SHAREHOLDER VOTING AND THE CHICAGO SCHOOL: NOW IS THE WINTER OF OUR DISCONTENT

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INTRODUCTION

Proponents of the Chicago School—the "free marketeers"[1]—have influenced corporate law significantly. Their views on the appropriateness (or inappropriateness) of government intervention have had a great impact on the debate over corporate governance. Whereas commentators and policymakers previously asked what specific policies were best for shareholders, they now ask what "enabling statute" will give shareholders the most freedom to choose their own corporate structure.

Using market-based economic analyses, the free marketeers have argued that in an efficient capital market a "race to the bottom"[2] would not occur. The free marketeers argue that the market takes all public information into account in its valuation of securities and that therefore the capital markets will punish companies that try to take advantage of their investors. Judge Ralph Winter has written that incorporation-friendly laws would create

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1. This Note refers to the adherents of the Chicago School as "free marketeers" in order to emphasize the type of beliefs with which they are generally associated. The free marketeers include Professor Ronald Coase, Judge Frank Easterbrook, Professor Richard Epstein, Professor Daniel Fischel, Judge Richard Posner, and Judge Ralph Winter. Sometimes these people are referred to as the "Chicago School" because many of them are, or have been, affiliated with the University of Chicago. For a general discussion of the Chicago School and its adherents, see ALLIANCE FOR JUSTICE, JUSTICE FOR SALE: SHORTCHANGING THE PUBLIC INTEREST FOR PRIVATE GAIN 23–44 (1993).

2. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). Professor Cary dubbed the phenomenon in which individual states compete for incorporations by removing shareholder protections a "race for the bottom." *Id.* at 705. U.S. Supreme Court Justice Louis D. Brandeis first raised the possibility of such a race in 1933, referring to a race "not of diligence but of laxity." Louis K. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting in part). The race is generally referred to now as the "race *to* the bottom," and this Note uses that terminology. For a brief list of articles articulating the theory, as well as a discussion of its history, see Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 469 n.1 (1987).

competition among the states and lead to a "race to the top" that leads to increased shareholder wealth.[3]

However, as the free marketeers themselves have noted, the race is not as efficient as they would like it to be.[4] In addition to the legislature's desire to maximize franchise tax revenues, political forces also influence state legislatures when they draft corporate codes.[5] Additionally, an overlay of federal securities law restricts states, and therefore shareholders, in their race to shareholder wealth. The free marketeers condemn these anti-market developments as detrimental to shareholder wealth and to the economy as a whole.

In contrast to their condemnation of anti-market restrictions, the free marketeers have embraced a regulatory shareholder voting scheme that restricts shareholders' freedom to choose their own corporate governance structure. They have asserted summarily that the current "one size fits all," primarily republican, form of shareholder democracy is ideal for corporate efficiency and that allowing increased shareholder voting would lead to inefficiency and "micromanagement" of companies.[6] Exhibiting the same type of paternalism they have criticized in Cary's race to the bottom argument, they profess to know what level of direct democracy is best for all shareholders.

The free marketeers may be correct that republicanism is, in many cases, the most efficient form of corporate governance. However, republicanism is not the only form of democracy in the political arena; various hybrid forms of government are considered democratic.[7] Similarly, within the universe of "corporate democra-

3. *See* Ralph K. Winter, Jr., *The Development of the Law of Corporate Governance*, 9 DEL. J. CORP. L. 524, 528 (1984) ("I would submit, rather, that the race is to the top."); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 5–6 (1991).

Because all agree that Delaware is the leader in the race (whether it be a race to the bottom or a race to the top), this Note primarily discusses Delaware law. In some places, it discusses the laws of California and New York and the provisions of the Model Business Corporation Act as well.

4. *See infra* notes 23–26 and accompanying text.

5. *See infra* notes 23–25 and accompanying text.

6. *See infra* note 83 and accompanying text.

7. *See* Julian N. Eule, *Judicial Review of Direct Democracy*, 99 YALE L.J. 1503, 1509–10 (1990) (noting the states' differing levels of acceptance of direct democracy in the political arena). *But see* Douglas H. Hsiao, Note, *Invisible Cities: The Constitutional Status of Direct Democracy in a Democratic Republic*, 41 DUKE L.J. 1267 (1992) (arguing that the Constitution allows only republican state governments). Mr. Hsiao argues that

cy," shareholders should be able to choose the corporate governance system that best fits their corporation. This Note does not argue for a mandated increase in shareholder democracy; to increase shareholder voting, new corporations would have to include specific provisions in their charters, and existing corporations would have to amend their charters. Particular areas of corporate governance or particular corporations may lend themselves to increased direct democracy. This Note looks specifically at executive compensation, in which inherent structural biases, as well as the peripheral nature of executive compensation decisions to other decisions, make direct democracy a more appealing option.

Part I discusses the free marketeers' advocacy of enabling statutes and reviews the race to the bottom debate. Part II analyzes the current legal environment surrounding shareholder democracy and notes the free marketeers' position on shareholder voting. It then suggests several concrete proposals for allowing increased shareholder choice in the area of corporate governance, specifically in the area of executive compensation. This Note concludes that the free marketeers have failed to apply their theories consistently to the issue of shareholder democracy.

I. THE BENEFICIAL NATURE OF ENABLING STATUTES

A. *Free Market Tenets*

The free marketeers have changed the focus of corporate law from a search for a specific, "one size fits all" policy that is "best" for shareholders to a search for a less restrictive scheme that allows each company's shareholders the most freedom to choose the corporate governance system that is best for them. The free marketeers generally favor enabling statutes that "allow[] managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator."[8] They argue that if certain provisions are detrimental to shareholders, shareholders either will not invest in corporations that have those provisions or will act to change those provisions.[9]

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there are valid policy arguments for limiting the use of direct democracy. *Id.* at 1270.

For a general discussion of political direct democracy and shareholder voting power, see *infra* notes 84–87 and accompanying text.

8. EASTERBROOK & FISCHEL, *supra* note 3, at 2.

9. *Id.* at 6.

Delaware has enacted a corporate governance scheme that is largely enabling in character.[10] Although some revile Delaware as leading the race to the bottom, the free marketeers see Delaware as merely setting up a system that shareholders prefer and have accepted by investing in Delaware corporations. As evidence, the free marketeers point to the fact that Delaware corporations' shares generally provide a higher rate of return than do other corporations' shares.[11]

The free marketeers acknowledge that shareholders' ability to exercise their investment power depends on two factors. First, shareholders, or at least the market, must have knowledge of the precise market impact of these legal provisions.[12] Second, shareholders need the actual power to act on this knowledge. If investors have knowledge that provisions will have a negative impact on share value, they have several options. If they do not own the shares, they can decline to purchase them or they can sell the shares short.[13] If they already own the shares, they can sell the shares or exercise shareholder democracy to amend the detrimental provisions.

10. *See infra* notes 35–44 and accompanying text.

11. *See infra* text accompanying notes 47–50.

In order to avoid confusion, it is necessary to discuss the two types of corporate competition. First, there is interstate competition, in which the regulatory schemes of two states compete for incorporations. Second, there is intrastate competition, in which corporations themselves compete for investors by varying the terms of their charters. The free marketeers see both types of competition as beneficial to shareholders. Interstate competition induces the "losing" state to conform its corporate code to the desires of shareholders. Intrastate competition induces the "losing" company to conform its charter to the desires of shareholders. Most of the race to the bottom debate has centered around interstate competition, that is, Delaware law's effect on other states. This Note focuses more on increasing intrastate competition by allowing corporations more latitude in varying their charters.

12. The free marketeers argue that even if individual shareholders do not recognize the impact of certain provisions, the stock markets reflect these impacts in the market valuation of shares. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 18–19; Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 257 (1977). Of course, in this case, the "market makers" must have the requisite knowledge of the provisions' impact.

13. In selling short, an investor commits to sell securities he does not own. The investor borrows the securities (generally from a broker) and delivers them to a clearing agency. If the price of the securities then declines, the investor can purchase the same securities at the reduced price, return the securities to the broker, and keep the difference in price. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1304 (1991).

