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Peter V. Letsou
George Mason University

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SHAREHOLDER VOICE AND THE MARKET FOR CORPORATE CONTROL

PETER V. LETSOU*

The standard form for publicly held corporations provides shareholders with very limited powers. Shareholders can elect and remove directors,[1] vote to amend, adopt, or repeal bylaws,[2] and exercise a veto power over fundamental corporate changes proposed by the corporation's board of directors, such as charter amendments,[3] mergers and consolidations,[4] sales of substantially all the corporation's assets,[5] and liquidations.[6] As a general rule, however, the standard form does not permit shareholders to control corporate business decisions.[7] In fact, shareholder efforts to alter the standard corporate form in order to provide themselves with a greater voice in the management of a corporation's business have sometimes been invalidated by the courts.[8]

Standard economic explanations for rules limiting shareholder power to control corporate business decisions[9] focus on the economic function of the corporate form and the collective action problems which arise when each shareholder owns only a small fraction of a corporation's stock. Dean Manne suggested in an early work[10] that limitations on the power of shareholders to control corporate business decisions should not

* Assistant Professor of Law, George Mason University; B.A., Harvard University, 1983; J.D., University of Chicago, 1986. I wish to thank Barry E. Adler, Jeffrey N. Gordon, Daniel Keating, Robert Rasmussen, Larry E. Ribstein, and participants at a faculty workshop at George Mason University School of Law for their helpful comments on earlier drafts of this Article. Financial support from the Sarah Scaife Foundation and the John M. Olin Foundation is gratefully acknowledged.

1. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141, 211, 214, 216 (1990).
2. *See, e.g.*, DEL. CODE ANN. tit. 8, § 109(a) (1990).
3. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(c) (1990).
4. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c) (1990).
5. *See, e.g.*, DEL. CODE ANN. tit. 8, § 271(a) (1990).
6. *See, e.g.*, DEL. CODE ANN. tit. 8, § 275(b) (1990).
7. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1990).
8. *See, e.g.*, Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 77 N.E.2d 633 (N.Y. 1948) (agreement divesting directors of the power to run the corporation held invalid).
9. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1990) (delegating authority to make business decisions to the corporation's board of directors).
10. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967).

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be surprising because the public corporation is designed primarily to facilitate specialization of the tasks of owning and managing.[11] More recent scholarship by Judge Easterbrook and Professor Fischel takes a slightly different view of rules that limit shareholders from exercising voting control over business matters.[12] Starting with the proposition that contracting costs make it impossible for shareholders and managers to write contracts covering all contingencies that might arise during a corporation's life,[13] Easterbrook and Fischel contend that voting provides a mechanism by which shareholders can fill gaps in their contract with the managers of the corporation.[14] Given this function of shareholder voting, there is no *a priori* reason why shareholders would not want to retain the right to make business decisions for the firm; however, Easterbrook and Fischel conclude that, because voting is expensive, shareholders might rationally delegate their right to control such decisions to elected directors.

Recently, however, both the rules that limit shareholder control over corporate business decisions and the theoretical justifications that underlie those rules have come under fire. For example, many are now calling for reforms that would give shareholders greater opportunities to participate in the process of setting executive pay.[15] And these calls for reform have struck a responsive chord in the United States Congress, where Senator Carl Levin is sponsoring the 1991 Corporate Pay Responsibility Act,[16] and at the Securities and Exchange Commission, where Commission Chairman Richard Breeden recently announced proposed rules requiring public corporations to give shareholders the right to vote on advisory proposals dealing with executive compensation.[17]

At the same time, several commentators have challenged the traditional justifications for limitations on shareholder voice. Professor Black

11. *Id.* at 261; *see also* Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 383 (1983).

12. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 401-03 (1983).

13. For a discussion of the costs involved in writing detailed contracts, see Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

14. Easterbrook & Fischel, *supra* note 12, at 401-02.

15. *See, e.g.*, Steve Lohr, *Recession Puts a Harsh Spotlight on Hefty Pay of Top Executives*, N.Y. TIMES, Jan. 20, 1992, at A1.

16. S. 1198, 102d Cong., 1st Sess. (1991).

17. *See Breeden Announces SEC Initiative on Executive Compensation Issues*, 24 Sec. Reg. & L. Rep. (BNA) No. 8, at 223 (Feb. 21, 1992).

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has argued that traditional law and economics scholarship underestimates the potential benefits of shareholder activism because that scholarship "assumes a stylized model of the large public corporation as having thousands of shareholders, each owning a tiny fraction of its shares."[18] And Professor Gordon has gone one step further, suggesting that traditional justifications for rules limiting shareholder voice show only that shareholders could ordinarily be expected to delegate most business decisions to management, but fail to show why shareholders would not retain a concurrent (albeit infrequently exercised) power to control corporate business decisions.[19]

Given these developments, the time seems ripe for a fresh look at standard corporate law rules that limit shareholder control over business decisions. This article undertakes that task, concluding that rules limiting shareholder power to direct corporate business decisions do increase shareholder wealth in some firms. However, this article contends that existing economic theories fail to provide an adequate basis for rules restricting shareholder voice. In place of existing explanations, this article offers a new theory: that rules limiting shareholder power to control corporate business decisions must ultimately rest upon the previously unexplored link between rules limiting shareholder voice in management, on the one hand, and the efficient operation of the market for corporate control and organized securities exchanges, on the other.

Part I examines in greater detail the role of shareholders in public corporations. In particular, Part I explores the power of shareholders to influence, both directly and indirectly, the business affairs of the corporation. Although Part I focuses on state law, federal law—especially the Securities and Exchange Commission's interpretation of its shareholder proposal rule—is also analyzed.

18. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567 (1990). Recent studies on ownership concentration appear to confirm Professor Black's observation that the collective action problems associated with shareholder activism may not be as great as once thought. *See* Carolyn K. Brancato, *The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project* (unpublished paper presented at the Conference on the Fiduciary Responsibilities of Institutional Investors, June 14, 1990); *see also* Demsetz, *supra* note 11, at 387-90 (study showing that about 50% of large corporations fall into owner-controlled category); Melvin A. Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 6 (1969) ("[S]tockholdings are much more highly concentrated, and shareholders much more likely to expect to participate in important corporate decisions, than is commonly assumed.").

19. Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991).

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Part II critiques existing explanations for rules that limit shareholder power over business decisions. Part II explores in more detail the standard economic explanations for rules that limit shareholder power. In addition, Part II considers Professor Gordon's recent explanation of the limitation on shareholder control over business decisions[20] which focuses on the potential pathologies in shareholder voting that greater shareholder power would create.

Part III presents an alternative explanation for the limitations on shareholder power to control business decisions based upon the link between shareholder voice in management, on the one hand, and the efficient operation of the market for corporate control and organized securities exchanges, on the other. Part III contends that rules limiting shareholder control over business decisions increase shareholder wealth in some firms by facilitating the efficient operation of organized securities markets and the market for corporate control. Specifically, Part III argues, first, that rules limiting shareholder voice in management both reduce transaction costs incurred in connection with control transactions and decrease the premium that bidders must pay to acquire control, thereby facilitating the efficient operation of the market for corporate control; and second, that rules limiting shareholder voice allow market prices to impound additional information about firm value, thereby facilitating the efficient operation of organized securities exchanges.[21]

Finally, this article discusses the connection between the article's main conclusion regarding the economic justification for rules that limit shareholder voice and the current debate regarding the appropriate role for institutional investors in corporate governance.[22] The concluding com-

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20. *See id.*

21. In many respects, the justification for rules limiting shareholder voice presented in Part III is similar to the justification for the doctrine of limited liability offered by Judge Easterbrook and Professor Fischel in *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

22. In contrast to their counterparts in Japan and Germany, institutional investors in the United States have played a relatively passive role in corporate governance. *See* Louis Lowenstein & Ira M. Millstein, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad?*, 1988 COLUM. BUS. L. REV. 739. Mark Roe has argued that the passivity of institutional investors in the United States results from legal rules that prevent certain types of institutions from holding sufficiently large stakes in firms to make institutional activism economically feasible. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); *see also* Black, *supra* note 18. The recognition that institutional shareholder passivity is not inevitable, combined with evidence suggesting that public corporations have high levels of institutional ownership, see Brancato, *supra* note 18, has led a number of commentators to consider the benefits and limitations of institutional shareholder activism. *See, e.g.*, BERNARD S. BLACK, AGENTS WATCHING AGENTS: THE PROMISE AND LIMITS OF SHAREHOLDER VOICE (The Center for Law and Economic

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ments suggest that changes to corporation laws designed to facilitate monitoring of corporate managers by increasing shareholder influence over business decisions should only be undertaken with caution. Although such changes may increase the effectiveness of shareholder monitoring of managers, this analysis suggests that such changes may inadvertently decrease the effectiveness of a more important mechanism for controlling corporate managers—the market for corporate control.

I. THE ROLE OF THE SHAREHOLDER IN CORPORATE DECISIONMAKING

A. Shareholder Power to Direct Corporate Action

The starting point for an analysis of the shareholders' role in corporate decisionmaking is state corporation law. All state corporation statutes have roughly the same form. A board of directors elected by the shareholders is given authority to manage the business and affairs of the corporation,[23] and shareholders are given the power to attend shareholders meetings and to vote on proper business matters brought before those meetings.[24] However, state corporation statutes provide only limited guidance on the question of what constitutes "proper business" for a shareholders meeting. Not surprisingly, this question has been subject to substantial debate.[25]

Studies, Columbia University Working Paper No.52, Oct. 1991); John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (1990); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991). While most view an increased role for institutions in corporate governance as a positive development, some commentators remain skeptical. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

23. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1990).

24. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 211, 212 (1990).

25. Most of this debate has occurred in connection with the Securities and Exchange Commission's nearly 50 year effort to define a "proper subject for shareholder action" for purposes of its shareholder proposal rule. *See, e.g.*, David C. Bayne, *The Basic Rationale of Proper Subject*, 34 U. DET. L.J. 575 (1957); Thomas M. Clusserath, *The Amended Stockholder Proposal Rule: A Decade Later*, 40 NOTRE DAME LAW. 13 (1964); Frank D. Emerson & Franklin C. Latcham, *The SEC Proxy Proposal Rule: The Corporate Gadfly*, 19 U. CHI. L. REV. 807 (1952); John G. Ledes, *A Review of Proper Subject Under the Proxy Rules*, 34 U. DET. L.J. 520 (1957); Henry G. Manne, *Shareholder Social Proposals Viewed by an Opponent*, 24 STAN. L. REV. 481 (1972); Note, *Proxy Rule 14a-8: Omission of Shareholder Proposals*, 84 HARV. L. REV. 700 (1971); Note, *Liberalizing SEC Rule 14a-8 Through the Use of Advisory Proposals*, 80 YALE L.J. 845 (1971). *See generally*

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Despite confusion over what constitutes a proper subject for shareholder action at a shareholders meeting, controlling principles can be derived from state corporation statutes and the cases and administrative rulings interpreting those statutes. Most importantly, the applicable statutes, cases, and rulings clearly demonstrate that shareholders *lack* power to direct the corporation's managers to make specific business decisions.[26] For example, even assuming that shareholders owning a majority of the corporation's shares agree to oppose the position of management,[27] the shareholders cannot direct the corporation to remove

Eisenberg, *supra* note 18. The Securities and Exchange Commission's shareholder proposal rule is codified at 17 C.F.R. § 240.14a-8 (1991).

26. *See* Continental Sec. Co. v. Belmont, 99 N.E. 138, 141 (N.Y. 1912); *see also* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 188, at 491 (3d ed. 1983); Eisenberg, *supra* note 18, at 5.

