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THE MYTH OF THE SHAREHOLDER FRANCHISE

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The Myth of the Shareholder Franchise

Lucian A. Bebchuk*

Abstract

The power of shareholders to replace the board is a central element in the accepted theory of the modern public corporation with dispersed ownership. This power, however, is largely a myth. I document in this paper that the incidence of electoral challenges has been very low during the 1996-2005 decade. After presenting this evidence, this paper first analyzes why electoral challenges to directors are so rare, and then makes the case for arrangements that would provide shareholders with a viable power to remove directors. Under the proposed default arrangements, a company will have, at least every two years, elections with shareholder access to the corporate ballot, shareholder power to replace all directors, and reimbursement of campaign expenses for candidates who receive a sufficiently significant number of votes (for example, one-third of the votes cast); and will have secret ballot and majority voting in all elections. Furthermore, opting out of default election arrangements through shareholder-approved bylaws should be facilitated, but boards should be constrained from adopting without shareholder approval bylaws that make director removal more difficult. Finally, I examine a wide range of objections to the proposed reform of corporate elections, and I conclude that the case for such a reform is strong.

Key words: Directors, boards, shareholders, shareholder voting, corporate elections, proxy fights, proxy contests, staggered boards, corporate governance, agency costs, accountability, myopia.

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

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INTRODUCTION

A well-known, often-quoted Delaware opinion states that “[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”¹ Similarly viewing the shareholder franchise as a key mechanism for making boards accountable, another landmark Delaware opinion states: “If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.”² I shall argue in this paper, however, that shareholders do not in fact have at their disposal those “powers of corporate democracy.” As a result, the shareholder franchise does not provide the solid foundation for the legitimacy of directorial power that it is supposed to supply. I shall also offer proposals for reforming corporate elections and thereby making directors truly accountable to shareholders.

Part I will argue that corporate elections do not in reality perform the critical role assigned to them in the accepted theory of the corporation. Because directors play a critical role in our system of corporate governance, the selection and incentives of directors are important. Shareholder power to remove directors is supposed to provide a mechanism for ensuring that directors are well chosen and have incentives to serve shareholder interests once chosen. This mechanism is made especially important by the lack of other adequate mechanisms for making boards accountable and attentive to shareholder interests.

Part I will then provide empirical evidence about the reality of corporate elections in the past decade. During the proxy seasons of the 1996–2005 decade, incumbents faced challenges from rival slates seeking to manage their firm better as a stand-alone entity in only 118 cases, or roughly twelve a year on average. For companies with a market capitalization that exceeds \$200 million, the number diminishes to only twenty-four cases, or less than three a year. Furthermore, during this nine-year period, among targets with a market capitalization exceeding \$200 million, challengers won in only eight cases, less than one a year. Thus, for public companies, the incidence of replacement of directors by a rival slate seeking to manage the company better as a stand-alone entity is negligible. After presenting this evidence, Part I will conclude by analyzing the impediments to electoral challenges that produce the low incidence of such challenges.

Part II will offer a set of default election arrangements intended to transform shareholder power to remove directors from a myth into a reality. In particular, I shall argue that, at least every two years, elections should be held with shareholder access to the corporate ballot, reimbursement of expenses to

¹ *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

² *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985).

shareholders nominating candidates who receive a sufficiently significant number of votes (for example, one-third of the votes cast), and shareholder power to replace all directors. Furthermore, confidential voting and majority voting should be required in all elections.

Part II will also discuss the process through which companies should be able to opt out of default election arrangements. I shall argue that, whatever default election arrangements are chosen by public officials, they should at the minimum facilitate shareholder adoption of bylaws opting out of these arrangements. While opting out through shareholder-adopted bylaws should be facilitated—in particular, by allowing shareholders to place bylaw proposals concerning elections on the corporate ballot—boards should be constrained from adopting *without* shareholder approval bylaws that make director removal more difficult.

Finally, Part III will discuss and respond to a wide range of possible objections to giving shareholders real power to remove directors. Among other things, I shall examine claims that market forces provide sufficient accountability; that the proposed reforms would in any event not have much practical significance; that they would have adverse effects on the interest of shareholders and/or stakeholders; and that, if anything, invigorating the market for corporate control would be superior to invigorating corporate elections. After reviewing all of these objections, I shall conclude that they do not, individually or in combination, undermine the strong case for reforming corporate elections.

Before proceeding, I should stress that my analysis of election reform in public companies will focus on the sole objective of effective corporate governance that enhances corporate value. From this perspective, increased shareholder power to replace directors would be desirable if and only if such a change would improve corporate performance and value. I do not view “shareholder voice” and “corporate democracy” as an end in itself—or as a necessary corollary of the nature of whatever property rights shareholders have.³ If the absence of viable shareholder power to replace directors were expected to produce better corporate performance and higher shareholder value, I would support a corporate governance system lacking such power. I support a viable shareholder power to replace directors as an instrument for enhancing shareholder value by making boards more accountable and more attentive to shareholder interests.

³ Cf. Matthias Benz & Bruno S. Frey, *Towards a Constitutional Theory of Corporate Governance 1–2* (Inst. for Empirical Research in Econ., Univ. of Zurich, Working Paper, 2006), available at <http://ssrn.com/abstract=933309> (viewing increases in shareholders' "constitutional" right as intrinsically desirable); Stephen Deane, *ISS Institute for Corporate Governance, Majority Voting in Director Elections: From the Symbolic to the Democratic 1* (2005), available at <http://issproxy.com/pdf/MVwhitepaper.pdf> (noting that advocates of reforming corporate elections view the issue as a "question of democratic principle").

I. THE MYTH AND REALITY OF CORPORATE ELECTIONS

A. *The Critical Role of the Shareholder Franchise*

Boards play a central role in the standard view and the legal structure of the modern publicly traded corporation with dispersed ownership. It is widely recognized that full-time executives managing such a company have an agency problem.⁴ Their private interests might provide them with an incentive to engage in empire-building, take excessive compensation or enjoy excessive perks, pursue pet projects or elevate cronies, refuse to accept beneficial acquisition offers, remain in power too long, and so forth. Such agency problems are supposed to be addressed by the board. Under the rules of corporate law, the power to run the company is not vested in the CEO or the company's senior executives. Rather, this power is vested in the board of directors, under whose direction the business and affairs of the corporation are supposed to be managed.⁵ The members of the board have a fiduciary duty to the corporation and are expected to serve as the shareholders' guardians.

Although the board has the formal authority and power to make all corporate decisions, directors are not expected to manage the company themselves. Most of the directors of publicly traded companies perform their board roles part-time. Directors are generally expected to delegate ongoing management decisions to the company's officers and especially to the CEO. Nonetheless, the board is supposed to make key decisions and to perform several crucial functions. The board selects and may fire the CEO and other top executives. The board sets the executives' compensation arrangements and thereby shapes their incentives. After selecting and hiring executives, the board is supposed to monitor their strategy and performance, replacing them if necessary. And major corporate decisions, such as how to respond to an acquisition offer, are made by the board, which has full power to accept or reject executives' recommendations.

Given the central role of the board, selecting directors with the appropriate abilities and characteristics is important. Furthermore, given that directors necessarily exercise significant discretion, it is important for them to have incentives to serve shareholder interests. Shareholder power to replace directors is supposed to play a key role in both areas. If incumbent directors are not well chosen, shareholders possessing such power will be able to replace them. Furthermore, the fear of replacement is supposed to make directors accountable and provides them with incentives to serve shareholder interests.

The importance of shareholders' power to replace directors in the corporate legal structure is reinforced by the legal system's choice to insulate directors'

⁴ See Michael C. Jensen, *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms* 86–87 (2000).

⁵ See, e.g., Del. Code Ann. tit. 8, § 141(a) (2006).

decisions from judicial review. According to established principles of corporate law, courts abstain from substantive review of the merits of director decisions and from imposing liability for decisions that could have been shown to be wrong had such a review been undertaken. In adopting this approach, courts have been moved not only by the significant difficulty of second-guessing directors' decisions but also by the existence of an alternative, superior accountability mechanism—shareholder power to replace directors whose performance they find unsatisfactory. Thus, for example, in the recent decision in the Disney case, Chancellor Chandler stated that “redress for [directors’] failures must come . . . through the action of shareholders . . . and not from this Court.”⁶

Also, corporate statutes greatly limit shareholders' power to intervene in major corporate decisions. Shareholders cannot, for example, adopt decisions to amend the corporate charter, merge, reincorporate, or dissolve the company; such decisions must be initiated by the board. Under the Republican paradigm of our corporate laws, when shareholders are dissatisfied with the board's decisions with respect to such issues, their only resort is to replace incumbent directors with a new team that would make different decisions.⁷ This basic aspect of the corporate structure reinforces, of course, the importance of the shareholder franchise.

This importance is not undermined by the fact that recent stock exchange requirements provide independent directors with a key role in board decisionmaking.⁸ Even though director independence is beneficial, it is hardly sufficient to ensure that directors are well chosen and incentivized.⁹ While independence requirements rule out some individuals who would be undesirable director candidates, they still leave a vast number of individuals from whom a choice needs to be made. Furthermore, while independence requirements rule out some undesirable motives that directors might otherwise have, they do not by themselves provide directors with affirmative incentives to serve shareholder interests.

In sum, in our board-based corporate governance system, a viable shareholder power to replace directors is important to ensure that directors are accountable and have strong affirmative incentives to focus on shareholder interests. And supporters of the existing state of affairs have asserted that shareholder power to replace directors is indeed effectual. For example, the

⁶ In re The Walt Disney Co. Derivative Litig., No. Civ.A. 15452, 2005 WL 20056651, at *2 (Del. Ch. Aug. 9, 2005), 31 Del. J. Corp. L. 349, 353.

⁷ Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 Harv. L. Rev. 1759, 1777 (2006).

⁸ See NYSE Listed Company Manual § 303A.01 (2003), available at <http://www.nyse.com/about/listed/1022221393251.html>; NASDAQ Manual § 4350(c) (2006), available at <http://nasdaq.complinet.com/nasdaq/display/index.html>; AMEX Company Guide § 121, available at <http://wallstreet.cch.com/AMEX/CompanyGuide>.

⁹ See Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (2004), at 202-204.

Business Roundtable stated: “[S]hareholders have used the . . . existing rules to launch election contests on numerous occasions.”¹⁰

Similarly, the prominent law firm of Wachtell, Lipton, Rosen & Katz stated: “[U]nder the existing rules, running an election contest through separate proxy materials is already a viable alternative and a viable threat . . . [S]hareholders do run election contests on a regular basis under the existing rules.”¹¹

And a task force of the New York Bar Association expressed a similar belief: “Under the existing proxy rules, running an election contest is a viable alternative and a meaningful threat, and election contests occur regularly.”¹²

B. The Actual Incidence of Electoral Challenges

To assess the view that running an election contest is a viable alternative and that election contests occur regularly, I conducted an empirical investigation of the frequency and outcome of such challenges.¹³ The starting point of the investigation was the universe of all cases of contested solicitations of proxies identified by Georgeson Shareholder, a well-known proxy solicitation firm, based on the data from the Investor Responsibility Research Center and Georgeson’s own data.¹⁴ Table 1 reports the number of such solicitations in each of the ten years 1996 through 2005. As the table indicates, there were about 300 contested solicitations during this decade, or about thirty a year.

¹⁰ Detailed Comments of Business Roundtable on The “Proposed Election Contest Rules” of the U.S. Securities and Exchange Commission, Attachment to Letter from Henry A. McKinnell, Chairman, Business Roundtable, to Jonathan G. Katz, Secretary, SEC (Dec. 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/brt122203.pdf>,

¹¹ Letter from Wachtell, Lipton, Rosen & Katz to Jonathan G. Katz, Secretary, SEC (June 11, 2003), available at <http://www.sec.gov/rules/other/s71003/wachtell061103.htm>.