In practice, however, although potential investors may decline to invest in a corporation's shares, current shareholders cannot always exercise their investment power so easily. Assuming they have sufficient knowledge, shareholders may not have sufficient power to act. Large institutional investors may not be able to divest themselves of their holdings in some corporations due either to the sheer magnitude of their holdings[14] or to the downward effect on share price that such a sale might have.[15] Additionally, if the company's shares are not publicly traded, it may be difficult for shareholders to sell their shares.

If shareholders are unable to sell, they could amend detrimental provisions in the certificate of incorporation or bylaws. However, many authors have questioned shareholders' power to control their own corporations in this way, noting that management gener-

14. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 866 n.7 (1991) (noting that in 1990, institutional investors held close to six trillion dollars, 45% of all U.S. equity securities); *see also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990), who estimates that institutional investors held 42.7% of all corporate equities in 1986, relying on an "incomplete definition of institution." *Id.* at 567. "Large companies typically have even higher institutional ownership, often over 60% and in some cases over 75%." *Id.* Professor Black adds:

> More importantly, individual institutions have grown to substantial size, and own significant percentages of individual companies. At yearend [sic] 1989, the 50 largest institutions owned . . . 27% of the entire U.S. stock market. The 13 largest institutions held over half of this amount—an average of over 1% of the U.S. market each. It's common for a single institution to hold 2–3% of the stock of a single company.

Id. at 567–68 (footnotes omitted).

As Professor Coffee has stated:

> Among the top one hundred American corporations in terms of stock market value, the level of institutional ownership is now at 53%. Among some of the largest and best-known corporations, the percentage of institutional ownership nearly swallows the market, for example: General Motors Corp. (82%), Mobil Corp. (74%), Citicorp (70%), Amoco (86%), and Eli Lilly & Co. (71%).

John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1291 (1991) (footnotes omitted). For more detailed figures, see Carolyn K. Brancato, *The Pivotal Role of Institutional Investors in Capital Markets*, *in* INSTITUTIONAL INVESTING: CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 3, 13–29 (Arnold W. Sametz ed., 1991).

15. *See* Coffee, *supra* note 14, at 1288–89 (noting that " 'exit' has become more difficult, because institutional investors, who increasingly own large unmarketable blocks, must accept substantial price discounts in order to liquidate these blocks"). Professor Coffee notes an additional reason that exit is seen as a less viable option: the more widespread acceptance of the Efficient Capital Market Hypothesis, which argues that investors "cannot outperform the market (at least without accepting additional risk)." *Id.* at 1289 n.33. Therefore "many institutions have turned to 'indexed' investing, which implies a buy-and-hold policy." *Id.*

ally controls the corporate machinery. The general view is that shareholders do not invest the resources necessary to make an informed decision and merely rubber-stamp management's decisions.[16] If the typical investor is unsophisticated, the paternalism Professor Cary advocated[17] may be desirable. Today, however, with more of the market in the hands of institutional investors, the force of Professor Cary's argument is greatly reduced. An institutional investor with a substantial stock position in a corporation has the incentive to educate itself about that corporation's affairs and possibly to become involved in its management.[18] With tremendous financial and technical resources at its disposal, an institutional investor is not powerless against management.[19]

Regardless of shareholder knowledge and power, two additional factors hinder a race to the top. First, even with full knowledge of the impact that Delaware's provisions may have on shareholders' rights, markets may undervalue certain contingencies in their analyses. The risks of incorporation in Delaware are enormously speculative. As long as management does not abuse its freedom from shareholder control, there is no tangible negative effect on shareholders, but shareholders (or the market) may be unable to determine the likelihood and magnitude of future adverse management action. It may be only after management has abused its power that the market adjusts. This phenomenon is known as the availability principle. This principle posits that although people, even experts in a field, know that a recent event is no more likely to occur a second time than it was the first time, they tend to be more wary of those events because they are most "available" in their memories.[20] The other side of the coin is that before the occurrence of the event, the public may be less worried

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16. *See, e.g.*, Black, *supra* note 14, at 521; *see also infra* notes 106–07 and accompanying text (noting collective action and free rider barriers to shareholder activism).

17. *See* Cary, *supra* note 2.

18. Black, *supra* note 14, at 580–81, 589–91. The inability to "exit," or sell shares, creates an additional incentive for the institutional investor to educate itself about the corporation and to become involved in the corporation's management. *Id.* at 572–73.

19. Indeed, many recent anecdotal situations point to the increased power of institutional investors. *See, e.g.*, *id.* at 571–75 (noting recent shareholder proposals by the California Public Employees' Retirement System (CalPERS), the College Retirement Equities Fund (CREF), and the Wisconsin Investment Board).

20. *See, e.g.*, ROBERT V. PERCIVAL ET AL., ENVIRONMENTAL REGULATION: LAW, SCIENCE, AND POLICY 31 (1992). One example of the availability principle is the public's sudden concern with oil tanker safety and the prevention of future oil spills following the Exxon Valdez disaster. *Id.* at 28–35.

than it should be. The operation of this principle was evident in the bond markets' reaction to RJR Nabisco's announcement of its historic leveraged buyout (LBO) in 1989. In failing to factor into its valuation the possibility of action so potentially detrimental to the RJR Nabisco bonds, the market had relied on RJR Nabisco's past practice.[21] The bonds' value dropped immediately after RJR Nabisco announced the LBO.[22] Although the RJR Nabisco scenario involved bonds, not stock, the same principle would apply to action taken to the detriment of shareholders.

Second, even if one state's overall corporate law package is best in terms of shareholder value, its individual provisions may not be optimal. In fact, it is not clear that any state has found an "optimal" corporate law. Additionally, state legislatures, even in Delaware, may hamper the race to the top with political motivations that cause them to depart from the pursuit of revenues.[23] These ulterior motives may explain, for example, the prevalence of anti-takeover statutes, which the free marketeers generally condemn as contrary to shareholders' interests.[24] In fact, Judge Winter has acknowledged the possibility that the "race to the top [may be] a leisurely walk."[25] Federal law, particularly federal proxy rules,[26] overlaps state laws and also may hamper the race to the top.

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21. Although the market and the bondholders had foreseen the possibility of an LBO of this magnitude, Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1511-14 (S.D.N.Y. 1989), the market did not expect an LBO of RJR Nabisco, perhaps because of statements made by RJR Nabisco's management regarding its commitment to maintaining its high credit rating. *Id.* at 1514.

22. *See* Christopher Farrell, *Bondholders Are Mad as Hell—and They're Not Going to Take It Anymore*, BUS. WK., Feb. 6, 1989, at 82, 82 (noting "dizzying" 20% drop in bonds' value); *see also Metropolitan Life*, 716 F. Supp. at 1506 n.4 (noting that "subsequent to the announcement of the LBO, RJR Nabisco's bonds lost their 'A' ratings").

23. Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1528 (1989); *see also* EASTERBROOK & FISCHEL, *supra* note 3, at 216-22.

24. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 218 (noting that the "proposition that the competition among states for corporate charters is beneficial to investors has been challenged by the proliferation of state anti-takeover statutes"); *id.* at 221 (noting that "when states adopt these statutes . . . [p]rices go down, not up"); Winter, *supra* note 12, at 287 (noting that, to the extent that state anti-takeover statutes increase the transaction costs of corporate takeovers, they "increase[] management's discretion . . . in a way that does not benefit shareholders").

25. Winter, *supra* note 23, at 1529.

26. 17 C.F.R. §§ 240.14a-1 to .14b-2 (1992).

