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by

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Abstract

Proxy contests have recently become an important feature of corporate life. The main aim of this paper is to put forward a framework for analyzing legal policy toward proxy contests. We also apply this framework to evaluate the rules governing the reimbursement by corporations of the costs incurred by incumbents and challengers in proxy contests; our conclusions endorse certain elements of the existing law on the subject but call for substantial change in others. Finally, we also examine, and make recommendations about, the extent to which companies should be allowed to opt out of the legal rules governing proxy contests.

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Voting rights of shareholders are a major element in the structure of corporate law; a shareholder vote is required to elect the board of directors and to approve fundamental corporate changes.[1/] But shareholder voting rights are meaningful only as long as there is a real possibility that shareholders will vote against the incumbent management. Because the ownership of shares in public corporations is for the most part widely dispersed, managers do not have to fear a defeat in a shareholder vote unless a challenger instigates a proxy contest, i.e., actively tries to convince other shareholders to vote against management.[2/] When such organized opposition arises, it may gather sufficient support to defeat the incumbent managers.[3/]

In most proxy contests, challengers oppose the slate of nominees proposed by the incumbents for election to the board of directors.[4/] We will refer to these contests as "control contests" since the challengers in them generally try to wrest from incumbent management full or partial control over the management of the corporation.[5/] The other subjects over which proxy

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1/ See, e.g., Gen. Corp. L. of Del., § 212, § 242, § 251, § 271, § 275. On the importance of voting rights, see generally R. Clark, Corporate Law (1986), Ch. 9.

2/ Most shareholders do not personally vote their shares, but rather issue proxies to their favored contestant -- hence the name.

3/ Typically, the requisite vote for electing directors is a plurality of the votes cast at the shareholder meeting. See, e.g., Gen. Corp. L. of Del., § 216(3); New York Bus. Corp. L., § 614. Mergers and like transactions generally require higher approval thresholds. Gen. Corp. L. of Del. § 251(c) (majority of outstanding shares), New York Bus. Corp. L., § 903(a)(2) (two-thirds of outstanding shares).

4/ See Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986), at 10-12 (from 1981 to June 1985, 81 of 129 proxy contests were about the election of directors).

5/ In election contests, challengers will generally contest a majority of the seats on the board of directors, giving them effective control over the company if they win the contest. Even if challengers do not contest a majority of the seats, their long-term objective generally is to obtain full control over the company. See Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 44-45 (partial control contests often occur in com-

(continued...)

contests are fought concern "fundamental" corporate changes such as proposed mergers[6/] or anti-takeover charter amendments.[7/] We will refer to the latter kind of contests as "issue contests".[8/] In total, about 30 major proxy contests are fought each year in the United States.[9/]

Proxy contests are already an important element of the corporate structure and are likely to become even more important. Control contests are the only alternative to the hostile takeover for replacing management. And, as the impediments to takeovers have grown, control contests have started to become increasingly common.[10/] In the first three months of 1990, proxy

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5/ (...continued)
panies with staggered boards as part of long term strategy to gain control). Id. at 114-116 (describing 1984 proxy contest over Mutual Real Estate Inv. Trust, in which one board member not up for reelection ran an alternative slate against three candidates that were up for reelection). And even challengers who do not ultimately seek full control generally intend to increase their influence over the way the company is managed. Id. at 153-154 (describing 1984 proxy contest over Thriftimart Inc. in which challengers sought board representation to influence management policies).

6/ See e.g. Proxy Statement, PC Shareholders' Committee, In Opposition To The Proposal By Management Of The Penn Central Corp. To Acquire Colt Industries, Inc. (October 15, 1981).

7/ See generally Pound, Shareholder Activism and Share Values, Discussion Paper, Kennedy School of Government (May 1988).

8/ In issue contests, victorious challengers will generally not obtain control over the management of the corporation. Rather, while issue contests can prevent some particular action, e.g. a merger or the adoption of a charter amendment, control over the company's management generally stays with the incumbents. Note that by issue contests we mean the corporate governance issue contests described above, but not social policy contests such as proposals relating to equal employment or to doing business in South Africa. Cf. Robert C. Clark, Corporate Law at 374 (1986). Social policy proposals are not meant to be addressed in this article.

9/ See Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986), at 10-12; and Barbara Franklin, "1988 Proxy Season: New Players, Rules May Aid Institutional Investors", 199 N.Y. Law Journal p. 5, Col. 2 (January 7, 1988).

10/ See, e.g., Proxy Contests: Oasis For Dissidents -- Or A Mirage, Corporate Control Alert, MAy 1990, at 1; Smith and Hilder, Raiders, Shorn of 'Junk,' Gird for Proxy Fights, Wall Street Journal, March 7, 1990, at C 1; Proxy Battles Assuming Critical Role as Takeover Tool, Merger Management Report,
(continued...)

contests have been initiated or threatened with respect to companies with such household names as Lockheed, United Airlines, and USX.[11] Indeed, in the aftermath of the recent Delaware Supreme Court's Opinion in Paramount Communications, Inc. v. Time, Inc.,[12] the widely shared opinion among acquisition experts is that proxy fights will assume new stature as the takeover method of choice.[13] Furthermore, with the growing interest of institutional investors in question of corporate governance, issue contests as well have greatly gained in significance.[14]

In spite of its importance, the legal policy toward proxy contests, unlike other major topics in corporate law, has not yet been subjected to a

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10/ (...continued)
February 1990, at 1; R. Hylton, Advisors in Forefront of New Proxy Wars, New York Times, March 30, 1990, at D1; Wall Street and the Proxy Fight: Paper Tigers, The Economist, April 14, 1990, at 89.

11/ Smith, Storming the Barricades with a Proxy, Wall St. J., May 9, 1990, at C1 (other companies subject to proxy contests during 1990 include American General, Great Northern Nekoosa, Norton, National Intergroup, Armstrong World Industries, Pic'n'Save Corp. and Xtra).

12/ Fed. Sec. L. Rep. (CCH) 94,938, Mar. 1, 1990.

13/ See "Delaware Supreme Court's decision in Time-Warner gives Board an Edge in the Corporate Governance Tug-of-War," Corporate Control Alert, March 1990, p. 1. For example, the law firm of Skadden, Arps expressed the opinion in a memorandum to its clients that "One legacy of the time decision may ultimately prove to be an increase in proxy contests reminiscent of the 1960s and 1970s." Ibid. See also articles cited in footnote 10.

14/ See, e.g., Leslie Wayne, As Proxy Use Widens, New Rules Are Urged, New York Times, June 15, 1990 at D1 (chart showing increase in number of corporate governance shareholder proposals and in percentage of votes gained by such proposals); Calpers Fights Companies in Effort to Create Shareholder Committees, Mergers & Corporate Policy, February 12, 1990, at 3 (major pension fund sponsored shareholder resolution calling for creation of special shareholder advisory committees); Raiders Aren't the Only Ones Using Proxies, Mergers & Corporate Policy, May 14, 1990, at 3 (institutional investors make increasing use of proxy process to propose corporate governance resolutions); Dennis J. Block & Jonathan M. Hoff, Emerging Role of The Institutional Investor, New York Law Journal, April 12, 1990, at 5 (institutional investors expected to influence issues relating to corporate governance); Institutional Shareholders Get Their Hands Dirty, Mergers & Corporate Policy, January 15, 1990, at 5 (greater activism by institutional investors on corporate governance proposals).

systematic economic analysis.[15] This paper provides such an analysis, and it puts forward a general framework for analyzing legal policy toward proxy contests. We also apply this framework to evaluate the rules that govern the reimbursement by the company of the substantial campaign expenditures that incumbents and challengers generally incur in proxy contests. The general framework that we provide, however, can be used to analyze any aspect of the rules governing proxy contests.

While we analyze both control contests and issue contests, initially our focus will be on control contests. Part I discusses the importance of control contests in the context of the governance structure of the corporation. We first identify control contests as the only alternative to hostile takeovers for changing control of a company against the incumbents' opposition. We then compare the relative advantages and disadvantages of control contests and hostile takeovers as means for effecting changes in control.

In Part II, we identify the choices that are involved in designing "cost allocation" rules -- that is, rules governing the extent to which the costs incurred by incumbents and challengers are reimbursed by the company (rather than borne by each contestant himself). Cost allocation rules play a major role in potential contestants' decisions and consequently have a substantial impact on the incidence and outcome of contests. The three most important choices that we identify are those that concern the extent to which

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15/ The few works that examine proxy contest rules include: Schulman, The Cost of Free Speech In Proxy Contests For Corporate Control, 20 Wayne L. Rev. 1 (1973); Easterbrook and Fischel, Voting in Corporate Law, 26 J. of L. & Econ. 395 (1983); Pound, Proxy Contests and the Efficiency of Shareholder Oversight, 20 J. of Financial Economy 237 (1988); Heard and Scherman, Conflicts of Interest in the Proxy Voting System (1987); Dodd & Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. of Fin. Econ. 401 (1983); Schrager, Corporate Conflicts: Proxy Fights in the 1980's (1986); and Moody & Bagley, Proxy Contests (1983). A recent comprehensive paper on the regulation of the proxy process is Black, Streamlining the Proxy Process: The Promise and Limits of Shareholder Voice (forthcoming Michigan L. Rev., December 1990). None of these articles, however, provides a systematic and comprehensive economic analysis of the kind that we offer.

the rules are neutral or non-neutral between incumbents and challengers, the extent to which reimbursement is tied to success in the contest (i.e., is success-contingent), and, finally, the extent to which reimbursement is partial or full. We describe, and explain the significance of, each of these dimensions of choice.

Part III provides a framework for analyzing proxy rules in general, and the rules governing contest expenditures in particular. We divide the effects of proxy rules into three categories: effects on potential contestants' decisions whether to enter contests (and thus on the incidence of contests), effects on contestants' spending decisions (and thus on the outcome of contests), and ex ante effects on managerial behavior. For each category, we investigate the conditions under which such effects are socially desirable, and then explain how these effects are shaped by the choices that proxy rules must make.

In Part IV, we apply our general framework to the rules governing reimbursement of expenses in control contests. Presently, incumbents are generally reimbursed for all of their expenditures whether they win or lose, but challengers generally only receive compensation for their expenses if they take control over the board of directors. We will argue that the present practice should be changed in two respects. First, incumbents should not automatically receive full reimbursement. Secondly, compensation of challengers (as well as of incumbents) should be made contingent on receiving a threshold percentage of votes.

In Part V, we turn our attention to issue contests. After identifying the differences between issue contests and control contests, we discuss the implications of these differences for the desirable legal policy toward issue contests. We conclude that challengers in issue contests should be reimbursed more generously than challengers in control contests. This conclusion implies that the existing rules, which provide no reimbursement to challengers in issue contests, are substantially deficient.

Finally, Part VI assesses the degree to which companies should be allowed to opt out of proxy rules by adopting appropriate charter provisions. We show that privately adopted arrangements will tend to be less favorable to challengers and more favorable to incumbents than the desirable, efficient arrangements. In light of this identified tendency, we propose certain restrictions on the freedom of companies to opt out of proxy rules.

I. CONTROL CONTESTS AND THE STRUCTURE OF THE CORPORATION

The discussion in this Part places control contests within the broader context of the corporate control structure. We briefly explain the nature of such contests as a means for changing control against the will of the board of directors. Then we contrast the relative merits of control contests and hostile takeovers as means for achieving such changes.

As a preliminary matter, one should note that who controls a company is of great importance to shareholders as well as to society. The value of a company's assets depends significantly on who manages the company. Thus, it is generally desirable to have the managers who control a company be those who will deploy its assets in the way that maximizes their value.

Incumbent management, however, may be disinclined to relinquish control even to better managers. Incumbents tend to have self-interested motives for maintaining control: they want to retain the private benefits that are associated with exercising control. Their interests in preserving control might exceed any interests they have in letting better managers run the company.

Thus, it is important to facilitate beneficial control changes in spite of incumbent opposition. From a social perspective, facilitating such changes will have two desirable consequences: the beneficial change itself will increase the value of the company ex post; and the threat of losing control may well provide ex ante incentives to incumbents to increase the value of the company.[16]

There are basically two ways to induce changes in control against incumbent opposition: proxy contests for control and hostile takeovers.[17] By hostile takeovers, we mean the acquisition of a controlling interest without approval of the incumbents, whether through a tender offer or through a series of open market or privately negotiated share purchases.

Control contests and hostile takeovers employ different mechanisms for transferring control. In control contests, the challenger tries to <u>persuade</u> other shareholders that he or she would manage the company better than the incumbents. In hostile takeovers, the raider offers to <u>buy</u> the shares of the other shareholders. As we will proceed to show, the relative advantages and disadvantages of control contests and hostile takeovers stem from these differences.

16/ See Manne, <u>Mergers and the Market For Corporate Control</u>, 73 J. Pol. Econ. 110 (1965) (takeover threat aligns shareholder and management interests); Scharfstein, <u>The Disciplinary Role of Takeovers</u>, 55 Rev. of Econ. Stud. 185 (1988); Schulman, <u>The Cost Of Free Speech In Proxy Contests For Corporate Control</u>, 20 Wayne L. Rev. 1, 31-32 (1973) (possibility of proxy contest makes management more concerned about shareholder support). See also the detailed discussion of these issues in Part III below. But see Lipton, <u>Corporate Governance in the Age of Finance Corporations</u>, 136 U. Pa. L. Rev. 1, 20-25 (1987) (threat of losing control encourages undesirable short-term focus by management).

17/ Cf. Fischel, <u>Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers</u>, 57 Tex. L. Rev. 1, 5 (1978). Hostile takeovers and control contests are the only ways to effect control transfers of solvent companies. Creditors can obtain control of insolvent companies by instituting bankruptcy proceedings.

If control contests could be relied on to work perfectly, they would generally be the superior tool for replacing managers.[18/] By perfect operation we mean that proxy challenges arise, and succeed, whenever a replacement of the incumbents by the challengers through a successful proxy contest would increase social wealth.[19/] The reason why such proxy contests would be preferable is that hostile takeovers suffer from three shortcomings.

First, hostile takeovers tend to involve higher transaction costs than control contests.[20/] Hostile takeovers, unlike control contests, necessitate a significant change in the ownership of the company. As there is no inherent reason to nearly acquire a company whenever one attempts to effect a change in its control, the transaction costs involved in acquiring a controlling interest (and to arrange the financing for the acquisition) are generally wasted.

Second, the changes in property rights involved in hostile takeovers can distort shareholder choice of whether to sell shares to a raider. This distortion can take two forms: shareholders may attempt to take a "free ride" (and refuse to tender their shares) or they may be pressured to tender their shares. Free riding attempts can arise when a shareholder is faced with a bid by a raider under whose control the value of his shares would increase. In such a case, shareholders might reject a bid even though the offered price is above present share value and retain their shares, speculating on "free

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18/ Even if proxy contests operated perfectly, takeovers might be superior tools to effect changes in control involving synergies. In such cases, a merger of the raider and the target is often necessary to increase company value.

19/ In addition, to be perfectly operating, proxy contests would have to involve transaction costs below those of hostile takeovers.

20/ Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 7 (proxy contests historically cheaper than tender offers).

riding" on the larger value increases created when the raider takes control.[21] Pressure to tender can arise when a shareholder is faced with a bid by a raider under whose control the value of shares would decline.[22] Shareholders might find themselves pressured to accept such a bid even at a price below the present share value if this price exceeds the value of minority shares after the raider has taken control.[23] Thus, free riding can lead to the failure of desirable takeover bids, and pressure to tender to the success of undesirable takeover bids.

Third, acquiring the number of shares sufficient to stage a hostile takeover can trigger various kinds of anti-takeover devices.[24] For example, "poison pills," e.g., granting shareholders (other than the raider) the right to buy treasury shares at a substantial discount, can greatly reduce the value of a raider's holdings;[25] and antitakeover charter provisions can restrict the ability of raiders to gain control or to use their control to effect changes in the corporate structure.[26] Such devices make it more expensive, or less profitable, to acquire a controlling interest against the will of the incumbents. Thereby, they lower the incentives to attempt hostile

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21/ See Grossman & Hart, Takeover Bids, the Free Rider Problem, and the Theory Of the Corporation, 11 Bell J. of Econ. 42 (1980).

22/ The raider might find it profitable to make such a bid if he can divert significant value from minority shareholders to himself.

23/ See Bebchuk, Toward Undistorted Choice and Equal Treatment In Corporate Takeovers, 98 Harv. L. Rev. 1693 (1985).

24/ *See*, *e.g.*, Investor Responsibility Research Center, Antitakeover Charter Amendments (1988). Under Delaware law, defensive tactics are permitted if they are reasonably related to a perceived threat. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. Supr. 1985).

25/ Cf. Moran v. Household Int., Inc., 500 A.2d 1346 (Del. Supr. 1985) (upholding poison pill defenses).

26/ See Investor Responsibility Research Center, Antitakeover Charter Amendments (1988) for an overview of such provisions. State antitakeover statutes will also tend to make takeovers more difficult. *See*, *e.g.*, Delaware General Corp. L.; § 203.

takeovers and reduce the likelihood of success of those hostile bids that are launched.[27/]

Transaction costs, distorted choice, and anti-takeover devices constitute significant drawbacks to hostile takeovers. Because of these drawbacks, we would, if control contests were to operate perfectly -- that is, if they could be relied on to induce beneficial transfers of control -- prefer to largely dispense with hostile takeovers.

Control contests, however, suffer from severe imperfections. We proceed with a brief preview of the two main causes for these imperfections: inadequate incentives to acquire information and inadequate incentives to initiate contests. Later on, we will present a systematic analysis of how these imperfections impact control contests[28/].

27/ Note that, unlike transaction costs and distorted choice, antitakeover devices do not constitute an inherent shortcoming of hostile takeovers. Rather, they only constitute a shortcoming because, under the present state of law, incumbents are free to use such devices with few legal constraints to fend off takeover attempts. To be sure, companies may also adopt defensive devices designed to fend off proxy challenges. See, e.g., Articles of Incorporation of Kysor Industrial Corporation (requiring 120 day pre-notification of nominations for directors by shareholders). However, there are two reasons why legal constraints on anti-proxy contest devices are likely to be more significant than those on antitakeover devices. First, state law fiduciary duties are likely to impose greater restrictions with respect to anti-proxy contest devices than with respect to antitakeover devices. See D. Block & J. Hoff, Defensive Tactics in Proxy Contests, New York L. J., November 16, 1989, at 5 (courts less deferential to management actions designed to manipulate voting process). Second, federal securities regulations protect several aspects of shareholder voting rights in proxy contests and may preempt anti-proxy contest devices. See, e.g., 17 C.F.R 240.14a-9 (no false or misleading statements may be made in proxy materials); Gen. Corp. L. of Del., §203(c)(8)(ii) (Delaware antitakeover statute does not apply to proxy contests subject to securities laws); SEC May Seek to Overrule Pennsylvania Takeover Law, Mergers & Corporate Policy, May 7, 1990, at 2 (SEC is questioning whether states can regulate proxy contests); see also Leslie Wayne, As Proxy Use Widens, New Rules Are Urged, New York Times, June 15, 1990 at D1 (SEC is considering new proxy regulation that could increase the power of dissidents and make it easier to replace incumbents); Witnesses at Hearing Split Over Confidential Proxy Voting, Securities Regulation & Law Report, August 4, 1989, at 1179 (Congress considers confidential voting requirement). See generally U.S. Equity Markets in the 1990s: Institutions andCorporate Governance, Remarks of R. C. Breeden, Chairman of the SEC, April 2, 1990.