27. Recent studies suggest that convincing shareholders who own a majority of the corporation's shares to oppose the position of management is not an easy task. This is true even for shareholders owning sufficiently large stakes in the firm to convince the firm's other shareholders that they are motivated by a desire to increase the profitability of the firm, rather than by a desire to benefit themselves at the firm's expense. These studies suggest that shareholders opposing management face an uphill battle because of the inherent advantages of management in proxy contests. *See* John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237 (1988) (presenting evidence that laws governing proxy solicitation give management a differential vote-getting advantage, that conflicts of interest lead institutional investors to vote with management even when doing so is contrary to their fiduciary interests, and that dissident shareholders are regarded with suspicion by other shareholders); *see also* James A. Brickley et al., *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267 (1988) (presenting evidence that institutional investors that derive benefits from lines of business under management control are more likely to support management than institutions that are less subject to management influence); *cf.* Black, *supra* note 18, at 530-66 (surveying legal barriers to shareholder action). In light of the advantages enjoyed by management in proxy contests, some have urged the Securities and Exchange Commission (the "Commission" or "SEC") to revise its proxy rules so that dissident shareholders can compete with management on a level playing field. *See, e.g.*, Letter from Ralph V. Whitworth, Director, United Shareholders Association, to Johnathan G. Katz, Secretary, Securities and Exchange Commission (Mar. 20, 1990) (SEC File No. S7-22-91) (calling on SEC to reform its proxy rules to, among other things, require confidential proxy voting, increase shareholder access to the corporation's proxy machinery, and reduce existing barriers to communication among shareholders); Letter from Richard H. Koppes, General Counsel, California Public Employees' Retirement System, to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission (Nov. 3, 1989) (SEC File No. S7-22-91). In response to these calls for reform, the Commission announced in April, 1990 that it was undertaking a comprehensive review of its proxy rules. *See* Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Remarks at the Council of Institutional Investors Annual Meeting (Apr. 2, 1990). Pursuant to that review, the Securities and Exchange Commission proposed a first series of proxy rule amendments on June 17, 1991. *See* Exchange Act Release No. 34-29,315 (June 17, 1991). After receiving more than 600 comment letters, the SEC announced on November 20, 1991 that it would revise its proposals. *See SEC to Revise Proxy Proposals on Shareholder Communications*, 23 Sec. Reg. & L. Rep. (BNA) No. 46, at 1669 (Nov. 22, 1991).

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an officer, nor can they direct the board to cause the corporation to expand into new lines of business.

The shareholders' inability to direct corporate action results from two basic characteristics of state corporation law: first, state corporation statutes expressly confer the power to manage the business and affairs of the corporation to the board of directors; and second, state corporation statutes confer no analogous power on the shareholders. The silence of state corporation law regarding shareholder power to direct corporate action, however, is not conclusive because shareholders, as owners, could arguably exercise an "inherent power" to direct corporate action (at least in states where the delegation to the board of directors is not expressly designated in the corporation statute as an exclusive delegation).[28] But the proposition that shareholders possess such inherent power finds little support in the cases. At best, the cases suggest that the shareholders' inherent power to direct corporate action is limited to matters closely connected with the basic rights expressly granted to shareholders under the state corporation law. Thus, although shareholders may have the inherent power to remove a director for cause,[29] to fill newly created directorships between annual meetings,[30] and to require the corporation to issue certain types of reports,[31] they do not have the inherent power to direct management to make specific business decisions on matters such as

28. *Cf.* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 86-87 (1976) (suggesting that shareholders may have "inherent powers" in addition to the legal powers expressly conferred on them by the state corporation statute); *see also* Rogers v. Hill, 289 U.S. 582, 589 (1933) (holding that shareholders have the inherent authority to amend corporation bylaws, reasoning that "[i]t would be preposterous to leave the real owners of the corporate property at the mercy of their agents").

29. *See* Campbell v. Loew's, Inc., 134 A.2d 852 (Del. 1957) (concluding that shareholders have an implied power to remove directors for cause); Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954) (explaining that stockholders who have the power to elect directors can also remove them for cause).

30. *See* Gold Bluff Mining & Lumber Corp. v. Whitlock, 55 A. 175 (Conn. 1903); Burr v. Burr Corp., 291 A.2d 409 (Del. Ch. 1972); Campbell v. Loew's, Inc., 134 A.2d 852 (Del. 1957); Automatic Steel Prods., Inc. v. Johnston, 64 A.2d 416 (Del. Super. Ct. 1949). For additional citations, see EISENBERG, *supra* note 28, at 86 n.5.

31. SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948); *cf.* Clusserath, *supra* note 25, at 45-46. In addition to the inherent powers discussed in the text, shareholders may also have the inherent power to create mechanisms to monitor management business decisions more effectively. For instance, shareholders may have the inherent right to require the appointment of independent auditors. *Transamerica*, 163 F.2d at 516-17; *cf.* Clusserath, *supra* note 25, at 45-46. Shareholders may also have the inherent right to establish shareholder advisory committees to work with and more closely monitor the performance of management. *See, e.g.*, Exxon Corporation, SEC No-Action Letters, Ind. & Summaries (WSB) # 030992020 (Feb. 28, 1992).

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hiring a new chief executive officer or closing an aging factory.[32]

That shareholders lack power to adopt binding resolutions that direct management to take specific actions with respect to corporate property does not automatically mean, however, that shareholders lack power to influence the corporation's business affairs. To establish the broader proposition, that shareholders lack power to influence the corporation's day-to-day business decisions, one must show that the powers granted to shareholders under state corporation laws are not close substitutes for a general power to direct corporate action. More concretely, one must show that the shareholders' state law powers[33] cannot be utilized by shareholders to force the corporation to adopt a course of action not favored by management.

The following subsections of this Part undertake that analysis. Considering each of the shareholders' basic state law powers in turn, the paper concludes that—at least in the case of corporations where a single shareholder (or group of related shareholders) fails to hold a controlling interest[34] in the firm[35]—none of the state law powers gives the sharehold-

32. *Cf.* Clusserath, *supra* note 25, at 22 (citing instance in which the SEC held that shareholders lacked the power to vote on a proposal directing management to study the benefits of an acquisition program aimed at diversifying the corporation's activities).

33. For example, the power to elect and remove directors, *see, e.g.*, DEL. CODE ANN. tit. 8, §§ 141, 211, 214, 216 (1990), the power to vote to amend, adopt or repeal bylaws, *see, e.g.*, DEL. CODE ANN. tit. 8, 109(a) (1990), the power to veto fundamental corporate transactions, *see, e.g.*, DEL. CODE ANN. tit. 8, § 242(c) (1990) (charter amendments); § 251(c) (mergers and consolidations); § 271(a) (sales of all, or substantially all, of a corporation's assets); § 275(b) (voluntary dissolution), and the power to vote on certain proposals *recommending* specific corporate action to the board of directors (even though state corporation law expressly places authority to make the final decision regarding the particular issue in the board of directors), *see* Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954); *see also* 17 C.F.R. § 240.14a-8 (1991) (SEC shareholder proposal rule).

34. A shareholder who owns 51% of a corporation's common stock will generally have the power to control the affairs of the corporation. However, where share ownership is dispersed among a large number of passive investors, de facto control may be lodged in much smaller blocks of stock. *See* LARRY E. RIBSTEIN, BUSINESS ASSOCIATIONS 987 (2d ed. 1990) (citing BARCLAY & HOLDERNESS, THE LAW AND LARGE-BLOCK TRADES (Managerial Economics Research Center, William E. Simon Graduate School of Business Administration, University of Rochester Working Paper No. 89-17, Sept. 1989) (presenting evidence that, where ownership is sufficiently diffuse, a holder of 5-10% of common stock may have substantial control)).

35. A shareholder may not want to acquire a controlling interest for a number of reasons. First, the shareholder may not have access to the financing necessary to acquire a controlling interest in the firm. Second, because acquisition of control involves significant transaction costs, the benefits of acquiring control may not be great enough to justify the costs. Finally, holders of control are subject to significant legal restrictions, such as prohibitions on insider trading and short-swing trading under §§ 10(b) and 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78p(b)

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ers any significant ability to influence the corporation's business decisions.

B. The Right to Elect Directors

All state corporation statutes grant the shareholders the right to nominate and elect directors to manage the corporation's affairs.[36] Accordingly, by nominating and electing a slate of directors that supports their position, shareholders may attempt to force the corporation to adopt an alternative business plan. Although this approach is clearly available to shareholders under state law,[37] it is not an attractive option.

First, many state corporation statutes severely restrict shareholder power to call special shareholders meetings.[38] Therefore, shareholders may have to wait until the corporation's next annual meeting to present and vote on proposals to replace the corporation's board of directors. If the meeting is sufficiently far in the future, the course of action advocated by the shareholders may no longer be available to the corporation.

Second, replacing the board of directors with directors that support the shareholders' position may be impractical when the corporation has a classified board of directors.[39] If a board is classified to the fullest extent permitted by law, it may take two years for the shareholders to replace a majority of the board.[40] During this period, management will be able to cause the corporation to pursue the course of action that it prefers, with-

(1988), and rules imposing liability on "controlling persons" for securities laws violations, *see* 15 U.S.C. §§ 77o, 78t(a) (1988). *See generally* Black, *supra* note 18.

36. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141, 211, 214, 216 (1990).

37. *Id.* Although shareholders clearly have the power under state law to propose candidates for the corporation's board of directors, they lack the power to force management to include such proposals in management's proxy materials. *See* 17 C.F.R. § 240.14a-8(c)(8) (1991) (permitting management to omit shareholder proposals relating to an election to office). Thus, shareholders who want to propose and solicit proxies for the election of a slate of directors not favored by incumbent management must do so at their own expense.

38. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(d) (1990) (giving the board of directors the exclusive power to call special shareholder meetings unless the certificate of incorporation or the bylaws provides otherwise).

39. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(d) (1990) (permitting a corporation's board of directors to be divided into one, two, or three classes).

40. For example, if a corporation has a board of directors divided into three classes, only one-third of the directors will be elected at any annual shareholders meeting. Although the dissident shareholder might try to replace a majority of the members of the board by seeking to remove other directors before their term in office expires, this effort is not likely to succeed. As a general rule, shareholders may only remove a member of a classified board of directors for cause. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k) (1990).

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out regard to shareholder complaints. Consequently, by the time directors who support the shareholders' position constitute a majority of the board of directors, pursuit of the course of action advocated by the shareholders may be impractical. For instance, it may be impossible to reverse the prior board's actions or the opportunity that the shareholders wished to pursue may no longer be available.

Third, even assuming both that a meeting can be held in a timely fashion and that it is possible to remove a majority of the corporation's board of directors at a single shareholders' meeting, owners of a majority of the firm's shares may be unwilling to remove the entire board of directors. Even though the shareholders may prefer an alternative course of action on a particular issue, they may not be willing to oust an otherwise satisfactory management over a single business issue, especially if the economic significance of the issue is limited.

Finally, a proxy contest for control of the board of directors is likely to be very expensive for the shareholders leading the challenge. Because a proxy contest for control represents a direct threat to the continued employment and influence of management, the incumbent managers will devote considerable resources to defend their positions.[41] Faced with these large expenditures by management, the shareholders challenging management must either increase their own expenditures or accept a decreased probability that they will convince owners of a majority of the shares to support them. Therefore, a proxy contest for control is only likely to be a viable option in a small class of cases: those involving business decisions having dramatic economic consequences for the firm. Even then, evidence suggests that the shareholders' chance of success is small.[42]

41. Liberal spending by incumbent managers is extremely likely because state corporation laws permit managers to use corporate assets to defend their positions. In particular, incumbent directors are allowed to use the corporate proxy statement at no expense to themselves to solicit votes from the corporation's shareholders for a new term in office. *See* Melvin A. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1494-95 (1970).

42. For evidence that dissident shareholders generally fail to obtain a majority of board seats, see Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401 (1983) (study of proxy contests from 1962 to 1978). However, dissident shareholders often attain their objectives, even though they fail to capture a majority of board seats. *See* Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29 (1989).

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C. *The Power to Adopt, Amend, and Repeal Bylaws*

In addition to granting shareholders the right to elect and remove directors, most state corporation statutes grant shareholders the power to adopt, amend, and repeal bylaws.[43] Corporation statutes typically provide that bylaws may contain any provision relating to the business of the corporation or the conduct of its affairs.[44] Therefore, it would appear that shareholders could utilize the power to amend the corporation's bylaws to force the board of directors to follow the particular business policies that the shareholders prefer.

The power to adopt, amend, and repeal bylaws, however, is not as expansive as it appears. First, the shareholders generally share power over the corporation's bylaws with the board of directors.[45] Accordingly, the shareholders' power over the bylaws is "constrained by the board's ability to . . . undercut, if not contradict, the shareholder measure."[46] Second, the corporate statutes that authorize the inclusion in the bylaws of provisions relating to the business of the corporation also require that all bylaws be consistent with state law and the corporate charter.[47] Thus, since state law provisions vesting authority to manage the corporation's business in the board of directors are generally held to bar shareholders from ordering the board of directors to follow particular practices and policies,[48] bylaw amendments mandating specific busi-

43. *See* DEL. CODE ANN. tit. 8, § 109(a) (1990); *see also* Rogers v. Hill, 289 U.S. 582 (1933) (concluding that shareholders have inherent authority to adopt and amend bylaws).

44. *See* DEL. CODE ANN. tit. 8, § 109(b) (1990); *see also* REV. MODEL BUSINESS CORP. ACT § 2.06(b) (1984) ("The bylaws of a corporation may contain any provision for managing the business and regulating the affairs of the corporation . . . .").