B. *The Race to the Bottom Debate*

In 1974, Professor William Cary published an article in the *Yale Law Journal* that sparked a major debate in academic and corporate circles over the existence of a race to the bottom.[27] Professor Cary argued that to increase revenues and prestige, state legislatures seek to induce companies to incorporate in their states by writing corporate codes that appeal to managers, to the detriment of shareholders.[28]

Although acknowledging that the "principle of states' rights and the idea that each state is a laboratory are strong in this country,"[29] Professor Cary argued that "one can fairly hope that the growth of the law in a civilized society should be evolutionary."[30] He asserted that management, supported by the corporate bar, is interested in avoiding shareholder control over its actions and described how the Delaware corporate code caters to these management interests.[31] This race to the bottom demeans management's integrity.[32] Emphasizing "the need for uniformity, so that states shall not compete with each other by lowering standards for competitive reasons or for the purpose of generating revenue,"[33] he concluded that federal intervention is necessary to ensure certain minimum standards of shareholder protection against manager misconduct.[34]

Delaware is the clear leader in this race to the bottom.[35] Judge Ralph Winter has suggested that

> [s]olely to make money, Delaware sold law. The way that it sold law was to have the Delaware bar determine what law would bring more corporate charters to the state and then go to the legislature and say, "this language will bring more charters to the state of Delaware." Without the vaguest idea of what it was

27. *See* Cary, *supra* note 2.
28. *See id.* at 664–65.
29. *Id.* at 696.
30. *Id.*
31. *Id.* at 698–99.
32. *Id.*
33. *Id.* at 697.
34. *Id.* at 700–03.
35. *See id.* at 668. "Delaware is the state of incorporation of roughly half of the Fortune 500 companies. Approximately 80 percent of firms that change their state of incorporation move to Delaware." EASTERBROOK & FISCHEL, *supra* note 3, at 212–13.

> doing, other than bringing more charters to the state of Delaware, the legislature would pass the legislation.[36]

Although early in the twentieth century, other states attempted to compete with Delaware, after New Jersey dropped out of the race in 1913,[37] Delaware became the premier state of incorporation for American corporations.[38]

Many other states have tried to emulate Delaware in an attempt to keep or attract corporations;[39] those states that have not have seen companies reincorporate elsewhere.[40] Because of this competitive pressure, even the Model Business Corporation Act, which began as a response to Delaware's corporate code, eventually modelled itself after the Delaware code.[41] The Report of the Corporation Law Revision Commission of New Jersey in 1968 stated in part: "Any attempt to provide [pro-shareholder] regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions."[42] It is this inability of any one state to reverse the trend that led Professor Cary to urge federal action.

Professor Cary did not argue that all of Delaware's provisions are detrimental to shareholders and admitted that some have "effected simplification and flexibility and have eliminated unnecessary and vestigial procedures."[43] Despite these benefits, the Delaware provisions as a whole "have watered the rights of shareholders vis-à-vis management down to a thin gruel."[44]

The free marketeers do not dispute the fact that many of Delaware's code provisions appeal to managers because they permit managers to take many corporate actions unfettered by reg-

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36. Ralph Winter, *Private Goals and Competition Among State Legal Systems*, 6 HARV. J.L. & PUB. POL'Y 127, 127 (1982). Judge Winter does not disagree with Professor Cary's argument that Delaware appeals to managers. *See* Winter, *supra* note 12, at 254-55. Rather, he disagrees with the implications of this appeal and with the effect it has on shareholders. *Id.* at 256-58.

37. *See* Cary, *supra* note 2, at 664.

38. *See infra* text accompanying note 49.

39. *See* Cary, *supra* note 2, at 665-66.

40. *See id.* at 668 (discussing experiences of North Carolina and New York).

41. *See id.* at 665 (noting that "the Model Act has been watered down to compete with the Delaware statute on its own terms").

42. *Id.* at 666 (quoting N.J. STAT. ANN. § 14A, at XI (West 1969)).

43. *Id.*

44. *Id.*

ulation.[45] They argue, however, that the race to the bottom theory cannot be valid because the market for capital is competitive enough that shareholders would not invest in Delaware corporations if they saw the Delaware code as unfavorable to them.[46] The free marketeers point out that shares of Delaware corporations have a higher return than those of other corporations[47] and that shares of companies incorporated elsewhere rise in value in anticipation of and on reincorporation in Delaware.[48] In the free marketeers' eyes, the fact that Delaware is the state of incorporation for roughly half of the Fortune 500 companies[49] means that shareholders do not desire additional power or protection and that any federal attempt to force additional protection would be wasteful.[50]

1. *Specific Legislative Developments.* According to Professor Cary, several legislative developments in Delaware's corporate law are particularly adverse to shareholder interests. These include minimal corporate disclosure requirements and the allowance of extensive directors' and officers' insurance and indemnification. The free marketeers have responded that investors' willingness to invest in Delaware corporations indicates their support for Delaware law.[51] On some specific issues, the free marketeers have suggested rationales explaining why shareholders support provisions that at first glance seem contrary to their interests. For example, insurance and indemnification benefits shareholders by inducing management to take risks, thus promoting corporate innovation and investment.

As noted above, Professor Cary decried Delaware's minimal disclosure requirements[52] and contrasted its provisions with the increased emphasis on disclosure at the federal level.[53] Relatedly, he noted that because under Delaware law "shareholders meetings

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45. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 213; Winter, *supra* note 12, at 254–55.

46. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 213–14; Winter, *supra* note 12, at 256–58.

47. *See* Winter, *supra* note 36, at 128.

48. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 214 & n.4.

49. *Id.* at 212.

50. *See id.* at 83–86; Winter, *supra* note 12, at 276–77.

51. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 5–6, 212–18.

52. Cary, *supra* note 2, at 667.

53. *Id.*

may now be dispensed with if a consent is signed by the number of votes necessary to take the intended action,"[54] management is able to avoid the full disclosure required at a shareholder meeting.[55] The free marketeers' theory holds that if shareholders found a lack of disclosure undesirable, they would amend their charters to require shareholder meetings or they would invest elsewhere.

Next, Professor Cary lamented that "any corporation may in its certificate of incorporation confer the power to amend or repeal by-law provisions upon the directors and thus possibly foreclose any initiative outside the management."[56] The free marketeers have responded that shareholders do not require protection because they have the power to approve[57] such provisions.[58]

Finally, Professor Cary noted that others have criticized various provisions for indemnification and insurance of directors and officers as excessively liberal.[59] The free marketeers argue that shareholders view these provisions as necessary to encourage management to take risks. Shareholders tend to be risk-seeking because they can easily diversify in the market.[60] Directors, on the other hand, tend to be risk-averse because "they cannot diversify the value of their human capital."[61] To the free marketeers, insurance and indemnification provisions are actually pro-shareholder because they attempt to make management's and shareholders' interests more closely parallel.[62]

54. *Id.* at 669.
55. *Id.*
56. *Id.* (footnote omitted).
57. This "approval" could be in the form of either voting for the provision in question or purchasing the shares with the provision in effect. This Note uses the words "approve" or "choose," or variations of these words, to convey both meanings.
58. DEL. CODE ANN. tit. 8, § 242 (1992).
59. Cary, *supra* note 2, at 669-70 (citing Joseph W. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1081 (1968)).
60. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 99-100; Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1472 (1989); Winter, *supra* note 3, at 527.
61. EASTERBROOK & FISCHEL, *supra* note 3, at 99; *see* Eisenberg, *supra* note 60, at 1472 (noting "riskiness of [management's] human-capital investments"); Winter, *supra* note 3, at 527 (noting that "management's viewpoint is closer to that of the undiversified shareholder").
62. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 100.

2. *Specific Judicial Developments.* Professor Cary also criticized a number of judicial developments in Delaware. He argued that the Delaware courts had "create[d] a 'favorable climate' for management"[63] by relaxing fiduciary standards and the standards of fairness.[64] For example, Delaware courts have been unwilling to find that boards of directors are acting with entrenchment motives even when the board authorizes the corporation to pay greenmail to combat a hostile takeover that might cost the directors their jobs.[65] The free marketeers argue that the Delaware courts' position actually reflects shareholders' desires. It is the free marketeers' belief that, much like indemnification and insurance, a more relaxed standard of review of management actions leads to increased risk taking, to the benefit of shareholders.[66]

Professor Cary also argued that the Delaware courts' shareholder voting and proxy decisions tend to favor management at the expense of shareholders.[67] Professor Cary found particular fault with *American Hardware Corp. v. Savage Arms Corp.*,[68] in which the Supreme Court of Delaware relied on the state's corporate code, as well as on corporate bylaw provisions that mandated only ten-days notice of a shareholder meeting, to uphold the sufficiency of sixteen-days notice for a meeting.[69] Under the free marketeers' theory, no fault can be found with the outcome of the case because the shareholders specifically approved the ten-days notice. The free marketeers' philosophy is built on the freedom of contract doctrine; the shareholders in *American Hardware* made a contract calling for a ten-days notice period and were rightly bound.[70]

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63. Cary, *supra* note 2, at 670.