28/ See Part III below.

Inadequate incentives to shareholders to ascertain which contestant is superior are the primary reason why the outcome of proxy contests may be flawed. This lack of proper incentives is caused, in two distinct ways, by the dispersion of share ownership. First, shareholders who own only a small fraction of the company's shares will not be greatly affected by the outcome of the contest. That is, even a large increase in company value could result in only a small increase in the wealth of such shareholders. Secondly, these shareholders will consider it likely that their votes will not affect the outcome of the control contest. That is, their few votes are unlikely to determine whether the incumbents or the challengers win the contest. As their votes will generally not affect the outcome, and the outcome will not greatly affect their wealth, such shareholders will have little reason to acquire information about the contestants.[29/] As a result of shareholders' lack of incentive to become informed, inferior contestants will often emerge from proxy contests as winners.[30/]

By contrast, for two reasons, information incentive problems have less of an impact on hostile takeovers. For one, shareholders need less information in deciding whether to tender than in deciding how to vote: rather than having to evaluate the management abilities of incumbents and challengers, they merely have to compare the bid by the raider with the current value (and share price) of the company. In addition, shareholders will face greater incentives to acquire information. To be sure, the outcome

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29/ Cf. Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harvard L. Rev. 1820, 1836-40 (1989) (investors have less incentive to make an informed vote than an informed decision whether to buy or sell stock).

30/ Empirical evidence confirms that shareholders do not always vote in a way that maximizes firm value. Cf. Jarrell & Paulson, Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980, 19 J. Fin. Econ. 127 (1987) (shareholders approve antitakeover amendments even though such amendments reduce firm value).

of a tender offer might not greatly affect shareholder wealth and whether the shareholder tenders might not greatly affect whether the offer succeeds. But whether a shareholder tenders his shares will be significant to the shareholder even if it does not determine the success of the bid. If the bid succeeds, a tendering shareholder will receive the price offered by the raider; a non-tendering shareholder, on the other hand, will retain his shares.[31/]

Inadequate incentives for challengers to engage in control contests, and the resulting imperfection in the outcome of control contests, pose a second, and related, problem. The possibility for a good contestant to lose the contest will make it less worthwhile for that contestant to enter the contest. But the possibility for a bad contestant to win the contest may make worthwhile for the bad contestant to enter. That is, contestants will be subject to inadequate incentives to enter contests. As a result of these inadequate incentives to enter, proxy challenges do not always arise whenever they are desirable -- and sometimes arise when they are undesirable.

Moreover, good contestants are not always compensated for the costs of leading control contests. If contestants are not compensated, they bear all costs of waging a contest; but any increase in company value resulting from a successful contest is shared proportionally with all other shareholders.[32/] The risk of not being reimbursed further reduces incentives for good contestants to wage proxy contests.

31/ See also Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Tex. L. Rev. 1, 6-7 (1978) (tender offers are easier to evaluate than complex arguments in proxy contests). Note also, the existence of cash-out provisions for shares that are not tendered.

32/ See, e.g., Easterbrook & Fischel, Voting In Corporate Law, 26 J. of L. & Econ. 395, 413 (1983).

In fact, over the last decades, the number of control challenges has declined.[33] Instead, in the 1980s, tender offers became the prime vehicle for effecting changes in control.[34] But the rend towards tender offers seems to be reversing.[35] As takeover defenses continue to proliferate[36] and to grow in sophistication,[37] it becomes, in many instances, difficult for hostile bids to succeed. By contrast, the growth in institutional investment has reduced the dispersion of share ownership and ameliorated the information incentive problems of proxy contests.[38] Thus, proxy contests have reemerged as important tool for acquiring control.

In light of the renewed significance of proxy contests, it is important to stress that the imperfections of proxy contests are only in part inherent in the nature of proxy contests; in addition, the extent of these imperfections is a function of the legal rules governing proxy contests. For the remainder of this article, we will examine how the imperfections in proxy contests relate to these rules. In particular, we will endeavor to provide a

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33/ See Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 9-11 (average number of control contests declined from about 25 in the years 1958 to 1962 to about 16 in the years 1981 to 1984).

34/ Pound, Proxy Contests and the Efficiency Of Shareholder Oversight, 20 J. Fin. Econ. 237 (1988); Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 12.

35/ See articles cited in footnote 10.

36/ See Investor Responsibility Research Center, Antitakeover Charter Amendments (1988).

37/ See Robert C. Clark, Corporate Law (1986) at 571-577 for an overview of defenses.

38/ See Carolyn K. Brancato, The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project, Columbia Institutional Investor Project, Center for Law and Economics Studies (1990) (institutional investors estimated to hold more than 45% of total equity securities in U.S.); see also Black, supra note __ (institutional investors have grown large enough so that a limited number of institutions own a substantial percentage of the shares of most public companies).

framework for analyzing the desirable legal policy towards proxy contests. In applying this framework, we will focus on how the rules governing expense allocation should be structured in order to transform proxy contests into a more viable means for inducing beneficial control changes.

II. ALTERNATIVE LEGAL RULES

Proxy contests are governed by a blend of federal regulation, state law, and corporate charter and by-law provisions.[39] These rules regulate matters such as the type of information required to be disclosed in proxy statements,[40] fraud in proxy solicitation materials,[41] revocability of proxies,[42] access by shareholders to corporate information,[43] and time and place of shareholder meetings.[44]

In this paper, we will focus on the rules on allocation of expenses in proxy contests. By allocation rules we mean the set of conditions that determine whether the contestant bears the costs of a proxy contest himself, or whether he is reimbursed for these expenses by the company. As we show in Parts III and IV, allocation rules have a significant impact on incidence and outcome of proxy contests, as well as and on ex ante managerial behavior, and thereby on the efficacy of proxy contests as means for furthering changes in

39/ For a more detailed overview of the subjects covered by such rules, see Black, supra note __.

40/ 17 C.F.R. 240.14a-3 and 240.14a-11(a).

41/ 17 C.F.R. 240.14a-9.

42/ See, e.g., Gen. Corp. L. of Del., sec. 212(c).

43/ See, e.g., Gen. Corp. L. of Del., sec. 220.

44/ See, e.g., Gen. Corp. L. of Del., sec. 211(a) and (b).

control.[45/] Furthermore, the multi-fold alternatives for the design of allocation rules merit a full and systematic analysis.

The purpose of this Part is to provide a matrix of the dimensions of choice in the design of allocation rules. For purposes of this article, we will confine our analysis to the three main dimensions of choice: whether incumbents and challengers are reimbursed pursuant to the same conditions; whether reimbursement is contingent on success; and whether reimbursement, when granted, is full or partial.[46/] As we will proceed to show in Part IV, the design of allocation rules along these dimensions (and every rule will, explicitly or implicitly, yield a design along each dimension) has important consequences for the efficacy of proxy contests.

45/ Other aspects of proxy contest rules that may have a significant effect of the efficacy of proxy contests include the extent of the shareholder proposal rule; 11 C.F.R. 240.14a-8; whether proxy voting is confidential; Witnesses at Hearing Split Over Confidential Proxy Voting, Securities Regulation & Law Report, August 4, 1989, at 1179; and whether contestants are permitted to buy votes; see, e.g., Chew v. Inverness Mgmt. Corp., 352 A.2d 426 (Del. Ch. 1976) (vote-buying from shareholders is against public policy). See generally Black, Streamlining the Proxy Process: The Promise and Limits of Shareholder Voice (forthcoming Mich. L. Rev., December 1990) (discussing several aspects of proxy regulations); Letter from United Shareholders Association to Jonathan G. Katz, Secretary, Security and Exchange Commission, dated March 20, 1990 (proposing revisions of federal proxy rules to provide for confidential voting and increased shareholder access to the proxy machinery); Letter from California Public Employees' Retirement System to Linda S. Quinn, Director, Division of Corporate Finance, Securities and Exchange Commission, dated November 3, 1989 (proposing 48 revisions of federal proxy rules, including a clarification of the definition of "solicitation," adoption of a requirement of confidential voting, and various modifications in the disclosure requirements).

46/ Other conceivable dimensions include differentiating between contests over policy and contests over personnel; see infra, Section IV.A.; or between compensation of contestants who have high or low stakes in the company; Cf. 17 C.F.R. 240.14a-8(a)(1) (only shareholders holding at least 1% or $1,000 of shares eligible to make shareholder proposal); Letter from United Shareholders Association to Jonathan G. Katz, Secretary, Security and Exchange Commission, dated March 20, 1990 (proposing proxy regulation requiring compensation of challengers' expenses up to amount of expenses incurred by board if challenger is beneficial owner of at least 3% of voting power or of voting securities with a market value of at least $1 million). We believe, however, that the dimensions discussed in this article represent the most fundamental ones.

A. Neutrality Among Contestants

One dimension of each cost allocation rule is the degree of neutrality. By a neutral rule, we mean that the availability of compensation does not depend on whether the contestant is an incumbent or a challenger. By contrast, differential rules set different standards for the reimbursement of incumbents and of challengers. For simplicity we will, for the most part, assume that differential rules provide more generous compensation to incumbents than to challengers.[47/]

An allocation rule can lack neutrality either by tying compensation directly to the status of a contestant as incumbent or challenger or by tying it to board approval. As an example of the former, take a rule that provides for reimbursement of only incumbents, but not of challengers. A rule that gives the board of directors discretion to grant or deny reimbursement would fall in the latter category.[48/] Even though the latter rule does not directly tie reimbursement to the status of contestants, its de facto result is to grant compensation to all incumbents, but only to those challengers that take control of the board.[49/] Providing more generous reimbursement to incumbents obviously benefits incumbents relative to challengers.

It is worth noting that even under neutral allocation rules, institutionalized advantages will favor incumbents. Incumbents set the date the

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47/ This assumption appears reasonable as the current compensation rules favor incumbents (see *infra* Part IV) and as, to our knowledge, no commentator has argued for rules that should be biased in favor of challengers. Analytically, rules biased in favor of challengers will have effects reverse of those favoring incumbents.

48/ This is the current legal rule. See infra, Section IV.A.

49/ *See*, infra, Section IV A.

shareholder meeting is held[50/] and the record date for determining voting rights.[51/] Their immediate access to the shareholder list and to corporate information gives them an informational edge over challengers.[52/] The incumbent board will usually have established goodwill among shareholders through glossy annual reports or other promotional literature[53/] and may have created collateral motives for institutional investors to vote with management;[54/] (for example, by hinting that bank and insurance companies might lose the company's business if they do not[55/]). Lastly, incumbents could use their present control to issue shares to holders friendly to management or to fund payments of greenmail.

B. Success Contingency

A second important dimension of cost allocation rules is success contingency: whether, and to what extent, reimbursement of a contestant is

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50/ See, e.g., Pound, Shareholder Activism and Share Value, at 8, Discussion Paper 169D, Kennedy School of Government (1988). While most proxy contests occur at annual meetings, challengers can occasionally use a special shareholder meeting as forum for the proxy contest. See, e.g., Florida National Banks of Florida, Proxy Statement of the Board of Directors for the Special Meeting of Shareholders Called for December 17, 1981.

51/ See Pound, Shareholder Activism and Share Value, at 8 Discussion Paper 169D, Kennedy School of Government (1988).

52/ See Graham B. Moody & Constance E. Bagley, Proxy Contests (1983), at A-29; Yoran, Restraints on Incumbent Directors in Intracorporate Battles for Control, 7 U. Rich. L. Rev. 431, 435-439 (1973).

53/ Cf. Pound, Proxy Contests and the Efficiency Of Shareholder Oversight, 20 J. Fin. Econ. 237 (1988) (management has advantage since it often has developed relationships with, and thus loyalty of, relatively uninformed shareholders); Graham B. Moody & Constance E. Bagley, Proxy Contests (1983), at A-3.

54/ See Heard & Sherman, Conflicts Of Interest In the Proxy Voting System (1987) at 50-53.

55/ See, e.g., Brickley, Lease & Smith, Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267 (1988) (empirical evidence that institutions which are less subject to management influence are more likely to oppose management than banks, insurance companies and trusts which derive benefit from lines of business under management control).

conditioned on attaining some measure of "success." Success may be defined as the contestant getting elected.[56] But one can also define success as the contestant receiving votes in excess of a certain threshold -- for example, more than 15 percent[57] -- or as taking (or keeping) control of the board. Alternatively, one might give contestants a certain amount for each vote they receive.[58]

Tying compensation to "success" influences proxy contests by benefitting contestants that are likely to receive a number of votes sufficient to make them "successful." The number of votes a contestant expects to receive will depend on two factors: the number of shares held by the contestant[59] and the number of votes expected to be received from other shareholders. The larger these numbers are, the higher are the chances to be successful and thus, to be compensated.

C. Full or Partial Reimbursement

The last significant dimension of any allocation rule is whether compensation, if granted, is full or partial. By full compensation we mean that a contestant is reimbursed for all the costs of the proxy contest. There are obviously many ways in which the amount of compensation can be

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56/ Easterbrook & Fischel, Voting In Corporate Law, 26 J. of L. & Econ. 395, 413-414 (1983) seem to favor that definition of success.

57/ *See*, *e.g.*, Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 963 (1951); Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 16 (1952) (both articles suggesting a 10 to 15 percent threshold).

58/ See Emerson & Latcham, Proxy Contests: A Study in Shareholder Sovereignty, 41 Calif. L. Rev. 393, 436 (1953) (challengers should receive same dollar amount per vote received as incumbents; incumbents are fully reimbursed).

59/ *Cf*. Schulman, The Cost Of Free Speech In Proxy Contests For Corporate Control, 20 Wayne L. Rev. 1, 37 (1973) (suggesting that votes cast by challengers themselves not be counted in determining whether they met the threshold).

circumscribed. We will briefly discuss the four most basic methods: upper limits, deductibles, fractional reimbursement and itemized reimbursement.

(i) Upper Limits, Deductibles and Fractional Reimbursement

If an upper limit is imposed on reimbursable expenses, a contestant will only be compensated for expenses up to that limit. The portion of expenses that exceeds that ceiling would be borne by the contestant. Under such a scheme, expenses would be limited to a fixed dollar amount, to a "reasonable amount of expenses"[60/] or to an amount determined by some formula[61/] (e.g., to $10 per record holder[62/] of shares or to half of the expenses incurred by the opposing contestant).

Deductibles are the mirror image of upper limits. Any contestant would bear the "initial" costs of the contest up to the deductible, but would receive compensation for all expenses in excess of the deductible. Like upper limits, deductibles can be expressed as fixed amounts or be based on a combination of factors (such as the value of shares owned by the contestant or the size of the company).

Another method for limiting reimbursement is to provide for reimbursement of only a specified fraction of the expenses. A simple fractional reimbursement rule would limit reimbursement to a fixed percentage (e.g. 50%) of expenditures. A more complex rule might provide for graduated

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60/ See, e.g., Barnhill, The Corporate Raider: Contesting Proxy Solicitations and Take Over Defenses, 20 Bus. Law 763, 779 (1965).

61/ Stifel, Shareholder Proxy Fight Expenses, 8 Clev. Marshall L. Rev. 339, 347 (1955) (suggesting possibility of formula based on company size, industry, and number and distribution of shares, or, alternatively, fixed annual amount for campaign expenditures).

62/ Cf., Barnhill, The Corporate Raider: Contesting Proxy Solicitations and Take Over Defenses, 20 Bus. Law 763, 779 (1965) (suggesting that the cost of contests will increase with the number of shareholders).

reimbursement, for instance for half of the expenses up to $100,000 and for a quarter of the expenses above that amount.

Compared to full reimbursement, each of these methods would provide disincentives to initiating a contest and to escalating its costs since such acts would entail costs to contestants. But note that the relative power of these incentives will differ. Clearly, the significance of these incentives will depend on the degree of limitation (e.g., whether the upper limit is high or low). Furthermore, their strength will depend on the way compensation is limited. A properly set upper limit will tend to have stronger effects on incentives not to increase expenditures than on incentives not to initiate a contest since the contestant can initiate a contest and spend up to the upper limit and still get fully reimbursed. A properly set deductible will create more powerful incentives against initiation of a contest than its escalation as, once the deductible is reached, additional expenditures are reimbursed). And under proper fractional reimbursement, incentives against initiation and escalation will be balanced in relation to upper limits and deductibles.

(ii) Itemized Reimbursement

Finally, an allocation rule can treat expenses on different cost items differently. That is, whether an expense item is reimbursed or not could be made to depend on the nature of the expense. Expenses in proxy contests[63/]

63/ Some of these cost items, like those for giving notice of the meeting to the shareholders, for conducting the meeting and the voting and for other costs necessary to obtain a quorum, are more aptly characterized as corporate expenses. As such, they should always be borne by the corporation. Cf. Rosenfeld v. Fairchild Engine and Airplane, 128 N.E.2d 291, 294 (Ct. App. 1955) (concurring opinion stating that cost of giving routinely necessary notice is, "of course, chargeable to the corporation"); Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 954 (1951) (expenses for proxy solicitors should be reimbursed only if they were necessary to obtain quorum). Some expense items, however, might be both corporate and campaign expenses, e.g. the cost of mailing to the shareholders the notice of the shareholder meeting together with campaign literature. Parts of these costs should be allocated according to the respective rule.

include the costs of designing the campaign literature (including fees to accountants, security analysts, lawyers, public relations experts, and professional proxy solicitors); and travel, telephone and entertainment expenses in connection with the solicitation of proxies from important shareholders; the costs of printing and mailing proxy statements to shareholders; and expenses for advertisements,[64] speeches and similar campaign activities.

Itemized reimbursement provides incentives to spend more on items that are compensated and less on items that are not. For example, if the costs of mailing proxy statements to shareholders is compensated but the costs of oral communications is not, a contestant would tend to mail more materials to shareholders, but make fewer speeches and telephone calls. Thus, itemized reimbursement may have significant effects on the composition of proxy contest expenditures.

Any rule on cost allocation necessarily involves conditioning reimbursement along the dimensions of neutrality, success contingency and reimbursement level. As there are numerous choices along each dimension, a large number of different legal rules are conceivable. For example, one could compensate both incumbents and challengers for all expenses up to a reasonable amount if they win at least 20 percent of the votes cast; one could compensate incumbents for all expenses and challengers for printing and mailing expenses only; or one could fully compensate the contestant who receives more votes and compensate the other contestant for only half of her expenses. In Part IV, we

64/ For the use of advertisements in a recent proxy contest, see Wall Street Meets Madison Avenue in the Lockheed Simmons Proxy Battle, Corporate Control Alert, April 1990, at 1 (both parties to Lockheed proxy contest spent about $2 million on full page newspaper advertisements).

reexamine these dimensions by exploring how cost allocation rules should be designed along each dimension of choice.

III. A FRAMEWORK OF ANALYSIS

In this Part, we provide a framework for analyzing the effects of proxy rules and whether these effects are desirable. The normative objective we use in this Part is the standard of efficiency. By efficiency, we mean the maximization of social wealth. Social wealth consists of the net benefits accruing to <u>all</u> parties affected by proxy contests. While we will proceed to apply the framework we develop to allocation rules, it can be employed as well to assess other elements in the legal policy towards proxy contests.

