

ESSAYS

THE MYTH OF THE SHAREHOLDER FRANCHISE

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INTRODUCTION

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

Part I will discuss the critical role assigned to corporate elections in the accepted theory of the corporation. Because directors play a critical role in our system of corporate governance, the selection

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

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

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and incentives of directors are important. Shareholder power to remove directors is supposed to provide a mechanism for ensuring that directors are well chosen and have incentives to serve shareholder interests once chosen. This mechanism is made especially important by the lack of other adequate mechanisms for making boards accountable and attentive to shareholder interests.

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

Part II will put forward a set of default election arrangements intended to transform shareholder power to remove directors from a myth into a reality. In particular, at least every two years, elections should be held with shareholder access to the corporate ballot, reimbursement of expenses to challengers receiving a sufficiently significant number of votes (for example, one-third of the votes cast), and shareholder power to replace all directors. Furthermore, confidential voting and majority voting should be required in all elections.

Part II will also discuss the process through which companies should be able to opt out of default election arrangements. Whatever default arrangements public officials choose, they should at minimum facilitate shareholder adoption of bylaws opting out of these arrangements. In particular, shareholders should be permitted to place bylaw proposals concerning elections on the corporate ballot. While opting out through shareholder-adopted bylaws should be facilitated, boards should be constrained from adopting

without shareholder approval bylaws that make director removal more difficult.

Finally, Part III will discuss and respond to a wide range of possible objections to the proposed reforms. Among other things, I shall examine claims that market forces provide sufficient accountability; that the proposed reforms would not have much practical significance; that they would have adverse effects on the interests of shareholders and stakeholders; that the increased activism by hedge funds makes them unnecessary; and that, in any event, invigorating the market for corporate control would be superior to invigorating corporate elections. After analyzing all of these objections, Part III will conclude that they do not, individually or in combination, undermine the strong case for reforming corporate elections.

Before proceeding, I should stress that my analysis of election reform in public companies will focus on the sole objective of enhancing shareholder value. From this perspective, increased shareholder power to replace directors would be desirable if and only if such a change would improve corporate performance and value. Some critics have argued that proponents of reforming corporate elections inappropriately conflate political ideas with market institutions.³ It is therefore worth stressing that I do not view “shareholder voice” and “corporate democracy” as ends in themselves—or as a necessary corollary of the nature of shareholders’ ownership rights.⁴

My support for reforming corporate elections is not motivated by political ideas but rather by the goal of making a market institution—the modern publicly traded company—function better. If the absence of viable shareholder power to replace directors were ex-

³ Henry Manne recently criticized my proposals for reforming corporate elections on these grounds. See Henry G. Manne, *The ‘Corporate Democracy’ Oxymoron*, *Wall St. J.*, Jan. 2, 2007, at A23.

⁴ Cf. Matthias Benz & Bruno S. Frey, *Towards a Constitutional Theory of Corporate Governance* 1–2 (June 14, 2006) (unpublished manuscript, on file with the Virginia Law Review Association), available at <http://ssrn.com/abstract=933309> (viewing increases in shareholders’ “constitutional” rights as intrinsically desirable); Stephen Deane, *Institutional S’holder Servs., Majority Voting in Director Elections: From the Symbolic to the Democratic* 1 (2005), <http://issproxy.com/pdf/MVwhitepaper.pdf> (noting that advocates of reforming corporate elections view the issue as a “question of democratic principle”).

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pected to produce better corporate performance and higher shareholder value, I would fully support a corporate governance system lacking such power. I support a viable shareholder power to replace directors only because I view it as a valuable instrument for enhancing shareholder value by making boards more accountable and more attentive to shareholder interests.

I. THE MYTH AND REALITY OF CORPORATE ELECTIONS

A. *The Critical Role of the Shareholder Franchise*

Boards play a central role in the standard view and the legal structure of the modern publicly traded corporation with dispersed ownership. It is widely recognized that full-time executives managing such a company have an agency problem.⁵ Their private interests might provide them with an incentive to engage in empire-building, take excessive compensation, enjoy excessive perks, pursue pet projects, elevate cronies, refuse to accept beneficial acquisition offers, remain in power too long, and so forth. Such agency problems are supposed to be addressed by the board.

Under the rules of corporate law, the power to run the company is not vested in the CEO or the company's senior executives. Rather, this power is vested in the board of directors, under whose direction the business and affairs of the corporation are supposed to be managed.⁶ The members of the board have a fiduciary duty to the corporation and are expected to serve as the shareholders' guardians.