¹² See Letter from David M. silk, Chairman, Task Force on Potential Changes to the Proxy Rules, the Association of the Bar of the City of New York, to SEC (June 13, 2002), at <http://www/sec.gov/rules/other/s71003/tfpcprabny061303.htm>.

¹³ Much of the collating and review of data was carried out by research assistants—especially Fred Pollock, Arianna Kelley, and Rob Maynes—and I am grateful to them for their work. The 2005 contests were reviewed in C. Lee Wilson, *The Continuing Myth: An Examination of the Exercise (or Lack Thereof) of Shareholder Power in 2005 and Possible Solutions to Improve the Situation* (Harvard Law School, 2006).

¹⁴ Georgeson provides a list of all the cases of contested solicitation in any year in its annual review of the elections of that year. These reviews are available at Georgeson Shareholder’s website, www.georgesonshareholder.com. For a chart depicting contested solicitations from 1981 to 2005, see Georgeson Shareholder, 2005 Annual Corporate Governance Review 44 fig. 19, available at www.georgesonshareholder.com/pdf/2005_corpgov_review.pdf.

TABLE 1: CONTESTED SOLICITATIONS 1996 – 2005	
Year	Number of Contested Solicitations
2005	24
2004	27
2003	37
2002	38
2001	40
2000	30
1999	30
1998	20
1997	29
1996	28
Total	303

But the set of contested solicitations is wider than the set of electoral challenges by a rival slate of directors that seeks to take over management of the firm as a stand-alone entity. To identify the nature of the contest, target company SEC filings were reviewed. In a few rare instances where the challenge was newsworthy, press accounts of the contest were also reviewed. To be conservative, a contest was classified as an electoral challenge by a rival slate seeking to run the target differently as a stand-alone entity whenever the documents reviewed did not enable a confident classification as something other than such a challenge. The analysis led to the classification of contested solicitations into several groups.

(i) Contested Solicitations Not Involving the Election of Directors: In each of the years of the period under consideration, there were a number of contested solicitations that did not involve a contest over the election of directors. Rather, shareholders opposed management on matters such as whether a merger proposal should be approved or whether bylaws should be amended.

(ii) Director Contests Focusing on Takeover/Sale of the Company: In a significant fraction of the contested solicitations, the contested proxy solicitations formally sought to replace directors but were essentially a mechanism to facilitate the takeover or sale of the company. When a company is protected by a poison pill, the only option for a bidder is to seek to remove the directors with a slate of directors that will redeem the pill. In such a case, the shareholder vote on the election of directors is essentially a referendum on the bidder's offer. If the bidder's team gets control of the board, the company will not be run differently;

rather, it will be sold to the bidder.¹⁵ Of course, the number of contests in this category is relevant for assessing the disciplinary force of the market for corporate control. The question we are examining here, however, is whether election contests over the management of a stand-alone company are common.

(iii) Director Contests Focusing on Opening or Restructuring a Closed End Fund: The data also include some instances in which the contested solicitation primarily focused on the opening of a closed-end fund, restructuring a fund, or some other fund management issue. For example, attempts to switch from a closed-end structure to an open-end structure took place in 2000 in the Italy Fund, and in the France Growth Fund in 2002.¹⁶

(iv) Director Contests in which a Rival Slate of Directors Sought to Manage the Company: This is the category on which I focus—contested solicitations that focus on a change in the director team at the helm of the company are the primary concern of the current policy debate over proxy solicitation rules and shareholder involvement in affecting the mode of corporate governance. In these contests, the dissident team seeks to replace current director(s) to alter the management of the corporation as a going concern. For example, in 2000, J2 Communications was the subject of a contested proxy solicitation that sought to alter the course of the company’s continuing operations, with dissidents seeking to replace the incumbent directors with a team that would better capitalize on the company’s intellectual property and other rights to the “National Lampoon” brand.¹⁷

Table 2 below displays the incidence of different types of contested solicitations. As the table indicates, electoral challenges by a rival team seeking to

¹⁵ For example, in 1998, AMP Inc. was the subject of a contested proxy solicitation that sought to replace a majority of the incumbent directors with directors who would accept Allied Signal’s hostile bid. See Steven Lipin & Gordon Fairclough, *As AMP Fortifies, Some Big Holders Urge Olive Branch*, Wall St. J., Sept. 1, 1998, at B4. Similarly, in 2001, Willamette Industries Inc. was the subject of a contested proxy solicitation that sought to replace incumbents with new directors who would accept Weyerhaeuser’s hostile bid. See Jim Carlton & Steven Lipin, *Willamette, Weyerhaeuser Send Appeals to Shareholders Amid Takeover Attempt*, Wall St. J., Mar. 13, 2001, at C16.

In some cases, the contest was over the sale of the company, even though there was no particular hostile bidder. For example, in 2001, Wells Financial Corp. was the subject of a contested proxy solicitation that sought to install directors who would pursue a sale of the company. Financial Edge Fund (the dissident) accompanied this solicitation with a nonbinding resolution requesting that management begin the open process of selling the company to the highest bidder. See Bill Stoneman, *Activist Investors: If You Can’t Beat ’Em, Accept ’Em*, Am. Banker, Sept. 26, 2001, at 6A.

¹⁶ see Sarah O’Brien, *Phil Goldstein Steps Out; Care to Tango?; Activist Ready to Do Battle to Open Closed-End Funds*, Investment News, Apr. 24, 2000, at 3; Paul Taylor, *Investors Abandon Nationwide Investments*, Fin. Times, June 10, 2002, at 8.

¹⁷ See Greg Andrews, *Investors Urge Ouster at Lampoon*, Indianapolis Bus. J., Oct. 2, 2000, at 1A.

run the company differently were mounted in 118 companies during the 1996–2005 decade, an average of about twelve a year.

In the second half of the decade, the incidence of such challenges was somewhat higher. There were forty-seven such challenges in the first half of the decade, and seventy-one challenges, about 50% more, in the second half. Thus, although shareholder activism (as expressed, for example, in the incidence of shareholder precatory resolutions) was markedly higher in the second half of the decade, the incidence of electoral challenges remained small—an average of about fourteen a year.¹⁸

TABLE 2: CLASSIFICATION OF CONTESTED PROXY SOLICITATIONS 1996 – 2005					
Year	Number of Contested Solicitations	Director Contests Not Involving the Election of Directors	Director Contests Focusing on Takeover/Sale of Company	Director Contests Focusing on Opening or Restructuring a Closed-End Fund	Director Contests Focusing on an Alternate Team for Governing Company
2005	24	8	2	4	10
2004	27	8	3	1	15
2003	37	5	13	3	16
2002	38	5	13	6	14
2001	40	8	15	1	16
2000	30	7	13	4	7
1999	30	10	4	2	13
1998	20	4	5	1	13
1997	29	10	12	1	5
1996	28	9	8	0	9
Total	303	74	88	23	118

C. The Targets and Outcomes of Electoral Challenges

Which companies become targets of electoral challenges by rival teams of directors? Table 3 displays statistics about the company size (as measured by market capitalization) of such targets.¹⁹ As the table indicates, the great majority

¹⁸ It might be argued that, although the incidence of proxy contests is small, there are cases in which changes are brought about by the mere threat of a proxy fight. However, I am unaware of any case in which such a threat led to replacement of all or most of the incumbent directors.

¹⁹ SEC filings closest in date to the contest were used to arrive at a number of shares outstanding, which was used to calculate a market capitalization as of that date.

were small. Only twenty-four companies, or less than three a year on average, had a market capitalization exceeding \$200 million at the time of the electoral challenge. Indeed, about half of the companies had a market capitalization below \$50 million.

TABLE 3: SIZE DISTRIBUTION OF THE TARGETS OF ELECTORAL CHALLENGES 1996–2005		
Market Capitalization	Number	Percentage of Total
\$0–\$50M	61	52%
\$50M–\$100M	20	17%
\$100M–\$200M	13	11%
> \$200M	24	20%
Total	118	100.0 %

Any assessment of the viability of shareholder replacement of directors should take into account not only the incidence of electoral challenges but also the incidence of successful electoral challenges. Assuming hypothetically that the incidence of challenges were large, this incidence would still have limited influence on incumbents if they generally expected to successfully rebuff challenges.

Table 4 displays statistics concerning the number of successful electoral challenges, ranked by market capitalization of the target. About two-thirds of the challengers lost. The absolute numbers make the picture especially stark: putting aside contests over a sale of the company or open-ending a closed-end fund, rivals seeking to oust incumbents succeeded in gaining control in only eight companies with a market capitalization above \$200 million during the decade.

TABLE 4: SUCCESSFUL CHALLENGERS 1996–2005		
Market Capitalization	Number	As Percentage of Electoral Challenges in Size Group
\$0 - \$50M	23	38%
\$ 50M - \$100M	8	40%
\$ 100M - \$200M	6	46%
> \$200M	8	33%
All Cases	45	38%

D. Impediments to Electoral Challenges

We have seen that the incidence of electoral challenges by a rival team proposing to run the company better is quite small—and successful such challenges are extremely rare. One possible interpretation is that shareholders are uniformly happy with incumbent directors. However, given the large number of public companies, one would still expect significant shareholder dissatisfaction in a significant number of the companies that belong to the set of firms performing in the bottom 10% of their peers. Given the set of hundreds of firms that restated earnings in recent years, and the large set of companies whose boards elect not to follow majority-passed shareholder resolutions, one would expect to see more challenges by rival teams.

A more plausible interpretation of the evidence is that, even when shareholder dissatisfaction with board actions and decisions is substantial, challengers face considerable impediments to replacing boards. Below I discuss the existing impediments. Although these impediments are partly inevitable, they are also partly a product of existing legal arrangements.

1. Costs

A rival team seeking to replace incumbents will bear significant costs—often in the hundreds of thousands of dollars.²⁰ To begin, even assuming that all shareholders recognize the rival team's superiority and are willing to vote for it, the rival team would have to incur significant "procedural" costs. Because rival teams cannot place the names of their director candidates on the corporate ballot, they have to pay to mail proxy cards to individual shareholders and receive them back. In addition, rivals have to bear the legal costs involved in filing a proxy statement with the SEC and possibly also in dealing with incumbents' legal challenges to the completeness or accuracy of their proxy statement. In the recent proxy contests at Six Flags, Inc., insurgent Red Zone LLC incurred \$813,000 in legal fees and \$36,000 for the cost of preparing, printing and mailing proxy materials.²¹

In addition to the above procedural and inevitable expenses, rivals must commonly incur additional costs. Even when shareholders are dissatisfied with incumbents, they must still be persuaded that the rival team offers a superior

²⁰ In a recent letter comment filed with the SEC, Automatic Data Processing reported that, based on proxy statements filed by outsiders engaged in proxy solicitations during 2003–2005, the average cost of a contest was \$368,000. It also noted that the reported estimates of costs were likely lower than the actual costs incurred. See Letter from Richard Daly, Co-President of Automatic Data Processing, to Nancy M. Morris, Secretary, SEC (Apr. 20, 2006), available at <http://www.sec.gov/rules/proposed/s71005/ccallan1565.pdf>.

²¹ Six Flags, Inc., Proxy Statement (Form PRE 14A), at 32–33 (Apr. 11, 2006) [hereinafter Six Flags Proxy Statement].

alternative. As will be discussed in Section B, doing so is far from straightforward and likely involves significant costs beyond the baseline procedural costs. The rival team needs to communicate with shareholders, develop and present its strategy and plans for the company, address questions or concerns that shareholders may have, and respond to the incumbents' attacks on its plans and candidates.²² Furthermore, when persuasion needs to be done, it becomes important to communicate directly with shareholders. Many shareholders hold shares in street names and are thus not automatically known and accessible. To identify and reach such shareholders, challengers may well have to use the expensive services of proxy solicitors as well as incur significant travel expenses. In the proxy contests at Six Flags, Inc., Red Zone incurred \$2,400,000 in investment banking fees, about \$950,000 in travel expenses, and about \$600,000 in fees and expenses for professional proxy solicitors.²³

The issue of significant costs is especially difficult because of the existence of a "free-rider" problem.²⁴ At first glance, it might be thought that, while the presence of the above costs will discourage some contests, it will not deter those that would produce benefits exceeding these costs. This is not the case, however, because potential rivals will not fully internalize the potential benefits from a contest. Although the challengers must bear their full costs, they can capture only a fraction of the benefits that the contest confers on the shareholders collectively.