Note that, in Part VI, we will reexamine proxy rules from a different perspective: the maximization of private wealth of the parties to the corporate contract. Unlike efficiency, this standard does not take into account costs and benefits to those that have a stake in proxy contests, but were not present when the corporate contract was designed -- in particular, potential challengers. We will argue in Part VI that companies face incentives to adopt rules that maximize this private wealth even if such rules are not efficient.

In determining whether a proxy rule is efficient, one must not only into take account all the parties affected by it, but as well all the various consequences of the rule. As these consequences are highly complex, we will, for analytical purposes, divide them into three categories and examine each category separately.

In Section A, we discuss the effects of proxy rules on the decisions by potential contestants whether to enter proxy contests and on the resulting incidence of proxy contests. At the outset, we model the conditions under which it is socially desirable for contestants to enter a proxy contest. Then we address the conditions under which contestants will find it privately profitable to do so. Next we discuss why contestants make inefficient entry decisions. Finally, we conclude Section A by sketching the connection between allocation rules and entry decisions.

Section B considers the effects of proxy rules on contestants' spending decisions and thereby on the outcome of contests. After reviewing why the outcome of proxy contests is imperfect in that the better contestant may still lose, we delineate the relation between campaign expenditures and the outcome of proxy contests. We then examine the circumstances under which it is efficient, and those under which it is privately profitable, to incur additional campaign expenditures. Finally, we briefly explore the effect of cost allocation rules on the outcome of contests and the amount of campaign expenditures.

In Section C, we address the effects of proxy rules on ex ante managerial behavior. By affecting incidence and outcome of proxy contests, proxy rules generate ex ante incentives to reduce the probability of ouster. We will examine the two kinds of managerial responses to these incentives -- increasing shareholder support or adopting defensive measures -- and discuss their desirability relative to the risk-bearing costs created by the probability of ouster.

A. Entry Decisions and Incidence of Proxy Contests

In this Section, we discuss the decisions, by challengers and incumbents, whether to enter into proxy contests.[65] By entering into a proxy contest we mean, for challengers, initiating the contest;[66] and, for

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65/ In analyzing the decision to enter, we take the costs and outcomes of contests as given. Costs and outcomes will be analyzed in Section B.

66/ Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 962 (1951).

incumbents, defending against proxy challenges.[67] A proxy contest ensues only if both challengers and incumbents decide to enter.

Many commentators have implicitly assumed that incumbents will always defend against proxy challenges. Therefore, they have paid little or no attention to the effect of proxy rules on entry decisions by incumbents.[68] But, incumbents, like challengers, will only enter proxy contests if proxy rules make it privately profitable for them to do so. Thus, proxy rules not only influence whether challengers initiate contests, but also whether incumbents defend against challenges.

This Section is divided into four Subsections. In the first Subsection, we model under what circumstances it is socially desirable to enter contests. In the second Subsection, we examine when entry is privately profitable. Then, we explore in detail how privately profitable entry decisions deviate from the socially optimal ones. At last, in the fourth Subsection, we delineate the effects of cost allocation rules on entry decisions.

As we proceed to show, the same factors determine for both challengers and incumbents when it is socially desirable, and when it is privately profitable, to enter contests. Therefore, for most of this Section, we focus on entry by challengers and do not repeat the identical analysis for

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67/ By not defending against proxy challenges we mean, in control contests, withdrawing as nominees for election to the board and, in issue contests, retracting incumbent proposals or implementing challenger proposals. Contestants could also decide to settle a contest, e.g. by electing some of the challenger nominees or by modifying an incumbent proposal. For analytical purposes, we will disregard settlements and assume that contestants either fully enter or completely withdraw from a contest.

68/ See, e.g., Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951 (1951); Latchman & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5 (1952) (authors do not analyze the connection between cost allocation rules and incumbents' decisions to defend). But see Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 216 (1968).

incumbents. We stress, however, that the results we derive for socially desirable and privately profitable decisions with respect to challengers apply equally to incumbents.

(i) Efficient Entry into Proxy Contest

In this Subsection, we analyze when entry into proxy contests is socially desirable. We will first discuss a necessary condition for entry to be desirable: victory by the contestant must produce social gains. We then examine the conditions sufficient for efficient entry, i.e., that expected social gains from entry exceed social costs.

For entry by a challenger to be efficient, it is necessary that victory by that challenger results in social gains. That is, social wealth must be higher if the challenger wins the contest than if the incumbent wins. If victory by a challenger decreases social wealth (and thus results in social losses), it is never desirable for that challenger to initiate a contest.

Social wealth principally consists of the value of the company, under the respective contestant's control, which is captured by all shareholders. We will refer to this value as "company value". Changes in company value, as a result of a shift in control, are generally reflected by changes in the company's stock price.

In addition, social wealth includes any value captured by those controlling the company after the contest (and not shared among shareholders at large). We will refer to such value as private benefits of control.[69/] Private control benefits may arise from high salaries, benefits from self-

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69/ Other commentators have recognized the existence of private control benefits. See Grossman & Hart, Takeover Bids, the Free Rider Problem, and the Theory Of the Corporation, 11 Bell J. of Econ. 42 (1982) (private control benefits may be desirable since they can serve to overcome free rider problem); Harris & Raviv, Corporate Control Contests and Capital Structure, 20 J. Fin. Econ. 55 (1998) (private control benefits impact resistance strategy and choice of takeover method).

dealing or looting,[70] the power to tailor company policy to one's personal interests,[71] or psychological utility from running the company.[72] Ordinarily, the amount of private benefits that the challenger would derive from capturing control will differ from those accruing to the incumbent.

We will denote those challengers whose victory would result in social gains (i.e., under whom the sum of company value and private benefits is higher than under the respective incumbent) as "good" challengers, and those whose victory would result in social losses as "bad" challengers. Similarly, we will refer to incumbents as "good" incumbents and "bad" incumbents, and to contestants in general as "good" and "bad" contestants.

Assume, for example, that challenger *A* would derive private benefits of $1 million if he wins control and that company value under his control would be $50 million. If incumbent *B* wins, *B* would derive private benefits of $1.5 million, but the company would only be worth $45 million. Social wealth would then be $51 million under *A* and $46.5 million under *B*; that is, victory by *A* would result in social gains of $4.5 million. *A* would be a good challenger and *B* a bad incumbent.

Note that if two contestants derive similar private benefits from control, social wealth will generally be greater under the contestant who produces higher company value. Similarly, if the impact of control on the amount of private benefits (in our example, $500,000) is less than the impact on company value (in our example, $5 million), it is desirable to elect the contestant under whom company value would be higher.

70/ See, e.g., Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955), cert. denied, 349 U.S. 952 (1955).

71/ Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (directors have wide discretion over dividend policy).

72/ We assume, for simplification, that no other constituents, e.g., creditors, employees, or suppliers, are affected by who controls the company.

For entry to be desirable it is necessary that victory by the challenger results in social gains. However, even if this necessary condition is met, entry will not always be desirable. Rather, entry will only be desirable if another condition is met: expected social gains must exceed social costs. We will refer to contestants for whom expected social gains exceed social costs as "desirable" entrants.

Expected social gains from entry equal the social gains from winning weighted by the probability of winning. Take, for instance, our preceding example in which the social gains from *A* taking control from *B* were $4.5 million. Further assume that *A* has a 40% chance of winning if he initiates a contest. Expected social gains from *A* initiating a contest would then be $1.8 million: $4.5 million social gains times his 40% chance of winning. (But note that a decision by *B* to defend would not result in social gains.)

Social costs consist of the costs of all the parties engaged in the proxy contest. Thus, social costs will principally include the costs of the contest borne by the company and those borne by the contestants. To continue our example, further assume that a contest would result in expenses to the company of $300,000, expenses to *A* of $200,000 and expenses to *B* of $100,000. As shown, expected social gains from *A* initiating the contest were $1,800,000. Social costs are the sum of the costs to *A*, *B* and the company, i.e. $600,000. As expected social gains exceed social costs, it is desirable for *A* to initiate the contest. (Entry by *B*, of course, is not desirable.)

Thus, to summarize this Subsection, entry into proxy contests is desirable if social gains weighted by the probability of winning exceed social costs. Social gains consist of the difference between social wealth if the contestant wins and social wealth if he loses. Social wealth, in turn, is the sum of the company value and private control benefits. Social costs consist of the proxy contest expenditures borne by each contestant and by the company.

(ii) The Private Decision to Enter Contests

In this Subsection, we shift our attention to the conditions under which entry into proxy contests is privately profitable.[73] Challengers will initiate a contest, and incumbents will defend, whenever the expected gains accruing to them exceed the costs accruing to them. As in the preceding Subsection, we first discuss the necessary condition for entry to be profitable: victory produces private gains to the contestant. Then we discuss the sufficient condition: that expected private gains exceed private costs.

If a challenger wins the proxy contest, he will derive private gains from two sources. First, as we explained in the preceding Subsection, he will derive the private benefits from controlling the company. Second, he will, to the extent he holds stock of the company, share, equally with all other shareholders, in any resulting change in company value.[74] We will refer to this difference between the value of a contestant's shares if he wins the contest and their value if he loses as "stock appreciation gains" (or "losses").[75] If taking control results in a decline in company value, and

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73/ The model on entry we develop is similar to the model used by Harris & Raviv, Corporate Control Contests and Capital Structure, 20 J. Fin. Econ. 55 (1988).

74/ In efficient markets, the increase in company value will be reflected in increase in stock price. See Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383 (1970).

75/ We assume that the value accruing to a contestant if he loses a contest is the same as the value if he does not engage in the contest. But note that Dodd & Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. Fin. Econ. 401 (1983), find that even unsuccessful contests, on average, increase company value. Easterbrook and Fischel interpret their results to show that unsuccessful contests increase the prospect of future monitoring and thereby lead to an improved performance by the incumbents. Easterbrook & Fischel, Voting In Corporate Law, 26 J. of L. & Econ. 395, 407 (1983); cf. DeAngelo & DeAngelo, Proxy Contests and the Governance of Publicly Held Corporations, 23 J. Fin. Econ. 29 (1989) (stock price gains from proxy contests disappear if company not subsequently sold or liquidated). Another possible explanation is that, during the proxy contest, positive information about company value caused both a share price increase and success by the incumbents.

if the resulting stock appreciation losses are higher than the private control benefits, a challenger would never initiate a contest.

Take our example from the preceding Subsection in which *A* would derive $1 million in private control benefits from winning and company value would increase by $5 million. Assume *A* owns 10% of the shares of the company. His private gains from winning the contest would then be $1.5 million: $1 million in private benefits and $500,000 in stock appreciation gains.

A contestant will find it privately profitable to enter a contest if expected private gains from entry exceed private costs. Expected private gains from entry are the product of the private gains to a contestant if he wins and the probability of winning. For instance, in our example, as *A* has a 40% chance of winning, his expected private gains amount to $600,000.

The private cost to contestants primarily consist of his unreimbursed costs of waging the contest. But the contestant will also bear a part of the expenses borne by the company proportional to his fraction of company shares. Total private costs will then be the sum of uncompensated costs incurred by the contestant himself and a pro rata portion of the costs borne by the company.

Take our example from in the preceding Subsection. Recall that a contest would involve expenses of $300,000 to the company, expenses of $200,000 to *A*, and expenses of $100,000 to *B*. The private costs to *A* would then be $230,000: $200,000 in his own unreimbursed expenses and 10% of the expenses to the company. As expected private gains are $600,000, *A* will initiate a contest.[76/] To recapitulate, whether a contestant enters contests depends on whether the expected gains accruing to such contestant

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76/ Note that even a contestant who derived losses from decreases in company value would decide to enter a contest if his private benefits from obtaining control are large enough. Cf. Easterbrook & Fischel, Voting In Corporate Law, 26 J. of L. & Econ. 395, 413 (1983); Harris & Raviv, Corporate Control Contests and Capital Structure, 20 J. Fin. Econ. 55, 63 (1988).

exceed his costs. The gains from winning consist of private control benefits and stock appreciation gains; expected gains are these gains from winning weighted by the probability of winning. Costs consist of unreimbursed expenses incurred by the contestant and a pro rata share of the costs borne by the company.

(iii) The Divergence of the Private Decision From Optimality

Having examined when it is socially optimal for a contestant to enter a contest and when a contestant will find it privately profitable to do so, we now turn to explore in greater detail the divergence of the private decision from optimality. As we noted, whether entry is efficient is a function of social gains and social costs, while the profitability of entry depends on private gains and private costs. As we proceed to show, there are three reasons why the private decision to enter can diverge from the socially desirable one. Two of these grounds relate to divergences between private gains and social gains; the third to private and social costs. We will examine each of these three grounds separately.

First, as other commentators have noted,[77] entry decisions might be skewed because contestants do not capture the full change in company value. Rather, any change in company value will accrue to a contestant only to the extent that he owns stock of the company. That is, stock appreciation gains (or losses) by the contestant amount to only a fraction of the change in company value. Thus, if entry by a contestant is expected to increase company value, the contestant would gain less than society in stock appreciation and thus may be biased against entering the contest. If company value is expected

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77/ Easterbrook & Fischel, Voting in Corporate Law, 26 J. of Law & Econ. 395, 420; Hirschman, Exit, Voice and Loyalty (1970).

to decline, the contestant would expect to lose less (or "gain" more) than society and may enter the contest even though entry is inefficient.

Assume, to continue our example, that company value is $5 million higher if challenger *A* wins the contest than if incumbent *B* wins. Their respective chances of winning are 40% and 60%.[78] If *A*, who owned 10% of the shares, enters the contest, his expected stock appreciation gains amount to $200,000 --less than the $2 million expected increase in company value. (If *B* owned 15% of the the company's shares, his entry would cause him expected stock appreciation losses of $450,000, but decrease company value by $3 million.)

The second ground for divergence also relates to gains but has not been noted before: private control benefits accruing to the contestant differ from <u>net</u> private benefits accruing to society. The reason is that, unlike private control benefits to the contestant, net private benefits to society include the loss of (or failure to gain) the control benefits to the <u>other</u> contestant. In our example, *A* taking control would result in control benefits to *A* of $1 million, but (since *B* loses $1.5 million in control benefits) in a net decrease of control benefits to society of $500,000.

The third ground for divergence between the private decision and optimality (which depends on the amount of expenditures) is that private and social costs of waging contest differ. As explained, any contestant will only bear his own unreimbursed costs of leading a contest and a fraction of the cost borne by the company. Society will bear the costs of each contestant and the full costs borne by the company.

Note that the degree of divergence on account of changes in company value (and, to a lesser extent, on account of costs of proxy contests) depend

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78/ If the probability of *A* winning if he initiates a contest is 40% and there is a positive probability that *B* will not defend, the probability of *B* winning the contest if he defends would have to be higher than 60%.

on the fraction of shares owned by the contestant. The larger this fraction is, the greater is the extent to which stock appreciation gains match changes in company value. Similarly, a greater fraction of share ownership causes a contestant to internalize more of the costs paid by the company.[79/] On the other hand, the degree of divergence on account of private control benefits in no way depends on the percentage of shares owned by the contestant.

Further note that the divergence on account of changes in company value could cause desirable contestants not to enter (when victory increases company value) or cause undesirable contestants to enter (when victory decreases company value, but the contestant suffers losses only to the extent of the stock ownership). But the divergences on account of private control benefits and on account of the costs of contests can only lead undesirable contestants to enter a contest, and never cause desirable contestants not to enter. Private control benefits will always exceed net private control benefits accruing to society as only the latter take account of the losses to the other contestant from not gaining control. Private costs will always be less than social costs since they do not include costs borne by the other contestant for all the costs reimbursed by the company.

As illustration, take a contestant that is fully reimbursed for his expenses and owns only a small percentage of the company's shares. Such a contestant would, in almost every instance in which gaining control bestows significant control benefits, decide to enter a contest -- even in instances in which entry is not socially desirable. He would tend to derive considerable expected private control benefits; but even if his victory causes a substantial reduction in company value, he would experience hardly any resulting losses since his interest in the company is low.

79/ However, to the extent the other contestant bears proxy contest cost, the degree of divergence does not depend on how many shares one owns.

On the other hand, take a contestant who is not reimbursed for his expenses and who would derive only small private control benefits from winning. Unless such a contestant owns a significant portion of the company's shares, he will be strongly inclined not to enter a contest -- even when entry is highly desirable. The reason is that the contestant would have to bear the full costs of leading the contest; but, even if he wins, his private gains in control benefits and stock appreciation would tend to be small.

(iv) Allocation Rules and the Decision to Enter

Allocation rules affect the decision to enter contests primarily through their impact on the cost of leading a contest and on the probability of success.[80/] In this Subsection, we briefly sketch the relationship between allocation rules and the private costs of leading contests. The connection between allocation rules and the outcome of contests and their social costs will be the subject of the next Section.

In general, a higher degree of reimbursement afforded to a contestant lowers the private costs of entering a contest. And the lower the private costs of entering a contest, the more contestants will find it privately profitable to enter contests. Thus, any increase in compensation will lead to a greater number of proxy contests.

But, as we showed above, an increase in the number of contests is only efficient to the extent desirable entrants are encouraged to engage in contests. As we have seen, undesirable entrants may also find it profitable to enter contests. To the extent increasing the level of compensation lowers

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80/ Cost allocation rules also affect proxy contests to the extent that they impact the benefits from success. These benefits mainly depend on factors like management abilities and are mostly independent of allocation rules (except for secondary effects such rules might have on the probability of the victorious contestant being replaced in subsequent contests).

the costs of, and induces entry by, such undesirable contestants, it is not desirable.

Thus the question arises of whether cost allocation rules (and proxy rules in general) can be designed in a way to promote desirable contestants but not undesirable contestants. In particular, it is pertinent to investigate how the dimensions of choice in the allocation rules can be structured to achieve such a result. We resume this inquiry in Part IV.

B. Expenditure Decisions and the Outcome of Proxy Contests

In the preceding Section, we analyzed the decision to enter a contest, taking as given the likelihood of winning and the social costs of the contests. In this Section we take as given that a contest ensues and focus our analysis on expenditure decisions and the outcome of contests. At the outset, we briefly restate why better contestants do not always win proxy contests. We continue by delineating the relationship between expenditures and the outcome of proxy contests. We then examine the optimal and the privately profitable allocation and amount of expenditures. Finally, we briefly delineate the general effect of cost allocation rules on the outcome of contests.

(i) Imperfections in the Outcome of Proxy Contests

If a contest ensues, it is generally preferable that the better contestant wins the contest. However, for a variety of reasons, the contestant under whom social wealth is higher does not always win. In this Subsection, we first review the main cause for deficient outcomes of proxy contests: shareholder lack of perfect information. We then briefly sketch other reasons why outcomes of contests can be flawed.

The most significant factor contributing to the defective outcome of proxy contest is that shareholders are insufficiently informed. If shareholders had perfect information, the contestant under whom company value is higher would generally win the proxy contest. However, as explained in Part I, shareholders lack adequate incentives to expend time and money in acquiring and evaluating information on proxy contests.

Imperfectly informed shareholders may frequently elect the contestant under whom company value is lower. To be sure, contestants under whom company value is higher possess certain advantages in waging proxy campaigns. For one, shareholders obtain some neutral information from independent sources, like newspaper articles, which tend to favor the superior contestant. Moreover, good contestants can generally make more convincing arguments why they should be elected and thus have potentially more effective proxy materials. Nevertheless, these advantages are far from sufficient to ensure that the contestant under whom company value is higher always wins.