Although the board has the formal authority and power to make all corporate decisions, directors are not expected to manage the company themselves. Most of the directors of publicly traded companies perform their board roles part time. Directors are generally expected to delegate ongoing management decisions to the company's officers and especially to the CEO. Nonetheless, the board is supposed to perform several crucial functions.

⁵ See generally Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *J. Fin. Econ.* 305, 308–10 (1976), *reprinted in* Michael C. Jensen, *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms* 83, 86–87 (2000).

⁶ See, e.g., Del. Code Ann. tit. 8, § 141(a) (2001).

The board selects the CEO and other top executives. The board sets the executives' compensation arrangements and thereby shapes their incentives. After selecting and hiring executives, the board is supposed to monitor their strategy and performance, replacing them if necessary. Finally, major corporate decisions, such as how to respond to an acquisition offer, are made by the board, which has full power to accept or reject executives' recommendations.

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

The importance of shareholder power to replace directors in the corporate legal structure is reinforced by the legal system's choice to insulate directors' decisions from judicial review. According to established principles of corporate law, courts abstain from substantive review of the merits of director decisions and do not impose liability for decisions that could have been shown to be wrong had such a review been undertaken. In adopting this approach, courts have been influenced by their belief that shareholders have available to them an alternative, superior accountability mechanism—shareholder power to replace directors whose performance they find unsatisfactory. Thus, for example, in the recent decision in the Disney shareholder suit, Chancellor Chandler stated that “redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from this Court.”⁷

Shareholder power to replace the board has also been used as a basis for providing boards with the power to block tender offers. In the classic *Unocal* decision, which introduced the principle under which boards have since been permitted to use defensive tactics, the Delaware Supreme Court relied on shareholders' ability to

⁷ In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005).

vote out the board; the court reasoned that stockholders displeased with directors' decision to block an offer would be able to replace them with directors that would pursue a different course of action.⁸ The insulation of directors from hostile takeovers under existing rules increases again the importance of shareholder power to replace directors via the ballot box.

Finally, the importance of the shareholder franchise is reinforced by the long-standing limits on shareholders' power to initiate major corporate decisions. Under existing corporate statutes, shareholders cannot adopt decisions to amend the corporate charter, merge, reincorporate, or dissolve the company; such decisions must be initiated by the board. These limitations have been justified on the ground that, under the republican paradigm of our corporate laws, shareholders dissatisfied with the board's decisions with respect to such issues have the power to replace incumbent directors with a new team that would make different decisions.⁹

The importance of the shareholder franchise is not undermined by the fact that recent stock exchange requirements provide independent directors with a key role in board decisionmaking.¹⁰ Even though director independence is beneficial, it is hardly sufficient to ensure that directors are well chosen and incentivized.¹¹ While independence requirements disqualify some undesirable director candidates, they still leave a vast number of individuals from whom a choice needs to be made.

Furthermore, while independence requirements rule out some undesirable motives that directors might otherwise have, they do not by themselves provide directors with affirmative incentives to

⁸ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (observing that “[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out”).

⁹ Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 *Harv. L. Rev.* 1759, 1777 (2006).

¹⁰ See American Stock Exchange LLC, *Company Guide* § 121A (2004), available at <http://wallstreet.cch.com/AMEX/CompanyGuide>; NASDAQ, Inc., *Manual* § 4350(c)(1) (2006), available at <http://nasdaq.complinet.com/nasdaq/display/index.html>; NYSE, Inc., *Listed Company Manual* § 303A.01 (2003), available at <http://www.nyse.com/about/listed/1022221393251.html>.

¹¹ See Lucian Bebchuk & Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* 202–04 (2004).

serve shareholder interests. Thus, notwithstanding independence requirements, a viable shareholder power to replace directors is important in our board-based corporate governance system. Such power is necessary to provide directors with strong affirmative incentives to focus on shareholder interests.