64. *Id.*

65. *Id.* at 673–75; *see, e.g.*, Cheff v. Mathes, 199 A.2d 548 (Del. 1964) (rejecting the vice chancellor's finding of entrenchment motives on the part of the board of directors).

Greenmail involves the "purchase by a hostile investor of a sizeable portion of a target company's stock in order to induce the target to repurchase those shares at a substantial profit to the investor and to enter into a peace treaty known as a 'standstill agreement.'" LEWIS D. SOLOMON ET AL., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 1057 (2d ed. 1988). A standstill agreement "preclud[es the bidder] from thereafter commencing another bid." COX ET AL., *supra* note 13, at 989.

66. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 100.

67. Cary, *supra* note 2, at 675–77.

68. 136 A.2d 690 (Del. 1957).

69. *Id.* at 692–93.

70. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 16–17, 22–25.

Cary then argued that the Delaware courts' rejection of the *de facto* merger doctrine and acceptance of the doctrine of independent legal significance[71] allows a corporation to evade the corporate law and works to the detriment of shareholders.[72] Although it is unclear why shareholders might find these particular policies desirable, the free marketeers would rely on the fact that the shareholders, who could have invested elsewhere, chose Delaware as their state of incorporation; they must therefore approve of such policies.[73]

Professor Cary also found Delaware courts lax in their protection of minority shareholder interests.[74] Judge Winter responded that increased judicial involvement would merely increase costs to corporations and that any blanket rule to protect minority shareholders would fail to take into account the greater (monetary) interest of the majority shareholder.[75] In addition, a majority shareholder could force the minority shareholder out of the corporation via a freeze-out merger.[76] Therefore, any additional judicial protection would be largely illusory because it might only lead to an increase in the number of freeze-out mergers.

Finally, Professor Cary complained that the Delaware courts impose an inadequate duty of care standard on directors and argued that directors should be required to install monitoring procedures to prevent recurrences of past wrongdoing.[77] In *Graham v. Allis-Chalmers Manufacturing Co.*,[78] the Delaware courts considered a derivative action against a company's directors for breach of the duty of care. The company had been indicted for antitrust violations committed twenty-two years after the Federal Trade

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71. Cary, *supra* note 2, at 679. In 1962, the Delaware Court of Chancery declined to hold that a sale of assets was a *de facto* merger. The court held that the provisions of Delaware's corporate code had "independent legal significance"—that a corporation could bring about a result under one provision of the code, even if another section would preclude another method of accomplishing the same result. Hariton v. Arco Elecs., Inc., 182 A.2d 22, 26–27 (Del. Ch. 1962) (quoting Langfelder v. Universal Labs., 68 F. Supp. 209, 211 (D. Del. 1946), *aff'd*, 163 F.2d 804 (3d Cir. 1947)), *aff'd*, 188 A.2d 123 (Del. 1963).

72. Cary, *supra* note 2, at 679.

73. *See supra* note 51 and accompanying text.

74. Cary, *supra* note 2, at 679–82.

75. Winter, *supra* note 12, at 261.

76. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 3, at 134–35.

77. Cary, *supra* note 2, at 683–84 (discussing Graham v. Allis-Chalmers Mfg. Co., 182 A.2d 328 (Del. Ch. 1962), *aff'd*, 188 A.2d 125 (Del. 1963)).

78. 182 A.2d 328 (Del. Ch. 1962), *aff'd*, 188 A.2d 125 (Del. 1963).

Commission had issued a cease and desist order against the company for similar violations.[79] The court held that the directors were not under a duty to install an internal control system to prevent repeated antitrust violations.[80] Judge Winter has argued that it was not enough for Professor Cary to assert that the fines could have been avoided; one's calculus must take into account the probability of the harm, the gravity of the harm, and the cost of avoiding the harm. If the cost of avoiding the harm exceeds the expected value of the damage from the harm, it is not in the shareholders' interest to avoid the harm.[81]

> Requiring perfect fail-safe systems in every corporation can be far more costly than any potential loss to shareholders, and Professor Cary presents an incomplete analysis in concluding that loss could have been avoided. He is on more solid ground in suggesting that the need for preventive measures was greater in the particular case in light of past conduct since that is relevant to the likelihood of loss.[82]

On a broad scale, then, the free marketeers argue that Professor Cary's solutions to the "problems" with Delaware corporate law are paternalistic and that shareholders do not desire many of his proposed solutions. Those developments that Professor Cary characterized as detrimental to shareholders may actually benefit shareholders by increasing their choices or by giving management certain incentives.

II. THE FREE MARKETEERS' FAILURE TO APPLY THEIR OWN THEORIES TO SHAREHOLDER VOTING

Underlying the free marketeers' refutation of Professor Cary's argument is an assumption of shareholder competence. Consistent with this assumption, the free marketeers should favor extending free market principles to corporate governance by allowing shareholders to opt for increased direct shareholder democracy. However, the free marketeers actually favor limiting shareholder voting power.[83]

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79. *Id.* at 331.
80. *Id.* at 332.
81. Winter, *supra* note 12, at 261 & n.32.
82. *Id.* at 261. In fact, Vice Chancellor Marvel, in *Allis-Chalmers*, noted that "the degree of care taken in any specific case must . . . depend upon the surrounding facts and circumstances." *Allis-Chalmers*, 182 A.2d at 332.
83. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 84–86; Winter, *supra* note 12, at

A. *State and Federal Restrictions on Shareholder Action*

Political democracy can be accomplished either directly or through republicanism. Under a direct democratic system, the electorate is given direct control over decisions through two political mechanisms: the referendum and the initiative.[84] In the corporate system, direct democracy is exercised through the shareholder vote.[85] Nonetheless, the corporate machinery relies primarily on republicanism, in which shareholders elect directors[86] and delegate power to them.[87] The directors are then expected to carry out the shareholders' desires.

Although limited, there is a certain level of direct democracy built into the corporate governance system. State law requires a shareholder vote on major structural issues, such as amendments to the articles of incorporation, proposed mergers, substantial sales of assets, and liquidation.[88] There are two reasons for requiring shareholder approval of such acts. First, these types of actions are likely to cause fundamental changes in shareholders' rights. State legislatures have made the decision that such fundamental changes in corporate direction should be approved by the direct vote of

276–77. Judge Winter has noted that "[t]he idea that more in the way of operational control of corporate affairs should be placed in the hands of shareholders—*e.g.*, the power to initiate proposals, cumulative voting, required votes on some issues, etc.—seemingly will not die, no matter how often it is dispatched by rational discussion." *Id.* at 276 (footnote omitted). Judge Easterbrook and Professor Fischel have argued that any proposals to increase shareholder "involvement in the corporate decision-making process . . . would reduce shareholders' welfare." EASTERBROOK & FISCHEL, *supra* note 3, at 86.

84. A referendum is placed on the ballot by the legislature for approval by the electorate. An initiative is proposed by the electorate (or a member thereof) and voted on by the electorate. *E.g.*, THOMAS E. CRONIN, DIRECT DEMOCRACY: THE POLITICS OF INITIATIVE, REFERENDUM, AND RECALL 2 (1989).

85. The board of directors is required to submit only a very few matters to a shareholder vote. *See infra* note 88 and accompanying text.

86. *E.g.*, CAL. CORP. CODE § 301(a) (West 1990); DEL. CODE ANN. tit. 8, § 211(b) (1991); N.Y. BUS. CORP. LAW § 703(a) (McKinney 1986); MODEL BUSINESS CORP. ACT § 8.03(d) (Supp. 1986).