Even if shareholders had perfect information, the better contestant might, in two peculiar circumstances, not win the contest. First, even though perfectly informed impartial shareholders will vote for the contestant under whom company value is higher, that contestant might not be the better one. That is, in certain unusual instances, the better contestant might derive private benefits from control that are so much larger than those of the worse contestant that social wealth is higher under the better contestant even though company value is higher under the worse contestant.[81/] Secondly, shareholders that are partial towards one of the contestants might hold a majority of the votes. By partial we mean that the shareholder benefits if a certain contestant wins for reasons unrelated to his ownership of shares.

81/ We will not devote attention to this problem both because it is likely to be relatively insignificant and because it is unlikely that cost allocation rules can effectively alleviate it.

Partial shareholders are primarily the contestants themselves (who obtain private control benefits if they win) and secondarily shareholders who derive commercial advantages from having a certain contestant exercise control, e.g., banks, and insurance companies which do business with the company.[82/]

Several factors then contribute to better contestants losing contests. Most often, shareholders might not vote for the better contestant because they lack perfect information. Less frequently, shareholders might not vote for the better contestant because company value is higher under the worse contestant or because they are partial towards the worse contestant.

(ii) Expenditures and the Outcome of Proxy Contests

As shown in the preceding Subsection, better contestants do not win each proxy contest. One of the other factors which determines the outcome of contests is the amount of proxy contest expenditures by the contestants. In this Subsection, we will briefly illustrate this relationship between expenditures and outcome.

The bulk of proxy contest expenditures are incurred in formulating and transmitting information to shareholders. The information so provided constitutes a large part of the total mix of information available to shareholders in deciding how to vote. As we will show, proxy contest expenditures affect information, and thereby voting in two ways. The *relative amount* of expenditures by challengers and incumbents influences to what degree this mix of information is objective. And the *total amount* of expenditures by both parties influences how much information shareholders receive.

Each contestant will try to phrase the information he provides to shareholders such that the shareholders vote in his favor. Naturally, a

82/ See Brickley, Lease & Smith, Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267 (1988).

higher level of expenses enables a contestant to provide more information to shareholders. As a contestant provides more information, he slants the total mix of information in his favor. Thus, a contestant's chances of winning increase if only he increases the amount of expenditures or if only his opponent decreases the amount of expenditures.

The amount of expenditures, however, also affects the total amount of information available to shareholders. The better shareholders are informed (that is, the more accurate and complete the information they possess), the more likely are they to vote for the better contestant. If both sides increase their expenses by the same amount, it is likely that shareholders become better informed. Thus, increasing the total amount of expenditures in such a way will generally improve the better contestant's chances of winning.

Assume, for example, that incumbent *I* is a better contestant than challenger *C*. If only *I* (or only *C*) increased his expenditures by $100,000, his chances of winning would increase. The increased information he would make available to shareholders would tend to induce some additional shareholders to vote for him. But if both *I* and *C* spent an extra $100,000, the added information provided by them, taken on a whole, would tend to be relatively objective and accurate. Shareholders, thus being better informed, would be more likely to vote for the better contestant. As a result, if both *I* and *C* so increased their expenditures, *I*'s chances of winning would improve (though by less than if only *I* increased his expenditures).

(iii) <u>The Efficient and the Privately Profitable Allocation and Amount of Proxy Contest Expenditures</u>

Having explained why the better contestant does not always win a proxy contests and analyzed how expenditures will affect the outcome of proxy contests, we now direct our inquiry to efficient and privately optimal spending decisions. We first discuss when it is efficient to increase expenditures. Then we examine when it is privately profitable to do so.

From the social perspective, all proxy contests expenditures are social costs of leading proxy contests. Thus, it is desirable to increase expenditures only if the social gains from an improved outcome of contest exceed the increase in costs. Such social gains to society are the product of two factors: the change in the probability of the better contestant winning; and the difference between social wealth under the better and under the worse contestant (which is generally independent of the amount of expenditures). We will refer to these gains as the "improved outcome gains" from increasing expenditures. An increase in proxy contest expenditures is desirable if it results in improved outcome gains that exceed the increase in contest expenses.

Assume, for example, that social wealth under contestant *A* is $100 million and under contestant *B*, $70 million. Further assume that increasing the amount of expenditures by $1 million will increase *A*'s chances of winning from 60% to 65%. The improved outcome gains from spending the extra million are then $1.5 million: a $30 million difference in social wealth weighted by a 5% improvement in *A*'s chances of winning. As improved outcome gains exceed the additional costs, it is desirable to spend the extra million. Obviously, from the social perspective, any expenditures by the worse contestant *B* are undesirable. Such expenditures are not only costly in themselves; in addition, they create social losses by increasing the likelihood of the worse contestant winning.

From the perspective of an individual contestant, it will be desirable to increase expenditures only if the resulting gains to her -- private gains weighted by the increase in the probability of winning -- exceed the increase in her costs. Assume that, in the example before, private gains to *A* are $10 million and *that* *A* would bear the full cost of the $1 million increase in expenditures. Then, *A* would not find it profitable to spend the extra $1 million. The gains to her are only $500,000 ($10 million weighted by the 5% increase in the probability of winning), while her costs are $1 million.

Note then that the reasons why contestants may spend too little or too much are equivalent to the reasons discussed before why the wrong contestants may enter contests. First, private control benefits differ from net control benefits to society -- leading contestants to spend too much. Second, stock appreciation gains to the contestant differ from changes in company value -- leading contestants under whom company value is higher to spend too little and others to spend too much. Third, the cost of spending more to a contestant may be less than the cost to society -- again leading contestants to spend too much. Whether, on the whole, contestants will spend more or less than the efficient amount will, of course, depend on the relaitve strength of these factors.

(iv) Allocation Rules, Expenditures, and the Outcome of Contests

Cost allocation rules have a direct impact on the expenditures incurred in proxy contests and, through the impact on expenditures, affect the outcome of proxy contests. As the degree of compensation increases, the cost to the contestant of incurring expenditures decreases, and the level of his expenditures increases. Thus, other things being equal, granting more compensation to a contestant increase his chances of winning.

Assume, for example, that if contestant *A* wins the contest, he derives private benefits and stock appreciation gains of $500,000. If he spends $100,000 on the contest, his chances of winning would be 30%; if he spends $200,000 on the contest, his chances increase by 10% to 40% (and thus his expected gains by $50,000). *A* would not spend the additional $100,000 if he is does not get compensated for his expenditures. But if the company were to compensate him fully, he will spend the second $100,000 and have a higher chance of winning.

In the previous Subsection, we discussed when spending is efficient and when it is privately profitable. We noted that spending by bad contestants is always undesirable, while a limited amount of spending by good contestants is desirable. We thus face the question whether proxy rules can be designed to discourage any spending by bad contestants, while encouraging good contestants to spend -- but not more than the efficient amount. In Part IV, we will address the question of whether, and how, allocation rules can be structured to achieve this purpose.

C. Ex Ante Managerial Decisions and Compensation

So far, we have examined the ex post effects of proxy rules -- when we have a potential contestant, will he engage in a contest, and if he does, how much will he spend and how likely is he to win? We now turn to how the prospect of proxy contests -- that is, the possibility of being ousted and the conditions under which such ouster is likely -- influences ex ante managerial behavior before a potential contestant appears. We first discuss the effects of proxy rules on managerial incentives to reduce the probability of ouster. We then address the effects of proxy rules on risk-bearing costs.

(i) Ouster and Managerial Incentives

Given the risk of proxy contests, managers face the possibility of being ousted in a contest and thus losing their private benefits of control.[83] This prospect will create incentives for managers to act in a

83/ In addition, if incumbents are not fully compensated, contests could create risk to incumbents of having to spend personal funds on proxy (continued...)

manner which reduces the probability of being ousted. Typically, any change in proxy rules that increases the likelihood of a successful challenge will tend to lead managers to intensify these ouster-preventive activities.[84/] In this Subsection, we analyze how managers can reduce the chances of ouster and to what extent such activities are desirable.

Ouster-preventive activities generally fall into two categories. The first includes activities that increase the level of shareholder support,[85/] i.e., that make it less likely that disinterested shareholders would want to replace management. The second category consists of defensive devices which, given the level of shareholder support, make it less likely for successful challenges to be initiated.

(a) The Level of Shareholder Support

Shareholder support, and thus the degree to which disinterested shareholders are inclined to vote for challengers rather than incumbents,

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83/ (...continued)
campaigns. This risk is analytically similar to the risk of ouster. Thus, if incumbents are not fully compensated, the effects derived in this Section with respect to the risk of ouster will be enhanced by the effects of the risk of having to spend personal funds.

84/ We assume that management efforts to prevent ouster intensify as the risk of ouster increases. This assumption presupposes that such efforts become more effective as the underlying risk increases. This is not necessarily the case. Consider, for example, two allocation rules corresponding to a priori probabilities of ouster of 10% and 20%, respectively. Assume that, under either rule, response 1 is equally effective, e.g. that it reduces the probability of ouster from 10% to 2% and from 20% to 12%, respectively. In such circumstances, a move from the first to the second allocation rule should not make it more likely for managers to adopt response 1. Assume, however, that response 2 reduces the chances of ouster from 10% to 5% and from 20% to 10%, respectively. That is, response 2 is (in the absolute sense) more effective under the first rule than under the second: it reduces the probability of ouster by 10% rather than by 5%. In that case, a move from the first to the second rule should make it more likely to adopt response 2. Presumably, many responses are similar to response 2 -- i.e. they become more effective if the a priori probability of ouster increases.

85/ See also Schulman, The Cost of Free Speech in Proxy Contests for Corporate Control, 20 Wayne L. Rev. 1, 30-32 (1973) (threat of proxy contest stimulates management to be more concerned with shareholder satisfaction).

primarily depends on shareholder perceptions of the relative quality of management.[86] As we proceed to show, managerial efforts to enhance shareholder perception of its quality can result in a greater level of efficiency and would thus be desirable. But the desire to increase shareholder support may, under certain circumstances, also lead to inefficient behavior.

The most straightforward way to increase shareholder support is to improve the actual quality of managerial performance.[87] Shareholders may learn about this improvement through a variety of sources -- the stock price of the company or earnings may increase, stock analysts may report favorably on management, or shareholders may read about the improvement in business publications. As shareholders observe improvements in management, the risk of ouster declines for two reasons. First, shareholders will be less inclined to vote for challengers, thus reducing the likelihood for challengers to win. Secondly, challengers will have less opportunity to earn stock appreciation gains and thus have less of an incentive to initiate contests, independent of their chances of winning.[88]

Increasing shareholder support through improved actual performance generally also increases social wealth. Better management increases company value, but in most cases, does not lead to a commensurate decline in private control benefits. Therefore, increasing shareholder support through improved performance is likely to be efficient.

86/ Other generally insignificant factors that may impact shareholder support include the political views and the ethical behavior of management.

87/ Cf. Manne, Mergers and the Market For Corporate Control, 73 J. Pol. Econ. 110 (1965); Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harvard L. Rev. 1161 (1981) (disciplinary effect of hostile takeovers leads to management improvements).

88/ Cf. See Duvall & Austin, Predicting the Penalty of Proxy Contests, 20 J. of Finance 464, 471 (1965) (empirical evidence that proxy contests are begun in firms with relatively low rates of return).

Another way to increase shareholder support is to enhance shareholder perceptions of the quality of management without improving actual performance. In particular, management may try to enhance shareholder perception by myopically increasing short-term earnings[89] -- e.g. by underinvesting in research and development and other long-term projects[90] -- or by boosting short-term distributions to shareholders[91] -- e.g. by raising additional debt to finance a special dividend[92]. Increasing shareholder support in this manner is, of course, only possible because shareholders lack perfect information.[93]

Increasing shareholder support by manipulating shareholder perception of management quality can be costly and reduce company value without offering offsetting benefits. The myopic behavior noted above can involve particularly high costs. For example, in order to raise quarterly earnings, management may decide to cancel the development of a promising new product line. Or a high debt burden taken on to finance special dividends may, in a minor business

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89/ Stein, Takeover Threats and Managerial Myopia, 96 J. of Political Economy 61 (1988) (myopic stock market may lead to myopic managerial behavior); Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Behavior, 104 Quarterly J. of Economics 655 (1989) (myopic managerial behavior may occur in rational stock market).

90/ Lipton, Corporate Governance in the Age of Finance Corporations, 136 U. Pa. L. Rev. 1, 23-25 (1987) (managers may reduce long term planning and R&D to satisfy shareholders).

91/ Note that increasing leverage may be efficiency enhancing by reducing agency costs of free cash flows. See Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 American Economic Rev. 323 (1986).

92/ See, e.g., Lipton, Corporate Governance in the Age of Finance Corporations, 136 U. Pa. L. Rev. 1, 20-23 (1987) (risk of ouster can cause companies to incur huge amounts of debt as defensive measure). Other ways to enhance shareholder perception of management quality include the distribution of self-promotional literature or changes in accounting standards that result in increased book earnings.

93/ To the extent shareholder support is a function of the stock price, increasing shareholder support in this manner will only be possible if stock markets are inefficient.

downturn, force companies into bankruptcy even if they earn substantial operating profits[94/]. Thus, whether an increased threat of ouster is desirable will, to a large extent, depend on whether managers find it more effective to improve their actual performance or to manipulate shareholder perception thereof.

Note, in this respect, the parallel to hostile takeovers. It is generally recognized that an increased threat of a hostile takeover creates managerial incentives to increase the share price. To increase the share price -- like to enhance shareholder support -- management could either try to increase the actual value of the company or to manipulate the perception of that value, e.g. by myopically increasing short-term earnings. Thus, the potential alternatives for enhancing shareholder support in order to reduce the likelihood of a proxy challenge, and their desirability, are analogous to the alternatives for increasing the stock price in order to reduce the likelihood of a hostile takeover[95/].

(b) Defenses Devices Against Proxy Contests

Apart from increasing shareholder support managers can reduce the threat of ouster by adopting defensive measures.[96/] They could, for

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94/ F. Schwadel & G. Anders, Interco Threatens a Chapter 11 Filing To Pressure Bondholders On Debt Plan, Wall Street J., May 18, 1990, at A2 (Interco, which in 1988 borrowed $2 billion to pay special cash dividend in order to defend against hostile takeover bid, close to bankruptcy filing).

95/ Cf. Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harvard L. Rev. 1161 (1981) (threat of takeovers leads to desirable improvements in management); Lipton, Corporate Governance in the Age of Finance Corporations, 136 U. Pa. L. Rev. 1, 20-28 (1987) (threat of takeovers leads to undesirable short-term responses and overleverage).

96/ Cf. Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 42 (threat of proxy contests is one reason for adoption of antitakeover charter amendments).

example, recapitalize with non-voting stock;[97] provide for staggered board (i.e. for the election in each year of only 1/3 of the board);[98] otherwise modify the charter provisions governing elections of directors;[99] grant special favors to large shareholders in exchange for their support in proxy contests[100] or issue shares to "friendly" shareholders who would tend to vote for them in a contest. These measures are not designed to increase shareholder support but rather to make it harder for challengers to succeed, regardless of the level of support by disinterested shareholders.[101]

By making it harder to stage a successful challenge, defensive devices relieve managers from pressure to increase shareholder support. In addition, some of these measures may be wasteful in themselves. For example, management may offer the company's business to a bank that owns stock of the company, and which is expected to support management in a proxy contest, even if a different institution can provide the same services at lower rates. That is, management would be willing to have the company pay the additional charges to

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97/ See, e.g., Ruback, Coercive Dual Class Exchange Offers, 20 J. Fin. Econ. 153 (1988); Jarrel & Poulson, Dual Class Recapitalizations as Antitakeover Mechanism, 20 J. Fin. Econ. 129 (1988). In 1988, the Securities and Exchange Commission adopted Rule 19c-4 (commonly known as the one share-one vote rule) which severely limited the ability of companies with listed stocks to recapitalize with non-voting stock. 17 C.F.R. §240.19c-4. However, the D.C. Circuit Court held that the SEC did not have statutory authority to promulgate Rule 19c-4 and accordingly vacated the rule. The Business Roundtable v. Securities and Exchange Commission, __ F.2d _____ (D.C. Cir. 1990).

98/ See, e.g., Gen. Corp. L. of Del., §141(d).

99/ See generally Investor Responsibility Research Service Antitakeover Charter Amendments (1988).

100/ See, e.g., Brickley, Lease & Smith, Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267 (1988).

101/ Note that while some of these measures could be prohibited by law, others cannot be dealt with adequately. For example, it would, in practice, be difficult to distinguish between incumbents who exchange equity for debt in order to secure control and those who seek the tax benefits from deductible interest payments.

the bank in order to secure the bank's support in a proxy contest and thus reduce the likelihood of being ousted.

The desirability of these defensive measures depends then both on the desirability of shareholder support responses that would otherwise be adopted and on the wastefulness of the defensive tactic itself. That is, if managers were to improve their actual performance if they were not permitted to adopt defenses, then defenses would not be desirable; on the other hand, if managers were to manipulate shareholder perception of managerial performance, a proxy contest defense may be desirable unless it generates significant costs in itself.[102]

(ii) Risk-bearing Costs

The prospect of ouster also creates uncertainty for managers. In the presence of proxy contests, managers have to face uncertainty over the amount of private control benefits they will be able to derive in the future. Generally, the higher the risk of ouster is, the greater is the uncertainty borne by managers.[103]

This uncertainty constitutes a cost to managers (and thereby as well to society). Managers are generally risk averse. That is, given a certain amount of expected gains, they prefer to receive this amount for certain in all cases, rather than to receive more than expected in some circumstances and less in others. Thus, increasing uncertainty over the expected amount of private control benefits inflicts risk-bearing costs on managers. Note that

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102/ Defenses instituted in response to an increased threat of ouster also affect social wealth by impacting incidence and outcome of actual contests. But note that such defenses will generally only limit the increase in the threat of ouster, and not cause a decrease in the threat.

103/ If uncertainty costs are proportional to the variance in expected private benefits, uncertainty costs would increase with an increase in the probability of ouster as long as this probability is less than 50%.

these risk-bearing costs constitute a cost to society even if managers are compensated for bearing these costs, e.g. by a higher salary.

Take, for example, incumbent *B* who is to derive private control benefits of $1.5 million unless ousted in a proxy contest. Assume that a change in the proxy rules increases the risk of ouster from 0% to 10%. Under the new rule, *B*'s expected private benefits are $1.35 million:[104/] $1.5 million in the 90% of cases where he stays in control; nothing in the 10% of cases where he does not. Further assume that, since *B* is risk averse, he would prefer to receive $1.3 million for certain rather than $1.5 million if not ousted and nothing if ousted. The $50,000 between the uncertain expected control benefits of $1.35 million under the new proxy rule and the $1.3 million in certain benefits *B* would prefer are a measure of the risk-bearing costs imposed by the proxy rule.

Assume that, to offset the risk of ouster created by the change in proxy rules, *B* receives an additional $30,000 in salary. Thus, *B* would only suffer a net loss of $20,000 as a result of the change in the proxy rules: $50,000 in risk-bearing costs less $30,000 in additional salary. But the amount of risk-bearing costs to society would nevertheless be $50,000 -- $20,000 in net risk-bearing costs to *B* and $30,000 in costs to shareholders for compensating *B* for his risk-bearing.[105/]

104/ Obviously, a rule that increases the risk of ouster also reduces the expected amount of private control benefits to incumbents (and increases those to challengers). The respective efficiency implications have been analyzed in Section A.