To illustrate, consider a potential challenger that holds a 3% block in a company with a market capitalization of \$200 million. Suppose the challenger believes that, if it were to mount a contest, it would have to spend an amount of \$0.5 million; that incumbents would counter by spending \$2 million (1% of firm value); that the rival's probability of winning would be 50%; and that in the event of such a victory the rival would be able to increase share value by 5%; and that even a challenge that fails would still give incumbents a "kick in the pants" that would increase share value by 2%. In this case, a challenge would increase shareholder value: while incumbents' spending would reduce firm value by 1%, improved performance would increase it by 5% or 2% (depending on whether the rival wins or loses), resulting in a net increase in stock value of either 4% or 1%—or 2.5% on average. The expected benefit from a contest would thus be \$200 million * 2.5% = \$5 million, which easily exceeds the challenger's \$0.5 million cost.

²² For example, when seeking to persuade Disney shareholders to withhold votes from board members—more modest goal than persuading shareholders to vote for a competing slate—two dissident shareholders used a private jet to crisscross the country to meet with institutional investors. See Andrew Parker, *Battle for Board Would Be Costly and Carry Risk*, *Fin. Times*, Nov. 30, 2005, at 34.

²³ Six Flags Proxy Statement, *supra* note 21, at 33.

²⁴ Robert Charles Clark, *Corporate Law* § 9.5.2, at 392–93– (1986).

However, even though mounting a challenge would be beneficial in these circumstances from the perspective of the shareholders collectively, it would not be worthwhile from the potential challenger's private perspective. The challenger would be able to capture only 3% of the expected benefit of the contest, i.e., \$5 million * 3% = \$0.15 million. And even though the challenger would be able to reimburse its expenses if it wins, it would have to bear the cost of \$0.5 million in the event (which has a 50% probability) that its challenge fails.

The problem of costs is exacerbated by the asymmetric treatment of challengers and incumbents by existing legal arrangements. Although challengers get no reimbursement in the event that they lose, incumbents can charge their full expenses to the company, regardless of the outcome. With such *carte blanche*, incumbents facing a meaningful chance of ouster will be prepared to spend substantial amounts. Where potential challengers have *insufficient* incentive to invest in mounting a proxy contest, incumbents have *excessive* incentive to invest in opposing a challenge: indeed, they have an incentive to spend more than is optimal from the shareholders' collective perspective. The incumbents' easy access to the company's coffers further increases the amount that challengers must spend to counter incumbents' campaigning.

In examining the importance of challengers' costs as a barrier to proxy contests, it should be noted that, for some shareholders with significant stakes, the potential costs of mounting a challenge go beyond the out-of-pocket costs involved in running a contest. Mutual funds, including those belonging to the main mutual fund family groups, would be unlikely to mount challenges even if they had to bear only a small fraction of these out-of-pocket costs. As Robert Pozen observed, for mutual fund families such as Fidelity or Vanguard, mounting a proxy contest is not part of the *modus operandi*.²⁵ Running a contest requires attention and management time; moreover, it involves pursuing a fight with incumbents that does not sit well with the business model of such funds. Such funds are at most "reluctant activists," to use Pozen's term, that could conceivably vote for a challenger but could not be expected to initiate contest themselves.

Nonetheless, there is a potential pool of challengers for whom mounting a challenge is not inconsistent with their business model. This pool of potential candidates is comprised of individuals, family firms, and "activist" mutual funds or hedge funds that have or take a significant stake in a target company prior to mounting a contest. While these candidates are open to the idea of mounting a challenge, their behavior is likely to be sensitive to the magnitude of costs they would have to bear in mounting a proxy contest, and their past reluctance to mount such contests has likely been due, at least in part, to cost barriers.²⁶

²⁵ Robert C. Pozen, Institutional Investors: The Reluctant Activists, *Harv. Bus. Rev.*, Jan.–Feb. 1994, at 140.

²⁶ See Sarah Teslik, Executive Director, Council for Institutional Investors, Remarks at the Symposium on Corporate Elections 62 (John M. Olin Ctr. for Law, Econ., and Bus., Harv. Law

2. *Shareholders' Uncertainty about the Rival*

Even when a rival team would be better at leading the firm, convincing the shareholders that this would be the case would require significant efforts with no guarantee of success. Shareholders would be making their choices under conditions of uncertainty: to vote for the rival team, they must be convinced not only that the incumbents' performance is sub-par, but also that the rivals would likely perform better. Otherwise, shareholders might well choose to stay with the devil they know.²⁷

The important point to recognize is that shareholders cannot infer from a rival's mounting a challenge that the rival directors would perform better. To begin with, even a rival team that believes it will perform better may be acting out of hubris. Furthermore, and very important, a rival's decision to mount a challenge does not even imply that the rival itself believes it will perform better. After all, a challenge could be motivated instead by a desire to obtain the private benefits associated with control.²⁸

Thus, a challenger that knows it will in fact perform better may still have to do a significant amount of work—and may still fail—to convince shareholders to vote its way. The challenger must persuade shareholders that it is not merely attracted by private benefits, and present them with a credible and convincing case that its slate of directors and its plans for the company would likely produce an improvement.

This task is made difficult by the fact that many shareholders pay little or limited attention to the question of how to vote. While one externality problem leads rivals to underinvest in launching contests and running them, another externality leads shareholders to underinvest in assessing which slate of directors would be better: a shareholder would have to bear the full costs of such an investment in decisionmaking, but most of the benefits from improved decisions would be shared with fellow shareholders.²⁹

One difficulty rivals have in this connection is that they generally are unable to give as complete a picture of their plans as the incumbents can. For shareholders assessing a slate of directors, one important consideration is the identity of the person who would serve under the directors as CEO. Shareholders

Sch., Discussion Paper No. 448, Lucian Bebchuk ed., 2003), available at <http://www.law.harvard.edu/faculty/bebchuk/pdfs/Olin-Symposium-Corporate-Elections.pdf> (describing how the costs of launching a proxy contest discourage challenges by public funds).

²⁷ Lucian Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control 2* (Nat'l Bureau of Econ. Research, Discussion Paper No. 8633, 2001), available at <http://papers.nber.org/papers/w8633.pdf>.

²⁸ See Lucian Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1071, 1090 (1990).

²⁹ See Lucian Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820, 1837–38 (1989).

know who the CEO chosen by the incumbents is, but rival teams may have difficulties specifying their nominee in advance. Potential candidates for the CEO position may be executives in other companies. When incumbents wish to attract a new CEO, they can hold confidential discussions with such candidates. The willingness of the candidate to take the CEO position will be made public only when the board offers and the candidate accepts the position. In contrast, if a rival team of directors approaches such a candidate, the candidate may be reluctant to be named even if he or she is in fact willing to become CEO in the event of the rival's victory.³⁰

Finally, the reluctance of some money managers to vote against incumbents also makes it difficult for even of highly qualified rival team to attract sufficient support. . Many money managers interested in attracting business from companies may be concerned that voting for a challenger may make it more difficult for them to get business from incumbents in general or from the incumbents of the target company in particular. Indeed, there is some evidence suggesting that the voting decisions of money managers are at least somewhat distorted toward positions favored by management.³¹

All of the above factors make it difficult for a rival slate of directors to win, even a rival slate in fact superior to the incumbents. As a result, these factors also discourage rivals from mounting challenges in the first place. And given that rivals must bear the costs of running the challenge themselves if they fail, anything that operates to reduce the likelihood of winning also discourages launching an attempt in the first place.

Thus, the difficulties that even a superior rival slate faces in persuading shareholders to vote for it reinforces the current cost barriers to mounting challenges. And because even a rival superior to the incumbents cannot be certain of winning, it is worthwhile to consider (as will be done below) providing reimbursement of costs to rivals who attract significant support but fall short of winning.

3. *Staggered Boards*

A majority of U.S. public companies have a staggered board of directors.³² In such cases, directors are divided into classes, usually three, and only one class

³⁰ In the proxy contest that Red Zone fought successfully to oust three of the directors of Six Flags, Inc., Red Zone felt compelled to spend \$5.5 million as a signing bonus to get a seasoned executive to join the insurgent slate. See Six Flags Proxy Statement, *supra* note 21, at 32.

³¹ *Hewlett v. Hewlett-Packard Co.*, No. CIV.A. 19513-NC, 2002 WL 818091, at *8 (Del. Ch. Apr. 30, 2002), 28 Del. J. Corp. L. 326, 340 (2003).

³² See Lucian Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 *Stan. L. Rev.* 887, 889 (2002); Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 *J. Fin. Econ.* 409, 410 (2005).

comes up for re-election each year. To gain control of a company whose directors are protected by a three-class staggered board, a rival needs to win two elections, held at least one year apart.

The need to win two elections discourages and impedes electoral challenges in two ways. First, it makes mounting a challenge more costly. Rivals need to run a slate of directors twice, which increases costs, and be prepared to sustain a campaign for more than a year. And having to win two elections before gaining control makes it all the more difficult to specify during the campaign the identity of the CEO whom the rival directors will appoint if they gain control. That individual will have to sit on the sidelines, in a stand-by position as it were, for more than a year.

Second, assuming that a rival team did mount a challenge to incumbents protected by a staggered board, the very existence of the staggered board makes it less likely that the rival will be able to win. In the first round, shareholders may be reluctant to vote for the rival's slate of directors even if they view them as superior to the incumbents; for a victory *by* the rival would lead to a period longer than a year in which the incumbents would still be in control, but the board would have internal divisions and friction.

II. REFORMING CORPORATE ELECTIONS

Part I's analysis of the impediments to mounting and winning an electoral challenge to incumbents provides a basis for identifying reforms that could provide shareholders with a viable power to replace directors. I now turn to putting forward a set of proposals for reforming elections in this way.

A. Periodic Facilitation of Electoral Challenges

1. Frequency

At the outset, I would like to stress that, while it is essential to have periodic elections in which shareholders have a genuine option to replace incumbents, the frequency of such elections is a matter on which there is room for reasonable disagreement. Under existing arrangements, elections are held each year, but they are held under arrangements that make it difficult for shareholders to replace directors. Having frequent elections is of little significance if they do not offer a genuine opportunity to replace the incumbents. Having "real" elections less often is clearly superior to having annual elections under arrangements that make it difficult for challengers to run and win.

Furthermore, *a priori*, there is no reason to assume that the optimal frequency of scheduled elections for directors is once a year. On the one hand, the more often shareholders get a genuine opportunity to replace the board, the faster

they will be able to do so if they conclude this is necessary. On the other hand, if elections are more meaningful, scheduling them frequently could unduly “shorten the horizon” of incumbents and lead to short-termism. Furthermore, scheduling elections less frequently than once a year might enable institutional investors, which generally have positions in many public companies, to devote more attention to making the right voting decision when an election does take place.

For these reason, while I support giving shareholders a genuine opportunity to replace the board from time to time, I am open to the possibility of giving them such an opportunity less often than once a year.³³ For concreteness, I will discuss below a system under which the arrangements facilitating challenges are triggered every two or three years.