87. *E.g.*, CAL. CORP. CODE § 300(a); DEL. CODE ANN. tit. 8, § 141(a); N.Y. BUS. CORP. LAW § 701; MODEL BUSINESS CORP. ACT § 8.01(b) (Supp. 1992).

88. *E.g.*, CAL. CORP. CODE § 903(a) (charter amendment); *id.* § 1001 (sale of all or substantially all assets); *id.* § 1201(a) (reorganization); *id.* § 1900 (dissolution); DEL. CODE ANN. tit. 8, § 242 (charter amendment); *id.* § 251 (Supp. 1992) (merger); *id.* § 271 (1991) (sale of all or substantially all assets); *id.* § 275 (liquidation); N.Y. BUS. CORP. LAW § 803(a) (charter amendment); *id.* § 903 (merger); *id.* § 909(a) (sale of all or substantially all assets); *id.* § 1001 (dissolution); MODEL BUSINESS CORP. ACT § 10.03 (1993) (charter amendment); *id.* § 11.03 (merger); *id.* § 12.02 (sale of all or substantially all assets); *id.* § 14.02 (dissolution).

shareholders, rather than solely by the directors exercising their delegated power.[89] Second, as Professor Melvin Eisenberg has noted, because these types of changes create new entities, remaining a shareholder is akin to making a new investment decision. The shareholder should be entitled to decide whether to invest in the "new" corporation.[90]

As to all other matters, however, corporate codes do not require a shareholder vote. In fact, the corporate charter cannot provide for increased shareholder control over more mundane matters because "[t]he business and affairs of every corporation organized [under the Delaware General Corporation Law] shall be managed by or under the direction of a board of directors."[91]

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89. EASTERBROOK & FISCHEL, *supra* note 3, at 79-80 (viewing such votes as a "mid-term election [of directors] as a partial response to the collective action problems that make it difficult for shareholders to organize to oust directors between elections").

90. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 78-84 (1976). Professor Eisenberg discussed the rationale behind appraisal remedies for dissenting shareholders after the majority or supermajority, as required by state law, has approved organic change. The same rationale argues even more strongly, however, for shareholder voting on the fundamental issue of whether the corporation should undergo the organic change at all.

91. DEL. CODE ANN. tit. 8, § 141(a). Other states' corporate codes contain similar language. *E.g.*, CAL. CORP. CODE § 300(a); N.Y. BUS. CORP. LAW § 701; MODEL BUSINESS CORP. ACT § 8.01 (Supp. 1992). All of these acts provide that the corporate governance structure can be modified by a provision in the certificate of incorporation, but there are significant restrictions. California's code and the Model Act limit such provisions to close corporations. *See* CAL. CORP. CODE § 204(a)(9) (allowing restriction on board's power); *id.* § 300(b) (implicitly limiting such restrictions to close corporations); MODEL BUSINESS CORP. ACT § 7.32 & cmt. (allowing close corporations to restrict board's power). Even those states which allow restrictions on the board's power in non-close corporations restrict such provisions to those not conflicting with other provisions of state law. DEL. CODE ANN. tit. 8, § 102(b)(1); N.Y. BUS. CORP. LAW § 402(b). New York law allows close corporations to restrict the board's powers, even if it would contravene other provisions of state law. *Id.* § 620(b).

The courts in New York and Delaware have interpreted their respective corporate codes as clearly forbidding the exercise of "day-to-day" powers by shareholders. According to the Delaware courts, "[t]he directors, not the stockholders, are the managers of the business affairs of the corporation." Maldonado v. Flynn, 413 A.2d 1251, 1255 (Del. Ch. 1980), *rev'd on other grounds sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). This "managerial province" is not modifiable by the corporate charter because "[d]irectors of Delaware corporations derive their managerial decision making power . . . from [the legislature]," *Zapata*, 430 A.2d at 782, as provided in title 8, section 141(a) of the Delaware Code.

The New York courts have held similarly. *See, e.g.*, Ripley v. Storer, 139 N.Y.S.2d 786, 794 (Sup. Ct.) (noting that "directors are not in any strict sense agents of the stockholders, . . . that they are to a very large extent free from stockholder control, and that no agreement or by-law which deprives them of their power to act for and in the best interest of the corporation is valid"), *aff'd*, 142 N.Y.S.2d 269 (App. Div. 1955), *modified*, Professors Henry Butler and Larry Ribstein have argued that a corporation's founders and shareholders have chosen the corporate form, with its separation of ownership and control, over other possible forms, such as a partnership, and that they therefore should accept the constraints of the corporate code.[92] They did not explain why founders and investors should not be able to dictate the shareholder-director relationship without being unnecessarily constrained by the corporate code.

Judge Frank Easterbrook and Professor Daniel Fischel have called corporate law "a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting."[93] It is efficient to have available a standard contract that conforms to the structure of corporate governance that corporations most often choose. However, the current corporate law system does not allow incorporators, at least in the area of corporate governance, to vary the terms if they desire. If the parties are sophisticated and possess a high level of knowledge and power, they should be allowed to vary the terms to create the governance structure that would best fit their particular corporation.[94] For

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132 N.E.2d 87 (N.Y. 1956). *Ripley* actually allowed by-law provisions that significantly restricted the board's power, *id.* at 795, but the corporation was a close corporation, with only four shareholders, *id.* at 791. In Barr v. Wackman, 329 N.E.2d 180 (N.Y. 1975), the New York Court of Appeals stated that it is "one of the basic principles of corporate control—that the management of the corporation is entrusted to its board of directors, who have primary responsibility for acting in the name of the corporation . . . ." *Id.* at 185–86 (citation omitted).

92. *See* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 18–21 (1990).

93. EASTERBROOK & FISCHEL, *supra* note 3, at 34.

94. Bondholders, as opposed to shareholders, have almost complete freedom of contract in setting up the terms of the indenture. *See, e.g.*, Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1049 (2d Cir. 1982) (Winter, J.) (citing AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 2 (1971)), *cert. denied*, 460 U.S. 1012 (1983). It is, however, a little misleading to say that the bondholders have "freedom of contract," as they are not involved in the drafting of the indenture; the indenture trustee theoretically represents their interests at the drafting stage. In any event, because bondholders need not buy into bonds with unfavorable terms, issuers and underwriters are under pressure to make the bonds appealing if they want them to sell. Debt indenture drafting, however, does have the benefit of both characteristics of the standard form agreement. Especially since the publication of the *Commentaries*, there are many off-the-rack terms available to bondholders. However, these terms are merely guides and may be varied by the parties. COMMENTARIES ON INDENTURES, *supra*, at 3, 14–15 (1971).

Judge Winter appears to accept the general applicability of the freedom of contract doctrine to corporate charters. In describing the relation between the government and corporate charters, he stated: "Where a private transaction imposes no substantial cost on example, shareholders may wish to provide for automatic shareholder votes on certain transactions, such as changes in executive compensation or dealings with certain foreign entities, perhaps because of the political implications of such transactions.[95]

Supplementing state law provisions, the federal proxy rules place additional restrictions on the exercise of direct democracy. Although the federal proxy rules currently give shareholders the right to place certain proposals on the proxy statement for a shareholder vote,[96] the Securities and Exchange Commission (SEC) has imposed restrictions, both procedural[97] and substantive, on even this limited shareholder power. Substantively, the corporation is permitted to exclude any proposal that: (1) is not a proper subject for shareholder action under the laws of the corporation's state of incorporation;[98] (2) relates to the conduct of the ordinary business operations of the registrant;[99] or (3) relates to operations that account for less than five percent of both the corporation's assets and net sales, unless it is otherwise significantly related to the registrant's business.[100] As a result of these restrictions, the

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society or third parties, the parties to it should be allowed to arrange their affairs in a way that satisfies them rather than some distant official; they should, in short, be given freedom to 'make their own deal.' " Winter, *supra* note 12, at 253.

95. *See, e.g.*, Medical Comm. for Human Rights v. SEC, 432 F.2d 659, 680–81 (D.C. Cir. 1970) (describing shareholder anger and public outrage directed at Dow Chemical for manufacturing napalm); *infra* notes 122–25 and accompanying text (describing the politicization of compensation).