105/ In addition to leading to a higher average salary, an increase in the risk of ouster would also tend to cause a decrease in risk-bearing costs inflicted by other salary items (e.g. bonuses or stock options) and a corresponding decrease in incentives. If increasing the threat of contests is efficient (i.e. if gains from incentives exceed risk-bearing costs), the net effect would tend to consist of an increase in incentives, and either an increase or a decrease in risk-bearing costs. If increasing the threat is inefficient, the net effect would tend to consist of an increase in risk-bearing costs, and either an increase or a decrease in incentives.

In summary, then, whether proxy rules increasing the risk of ouster have desirable ex ante effects will depend on the kind of responses managers adopt to the rules and on the relative magnitude of risk-bearing costs. As we argued in Subsection (i), the desirability of management responses to an increased threat of ouster depends on whether it is more effective to improve actual performance, manipulate shareholder perception of managerial performance or adopt defensive devices. If the overall response is undesirable, the corresponding rule is, from an ex ante perspective, inefficient. If the overall response is desirable, the corresponding rule is, from an ex ante perspective, efficient if the net benefits from enhanced incentives to increase company value exceed the risk-bearing costs.

In conclusion, note that the ex ante effects we have described in this Section are lessened if managers obtain private benefits from <u>losing</u> control; e.g., golden parachutes triggered by losing a proxy contest. To the extent that managers have such golden parachutes, they are subject to fewer incentives to engage in ouster-preventive activities and bear less risk-bearing costs. However, as long as golden parachute payments are not so high that managers prefer to be ousted, changing the risk of ouster has the results described in this Section.

IV. ANALYZING THE EXISTING RULES

In this Part, we will apply the proposed framework to analyze the existing legal rules governing the allocation of proxy contest costs. First, in Section A, we describe the present state of the law and the current reimbursement practice. Then, we evaluate the current rules: in Section B, we focus on the allocation of costs incurred by challengers, and then, in Section C, on the allocation of costs incurred by incumbents. In these

Sections, we seek to assess how cost allocation rules can be structured to enhance efficiency, to identify the desirable elements of the existing legal rules and to determine in which directions, if any, these rules should be modified.

A. The Current Legal Rules and Practice

Only a few reported cases, mostly by New York and Delaware courts, have dealt with compensation of proxy contest expenses. In general, courts largely left the decision whether to reimburse[106/] contestants to the discretion of the board of directors[107/]. The consequence of this rule is that the company generally pays all the expenses for the reelection campaign of incumbents, but reimburses challengers for their expenses only if they gain control over the board of directors. We now examine in greater detail the case law on compensation of incumbents and challengers.

(i) Conditions for Reimbursing Incumbents

Both New York and Delaware ostensibly impose limitations on ability of the board to award reimbursement to incumbents. But in practice incumbents encounter only few restrictions on their use of corporate funds in proxy contests. As incumbents control the board during the contest, they are largely free to authorize the company to pay for their proxy campaign. As a result, incumbents can generally count on full reimbursement.

106/ The term "reimbursement" is technically incorrect in describing the compensation practice of incumbents. Contest expenditures for the benefit of incumbents are mostly paid directly by the company, so that incumbents are not literally reimbursed.

107/ *See*, *e.g.*, *Grodetsky v. McCrory*, 267 N.Y.S.2d 356, 359 (S. Ct. 1966) (court cannot direct compensation but may merely determine whether corporation may pay compensation); but see *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339 (Del. 1983) (incumbent directors entitled to reimbursement even though expenses not explicitly authorized by board).

Under both New York[108/] and Delaware[109/] law, the reimbursement of incumbents is subject to two nominal conditions. First, incumbents may only be reimbursed if the proxy contest involved a question of policy, rather than personnel. Secondly, reimbursement is limited to expenses which are both reasonable in amount and reasonably necessary to inform the stockholders.[110/] But reimbursement is rarely, if ever, denied on account of these limitations.

Both courts[111/] and commentators[112/] have asserted that the distinction between contests over policy and contests over personnel is spurious and unworkable. As has been noted, policy and personnel questions are not easily compartmentalized.[113/] But even in proxy contests that are,

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108/ See Rosenfeld v. Fairchild Engine and Airplane, 128 N.E.2d 291, 293 (Ct. App. 1955); Begleiter v. Moreland, 225 N.Y.S.2d 577, 579 (S. Ct. 1961); Grodetsky v. McCrory, 267 N.Y.S.2d 356, 358 (S. Ct. 1966); Levin v. Metro-Goldwyn-Mayer, 264 F. Supp. 797, 801 (S.D.N.Y. 1967).

109/ Steinberg v. Adams, 90 F. Supp. 604, 607 (S.D.N.Y. 1950); Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226, 227 (Del. 1934); Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D. Del. 1944).

110/ Steinberg v. Adams, 90 F. Supp. 604, 607 (S.D.N.Y. 1950); Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226, 227 (Del. 1934); Campbell v. Loew's, 134 A.2d 852, 864 (Del. Ch. 1957); Rosenfeld v. Fairchild Engine and Airplane, 128 N.E.2d 291, 293 (Ct. App. 1955); Begleiter v. Moreland, 225 N.Y.S.2d 577, 579 (S. Ct. 1961).

111/ See, e.g., Steinberg v. Adams, 90 F. Supp. 604, 608 (S.D.N.Y. 1950); Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226, 228 (Del. 1934).

112/ See, e.g., Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 952 (1951); Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 215 (1968); Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 10 (1952); Easterbrook & Fischel, Voting in Corporate Law, 26 J. of L. & Econ. 395, 413 (1983); Barnhill, The Corporate Raider: Contesting Proxy Solicitations and Take Over Defenses, 20 Bus. Law 763, 779 (1965). But see Note, 31 N.Y.U. L. Rev. 825, 838 (1956) (policy/personnel distinction should be retained to allow just disposition of cases in which contestants care merely about their own interests).

113/ See, e.g., Steinberg v. Adams, 90 F. Supp. 604, 608 (S.D.N.Y. 1950); Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 952 (1951); Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 215 (1968).

in truth, exclusively about questions of personnel, incumbents would have no difficulty couching the issues in terms of policy if their reimbursement depended on it.[114/] Predictably, reimbursement is rarely denied because a proxy contest did not involve a question of policy.[115/]

Courts have also declined to significantly restrict incumbent reimbursement through the requirement that expenses be reasonable. Several commentators have suggested that the use of proxy solicitors,[116/] last minute telegrams and long distance telephone calls,[117/] or of corporate employees[118/] is unreasonable as these methods are unfair and put pressure on the shareholders rather than inform them. Courts, however, have so far not disallowed any of these expense items;[119/] and in the one reported case in

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114/ See Rosenfeld v. Fairchild Engine and Airplane, 128 N.E.2d 291, 299 (Ct. App. 1955) (dis. op.) ("[N]either the 'ins' nor the 'outs' ever say that they have no program to offer shareholders, but just want to acquire or to retain control ... As in political contests, aspirations for control are invariably presented under the guise of policy or principle."); see also Easterbrook & Fischel, Voting In Corporate Law, 26 J. of L. & Econ. 395, note 45 (1983).

115/ See Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 952 (1951); Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 10 (1952) (both noting that only one case from 1907 did disallow expenses for that reason); Stifel, Shareholder Proxy Fight Expenses, 8 Clev. Marshall L. Rev. 339, 343 (1956) (citing two cases in which expenses were disallowed because the proxy contest did not involve a policy issue). We are not aware of any subsequent decisions disallowing expenses on this ground.

116/ Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 954 (1951); Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 215 (1968); Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 11 (1952).

117/ Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 215 (1968); Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 11 (1952).

118/ Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 954 (1951).

119/ Proxy solicitors have been employed in several cases in which compensation was granted. See e.g. Steinberg v. Adams, 90 F. Supp. 604, 606 (S.D.N.Y. 1950); Begleiter v. Moreland, 225 N.Y.S.2d 577, 578 (S. Ct. 1961); see also Stifel, Shareholder Proxy Fight Expenses, 8 Clev. Marshall L. Rev.

(continued...)

which the reasonableness of certain expenses was at issue, the court found nothing wrong with the incumbents employing two proxy solicitation firms, one consultant, and one public relations firm; and using 150 corporate employees to make telephone calls to shareholders "on their own time".[120/] Nevertheless, it would seem that some expense items, like "solitary wining and dining a trustee or broker entrusted with a substantial number of proxies in an attempt to influence his decision",[121/] might be found unreasonable.

Courts have also not elaborated as to what amount of total expenses would be regarded as unreasonable. It has been suggested that the test for reasonableness should take into account the type of contest, the number of shareholders, and the level of expenditure by the challengers.[122/] Although we know of no reported decisions in which expenses were held to be excessive, it is conceivable that the existence of the reasonableness requirement restrains incumbents to some extent.[123/] But whatever restraints incumbents may feel, in practice they are reimbursed for all their proxy contest expenses.[124/]

119/ (...continued)
339, 343 (1956) (noting the reluctance of courts to disallow expenditures unless clearly beyond the scope of business judgment).

120/ Levin v. Metro-Goldwyn-Mayer, 264 F. Supp. 797, 801-803 (S.D.N.Y. 1967); see also In re Zickl, 73 N.Y.S.2d 181, 185 (1947) (authorizing use of corporate funds to pay proxy solicitors).

121/ Note, 31 N.Y.U. L. Rev. 825, 836 (1956).

122/ Barnhill, The Corporate Raider: Contesting Proxy Solicitations and Take Over Defenses, 20 Bus. Law 763, 779 (1965).

123/ Despite the existence of the reasonableness requirement, the board of Lockheed Corporation apparently did not hesitate to spend approximately $8 million of corporate funds on its reelection (compared to approximately $6 million spend by the challengers). Wall Street Meets Madison Avenue in the Lockheed Simmons Proxy Battle, Corporate Control Alert, April 1990, at 1.

124/ Private Information from Georgenson & Co. (a major proxy solicitation firm).

(ii) Conditions for Reimbursing Challengers

When a company may reimburse challengers is subject to somewhat greater limitations than reimbursement of incumbents. However, the main cause for divergence in the compensation practice lies not in these different limitations but in the fact that there is no affirmative entitlement to reimbursement. This lack of entitlement does not present a problem to incumbents -- by definition, incumbents control the board at least during the contest and can thus have the company authorize reimbursement of their expenditures. Challengers, however, only control the board if they win the contest. That is, challengers who lose the contest do not have the power to award themselves compensation even if the company were permitted to reimburse them.

With respect to the limitations on reimbursement of challengers, legal rules distinguish between challengers who win the proxy contest and those who do not. Reimbursement of victorious challengers is subject to the same conditions as reimbursement of incumbents, i.e. if the contest was over policy and the expenses were reasonable.[125] It is, however, unclear whether reimbursement of challengers requires shareholder approval[126] or whether authorization by the board of directors is sufficient.[127] But note that

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125/ See Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine and Airplane, 128 N.E.2d 291 (Ct. App. 1955). Note that Rosenfeld was only a plurality decision and that the concurring opinion by Judge Desmond is ambiguous on what expenses may be reimbursed. Still, subsequent decisions have followed the plurality approach. Begleiter v. Moreland, 225 N.Y.S.2d 577 (S. Ct. 1961); Grodetsky v. McCrory, 267 N.Y.S.2d 356 (S. Ct. 1966).

126/ Steinberg v. Adams, 90 F. Supp. 604, 608 (S.D.N.Y. 1950) (reimbursement permissible at least where there is approval by board and majority of shareholders); Rosenfeld v. Fairchild Engine and Airplane, 128 N.E.2d 291, 293 (Ct. App. 1955) (stockholders have right to reimburse successful contestants).

127/ Steinberg v. Adams, 90 F. Supp. 604, 607 (S.D.N.Y. 1950) (successful challengers should be treated in same manner as incumbents); see also
(continued...)

even challengers who win a contest are not automatically entitled to reimbursement. Thus, for example, challengers who defeated a merger proposal would still need the approval of a presumably hostile board to obtain reimbursement.[128/]

No reported cases have decided whether shareholders may reimburse challengers who lost. The cases that permitted reimbursement of successful challengers placed great weight on the fact that they benefitted the corporation by "ridding [the] corporation of a policy frowned upon by a majority of the owners."[129/] This rationale would not apply to unsuccessful challengers.[130/] Some commentators, however, have argued that there is no reason not to permit shareholders to reimburse a challenger who lost if they find that he has rendered a beneficial service to the corporation.[131/]

The practical effect of these rules is as one would expect. Challengers that gain control of the corporation, i.e. win a majority of the

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127/ (...continued)
Machtinger, Proxy Fight Expenditures of Insurgent Shareholders 19 Case West. Res. L. Rev. 212, 217 (1968); E. Aranow & H. Einhorn, Proxy Contests for Corporate Control (1968), at 573 (if reimbursement lawful, shareholder approval should be unnecessary; if unlawful, approval would be of no avail); Yoran, Restraints on Incumbent Directors in Intracorporate Battles for Control, 7 U. Rich. L. Rev. 431, 469 (1973) (if shareholder ratification is required to compensate challengers, shareholder ratification would also be required to compensate incumbents); Proxy Statement, Chock Full O'Nuts, Oct. 27, 1982 at 6 (question of reimbursement of challengers not to be submitted to shareholder vote).

128/ Grodetsky v. McCrory, 267 N.Y.S.2d 356 (S. Ct. 1966).

129/ Steinberg v. Adams, 90 F. Supp. 604, 607-608 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine and Airplane, 128 N.E.2d 291, 293 (Ct. App. 1955) (shareholders may vote to reimburse "successful contestants for achieving the very end sought and voted for by them as owners of the corporation").

130/ Cf. Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 217 (1968).

131/ E. Aranow & H. Einhorn, Proxy Contests for Corporate Control (1968), at 577.

seats on the board, receive reimbursement for their expenses.[132/] Challengers who tried to but failed to gain control receive reimbursement only in rare circumstances.[133/] In contests for partial control, i.e. in contests where less than a majority of the seats on the board were contested, successful challengers sometimes receive compensation or partial compensation.[134/] In proxy contests that are settled,[135/] challengers also sometimes receive full or partial reimbursement.[136/]

One should also note that federal proxy rules contain some procedural provisions pertinent to reimbursement of contestants. In all proxy contests, the proxy statement must disclose the persons who bear the costs of the solicitation.[137/] And in proxy contests about the election of directors, the statement must further disclose the estimated total cost of the solicitation, the total expenditures to date, the fees to be paid to proxy solicitation firms, and, if the contest was settled, the terms of the settlement; as well as whether reimbursement of the expenses will be sought

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132/ Private information from Georgenson. We also obtained information from 11 companies who had proxy contests between 1981 and 1985. In the four contests where the challengers won, they received reimbursement, although in one there is still some ongoing litigation. In the seven contests where the incumbents maintained their majority, the challengers were not reimbursed.

133/ Private Information, Georgenson. Challengers sometimes receive compensation where they gained representation on but not control of the board. See e.g. American Bakeries Comp., Proxy Statement, August 18, 1981 (shareholder approval sought for reimbursement of expenses to challenger for up to $1.1 million after challenger won 4 of 12 board seats).

134/ Informal survey of 7 contests for partial control.

135/ About 25% of all proxy contests are settled before the shareholder vote. Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 173.

136/ See Graham B. Moody & Constance E. Bagley, Proxy Contests (1983) at note 10 (Settlement of Pabst Brewing Co. 1982 proxy contest and of Bradford National Corp. 1983 contest included provision for reimbursement of challenger expenses of $7.5 million and $800,000, respectively).

137/ 17 C.F.R. 240.14a-101, Item 4(a).

from the corporation and whether the question of reimbursement will be submitted to a shareholder vote.[138]

B. Assessing the Rules on Reimbursement of Challengers

In this Section, we analyze the extent to which companies should reimburse challengers for expenses incurred in control contests. First, we explain why it is not desirable to give full unconditional reimbursement to challengers. We then show that it is probably appropriate to provide some reimbursement to challengers. Having determined that an intermediate approach may be called for, we conclude that such intermediate reimbursement should be made contingent on success. Finally, we discuss the success threshold for challenger reimbursement. For purposes of this Section, we assume that incumbents receive at least as much reimbursement as challengers. Reimbursement of incumbents will be considered in the next Section.

(i) Should Challengers Receive Full Reimbursement?

In this Subsection, we analyze the effect of giving full reimbursement to challengers. We first argue that full reimbursement is likely to lead to a large number of undesirable entry decisions and to excessive spending on proxy campaigns. We then briefly consider the ex ante effects of providing full reimbursement.

If challengers were to receive full reimbursement, they would face few disincentives to entering proxy contests. Specifically, under full reimbursement, challengers would face two possible limited disincentives to entry. First, to the extent that challengers own stock in the company, they will bear part of the contest expenditures borne by the company; second, if they win the contest, they could endure losses from a decline in company value

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138/ 17 C.F.R. 240-14a-101, Item 4(b).

to the extent that they own stock in the company. Thus, potential challengers who own only minimal amounts of company stock would have hardly any motivation not to initiate contests.

At the same time, almost all challengers will derive private control benefits if they win the contest. Such control benefits would accrue to victorious challengers regardless of the number of shares owned, the costs of the contest, and the effect on company value. Thus, as long as potential challengers have any chance of winning, control benefits provide a stimulus for entering contests.

As a result, if challengers are fully reimbursed, many undesirable challenges will be initiated. A large number of potential contestants who own hardly any shares (and thus bear infinitesimal costs of entering) will find it profitable to enter a contest -- even if they have only a low chance of winning. But entry by such challengers is, for two reasons, generally inefficient. First, since potential challengers will not personally suffer from a decline in stock value if they take control, bad contestants will not be deterred from initiating contests. Second, even many good challengers with small chances of winning may be undesirable entrants. This would be the case because the <u>expected</u> gains of entry would often be less than the cost of the contest.

Providing full reimbursement will also lead to inefficiently high proxy contest expenditures. This is necessarily true if the challenger is undesirable. Any amount of expenditures by an undesirable contestant is inefficient. But even desirable challengers will, if fully reimbursed, uniformly overspend.

As discussed, it is only efficient for a contestant to increase expenditures if social gains from her victory weighted by the resulting increase in the probability of winning exceed social costs. But contestants will find it profitable to increase expenditures as long as their private gains weighted by the increase in the probability of winning exceed the cost to them.

Assume that the cost to challengers of spending $1 million more is a fraction, say half, of the cost to society, i,e. $500,000. It is easy to see that challengers will spend the efficient amount only if private gains amount to exactly the same fraction of social gains. Assume, for example, that private gains are $5 million and social gains $10 million. It would be both efficient and privately profitable to spend the extra million if the chances of winning increase by 10% or more. Otherwise it would be both inefficient and unprofitable. Similarly, if private gains were more than the pertinent fraction of social gains, challengers would overspend; and if they were less than that fraction, they would underspend.

Under full reimbursement, the only cost challengers would face by increasing expenditures is the portion of these expenditures indirectly paid by them as shareholders of the company. For example, if a challenger increases expenditures by $1 million, is fully reimbursed by the company, and owns 5% of the company's stock, the cost to her is $50,000 -- increased social costs of $1 million times the fraction of the shares owned by her. Thus, challengers will overspend if private gains are more than the pertinent fraction -- in the example, 5% -- of social gains.

