judgment concerning the benefits from accepting the proposal brought to a vote (if they view the case for it as marginal, for example, 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).[81]

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[80] 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).

[81] It is worth noting that in a regime with intervention power, management opposing a termination decision could credibly signal that its recommendation is indeed based on their 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 certain high price (say, about the level of the payoff per share 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 if and only 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

In any event, after balancing the considerations for and against deferring to the directors, rational shareholders might sometimes conclude that deference would be best on an expected-value basis, and might sometimes reach the opposite conclusion. Of course, shareholders might not always get it right. But given that their money is on the line, shareholders naturally would have incentives to evaluate the tradeoff as well as possible.[82]

In contrast, in a regime with no intervention power, 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 whether to defer were in their hands. Thus, to block any shareholder intervention, one would have to believe that—due to ignorance of their imperfect information, irrationality, or hubris—shareholders would be making the wrong choice in most of these 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."[83]

The substantial presence of institutional investors makes paternalistic mandating of deference especially unwarranted. Institutions are likely to be aware of the informational advantage that management might have, 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

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proposal as in shareholders' interests. Under a regime with no power to intervene, management does not need to make such a commitment.

[82] 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 trade off the costs and benefits of deference as well as possible, we generally believe that such parties would be better off if they were allowed to make the decision rather than required to defer to the expert agent.

[83] Basic, Inc v Levinson, 485 US 224, 234 (1988), quoting Flamm v Eberstadt, 814 F2d 1169, 1175 (7th Cir 1987).

Investors Services, which researches questions put to a shareholder vote and recommends to institutions how to vote.[84] There is little reason to believe that the decisions of institutional investors on whether to defer would be so poor that mandating deference would be preferable to letting them make such decisions.[85]

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.[86] But that is, of course, not a reason to mandate deference. When circumstances would make shareholders sufficiently confident that lead shareholders to overcome the tendency to defer to management, imposing deference on them would be unlikely to be beneficial.

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,[87] a 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 study done by Coates, Subramanian, and myself, however, we examined long-term returns and found no such long-term payoff. To the contrary, we found that thirty months

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[84] 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").

[85] In Chesapeake, 771 A2d at 328, Vice Chancellor Strine rhetorically asks: "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?" I would replace the second clause in this question with "why are they not presumed competent to decide whether to defer to directors' recommendation to reject the offer after an adequate time for directors' communications and shareholders' deliberation?"

[86] This concern is discussed in supra Section IV.D.2.

[87] See James F. Cotter and Marc Zenner, How Managerial Wealth Affects the Tender Offer Process, 35 J Fin Econ 63, 86 (1994).

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.[88]

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. Of course, the owner might on such matters seek the manager's recommendation and might defer to it whenever 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 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 some particular pieces of information but because their decisions would not cohere as well with other corporate decisions as would decisions made by management. There is much value, so the argument goes, to corporate decisions having sufficient internal consistency to add up to a coherent and well-integrated whole. The question of whether a certain issue is decided with A or with B, it is argued, cannot be well answered in isolation from how other issues are expected to be resolved. [89]

Those making this argument might accompany it by appealing to our intuition (or experience) which advise us against back-seat driving or letting two or more chefs prepare together one dish. Shareholders should similarly sit calmly in their back seat and not instruct the person at the wheel how to

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[88] See Lucian Bebchuk, John Coates IV and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants," 55 Stan. L. Rev. 885-917 (2002).

[89] 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.

drive. That would be a recipe for accidents or at least a nerve-racking trip. As long as they have not replaced management, shareholders should let it prepare the meal and not intervene and throw additional ingredients into the pot. Such interventions are hardly a recipe for a tasty meal.

This argument, however, is unpersuasive. To begin, 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. Termination decisions can be best 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 to give you back whatever is left from the funds you gave her for the meal and not invest them in preparing another meal for you later in the week.

Furthermore, the argument against back-seat driving suffers from the same problems as the argument from 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 be constantly using it. They might commonly defer to management, and in doing so they might be guided by their recognition that management might have superior information and that consistency in decision-making might sometime be 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 might well be in their interest.