B. The Incidence of Electoral Challenges

But do shareholders have real power to replace the board, as the accepted theory of the corporation and court decisions assume they do? Supporters of the existing state of affairs have asserted that this assumption is indeed valid. For example, the Business Roundtable stated: “[S]hareholders have used the . . . existing rules to launch election contests on numerous occasions.”¹²

Similarly, the prominent law firm of Wachtell, Lipton, Rosen & Katz stated: “[U]nder the existing rules, running an election contest through separate proxy materials is already a viable alternative and a viable threat. . . . [S]hareholders do run election contests on a regular basis under the existing rules.”¹³ A task force of the New York Bar Association expressed a similar belief: “Under the existing proxy rules, running an election contest is a viable alternative and a meaningful threat, and election contests occur regularly.”¹⁴ These statements express a strong belief that shareholders do in fact have the real power to replace directors that serves a critical role in the accepted theory of the corporation.

To assess the view that running an election contest is a viable alternative and that election contests occur regularly, I conducted an empirical examination of the frequency and outcome of such challenges.¹⁵ The starting point of this examination was the universe of

¹² Detailed Comments of Business Roundtable on The “Proposed Election Contest Rules” of the U.S. Securities and Exchange Commission 25, Attachment to Letter from Henry A. McKinnell, Chairman, Bus. Roundtable, to Jonathan G. Katz, Sec’y, SEC (Dec. 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf> [hereinafter Business Roundtable, Proposed Election Contest Rules].

¹³ Letter from Wachtell, Lipton, Rosen & Katz to Jonathan G. Katz, Sec’y, SEC (June 11, 2003), available at <http://www.sec.gov/rules/other/s71003/wachtell061103.htm>.

¹⁴ See Letter from David M. Silk, Chairman, Task Force on Potential Changes to the Proxy Rules, Ass’n of the Bar of the City of N.Y., to SEC (June 13, 2002), available at <http://www.sec.gov/rules/other/s71003/tfpcprabny061303.htm>.

¹⁵ Much of the collating and review of data was carried out by research assistants—especially Fred Pollock, Arianna Kelley, and Rob Maynes—and I am grateful to them

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all cases of contested solicitations of proxies identified by Georgeson Shareholder, a well-known proxy solicitation firm.¹⁶

Table 1 reports the number of such solicitations in each of the ten years from 1996 through 2005. As the table indicates, there were about three hundred contested solicitations during this decade, or about thirty per year.

Table 1: Contested Solicitations 1996–2005

<i>Year</i>	<i>Number of Contested Solicitations</i>
2005	24
2004	27
2003	37
2002	38
2001	40
2000	30
1999	30
1998	20
1997	29
1996	28
Total	303

However, the set of contested solicitations is larger than the set of electoral challenges by a rival slate of directors seeking to take

for their work. The 2005 contests were reviewed in Christopher Lee Wilson, *The Continuing Myth: An Examination of the Exercise (or Lack Thereof) of Shareholder Power in 2005 and Possible Solutions to Improve the Situation* (2006) (unpublished third-year paper, Harvard Law School) (on file with the Virginia Law Review Association).

¹⁶ Georgeson defines a case of contested solicitation as any case in which a challenger filed a proxy statement, whether or not the challenger subsequently did in fact solicit proxies, and it attempts to identify all such instances, even those involving very small public companies, by searching through SEC data for all proxy statements filed by challengers. Telephone Interview with Steven Pantine, Dir. of Research, Georgeson S'holder (Jan. 24, 2006). Georgeson provides a list of all cases of contested solicitation in any year in its annual review of the elections of that year. These reviews are available at Georgeson Shareholder's website, www.georgesonshareholder.com. For a chart depicting contested solicitations from 1981 to 2005, see Georgeson S'holder, 2005 Annual Corporate Governance Review: Annual Meetings, Shareholder Initiatives, Proxy Contests 44 fig.19 (2005), http://www.georgesonshareholder.com/pdf/2005_corpgov_review.pdf.

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

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

(ii) **Director Contests Focusing on Takeover/Sale of the Company:** In a significant fraction of the contested solicitations, the contested proxy solicitations formally sought to replace directors but were essentially a mechanism to facilitate the takeover or sale of the company. When a company is protected by a poison pill, the only option for a bidder seeking to acquire the company is to replace the directors with a slate of directors that will redeem the pill. In such a case, the shareholder vote on the election of directors is essentially a referendum on the bidder's offer. If the bidder's team gains control of the board, the company will not be run differently; rather, it will be sold to the bidder.¹⁷ Of course, the number of con-

¹⁷ For example, in 1998, AMP Inc. was the subject of a contested proxy solicitation that sought to replace a majority of the incumbent directors with directors who would accept AlliedSignal's hostile bid. See Steven Lipin & Gordon Fairclough, *As AMP Fortifies, Some Big Holders Urge Olive Branch: Talk Suggests AlliedSignal Just May Win Votes to Wrest Control of Board*, *Wall St. J.*, Sept. 1, 1998, at B4. Similarly, in 2001, Willamette Industries Inc. was the subject of a contested proxy solicitation that sought to replace incumbents with new directors who would accept Weyerhaeuser's hostile bid. See Jim Carlton & Steven Lipin, *Willamette, Weyerhaeuser Send Appeals to Shareholders Amid Takeover Attempt*, *Wall St. J.*, Mar. 13, 2001, at C16.