Now consider the relationship of private gains (stock appreciation gains plus private control benefits) and social gains (changes in company value and net social control benefits). Take first stock appreciation gains and company value. As explained, stock appreciation gains will equal gains from an increase in company value times the fraction of shares owned by the challenger. If, to continue our example, victory by the challenger increases company value by $5 million, her stock appreciation gains would be 5% of $5 million or $250,000. Next, take private control benefits and net social control benefits. As explained, private control benefits exceed net control benefits to society since the latter include the loss of control benefits by the opponent.

The implication of these relationships is that, under full reimbursement, private gains exceed the pertinent fraction of social gains and thus that challengers will overspend. Since private costs equal social costs times the fraction of shares owned by the challenger and stock appreciation gains equal changes in company value times the fraction of shares owned by the challenger, challengers would spend the efficient amount if private control benefits equaled net social control benefits times the fraction of shares owned by the challenger. In our example, if private control benefits were $100,000 and social net benefits $2 million, private gains would amount to $350,000 -- i.e. 5% of social gains of $7 million. But private benefits *exceed* net social control benefits (and, a fortiori, any fraction of net social control benefits) -- causing fully reimbursed challengers to spend too much.

While the ex post effects of full reimbursement are unequivocably undesirable, we cannot say for certain whether providing full reimbursement would have positive or negative effects on ex ante managerial behavior. As we noted, full reimbursement would lead to more challenges and higher spending by challengers and thus increase the risk of ouster. This will generally lead to increased efforts to enhance shareholder support.

As explained, managers may be able to enhance shareholder support by actions that are desirable -- i.e. by improving their actual performance -- as well as by actions that are undesirable -- e.g. by myopic underinvestment in R&D. Whether the ex ante effects on managerial behavior are desirable will, to a large degree, depend on how managers increase shareholder support.

Neither theory nor empirical studies enable us to infer which path management will chose. But even if managers were to chose to improve their performance, the resulting ex ante gains may easily be dwarfed by the ex post losses described above.

(ii) Should Challengers Receive Any Compensation?

In the preceding Subsection, we argued that it is more efficient to give challengers *some* compensation than it is to give them *full* compensation. Full compensation is likely to attract many undesirable challengers and to lead to excessive expenditures. In this Subsection, we discuss why it may be more efficient to give challengers *some* compensation than it is to give them *no* compensation at all. For most of the Subsection, we present theoretical and empirical arguments why intermediate compensation is apt to lead to more efficient entry decisions than no compensation. Then we briefly discuss intermediate compensation from the perspective of spending decisions and ex ante managerial behavior.

(a) Entry Decisions by Challengers

In discussing whether full compensation is desirable, we concluded that, under full compensation, many potential challengers have strong incentives to enter even if their entry is undesirable. In this Subsection, we will make two arguments. First, as the level of reimbursement falls, it first becomes unprofitable for contestants with lower expected gains to enter a contest. As the level of reimbursement is further decreased, contestants with relatively higher expected gains will also not enter. That is, each decrease in the level of reimbursement causes contestants with higher expected gains to drop out. Second, we will argue that contestants with higher expected gains are, on average, better contestants than those with lower expected gains. Therefore, each decrease in the level of reimbursement will cause relatively better contestants to drop out.

These two relations have important implications. Decreasing the level of reimbursement from full reimbursement is initially desirable as it leads contestants with the lowest expected gains (i.e., on average, the worst contestants) not to engage in contests. But any further decrease in the reimbursement level leads contestants with ever increasing expected gains -- that is, increasingly desirable contestants -- not to enter contests. That is, as the level of reimbursement falls, the average quality of the contestants moved not to enter rises. At some point, further decreases in the level of reimbursement become undesirable since entry by the contestants moved not to enter would be desirable.

It is easy to see that higher levels of reimbursement reduce the expected gains necessary to make it profitable to enter a contest. As explained, challengers enter contests if expected gains exceed the costs of leading the contest. Any decrease in the level of reimbursement increases these costs and thus raises the threshold for entry. Thus, any marginal decrease in compensation causes challengers with marginally higher expected gains not to enter.

Assume, for example, that waging a proxy contest costs $100,000. Then, decreasing the level of reimbursement from full compensation to compensation of 80% of the expenses increases the costs of entry from almost nothing to close to $20,000. Further decreasing the level of reimbursement to 60% increases the threshold for entry to approximately $40,000. That is, the first decrease in compensation makes it unprofitable for contestants with expected gains below $20,000 to enter. The second decrease also makes it unprofitable for contestants with expected gains between $20,000 and $40,000 to enter.

We now address the reasons why challengers with higher expected gains are, on average, more desirable. Assume, as an initial matter, that all contestants derive equal private benefits from control. The expected gains of a particular contestant would then depend only on his probability of winning and on his stock appreciation gains if he wins. As we demonstrate, better challengers generally have both a higher probability of winning and derive larger stock appreciation gains than bad challengers.

Consider first the probability of winning. We argued above that,[139/] even though voting in proxy contests is subject to significant imperfections, the contestant under whom the value of the company is higher tends to have better chances of winning a contest.[140/] But if a better contestant has a higher likelihood of winning, her expected gains (both from stock appreciation and from private control benefits) tend to be larger as well. For example, assume that both good and bad challengers realize $100,000 from gaining control and that good challengers have, on average, a 30% chance of winning while bad challengers have, on average, only a 10% chance. Then, good challengers would have average expected gains of $30,000, while bad challengers would expect average gains of only $10,000.

Let us now turn to stock appreciation gains. They depend upon the per share increase in value and on the amount of stock held by the challenger. Obviously, victory by better challengers results in larger increases in company value and share price. Therefore, better contestants who win contests will experience larger stock appreciation gains per share than worse contestants who win contests. Moreover, as we will argue below, good contestants,

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139/ As we will argue below, the probability of winning will be larger for large shareholders, and large shareholders will, on average, be more desirable entrants than small ones.

140/ As private benefits do not differ, it will be socially desirable for the contestant to win under whom company value is higher.

on average, own a greater amount of shares.[141] Thus, better challengers unequivocably tend to derive larger stock appreciation gains if they win.

Up to this point, we have shown that, if private benefits are equal, better challengers, on average, have larger expected gains from initiating a contest. This relationship holds even when contestants do not derive equal private benefits from control. In fact, better challengers will have systematically higher expected gains so long as better contestants, on average, do not derive lower private benefits from control than do worse contestants.[142] The reason is that, as long as better challengers do not generally derive lower private benefits than worse challengers, both their average gains from winning the contest and their average chances of winning remain larger than those of worse challengers. But it is unlikely that better contestants systematically derive lower control benefits than worse ones. To the contrary, since social wealth is higher under better contestants, it is likely that better contestants both derive larger control benefits and generate higher company values than worse contestants.

To sum up, then, as better contestants tend to have higher expected gains from initiating contests, decreasing the level of compensation from full compensation initially causes predominantly undesirable contestants not to enter contests. But any further decreases causes fewer and fewer undesirable, and more and more desirable, challengers not to enter. At some point, further decreases in the level of reimbursement become undesirable since entry by the contestants moved not to enter would be desirable.

141/ But note that, if the contestant is inferior to the incumbent, a smaller amount of shares held will lead to "larger" stock appreciation gains in the form of small losses from a decline in stock value if the challenger wins.

142/ Even if better contestants stood to gain less in private control benefits, their expected gains might still be larger as they would tend to derive higher stock appreciation gains and have a higher probability of winning.

Nevertheless, the preceding arguments do not definitively prove that some compensation leads to preferable entry decisions than no compensation. To be sure, the challengers that would drop out after a move from next to no compensation to no compensation would be substantially superior to those that would drop out after a move from full compensation to next to full compensation. But the former challengers may still, on average, be undesirable. That is, the point at which further decreases in the level of reimbursement become undesirable may not yet be reached at no compensation. Rather, in order to reach that point, one may have to impose "negative" reimbursement -- in effect, a tax on proxy contest.

(b) Empirical Evidence on Entry Decisions by Challengers

The empirical evidence on proxy contests, though scant, supports a tentative conclusion that an intermediate level of compensation is efficient. The most significant empirical study on proxy contests concluded that the initiation of proxy contests generally leads to an increase in company value.[143/] This study, of course, measures the average effect of proxy contests initiated in the present environment (in which challengers receive substantially more than no reimbursement), and not the marginal effect of providing some reimbursement. The study includes all proxy contests initiated under the current level of reimbursement. Some of those contests would have been initiated even at zero reimbursement. Other would not have been initiated at any level of reimbursement lower than that presently provided. Nevertheless, the fact that proxy contests, at the level of reimbursement level presently provided, on average lead to an increase in company value

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143/ Dodd & Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. Fin. Econ. 401 (1983).

lends empirical support for granting at least some compensation to challengers.

Two other types of studies buttress the argument for providing reimbursement to challengers. One type has found that proxy challenges tend to be initiated in companies with low rates of return,[144] and, if successful, generally result in improved company performance.[145] The other type[146] has shown that managers, in a variety of contexts, do not act in the interest of shareholders. These studies suggest that internal control mechanisms function far from perfectly, that stock appreciation can be an important, if not dominant, motive for challengers, and that successful challenges benefit the company. In conjunction with the study on initiation of contests, these studies lead us to conclude tentatively that an intermediate level of compensation leads to more efficient entry decisions than no compensation.

(c) Spending Decisions and Ex Ante Managerial Behavior

Having tentatively concluded that an intermediate level of reimbursement will induce more efficient entry decisions than no reimbursement, we now turn briefly to the effect of an intermediate level of reimbursement on spending decisions and outcome and on ex ante managerial

144/ Duvall & Austin, Predicting the Penalty of Proxy Contests, 20 J. of Finance 464 (1965).

145/ See Austin, The Proxy Contest and Corporate Performance, 33 Fin. Exec. 20 (1965).

146/ See e.g. Jarrell & Poulsen, Dual Class Recapitalizations as Antitakeover Mechanism, 20 J. Fin. Econ. 129 (1988); Malatesta & Walkling, Poison Pill Securities, 20 J. Fin. Econ. 347 (1988); Dann & DeAngelo, Standstill Agreements, Privately Negotiated Share Repurchases and the Market For Corporate Control, 11 J. Fin. Econ. 275 (1983); Easterbrook & Jarrell, Do Targets Gain From Defeating Tender Offers?, 59 N.Y.U. L. Rev. 277 (1984) (all these studies finding that managers engage in defensive tactics that decrease company value).

behavior. Clearly, it is not efficient to give intermediate reimbursement to bad challengers. Bad challengers will spend too much even if they receive no reimbursement -- and should not be encouraged to spend even more. However, as explained, if no reimbursement is provided, most challengers are likely to be desirable. As we show, we cannot determine whether those good challengers will spend too much or too little if no reimbursement is provided. Therefore, we are unable to conclude whether, from the perspective of spending decisions and outcome, it is preferable to provide no or intermediate reimbursement.

If challengers receive no reimbursement, the costs to them of incurring additional expenditures is equal to the cost to society[147/]. As discussed in the preceding Section, if private costs equal social costs, a challenger will underspend (and more reimbursement would be efficient) if her private gains are less than social gains; but she would overspend (and more reimbursement would be undesirable) if her private gains exceed social gains. Private gains and social gains differ for two reasons. First, private control benefits to the challenger exceed *net* control benefits to society -- thereby providing an incentive to overspend. But, in the case of most good challengers, private stock appreciation gains are less than the increase in company value -- thereby providing an incentive to spend to little. Thus we cannot determine whether, on the whole, social gains are more or less than private gains and therefore whether providing intermediate rather than no compensation improves proxy contests from the perspective of spending and outcome.

147/ We assume that incumbents will not raise their expenditures in response to an increase in spending by challengers. If incumbents were to raise their expenditures, social cost would exceed private costs even under no reimbursement. For the effect thereof on the desirability of compensation, see also Section B(i).

We also cannot arrive at any firm conclusions as to whether intermediate compensation leads to more efficient ex ante managerial behavior than no compensation. The reasons are substantially the same as the ones discussed in the preceding Subsection on full reimbursement. Compared to no compensation, an intermediate level of compensation increases the threat of ouster. This, in turn can cause managers to undertake desirable improvements in performance (to enhance shareholder support), but it may also lead to undesirable myopic behavior (if shareholders mistake artificial earnings increases for a true improvements) or to wasteful defensive measures (in order to entrench management even if it lacks substantial shareholder support). On the basis of our discussion, we are not able to predict which course managers are likely to chose.

In this Subsection, we have discussed whether challengers should receive an intermediate level of reimbursement or no reimbursement. After examining both theoretical arguments and empirical studies, we have tentatively concluded that an intermediate level or reimbursement would lead to more efficient entry decisions than no reimbursement. We have not been able to arrive even at a tentative conclusion as to whether intermediate reimbursement or no reimbursement would lead to more efficient outcomes and spending decisions or to more efficient ex ante managerial behavior.

In conclusion, we note that, as long as incumbents, as they presently do, receive full reimbursement, granting no reimbursement to challengers would be highly non-neutral. As we explain in the next Section, a moderate degree of non-neutrality may be desirable. However, providing full reimbursement to incumbents and no reimbursement to challengers appears to be excessively non-neutral. Thus, if incumbents continue to receive full reimbursement, there is one more reason to provide an intermediate level of reimbursement to challengers.

(iii) Providing Intermediate Reimbursement

On the basis of the analysis in the previous two Subsections we concluded that challengers should receive less than full compensation, but probably more than no compensation. In this Subsection, we examine how this intermediate level of reimbursement should be structured. The first question we consider is whether it is desirable to make reimbursement contingent upon success. Then we briefly examine other features of the allocation rule.

With respect to the first question, our analysis below suggests that it is preferable to provide a higher level of reimbursement contingent on success than a non-contingent lower level of compensation that would, on average, yield the same total amount of compensation. We show that success-contingent reimbursement lowers the cost of entering contests and reduces a good contestant's marginal cost of expenditures more than it reduces a bad contestant's. By benefitting desirable contestants, success-contingent compensation tends to lead both to more efficient entry and to more efficient spending decisions than providing the same average level of compensation independent of success.[148/]

As we explained in Part II, under success-contingent compensation, reimbursement (and thus the contestant's expected cost) depends on the

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148/ Note also that any rules that improve the outcome of proxy contests will by themselves tend to make the incidence of contests more efficient. As we showed in Part III, it will never be desirable for the worse contestant to enter a contest. Thus, any decrease in the likelihood of victory for the worse contestant will make the incidence of proxy contests more efficient by prompting fewer bad contestants to enter. We also showed that it will often (though not always) be desirable for better contestants to enter a proxy contest. Thus, any increase in the likelihood of victory for better contestants will tend to make the incidence of proxy contests more efficient by inducing more good contestants to engage in contests.

probability of attaining success, however defined.[149] The probability of meeting the success threshold will be higher for contestants who expect to receive significant outside support or who are large shareholders themselves.[150] Thus, success-contingent compensation leads to relatively more entries and spending by contestants in these categories, and to relatively fewer entries and lower spending by contestants that are small shareholders and do not expect to receive outside support.

It is generally desirable to encourage entry and spending by contestants who are likely to receive significant outside support.[151] As we explained, contestants who raise company value have an advantage in campaigning for support of disinterested shareholders. Thus, company value under such contestants tends to be higher than under those who do not receive a large number of votes by disinterested shareholders.[152]

Encouraging large shareholders to enter and spend on proxy contests is also likely to be desirable. Since larger shareholders own a greater fraction of the shares of the company, they profit more in stock appreciation gains if the value of the company increases and suffer more stock appreciation losses

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149/ Note that unless "success" is defined as gaining control, the probability of success is different from the probability of winning.

150/ See also Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 16 (1952).

151/ See also Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 963-964 (1951) (getting substantial support is evidence of merit); Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 19 (1952) (support important factor in determining benefits of proposal).

152/ As in the case of large shareholders, shareholders who expect to receive outside support would not tend to be better contestants if their net private control benefits are significantly lower and social costs of their contest significantly higher than those of shareholders who do not expect to receive outside support. But it is highly unlikely that this would be the case. If it were, we would find ourselves in a somewhat anomalous situation in which entry by contestants who tend to win proxy contests is less desirable than entry by those who would tend to lose them.

if it falls. Thus, other things being equal, large shareholders are more likely than small shareholders to participate in a contest if company value increases, and less likely to do so[153] if company value falls under their control.

As an example, assume that *C* gains private benefits of $100,000 from taking control of *X* but that the value of *X* would drop by $500,000. If *C* owned 20% of *X's* shares, he would derive no gain from taking control: his private benefits would be eradicated by the drop in the value of his shares. But if he owned only 1% of the shares, his benefits from control would be $95,000 and he might, in the proper circumstances, initiate a contest.[154]

Success-contingent compensation then leads to more efficient entry and spending in two ways. By benefitting shareholders who expect more outside support, it encourages those whom other shareholders believe to increase company value.[155] By benefitting large shareholders, it encourages those who have a higher stake in the value of the company. Thus, there will be relatively more desirable entrants and better contestants among shareholders

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153/ Cf. Easterbrook & Fischel, Voting In Corporate Law, 26 J. of L. & Econ. 395, 413 (1983) (small shareholders more likely to lead contest because of superior ability to siphon profits).

154/ Even if company value would be generally higher under large shareholders, encouraging them to enter might not be desirable if smaller shareholders generate higher net private benefits from controls or lower social costs in waging contests. But, it is not likely that smaller shareholders derive systematically greater control benefits than larger shareholders. And, since larger shareholders bear a greater portion of the cost of proxy contests to the company, they have, if anything, greater incentives to limit their expenses than smaller shareholders. Thus, larger shareholders will, on average, be more desirable entrants and better contestants than smaller shareholders.

155/ In addition, since incumbents tend to be challenged by desirable contestants, success contingent compensation creates greater ex ante incentives to managers to improve their performance than non-contingent reimbursement. If managers improve their performance, such potential challengers will have less reason to initiate a control challenge.

who expect to receive outside supportand among large shareholders[156] than among shareholders who do not expect to receive outside support or among small shareholders.[157]

Of course, making compensation contingent on success only partially solves the issue of how to structure intermediate reimbursement. We must still determine the success threshold and whether reimbursement, if awarded. For the remainder of this Subsection, we briefly discuss whether compensation should be full or partial, once the success threshold is attained. The threshold question will be addressed in the following Subsection.

In Part II, we discussed various ways of providing partial compensation. One way to provide partial compensation is to itemize reimbursement, i.e. to compensate for certain expense items, but not for others. Differential rather than uniform treatment of expense items can, at least in theory, improve the outcome of proxy contests. For example, certain expense items might tend to provide objective information to shareholders,

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156/ As explained, neither group will tend to be associated with smaller net private benefits or larger social costs.

157/ Providing success contingent compensation might evoke some concerns as challengers might be risk averse or have financing difficulties. Neither of these concerns, though, is likely to present a major problem for good challengers. For risk averse challengers, the level of expected compensation necessary to induce them to lead a control contest would have to be higher if compensation is contingent rather than fixed. But such higher compensation could be easily achieved by reducing the threshold level of success (the question of which threshold is optimal will be discussed below in subsection (iv)) or by increasing the level of compensation given if the threshold of success is met.