In between the points in time in which these arrangements are triggered, it could be desirable to have a “safety valve.” For example, elections could still occur at each year’s annual meeting, but the arrangements facilitating challenges (access to the ballot, cost reimbursement, etc.) would be triggered only every two or three years. Alternatively, one could have no “interim” elections scheduled, but enable shareholders to call a special meeting in certain circumstances to have a vote on replacing the directors.³⁴

2. Access to the Ballot

Putting aside the question of when corporate elections should take place, I now turn to how they should be conducted when they do take place, and I start with the problem of contest costs. Under the existing arrangements, challengers incur the costs of sending their own proxy materials to shareholders and getting them back. These “mechanical” costs can be reduced by allowing challengers who satisfy some threshold ownership and holding requirements to place their candidates on the corporate ballot.

The SEC has considered several times (starting in the 1940s, and most recently during 2003–2004) whether to provide shareholders with a right to place

³³ For views supporting or accepting frequency lower than once a year for times in which boards have to face a meaningful possibility of removal, see William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 *U. Chi. L. Rev.* 1067, 1072 (2002); Bebchuk et al., *supra* note 32, at 895; Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 *U. Chi. L. Rev.* 187, 243 (1991); Strine, *supra* note 7, at 1780.

³⁴ A move to a system in which elections are held less often than once a year would require changes in state corporate codes and stock exchange requirements. Annual elections are required by the NYSE, NASDAQ, and AMEX, as well as by the codes of all states other than Minnesota and North Dakota. For a review of these requirements, see William K. Sjostrom, *The Case against Mandatory Annual Director Elections and Shareholders’ Meetings 2–3* (2006), available at <http://law.bepress.com/expresso/eps/1474>.

candidates on the corporate ballot.³⁵ Although the Business Roundtable and others have been able to discourage the SEC from adopting a shareholder access rule, adopting such a rule would be desirable. Given that the company is already mailing and receiving shareholders' proxy cards, the need for rivals to do the same separately is a cost that can easily be avoided.

Of course, a system with shareholder access to the ballot should have some threshold criteria of minimum ownership for any shareholder or shareholder group wishing to place a candidate of the ballot. The ownership requirement would seek to prevent a situation in which the firm's ballot becomes stuffed with candidates nominated by fringe investors. Shareholder access to the ballot is intended to facilitate challenges that might succeed, not to offer a mode of expression for all shareholders.

Although the case for an ownership threshold is strong, it is less clear that a minimum holding requirement is desirable. When the SEC considered providing shareholders with access to the ballot in some limited circumstances, it proposed limiting access to shareholders who have held shares for at least one year.³⁶ This limitation seemed to be motivated by a desire to limit access to shareholders who might have an interest in improving the company's long-term value, rather than making a short-term profit. However, if one seeks to limit access to shareholders with a long-term perspective, what matters is not how long a shareholder has held shares in the company, but rather how long the shareholder plans to hold the shares going forward. Accordingly, it might be better to require shareholders who nominate a candidate to commit to maintaining their position for at least a year in case the candidate is elected. .

Finally, access to the ballot should not be provided when a potential buyer runs a slate to overcome or bypass potential board opposition to an acquisition.³⁷ In such a case, the fuller disclosure provided by a separate proxy statement is needed, and inclusion of the buyer's candidates in the company's proxy statement is thus inappropriate.

3. Reimbursement of Campaign Expenses

Although the above arrangements would much reduce or even eliminate challengers' "mechanical" costs, these are commonly not the main expenses

³⁵ The SEC considered proposals for granting shareholders some access to the corporate ballot at different points in time, starting in the 1940s. For a review of the debate over the SEC's recent consideration of a rule establishing modest shareholder access, see *Shareholder Access to the Corporate Ballot* (Lucian Bebchuk ed., forthcoming 2006).

³⁶ Div. of Corp. Fin., SEC, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors 32–33 (July 15, 2003), available at <http://www.sec.gov/news/studies/proxyreport.pdf>.

³⁷ Such an exception was included in the shareholder access rule proposed by the SEC in 2003. Security Holder Director Nominations, 68 Fed. Reg. 60784, 60787 (proposed Oct. 23, 2003).

involved in mounting a successful challenge.³⁸ Therefore, as long as challengers have to bear their own costs fully, contest charges would remain a substantial impediment that would discourage some beneficial challenges.

Under existing arrangements, challenges are impeded by incumbents' financing advantage: incumbents can fully charge their expenses to the company, whereas challengers have to pay their own way. This asymmetry should be reduced. Under the system I support, challengers will get reimbursement of their reasonable expenses under some conditions.

Under what circumstances should challengers receive reimbursement of costs? In answering this question, it is important to recognize two points. First, not all rivals running a campaign should be reimbursed. Such a universal reimbursement arrangement would facilitate "frivolous" challenges that are expected to get little support. Therefore, it would be desirable for there not to be reimbursement to challengers that perform poorly enough at the ballot box.

Second, requiring a rival team to obtain the majority support needed to elect one or more candidates to the board as a condition for reimbursement would be too demanding. Even rivals superior to the incumbents cannot be certain of winning. Such rivals will have to take into account the possibility that they will fail to gain a majority. Thus, making reimbursement conditional on obtaining majority support will go too far and discourage some beneficial challenges.

Putting these two points together, it would be desirable to encourage challenges when potential rivals believe they have a substantial likelihood (even though no certainty) of winning. Thus, the condition for reimbursement should be obtaining sufficiently wide support.³⁹ For example, consider an arrangement that would provide reimbursement in the event rivals garnered support from one-third of the shareholders voting on the election of directors. Such a requirement would not encourage challenges that are expected to have little practical significance. At the same time, because rivals who have a meaningful chance of winning will also have a high likelihood of getting, say, only 40% of the votes, such an arrangement will facilitate challenges by such rivals.

It is worth noting why the proposed reimbursement arrangement is superior to a proportional reimbursement arrangement under which rivals obtaining X% of the votes would have X% of their costs reimbursed.⁴⁰ A proportional reimbursement arrangement has two disadvantages relative to the one proposed. First, in cases in which the challenger obtains little support—say, 10% of the votes—a proportional reimbursement arrangement would provide excessive reimbursement. In such cases, the challenger should receive *nothing* (as with the

³⁸ See letter from Automatic Data Processing to the SEC (April 20, 2006), available at <http://www.sec.gov/rules/proposed/s71005/ccallan1565.pdf>

³⁹ See Bebchuk & Kahan, *supra* note 28, at 1096–1100.

⁴⁰ Such an arrangement was discussed in Melvin A. Eisenberg, *The Structure of the Corporation* 121–27 (1976).

proposed arrangement), because in all likelihood it had no meaningful likelihood of winning in the first place.

Second, in cases in which a challenger falls just short of winning a majority, proportional reimbursement would provide insufficient reimbursement, because such a challenger would still have to bear a substantial fraction of the challenge costs. As a result, the “public-good” problem of underinvestment by challengers with a substantial likelihood of winning would not be eliminated.

The above discussion indicates that the optimal reimbursement schedule should (i) provide no reimbursement at sufficiently low levels of support, and (ii) provide full reimbursement at levels below majority support that are sufficiently high. A proportional reimbursement arrangement does not have either one of these features. While the reimbursement arrangement that I put forward does fall within the class of such schedules, I do not wish to claim it is necessarily optimal; I am putting it forward as a simple rule that has certain attractive features, leaving the examination of how it could be refined and improved to future work.⁴¹

4. Replacement of All Directors

Shareholders should be able to vote to replace *all* of the incumbent directors with new candidates at least every two or three years. There should be a point in time at which shareholders have an opportunity to vote for a full slate of new directors. As was explained earlier, requiring rivals to win two elections in a row to gain control is a substantial impediment to challengers.

Note that this proposal would not eliminate certain advantages cited by supporters of staggered boards.⁴² Such supporters believe that electing independent directors for a term longer than one year protects them from insiders and thus bolsters their independence. Such supporters also argue that a staggered board ensures that the roster of directors changes only gradually, thus ensuring stability.

The elections system that I support is consistent with largely maintaining these advantages. A company could have a bylaw (or a company policy) requiring that the composition of the company's slate—that is, the slate put forward by the incumbent directors—be done in the same way as it is done under a staggered board. Under such an arrangement, independent directors would know that their place on the company's slate would be reassessed only once every three years; they would thus be fully protected from earlier replacement by the incumbent team. (They could be removed earlier if shareholders revolt, but this possibility would

⁴¹ Among other things, whereas the proposed arrangement shifts from no reimbursement to full reimbursement at a certain threshold level of support, one could consider arrangements under which the percentage of reimbursed expenses moves up from 0 to 100 gradually over a certain range.

⁴² See Richard H. Koppes et al., *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 *Bus. Law.* 1023, 1051–54 (1999).

certainly not undermine their independence.) Furthermore, in the ordinary course of events, absent a shareholder revolt, stability in the company's slate would be ensured. Replacement of more than one-third of the board would occur only in the event of shareholder revolt, when dissatisfaction with the incumbent team as a whole should take precedence. Thus, the proposed system would be consistent with maintaining whatever advantages might flow from commitment by the incumbent board to maintain stability in the composition of its slate. However, it would preclude insulating incumbents from ever losing control of the board in one election.

The proposed system would also be consistent with an arrangement under which all directors are elected for two- or three-year terms, provided that they all then come up together for reelection. Providing directors with a longer time horizon would be acceptable as long as shareholders at some point get a genuine opportunity to replace the full board. Such an arrangement would provide independent directors with the security of remaining on the board for the two or three years that supporters of staggered boards deem desirable, but would do so without insulating the incumbent directors from being replaced by a rival team.

B. Arrangements Applying to All Elections

I have thus far discussed the ways in election arrangements should periodically facilitate electoral challenges. I now turn to discussing some additional changes in existing default arrangements which should apply to all elections. First, directors should not serve when more votes are cast against them than for them. Second, shareholders should vote by secret ballot.

1. "Withhold" and "Against" Votes

For shareholders to be able to replace incumbent directors with outside candidates, some such outside candidates need to be on the ballot. However, even with the arrangements put forward in Section II.A to facilitate electoral challenges, most elections will likely be uncontested, with no candidates on the ballot other than those put forward by the company. In such situations, it will still be desirable for shareholders to be able to vote down a candidate put forward by the company.

Under existing default arrangements, shareholders do not have a meaningful power to veto candidates put forward by the board in an uncontested election.⁴³ To begin, under the existing default arrangements established by state law, whether a candidate is elected is determined according to a plurality standard:

⁴³ For a description and discussion of these arrangements, see Comm. on Corporate Laws, Discussion Paper on Voting by Shareholders for the Election of Directors (June 22, 2005), available at <http://www.abanet.org/buslaw/committees/CL270000pub/directorvoting/20050621000000.pdf>.

the candidate with the most votes is elected, which means that a candidate placed on the ballot by the board will be elected in an uncontested election as long as the candidate obtains one "for" vote. Furthermore, if no one is elected to fill a board seat, the incumbent remains in place. Both arrangements make it possible for a director to serve on the board, even following an election in which that director failed to obtain support from most of the shareholders that voted.

This state of affairs of affairs has attracted a great deal of shareholder criticism.⁴⁴ This shareholder opposition has led to changes both in the Delaware Code and in the Model Business Corporation Act that facilitate the adoption of bylaws that establish "majority voting," i.e., that prevent or constrain the election of candidates who failed to gain the support of a majority of the shareholders.⁴⁵ Given that majority voting has been extensively discussed, and that my interest is in majority voting as one element of a comprehensive reform of corporate elections, I will limit my discussion of the subject to four general points.

First, in my view, majority voting should be the default arrangement, given the clear and widely accepted flaws of plurality voting. Yet even though Delaware and the Model Business Corporation Act have now moved to facilitate opting into majority voting arrangements, they have not made majority voting the default arrangement. Although there is room for reasonable disagreement about which of the variations of majority voting should be adopted as the default, there is little basis for continuing to accept an arrangement under which directors may hold office even after an election in which they obtained, say, a single shareholder vote.