45. *See, e.g.*, DEL. CODE ANN. tit. 8, § 109(a) (1990) (providing that the certificate of incorporation can confer the power to adopt, amend, or repeal bylaws upon the corporation's directors, but clearly emphasizing that "[t]he fact that such power has been so conferred . . . shall not divest the stockholders . . . of the power . . . to adopt, amend or repeal bylaws").

46. Gordon, *supra* note 19, at 350.

47. *See* DEL. CODE ANN. tit. 8, § 109(b) (1990); REV. MODEL BUSINESS CORP. ACT § 2.06(b) (1989). In several cases courts have stricken bylaw provisions on the grounds that they were inconsistent with the state corporation statute or with the corporate charter. *See* Automatic Steel Prods., Inc. v. Johnston, 64 A.2d 416 (Del. 1949); *In re* William Faehndrich, Inc., 141 N.E.2d 597 (N.Y. 1957) (bylaw provision regarding size of quorum invalid because it was not authorized by certificate of incorporation); Benintendi v. Kenton Hotel, Inc., 60 N.E.2d 829 (N.Y. 1945) (bylaw requiring directors to receive unamimous approval invalid as contrary to corporation law). For additional cases, see HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 133, at 307 nn.3 & 4 (3d ed. 1983).

48. Continental Sec. Co. v. Belmont, 99 N.E. 138 (N.Y. 1912) (shareholders can only make requests or recommendations with respect to the management of the corporation); Associated Grocers, Inc. v. Willingham, 77 F. Supp. 990 (N.D. Ala. 1948) (holding that directors' authority to run

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ness decisions would likely be held invalid.[49] Finally, even assuming that the shareholders could use the power to amend corporate bylaws to control corporate business decisions, the power is limited in its effectiveness due to the shareholders' inability under the corporate law of many states to call a special meeting at which the power could be exercised.[50]

D. The Right to Approve Fundamental Corporate Changes

The final source of express shareholder authority is the power to vote on fundamental corporate transactions.[51] Unlike the power to elect directors and the power to adopt, amend, and repeal bylaws, the right to vote with respect to fundamental corporate transactions gives the shareholders a direct voice in the firm's business decisions. Assuming, then, that the course of action favored by management involves a "fundamental corporate transaction," shareholders can use their power to approve the transaction to block management from pursuing its chosen course.

But while the power to vote on fundamental corporate transactions clearly gives shareholders a voice in the corporation's business decisions, that voice is extremely limited. Most importantly, shareholders can only use the power to vote on fundamental transactions in connection with a small class of business transactions—those that require charter amendments or those that involve mergers, consolidations, or sales of all or substantially all the corporation's assets. Although this list includes some of the most economically significant transactions in the life of the corporation, it does not include all business matters on which shareholders may wish to speak. Clearly, as a theoretical matter, some business matters that do not constitute "fundamental corporate changes" under a state's corporation law may involve gains or losses that are large enough

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the corporation is controlling and exclusive); Amdur v. Meyer, 224 N.Y.S.2d 440 (App. Div. 1962) (concluding that directors have the absolute authority to do any acts which pertain to the ordinary business of the corporation). *See generally* ROBERT C. CLARK, CORPORATE LAW § 3.1.1, at 94 (1986).

49. *See* Capitol Cab Coop. Ass'n v. Darden, 169 A.2d 463 (D.C. 1961) (striking down bylaw that provided method for compensating counsel in a manner that restricted board's discretion); Richford Industries, Inc., SEC No-Action Letter Ind. & Summaries (WSB) # 067502039 (Apr. 2, 1975) (proposal to amend bylaw dealing with directors' remuneration improper infringement on duties of board); *cf.* Donald E. Schwartz & Elliot J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635, 669-70 & nn.168-70 (1977).

50. *See supra* note 38 and accompanying text.

51. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(c) (1990) (charter amendments); § 251(c) (mergers and consolidations); § 271(a) (sales of all, or substantially all, of a corporation's assets); § 275(b) (voluntary dissolution).

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to make feasible active oversight by shareholders.[52]

In addition, a determined management can often avoid the shareholders' right to vote on fundamental corporate transactions because state corporation statutes frequently treat transactions of similar economic substance differently. For instance, while state corporation statutes generally give shareholders the right to approve mergers or consolidations, the laws often fail to provide voting rights for direct acquisitions of stock or assets.[53] Therefore, a management determined to cause the corporation to merge with another firm can simply restructure the transaction as a direct acquisition of the other firm's stock or assets if management determines that its shareholders are not likely to vote to approve the combination.[54]

Finally, shareholder voice in business decisions provided by the right to vote on fundamental corporate transactions is limited because the right provided is only a veto power; it does not give shareholders the power to initiate fundamental transactions.[55] Thus, the right to vote on fundamental corporate transactions only provides the shareholders with the power to block management's proposed course of action; it does not empower the shareholders to force the corporation to undertake a course of action they prefer in place of the course of action preferred by management.

E. Inherent Rights of Shareholders to Recommend Corporate Action

The shareholders' final source of authority lies in their purported abil-

52. *Cf.* Easterbrook & Fischel, *supra* note 12, at 415-16.

53. *See* Hariton v. Arco Elecs., 188 A.2d 123 (Del. 1963) (no voting rights for acquiror's shareholders when acquiror issues stock in exchange for all of target's assets, even though combination had same economic effect as merger or consolidation). *But see* Farris v. Glen Alden Corp., 143 A.2d 25 (Pa. 1958) (corporate combination accomplished by way of stock for assets exchange held to be *de facto* merger for purposes of shareholder voting rights); *see also* Applestein v. United Board & Carton Corp., 159 A.2d 146 (N.J. Super. Ct. Ch. Div. 1960) (accepting *de facto* merger doctrine), *aff'd per curiam*, 161 A.2d 474 (N.J. 1961).

54. For example, in 1989, Time Inc. restructured a proposed merger of Warner Communications into a subsidiary of Time (pursuant to which Warner shareholders would have received Time common stock) as a cash tender offer for the common stock of Warner in order to avoid a New York Stock Exchange rule which would have required Time to obtain approval for the merger from its shareholders. However, the power of incumbent management to restructure the terms of a transaction in order to avoid rules requiring a shareholder vote may be limited by case law. *See, e.g.*, Aiple v. Twin City Barge & Towing Co., 143 N.W.2d 374 (Minn. 1966) (invalidating an attempt to avoid shareholder vote required to issue additional shares of stock by causing wholly owned subsidiary to issue the shares).

55. *See* CLARK, *supra* note 48, § 9.3, at 378.

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ity to make recommendations to the board of directors, even when those recommendations deal with matters that state corporation law places squarely within the jurisdiction of the board of directors. Accordingly, shareholders may try to cause the corporation to engage in a particular course of action by sponsoring and approving a precatory proposal expressing the shareholders' position.[56] Although such a proposal would not bind the board of directors, shareholders might expect the board to hesitate to act contrary to the clearly expressed (albeit legally unenforceable) will of the corporation's owners. After all, a failure to act in accordance with the unambiguously expressed will of the shareholders could lead to the ouster of the offending directors at the corporation's next annual meeting.[57]

At first glance, the precatory proposal appears to offer shareholders a more promising mechanism for exerting influence over corporate decisions than the alternatives considered previously. However, closer analysis of the legal basis for the shareholders' power to propose precatory resolutions shows that this is not true. First, the shareholders' power to propose precatory resolutions may not, in fact, exist under applicable state corporation law.[58] Second, even if the power exists, it may not extend very far into the realm of business decisions.

The power of shareholders under state corporation law to offer precatory proposals is generally assumed,[59] although the validity of the assumption is debatable. Proponents of the shareholders' power to offer precatory proposals generally rely upon the decision of the New York Court of Appeals in *Auer v. Dressel*.[60] In *Auer*, the petitioners sought to

56. Advisory proposals have generally been advanced by social activists. *See* Schwartz & Weiss, *supra* note 49, at 642-48 (describing social proposals that have significantly impacted corporate behavior). More recently, however, institutional investors have begun advancing advisory proposals on corporate governance issues, such as confidential voting, poison pill defenses, and shareholder advisory committees. *See* Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1988).

57. The risk to managers who fail to follow shareholder advice has been noted elsewhere. *See, e.g.*, Ryan, *supra* note 56, at 112.

58. The state law power to make precatory proposals should not be confused with the Securities and Exchange Commission's shareholder proposal rule. The latter permits shareholders to have certain proposals included in management's proxy materials, *provided* that those proposals are permissible under state law. *See* 17 C.F.R. § 240.14a-8(c)(1) (1991).

59. *See* Eisenberg, *supra* note 41, at 1519; Ryan, *supra* note 56, at 119 n.81; Note, *Proxy Rule 14a-8: Omission of Shareholder Proposals*, *supra* note 25, at 708-09; Note, *Liberalizing SEC Rule 14a-8 Through the Use of Advisory Proposals*, *supra* note 25, at 852. *But cf.* Manne, *supra* note 25 (suggesting that shareholder power to offer social proposals may be highly illusory).

60. 118 N.E.2d 590 (N.Y. 1954).

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compel the corporation's president to call a special shareholders meeting to, among other things, permit the shareholders to vote on a proposal endorsing the former president's administration of the firm and demanding his reinstatement. Although the court recognized that the shareholders lacked the power to effect a change in the corporation's officers, it nonetheless held that the precatory shareholder proposal was a proper subject for a shareholders meeting.

The New York Court of Appeals holding in *Auer* clearly supports the position of those favoring the shareholders' right to offer and vote on precatory proposals. However, in rendering the opinion, the court neither cited legal support nor offered theoretical justification for its conclusion that shareholders could offer precatory proposals where mandatory proposals dealing with the same subject matter would be prohibited. Instead, the court dealt with the issue in a single sentence, stating only that "there is nothing invalid in . . . [shareholders] expressing themselves and thus putting on notice the directors who will stand for election at the annual meeting."[61]

The shortcomings of the majority's approach in *Auer* are manifest. First, the shareholders' power to make precatory proposals appears to conflict with one of the most basic provisions of corporation law. As Justice Van Voorhis noted in his dissent: "For the stockholders to vote on this proposition would be an idle gesture, since [state corporate law provides] . . . that 'The business of a corporation shall be managed by its board of directors'."[62] Second, the premise that implicitly underlies the majority's approach—that giving shareholders the power to make precatory proposals will not alter the balance between managers and shareholders—is flawed. Granting shareholders the power to make precatory proposals at least in part shifts the power to set the corporate agenda to the shareholders. Modern political theory clearly demonstrates that the power to set the agenda is often equivalent to the power to control the outcome.[63] Thus, it would seem that proponents of the shareholders' right to offer precatory proposals on matters that would not be proper for shareholder action if phrased in mandatory language should offer more than the *Auer* opinion if their position is to prevail.[64]

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61. *Id.* at 593.

62. *Id.* at 594-95 (Van Voorhis, J., dissenting).

63. *See* PETER C. ORDESHOOK, GAME THEORY AND POLITICAL THEORY: AN INTRODUCTION 65-66 (1986).

64. Perhaps not surprisingly, the *Auer* decision has been rejected by at least one other state

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But even assuming that shareholders have some power to make precatory proposals under state corporate law, it remains unclear whether that power extends to proposals that address specific business decisions or whether it is limited to matters over which shareholders generally share authority with the board of directors, such as charter amendments and bylaw provisions. The Securities and Exchange Commission, which has largely usurped the states' role in determining what constitutes a proper subject for shareholder action under state law through the administration of its shareholder proposal rule,[65] has itself taken different positions on the issue.

In its earliest interpretations of the shareholder proposal rule, the Commission interpreted the power of shareholders to make advisory proposals very broadly. In 1952, the Commission ruled that "proposals relating to matters in those areas which are confined to management *exclusively* under state law are held proper by the Commission, if they are phrased as a request or recommendation that the board consider the advisability of the action or procedure proposed by the stockholders."[66] Not surprisingly, an early study of the Securities and Exchange Commission's shareholder proposal rule illustrated that a significant number of shareholder proposals related to ordinary business operations.[67] Most

supreme court. *See* Carter v. Portland Gen. Elec. Co., 362 P.2d 766 (Or. 1961) (refusing to permit shareholders to vote on proposal opposing board of directors' decision to build dam where state law plainly vests power of decision in the board).

65. The Securities and Exchange Commission's shareholder proposal rule requires that shareholders provide management with copies of their proposals to be included in management's proxy materials at least 120 days in advance of the date of management's proxy statement for the previous year's annual meeting. 17 C.F.R. § 240.14a-8(a)(3) (1991). If management wishes to omit the proposal from its proxy statement on the ground that the proposal is not a proper subject for shareholder action, it must file with the Commission a copy of the proposal, a statement of its reasons for omitting the proposal, and a supporting opinion of counsel at least 80 days before copies of the definitive proxy statement are mailed to shareholders. 17 C.F.R. § 240.14a-8(d) (1991). The Commission staff then determines whether or not management's proxy statement must include the shareholder proposal.