Contingent compensation would also present a problem for challengers who have to rely on outside funds to finance a control contest. Since compensation of their expenses would not be assured, lenders would be more reluctant to extend credit to such challengers. However, there is no reason to believe that such problems would disproportionally affect good challengers. If anything, good challengers would be better able to obtain financing since, in a success contingent scheme, they would, on average, have a better chance of getting reimbursed.

while others might tend to confuse them or to exert undue pressure.[158] The better and more objectively shareholders are informed, the more likely they are to vote for the contestant under whom company value is higher (who will tend to be the better contestant).[159] Thus, from a social perspective, spending on informative items should be encouraged and spending on disinformative items should be discouraged.

Such a differentiation, however, depends on the ability to distinguish inherently informative from inherently disinformative expense items. In practice, drawing such a distinction is, at best, difficult and imprecise and involves substantial administrative costs. Therefore, we advocate no change in the current practice of considering all kinds of expenses, except those that are clearly improper, to be reimbursable.

We would, however, favor an upper bound on reimbursement, i.e., limiting reimbursement to a reasonable level of expenses. This reasonableness

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158/ Cf. Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 953-955 (1951); Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 214-215 (1968).

159/ Some commentators have argued that expenses for last-minute telephone calls and fees to proxy solicitors confuse rather than inform shareholders. They believe shareholders are adequately informed by mailed proxy statements. See e.g., Friedman, Expenses of Corporate Proxy Contests, 51 Col. L. Rev. 951, 953-955 (1951); Machtinger, Proxy Fight Expenditures of Insurgent Shareholders, 19 Case West. Res. L. Rev. 212, 214-215 (1968); Latcham & Emerson, Proxy Contest Expenses and Shareholder Democracy, 4 W. Res. L. Rev. 5, 11 (1952). The use of proxy solicitors has, however, become a standard feature in proxy contests, and proxy solicitors also perform functions other than personal solicitation (e.g. the preparation and mailing of the proxy statements) that these commentators regard as informative. See e.g., Graham B. Moody & Constance E. Bagley, Proxy Contests (1983), at A-13; E. Aranow & H. Einhorn, Proxy Contests for Corporate Control (1968), at 557-558. Also, since many shareholders will not read mailed communications (proxy statements are often several hundred pages long), personal proxy solicitations and telephone calls might have an important informative function. Cf. Schulman, The Cost Of Free Speech In Proxy Contests For Corporate Control, 20 Wayne L. Rev. 1, 17 (1973) (acknowledging that even visiting shareholders personally might increase shareholder information but nevertheless opposing reimbursement for such expenses). Thus, we are not convinced that telephone calls or proxy solicitations provide less valuable information than other proxy contest communications.

requirement should be more strictly construed than it presently is. An upper bound would impose some restraint even on contestants that are virtually assured of meeting the threshold of success. Thus, an upper bound would cut down on wasteful escalations of contest expenditures.

(iv) The Optimal Threshold for Success

So far, we concluded that challenger reimbursement should be success-contingent and that challengers who attain the requisite level of "success" should be reimbursed for their reasonable expenditures on all items that are not clearly improper. We now turn to the question of the optimal threshold of success. By threshold of success, we mean the percentage of votes challengers are required to receive in order to receive reimbursement.

Note that the present practice is also a form of success-contingent compensation: challengers receive compensation if they gain control of the board and can award compensation to themselves. It is, however, quite unlikely that the present practice is optimal since the difficulty of attaining the implicit success threshold -- gaining board control -- depends on whether all directors are elected in the shareholder meeting. Many corporate charters provide for staggered boards,[160/] i.e. for election of only some of the board members at each annual meeting. But if less than half of the board is up for reelection, no amount of shareholder support would give the challengers control of the board in one shareholder meeting. Thus, in companies with staggered boards, challengers face an implicitly higher threshold of success than in companies where all directors are elected at each annual meeting. This disparity between allocation rules for companies with staggered boards and those for companies without is not justified.

160/ Investor Responsibility Research Center, Antitakeover Charter Amendments (1988) (in survey, 154 of 485 companies had such provisions).

Having concluded that the allocation practices should not depend on staggered board provisions, we still face the question of the optimal success threshold. Presently, in contests in which the majority of the board is to be elected, the implicit success threshold is gaining a majority of the votes cast.

We are not able to determine with precision the optimal threshold of success and, in particular, whether for challengers winning more votes than the incumbents is too low a threshold, too high a threshold, or is indeed optimal. But note that establishing a threshold for compensation that deviates greatly from the threshold for winning the contest creates incentives to spend on contests not to affect its outcome, but merely to obtain reimbursement. Assume, for example, the success threshold is gaining 30% of the votes cast. Some challengers, as the contest progresses and they reassess whether to continue the contest, may decide to incur additional spending in order to increase the likelihood of meeting the success threshold, even if additional spending does not significantly increase the likelihood of winning. But, from the social perspective, such additional expenditures are wasted even if these challengers are good contestants. The greater the divergence among the success threshold and the winning threshold, the greater are the incentives to engage in this wasteful spending. Thus, since we have neither strong analytical arguments nor strong empirical evidence to show that winning a contest is not the optimal success threshold for compensation,[161] we tentatively advocate not changing the present rule other than by granting victorious challengers a right to reimbursement.[162]

161/ In cases where less or more than a majority of the votes cast suffices to win the contest, e.g. in approvals of mergers, we tentatively advocate the respective threshold required for winning.

162/ If it were determined that challengers should receive more compensation than they would get under this success threshold, we could either give some (continued...)

C. Assessing the Rules on Reimbursement of Incumbents

According to current practice, incumbents are generally compensated for all their expenditures in control contests.[163] The only two restrictions are that the contest must involve a question of policy and that the expenses must be reasonable. However, as explained above, reimbursement is rarely, if ever, denied because the contest was not over policy or because the expenses were excessive.[164] In this Section, we consider the consequences of this current practice.

In the preceding Section, we have considered the reimbursement scheme for challengers. We concluded that challengers should not receive full reimbursement, that their compensation should be success-contingent and subject to a strictly enforced reasonableness requirement, and that the success threshold should be based on the percentage of votes received.

The same general arguments apply to the reimbursement scheme for incumbents. That is, incumbents, like challengers, should not receive full compensation. As discussed, full compensation has two significant undesirable effects. First, as incumbents would often face virtually no costs in defending, they have few incentives to withdraw from a contest. As a result, many undesirable incumbents will chose to defend their control even when desirable challengers institute contests. Secondly, full compensation will impose too few restraints on spending. As a result, incumbents will incur excessive expenditures.

162/ (...continued)
compensation to those who do not meet the threshold or lower the threshold. Both of these options would entail certain disadvantages. Giving some compensation to losers would make the overall compensation scheme less success contingent. Lowering the threshold would, as described, encourage wasteful expenditures.

163/ See text accompanying note 125 supra.

164/ See text accompanying notes 109 to 124, supra.

Moreover, compensation of incumbents should be contingent on receiving a threshold level of success. Success contingent compensation favors incumbents that expect to receive outside support or are large shareholders themselves. Since incumbents in either of these groups tend to good contestants, success-contingent compensation leads to more efficient entry and spending decisions than providing the same average level of compensation independent of success.

Note that this analysis suggests that the current compensation practice for incumbents is significantly more flawed than the one for challengers. Incumbents presently receive full compensation automatically, while challenger compensation is already intermediate and success contingent (though gaining board control is not an efficient success threshold). Thus, we recommend major revisions in the present compensation practice for incumbents in order to make their compensation scheme more efficient.

For the remainder of this Section, we will discuss whether incumbent compensation should be more generous than challenger compensation or whether compensation rules should be neutral. We first briefly discuss the principal argument why favoring incumbents could be desirable -- incumbents may be more likely to be desirable contestants than challengers. We continue by investigating whether there are grounds for believing that incumbents are in fact more desirable contestants than challengers.

Providing incumbents with more generous compensation than challengers is likely to be desirable if incumbents are systematically more desirable contestants than challengers. If incumbents are generally better contestants than challengers, it can be efficient to give them a greater stimulus to enter the contest by providing more generous compensation[165/]. In addition, if

165/ For this to be the case, incumbents encouraged to enter by lowering the threshold of expected gains above which it is profitable to enter must, on (continued...)

incumbents who decide to enter contests are, on average, superior to their challengers, it can be efficient to provide them with greater incentives to make campaign expenditures, thereby increasing their chances of winning the contest.

On the other hand, note that, under the present proxy rules, other factors would favor incumbents even if incumbents were to receive compensation under the same neutral rules as challengers. First, as discussed in Part II, incumbents have certain institutional advantages. For instance, incumbents have greater access to corporate information and greater control over the timing of the shareholder meeting and the record date. Second, a higher average quality of incumbents should be reflected in a greater likelihood of winning. That is, if shareholder know that incumbents, on average, are more desirable than challengers, the mere fact that a contestant is an incumbent may make it more likely for shareholders to vote for that contestant. Arguably, these advantages sufficiently favor incumbents and additional advantages -- in form of more generous compensation -- are not needed[166/].

We now present two reasons why incumbents may, on average, be better than challengers and consequently why some advantages to incumbents may be warranted. We first argue that prior monitoring more effectively screens

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165/ (...continued)
average, be more desirable than challengers in that range. That is, whether more generous compensation to incumbents leads to more efficient entry decisions depends on whether incumbents in a certain range of expected gains are superior to challengers, and not on whether incumbents are generally superior to challengers.

166/ Note, however, that providing more generous compensation may be an efficient way of favoring incumbents because it can serve to target those incumbents most likely to desirable. A marginal increase in compensation to incumbents would marginally lower the amount of expected gains which make it profitable for incumbents to enter and thus cause entry by those incumbents which (compared to incumbents that withdraw) have higher expected gains. But as explained in the preceding Section, contestants with higher expected gains are likely to be more desirable. Thus, providing more generous compensation to incumbents than to challengers would cause those incumbents to enter which tend to be the better contestants.

against bad incumbents than against bad challengers. We then explain why the possibility of extortive threats would attract more bad challengers than bad incumbents.

The first reason for providing more generous compensation to incumbents is that incumbents are subject to greater internal and external monitoring than challengers. Some former bad incumbents will have been fired by their colleagues on the board of directors;[167] some will have had their companies taken over;[168] some will have been ousted in prior control contests; and, most importantly, many challengers, unlike incumbents, will have never been appointed as managers of a company.[169] Challengers, however, are not subject to the same kind of prior monitoring. While the possibility of monitoring does not mean that incumbents should never be ousted by proxy challenges,[170] the existence of prior monitoring provides a strong argument for the proposition that incumbents are, on average, better suited to manage the company than the challengers that would emerge under neutral rules.

167/ See Weisbach, Outside Directors and CEO Turnover, 20 J. Fin. Econ. 431 (1988).

168/ See Morck, Schleifer & Vishny, Management Ownership and Market Valuation, 20 J. Fin. Econ. 293 (1988).

169/ Duvall & Austin, Predicting the Penalty of Proxy Contests, 20 J. Fin. 464 (1965).

170/ Dodd & Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. Fin. Econ. 401 (1983).

Therefore, it might be efficient[171] to grant incumbents more generous reimbursement for expenses than challengers.[172]

Secondly, incumbents may, on average, be more desirable than challengers because they are, to a greater extent, vulnerable to extortion. By extortion we mean a threat by an inferior challenger to initiate a contest and thereby impose on incumbents the risk of not being fully reimbursed for his expenditures. Such extortion could lead incumbents to make inefficient settlements with bad challengers or withdraw from, rather than risk their personal wealth on, control contests. The possibility of such extortion being successful might, in turn, attract bad challengers to initiate control contests.

To be sure, challengers are subject to similar extortion by bad incumbents. That is, bad incumbents might threaten to defend a contest and thereby impose on good challengers the risk of not being fully reimbursed. However, the possibility of extortion is generally of greater concern to incumbents than to challengers. One reason is that incumbents may be less

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171/ One could, however, argue that more generous reimbursement is unnecessary because, as we explained, incumbents enjoy other advantages over challengers and because incumbents, if they are better than challengers, have a greater probability to meet the threshold of success. Whether these factors will suffice to outweigh the effects of greater monitoring will depend, among other things, on the degree to which such monitoring is effective in disciplining incumbents, on the degree to which shareholders will vote for better contestants and to which they will vote for incumbents, and on the significance of the other advantages to incumbents.

172/ For a related reason, it might be desirable to make compensation of incumbents less contingent on success. Good incumbents are more likely than good challengers to be small shareholders. Incumbents who are small shareholders are subject to a higher level of prior monitoring than incumbents who are large shareholders (since large shareholders are less likely to be fired by independent directors and their companies are less subject to takeovers). The same is not true for challengers who, whether small or large shareholders, are not subject to prior monitoring. Thus, the relationship between large shareholder and a good contestant outlined in Part III is likely to be stronger in the case of challengers than in the case of incumbents. Since the desirability of success contingency depends, in part, on the strength of this relationship, the optimal rule for incumbent compensation should be less contingent than the rule applicable to challengers.

resistant than challengers to, and therefore more inviting of, threats because they can better defray the cost of the extortion payment to the company. For instance, the company could pay challengers "greenmail" if they withdraw from the contest. By contrast, there are two factors inhibiting challengers from promising to have the company make such extortion payments. For one, a promise by challengers, as *future* directors, to have the company, say, pay greenmail, may be unenforceable since directors are not supposed by bind their business judgement[173/]. Moreover, a demand by the incumbents, as *present* directors, for, say, greenmail, may violate their fiduciary duties to the company.

A second reason why incumbents are more vulnerable to extortion is that one challenger who engages in such extortion can threaten incumbents in a large number of companies; but if one incumbent engages in such extortion, only one company (and the relative small number of potential challengers for that company) will be affected. Thus, if such extortive contestants are as

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173/ See generally Robert C. Clark, Corporate Law, at 781-784 (1986).

likely to be challengers as incumbents,[174] incumbents would be more vulnerable to extortion than challengers.[175]

Thus, there are some reasons why incumbents would be better contestants than challengers. As a result, it may be warranted to provide incumbents with more generous compensation than challengers. Note, however that as the compensation level to incumbents (but not to challengers) is increased, increasingly incumbents will enter, and spend on, proxy contests. Thus, even if incumbents are better than the challengers that emerge under

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174/ In fact, given the same reimbursement rules, it would be more likely for challengers to exercise extortion than for incumbents. For a threat to be likely to succeed, it is of crucial importance that the threat is credible, i.e. that the party making the threat will execute the threat if the other party does not give in. But very often, if the threat of leading a proxy contest fails, the costs of executing the threat (and not withdrawing from the contest) would be higher than the expected benefits from continuing with the contest. In such circumstances, the threat would not be credible and thus be likely to fail. Challengers will, on average, have an advantage in making such credible extortive threats. Even in cases where, merely considering the benefits and costs resulting from continuing the contest at hand, the threat is not credible, the threat can be made credible by investing "reputation" in it. That is, for contestants with a reputation for extortive behavior, the expected benefits from continuing with a contest would not only consist of the expected benefits of this one contest, but also of making future extortive threats more credible (and of not losing their reputation as effective extortionists). Challengers will generally have an advantage in, and greater incentives to, develop such a reputation, and thus the ability to make credible threats, since they exercise greater control over the number and kind of proxy contests they lead.

175/ Providing reimbursement to incumbents and to challengers might, however, have opposite ex ante effects on managerial behavior. Lowering reimbursement to incumbents and increasing reimbursement to challengers would result in an increased threat of being ousted. Schulman, The Cost Of Free Speech In Proxy Contests For Corporate Control, 20 Wayne L. Rev. 1, 16-17, 31 (1973)) Other things being equal, this would increase managerial incentives to enhance shareholder support. Depending on whether managers chose to improve their actual performance or manipulate shareholder perceptions of managerial performance, respectively, one might conclude that challengers should receive more reimbursement or less reimbursement, respectively, than incumbents.

But note that the ways in which increasing reimbursement to challengers and decreasing compensation to incumbents creates these incentives differ greatly. Increasing reimbursement to challengers primarily increases the risk of ouster. Decreasing reimbursement to incumbents primarily increases the risk of having to use personal funds in contests in order to preserve the private benefits of control. As explained, the latter risks creates the possibility of extortive threats.

neutral rules, non-neutral rules will screen more effectively against bad challengers than against bad incumbents. Therefore, at some point, increasing the degree to which incumbents are favored will no longer be efficient. In particular, it is not desirable to provide so much more compensation to incumbents than to challengers that incumbents receive full compensation. As we pointed out, since full compensation provides hardly any incentives to withdraw or limit expenses, it has significant undesirable effects on entry in, and spending on, proxy contests.

Our analysis, then, supports allocation rules for incumbents that provide less than full compensation and are success contingent. It may, however, be justified to provide incumbents with more generous compensation than challengers. The present system, by providing full compensation (subject to an ineffective reasonableness standard) independent of success, does not meet these criteria. Instead, we propose that full reimbursement (subject to a more strictly construed reasonableness requirement) be made contingent upon the incumbents' surpassing a threshold of support from the shareholders. This threshold might be lower than the threshold for challengers. In addition one could give some, but not full, reimbursement to incumbents that fall short of this threshold.[176]

V. ISSUE CONTESTS

So far, this analysis has focused on proxy contests for the election of directors. Even though proxy contests can be waged over any issue on which shareholders vote, historically almost no other contests have been fought. However, starting in the 1980s, an increasing number of proxy contests have

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176/ But, see, Easterbrook & Fischel, Voting In Corporate Law, 26 J. of L. & Econ. 395, 413 (1983) (if incumbents may not use corporate funds, they will not spend enough on proxy contests because they would incur expenses disproportionate to their shareholdings). Easterbrook and Fischel apparently believe that directors never make expenditures for private benefits.

been waged over issues other than director elections.[177] For example, issue contests have involved charter amendments,[178] merger agreements,[179] acquisitions of other companies,[180] liquidation plans,[181] stock repurchases,[182] reincorporations into other states,[183] recapitalization plans;[184] shareholder resolutions,[185] and executive compensation schemes.[186]

In this Part, we analyze cost allocation rules in issue contests. After briefly restating the current rules, we will consider whether the rules

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177/ Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 8-15 (up to 1980s, almost all proxy contests were about election of directors).

178/ See, e.g., Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 57-59 (describing 1985 contest over Alexander & Baldwin, Inc.). See, generally Brickley, Lease & Smith, Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267 (1988); Pound, Shareholder Activism and Share Value, Discussion Paper 169D, Kennedy School of Government (1988).

179/ See, e.g., Proxy Statement, PC Shareholders' Committee, Penn Central Special Meeting of Shareholders, October 29, 1981.

180/ See, e.g., Florida National Bank of Florida, Inc., Proxy Statement for the Special Meeting of Shareholders Called for December 17, 1981.

181/ See, e.g., Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 71-73 (describing 1984 contest over City Investing Co. involving a management proposed liquidation plan).

182/ See, e.g., Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 63-66 (describing 1984 contest over Beverly Hills Saving & Loan Assn. involving, among other issues, an agreement to repurchase shares).

183/ See, e.g., Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 67-68 (describing 1984 contest over Carter Hawley Hale Stores Inc. involving, among other issues, a reincorporation into Delaware).

184/ See, e.g., Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 132-136 (describing 1985 contest over Phillips Petroleum Co.).

185/ See, e.g., Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 143-145 (describing 1985 contest over Rorer Group in which shareholders proposed repeal of poison pill).