Second, as to the relative merits of alternative variants of majority voting, in my view shareholders should be able to cast both "withhold" and "against" votes, and to view director candidates as voted down only if a majority of the votes are cast against them. Shareholders now generally have the choice only between a "for" and a "withhold" vote, and majority voting proposals therefore seek to prevent or constrain the election of directors who receive more "withhold" than "for" votes. The problem with this approach, however, is that shareholders withholding support from a candidate might be seeking to register a signal of dissatisfaction, rather than prevent the candidate's election. Given that such "withhold" votes might currently reflect two very different preferences, it is desirable to enable shareholders to express clearly each of these preferences. If both "withhold" and "against" votes are permitted, shareholders wishing to register dissatisfaction but willing to allow the candidate to serve will cast a "withhold" vote, whereas shareholders who prefer to block the director's election will cast an "against" vote. Under my proposed arrangement, directors will be prevented from

⁴⁴ For discussions about the growing support for majority voting among shareholders, see, for example, the corporate governance blog of ISS, at http://blog.issproxy.com/majority_voting/; Wachtell, Lipton, Rosen & Katz, *Majority Voting—A Look Back at the 2006 Proxy Season* (June 12, 2006), available at http://www.realcorporatelawyer.com/pdfs/wlrk061306_02.pdf.

⁴⁵ See S.B. 322, 143d Gen. Assem. (Del. 2006).

serving only when a majority of the voting shareholders clearly prefers that outcome over merely sending a warning signal to the board.

Third, although a great deal of attention has been paid recently to majority voting, majority voting is not a substitute for the arrangements discussed earlier for facilitating electoral challenges. Boards often act as a team and shareholders cannot isolate the separate contribution of each director to the team's decisions and performance. As a result, when shareholders are dissatisfied with the board, their dissatisfaction often is not limited to one or few directors but rather extends to the team as a whole. In such a situation, improving matters might require adding to the board one or more new directors who are not part of the existing team. Majority voting, however, would not facilitate such changes; if majority voting prevents the election of a director targeted by shareholders, the seat either will not be filled or will be filled by the incumbent team, which will continue to call all the shots either way. Thus, even if most companies end up opting into majority voting, shareholders should hardly become complacent about corporate elections. Without the adoption of the other arrangements discussed in this section, shareholders will not obtain the viable power to replace incumbents with a new team, which is necessary if corporate elections are to perform their critical role.

Finally, while majority voting is hardly a substitute for the adoption of arrangements that facilitate electoral challenges, it is a useful complement to them. Even *with* such arrangements, challengers will not have sufficient incentive to mount a contest in all cases in which shareholder dissatisfaction might be substantial. But with majority voting, shareholders have a very inexpensive and decentralized way to discipline directors without any individual shareholder having to bear the cost of mounting a challenge. And even though majority voting cannot adequately address situations in which shareholders are dissatisfied with the board and its decisions in general, it can be effective with respect to problems limited to a small subset of the directors or to a specific board decision. For example, the ability to use majority voting to block the election of the chair of the compensation committee might make that committee *and* its chair more attentive to shareholder interests when making compensation decisions—and thereby prevent the adoption of pay packages likely to outrage shareholders.

2. Confidential Voting

All voting on directors, in both contested and uncontested elections, should be by secret ballot. At present, although precatory resolutions calling for confidential voting have long attracted substantial support,⁴⁶ voting is not

⁴⁶ See, e.g., Roberta Romano, Does Confidential Proxy Voting Matter?, 32 Journal of Legal Studies 465 (2003), at __.

confidential in the lion's share of public companies.⁴⁷ This lack of confidentiality distorts such decisions by some institutional investors in favor of incumbents. Many institutional investors, including mutual funds, banks, insurance companies, and other money managers, have an interest in being on good terms—or at least not on adversarial terms—with management in public companies. Such good terms might facilitate getting business from these firms, including managing the retirement accounts of the firms' employees or providing various other financial services.

Given that a particular money manager's vote is unlikely to be pivotal, and that whatever benefits may arise from an efficient outcome of a vote will largely be captured by others, the money manager's other business interests may have a substantial influence on its vote in such a contest. In particular, the money manager might elect to support the incumbent, even if the challengers appear to be somewhat better for shareholder value.

There is empirical evidence that institutions' voting decisions may be influenced by their other business interests. One study divided institutions into those that are "pressure-sensitive" (because of their interest in public firms' business, such as insurance companies and banks), "pressure-resistant" (because of the absence of such dealings, such as public pensions funds, endowments, and foundations), and "pressure-indeterminate."⁴⁸ The study found that the percentage of votes cast against antitakeover provisions was positively correlated with the ownership stake of pressure-resistant and pressure-indeterminate institutions, but not with the ownership stake of pressure-sensitive institutions.⁴⁹

While the above study contrasted the voting behavior of different categories of institutions, a recent study investigated differences among institutions belonging to the same category.⁵⁰ In particular, the study examined whether mutual funds that vary in the weight they place on obtaining pension business differ in

⁴⁷ In 2002, 89% of the companies in the large (1,500+) dataset of the IRRC did not have confidential voting. See Lucian Bebchuk et al., *What Matters in Corporate Governance?* 39 (John M. Olin Ctr. for Law, Econ., and Bus., Harv. Law Sch., Discussion Paper No. 491, 2004), available at

http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_et%20al_491.pdf

⁴⁸ James A. Brickley et al., *Ownership Structure and Voting on Anti-takeover Amendments*. 20 *J. Fin. Econ.* 267 (1988). [DE: the law library has the journal, but someone has it checked out. I didn't want to ILL it away from someone else working on this series of edits. Online does not have back to 1988]

⁴⁹ A related study found that CEO pay was positively correlated with pressure-sensitive institutions and negatively correlated with the presence of pressure-resistance institutions. See Parthiban David et al., *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 *Acad. Mgmt. J.* 200, 206 (1998).

⁵⁰ Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, *J. Fin. Econ.* (forthcoming).

how they vote. It found a positive correlation between the volume of pension business that a mutual fund family does and its propensity to vote with incumbents.

Recognizing the problem of potential conflicts of interest, the SEC adopted in 2003 a rule requiring mutual funds to disclose their votes.⁵¹ However, because investors in mutual funds base their choices on investment performance, not on how funds vote, the adopted requirement cannot be expected to eliminate the pro-incumbent bias of mutual funds that have a significant interest in obtaining business from public companies. The best approach, therefore, is *not* to make the funds' voting decisions in proxy contests transparent to both incumbents and outside investors, but to keep them secret from both incumbents and outside investors. And confidentiality is similarly the best way of dealing with potential conflicts of interests on the part of institutions other than mutual funds.

Whatever the significance of the potential benefits of confidentiality, there is simply no reason not to make voting in corporate elections confidential. The default arrangement for public companies should therefore provide for such confidentiality. As is currently done in companies using confidential voting, an outside tabulator should count the votes and announce the vote's outcome without disclosing to either incumbents or challengers how any given individual shareholder voted.

C. Private Ordering via Shareholder-Adopted Bylaws and Board-Adopted Bylaws

The above system is proposed as a default arrangement. One size does not fit all, and companies should be able to opt into different arrangements.

Regardless of whether public officials adopt the proposed arrangements as the legally provided default, it would be desirable for them to ensure that shareholders play a decisive role in opting out of default election arrangements. The election system is in place to provide a check on the board and to ensure its accountability to shareholders. Therefore, it would be desirable to prevent directors from controlling changes in the arrangements governing how easy/difficult it would be to replace them.⁵² In particular, it would be desirable for public officials to (i) facilitate shareholder initiation and adoption of election bylaws, and (ii) constrain directors from adopting election bylaws that make it more difficult for them to be replaced by shareholders.

⁵¹ See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270, 274).

⁵² For arguments in support of limiting boards' control over the adoption of corporate governance arrangements in general, see Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 914 (2005) [hereinafter *Shareholder Power*]; Lucian Bebchuk, *Letting Shareholders Set the Rules*, 119 Harv. L. Rev. 1784 (2006) [hereinafter *Shareholder Rules*].

1. *Facilitating Stockholder-Initiated Bylaws*

As long as public officials accept that increasing shareholder power to replace directors *might* be desirable, and that there is a role for private ordering in this area, facilitating shareholder adoption of such arrangements is desirable. Directors cannot be counted on to adopt bylaw provisions making it easier for them to be replaced, even if such provisions would increase share value. Therefore, to ensure that directors do not in practice have a veto power over any such move, shareholders should have the practical ability to initiate and adopt such arrangements.

To facilitate shareholder adoption of election arrangements, the SEC should allow shareholders to place on the corporate ballot any proposed bylaw concerning elections that would be valid under state law if adopted. Under SEC rule 14a-8, companies may exclude from the ballot any proposals relating "to an election for membership on the company's board of directors." And the SEC division of corporation finance has interpreted this provision as allowing companies to exclude from the corporate ballot proposals to adopt a bylaw provision that would provide shareholders with some access to the corporate ballot. The Second Circuit recently considered a challenge by AFSCME to AIG's exclusion of such a proposal from the corporate ballot,⁵³ and together with several colleagues I filed an *amicus curiae* brief opposing such exclusion.⁵⁴

In my view, allowing shareholders to place election bylaws on the corporate ballot is also called for by a reasonable interpretation of rule 14a-8. The provision allowing exclusion of a proposal that "relates to an election for membership on the company's board of directors" should be understood as permitting the exclusion of proposals that relate to the election of a particular individual to membership on the board of directors. This exclusion provision should not be understood as permitting the exclusion of "rules-of-the-game" provisions that relate to the procedural and substantive rules that govern the elections process.

The elections exclusion aims, and should be interpreted in light of this aim, at allowing companies to omit proposals involving matters for which it is necessary to require the proposing shareholders to make disclosures in a proxy statement. In such a case, the 500 words allotted by rule 14a-8 to shareholder proposals are insufficient for shareholders to cast an informed vote without a proxy statement. When a shareholder seeks to elect a particular individual to the board,

⁵³ See *Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc.*, 462 F.3d 121 (2006).

⁵⁴ See Brief of Amicus Curiae Harvard Law School Professors Lucian Bebchuk et al., available at http://www.law.harvard.edu/faculty/bebchuk/Policy/AmicusCuria_Brief.pdf. The discussion below draws on this *amicus curiae* brief.

an informed vote requires a proxy statement that would provide shareholders with particularized information about the characteristics and plans of the proposed individual. This is not the case, however, when the proposal concerns not the board membership of a particular individual or individuals but rather a governance arrangement—whether one regulating the election and nomination process or pertaining to some other aspect of corporate governance.

More important for the purposes of this paper, however, is that allowing shareholders to place proposed election bylaws on the ballot is desirable. Without that ability, shareholder power to initiate bylaw amendments loses much of its practical significance. To be sure, a shareholder that would like to see a bylaw amendment pass could in theory solicit proxies from fellow shareholders and file the proxy statement required in connection with such proxy solicitation. But shareholders have little incentive to incur the costs of such a contested solicitation. The proposing shareholder would have to bear the significant costs involved but would capture at most a limited fraction of the benefits from a bylaw amendment.⁵⁵ Allowing shareholders to place a proposed bylaw amendment on the corporate ballot is essential for overcoming this collective action problem. Thus, the ability of shareholders to place proposed election bylaws on the ballot is critical for them to be able to opt into alternative election arrangements. Allowing companies to exclude election bylaws from the corporate ballot all but eliminates shareholder initiation of such bylaws and severely curtails the potential benefits from private ordering in this area.

2. *Constraining Board-Adopted Bylaws*

While it is desirable to facilitate private ordering through shareholder-adopted bylaws, it is also desirable to constrain board-adopted election bylaws. In particular, it is necessary to constrain board-adopted election bylaws that opt out of the legally provided default arrangement in order to make it more difficult to replace incumbent directors. Given that the corporate elections system is intended to make directors accountable, allowing directors to make it more difficult to replace them is counterproductive.