In some cases, the contest was over the sale of the company even though there was no particular hostile bidder. For example, in 2001, Wells Financial Corp. was the subject of a contested proxy solicitation that sought to install directors who would pursue a sale of the company. Financial Edge Fund (the dissident) accompanied this solicitation with a nonbinding resolution requesting that management begin the open process

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tests in this category is relevant for assessing the disciplinary force of the market for corporate control. But the question we are examining here concerns the incidence of election contests over the management of a company as a stand-alone entity.

(iii) Director Contests Focusing on Opening or Restructuring a Closed-End Fund: The data also include some instances in which the contested solicitation primarily focused on the opening of a closed-end fund, restructuring a fund, or some other fund management issue. For example, attempts to switch from a closed-end structure to an open-end structure took place in 2000 in the Italy Fund, and in the France Growth Fund in 2002.¹⁸

(iv) Director Contests in Which a Rival Slate of Directors Sought to Manage the Company: This is the category on which I focus—contested solicitations seeking a change in the director team at the helm of the company are the primary concern of the policy debates over corporate elections. In these contests, the dissident team seeks to replace current director(s) to alter the management of the corporation as a going concern. For example, in 2000, J2 Communications was the subject of a contested proxy solicitation that sought to alter the course of the company's operations, with dissidents seeking to replace incumbents with a team that would better capitalize on the company's intellectual property and other rights to the "National Lampoon" brand.¹⁹

Table 2 below displays the incidence of different types of contested solicitations. As the table indicates, electoral challenges by a rival team seeking to run the company differently were mounted in 118 companies during the 1996–2005 decade, an average of about twelve per year.

In the second half of the decade, the incidence of such challenges was somewhat higher. There were forty-seven such challenges in the first half of the decade, and seventy-one challenges, about fifty percent more, in the second half. Thus, although shareholder activ-

of selling the company to the highest bidder. See Bill Stoneman, *Activist Investors: If You Can't Beat 'Em, Accept 'Em*, *Am. Banker*, Sept. 26, 2001, at 6A.

¹⁸ See Sarah O'Brien, *Phil Goldstein Steps Out; Care to Tango?: Activist Ready to Do Battle to Open Closed-End Funds*, *Investment News*, Apr. 24, 2000, at 3 (discussing Italy Fund); Paul Taylor, *Investors Abandon Nationwide Investments*, *Fin. Times*, June 9, 2002, at 8 (discussing France Growth Fund).

¹⁹ See Greg Andrews, *Investors Urge Ouster at Lampoon*, *Indianapolis Bus. J.*, Oct. 2, 2000, at 1A.

ism (as expressed, for example, in the incidence of shareholder precatory resolutions) was markedly higher in the second half of the decade, the incidence of electoral challenges remained small—an average of about fourteen per year.

Table 2: Classification of Contested Proxy Solicitations 1996–2005

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

C. The Targets and Outcomes of Electoral Challenges

Which companies become targets of electoral challenges by rival teams of directors? Table 3 displays statistics about the company size (as measured by market capitalization) of such targets.²⁰ As the table indicates, the great majority were small. Only twenty-four companies, or less than three per year on average, had a market capitalization exceeding \$200 million at the time of the electoral challenge.

²⁰ SEC filings closest in date to the contest were used to arrive at a number of shares outstanding, which was used to calculate a market capitalization as of that date.