96. 17 C.F.R. § 240.14a-8 (1992). Rule 14a-7 requires corporations to mail solicitations for shareholders if requested, but shareholders must reimburse the corporation for mailing expenses. *Id.* § 240.14a-7.

97. The most important procedural requirements are: (1) that the proponent must have been a record or beneficial owner of 1% or $1,000 in market value of the securities entitled to be voted, *id.* § 240.14a-8(a)(1); (2) that the proposal must be received by the corporation at least 120 days before the date the proxy statement was sent to shareholders the year before, *id.* § 240.14a-8(a)(3)(i); and (3) that each shareholder may submit only one proposal per year. *Id.* § 240.14a-8(a)(4).

98. *Id.* § 240.14a-8(c)(1). Depending on state law, votes on such matters may be able to proceed as nonbinding proposals. *Id.* note.

99. *Id.* § 240.14a-8(c)(7).

100. *Id.* § 240.14a-8(c)(5). Generally, executive compensation will account for less than five percent of sales and assets. With the increased attention paid to executive compensation in recent years, however, it may be "significantly related to the [corporation's] business." *Id*; *see also infra* text accompanying notes 122–25.

Although there are other allowable restrictions, they do not relate significantly to the topic of this Note. *E.g.*, 17 C.F.R. § 240.14a-8(c)(2) (1992) (implementation of proposal would violate law); *id.* § 240.14a-8(c)(3) (proposal is contrary to any of the proxy rules); *id.* § 240.14a-8(c)(4) (proposal relates to redress of personal grievance or to further personal interest not shared with security holders at large); *id.* § 240.14a-8(c)(6) federal proxy rules do little, if anything, to extend shareholder voting rights.

Currently, then, neither state nor federal corporate law allows corporations to individualize the corporate governance structure if it would take any ordinary, day-to-day affairs out of the hands of the board of directors. Therefore, any move towards democratization of corporate governance must come at both the state and federal levels.

B. *Specific Proposals*

This Note proposes that states amend their corporate codes to allow corporations to draft charters that provide for increased shareholder power, even over those "ordinary business affairs that historically have been reserved for management."[101] These would be true enabling statutes.[102] To accommodate such changes in state law, the federal proxy rules also would need to be amended. Two of the three restrictions discussed earlier — proposals on ordinary business matters and matters that do not amount to five percent of the corporation's assets and net sales[103]—would need to be repealed. Because the proposed state law changes would broaden the scope of matters permitted to be voted on under state law, the first of the three restrictions, which allows the exclusion

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(proposal is beyond corporation's power to effectuate); *id.* § 240.14a-8(c)(8) (proposal relates to election to office); *id.* § 240.14a-8(c)(9) (proposal is counter to proposal to be submitted by corporation at meeting); *id.* § 240.14a-8(c)(10) (proposal is moot); *id.* § 240.14a-8(c)(11) (proposal is substantially duplicative of a proposal to be included in the proxy statement); *id.* § 240.14a-8(c)(12) (proposal has been voted on within past three years, with minimal support); *id.* § 240.14a-8(c)(13) (proposal relates to specific dividend amounts).

101. Alternatively, a "federal corporate law" could displace state law in those areas in which state competition has worked to the benefit of management and not shareholders. *See* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

102. The free marketeers admit that not every aspect of Delaware's code is optimal for every situation. EASTERBROOK & FISCHEL, *supra* note 3, at 215; *see also* Winter, *supra* note 12, at 275. However, they remain uncritical of this "one size fits all" aspect of corporate law. *See, e.g.*, *id.* at 276 (stating that "[c]orporate efficiency calls for decisional and operational processes wholly inconsistent with periodic, much less constant, intrusion by shareholders"); *see also* EASTERBROOK & FISCHEL, *supra* note 3, at 82-84 (arguing that shareholders are rationally uninterested in voting on most corporate issues).

103. *See supra* notes 99-100 and accompanying text.

of those matters that were not a proper subject for shareholder action under state law,[104] would not need to be repealed.

Once the new system is in place, shareholders could choose how much direct democracy they desire and under what circumstances they desire to exercise it.[105] This Note is concerned with increased direct democracy in the area of executive compensation.

Increased shareholder voting would help shareholders avoid some of the "collective action" and "free rider" problems that now exist.[106] Any shareholder action has costs as well as benefits. The potential benefit must be discounted by the likelihood of success of the proposed action to arrive at the actual expected benefit. Moreover, even if the expected benefit to the corporation or its shareholders is greater than the cost, the benefit to the individual actor may not be sufficient to induce him or her to bear the costs of the action alone. Other, non-active shareholders will receive some of the benefit without expenditure of time, effort, or money. Shareholder voting ameliorates some of these problems because it makes the corporation bear the majority of the costs. Shareholders still bear information costs in deciding how to vote, but they do not bear the much higher costs of, for example, mounting an opposition campaign.[107] The free marketeers should have no qualms about forcing the corporation, and thus all shareholders, to bear the costs of voting because the shareholders themselves would have approved the charter provisions allowing such votes.

Presently, shareholders who are unhappy with a board's action must either combine forces with other shareholders to convince the directors to change course or mount a campaign to elect new directors. These alternatives are expensive and involve extensive registration requirements.[108] Under this Note's proposal, share-

104. *See supra* note 98 and accompanying text.

105. The free marketeers' worst nightmare—a corporation that allows shareholders to make any proposal at any time—is unlikely. Under the free marketeers' theory, such a corporation would be unable to attract investors because it would be inefficient. It is more likely that any provisions included in corporate charters would be limited, either in terms of the subject matter or in terms of the significance of the issue to the corporation.

106. For a general discussion of collective action and free rider problems, see PERCIVAL ET AL., *supra* note 20, at 47–56.

107. EASTERBROOK & FISCHEL, *supra* note 3, at 78 ("The collective choice problem that inhibits voters from learning about the firm in order to cast intelligent ballots applies in spades to waging a fight.").

108. *See* Black, *supra* note 14, at 530–31 (noting that restrictions limit group action, that action is difficult even for a single large owner, and that "legal obstacles are espe-

holder power would increase either through direct shareholder votes or increased leverage in gaining access to directors because of the threat of a shareholder vote.

C. *Executive Compensation*

1. *The Special Case of Executive Compensation.* Certain inherent structural biases in the relationship between management and the board of directors militate in favor of increased shareholder oversight of the executive compensation decision. Theoretically, directors are elected by, and accountable to, the shareholders. In reality, management has substantial control over elections, primarily through its access to the corporate machinery.[109] The Chief Executive Officer effectively hires the directors[110] and controls their compensation;[111] these directors then sit on the compensation committee and decide the CEO's salary.[112] Moreover, once

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cially great for shareholder efforts to nominate and elect directors, even for a minority of board seats"); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 966–67 (1993) (noting various restrictions on open communication among and concerted action by groups of shareholders). The California Public Employees' Retirement System (CalPERS) has been particularly successful at forcing corporate boards to meet with it. *See* Susan Beck, *A Nice Guy Who Knocks Heads*, AM. LAW., July-Aug. 1993, at 42. However, there has been some question as to the magnitude of the benefits achieved by CalPERS. *Id.* (noting that "some of the individual results of this year's [CalPERS] campaign don't look like much on close inspection"). CalPERS's normal tack is to threaten a shareholder proposal as a way to pressure the board into meeting with CalPERS. *See id.* at 44 ("We said if we didn't reach an agreement . . . , we would file a shareholder proposal and withhold our votes for the [company's slate of directors], and start soliciting [shareholder] support for the above two.") (quoting CalPERS general counsel Richard Koppes).

109. *See* Black, *supra* note 14, at 521 ("The managers—the current officers and directors—pick the directors, and the shareholders rubber-stamp the managers' choices."); *id.* at 533–41.

110. *See* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 226 (1991) (noting that although "a growing number of boards have their own nominating committees, . . . the names produced by those committees are not going to go very far if the CEO doesn't approve of them. After all, the CEO, in most companies, also is the chairman of the board."); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83, 97–98 (noting that "the nominating committee usually creates only an illusion of distance between the chief executive officer and the outside nominee").