One way to deal with this problem is for the legal rules that establish default arrangements concerning corporate elections to allow opting out only through a bylaw adopted by shareholders. This approach is not unfamiliar to drafters of corporate codes: under the Delaware code, a bylaw establishing a staggered board must be adopted by a vote of the shareholders.⁵⁶ This provision is presumably intended to prevent boards from adopting unilaterally a bylaw

⁵⁵ Indeed, the incentives to engage in contested solicitation over a proposed bylaw are usually even smaller than the incentive to engage in a contested solicitation over directors. See Bebchuk & Kahan, *supra* note 28, at 1126-29.

⁵⁶ See Del. Code Ann. tit. 8, § 141(d) (2006).

establishing a staggered board (which, as we have seen, makes director replacement more difficult). The same logic, however, should be extended to aspects of the election system other than the existence of annual elections.

If board-adopted bylaws that make replacement more difficult are not categorically ruled out for some reason, boards should at the minimum be prevented from repealing or amending election bylaws adopted by shareholders. A recent amendment to the Delaware code prohibits boards from repealing shareholder-adopted bylaws that prescribe majority voting.⁵⁷ Again, it is difficult to see any reason to prohibit directors from undoing election bylaws adopted by shareholders concerning majority voting, and at the same time allow them to undo election bylaws adopted by shareholders concerning other aspects of the directors' re-election process.

Furthermore, if the law elects not to categorically rule out board adoption of some bylaw amendments that make it more difficult to replace the directors (whether or not such amendments undo provisions adopted earlier by shareholders), then directors' decisions to adopt such an amendment should be subject to a demanding judicial scrutiny and upheld only when supported by a "compelling justification." In *Blasius Industries, Inc. v. Atlas Corp.*, Chancellor Allen invalidated a board decision that he viewed as disenfranchising shareholders and lacking a compelling justification.⁵⁸ In my view, a compelling justification test should be applied to any board decision to adopt a bylaw that makes it more difficult to replace directors, even if the bylaw does not make such replacement practically impossible.⁵⁹

It should be stressed that the approach advocated in this section would not prevent boards from initiating changes in election arrangements when such changes are desirable. It would only constrain boards' ability from making changes *without* shareholder approval that make it more difficult to remove directors. When such changes happen to be value-increasing, directors can be expected to obtain shareholder approval for them.

III. OBJECTIONS TO REFORM

I have thus far argued that the shareholder franchise and contested elections are largely a myth, and I have proposed a set of arrangements that would make

⁵⁷ See Del. Code Ann. tit. 8, 216 (prohibiting a board from amending or repealing a stockholder-adopted bylaw prescribing specific voting percentage - such as majority vote - for the election of directors).

⁵⁸ 564 A.2d 651, 659 (Del. Ch. 1988).

⁵⁹ In *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906, 914 (Del. Ch. 1980), the court invalidated a board-adopted bylaw that was adopted sixty-three days before the annual meeting and mandated seventy days' advance notice of opposing. While the invalidated bylaw completely precluded an electoral challenge in the subsequent meeting, I would go further and prevent bylaws that make challenges less likely or more difficult to win.

shareholder power to replace the board real. But some opponents of reform believe that, even if the shareholder franchise is now largely a myth and shareholders lack a real power to remove directors, this state of affairs is in fact optimal and should be maintained. On this view, giving shareholders effective power to replace boards that displease them—the power that they are assumed to have under the accepted theory of the corporation—would impose substantial costs and operate to the detriment of shareholders and the economy. This Part therefore examines the various objections and concerns that have been raised. I conclude that none of them provides a basis for retaining the existing state of affairs in which the shareholder franchise is largely a myth.

A. Is There Empirical Evidence in Support of Reform?

Those opposed to election reform might argue that corporate arrangements should not be significantly changed without empirical evidence indicating that such changes would increase shareholder value.⁶⁰ In the case under consideration, it is not possible to provide direct cross-sectional evidence about the effects of the proposed regime system on corporate value. To identify the effects of a given arrangement on shareholder value, cross-sectional studies compare firms that have and do not have the given arrangement. Such a cross-sectional study is therefore not possible to conduct with respect to a proposed new arrangement that does not have significant presence in the current marketplace.

Accordingly, the available empirical evidence is at most suggestive and indirect. Nonetheless, it is worth noting that this evidence, while hardly decisive, is consistent with the view that making boards more accountable tends to increase shareholder value. To begin, empirical studies consistently found that proxy fights are associated with accompanying increase in shareholder wealth.⁶¹ These studies focus only on the ex post effects of proxy contests (their effects on shareholder wealth once a proxy contest takes place) and do not attempt to assess the ex ante effects of proxy contests (the effects of the prospect of a proxy contest on boards in

⁶⁰ See Letter from Michael J. Holliday, Chairman, Committee on Securities Regulation, Business Law Section of the New York State Bar Association, to Jonathan G. Katz, Secretary, SEC (June 13, 2003), available at <http://www.sec.gov/rules/other/s71003/scrblsnysba061303.htm>.

⁶¹ See Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, 21 *Fin. Mgmt.* 22 (1992); Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 *J. Fin. Econ.* 29, 30 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 *J. Fin. Econ.* 401, 402 (1983); David Ikenberry & Josef Lakonishok, *Corporate Governance through the Proxy Contest: Evidence and Implications*, 66 *J. Bus.* 405, 432–33 (1993); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 *J. Fin. Econ.* 279, 280 (1998).

general). But the results of these studies are, of course, consistent with a favorable view of proxy contests.

Furthermore, there is solid evidence that the general direction in which the proposed reform would go—reducing incumbents’ insulation from removal—has an overall beneficial *ex ante* effect on the management of public companies. To begin, there is evidence that insulation of boards from replacement via a hostile takeover leads to increase in managerial slack. A study by Marianne Bertrand and Sendhil Mullainathan and a study by Gerald Garvey and Gordon Hanka found that stronger protection from antitakeover statutes causes increases in managerial slack.⁶² Another study 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.⁶³ This study also found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire-building.⁶⁴

There is also evidence that insulation from takeover threats results in greater consumption of private benefits by executives. Kenneth Borokhovich, Kelly Brunarski, and Robert Parrino found that executives with stronger antitakeover defenses enjoy higher compensation levels.⁶⁵ Marianne Bertrand and Sendhil Mullainathan obtained similar findings for executives who are more protected due to antitakeover statutes.⁶⁶

Finally, there is evidence of a correlation between antitakeover protections and lower firm value. This evidence indicates that the aggregate effect of management insulation on shareholder value is negative. In a recent study, Alma Cohen and I found that staggered boards, with the substantial antitakeover protection they provide, are correlated with an economically significant reduction

⁶² See Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 *RAND J. Econ.* 535, 545 (1999) (finding that the adoption of antitakeover statutes weakened managers’ incentives to minimize labor costs); Gerald T. Garvey & 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”).

⁶³ See Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 *Q.J. Econ.* 107, 111, 129 (2003).

⁶⁴ See *id.* at 136–37.

⁶⁵ See Kenneth A. Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 *J. Fin.* 1495, 1515 (1997).

⁶⁶ See Marianne Bertrand & Sendhil Mullainathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation*, Nat’l Bureau of Econ. Research, Working Paper No. 6830 (1998), available at <http://papers.nber.org/papers/W6830.pdf> (last visited Oct. 21, 2006).

in firm value.⁶⁷ In a subsequent study, Alma Cohen, Allen Ferrell, and I found that firm value is negatively correlated not only with staggered boards, but also with several other provisions associated with greater takeover protection, as well as with an entrenchment index based on these provisions.⁶⁸

To be sure, the empirical evidence about the effects of insulation from removal via a takeover does not directly identify the effects of reducing insulation from removal via a proxy fight. But the evidence indicates clearly that current levels of insulation are costly to shareholders and the economy. It thus provides general support for reforms, such as the one under consideration that would reduce management's insulation.⁶⁹

B. Market Forces Provide Sufficient Accountability

There are some who believe that viable shareholder power to remove directors is unnecessary because market forces provide a sufficient source of accountability.⁷⁰ As explained below, however, even though market forces impose some constraints on boards, they in no way obviate the need for the power to replace directors.⁷¹

(1) *The Market for Corporate Control*: Many economists and economically inclined legal scholars have looked to the market for corporate control to provide

⁶⁷ See Bebchuk & Cohen, *supra* note 32, at 430. The study investigates the connection between firm value and staggered boards during the period from 1995 to 2002 and uses Tobin's Q, a standard measure used by financial economists, as a proxy for firm value.

⁶⁸ See Lucian Bebchuk et al., *supra* note 47, at 3. This study also finds that these "entrenching provisions" and the "entrenchment index" based on them were negatively correlated with stock returns during the period from 1990 to 2003. *Id.* Further, the provisions in the entrenchment index drive the correlation that Paul Gompers, Joy Ishii, and Andrew Metrick identified between a broader index of management-favoring provisions and firm values as well as stock returns during the 1990s. See Gompers et al., *supra* note 63, at 144–45.

⁶⁹ Those opposing corporate governance reforms, in the elections area or elsewhere, sometimes argue that the performance of the U.S. economy and stock market over time provides evidence that no such reform is necessary. However, this performance does not at all rule out the possibility that reform would be beneficial for reasons discussed in Bebchuk, *Shareholder Rules*, *supra* note 52, at 1791–92.

⁷⁰ See, e.g., Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 *Harv. L. Rev.* 1735, 1741 (2006).

⁷¹ For a fuller analysis of the limits of the various market forces that boards face, see Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1435, 1461–67 (1992); Bebchuk, *supra* note 29, at 1840–46 (1989); Lucian Bebchuk & Jesse Fried, *Pay Without Performance* 53–58 (2004).

boards with incentives to perform well.⁷² However, under existing legal rules, boards have the power to resist and block hostile takeover bids. As a result, a hostile takeover is possible only if the bidder is willing to offer a high premium and to be sufficiently patient and determined, a situation that leaves a lot of room for slacking off in board performance.⁷³ Thus, at least under the existing, long-standing arrangements, the threat of hostile bids cannot provide a foundation for board accountability and does not render unnecessary the shareholders' power to vote out directors. Indeed, courts have used the shareholders' power to replace directors as a basis for allowing directors to block hostile bids.⁷⁴

(2) *The Market for New Capital*: It might be suggested that the need to go back to the capital market to raise additional capital is an important source of discipline. However, many public companies do not raise additional capital for long periods after they go public, but rather finance investment through retained earnings. Furthermore, failure to focus on shareholder interests would not generally prevent raising additional capital. It would mean only that the company would have to sell shares at a slightly lower price. The costs of raising capital at somewhat worse terms would be borne mainly by shareholders, with the members of the board bearing only a fraction.

(3) *The Product Market*: It might be argued that companies whose boards do not maximize shareholder interests would suffer a substantial disadvantage in competitive product markets, which might result in shrinking profits or even failure and exit, which in turn would discourage boards from deviating from shareholder interests in the first place. However, suboptimal board performance does not necessarily result in a reduction in increased product prices or a reduced market share. It might simply result in lower profits and cash flows for shareholders without worsening the company's product market performance. Furthermore, even if a given deviation from shareholder interests were to produce an increased likelihood of business failure, that might not be enough to discourage such a deviation if the directors' *private* benefits from such a deviation exceed the costs resulting from this increased risk of failure.

(4) *The Market for Shares and the Wall Street Rule*: Defenders of the current state of corporate affairs argue that shareholders dissatisfied with incumbent directors can “‘vote with their feet’ by selling the company’s stock” and that “[t]he purest form of corporate suffrage takes place in the capital markets.”⁷⁵

⁷² See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1169 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 112 (1965).

⁷³ See Lucian Arye Bebchuk et al., *supra* note 32, at 912–14.

⁷⁴ See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.3d 946, 953–54 (Del. 1985).

⁷⁵ See, e.g., Letter from Henry A. McKinnell, Chairman, The Business Roundtable, to Jonathan Katz, Secretary, SEC 24–25 (December 22, 2003), available at www.sec.gov/rules/proposed/s71903/s71903-381.pdf.