For all practical purposes, the staff's determination of whether a shareholder proposal constitutes a proper subject for shareholder action is final. *See* Schwartz & Weiss, *supra* note 49, at 648-53. Distributing a proxy statement to shareholders that has not been approved by the Commission staff risks antagonizing the Commission staff and exposing the corporation to a Commission enforcement action. Moreover, seeking a declaratory judgment in court poses the risk that the corporation's annual meeting may have to be delayed. For a discussion of the costs of litigating staff determinations under Rule 14a-8, see Manne, *supra* note 25, at 495-99.

66. Harry Heller, *Stockholder Proposals*, 4 VA. L. WEEKLY DICTA 72, 74 (1952-53) (emphasis added).

67. Emerson & Latcham, *supra* note 25 (study of shareholder proposals included in proxy statements during the years 1948-1951).

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notably, the study showed that, of the 286 shareholder proposals included in the proxy statements examined, forty-five concerned executive remuneration issues, such as suggestions for executive salary reductions, executive bonuses, and executive retirement plans.[68]

The Securities and Exchange Commission, however, quickly retreated from its broad interpretation of the shareholders' power to make advisory proposals. In 1954, the Commission amended its shareholder proposal rule to provide that management could omit proposals recommending or requesting action involving conduct of the corporation's ordinary business operations.[69] Although the Commission did not define "ordinary business operations" in its amended rule, the Commission subsequently adopted the view that proposals relating to matters within the board of director's exclusive authority involved "ordinary business operations."[70] As a consequence of this interpretation of "ordinary business operations," the Commission generally permitted corporations to exclude all advisory proposals related to the management of the business and affairs of the corporation, without regard to the significance or importance of the activity in the proposal.[71] Therefore, during the 1950s and 1960s, shareholders had little, if any, power to make precatory proposals that dealt with specific business decisions.[72]

The most recent shift in the Securities and Exchange Commission's view on the power of shareholders to make precatory proposals regarding the corporation's business decisions occurred in the early 1970s. During this period, the Commission abandoned its earlier view equating "ordinary business operations" with the scope of the board of directors exclusive authority under state corporation law and instead adopted a

68. *Id.* at 821.

69. Exchange Act Release No. 4979, 19 Fed. Reg. 246 (Jan. 14, 1954). The current version of the ordinary business operation's exclusion is codified at 17 C.F.R. § 240.14a-8(c)(7) (1991).

70. *See* Clusserath, *supra* note 25, at 34-36.

71. Thus, pursuant to its authority to exclude proposals relating to ordinary business operations, the Commission staff has permitted the exclusion of proposals relating to matters of considerable economic importance. *See* Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 34-12,999, 41 Fed. Reg. 52,994 (Dec. 3, 1976) (old interpretation of shareholder proposal supported exclusion of proposal relating to construction of nuclear power plant).

72. This is not to suggest that the power to make precatory proposals was unimportant during the 1950s and 1960s. During this period, the power to make precatory proposals was generally used by shareholders to make proposals in areas where shareholders shared authority with management, such as bylaw and charter amendments. Without the power to make precatory proposals, shareholders could not have raised these matters because state corporate law generally gives the board of directors the exclusive power to *initiate* action in respect of bylaw and charter amendments.

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view of "ordinary business operations" which focused on the importance to shareholders of the particular matter under consideration. This evolution in the interpretation of "ordinary business operations" began in 1972 when the Securities and Exchange Commission failed to assert, as a grounds for appeal to the Supreme Court in *Medical Committee for Human Rights v. SEC*,[73] that a shareholder proposal regarding Dow Chemical's production of napalm encompassed ordinary business operations.[74] The evolution in the interpretation of "ordinary business operations" culminated with the Commission's adoption of the 1976 amendments to the shareholder proposal rule. In the release accompanying those amendments, the Commission expressly stated that the ordinary business operations exclusion could no longer be used to omit proposals that involve "substantial policy or other considerations."[75] As a result of this reinterpretation of the exclusion, the Commission staff now permits some precatory proposals touching on a corporation's business decisions.

An examination of both the Commission's no-action letters and court decisions implementing the current Securities and Exchange Commission policy on shareholder proposals illustrates, however, that the shareholder proposal mechanism is still not very useful to shareholders whose primary motivation is to increase the economic value of their investment. For the most part, courts and the Commission staff have found that a proposal involves "substantial policy or other considerations" only when the proposal concerns important questions of social policy, such as environmental matters,[76] animal rights,[77] the manufacture of tobacco products,[78] and affirmative action.[79] Proposals that deal with matters of

73. 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972).

74. For a discussion of the significance of the failure of the Commission to assert various arguments in its appeal of the *Medical Committee* decision to the United States Supreme Court, see Manne, *supra* note 25, at 488-90.

75. *See* Exchange Act Release No. 34-12,999, *supra* note 71.

76. *See, e.g.*, Amoco Corp., SEC No-Action Letter Ind. & Summaries (WSB) # 031191026 (Mar. 8, 1991) (proposal regarding plan to reduce toxic chemical emissions).

77. *See, e.g.*, McDonald's Corp., SEC No-Action Letter Ind. & Summaries (WSB) # 031389013 (Mar. 3, 1989) (proposal that company take steps to encourage the development of more humane farming techniques).

78. *See* Philip Morris Cos., SEC No-Action Letter Ind. & Summaries (WSB) # 043090009 (Mar. 14, 1990); Kimberly-Clark Corp., SEC No-Action Letter Ind. & Summaries (WSB) # 022690035 (Feb. 22, 1990); American Brands, Inc., SEC No-Action Letter Ind. & Summaries (WSB) # 022690034 (Feb. 22, 1990).

79. *See* NYC Employees' Retirement Sys. v. American Brands, 634 F. Supp. 1382 (S.D.N.Y. 1986) (affirmative action proposal dealing with employment policies in Northern Ireland plant); *cf.*

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considerable economic importance, but which lack social policy implications, have often been held excludable.[80] Thus, even assuming that the Securities and Exchange Commission's current position on shareholder proposals is an accurate reflection of state corporation law, the shareholders' power to make precatory proposals regarding business matters is still severely limited. Moreover, any power that exists under state corporation law is subject to legal constraints (i.e., the nonbinding character of the resolution[81] and the inability of shareholders to call special meetings at which resolutions can be adopted)[82] limiting the usefulness of that power as a means of influencing corporate business decisions.

F. Conclusion

The powers of shareholders to influence corporate business decisions are quite limited. Shareholders lack power under state corporation law to adopt resolutions directing the corporation's board of directors to take specific actions with respect to corporate property. In addition, the powers that are granted to shareholders under state corporation law—for example, the power to elect and remove directors, the power to adopt, amend, or repeal bylaws, the power to veto fundamental corporate changes, and the purported power to adopt precatory resolutions—fail to

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Lovenheim v. Iroquois Brands, 618 F. Supp. 554 (D.D.C. 1985) (proposal dealing with importation of pâté de foie gras).

80. For example, until 1990, the SEC staff regularly permitted management to exclude shareholder proposals relating to anti-takeover devices such as golden parachutes (i.e., contracts providing for generous payments to managers in connection with changes in control or other extraordinary events closely associated with changes in control). *See, e.g.*, Georgia-Pacific Corp., SEC No-Action Letter Ind. & Summaries (WSB) # 022988026 (Feb. 22, 1988); Crown Zellerbach Corp., SEC No-Action Letter Ind. & Summaries (WSB) # 030386047 (Feb. 20, 1986); Phillips Petroleum Co., SEC No-Action Letter Ind. & Summaries (WSB) # 013084020 (Jan. 20, 1984). The Securities and Exchange Commission staff, however, has recently changed its position on shareholder proposals relating to golden-parachutes for firm managers. *See* Transamerica Corp., SEC No-Action Letter Ind. & Summaries (WSB) # 012290009 (Jan. 10, 1990). But while the Commission staff has been more generous in allowing shareholder proposals relating to anti-takeover devices like golden parachutes, it continues to permit the exclusion of proposals relating to other business matters, such as employee compensation, *see, e.g.*, MCI Communications Corporation, SEC No-Action Letter Ind. & Summaries (WSB) # 031191028 (Mar. 7, 1991); Pinnacle West Capital Corp., SEC No-Action Letter Ind. & Summaries, (WSB) # 040290021 (Mar. 23, 1990); Bell Atlantic Corp., SEC No-Action Letter Ind. & Summaries (WSB) # 122187017 (Dec. 16, 1987), and product design, *see, e.g.*, General Motors Corp., SEC No-Action Letter (Mar. 1, 1982) (proposal requesting company to design and develop new engine).

81. *See supra* notes 56-57 and accompanying text.

82. *See supra* note 38 and accompanying text.

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function effectively as substitutes for a general power to direct corporate affairs.

II. EXPLANATIONS FOR THE BAR ON SHAREHOLDER PARTICIPATION IN MANAGEMENT

Standard explanations for corporate law rules that limit shareholder influence over corporate decisionmaking focus on the economic function of the corporate form—facilitating the specialization of the economic functions of owning and managing—and the collective action problems that arise when each shareholder owns only a small fraction of a corporation's stock. This Part explores in greater detail the standard explanations for the rules limiting shareholder participation in business decisions.

The commentary in Part II is divided into two sub-parts: Sub-Part A sets forth and critiques the traditional explanations for rules limiting shareholder powers. Sub-Part B considers variations on the standard explanations that are designed to address the shortcomings of the traditional approaches.

A. Traditional Justification for Limitations on Shareholder Voice

As the first commentator to subject the corporate form to a systematic economic analysis, Dean Henry Manne was not surprised to find that modern corporation statutes failed to give shareholders a meaningful voice in corporate affairs.[83] In his view, limitations on shareholder voice were entirely consistent with the economic function of the public corporation: the creation of a business form that facilitated passive investment by specializing the economic functions of owning and managing.[84] Although Dean Manne recognized that the separation of ownership and control created a potential danger that managers would act to further their own interests rather than the interests of shareholders, he argued that the market for corporate control provided a strong incentive for management to operate corporations efficiently.[85]

More recent scholarship—most notably that of Judge Easterbrook and Professor Fischel[86]—adopts a slightly different view of rules limiting

83. Manne, *supra* note 10, at 261.

84. *Id. See also* Demsetz, *supra* note 11, at 383.

85. Manne, *supra* note 10, at 265-66; *see also* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

86. *See, e.g.*, Easterbrook & Fischel, *supra* note 12.

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shareholder control over business decisions. Judge Easterbrook and Professor Fischel's analysis suggests that the costs of specializing the economic functions of owning and managing could be reduced if shareholders retained some voting rights on business matters.[87] Beginning with the proposition that contracting costs make it impossible for shareholders to write contracts that cover all contingencies which may arise during a corporation's life,[88] Easterbrook and Fischel contend that shareholder voting provides a means by which shareholders can fill the gaps in their contract with management.[89] By retaining authority to complete the corporate contract, shareholders reduce the likelihood that management will use the powers granted to them to advance their own interests at the shareholders' expense. In other words, shareholder voting provides a means by which shareholders can reduce the agency costs that are inherent in the separation of shareholder ownership from management control.[90]

Although Easterbrook and Fischel recognize that shareholder voice in business decisions arguably plays a role in limiting agency costs in public corporations, they emphasize that the role of shareholder voice is quite limited. Their conclusion is based upon two factual premises regarding public corporations: first, that public corporations are comprised of thousands of shareholders, each owning a small fraction of the corporation's stock; and second, that public corporations are subject to powerful market constraints, especially the market for corporate control identified by Dean Manne, that perform the same economic function as shareholder voting—limiting the likelihood that managers will further their own interests at the shareholders' expense.[91] The first premise means shareholders are unlikely to want to influence corporate affairs, except in unusual instances where the expected benefits of their actions are great. This shareholder reluctance occurs because the shareholders leading the

87. *Id. See also* Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985) (arguing that corporate laws which give shareholders a larger voice in corporate affairs may reduce the costs of specializing ownership and management in *some* firms).

88. For a discussion of the costs involved in writing detailed contracts, see Smith & Warner, *supra* note 13.

89. Easterbrook & Fischel, *supra* note 12, at 401-02.

90. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

91. Other market constraints on managerial misconduct include product markets, capital markets, and the market for corporate managers.

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effort to influence corporate actions bear the lion's share of the costs,[92] but receive only a pro rata share of the benefits that accrue to the corporation if the effort succeeds.[93] The second premise means that the instances in which shareholder efforts to influence corporate affairs will involve sufficiently large expected gains are likely to be rare. This rarity occurs because other market mechanisms, such as the market for corporate control,[94] keep management from long ignoring opportunities that will substantially increase the value of the corporation to its shareholders. Therefore, if shareholders are motivated solely by a desire to increase the economic value of their investment, shareholder efforts to influence corporate affairs are unlikely to occur with great frequency, if at all.