111. *See* CRYSTAL, *supra* note 110, at 229–30; Cox & Munsinger, *supra* note 110, at 97.

112. *See* Elizabeth Holtzman, *Should Shareholders Have a Say in Execs' Pay? Yes: Link CEO's Pay to Performance*, USA TODAY, Apr. 27, 1992, at 11A ("Executive compensation is set by corporate boards of directors filled with company insiders and the

the board is elected, management usually dominates it. This is so for several reasons. Top officers are directly represented on the board because they invariably are elected directors.[113] Also, although there has been an increase in the number of outside directors on boards,[114] because "management typically selects its own outside directors[,] . . . directors who wish to retain their positions are not independent of management."[115] Finally, directors also are likely to come from similar backgrounds and bring similar beliefs and views to the board. As Professors James Cox and Harry Munsinger have stated,

> The leading criterion for selecting a board nominee is his probable identification with and acceptance of the company's goals and methods of operation . . . . Individuals who are quarrelsome, disagreeable, or rigid are disfavored: they fail to fit within the desired mold of "loyal independence" by which management is given the benefit of the doubt.[116]

Directors tend to seek appointment to boards where they will fit in, both professionally and personally. The outside directors sitting on the compensation committee are often CEOs themselves.[117] As managers of other companies, they bring self-serving views on the proper role of the board and have no desire to set a precedent for their own companies by interfering with the corporation's management in its handling of the proxy process. Because of all of these factors, it is much more likely that outside directors will resign rather than embroil themselves and the corporation in a challenge to management action.[118]

Executive compensation currently is not subject to alteration by the exercise of direct shareholder voting. In fact, until February

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chief executive's friends.").

113. As of 1987, in more than five out of six companies, the CEO is also the chairman of the board. HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD 13 (1987). Also as of 1987, management made up, on average, more than one-quarter of the board. *Id.* at 3.

114. *See, e.g.*, James D. Cox & Nis J. Clausen, *The Monitoring Duties of Directors Under the EC Directives: A View from the United States Experience*, 2 DUKE J. COMP. & INT'L L. 29, 31 (1992).

115. Gilson & Kraakman, *supra* note 14, at 875; *see also* Cox & Munsinger, *supra* note 110, at 98.

116. Cox & Munsinger, *supra* note 110, at 91 (footnotes omitted).

117. *See* CRYSTAL, *supra* note 110, at 227; Cox & Munsinger, *supra* note 110, at 95.

118. *See, e.g.*, Black, *supra* note 14, at 534 (describing the "'Wall Street Rule for Directors' (if you don't like the management, resign)").

1992, the SEC treated ordinary executive compensation as a day-to-day affair not subject to shareholder voting, except that the SEC considered "three classes of remuneration [to] transcend ordinary business because 'they raise important policy concerns,' and are thus permissible topics for shareholders to discuss:"[119] shareholders were able to "challenge . . . golden parachutes . . . ; ask for more detailed information on executive pay; and seek the creation of a shareholder advisory committee."[120] In other areas, however, the SEC routinely granted corporations' requests to exclude executive compensation proposals from proxy statements on the ground that these proposals violated Rule 14a-8 because they pertained to the ordinary business operations of the corporation.[121]

However, as public opinion on the issue has shifted,[122] so has the SEC's view. On February 14, 1992, the SEC sent letters to ten corporations refusing their requests to remove shareholder executive compensation proposals from proxy statements.[123] The increased media and scholarly attention devoted to the subject, as well as the staggering amounts of money involved,[124] have elevat-

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119. *Shareholder Rights: Nanny Changes Her Mind*, ECONOMIST, July 13, 1991, at 84, 85.

120. *Id.* A golden parachute is a contract between the corporation and senior management that provides substantial benefits if the officer leaves the corporation or is forced out after a change of control. SOLOMON ET AL., *supra* note 65, at 1061.

121. *See, e.g.*, Exxon Corp., SEC No-Action Letter, Jan. 7, 1987, *available in* WESTLAW, 1987 WL 107487; *see also* Kevin G. Salwen, *The People's Proxy: Shareholder Proposals on Pay Must Be Aired, SEC to Tell 10 Firms*, WALL ST. J., Feb. 13, 1992, at A1 [hereinafter Salwen, *The People's Proxy*]; Kevin G. Salwen, *SEC Unveils New Rules on Disclosures of Corporate Executives' Pay Packages*, WALL ST. J., Feb. 14, 1992, at A4 [hereinafter Salwen, *New Rules*].

122. *See, e.g.*, Thomas McCarroll, *Executive Pay: The Shareholders Strike Back*, TIME, May 4, 1992, at 46, 48 (noting that "CEO pay has emerged as a populist issue that no politician can resist," leading to numerous proposals for limiting CEO pay).

123. *See* Salwen, *The People's Proxy*, *supra* note 121, at A1; Salwen, *New Rules*, *supra* note 121, at A4.

124. Graef Crystal, a leading compensation consultant, has estimated that the average American CEO received about $2 million in direct compensation in 1991, as compared to $550,000 for Japanese CEOs and $800,000 for German CEOs. *See* Thomas McCarroll, *Motown's Fat Cats*, TIME, Jan. 20, 1992, at 34, 35. The disparity between American CEOs and American factory workers is especially blatant. On average, American CEOs earn between 85 and 160 times as much as the average worker. *See* John A. Byrne, *The Flap over Executive Pay*, BUS. WK., May 6, 1991, at 90, 93 (85 times); James R. Healey & Michelle Osborn, *Bush Contingent Takes Heat over CEO Pay*, USA TODAY, Jan. 8, 1991, at 1B (160 times); *Bill Seeking to Put Brakes on Exec Pay*, CHI. TRIB., June 5, 1991, § 3, at 1 (testimony of Graef S. Crystal at Senate hearings) (110 times). This com-

ed the issue of executive compensation beyond the level of ordinary business operations.

> An issue like executive compensation has really risen above the measure of ordinary business to a level of broad national interest . . . . I find it hard to fathom what arguments can be made that executive compensation shouldn't be voted on when it is reaching into the $10 million or $15 million range and is being covered in every newspaper in the country. I don't think the average citizen would view it as ordinary business any more.[125]

Nevertheless, the SEC's new policy does not solve the problem for corporations whose shareholders have decided that they should be able to vote on executive compensation. Under the SEC's new policy, any shareholder proposal is merely advisory in nature.[126]

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pares to multiples of 17 for Japan and 23 for Germany. *See id.* Additionally, personal income tax rates are higher in both Japan and Germany, lowering the effective salaries of CEOs in those countries. *Compare* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13201-02, 107 Stat. 312, 457 (1993) (to be codified at 26 U.S.C. §1) (top U.S. tax rate of 36% and high-income surtax of 39.6%) *with* Ronald Fink, *April in Paris*, FIN. WORLD, Oct. 13, 1992, at 78, 79 (stating that top tax rates range from 40-56% in Germany, France, and Japan) and CRYSTAL, *supra* note 110, at 206, 208 (using rate figures of 65% for Japan and 53% for Germany).

The rise in executive compensation has also drastically outpaced the rise in corporate earnings. In the 1980s, "CEO compensation jumped by 212% . . . . For the same period, the average earnings per share of the S&P 500 companies grew by only 78%." Byrne, *supra*, at 90. Additionally, during that time, the top personal income tax rates had fallen from 70% in 1980, *see* Revenue Act of 1978, 92 Stat. 2763, 2767 (1978) (amended several times subsequently), to 31% in 1992, *see* 26 U.S.C. § 1(a)-(e) (Supp. III 1991) (current version at 107 Stat. 312, 457 (1993)), making the after-tax disparity even greater. The overall tax rate on the richest 1% of Americans fell from 31.7% in 1980 to 26.7% in 1989. David Wessel, *The Wealthy Watch Gains of 1980s Become Political Liabilities*, WALL ST. J., Apr. 8, 1992, at A1.