186/ See, e.g., Ronald E. Schrager, Corporate Conflicts: Proxy Fights In the 1980s (1986) at 89-93 (describing 1985 contest over Fortune Financial Group Inc. in which shareholders, among others things, attacked a bonus plan).

in issue contests should differ from the rules in control contests. In light of our conclusions, we will then evaluate, and recommend significant changes to, the current rules. Throughout the Part, our focus will be on the allocation of challengers' expenses.[187]

The current rules are implicitly less favorable to challengers in issue contests than in control contests. Challengers receive the compensation awarded to them by the board of directors. In control contests victorious challengers gain control over, or at least some representation on, the board of directors. Thus, they can either grant reimbursement to themselves or they at least obtain some bargaining power. But in issue contests, challengers never gain any representation on the board. To receive reimbursement, they depend on the mercy of a generally hostile board. Unsurprisingly, in issue contests, even victorious challengers are often not compensated.[188]

There are, however, two reasons why challengers in issue contests should receive more, rather than less, compensation than in control contests. First, in issue contests, takeovers are a significantly less effective alternative to proxy contests than in control contests. Therefore, it is more important that proxy contests be a viable option for challengers. Second, in issue contests, challengers will generally both advocate better proposals and be more dependent on reimbursement.

Two factors make takeovers a less adequate alternative to issue contests than to control contests. For one, successful takeovers, like control contests, generally result in a shift in control from incumbents to challengers. But in issue contests, challengers might generally be content

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187/ Incumbents, in these contests, are compensated for all their expenses. As in election contests, we recommend that compensation of incumbents be made contingent on some threshold of success since success contingent compensation will tend to encourage incumbents to advocate better proposals. See Section III(A).

188/ *See*, *e.g.*, *Grodetsky*, supra note 102.

with the incumbents' management. Rather than seeking control for themselves, they might just oppose a particular management proposal. For example, shareholders might oppose adoption of an anti-takeover charter amendment, but they might not want to displace the incumbents. In these cases, a takeover would not be an effective way to attain the limited objectives of the issue contest.

Moreover, the nature of the issue contest might make a takeover harder to stage. Take, for instance, contests over antitakeover charter amendments or proposed mergers. As shareholders frequently learn about the proposed amendment or transaction only a short time before the scheduled vote,[189] it would be difficult to attempt a takeover beforehand. But after an antitakeover amendment is adopted or a merger is consummated, a takeover might have become more difficult to stage and the objectable transaction might have become difficult to reverse. In such cases, takeovers will often not be an effective option. Thus, it is more important to maintain issue contests as viable alternatives.

The second ground for treating challengers in issue contests more generously than in control contests is rooted in the fact that (with some exceptions to be discussed below) challengers in issue contests gain neither control nor the private benefits that come with control. The fact that challengers derive no private benefits of control has two implications. For one, challengers will tend to initiate issue contests only if they believe that doing so increases the value of their stock. Therefore, issue contests

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189/ See, e.g., Gen. Corp. L. of Del., Sec. 222(b) (notice of meeting may be given as little as 10 days in advance); Proxy Statement, PC Shareholders' Committee, Penn Central Special Meeting of Shareholders, October 29, 1981 (proxy materials calling for special meeting on October 29, 1981 mailed on September 28, 1981).

will tend to involve desirable challenges.[190] Moreover, the expected gains to challengers in issue contests will tend to be lower than to challengers in control contests since one source of gains -- private benefits -- is generally absent.[191] Therefore, challengers will have lower incentives to initiate issue contests. Both of these effects make it desirable for challengers to receive more generous reimbursement in issue contests: since the proposals advocated by challengers tend to increase company value, having challengers enter is desirable; and since challengers have lower expected gains, more compensation is needed to induce such challenges.

As we have seen, reimbursement for challengers in issue contests, rather than being more generous than in control contests, is less generous. We therefore propose that challengers who lead issue contests receive reimbursement at least according to the same de facto standards as challengers who lead control contests.[192] Preferably, however, reimbursement to challengers in issue contests should be contingent on a lower threshold of success than in control contests or should provide for more generous reimbursement if the threshold of success is not met.

There is, however, one category of issue contests in which challengers may well derive private control benefits: takeover issue contests. In takeover issue contests, the contest is often waged by a raider as part of a

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190/ Cf. Yoran, Restraints on Incumbent Directors in Intracorporate Battles for Control, 7 U. Rich. L. Rev. 431, 470 (1973) (proxy contests about corporate transactions only involve questions of policy; control contests involve questions of policy and control).

191/ Due to the absence of private benefits, expected gains to challengers in issue contests are lower than to challengers in control contests. The absence of private benefits does not mean that expected gains to society are lower. From society's perspective, there are private benefits: those of the incumbents. Issue contests merely differ from control contests in that the challengers do not seek to obtain private benefits.

192/ See also Yoran, Restraints on Incumbent Directors in Intracorporate Battles for Control, 7 U. Rich. L. Rev. 431, 470 (1973) (criticizes different standards for contests involving election of directors and other contests).

hostile takeover, e.g. to block an anti-takeover charter amendment or a defensive merger with a white knight. Success in such an issue contest increases the chances of success in the takeover bid and thus creates the potential for private benefits from control.[193] Since in takeover contests the raider aims at obtaining control, challengers should be reimbursed according to the same standards as in control contests.

VI. SHOULD PROXY RULES BE MANDATORY?

In our discussion so far, we have analyzed, and tried to identify, the efficient design of proxy rules in general and cost allocation rules in particular. These proxy rules should at least be instituted as "default" rules: i.e., they should apply to all corporations that do not, in their charter, provide for a different set of rules. In this Part, we discuss to what extent to which companies would elect to opt out of socially desirable proxy rules and, consequently, to what extent standard proxy rules should be made mandatory[194]. We conclude that companies would, if they were free to opt out of proxy rules, adopt rules that are more favorable to incumbents, and

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193/ Such control would, however, be attained only by ultimate success in the takeover.

194/ The question to what extent corporate rules should be mandatory has lately become the subject of debate among corporate scholars. For an overview of the debate, see Bebchuk, The Debate on Contractual Freedom in Corporate Law, 89 Colum. L. Rev. 1395 (1989). Recent contributions to the debate include Bratton, The 'Nexus of Contracts' Corporation: A Critical Appraisal, 74 Cornell L. Rev. 245 (1989); Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harv. L. Rev. 1820 (1989); Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract 85 Colum. L. Rev. 1403 (1985); Clark, Contracts, Elites, and Traditions in the Making of Corporate Law, 89 Colum. L. Rev. 1703 (1989); Coffee, No Exist? Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies, 53 Brooklyn L. Rev. 919 (1988); Coffee, The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. 1618 (1989); Easterbrook & Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416 (1989); Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461 (1989); and Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549 (1989).

less favorable to challengers, than the efficient rules. Therefore, companies should be free to adopt rules that, compared to the standard proxy rules, favor challengers and disfavor incumbents. But companies should be constrained in adopting proxy rules that favor incumbents over challengers.

Assume, for the moment, that a company has complete freedom in designing the corporate rules by which it is governed. Further assume that two other conditions are met. First, all parties to the corporate contract have perfect information about all the effects of such rules. Second, such rules do not generate any externalities, i.e. they do not affect any party which does not participate in the formation of the corporate contract. Under these conditions, companies would tend to adopt the rules that maximize social wealth. Under perfect information, companies would wish to adopt the rules that maximize the value captured by the parties that participate in the formation of the corporate contract. And if no other party is affected by the rules, these rules will also maximize social wealth. However, if corporate rules generate externalities, or parties do not possess perfect information, the privately adopted rules may deviate from the efficient ones.

We therefore turn to exploring, in the context of proxy rules, how either the presence of externalities or the lack of perfect information can cause companies to adopt inefficient rules. We first examine the effect of externalities assuming that companies possess perfect information and adopt proxy rules that maximize the value captured by the parties to the corporate contract[195]. Then, we consider how a lack of perfect information can cause inefficient proxy rules to be adopted.

195/ In discussing externalities, we limit ourselves to externalities that are of particular significance to proxy rules. For a discussion of some externalities that affect corporation law in more general ways, see Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549 (1989).

A. Externalities

The argument how externalities can cause inefficiency is straightforward. Rational and perfectly informed parties forming a corporation would wish to adopt the set of rules that maximizes the value they capture. However, the terms on which these parties would agree will fail to take account of the effects on parties that do not participate in the formation of the corporate contract. As a result, the privately adopted rules, while value maximizing to the parties forming the corporate contract, would tend to be inefficient.

This general reasoning on how externalities can lead to inefficient rules is undisputed. Even commentators that generally believe in the optimality of private market arrangements have recognized that the existence of significant externalities can justify mandatory corporate rules[196/]. It is therefore important to recognize that proxy rules generate substantial externalities.

As discussed, proxy rules principally affect three groups: shareholders, incumbents and challengers. However, only shareholders and incumbents are represented at the formation of the corporate contract[197/]. Thus, the value of the corporation to the parties to the corporate contract

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196/ Easterbrook & Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1436-1442 (1989).

197/ To be sure, the shareholders and incumbents at the time of the proxy contest are not necessarily identical with the shareholders and incumbents that designed the corporate contract. However, the former have a contractual relationship with the latter; e.g. the shareholders at the time of a contest may have bought their shares from those initial shareholders and the incumbents at the time of the contest may have been hired by the initial incumbents. Since the initial shareholders and incumbents have an interest in selling their shares at the highest price, they will, under perfect information, take full account of the interests of subsequent shareholders. Similarly, to the extent to which subsequent incumbents "pay" the initial incumbents or the initial shareholders for their control benefits (e.g. by consulting agreements with the initial incumbents or by a lower salary), their interests will be taken account of by the parties to the corporate contract.

differs from the value to society. The value to society includes the company value accruing to shareholders, the private control benefits to incumbents *and* the private control benefits to challengers. But the value that the parties to the corporate contract would try to maximize consists only of company value and control benefits to incumbents[198/].

Since control benefits to challengers are not taken account of[199/], the proxy rules which incumbents and shareholders would contract for would tend to be inefficient. In particular, these rules will be less favorable to challengers, and more favorable to incumbents, that the efficient rules. That is, the presence of externalities would cause companies, if permitted, to opt out of the standard proxy rules even if the standard rules maximize social wealth.

Note the parallel of this argument to one made in the context of hostile takeovers[200/]. In designing the rules on hostile takeovers, shareholders will wish to maximize the value accruing to themselves, without taking account of the value accruing to the hostile raider. Therefore, the takeover rules that are value maximizing to shareholders of the target company will be more pro-target than the socially efficient takeover rules[201/].

198/ Cf. Easterbrook & Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1436-1442 (1989) (private optimal corporate contract may be inefficient because it does not provide sufficient benefits to hostile raider).

199/ This does not mean that shareholders and incumbents would agree on proxy rules that would assure that incumbents always win. Shareholders have an interest in allowing for the possibility of successful proxy contests because, as a result of such contests, company value to shareholders may increase and because the threat of a contest may provide desirable ex ante incentives on managers to maximize company value.

200/ See, Grossman & Hart, Takeover Bids, the Free Rider Problem, and the Theory Of the Corporation, 11 Bell J. of Econ. 42 (1980).

201/ Such arguments have lead commentators who are usually strong believers in the efficiency of private arrangements to advocate legal limits on the ability of companies to resist takeovers. Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stanford L. Rev. 1 (1982) (advocating legal
(continued...)

B. Imperfect Information

Even absent externalities, imperfect information could cause companies to opt out of efficient rules. If the parties to the corporate contract are not fully informed, they may inadvertently fail to adopt the rules that maximize their joint wealth. More importantly, if one party is better informed than the other one, they may agree on rules that inefficiently favor the better informed party.[202/] The reason is that the other party, being less well informed, would not adequately resist such rule (e.g., by demanding other concessions)[203/].

In the context of proxy rules, informational advantages would tend to be on the side of the incumbents. Consider first the case of a privately held company that goes public with the previous owner staying on as manager and that has to design its initial charter. The owner/incumbent who offers stock to the public would have strong incentives to analyze the impact of proxy rules in the charter on her control benefits. But a buyers of shares may

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201/ (...continued)
prohibition against auctions); Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981) (advocating legal prohibition of defensive tactics in general).

202/ See Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 The Quarterly Journal of Economics 488 (1970) (lesser-informed buyers will base price offers on experted average product quality thereby reducing incentives to better-informed sellers to offer high quality products).

203/ By adequately resist, we mean that the lesser informed party would undervalue the differential between the efficient rule and the rule inefficiently favoring the better informed party. This does not mean that the corporate contract on the whole is necessarily advantageous to the better informed party. If the lesser informed party knows that the other party possesses superior information, and is likely to exploit such information, it would tend to assume that any rule proposed by the other party is unfavorable and "price" it accordingly. That is, the better informed party may very well pay the price for the (inefficiently) advantageous rule. But it would nevertheless propose such a rule since the price for the efficient rule would not be sufficiently lower (as the lesser informed party would not know that it is the efficient rule).

rationally elect not to assess fully the effects of the proxy rules since its impact on the value of shares she plans to purchase is small. As a result, it may profitable for incumbents to establish, in the initial charter, proxy rules which are more favorable to them than the efficient proxy rules[204/].

Note, however, that in the context of an initial public offering, companies will have an incentive to adopt efficient proxy rules *if* the stock market is efficient, even if individual shareholders do not possess perfect information. In an efficient stock market, stock prices accurately reflect the value of the company. The owner of the company who goes public will try to maximize her private control benefits as incumbent, the value of the shares she retains, as well as the price she receives for the shares she sells. Thus, if shares are accurately priced, she would by establishing inefficient proxy rules lose more from a lower value of the stock she retains and a lower price of the stock she sells than she would gain from higher control benefits.

Now consider the case in which incumbents in publicly held companies propose charter amendments to opt out of proxy rules[205/]. Incentives to individual shareholder to become informed on the effect of proposed amendments are even less than the incentives to become informed when purchasing stock. In addition to the fact that the impact of the amendment on the share value to an individual owner is small, individual owners will also consider it unlikely that their voting decision will determine whether the proposed amendment

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204/ For articles arguing, in a more general corporate context, that imperfect information justifies limits on opting out, see, e.g., Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract 85 Colum. L. Rev. 1403, 1411-1427 (1985); Clark, Contracts, Elites, and Traditions in the Making if Corporate Law, 89 Colum. L. Rev. 1703, 1718-1719 (1990); Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461, 1516-1518 (1989); and Coffee, The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. 1618, 1676-1677 (1989).

205/ See Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harvard Law Rev. 1820, 1836-39 (1989).

passes or not. Incumbents, however, continue to have strong incentives to identify, and propose, charter amendments that would increase their private control benefits. Therefore, incumbents may periodically succeed in passing amendments to proxy rules which, while they increase private control benefits, decrease company value.

Moreover, even if the stock market is efficient and stock prices accurately reflect company value, shareholders would not be sufficiently protected against inefficient amendments. Unlike owners about to go public, incumbents who propose amendments will generally own only a small fraction of the shares of the company. Therefore, such incumbents would not greatly suffer from a decline in stock prices as a result of an inefficient amendment -- but they would benefit from an increase in private control benefits. Thus, even if imperfect information does not justify limits on opting out of proxy rules in initial charters, it may very well justify limits on opt-out charter amendments[206/].

C. The Desirable Approach to Opt-outs

Note, in particular, that both the externalities and the sources of imperfect information we identified would cause companies to adopt rules which, compared with efficient rules, favor incumbents and disfavor challengers. As challengers are absent at the formation of the corporate contract, their potential control benefits will be not sufficiently taken account of. Similarly, informational asymmetries favoring incumbents would tend to cause proxy rules adopted by companies to be more favorable to incumbents than the efficient proxy rules.

206/ Commentators disfavoring limits on opting-out have so far not provided a full and adequate answer to opt-out charter amendments. Cf. Easterbrook & Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1442-1444 (1989).

In light of these considerations, we recommend that companies have complete freedom to adopt rules which favor challengers and disfavor incumbents more than the standard proxy rules. As we noted, companies will only be inclined to depart from the efficient rules to discriminate against challengers and in favor of incumbents. Thus, if a company wanted to change the standard proxy rules in a way which is more favorable to challengers, and less favorable to incumbents, than the standard rules, it is highly likely that such a change is desirable.

On the other hand, we recommend restrictions on the ability of companies to institute rules which favor incumbents over challengers. As discussed, companies are subject to substantial incentives to adopt rules that are inefficiently favorable to incumbents and unfavorable to challengers. Therefore, the freedom of corporations to change the standard proxy rules in such a manner should be limited[207/].

VII. CONCLUSION

This article has put forward a framework for analyzing legal policy towards proxy contests. We have applied this framework to evaluate the rules governing the reimbursement by the corporation of the costs incurred by incumbents and challengers. The general framework that we have developed, however, can be used to analyze any other aspect of the law governing proxy contests.

Proxy contests for control, on which much of our analysis has focused, are the only alternative to hostile takeovers for gaining control against the will of the incumbent directors. As we have shown, control contests avoid

207/ Factors to be considered to determining the degree of the restrictions to adopt rules favoring incumbents over challengers include the degree to which the proxy rules that would be privately adopted deviate from the efficient rules and the ability of regulators to identify efficient proxy rules.

certain disadvantages associated with hostile takeovers: the transaction costs of shifting ownership, the free rider problem, and the pressure to tender problem. But control contests involve other problems: shareholders commonly lack adequate incentives to become fully informed and cast an educated vote, and challengers often lack adequate incentives to initiate contests and expend resources on them. These problems, however, are in part a function of the legal policy toward proxy contests. In particular, these problems are affected by cost allocation rules, i.e., the rules governing the extent to which contestants' expenses are reimbursed by the company.

To provide an analytical framework, we have identified and analyzed the three major effects of proxy contest rules in general and cost allocation rules in particular. First, proxy rules have an impact on contestants' entry decisions and thus on the resulting incidence of contests. Second, proxy rules affect the amount of expenditures and in turn the contestants' chances of success. Third, proxy contest rules affect *ex ante* managerial behavior. All these effects, which we have described in detail, must be taken into account in designing proxy contest rules.

Applying our general framework to cost allocation rules, we have reached the following conclusions. First, incumbents should not, as they presently do, receive full compensation. Full compensation causes incumbents not to withdraw even when faced with desirable challengers and leads to excessive expenditures.

Second, success-contingent rules are desirable, and we thus favor this feature of the existing rule on challengers' reimbursement. The rule, however, should be modified by making reimbursement contingent on the percentage of votes received (rather than on gaining control of the board), thus making it independent of whether all the directors are up for re-election. Furthermore, the rule on incumbents' compensation, which is not success-contingent under existing law, should be made success-contingent as well.

Finally, turning to issue contests, we concluded that in such contests challengers should receive more generous reimbursement than in control contests: first, because hostile takeovers are a less available alternative to such contests, and second, because challengers generally derive no private control benefits from such contests. Thus, existing law, which provides challengers in issue contests with no reimbursement whatsoever is greatly flawed.

We have also shown that some restrictions on the ability of companies to opt out of proxy rules are warranted. Due to externalities and informational imperfections, companies are likely to adopt proxy arrangements that are more favorable to incumbents and less favorable to challengers than the socially optimal arrangements. Therefore, while we recommend that companies have a complete freedom to adopt proxy rules favoring challengers over incumbents, we advocate restrictions on the ability to adopt rules which, compared to the standard rules, favor incumbents over challengers.