Similarly, shareholders will use their power to intervene only in those cases in which they see strong considerations that call for such intervention and that outweigh the consideration of consistency as well as our considerations for 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 for themselves the decision whether to defer and therefore had to have their hands paternalistically tied.

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.[90] 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 to another potential provision *B*, that *B* is favored by (another) majority of shareholders to potential provision C, and that, finally, C is favored by (yet another) majority to *A*. As a result, there might fail to be one provision that would be "stable" and could not be defeated in a vote by some other provision. Instead, shareholder decision-making would confront a "cycle."[91] In this case, so 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 on by A, and so forth and so on.

Note that, in the considered situation, none of the three provisions A, B, and C can be viewed as "the best" for shareholders. Each one of them would do in a sense just as well. The one outcome that would be clearly inferior would be to have perpetually changing provisions. 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. To begin with, 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. [92]

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[90] Jeffrey N. Gordon, Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law, 60 U. Cin. L. Rev. 347 (1991).

[91] 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).

[92] 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 obtain fully. 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, what is

Second, the important problem for corporate governance concerns not the possibility that the set of top choices includes a cycle of three top choices, but rather the more realistic and likely possibility that there will be also some choices that will be inferior to all the regimes in the set of top choices. 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 provision, shareholders might be "stuck" with an arrangement that is inferior to all those in set of top choices. The power to intervene ensures that the company will not end up with any arrangement that does not belong to the set of top choices.

Thirdly, 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, that management prefers A, and that we are starting with 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 such votes would discourage the initiation of the proposal to begin with. Either way, the company would remain in a stable outcome with A.

Thus, whatever problem of cycles exists, it at most calls for providing management with the power to make schedule accompanying votes on counter-proposals and thereby be able to be a tiebreaker among choices that all belong to the set of top choices. It does not call for denying shareholders the power to initiate votes, which is necessary for the important purpose of ensuring that corporate choices are always in the set of top choices for shareholders.[93]

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likely to obtain is that the differences between the set of choices none of each dominates all the other is much less important than the difference between the set of these choices and some other dominated choices which managers might prefer due to their private interests.

[93] It should be noted that Gordon notes the possibility of letting shareholders initiate and let the managers then set the agenda. He argues, however, that with the agenda setting power the managers have the same power as without shareholder initiation. The power to set the agenda among votes, he says, is equivalent to the power to fully control

[To be added: discussion of ex ante effects, benefits from managerial bargaining in game-ending decisions, and panglossian claims that if shareholder power to intervene were good we would have it already by private adoption.]

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.[94] It might be argued that it is desirable to tie the hands of shareholders from taking 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 the enterprise, it is in the ex ante interest of the shareholders themselves to tie their own hands and let decisions made by the board which will take into account the interest of stakeholders and not only shareholders.[95]

The argument that management control is justified by stakeholder interests has played some role in the politics of takeovers. A majority of the states enacted statutes allowing managers responding to a takeover bid to take into account the interests of stakeholders.[96] In the debate on takeover

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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, this claim is not correct. It is correct if the only options are A,B, and C (which is what Gordon assumes in his discussion). In this case, whether or not shareholders have the power to initiate, the outcome would be the one preferred by management. But if there is also an option D – say, remaining independent – which is dominated by A, B, and C but favored by management – then this option could happen if managers can block any shareholder initiative but not if they can only set the agenda.

[94] 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).

[95] 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).

[96] See Gartman, State Takeover Laws §§ A-6 to A-7, supra note 7. The committee drafting the Revised Model Business Corporation Act, however, decided that directing directors to consider the interests of nonshareholder constituencies is undesirable. See

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 Stakeholders 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 is controlled by a given controlling shareholder; the firm might be closely held or it might be publicly traded but with the controller holding a controlling block. 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 is likely to do 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 goal should equally call for limiting the intervention power of the controlling shareholder. Similarly, if the elimination of intervention power serves the dispersed shareholders by inducing stakeholders to make firm-specific investments, this consideration should again be equally applicable to firms in the same industry that have a controller. And in the absence of legal rules that limit the controllers' power to intervene, they should be expected to set contractual arrangements that would limit their power to intervene (by, say, signing contracts with professional managers that provide the managers with discretion and tie the controller's hands from firing them).