The ability of shareholders to sell their shares on the market, however, is hardly a substitute for a viable route for replacing directors. Consider shareholders who believe that their board is and has been underperforming and that, as a result of this poor performance, the company's stock price is only \$40 per share rather than the \$60 per share it would be with adequate board performance. If the board performance cannot be improved, being able to sell shares on the market would not address the shareholders' problem: selling would still provide them with only \$40 per share. Thus, for shareholders concerned that poor board performance is reducing the value of their investment, the freedom to sell their shares is hardly an adequate remedy.⁷⁶

(5) *Pressure from Institutional Investors*: Finally, one could look to institutional investors and large outside blockholders to monitor board performance and put pressure on those that perform inadequately. There is evidence that such shareholders have a beneficial influence on how firms are governed.⁷⁷ The influence that institutions and large outside shareholders have, however, critically depends on the power that the background rules of corporate law give them. In particular, this influence is likely to depend on the extent to which institutional investors are able to vote out directors if the latter decline to follow the institutions' recommendations and requests. The less meaningful shareholders' voting power is, the less clout institutions and other holders of large blocks of stock have with boards.

One way of thinking about the arguments considered in this section is that, if they were correct, it would not matter if investors' shares had no votes attached to them at all (or, in the case of the market for corporate control, votes carried with them voting rights only when held by a buyer that has obtained a majority block). Readers who believe that it is important for shares in companies with dispersed ownership to have voting rights should not be prepared to accept these arguments.

⁷⁶ Indeed, to the extent that the company's share price already reflects poor governance, a shareholder's concern about this poor governance could well *not* lead to the selling of shares. Shareholders will have a reason to sell when they view the market price as higher than the company's true value. Thus, a shareholder believing the company to have good governance might elect to sell shares if the shareholder also believes that the market over-appreciates the company's good governance. Conversely, a shareholder believing the company to have poor governance might elect to *buy* additional shares if the shareholder also believes the market overestimates the extent to which the company's governance is poor.

⁷⁷ See, e.g., Marianne Bertrand & Sendhil Mullainathan, Are CEOs Rewarded for Luck? The Ones Without Principals Are, 116 Q. J. Econ. 901, 920–21, (2001).

C. The Proposed Reform Would Not Have Practical Significance

The proposed reform, it might be argued, would have little practical effect. Institutional investors tend to be passive and therefore cannot be expected to make much use of arrangements making it easier to challenge incumbent directors.⁷⁸

Most money managers indeed cannot be expected to initiate or to sponsor a dissident slate. Mutual funds are at most “reluctant activists.”⁷⁹ Many such funds would not wish to devote management time to a contest over one firm’s governance because they focus on trading and portfolio management and wish to avoid any risk of litigation or company retaliation. Active involvement in corporate governance is not part of their business model.

It is reasonable to expect, however, that challenges would come from some large blockholders and activist money managers. And when such shareholders launch a contest whose success would likely raise share value, other money managers could well vote for this slate. The past voting patterns of private money managers indicate that they commonly do not vote against management on social issues, but they do occasionally vote against management on takeover issues when management appears to be value-decreasing.

Finally, suppose that election reform would have only a limited effect on the viability of an electoral challenge and thus on the accountability of incumbents. Such a conclusion could justify consideration of more expansive reforms of corporate elections, but it could not provide a basis for *opposing* the proposed changes. To provide a basis for such opposition, opponents must argue that making it easier to replace directors would have significant negative consequences, rather than prove practically insignificant. I therefore now turn to such arguments.

D. Adverse Effects on Shareholders

1. Waste and Disruption

This objection runs in the opposite direction of the preceding one. Rather than claim that election reform would have little practical significance, this objection suggests that it would lead to large-scale disruption of corporate management. Opponents of reform worry that making it easier to run a competing

⁷⁸ Lang & Nathan, Task Force letter, *supra* note 12, at 11 (“New mechanisms to increase on a routine basis shareholder participation in director selection will not be worth their costs because they will not likely result in significant numbers of shareholder-nominated directors being elected.”).

⁷⁹ Pozen, *supra* note 25, at 140; Robert C. Pozen, Institutional Perspective on Shareholder Nomination of Corporate Directors, 59 *Bus. Law.* 95, 95 (2003).

slate would make contested elections the norm.⁸⁰ The Business Roundtable opposed even very limited access to the ballot by shareholders on the grounds that it “has the potential to turn every director election into a divisive proxy contest.”⁸¹ Such contests, it is argued, would not only require the company to incur substantial out-of-pocket costs, thereby wasting company resources, but also (and more importantly) divert management’s effort and attention.

However, the proposed reform should not be expected to lead to full-scale contests becoming the norm. To begin with, in companies that are adequately governed and lack widespread shareholder dissatisfaction, incumbents would largely remain secure in their board seats and challenges would continue to be unlikely.⁸² The past voting patterns of institutional investors clearly indicate that their voting *en masse* against incumbents is the exception, occurring only in the presence of some strong reasons for doing so. Without broad shareholder dissatisfaction resulting from a poor record, an electoral challenge would be futile. While the proposed reform would provide cost reimbursement to challengers, it would do so only when they attract a sufficiently substantial number of votes and thus would provide no encouragement to futile challenges.

Furthermore, even in the case of firms that would otherwise be inadequately governed, the proposed reform would mainly improve matters not directly, through proxy contests, but rather indirectly, by changing incumbents’ incentives. The mere existence of viable shareholder power to remove directors could well have a beneficial effect on the performance of such boards without an actual exercise of this power. The benefits of reform would be system-wide—coming from increased accountability—and would not be limited to cases in which actual contests, with their accompanying costs, take place.

Granted, some boards might fail to improve performance even in the face of viable shareholder power to remove them. In such a case, the proposed reform is likely to increase the incidence of contests somewhat from its extremely low current level. However, the small number of companies in which contests would occur in any given year would not be randomly drawn from the set of all companies. Rather, they would be concentrated among companies with high shareholder dissatisfaction and sub-par performance. Although these contests would involve some costs, these costs would be a price worth paying for a process

⁸⁰ See, e.g., Letter from David M. Silk, Chairman, Task Force on Potential Changes to the Proxy Rules, The Association of the Bar of the City of New York, to Jonathan G. Katz, Secretary, SEC (June 13, 2002), available at <http://www.sec.gov/rules/other/s71003/tfpcprabny061303.htm>.

⁸¹ Letter from Henry A. McKinnell, Chairman, The Business Roundtable, to Jonathan Katz, Secretary, SEC (June 13, 2003), available at <http://www.sec.gov/rules/other/s71003/brt061303.htm>.

⁸² For evidence that targets of proxy challenges tend to be companies that prior to the contest had negative abnormal stock returns and poor operating performance, see Ikenberry & Lakonishok, *supra* note 61, at 414–17.

that could improve corporate governance in these companies as well as produce system-wide benefits.

It should be stressed that, by appropriate adjustment of the parameters of the system, it should be possible to permit the incidence of contests to grow somewhat without their becoming too common. In particular, the incidence of contests will likely decrease as (i) the (ownership and holding) thresholds that must be passed to gain access to the ballot and/or (ii) the (support) threshold that must be passed to gain reimbursement are increased. Conversely, the less demanding these thresholds, the larger the expected incidence of contests. Setting these thresholds at zero could result in a very high incidence of contests, whereas setting them at a very high level would result in no change compared with the existing state of affairs. By moving the thresholds along the continuum in between, the incidence of contests can be reduced or raised.

Thus, if the initial increase in the incidence of contests is deemed to be too high, the thresholds set in the default arrangement could be tightened. More importantly, because the proposed system would be a default, firms themselves would be able to tighten the default thresholds if their shareholders find the likelihood of a contest too high and therefore are willing to approve such tightening.

2. *Special Interests*

Increases in shareholder power are also opposed on grounds that they would enable shareholder groups that have a “special interest” in protecting labor or some social agenda to gain influence that would undermine share value, which is what most shareholders would like to maximize.⁸³ The proposed reform, it might be argued, would enable special-interest groups to get one or more representatives on the board or to extract concessions from the board by threatening to mount challenges.

While the proposed system would make it easier for directors not nominated by the board to be elected if they are supported by a majority of shareholders, directors still could not be elected without majority support.⁸⁴ A slate proposed by a special-interest group in order to advance its particular agenda would have no meaningful chance of obtaining the majority of votes necessary to be elected. Given the tendency of most money managers to support management

⁸³ See, e.g., Bainbridge, *supra* note 70, at 1754–55; Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 *Bus. Law.* 67, 82–83 (2003).

⁸⁴ Note that the reform I support does not include cumulative voting. With cumulative voting, a special-interest candidate who appeals only to a minority of the shareholders might be elected. The approach I support, however, would not involve any departure from a majoritarian approach to filling each and every slot on the board.

and focus exclusively on shareholder value, a special-interest candidate would not be able to attract their votes.

The patterns of shareholder voting on shareholder precatory resolutions support this prediction. The only resolutions that systematically obtain majority support are those calling for changes that are viewed as value-enhancing by a wide range of financial institutions—such as de-staggering the board or rescinding poison pills.⁸⁵ In contrast, proposals that focus on social or special-interest issues uniformly fall far short of a majority. For example, in 2003, while precatory resolutions to expense options obtained an average of 46 percent support, precatory resolutions to abolish stock options obtained an average of only 6 percent, and precatory resolutions seeking to highlight the ratio of highest to lowest compensation paid by the company obtained an average of only 12 percent of shareholder votes.⁸⁶

Another concern is that, by threatening to run a competing slate, special-interest groups would be able to obtain “leverage” and pressure the board into actions that serve the special interest but not shareholder value; labor unions, for example, could in this way extract concessions for workers.⁸⁷ However, given that a labor union’s candidates will generally be unable to win electoral contests, the electoral reform under consideration would not provide unions with any significant “extortion” power. Indeed, because the threat to incumbents’ continued service would come *only* from losing the support of a majority of the shareholders, the proposed reform would make boards more reluctant, not more willing, to take actions that do not serve shareholder value.

3. *Bad Choices*

Reform may also be opposed on the grounds that shareholders seeking to enhance share value would misuse any increase in their power to remove directors. Shareholders, it might be argued, simply do not have the full information available to the board’s nominating committee.⁸⁸ Consequently, they would likely make bad choices, electing directors who would not be as well qualified as candidates selected by the board.

The question, however, is not whether board nominating committees or shareholders have better information about candidates. Granting that the former

⁸⁵ See Georgeson Shareholder, Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests 7–8 (2003), available at <http://www.georgesonshareholder.com/pdf/2003%20a.wrapup.pdf>.

⁸⁶ See *id.* at 7, 22.

⁸⁷ See John J. Castellani & Amy L. Goodman, The Case against the SEC Director Election Proposal, *in* Shareholder Access to the Corporate Ballot (Lucian Bebchuk ed., forthcoming 2007).

⁸⁸ See, e.g., Lipton & Rosenblum, *supra* note 83, at 82–83.

commonly have superior information does not resolve the issue at hand. First, however informed board nomination committees are, they do not always have adequate incentives to replace fellow directors or themselves when desirable. Accountability is important precisely because, given the divergence between directors' and shareholders' interests, directors may choose not to act in a certain way even if they recognize that it would likely increase share value. In contrast, shareholders, by definition, will always have an incentive to make choices that they view as enhancing shareholder value.

Furthermore, although institutional shareholders may not have the same information as the board, there is no reason to assume that they are unaware of the informational and other advantages possessed by the board and its nominating committee. Indeed, institutional shareholders usually display a substantial tendency to defer to boards. They would likely defer to the board's choices under the proposed reform. Thus, the question is whether shareholders should have the option to choose directors apart from the slate that the incumbent board recommends.