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Table 3: Size Distribution of the
Targets of Electoral Challenges 1996–2005

<i>Market Capitalization</i>	<i>Number</i>	<i>Percentage of Total</i>
\$0–\$50M	61	52%
\$50M–\$100M	20	17%
\$100M–\$200M	13	11%
> \$200M	24	20%
Total	118	100%

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

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

Table 4: Successful Challengers 1996–2005

<i>Market Capitalization</i>	<i>Number</i>	<i>As Percentage of Electoral Challenges in Size Group</i>
\$0–\$50M	23	38%
\$50M–\$100M	8	40%
\$100M–\$200M	6	46%
> \$200M	8	33%
All Cases	45	38%

D. Impediments to Electoral Challenges

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

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

1. Costs

A rival team seeking to replace incumbents will bear significant costs—often in the hundreds of thousands of dollars.²¹ To begin, even assuming that all shareholders recognize the rival team's superiority and are willing to vote for it, the rival team would have to incur significant "procedural" costs. Because rival teams cannot place the names of their director candidates on the corporate ballot, they have to pay to mail proxy cards to individual shareholders and receive them back. Furthermore, rivals have to bear the legal costs involved in filing a proxy statement with the SEC and possibly also in dealing with incumbents' legal challenges to the proxy statement's completeness or accuracy. In the recent proxy contest at Six Flags, insurgent Red Zone LLC spent about \$850,000 on le-

²¹ In a recent comment letter filed with the SEC, Automatic Data Processing reported that, based on proxy statements filed by outsiders engaged in proxy solicitations during 2003–2005, the average cost of a contest was \$368,000. It also noted that the reported estimates of costs were likely lower than the actual costs incurred. See Letter from Richard Daly, Co-President, Brokerage Servs. Group, Automatic Data Processing, to Nancy M. Morris, Sec'y, SEC 2 (Apr. 20, 2006), available at <http://www.sec.gov/rules/proposed/s71005/ccallan1565.pdf>.

gal fees and the cost of preparing, printing, and mailing proxy materials.²²

In addition to these procedural expenses, rivals must commonly incur additional costs. Even when shareholders are dissatisfied with incumbents, they must still be persuaded that the rival team offers a superior alternative. As will be discussed in Subsection I.D.2, doing so is far from straightforward and likely involves significant costs beyond the baseline procedural costs. The rival team needs to communicate with shareholders, develop and present its strategy and plans for the company, address questions or concerns that shareholders may have, and respond to the incumbents' criticism of its plans and candidates.²³

Furthermore, when persuasion is necessary, it will likely be important to communicate directly with shareholders. Many shareholders hold shares in street names and are thus not automatically known and accessible. To identify and reach such shareholders, challengers may well have to use the expensive services of proxy solicitors as well as incur significant travel expenses. In the proxy contest at Six Flags, Red Zone incurred \$2,400,000 in investment banking fees, about \$950,000 in travel expenses, and about \$600,000 in fees and expenses for professional proxy solicitors.²⁴

The issue of costs is especially difficult because of the existence of a "free-rider" problem.²⁵ At first glance, it might be thought that, while the presence of the above costs will discourage some contests, it will not deter those that would produce benefits exceeding these costs. This is not the case, however, because potential rivals would not fully internalize the potential benefits from a contest. Although challengers must bear their full costs, they can capture only a fraction of the benefits that the contest confers on the shareholders collectively.

²² Six Flags, Inc., Proxy Statement (Schedule 14A), at 32–33 (Apr. 11, 2006) [hereinafter Six Flags Proxy Statement].

²³ For example, when seeking to persuade Disney shareholders to withhold votes from board members—a more modest goal than persuading shareholders to vote for a competing slate—Roy Disney used a private jet to crisscross the country to meet with institutional investors. See Andrew Parker, *Battle for Board Would Be Costly and Carry Risk*, *Fin. Times*, Dec. 1, 2005, at 34.

²⁴ Six Flags Proxy Statement, *supra* note 22, at 33.

²⁵ Robert Charles Clark, *Corporate Law* § 9.5.2, at 392–93 (1986).

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

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

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

company's coffers further increases the amount that challengers must spend to counter incumbents' campaigning.

In examining the importance of challengers' costs as a barrier to proxy contests, it should be noted that, for some shareholders with significant stakes, the potential costs of mounting a challenge go beyond the out-of-pocket costs involved in running a contest. Mutual funds, including those belonging to the main mutual fund family groups, would be unlikely to mount challenges even if they had to bear only a small fraction of these out-of-pocket costs. As Robert Pozen observed, for mutual fund families such as Fidelity or Vanguard, mounting a proxy contest is not part of the *modus operandi*.²⁶ Running a contest that demands management time and attention and might displease incumbents does not sit well with the business model of such funds. Such funds are at most "reluctant activists," to use Pozen's term, that could conceivably vote for a challenger but could not be expected to initiate contests themselves.