Accordingly, rules that limit shareholder power to control corporate business decisions do not trouble Easterbrook and Fischel. Easterbrook and Fischel conclude that shareholders might rationally delegate their right to control business decisions to directors because shareholders understand that the board of directors make decisions more quickly and at a lower cost than can shareholders. Shareholders realize that shareholders' meetings not only take time to organize, but also involve high costs. The corporation must, among other things, draft, print and distribute proxy statements prior to the meeting; hold the shareholders' meeting; and tabulate the votes. Moreover, shareholders understand that, given the existence of collective action problems, as well as other mechanisms

92. The shareholder seeking to influence a corporation's affairs must bear the lion's share of the costs involved in the effort because the minority shareholders have little to gain if the effort succeeds, and, therefore, have little incentive to investigate the merits of the particular course of action in question on their own.

93. These collective action problems are limited, to some extent, by corporate law rules which allow, but do not require, corporations to reimburse expenses incurred by proponents of shareholder initiatives, provided that the initiative involves a question of corporate policy and the expenses are reasonable. *See, e.g.*, Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955). As a practical matter, however, corporations never exercise their discretionary power to reimburse shareholder proponents for costs incurred in connection with unsuccessful initiatives and, in fact, some doubt exists as to whether reimbursement in such a case is proper. *See Steinberg*, 90 F. Supp. at 607-08; *Rosenfeld*, 128 N.E.2d at 293. Accordingly, existing legal rules, which do not provide for reimbursement to shareholder proponents in all cases, do not completely overcome problems of collective shareholder action. For a comprehensive analysis of the rules governing reimbursement of expenses in proxy contests, see Lucian A. Bebchuck & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071 (1990).

94. *See supra* note 91; *see also* Baysinger & Butler, *supra* note 87, at 181 (explaining that the optimal mix of mechanisms to control agency costs varies "in response to the relative effectiveness of each mechanism under the particular firm's circumstances").

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that prevent management's interests from diverging too far from the shareholders' interests, shareholder voting would have a function only in extreme instances. In most instances, shareholders who own only a small stake in the corporation would simply follow management's recommendations without conducting an independent investigation. As Easterbrook and Fischel conclude, "[w]hen many are entitled to vote, none of the voters expects his votes to decide the contest [and c]onsequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."[95]

Despite extensive treatment by scholars, the standard explanations for rules limiting shareholder participation in management are not complete. These explanations show why shareholders could ordinarily be expected to delegate *most* business decisions to management. However, as Professor Gordon recently noted, the traditional explanations fail to show why the delegation would be absolute.[96] Stated otherwise, the standard views fail to show why shareholders would not retain the power to revoke the delegation to management when a particular shareholder (or group of shareholders) could establish that the owners of a majority of the corporation's shares (or such greater percentage as may be stated in the corporation's charter or bylaws) agreed that shareholders, as a group, would be better off if the corporation followed a different business strategy than the approach advocated by management.

For instance, a shareholders' role in the management of the corporation is arguably consistent with Dean Manne's analysis of the public corporation. As noted earlier, Dean Manne views the corporation as a device for specializing the economic functions of owning and managing. However, no *a priori* reason exists to reject the possibility that the costs of specializing the functions of owning and managing might be reduced if shareholders retained concurrent (albeit infrequently exercised) power to make business decisions. Accordingly, a role for shareholders in corporate management may well be consistent with Dean Manne's view.

The possibility that shareholder activism may decrease the costs of do-

95. Easterbrook & Fischel, *supra* note 12, at 402. Indeed, given the limited utility of shareholder voting when share ownership is widely dispersed, Easterbrook and Fischel argue that shareholder voting rights in publicly held corporations can only be explained in terms of the market for corporate control—i.e., that shareholder voting rights are important because they enable those who acquire control of the corporation's common stock to exercise control over the firm. *Id.*; *see also* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 25 (1990).

96. Gordon, *supra* note 19, at 354.

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ing business in the corporate form is demonstrated by research conducted by Barry Baysinger and Henry Butler.[97] Baysinger and Butler analyzed the effect of management decisions regarding the selection of a jurisdiction for incorporation. In particular, they examined factors that encourage some firms to select jurisdictions of incorporation that provide for greater involvement of shareholders in managing the firm, while others select jurisdictions of incorporation that provide for lesser shareholder involvement in managing the firm. In the sample of firms studied, Baysinger and Butler found that firm performance did not vary based on management's decision regarding the jurisdiction of incorporation. This conclusion suggests that some firms benefit from rules facilitating shareholder activism. Thus, Baysinger and Butler's research confirms the existence of a "logical role for shareholder activism" in reducing the costs of doing business in the corporate form.[98]

Similarly, a role for shareholders in corporate business decisions may be consistent with Easterbrook and Fischel's analysis. As noted earlier, Easterbrook and Fischel's analysis of limitations on shareholder voting rights focuses on the expense of shareholder voting and on collective action problems that arise when each shareholder owns only a small fraction of the corporation's stock. This analysis clearly shows that shareholders cannot be expected to exercise power to control business decisions in many instances; however, it says nothing about whether shareholders should be permitted to direct corporate action in the rare instance where the benefits of an alternative course of action are sufficiently large so that shareholder initiatives are economically feasible. Clearly, as a theoretical matter, some business decisions may involve the possibility of sufficiently large gains or losses for the corporation to make shareholder activism rational, at least for shareholders owning a sufficiently large stake in the firm.[99] Thus, the conclusion that shareholders

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97. Baysinger & Butler, *supra* note 87.

98. *Id.* at 191.

99. In connection with their discussion of shareholder voting on fundamental corporate changes, Easterbrook and Fischel acknowledge that some business decisions may involve the possibility of sufficiently large gains and losses to make shareholder activism rational, at least for shareholders owning a large stake in the firm. Easterbrook & Fischel, *supra* note 12, at 415-16. However, Easterbrook and Fischel fail to explain why instances in which shareholder activism is rational are limited to those transactions that fit within the category of "fundamental corporate changes" under a particular state's corporate law. It is not difficult to find examples of business decisions having dramatic economic consequences that fail to qualify as "fundamental corporate changes." Similarly, it is not difficult to find instances of transactions that qualify as "fundamental corporate changes" that have little economic significance. Moreover, as was noted earlier, *see supra* notes 53-54 and

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may further their interests by retaining concurrent authority over corporate business decisions appears consistent with Easterbrook and Fischel's economic analysis of shareholder voting.

B. Additional Explanations for Limitations on Shareholder Voice

Rules that limit shareholder power to influence corporate affairs, then, cannot be based solely upon the conclusion that the limited benefits of shareholder activism in controlling agency costs make shareholder efforts to influence corporate affairs unlikely.[100] Instead, rules limiting share-

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accompanying text, transactions which qualify as fundamental corporate changes can often be restructured so as to escape that characterization without significantly altering the economic substance.

100. Indeed, some who have examined the role of institutional shareholders in the modern corporation challenge the traditional view that the benefits of shareholder activism are limited. *See* Black, *supra* note 18, at 567; *see also* Eisenberg, *supra* note 18. Most notably, Professor Black has argued that traditional law and economics scholarship underestimates the potential benefits of shareholder activism because such scholarship "assumes a stylized model of the large public corporation as having thousands of shareholders, each owning a tiny fraction of its shares." Black, *supra* note 18, at 567; *see also* Eisenberg, *supra* note 18, at 46-48 (arguing that corporations are largely owned by institutional investors, not by individual investors). In fact, the evidence suggests that large publicly held companies have had high levels of institutional ownership for some time. For instance, the New York Stock Exchange estimated in 1967 that financial institutions other than bank trust departments held 22.5% of all stock listed on the Exchange. *See* Eisenberg, *supra* note 18, at 46 (citing NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 42 (1968)). And a more recent study on share ownership estimated that institutions owned more than 42% of all corporate equity securities in 1986. Brancato, *supra* note 18, at table 6. This evidence, and information showing that institutions tend to hold substantial investments in individual companies, Black, *supra* note 18, at 567-68; Eisenberg, *supra* note 18, at 46-48, suggests that publicly held corporations are increasingly owned by skilled investors with significant financial stakes.

That corporations tend to be owned by skilled investors with large stakes implies an increased probability that shareholders will seek to influence the affairs of the corporation. This increased probability of shareholder activism results both from the higher percentage of a firm's shares owned by a single investor and from the decreased costs of coordinating action among a smaller number of sophisticated investors. This point can be easily illustrated with a simple example. Assume that Corporation A is owned by 100 shareholders, each of whom has a one percent stake and none of whom knows any of the others. Corporation B, on the other hand, is owned by 73 shareholders, three of whom own 10% stakes and 70 of whom own one percent stakes; furthermore, the three investors with 10% stakes are institutions that regularly coordinate their activities through an institutional investor organization. Shareholder activism is obviously more likely to occur in Corporation B. Assuming an improvement that yields a $100 benefit to the corporation, shareholder activism is a possibility in Corporation B, provided that the three institutional investors in Corporation B believe with certainty that they can cause the corporation to take the necessary steps to secure the benefit by making an expenditure of less than $30 (the portion of the $100 benefit that they receive if their efforts are successful). Assuming the same $100 benefit, shareholder activism only becomes a possibility at Corporation A if a particular shareholder believes that he can cause the corporation to take the necessary steps to secure the benefit by making an expenditure of less than $1

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holder voice must rest upon an analysis of the costs of shareholder activism to the firm *in those cases where activism is economically feasible for some shareholders*. Accordingly, this Sub-Part examines the harms traditionally associated with rules giving shareholders the power to control corporate business decisions. This Sub-Part concludes that the costs traditionally associated with shareholder activism fail to provide an adequate explanation for existing corporate law limitations on shareholder power to control business decisions.

1. *The Costs of Shareholder Activism*

The cost most often cited concerns the danger of misuse of a power to control business decisions by shareholders who have a small financial stake in the firm.[101] Such shareholders, it is argued, will not consider the full cost of their use of the corporation's proxy machinery, since many of the costs—such as the cost of printing shareholder proposals in the proxy statement and the cost of communicating such proposals to other shareholders—are borne by the corporation. Accordingly, shareholders may, on occasion, use the corporate proxy machinery to obtain benefits for themselves, such as publicity regarding issues of concern to the particular shareholders, even though the corporation's cost exceeds the benefit that the particular shareholders receive.

Shareholder social responsibility proposals are especially good examples of this phenomenon.[102] Social responsibility proposals appear to of-

(1% of $100). Thus, because a much higher level of shareholder expenditures can be justified in the case of Corporation B, shareholder efforts to influence corporate affairs are more likely to occur.

Professor Black's analysis, however, does not by itself show that shareholders will frequently seek a voice in corporate affairs. His analysis shows that the collective action problems which contribute to shareholder passivity may not be as great as previously thought. However, the traditional shareholder passivity story is not based upon collective action problems alone. More fundamentally, the shareholder passivity story rests upon the proposition that there is little reason for shareholders to want a voice in corporate affairs. Other mechanisms, such as the market for corporate control, the product market, the market for corporate managers, and the capital markets, exist to deal with the agency problems that increased shareholder voice seeks to address. Assuming that these market mechanisms operate effectively, the marginal benefit in reduced agency costs that arises from increased shareholder voice is likely to be small, even in cases where collective action problems can be overcome at a low cost.

101. *See* Manne, *supra* note 25; *see also* George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1 (1985).

102. Social responsibility proposals trace their origin to Campaign GM in 1970, where the Project on Corporate Responsibility sponsored two proposals at General Motors. The first proposal would have expanded the corporation's board of directors to increase the representation of minorities, women, consumer advocates, community activists, and ecologists. The other proposal would have created a Shareholder Committee for Corporate Responsibility to conduct a one-year study of a

fer few benefits to the corporation's shareholders (other than to the proponents of the proposal who benefit by obtaining inexpensive publicity), as evidenced by the fact that few social proposals receive more than three percent of the vote.[103] However, these proposals impose substantial costs on the corporation, including costs associated with publishing the proposal in management's proxy statement, preparing management's response, and soliciting shareholder votes against the proposal.[104]

A second cost of the rules that give shareholders greater power to influence corporation's business decisions concerns the use of that power by shareholders owning larger stakes in the firm. Professor Gordon has argued that an expansive power to influence corporate action will lead "credible shareholders"—shareholders that own sufficiently large stakes in the firm to convince other shareholders that they are motivated by a desire to increase the firm's profitability rather than by a desire to benefit themselves—to pursue private gains through bargaining with their fellow shareholders.[105] This private gain seeking behavior by shareholders has two main adverse consequences. First, it will lead the firm to pursue courses of action which may not be in the best interests of shareholders as a group. And second, bargaining among shareholders will lead to potentially costly delays in corporate decisionmaking.[106]

An example which is based on one included in Professor Gordon's paper clearly illustrates these costs.[107] Assume that two shareholders, B and C, each own 25% of Manufacturing Corporation's stock and that

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number of issues concerning General Motors' role in society. *See* Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419 (1971). In the wake of Campaign GM, shareholders have offered social responsibility proposals on matters such as the Arab boycott of Israel; corporate operations in South Africa, Korea, and Chile; corporate equal opportunity employment programs; and, more recently, animal rights. *See* Schwartz & Weiss, *supra* note 49, at 642-48.