In some cases, the past record of the incumbent directors might lead shareholders to conclude that they would be better off replacing some or all of the incumbents. Of course, shareholders may not always get it right. But given that their money is on the line, shareholders naturally have incentives to make the decision that best serves their interests. There is no reason to expect that the choices they make in favor of a shareholder-nominated candidate are likely to be wrong. When circumstances convince shareholders to overcome their tendency to defer to management, there is little basis for a paternalistic view of their choices as misguided.

4. *Short-Termism*

The strongest objection to changing the existing state of affairs comes from concerns about short-termism. The fear of being replaced, it might be argued, could lead boards seeking to please shareholders to take actions that improve short-term results but are not optimal from a long-term perspective.⁸⁹

If this consideration is given sufficient weight, it should be taken into account in designing reform in specific cases. This consideration weighs in favor of reducing the frequency of occasions in which shareholders have a viable power to replace directors. Thus, this consideration might lead one to support having such occasions come, say, only once every two or three years.

⁸⁹ For an analysis of the possible distortions in the choice between long-term and short-term projects that could result from a "short horizon," see Lucian Arye Bebchuk & Lars A. Stole, Do Short-Term Managerial Objectives Lead to Under- or Over-Investment in Long-Term Projects? 48 J. Fin. 719, 719–20 (1993); Jeremy C. Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, 104 Q. J. Econ. 655, 655–56 (1989).

Thus, the short-termism concern might justify providing boards with periods of significant length during which they do not face a meaningful chance of ouster. But the short-termism concern cannot provide a basis for a system under which shareholders, however long they wait, never have a real option to replace directors. While short-term insulation might induce directors to focus on long-term performance, indefinite insulation would enable boards to deviate from focusing on shareholder interests in both the short and long run.

5. *Deterring Directors from Serving*

The proposed reform, it might be argued, would deter some potentially good directors from serving on boards of publicly traded companies.⁹⁰ In this view, some good candidates would not be willing to serve if they faced any meaningful prospect of a contested election or even removal when they stand for re-election.

Clearly, any position is more attractive (and, other things equal, easier to fill) if the holder of the position has complete security from removal. But most individuals occupying business positions are not granted security by their firms, even though doing so might well attract more job seekers and reduce the required level of compensation. In most cases, firms find that the benefits of retaining the power to replace employees—the ability to make desirable replacements and the provision of incentives to perform well—exceed the costs.

Because directors' use of their power and discretion can have major effects on corporate value, improving their selection and incentives is especially valuable. Thus, if reform would improve director selection and incentives, that consideration should be given much weight. Is there really no way to run our corporate system without granting the people at the very top of the pyramid protection from any risk of removal?

Note that, even with reform, directors would face a rather small likelihood of removal relative to those holding other positions in the business world. Thus, it is far from clear that the proposed reform would have any meaningful adverse effect on the attractiveness of the well-paid and highly prestigious positions of directors. Even if reform did make these positions somewhat less attractive, shareholders would be better off countering this effect with increased pay rather than with reduced accountability. Providing complete job security as a means of attracting directors is counterproductive.

6. *The U.K. Example*

In assessing the claims that a system in which shareholders have more power to replace or remove directors would have adverse effects, it is worth recognizing that the U.K. has long had such a system. Under mandatory U.K. rules,

⁹⁰ See, e.g., Lipton & Rosenblum, *supra* note 83, at 82–83.

shareholders always have the power to replace *all* the directors; they may call a special meeting in order to do so; and they may place a candidate on the corporate ballot.⁹¹ The U.K. experience disproves some of the doomsday scenarios suggested by those opposing reform of corporate elections in the U.S. While the U.K. experience does not demonstrate that such a reform would be positive on balance, it does undermine any warnings that reform would substantially undermine boards' and companies' ability to function.

There is no evidence that the U.K. system leads to contested elections being the norm, discourages good directors from serving, empowers special interests, or leads boards to pursue value-reducing strategies. Rather than lead to frequent contests, shareholders' greater power in the U.K. enables them to exert greater influence on boards and make boards more attentive to their interests and wishes. Indeed, a recent study of shareholder activism in the U.K. documents how large U.K. shareholders are able to use their power to influence companies to make changes that turn out to have significant value-increasing effects.⁹²

D. Invigorate the Market for Corporate Control Instead

There are some who accept that boards are now insufficiently accountable but believe that a better mechanism for restoring accountability is the market for corporate control.⁹³ On this view, instead of reforming corporate elections, we should dismantle the antitakeover defenses that have been erected over the past two decades. A vigorous market for corporate control, it is argued, would be sufficient to discipline line boards and ensure that they do not deviate from shareholder interests.

Although I support reforms that would reduce antitakeover protection,⁹⁴ I view them as a complement rather than as a substitute for reforming corporate elections. There are some types of board failure that could be more effectively disciplined by the prospect of a proxy fight than by a hostile takeover bid. Consider a board decision whether, say, to grant a CEO pushed out for failure an unwarranted golden goodbye in the form of extra payments not required by contract. Such a decision might produce some investor outrage that could hurt the board in a proxy contest, and the board might thus be deterred from making it under a system that facilitates contested elections, whereas the same decision might

⁹¹ See Paul L. Davies, *Gower's Principles of Modern Company Law* 188–93 (6th ed. 1997).

⁹² See Marco Becht et al., *Returns to Shareholder Activism* (Eur. Corporate Governance Inst. Working Paper, 2006).

⁹³ See, e.g., Randy Kroszner & Peter Wallison, *Remarks at the SEC Roundtable on Proposed Security Holder Director Nominations Rules* (Mar. 10, 2004), available at <http://www.sec.gov/spotlight/dir-nominations/transcript03102004.txt>.

⁹⁴ See, e.g., Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 *U. Chi. L. Rev.* 973, 988 (2002).

not reduce firm value enough to make a hostile takeover bid profitable. Even in a system that facilitates hostile bids, the takeover mechanism would be costly and thus triggered only in cases in which the bidder could make substantial profit from taking over the company.⁹⁵

U.K. law facilitates the removal of directors by shareholders more than does U.S. law, even though the British City Code also facilitates hostile takeovers by preventing incumbents from blocking hostile offers.⁹⁶ These two elements reinforce each other and both operate to make boards more accountable and more attentive to shareholder interests. The U.S. should follow a similar approach.

E. Adverse Effects on Stakeholders

Finally, increasing shareholder power may be opposed on the grounds that, even if it were to make directors more attentive to shareholder interests, it could well make them insufficiently attentive to stakeholder interests.⁹⁷ The board, it is argued, should take into account and balance all of the possibly competing interests of shareholders and other constituencies, such as creditors, employees, customers, and so forth. Indeed, it has been argued that it is in shareholders' ex ante interest to tie their own hands and let boards make decisions that will take into account

⁹⁵ Not only is facilitating takeovers not a substitute for reforming corporate elections, but the latter is also not a substitute for the former. When a rival team knows that a change in the company's course of action would produce considerable benefits, but cannot credibly signal this to shareholders, the rival would not be able to win a proxy contest and a takeover would be necessary. See Bebchuk & Hart, *supra* note 27, at 1–2.

⁹⁶ See Panel on Takeovers and Mergers, *The City Code on Takeovers and Mergers* (2005), available at <http://www.thetakeoverpanel.org.uk/code/code.pdf>.

⁹⁷ In a series of influential articles written over the past decade, Margaret Blair and Lynn Stout have systematically developed such stakeholder-based objections to increases in shareholder power. See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999) [hereinafter *A Team Production Theory*]; Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, J. Corp. L. (forthcoming 2006), available at <http://ssrn.com/abstract=819365>; Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 Stan. L. Rev. 845 (2002); Lynn A. Stout, *The Shareholder As Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. Pa. L. Rev. 667 (2003). Their work builds on earlier work by writers viewing antitakeover defenses as beneficial for protecting stakeholder interests. See, e.g., Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in *Corporate Takeovers: Causes and Consequences* 33, 37–41 (Alan J. Auerbach ed., 1988); John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich. L. Rev. 1, 23–24 (1986); Lipton & Rosenblum, *supra* note 33, at 188–89.

the interests of stakeholders in order to induce the stakeholders to invest in their relationship with the firm.⁹⁸

Even if one fully accepts that it would be desirable to provide stakeholders with additional protections, it is far from clear that insulating boards from removal benefits stakeholders. For one thing, there is little reason to expect that boards commonly use their discretion to serve stakeholder interests. Under existing rules, directors may sometimes take stakeholders' interests into account, but are generally not required to do so.⁹⁹ Those who support insulating boards in order to serve stakeholders do not call for requiring boards to take stakeholder interests into account, but rather express hopes that boards will do so.

The interests of directors, however, are likely to be even less aligned with the interests of stakeholders than they are with the interests of shareholders. Whereas directors often hold shares and options, they do not usually have any instruments that tie their wealth to that of bondholders or employees. Thus, we can expect directors to be an even less reliable agent for stakeholders than they are for shareholders. To be sure, directors may sometimes have self-serving reasons to favor a decision that serves stakeholders but not shareholders (such as rejecting an acquisition offer that would benefit shareholders but result in layoffs). But there is no systematic overlap between the interests of directors and stakeholders that could provide any basis for confidence that increased board discretion would commonly operate to benefit stakeholders.

Standard board practices do not generally reflect a conception of boards as an agent for both stakeholders and shareholders. The compensation schemes designed for officers and directors generally tie such compensation to shareholder wealth but not to stakeholder wealth. While equity-based plans and bonus plans based on financial performance are common, I know of no company that links the compensation of executives or directors to measures of stakeholders' interests such as the average compensation paid to employees.

There is little reason to expect reduced board accountability to shareholders to translate into increased attention to other stakeholders. Insulating boards from removal does not make them more accountable to stakeholders at the expense of accountability to shareholders. Rather, such insulation makes boards accountable to no one. By protecting boards from removal even in the event of consistent poor

⁹⁸ See, e.g., Blair & Stout, *A Team Production Theory*, *supra* note 97, at 253; Shleifer & Summers, *supra* note 97, at 37–38.

⁹⁹ The drafters of state constituency statutes have used, in all cases but one, language that authorizes but does not require directors to take into account the interests of nonshareholder constituencies. See *Comm. on Corporate Laws, Other Constituencies Statutes: Potential for Confusion*, 45 *Bus. Law.* 2253, 2261–63 (1990).

performance, insulation from removal could well be costly to *both* shareholders and stakeholders.¹⁰⁰

CONCLUSION

The shareholder franchise is largely a myth. Shareholders commonly do not have a viable power to replace the directors. Electoral challenges are rare, and successful electoral challenges for companies of any significant size are practically nonexistent. To restore accountability and place our corporate governance system on solid foundations, the shareholder franchise should be transformed from a myth into a reality. The reforms discussed in this paper would provide shareholders with a viable power to replace directors, and they would thereby improve the accountability and performance of corporate boards.

¹⁰⁰ Finally, as discussed in Bebchuk, *Shareholder Power*, *supra* note 52, at 909–10, the objection to shareholder power under consideration in this section has a puzzling aspect. Those advancing this objection seek to limit the power of the shareholders of large companies only when the companies have dispersed ownership. They do not seek to limit the power of shareholders in large companies controlled by controlling shareholders or privately held. If it is desirable to limit the influence of shareholders on corporate decisionmaking in publicly traded firms with dispersed ownership in a given industry, then it should also be desirable to limit the influence of the shareholders of other large firms in the industry that are publicly traded but have a controlling shareholder or are privately held (say, by a private equity firm, a family, or a publicly traded parent).

A substantial fraction of large firms in the United States, and most large firms around the world, do not have dispersed shareholders. The shareholders in these companies have more power in practice to influence corporate decisions than dispersed shareholders would have under the reforms advocated in this paper. However, neither legal rules nor the charters nor contracts of these firms attempt to provide management of these firms with a degree of insulation from shareholders that is even close to that currently enjoyed by management in publicly traded companies. At the outset, this observation suggests some skepticism for claims that management insulation from shareholders is desirable for companies with dispersed shareholders.