Nonetheless, there is a pool of potential challengers whose business model is consistent with mounting a challenge. This pool is comprised of individuals, family firms, and "activist" mutual funds or hedge funds that have or are willing to take on a significant stake in a target company. While these candidates are open to the idea of mounting a challenge, their behavior is likely to be sensitive to the magnitude of costs they would have to bear in mounting a proxy contest. The low incidence of contests has likely been due, at least in part, to cost barriers.²⁷

2. *Uncertainty About the Rival*

Even when a rival team would be better at leading the firm, convincing shareholders that this is the case would likely require significant efforts with no guarantee of success. Shareholders would be making their choices under conditions of uncertainty: to vote for

²⁶ Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, *Harv. Bus. Rev.*, Jan.-Feb. 1994, at 140.

²⁷ See Sarah Teslik, Executive Dir., Council for Institutional Investors, *Remarks at the Symposium on Corporate Elections 62* (Oct. 3, 2003) (transcript available in *Symposium on Corporate Elections* (John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 448, 2003), <http://www.law.harvard.edu/faculty/bebchuk/pdfs/Olin-Symposium-Corporate-Elections.pdf>) (describing how the costs of launching a proxy contest discourage challenges by public funds).

the rival team, they must be convinced not only that the incumbents' performance is sub-par, but also that the rival team would likely perform better. Otherwise, shareholders might well choose to stay with the devil they know.²⁸

The important point to recognize is that shareholders cannot infer from a rival team's mounting a challenge that the rival directors would perform better. To begin, even a rival team that believes it would perform better may be acting out of hubris. Furthermore, and very important, a rival's decision to mount a challenge does not even imply that the rival itself believes it would perform better. After all, a challenge could be motivated instead by a desire to obtain the private benefits associated with control.²⁹

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

This task is made difficult by the fact that many shareholders pay little or limited attention to the question of how to vote. While one externality problem leads rivals to underinvest in launching contests and running them, another externality problem leads shareholders to underinvest in assessing which slate of directors would be better: a shareholder would have to bear the full costs of such an investment in decisionmaking, but would share the benefits from an improved decision with fellow shareholders.³⁰

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

²⁸ Lucian Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control 2* (Nat'l Bureau of Econ. Research, Working Paper No. 8633, 2001), available at <http://papers.nber.org/papers/w8633.pdf>.

²⁹ See Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1071, 1090 (1990).

³⁰ See Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820, 1837–38 (1989).

CEO chosen by the incumbents is, but rival teams may have difficulties specifying their CEO candidates in advance. Potential candidates for the CEO position may be executives in other companies. When incumbents wish to attract a new CEO, they can hold confidential discussions with such candidates. The willingness of the candidate to take the CEO position will be made public only when the board offers and the candidate accepts the position. In contrast, if a rival team of directors approaches such a candidate, the candidate may be reluctant to be named even if he or she is in fact willing to become CEO in the event of the rival's victory.³¹

Finally, the reluctance of some money managers to vote against incumbents also makes it difficult for even highly qualified rival teams to attract sufficient support. Money managers interested in attracting business from companies may be concerned that voting for a challenger may make it more difficult for them to get business from incumbents in general or from the incumbents of the target company in particular. Indeed, there is some evidence suggesting that the voting decisions of money managers are distorted toward positions favored by management.³²

All of the above factors make it difficult for a rival slate of directors to win, even a rival slate superior to the incumbents. As a result, these factors also discourage rivals from mounting challenges in the first place. Given that rivals must bear the costs of running the challenge themselves if they fail, anything that operates to reduce the likelihood of winning also affects challengers' willingness to initiate contests. Thus, the difficulties that even a superior rival slate faces in persuading shareholders to vote for it reinforce the current cost barriers to mounting challenges. Since even a rival superior to the incumbents cannot be certain of winning, it is worthwhile to consider (as I propose below) providing reimbursement of costs to rivals who attract significant support but fall short of winning.

³¹ In the proxy contest that Red Zone fought successfully to oust three of the directors of Six Flags, Inc., Red Zone felt compelled to spend \$5.5 million as a signing bonus to get a seasoned executive to join the insurgent slate. See Six Flags Proxy Statement, *supra* note 22, at 32.

³² *Hewlett v. Hewlett-Packard Co.*, No. CIV.A. 19513-NC, 2002 WL 818091, at *8 (Del. Ch. Apr. 30, 2002).