103. For instance, Campaign GM, a well-organized effort supported by Ralph Nader, only received 2.73% of the vote for its proposal to establish a shareholder social responsibility committee and 2.44% of the vote for its proposal to expand the board. *See* Schwartz, *supra* note 102, at 430 (1971). However, some argue that success, alone, is not a proper measure of the benefits of social responsibility proposals. *See, e.g.*, Schwartz & Weiss, *supra* note 49, at 639. These commentators argue that indirect benefits, such as increased accountability and legitimacy of corporate managers and the possible beneficial impact of an unsuccessful proposal on corporate behavior, must also be taken into account. *Id.* at 639-48. ***But see*** Dent, *supra* note 101, at 16-22 (arguing that indirect benefits are neither empirically proven nor intuitively persuasive).

104. For a discussion of some of the costs of shareholder proposals, see Dent, *supra* note 101, at 14-16.

105. *See* Gordon, *supra* note 19, at 376-81.

106. *Id.*

107. *Id.* at 376-77.

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the remainder of the corporation's stock is dispersed among a large number of shareholders, each of whom owns only a small fraction of the corporation's shares. Manufacturing Corporation plans to open a new factory in Cincinnati that will increase firm value by $10 million. Shareholder B also owns a chain of retail stores in Sacramento, and if Manufacturing Corporation locates its new plant there, the business from the plant's workers will increase the value of B's retailing business by $750,000. However, the Sacramento location will be more costly for Manufacturing Corporation and will reduce the benefit of the new plant from $10 million to $9 million. Clearly, shareholder B would prefer the Sacramento location, since the $750,000 gain from his retailing operation more than offsets his $250,000 loss as a shareholder of Manufacturing Corporation. If the decision of where to locate the new plant is put to a shareholder vote, the shareholders will likely select Sacramento, because shareholder B can afford to make a side payment of more than $250,000 to shareholder C to convince C to vote his 25% of Manufacturing Corporation's stock for the Sacramento location.[108] Thus, by allowing a shareholder vote on the issue, the corporation may ultimately adopt a suboptimal course of action: it may select the Sacramento location, which provides net benefits of $9,750,000 to the corporation and its shareholders (including shareholder B), over the Cincinnati location, which provides net benefits of $10 million to the corporation and its shareholders. Moreover, by allowing a shareholder vote, the firm's decision is delayed while a proxy statement is prepared and a shareholders meeting is held.

A third cost of an expansive shareholder power to control business decisions focuses upon the potential detrimental impact that such a power would have on corporate decisionmaking. In particular, it is argued that shareholder voting is a poor mechanism for corporate decisionmaking because of the potential for "cycling,"[109] a problem identified by political scientists who study the mechanisms of social choice.[110] Briefly,

108. The selection of the Sacramento location is not guaranteed. First, state corporate law generally makes vote buying illegal. *See, e.g.*, N.Y. BUS. CORP. LAW. § 609(e) (McKinney 1991) ("A shareholder shall not sell his vote . . . to any person for any sum of money . . . ."); *see also* Robert C. Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776 (1979). Therefore, the side payment involved in the above example would have to be effectively concealed. Second, the remaining 50% of Manufacturing Corporation's stock must be dispersed among a sufficiently large number of shareholders so that those shareholders cannot cooperate to outbid B in an auction for C's votes.

109. *See* Gordon, *supra* note 19, at 359-70.

110. *See generally* ORDESHOOK, *supra* note 63, at 56-65.

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political scientists have demonstrated that, when voters hold dissimilar preferences, it is impossible to design voting rules short of dictatorship that guarantee a consistent ordering of social preferences.[111] For example, if three outcomes—X, Y, and Z—are possible and there are at least three voters, pairwise voting among alternatives may yield the following results: X defeats Y; Y defeats Z; and Z defeats X. Applying this insight to shareholder voting, it follows that shareholder voting may be destructive: the corporation risks paralysis because of the potential inability of shareholders to aggregate their preferences in a consistent manner.

Finally, a fourth cost of rules that give shareholders power to control business decisions concerns the potential for shareholder initiatives to result in greenmail payments to the proponent shareholders, rather than increases in firm profitability.[112] When faced with a shareholder initiative that threatens management benefits, management will attempt to "buy off" the proponent shareholder to prevent a vote on the initiative. Further, management efforts to buy off proponents of shareholder initiatives will often succeed because the proponent shareholder is indifferent between receiving the return for his efforts in the form of increased share values and receiving that return in the form of cash payments. Since the payment to the proponent shareholder comes from the corporate treasury, the result of this greenmail payment is a decrease in firm value with a corresponding decrease in the value of the shares held by the firm's investors. The only individuals that profit from the greenmail payments are the proponent shareholders who receive the payment and the firm's management who succeed in averting a shareholder initiative that may threaten their perquisites. Consequently, rules that permit shareholders to control business decisions will themselves create opportunities for both managerial and shareholder misconduct.

In summary, under the analysis presented in this part of the article, rules that limit shareholder voice can be understood as a rational response by shareholders to the costs discussed above. Although shareholders understand that there are potential benefits from shareholder activism, they also realize that the costs of shareholder activism are potentially great. Thus, shareholders conclude that rules limiting shareholder control of corporate business decisions advance their interests.

111. KENNETH ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (2d ed. 1963).

112. Gordon, *supra* note 19, at 381-84.

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2. *Critique of the Costs of Shareholder Activism*

The analysis presented in Sub-Part II.B.1, while an improvement over analyses which focus only on the limited benefits of shareholder activism, ultimately fails to provide a sufficient basis for the existing corporate law rules dramatically restricting the ability of shareholders to influence corporate business decisions. As will be explained more fully below, the costs of shareholder activism on which that analysis is based are overstated: either (1) the costs can be controlled by measures falling short of an absolute bar on shareholder participation in management, or (2) the costs are offset by previously unidentified benefits, or (3) the costs are simply not that large. Thus, while the justification for rules that limit shareholder voice offered in Sub-part II.B.1 correctly focuses on the costs of shareholder activism in cases where shareholder activism is actually consistent with the interests of some shareholders, that justification cannot provide a sufficient explanation for existing corporate law limitations.

The first cost discussed above—the danger of misuse of voting rights by shareholders with a small financial stake in the firm—is certainly a real cost of expansive shareholder voting rights. Shareholders undoubtedly use the corporation proxy machinery, on occasion, to obtain benefits for themselves, such as publicity regarding issues of concern to them (but possibly not to shareholders generally), even though the cost of that publicity to the corporation exceeds the benefit to the particular shareholders. As noted above, shareholder social responsibility proposals provide a case in point.[113]

The risk that shareholders with small financial stakes in the firm will misuse voting rights, however, does not justify the broad prohibitions on shareholder voice included in modern corporation statutes. As Professor Gordon notes, the costs associated with this type of misuse of shareholder voting rights are controllable by less dramatic measures.[114] For instance, corporations could condition the shareholders' power to offer proposals on minimum ownership requirements or could require that shareholders who do not meet the minimum ownership requirements reimburse the corporation for costs incurred in connection with their proposals.[115] Either of these proposals would significantly reduce the likelihood that shareholders with small stakes in the firm would misuse

113. *See supra* notes 102-04 and accompanying text.

114. Gordon, *supra* note 19, at 356.

115. *Id.*

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the corporate proxy machinery. Under the first proposal, small shareholders would simply be disqualified from using the corporation's proxy machinery; under the second proposal, small shareholders would have to pay the full cost of the publicity obtained, thus eliminating the imbalance between costs and benefits which creates the potential for misuse of the corporation's proxy machinery.

The second cost of rules that give shareholders greater power to influence the firm's affairs—the costs incurred when larger "credible shareholders" use their voting power to force the firm to adopt suboptimal courses of action—causes greater problems. Unlike opportunistic behavior by shareholders holding small stakes in the firm, opportunistic behavior by shareholders with larger stakes cannot be controlled by less dramatic means without entirely eliminating the possibility of shareholder activism. The potential for this type of opportunistic behavior may be decreased by strict enforcement of existing corporate law rules that prohibit vote buying, thereby preventing the consummation of the side deals that are necessary to secure shareholder support for suboptimal projects. However, these efforts are unlikely to succeed because side payments can be disguised or dispensed with entirely if shareholders adopt a practice of supporting each others' proposals. Consequently, opportunistic behavior by shareholders who own large stakes in a corporation is likely to be a cost of any system that permits shareholders to influence corporate affairs.

Nonetheless, opportunistic behavior by shareholders owning larger stakes in the firm does not necessarily justify rules limiting shareholder voice. True, as Professor Gordon notes, rules that permit shareholders to influence corporate affairs will allow shareholders to pursue private gains through bargaining and, therefore, may lead firms to undertake suboptimal projects.[116] However, Professor Gordon's analysis ignores the fact that shareholders as a group may benefit in some cases from such private gain seeking behavior.

As an illustration, assume that two shareholders, B and C, each own 25% of Manufacturing Corporation's stock and that the remaining stock is dispersed among a large number of shareholders. The value of Manufacturing Corporation can be increased by $1 million by moving its factory from Cincinnati to Sacramento. However, Manufacturing Corporation's managers who are all life-long Cincinnati residents oppose

116. *See supra* notes 107-08 and accompanying text.

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the move. As in the example discussed in Sub-Part II.B.1, assume further that shareholder B owns a chain of retail stores in Sacramento. If Manufacturing Corporation locates its new plant in Sacramento, the business from the plant's workers will increase the value of B's retailing business by $750,000. Because shareholder B will receive a $750,000 gain from his retailing operations and a $250,000 gain as a shareholder of Manufacturing Corporation, he is willing to spend up to $1 million to convince his fellow shareholders to support the move to Sacramento. In contrast, shareholder C, who has no opportunity for private gain, is only willing to spend $250,000—his pro rata portion of the $1 million benefit that accrues to the corporation—to convince other shareholders to support the move. Since B can capture private benefits by causing Manufacturing Corporation to move to Sacramento, such a move—a step beneficial to shareholders as a group—is more likely to occur.

Thus, the opportunity for shareholders to capture private benefits can make shareholder voice a more effective tool for monitoring management. This result, however, should not be surprising. One of the principal limitations on shareholder voice as a check on agency costs inherent in public corporations concerns the problem of collective shareholder action: shareholders who seek to influence the corporation's affairs bear the lion's share of the cost of the effort, but receive only a pro rata portion of the benefits. The receipt by these shareholders of private gains offsets this imbalance between costs incurred and benefits received. Therefore, shareholder voice becomes a more effective vehicle for monitoring management. Indeed, shareholders' private gains can be understood as a form of compensation for the increased monitoring of management that shareholders owning larger stakes provide.

Thus, voting rules that facilitate private gain seeking behavior by shareholders who own larger stakes in the firm are not necessarily detrimental to the firm. No *a priori* reason exists to believe that shareholders will be unwilling to absorb the costs of suboptimal projects in exchange for the benefits of increased monitoring of management by large shareholders. In fact, pointing to the corporate law of fiduciary duties, many argue that shareholders have already made precisely this tradeoff in connection with the operation of the market for corporate control.[117] Corporate law fiduciary standards generally permit controlling shareholders

117. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Stanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

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to cause the corporation to engage in transactions that maximize their private gains, subject only to the constraint that no investor is made worse off by the transaction.[118] Such rules permit controlling shareholders to cause corporations to engage in transactions that benefit themselves, despite the fact that alternative courses of action would have provided minority shareholders with greater gains. However, minority shareholders are willing to absorb these losses because the ability of controlling shareholders to keep the gains that result from their managerial efforts following a takeover makes takeovers more profitable and, therefore, more likely to occur. The result is more vigorous monitoring of management by the market for corporate control.