125. Kevin G. Salwen, *Shareholders Likely to Get Vote on Pay*, WALL ST. J., Feb. 3, 1992, at A3 (quoting SEC Commissioner Mary Schapiro).

Predictably, the management-oriented Business Roundtable, made up of the CEOs of approximately 200 of the largest companies in the United States, opposes the SEC's recent reforms in the area of executive compensation. The Roundtable opposes not only increased shareholder voting but also increased and clarified disclosure of executive compensation. The Roundtable believes that shareholders have sufficient power to affect management decisions and that additional protection is unwarranted. *See* Amanda Bennett, *Executive-Pay Ideas Offered by Roundtable*, WALL ST. J., Feb. 14, 1992, at A4.

126. *See, e.g.*, Chrysler Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,103, at 79,215 (Feb. 13, 1992) (allowing shareholder proposal "if the proposal is cast as a recommendation or request"). Rule 14a-8 bars shareholder proposals on issues that are not "proper subject[s] for action by security holders" under state law. 17 C.F.R. § 240.14a-8(c)(1) (1992). However, some states allow precatory, nonbinding proposals on issues for which binding proposals would be barred. *Id.* note.

Additionally, the new policy is very limited in scope; it has no effect on shareholder voting in areas other than executive compensation,[127] so the overall benefit to shareholder democracy is minimal.

The inherent structural biases and the rising importance of executive compensation as an issue to shareholders and the public make it a subject particularly suited to direct shareholder involvement. Shareholders, of course, have the power to vote directors out of office. This course of action may not be the most satisfactory solution, however, because replacement directors would have the same incentives as did prior directors to overpay themselves and their colleagues. Furthermore, the board's approval of excessive executive compensation may be an isolated problem. The board may otherwise be performing satisfactorily; ousting them and replacing them with other directors may be detrimental to the corporation.

2. *Sample Charter Provisions.* Under this Note's proposal to liberalize shareholder voting, there are many possible charter provisions allowing shareholder votes on executive compensation.[128] A few seem most likely to be adopted. None of the options threaten the efficient management of the corporation. Under this Note's proposal, the government would not mandate how much direct democracy a corporation must have; rather, government would stop mandating that direct democracy be limited to certain areas.

The broadest provision corporations could adopt would be one allowing all shareholder proposals to be included in the proxy statement, possibly restricted to particular issues, for example, executive compensation. Such a broad provision would expand the universe of subjects on which proposals could be made. To ensure that proponents are likely to have the interests of the company in mind, corporations should retain the procedural requirements of

127. The SEC's new policy does not even apply to *all* compensation. *See* Chrysler Corp., SEC No-Action Letter, *supra* note 126, at 79,217 (allowing proposal if proponent clarifies that it applies only to "senior executive compensation," not to "general compensation policy").

128. This subsection discusses possible provisions aimed at the issue of executive compensation. Much of the analysis could be carried over to other issues of corporate policy. A company more concerned about another issue, such as the environment, might adopt provisions similar to those discussed in this subsection, but emphasizing that issue.

Rule 14a–8.[129] Retaining the procedural limitations contained in Rule 14a–8 would ensure that the provision does not vastly increase the universe of potential proponents or allow one corporate gadfly to make numerous proposals.

A second option would be a provision that calls for a mandatory vote on all high level executive compensation at each annual meeting. The cost of such a provision would be *de minimis* because the necessary compensation information is already included in the proxy statement.[130]

A third option for increasing shareholder control over executive compensation would be a charter provision that grants a vote—at a special meeting if the annual meeting is not imminent—in the event of a substantial change in executive compensation, as defined in the provision.

Despite the minimal direct costs to the corporation of such provisions, there is the possibility of damage to the corporation from a loss of management talent. Some may worry that populist shareholders will drastically trim CEOs' and other executives' salaries. However, as noted above, nearly half of U.S. equity securities are held by institutional investors with sophisticated research resources who have no desire to damage their investments. Finally, considering the rapid increase in executive compensation during the 1980s and the much more modest level of executive compensation in Japan and Germany, it is likely that the current situation is resulting in an inefficient use of resources greater than any possible inefficiency from increased shareholder control. Inefficiency can be very serious, not only to the corporation and its shareholders but to those who depend on the corporation's health, such as its employees, employees' families, and the corporation's suppliers.

Judge Winter recently has acknowledged that when a corporation is run inefficiently, "much wealth is lost, and the lives of

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129. 17 C.F.R. § 240.14a–8 (1992). For a discussion of the procedural requirements, see *supra* note 97.

130. The SEC has recently amended its rules to require increased disclosure of executive compensation. *See* 57 Fed. Reg. 48,126 (1992) (to be codified at 17 C.F.R. §§ 228, 229, 240, 249). Under the new rules, in most cases, companies will be forced to disclose the compensation of the CEO and the four most highly compensated executives, as well as performance comparisons with other companies in the industry. *Id.* at 48,127, 48,139, 48,150–51 (to be codified at 17 C.F.R. § 229.402). The information is required to be disclosed on all registration statements, periodic reports, proxies, and information statements under the Securities Act of 1933 or the Securities Exchange Act of 1934. *Id.* at 48,126.

many ordinary citizens dependent on the firm are disrupted."[131] However, Judge Winter does not support enlarging the sphere within which shareholders may exercise direct democracy. Rather, he advocates a relaxation of the proxy rules, allowing shareholders to consult each other with fewer restrictions while keeping the opportunities for direct democracy to a minimum.[132] Again, Judge Winter has determined summarily that increasing direct democracy would be inefficient in all instances.

III. CONCLUSION: A TRUE RACE TO THE TOP

Although the free marketeers have rightly decried the type of paternalism that Professor Cary advocated, in the area of shareholder democracy, they actually support paternalism. In arguing for enabling statutes, Judge Easterbrook and Professor Fischel have stated that "[t]he history of corporate law has been that states attempting to force all firms into a single mold are ground under."[133] Although current corporate law may be enabling in many respects, not all its provisions support private contracting. As discussed above, in the area of shareholder democracy, the current system forces firms into a single, largely republican, mold.

The free marketeers, however, do not criticize these imperfections in Delaware law. Instead, they worry that increased shareholder voting would lead to shareholder micromanagement and therefore inefficiency.[134] Applying the same principles they used to refute Professor Cary's argument, the free marketeers should conclude that, if given the power to do so, shareholders would choose the most efficient form of corporate governance. The market would punish any company choosing an inefficient governance structure.[135] If shareholders are not interested in increased share-

131. Winter, *supra* note 108, at 977.

132. *Id.* at 966–68, 976–77.

133. EASTERBROOK & FISCHEL, *supra* note 3, at 13.

134. *See supra* note 83. However, if structures allowing increased shareholder participation are inefficient, corporations will not implement them.

The free marketeers' willingness to allow shareholders the freedom to have their rights taken away by management, combined with their unwillingness to allow shareholders to exert control over their own money, indicates their pro-management bias.

135. It is possible to make an argument that shareholders would be unable to act in their own best interests, but the free marketeers have already rejected such paternalism. The free marketeers cannot plausibly claim that shareholders are not sophisticated or informed enough to benefit from a more direct democratic form of corporate governance because they have already relied on the sophistication of the market in refuting Professor

holder democracy, or if they discover that it is inefficient, they will return to the republican model. There would be no lasting negative effect on the investment market from such an experiment.

The issue eventually boils down to a single question: "Whose money is it, anyway?" If the shareholders run the company into the ground through micromanagement, they will lose their investment, but *it is their money*. Under any self-respecting market theory, the shareholders will choose not to exercise their power if it results in a diminution of their investment.

The free marketeers have accepted a race among the states instead of advocating a race among corporations. The ideal system of corporate law under the free market approach should create competition both between states and within states, allowing corporations to experiment with different corporate structures. Judge Winter has noted that "[n]either Delaware's nor any code, nor the case law interpreting it, is perfect."[136] A true enabling scheme, under which thousands of corporations, not just fifty states, competed, would make it more likely that each corporation would find and implement its own optimal structure.

Cary's arguments. *See supra* notes 46, 57–58 and accompanying text.

136. *See* Winter, *supra* note 12, at 275.