3. Staggered Boards

A majority of U.S. public companies have a staggered board of directors.³³ In such cases, directors are divided into classes, usually three, and only one class comes up for reelection each year. To gain control of a company whose directors are protected by a three-class staggered board, a rival needs to win two elections, held at least one year apart.

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

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

II. REFORMING CORPORATE ELECTIONS

Part I's analysis of the impediments to mounting and winning an electoral challenge to incumbents provides a basis for identifying arrangements that could provide shareholders with a viable power to replace directors. I now turn to putting forward a detailed proposal for such a reform.

³³ See Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 *J. Fin. Econ.* 409, 410 (2005); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 *Stan. L. Rev.* 887, 889 (2002).

*A. Periodic Facilitation of Electoral Challenges**1. Frequency*

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

Furthermore, a priori, there is no reason to assume that the optimal frequency of scheduled elections for directors is once a year. On the one hand, the more often shareholders get a genuine opportunity to replace the board, the faster they will be able to do so if they conclude this is necessary. On the other hand, if elections are more meaningful, scheduling them frequently could “shorten the horizon” of incumbents and lead to short-termism. Furthermore, scheduling elections less frequently than once a year might enable institutional investors, which generally have positions in many public companies, to devote more attention to making the right voting decision when an election does take place.

For these reasons, while I support giving shareholders a genuine opportunity to replace the board from time to time, I am open to the possibility of giving them such an opportunity less often than once a year.³⁴ For concreteness, I will discuss below a system under which the arrangements facilitating challenges are triggered every two or three years.

In between the points in time at which these arrangements are triggered, it could be desirable to have a “safety valve.” For exam-

³⁴ For views supporting or accepting a frequency of less than once a year for times in which boards have to face a meaningful possibility of removal, see William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. Chi. L. Rev. 1067, 1072 (2002); Bebchuk et al., *supra* note 33, at 893; Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187, 243 (1991); Strine, *supra* note 9, at 1780.

ple, elections could still occur at each year's annual meeting, but the arrangements facilitating challenges (access to the ballot, cost reimbursement, etc.) would be triggered only every two or three years. Alternatively, one could have no "interim" elections scheduled, but enable shareholders in certain circumstances to call a special meeting to have a vote on replacing the directors.³⁵

Finally, I should note that the arrangements proposed below for periodic facilitation of challenges should not apply to potential buyers running a slate to overcome or bypass board opposition to a hostile takeover. The proposed reform focuses on lowering the existing impediments facing challengers that seek to run a company differently as a stand-alone entity.

2. Access to the Ballot

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

The SEC has considered several times, most recently during 2003–2004, whether to permit shareholders to place candidates on the corporate ballot.³⁶ Although the Business Roundtable and others have been able to discourage the SEC from adopting a shareholder access rule, adopting such a rule would be desirable. Given that the company is already mailing and receiving shareholders'

³⁵ A move to a system in which elections are held less often than once a year would require changes in state corporate codes and stock exchange requirements. Annual elections are required by the NYSE, NASDAQ, and AMEX, as well as by the codes of all states other than Minnesota and North Dakota. For a review of these requirements, see William K. Sjostrom, *The Case against Mandatory Annual Director Elections and Shareholders' Meetings 2–3* (ExpressO Preprint Series, Working Paper No. 1474, 2006), <http://law.bepress.com/expresso/eps/1474>.

³⁶ The SEC considered proposals for granting shareholders some access to the corporate ballot at different points in time, starting in the 1940s. For a review of the debate over the SEC's recent consideration of a rule establishing modest shareholder access, see *Shareholder Access to the Corporate Ballot* (Lucian Bebchuk ed., forthcoming 2007).

proxy cards, the need for rivals to do the same separately imposes costs that can easily be avoided.

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

Although the case for an ownership threshold is strong, it is less clear that a minimum holding requirement is desirable. When the SEC considered providing shareholders with access to the ballot in some limited circumstances, it proposed limiting access to shareholders who have held shares for at least one year.³⁷ This limitation seemed to be motivated by a desire to limit access to shareholders who might have an interest in improving the company's long-term value rather than making a short-term profit. However, if one seeks to limit access to shareholders with a long-term perspective, what matters is not how long a shareholder has already held shares in the company, but rather how long the shareholder plans to hold the shares going forward. Accordingly, it might be better to require shareholders who nominate a candidate to commit to maintaining their position for a certain period of time in case the candidate is elected.