The third cost of rules that give shareholders expansive voting rights—the potential for shareholder voting to reveal a cyclic ordering of shareholder preferences (i.e. "cycling")[119]—also fails to provide an adequate basis for rules limiting shareholder voice in corporate business decisions. Preference cycling is possible only when at least three groups of voters hold dissimilar preferences.[120] Thus, for a preference cycling problem to exist, there must be a sufficient number of issues on which at least three groups of shareholders are likely to hold distinct views.

An analysis of shareholder voting shows that issues dividing shareholders into three or more separate factions are unlikely to arise with great frequency. Because most shareholders share a common goal—to maximize the firm's value—the range of disagreement among shareholders should be relatively narrow. Most shareholders will attempt to order alternatives based upon the returns to the firm generated by the particular project or business strategy. Therefore, chances are good that shareholders will order alternatives in the same fashion. Since shareholders are unlikely to hold distinct views on a significant number of issues, preference cycling is unlikely to be a significant concern in the context of shareholder voting.

Some shareholders may, of course, have special concerns regarding particular business strategies under consideration by the firm. For instance, shareholders who are also employees of the firm may be worried

118. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("Self-dealing occurs when the parent by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, *and detriment to*, the minority stockholders of the subsidiary.") (emphasis added).

119. *See supra* notes 109-11 and accompanying text.

120. *See* ORDESHOOK, *supra* note 63, at 56-60.

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about the impact of the particular business strategy on their level of compensation or on their job security. In addition, some shareholders may have large investments in other businesses which may be significantly affected by the firm's decision on a particular matter.[121] However, these sources of differing preferences among shareholders are unlikely to result in a significant amount of cycling in shareholder voting. First, instances in which particular business decisions have special effects on employee shareholders or other shareholder groups are likely to be rare. Most ordinary business decisions, such as the decision to construct a new factory or develop a new product, will not threaten employee compensation or job security or offer shareholder groups opportunities to capture private gains. Second, differing preferences that arise from the special interests of particular sub-groups of shareholders are unlikely to divide shareholders into a large number of sub-groups. It is difficult to find examples of issues that divide shareholders into more than three or four groups—i.e., managers, one or two groups of shareholders who may be specially affected by the firm's decision, and the remaining shareholders who care only about the market value of their shares. Where the number of voting groups is small, the probability that pairwise voting among alternatives will reveal a cycle of preference orders is low, ranging from five percent when there are three shareholder groups and three alternatives to approximately thirteen percent when there are four shareholder groups and four alternatives.[122] These percentages appear insufficient to justify dramatic limitations on shareholder voting rights.

However, the view that shareholders are a relatively homogenous group that share similar investment goals has been challenged. Some contend that differing shareholder preferences as to time of payout and risk level could lead groups of shareholders to consistently prefer different business strategies than other groups.[123] For example, Professor Gordon notes that a shareholder who needs a payout in an early period may vote for project A, even though project B, which provides for a later payout, maximizes the market value of the firm's shares.[124] Thus, in Pro-

121. *See supra* notes 107-08 and accompanying text.

122. *See* ORDESHOOK, *supra* note 63, at 58. The percentages set forth in the text are based upon the assumption that all orderings of preferences are equally likely for each issue under consideration by a body of voters. This assumption may not be valid in the corporate context since shareholder groups are likely to have similar preferences on many issues. Thus, the percentages referred to in the text may well overestimate the likelihood of cycling in corporate decisionmaking.

123. Gordon, *supra* note 19, at 368-70.

124. *Id.*

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fessor Gordon's view, since shareholders cannot be considered a homogeneous group, preference cycling in shareholder voting cannot be dismissed as an oddity that arises only in isolated instances.

Professor Gordon's concerns regarding the potential for cycling in shareholder voting, however, are not well founded. Shareholders can be expected to have similar expectations regarding the firm's performance.[125] Differences in shareholder expectations should be eliminated by mutually beneficial trades between investors in a firm's shares: investors who desire or expect a firm to pursue a strategy which fails to maximize the market value of the firm's shares can be expected to sell their shares to investors with more optimistic expectations.[126] But even assuming that individual shareholders have differing preferences regarding factors such as time of payout and risk level, shareholders are still likely to be a reasonably homogeneous group with respect to their desires for the firm. They will generally find it in their best interest to select a course of action that maximizes the market value of their shares, without regard to time of payout or risk level associated with the particular project or business strategy. Differing preferences regarding the timing of payout or the level of risk can be handled by trading in securities markets. For example, shareholders that favor an earlier payout can obtain that payout by selling their shares at the desired time or by borrowing. Shareholders that fear the risk associated with a particular business strategy can reduce their exposure to that risk by selling shares short or by investing in a diversified portfolio. Although these investment strategies involve some cost to investors, in most cases the cost will not be so high as to lead investors to prefer a business strategy that fails to maximize the market value of their shares. Therefore it appears unlikely that the potential for cycling in shareholder voting is very great. Accordingly, the potentially destructive impact of cycling does not appear to provide an adequate basis for rules limiting the shareholders' ability to control corporate business decisions.

The fourth cost of rules that give shareholders greater power to control corporate business decisions—the danger that the power will result in greenmail payments—suffers the same fate as the three costs consid-

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125. *See* Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411 (1961); Myron S. Scholes, *The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179 (1972); *see also* Easterbrook & Fischel, *supra* note 117, at 726-27.

126. Easterbrook & Fischel, *supra* note 117, at 727.

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ered above. Managers may attempt to buy off shareholder proponents where the initiative threatens managerial perquisites. However, it is unlikely that greenmail payments will occur with sufficient frequency and magnitude to offset the benefits that flow from a power of shareholder initiative. First, greenmail payments can be challenged as breaches of managerial fiduciary duties under state corporate law.[127] Second, shareholders can freely draft anti-greenmail provisions into the corporate charter or bylaws. Furthermore, an argument against shareholder powers based upon the potential for greenmail payments proves too much. Many mechanisms for controlling managerial misconduct can be avoided by managers who are determined to protect their perquisites. For instance, managers can erect takeover barriers that decrease shareholder wealth; but no one argues that the existence of these tactics means that takeovers should be banned. Without more, there appears to be little reason to conclude that the potential for greenmail payments provides any greater basis for rules that limit shareholder power to control corporate business decisions.

III. THE RATIONALE FOR LIMITATIONS ON SHAREHOLDER VOICE

The standard explanations for rules that limit shareholder voice fail to provide an adequate basis for rules limiting shareholder voice in management. Although these explanations show why shareholders would ordinarily delegate the power to make business decisions to the corporation's officers and directors, they fail to show why shareholders would not retain concurrent (albeit infrequently exercised) authority over business decisions. This Part addresses the shortcoming of these traditional explanations by showing how rules that limit the ability of shareholders to control corporate business decisions facilitate the primary economic function of the public corporation—the specialization of the economic functions of owning and managing. This section argues that rules limiting shareholder control of a corporation's business affairs are necessary to insure the efficient operation of organized securities exchanges and the market for corporate control.

A. The Economic Function of the Public Corporation

People can organize business activities in a variety of forms, such as

127. *Cf.* Grobow v. Perot, 539 A.2d 180 (Del. 1988) (plaintiffs failed to allege facts sufficient to state cause of action based upon corporation's stock repurchase).

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sole proprietorships, general partnerships, limited partnerships, close corporations, or public corporations. The public corporation is particularly well suited to business activities that require a combination of many specialized skills with large amounts of capital, since the features of the public corporation are designed, in large part, to facilitate the division of labor.[128] Public corporations permit "[t]he distinct functions of managerial skills and the provision of capital (and the bearing of risk) . . . [to] be separated and assigned to different people—workers who lack capital, and owners of funds who lack specialized production skills."[129] By facilitating the separation of the functions of managing and owning, the public corporation allows entrepreneurs to raise capital from a large number of passive investors.

The market for corporate control plays a key role in the operation of the public corporation. Because the public corporation involves the separation of managing and owning, the owners (i.e., the shareholders) are exposed to the risk that the managers will use their control to advance their own interests.[130] For example, managers may prefer to use the firm's capital to furnish their offices or to purchase corporate jets, rather than to revitalize the firm's manufacturing facilities. The market for corporate control reduces the divergence between the interests of owners and managers. If managers fail to manage the corporation efficiently, the price of the firm's shares will fall. This decline in share price will allow outsiders to profit by purchasing control of the firm and replacing management with a new management team that will act to maximize the market value of the firm's shares. Thus, the market for corporate control reduces the divergence between the interests of shareholders and managers by pressuring management to be attentive to the shareholders' principal concern—the market value of the firm's stock. The reduced divergence between the interests of shareholders and managers decreases the cost of capital for public corporations, since investors who are exposed to a reduced risk of mismanagement will be willing to accept a lower rate of return on their equity investments.

Organized securities exchanges also play an important role in the operation of public corporations. Because corporations are not required to return capital to shareholders prior to dissolution of the corporation, equity investors risk being locked into undesirable investments. For in-

128. *See* Manne, *supra* note 10.
129. Easterbrook & Fischel, *supra* note 21, at 94.
130. *See* Jensen & Meckling, *supra* note 90.

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stance, an equity investor's preferences may change in the future, but he will be unable to shift his investment to match his new preferences if the corporation refuses to redeem his shares or a ready, willing, and able buyer cannot be located. Organized securities markets ameliorate this concern. By making it inexpensive and easy for an investor to locate a ready, willing, and able buyer, organized securities exchanges provide equity investors with increased liquidity, and, therefore, an increased ability to respond to changed circumstances. The increased liquidity provided by well functioning securities markets means lower costs of capital for public corporations, since investors who can easily sell their shares when their preferences change will be willing to accept a lower rate of return than investors who cannot.

Important features of the corporate form can be understood, by the role they play in facilitating the efficient operation of organized securities exchanges and the market for corporate control. For example, Judge Easterbrook and Professor Fischel have demonstrated how the smooth operation of the market for corporate control depends upon an institution like limited liability for shareholders.[131] Easterbrook and Fischel suggest that, under a rule of unlimited liability, shares would not be fungible since their "value would be a function of the present value of future cash flows *and* of the wealth of shareholders."[132] This lack of fungibility would make control transactions more difficult because a potential acquiror of control would have to negotiate separately with individual shareholders, paying each shareholder a different price.[133] Moreover, because the acquiror in a control transaction is generally wealthier than the selling shareholders, the potential cost of forced additional capital contributions that may be required under a rule of unlimited liability would be higher to the acquiror than to the selling shareholders. Therefore, the acquiror's ability to offer a sufficient premium over the market price to induce existing shareholders to tender their shares would be inhibited.[134]

131. Easterbrook & Fischel, *supra* note 21.

132. *Id.* at 96; *see also* Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117 (1980).

133. Easterbrook & Fischel, *supra* note 21, at 96.

134. *Id.* Along the same lines, Grossman and Hart have shown how the efficient operation of the market for corporate control is advanced by common law fiduciary duty rules that permit controlling shareholders to exclude minority shareholders from sharing in the gains generated by a takeover. Grossman & Hart, *supra* note 117; *see also* Easterbrook & Fischel, *supra* note 117. In particular, Grossman and Hart focus on corporate law fiduciary standards that permit controlling shareholders to cause the corporation to engage in transactions that maximize the private gains received by the controlling shareholders, subject only to the constraint that no minority shareholder

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Similarly, Easterbrook and Fischel have illustrated how a rule of limited liability contributes to the smooth operation of organized securities exchanges.[135] Without a rule of limited liability, Easterbrook and Fischel argue that shares would not have one market price because the value of each share would be dependent upon the wealth of its owner. Since shares would no longer have one market price, investors would not be able to rely upon a single market price in making investment decisions. Instead, investors would have to devote greater resources to analyzing the value of the firm to determine the right price for the shares being offered. These increased investor expenditures in a world without limited liability would mean diminished liquidity for equity investors and therefore a higher cost of capital for public corporations. With limited liability, however, organized securities exchanges operate more efficiently. Investors can rely on a single market price in buying and selling securities. Moreover, this price will impound additional information about the value of the firm since, "[w]hen all can trade on the same terms, . . . investors trade until the price of shares reflects the available information about a firm's prospects."[136]

B. *The Economic Rationale for Limitations on Shareholder Voice*

Similar to limited liability, rules that limit the shareholders' ability to control corporate business decisions can be understood by the role they play in facilitating the efficient operation of securities exchanges and of the market for corporate control. This Sub-Part explores the link between rules limiting shareholder voice, on the one hand, and the market for corporate control and organized securities exchanges, on the other.

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is made worse off by the transaction. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). Such rules permit controlling shareholders to cause corporations to engage in transactions that benefit controlling shareholders, notwithstanding the fact that alternative courses of action would have provided minority shareholders with greater gains. Grossman and Hart contend, however, that shareholders are willing to accept the losses associated with these transactions because the ability of controlling shareholders to keep the gains that result from their management efforts following a takeover makes takeovers more profitable. In other words, fiduciary duty principles that permit controlling shareholders to adopt devices to exclude minority shareholders from sharing in the gains generated by a takeover prevent minority shareholders from free riding on the efforts of the control acquiror and therefore increase the likelihood of successful takeovers which benefit the corporation and all the shareholders.