A substantial fraction of large firms in the US, and most large firms around the world, do have a controlling shareholder or family. And in many

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Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 Bus Law 2253, 2270–71 (1990).

such cases, the firm has a professional manger. Still, neither legal rules nor the charters or contracts of these firms themselves attempt to block the controller's power to intervene. At the outset, this observation suggests some skepticism is warranted for the claim that such blocking of power is called for when the shareholdings are held by 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 for some scaling down decision; 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 some 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.[97] 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

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[97] 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).

view, protection of stakeholder interests should be left to contracts between them and the corporation or to nonlegal sanctions.[98]

In any event, even assuming that (i) termination, scaling-down, and rule-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, 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."[99]

Supporters of management control indeed do not assume or imply that management should be required to use its power in ways that would protect stakeholders and that courts would review whether this is done. Indeed, lest there be any misunderstanding that courts are expected to ensure that directors take stakeholders' interests into account, drafters of state constituency statutes used (in all cases but one) language that authorizes (rather than requires) directors to take into account the interests of other constituencies.[100] Supporters of management control wish to give management *discretion* with the aspiration and 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

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[98] 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).

[99] Oliver Hart, An Economist's View of Fiduciary Duties, 43 U Toronto L J 299, 303 (1993).

[100] See Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 Bus Law 2253, 2261–63 (1990).

to overlap with the interests of the stakeholders that are supposed to benefit from this discretion.[101]

Do we have good reasons for expecting management to be good agents for stakeholders? To begin, note that, 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 as much of their wealth tied to bondholder or employee wealth. Thus, if we expect management to be an imperfect agent of 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 of 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 management's and stakeholders' preferences might arise because some termination decisions might be a threat to management (which might lose its private benefits of control) and also to employees (who might lose their jobs) or creditors (who might be harmed by an increase in leverage). But this correlation of interests is likely to be rather limited; management's and stakeholders' 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 might well disfavor 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 for itself, would favor. Finally, in cases in which an acquisition is likely to occur ultimately,

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[101] Some supporters of board veto list "managers" as a constituency whose interests should be taken into account. See Margaret M. Blair and Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va L Rev 247, 297 (1999). One can safely assume that the expanded discretion under consideration would ensure that the interests of this particular constituency be taken into account. But such an assumption cannot be made with respect to other constituencies.

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's and stakeholders' interests, there is no basis for expecting management control to translate into an effective protection of stakeholders.[102]

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 managerial interested. Once stakeholders are brought into the debate, shareholders no longer have a central claim on what management should do, but rather become one constituency out of several whose interests should be protected.

Thus, opposition to shareholder intervention can be presented as a rejection of the view that only shareholders count in favor of the view that stakeholders, especially employees, count too. Supporters 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 a broad, inclusive view of the corporation.[103]

The arguments made in this Part question this account of what is at stake in the debate over shareholders' power vis-avis management. Management is unlikely to be good agents of stakeholders. Limits on shareholder power should

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[102] Interestingly, the push for constituency statutes seems to have come from those seeking to enhance management power. Although acquisitions with 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.

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

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, gives management substantial power and has profound influence on corporate governance. The analysis has shown that the case for giving management such insulation from shareholder intervention is far from compelling.

The case against shareholder intervention does not follow from the structure of the modern corporation with dispersed ownership. 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 game-ending decisions could do much to counter the tendency of management to favor continuation of their company and thus also of their private benefits of control. Scaling-back decisions – decisions to order large cash or in kind distributions – could do much to address the problems of excess cash flow and empire-building. Shareholder power to make rules-of-the-game decisions – decisions to amend the charter or to move the company to another jurisdiction – could do much to improve the contractual and legal arrangements governing corporations and to address concerns that management control might produce an inefficient managerial tilt of such arrangements. The paper has also analyzed how such a regime could be best 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 and a basis for such work. The allocation of power between management and shareholders is a subject that warrants a careful reconsideration by all those interested in corporate governance.