135. Easterbrook & Fischel, *supra* note 21, at 96.

136. *Id.*

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1. *The Relationship of Shareholder Voice and the Market for Corporate Control*

Rules that limit shareholder power to control corporate business decisions facilitate the efficient operation of the market for corporate control in two ways. First, rules limiting shareholder voice decrease transaction costs involved with acquisitions of control by eliminating the need for acquirors to negotiate separately with individual shareholders. As an illustration, consider a world in which shareholders have the power to propose binding resolutions on any subject at any time. In such a world, shareholders would have an incentive to pursue private gains through bargaining with their fellow shareholders;[137] shareholders could be expected to make side payments to, or enter into reciprocal arrangements with, their fellow shareholders in the hopes of causing the firm to take actions that would generate private gains. Therefore, share value would be a function of the present value of the firm's cash flows *and* of the expected value of any private benefits that a shareholder may receive as a result of his relationship with the firm. The amount of private gains that a shareholder could expect would vary depending upon the nature of the shareholder's other business activities. The closer the relationship between the firm's activities and the shareholder's other business ventures, the greater the potential for the shareholder to capture private gains and, consequently, the greater the value that the shareholder would attach to his shares. Thus, under rules that facilitate shareholder voice, an acquiror of control would face the same problem that Easterbrook and Fischel identified in their explanation of limited liability: the acquiror would have to negotiate separately with individual shareholders, paying different prices to each. Therefore, control transactions would become more difficult.[138]

Second, rules limiting shareholder voice increase the probability of a successful takeover by decreasing the premium that a potential acquiror must pay for control. Because the analysis of this phenomenon is somewhat complicated, an example is helpful to demonstrate the effect on the market for corporate control.[139] Assume a firm exists with two distinct

137. *See supra* notes 105-08 and accompanying text; *see also* Gordon, *supra* note 19, at 376-79.

138. *See* Easterbrook & Fischel, *supra* note 21, at 95-96.

139. The analysis that follows is analogous to the analysis in René M. Stulz, *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, 20 J. FIN. ECON. 25, 28-34 (1988). Stulz examines the effect of managerial control of voting rights on firm value and financing policies. Stulz demonstrates that an increase in the percentage of voting rights under manage-

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groups of shareholders. The first group ("rent-seeking shareholders") is composed of individuals that have the ability to capture private gains if they can influence the business affairs of the firm. Accordingly, under rules that facilitate shareholder voice, the share value to a rent-seeking shareholder is a function of the firm's expected cash flows and the value of private gains that the shareholder expects to receive as a result of his power to influence the firm's affairs. The second group ("disinterested shareholders") is composed of individuals who have no capacity to capture private gains. The share value to this group is a function only of the firm's expected cash flows. Assume further that rent-seeking shareholders will lose their power to influence the firm's affairs (and therefore suffer a diminution in the value of their shares) in the event that a potential acquiror captures control of the corporation.[140]

Under rules that facilitate shareholder voice, a conflict of interest exists between the two groups of shareholders. Rent-seeking shareholders will tender their shares to a potential acquiror only if the premium offered is large enough to compensate them both for their pro-rata share of the firm's expected cash flows *and* for the potential private gains lost.[141] Assuming for simplicity that a potential acquiror's gain from control is too small to enable it to pay a premium large enough to induce rent-seeking shareholders to tender their shares, then, rent-seeking shareholders will never tender their shares to a potential acquiror. Disinterested shareholders, however, will be amenable to tendering their shares for a smaller premium than rent-seeking shareholders, since disinterested shareholders only require compensation for their pro-rata portion of the firm's expected cash flows. Thus, situations may arise where disinter-

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ment's control decreases the possibility of a successful tender offer and increases the premium that must be paid.

140. This assumption appears reasonable. First, shareholders who capture control of a firm generally follow their acquisition of control with a cash-out merger (i.e., a merger in which minority shareholders are forced to accept cash for their shares). Thus, a rent-seeking shareholder would not be likely to continue to be a stockholder in the firm following a control transaction. Even assuming that a cash-out merger did not occur, a minority shareholder is not likely to be able to successfully influence the firm's affairs following a control transaction, since a shareholder who owns 51% of a firm's shares is unlikely to agree with schemes that benefit a minority shareholder at the expense of the firm.

141. This analysis assumes that rent-seeking shareholders must make firm-specific investments in order to obtain private benefits from influencing the firm's affairs. If rent-seeking shareholders could obtain private benefits without making firm-specific investments, they would not insist on compensation for the private benefits lost when an acquiror captures control. In that case, a rent-seeking shareholder could obtain private gains by selling his shares and investing in a different firm where private gains remained available.

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ested shareholders would be willing to tender their shares, but rent-seeking shareholders would not.

Under these conditions, if a takeover attempt is to succeed, a potential acquiror must acquire a controlling stake solely from disinterested shareholders. When no shares are owned by rent-seeking shareholders, this task is relatively easy. Using his knowledge regarding the upward sloping supply curve for shares owned by disinterested shareholders,[142] the potential acquiror selects the lowest premium that will induce disinterested shareholders to tender fifty-one percent of their shares. However, as the percentage of shares owned by rent-seeking shareholders increases, the potential acquiror's task becomes more difficult. Now the potential acquiror must induce disinterested shareholders to tender a larger percentage of their shares (equal to at least $1/[2(1-\alpha)]$ where α equals the percentage of shares owned by rent-seeking shareholders) in order for the offer to succeed. Because the supply curve for shares owned by disinterested shareholders increases, the potential acquiror must therefore increase the premium offered to induce the disinterested shareholders to tender the larger fraction of their shares. Thus, under rules that facilitate shareholder voice, an increase in the percentage of shares owned by rent-seeking shareholders increases the premium which the potential acquiror must offer in order to acquire at least 51% of the shares. Takeovers therefore become less profitable for potential acquirors and, hence, less likely to occur.[143]

142. For a general discussion of empirical and theoretical evidence suggesting that the supply curve of shares tendered is an increasing function of the premium offered by a potential acquiror, see Stulz, *supra* note 139, at 29-30. Briefly, empirical evidence on the upward slope of the supply curve for shares includes evidence of bids that are oversubscribed. *See* Michael Bradely et al., *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183 (1983). It also includes evidence that the number of shares purchased in share repurchases increases with the premium offered, *see, e.g.*, Ronald W. Masulis, *Stock Repurchase by Tender Offer: An Analysis of the Causes of Common Stock Price Changes*, 35 J. FIN. 305 (1980), and evidence that the probability of success of a tender offer increases with the premium offered, *see* Ralph A. Walkling, *Predicting Tender Offer Success: A Logistic Analysis*, 20 J. FIN. & QUANT. ANAL. 461 (1985). Theoretical justifications for the upward slope of the supply curve for shares include the differing income tax impact of a cash tender offer on differently situated shareholders. *See* Stulz, *supra* note 139, at 30.

143. The foregoing analysis assumed a situation in which a potential acquiror's gain from control was too small to enable it to pay a premium large enough to induce rent-seeking shareholders to tender their shares. The conclusion—that an increase in the fraction of shares owned by rent-seeking shareholders increases the premium which must be offered in order for a potential acquiror to capture control—does not, however, rest on that assumption. For a detailed discussion of the mathematical steps necessary to generalize this analysis, see Stulz, *supra* note 139, at 36-40 (analyzing the effect of managerial control of voting rights).

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Stated otherwise, under rules facilitating shareholder voice, shareholders who have the capacity to capture private benefits by influencing the corporation's affairs begin to resemble firm managers. Like firm managers, these shareholders make firm-specific investments to maximize the benefits that they receive as a result of their affiliation with the firm. Moreover, these shareholders resist efforts by potential acquirors that threaten to render these firm-specific investments valueless by refusing to tender their shares (or at least holding out for a price that is sufficiently high to compensate them for the value of their firm-specific investments). Not surprisingly, the result of resistance by these shareholders is identical to the result of resistance by firm managers: an increase in the cost of tender offers to potential acquirors and a corresponding reduction in the effectiveness of the market for corporate control.[144]

2. *Relationship Between Rules Limiting Shareholder Voice and the Operation of Securities Exchanges*

In addition to contributing to the efficient operation of the market for corporate control, rules limiting shareholder voice contribute to the efficient operation of organized securities exchanges. Without rules that limit shareholder voice, shares would not have a single market price; the value of a share would partially depend on the expected value of any private gains that a particular shareholder could expect to receive as a result of his relationship with the firm. Since shares would no longer have a single market price, investors would have to expend greater resources analyzing the firm's value before trading. These greater expenditures would mean diminished liquidity for investors and an increased cost of capital for firms. However, under rules that limit shareholder voice, these impediments to the smooth operation of securities markets do not exist. Investors can trade in reliance on a market price which impounds all available information. Therefore, rules that limit shareholder voice have the same beneficial impact on organized securities exchanges as rules limiting the liability of shareholders.

3. *A Final Caveat*

The above analysis illustrates that rules limiting the ability of shareholders to control business decisions may increase shareholder wealth in some firms; however, it should not be construed to suggest that rules

144. *See* Stulz, *supra* note 139.

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limiting shareholder voice are appropriate for all firms. The above analysis implies that a tradeoff exists between market and voice mechanisms for controlling agency costs inherent in the structure of the public corporation. On the one hand, legal rules limiting shareholder participation in management invigorate the market for corporate control by making takeovers less expensive. On the other hand, legal rules facilitating shareholder participation in management invigorate the voice method of monitoring management by providing shareholders that engage in active monitoring with the power to capture private gains. Therefore, since the evidence suggests that different mixes of monitoring methods are appropriate for different firms,[145] the proper legal rule regarding shareholder voice in management should vary depending upon the firm's characteristics.

One way to test the theory advanced in this article would be to examine the legal rules relating to shareholder voice in a large sample of public corporations. Controlling for all other variables one would expect to find that firms with the greatest profit potential from active shareholder oversight would more often be characterized by rules giving shareholders a greater role in management decisions. As Demsetz and Lehn note in another context,[146] firms where the profit potential from shareholder activism is the greatest could be identified by virtue of the noisiness of the environment in which they operate. One would therefore expect firms that operate in less stable environments (i.e., environments not characterized by stable prices, technology, or market share) to benefit more from active shareholder oversight.[147]

145. *See* Baysinger & Butler, *supra* note 87; Harold Demsetz & Kenneth Lehn, *The Structure of Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985). Baysinger and Butler examine the factors that lead firms to choose between jurisdictions with strict and liberal corporate laws; Demsetz and Lehn, on the other hand, examine the factors that lead different firms to have different levels of concentration of ownership of equity securities. These studies present evidence that firm performance does not vary depending upon the jurisdiction of incorporation (in the case of the Baysinger and Butler study) or the level of concentration in share ownership (in the case of the Demsetz and Lehn study). Therefore, these studies support the conclusion that different monitoring mechanisms are appropriate for different types of firms.

146. Demsetz & Lehn, *supra* note 145, at 1159.

147. *Id.* It should be noted, however, that a finding that few public corporations have rules giving shareholders a significant voice in management would not necessarily undermine the theory set forth in this paper. Perhaps the market for corporate control and organized securities exchanges are of such importance to the efficient operation of public corporations that it is almost never in the interest of a firm's organizers to select a structure that significantly impairs the effectiveness of those markets.

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CONCLUSION

This article has examined the economic impact of rules limiting the power of shareholders to influence corporate business decisions. In particular, this Article contends that rules limiting shareholder voice cannot be based solely upon the conclusion that shareholders will rarely wish to play an active role in the firm's affairs. Instead, rules limiting shareholder voice must rest upon an analysis of the costs of shareholder activism to the firm in those few cases where activism is consistent with the interests of some of the firm's shareholders. Reasoning that rules facilitating shareholder activism reduce the efficiency of both the market for corporate control and organized securities exchanges, this article concludes that limitations on shareholder voice may increase shareholder wealth in some firms by decreasing the costs of specializing the economic functions of owning and managing.

The analysis presented here has significant policy implications for the current debate surrounding the appropriate role of institutional shareholders in corporate governance. The analysis suggests that changes to corporation laws designed to facilitate monitoring of corporate managers by increasing shareholder influence over business decisions should only be undertaken with caution. Although changes designed to facilitate institutional activism will certainly increase the effectiveness of shareholder monitoring of managers, these changes may inadvertently decrease the effectiveness of a more important mechanism for controlling management—the market for corporate control.

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