3. Reimbursement of Expenses

Although shareholder access to the ballot would much reduce challengers' "mechanical" costs, these are commonly not the main expenses involved in mounting a successful challenge.³⁸ Therefore, as long as challengers have to bear their own costs fully, contest costs would remain a substantial impediment and deterrent to some beneficial challenges.

³⁷ See Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, and 274), reprinted in [2003–2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,101 (Oct. 23, 2003).

³⁸ See Letter from Richard J. Daly to Nancy M. Morris, *supra* note 21.

Under existing arrangements, challenges are impeded by incumbents' financing advantage: incumbents can fully charge their expenses to the company, but challengers have to pay their own way. This asymmetry should be reduced. Under the system I support, challengers would get reimbursement of their reasonable expenses under certain conditions.³⁹

Under what circumstances should challengers receive reimbursement of costs? In answering this question, it is important to recognize two points. First, not all rivals running a campaign should be reimbursed. Such a universal reimbursement arrangement would facilitate "frivolous" challenges that are expected to get little support. Therefore, it would be desirable to provide no reimbursement to challengers that perform poorly enough at the ballot box.

Second, requiring a rival team to obtain the majority support needed to elect one or more candidates to the board as a condition for reimbursement would be too demanding. Even rivals superior to the incumbents cannot be certain of winning. Such rivals will have to take into account the possibility that they will fail to gain a majority. Thus, making reimbursement conditional on obtaining majority support will go too far and discourage some beneficial challenges.⁴⁰

Putting these two points together leads to the conclusion that it would be desirable to encourage challenges when potential rivals believe they have a substantial likelihood (even though no cer-

³⁹ The reimbursement of challengers' costs has long been part of discussions of reforming corporate elections. For early discussions of the subject, see Melvin A. Eisenberg, *The Structure of the Corporation: A Legal Analysis* 121-27 (1976); Frank D. Emerson & Franklin C. Latham, *Proxy Contests: A Study in Shareholder Sovereignty*, 41 *Cal. L. Rev.* 393, 435-36 (1953); Daniel M. Friedman, *Expenses of Corporate Proxy Contests*, 51 *Colum. L. Rev.* 951 (1951); Comment, *Proxy Contests: Corporate Reimbursement of Insurgents' Expenses*, 23 *U. Chi. L. Rev.* 682 (1956).

⁴⁰ In two well-known cases, courts held that challengers gaining control of the board may, with shareholder approval, reimburse themselves for costs incurred during the contest. See *Steinberg v. Adams*, 90 F. Supp. 604, 607-08 (S.D.N.Y. 1950); *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291, 293 (N.Y. 1955). Eisenberg, *supra* note 39, at 124-25, argues that this doctrine provides a reasonable approach for dealing with challengers' costs. As explained above, however, requiring challengers to win director elections is too demanding a condition for granting reimbursement. Furthermore, under the approach of these cases, a challenger might not be able to obtain reimbursement even if the challenger wins the director elections. When the board is staggered, a challenger may win one election without gaining control of the board.

tainty) of winning. Thus, the condition for reimbursement should be obtaining sufficiently wide support.⁴¹ For example, consider an arrangement that would provide reimbursement in the event a rival garnered support from one-third of the shareholders voting on the election of directors. Such a requirement would not encourage challenges that are expected to have little practical significance. At the same time, because rivals who have a meaningful chance of winning might also have a significant likelihood of getting, say, only forty percent of the votes, such an arrangement will facilitate challenges by such rivals.

It is worth noting why the proposed reimbursement arrangement is superior to a proportional reimbursement arrangement under which rivals obtaining $X\%$ of the votes would have $X\%$ of their costs reimbursed.⁴² A proportional reimbursement arrangement has two disadvantages relative to the one proposed. First, in cases in which the challenger obtains little support—say, ten percent of the votes—a proportional reimbursement arrangement would provide excessive reimbursement. In such cases, the challenger should receive nothing (as with the proposed arrangement), because in all likelihood it had no meaningful likelihood of winning in the first place.

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

The above discussion indicates that the optimal reimbursement schedule should (1) provide no reimbursement to the challenger at sufficiently low levels of shareholder support, and (2) provide full reimbursement at levels below majority support that are sufficiently high. A proportional reimbursement arrangement does not have either one of these features. While the reimbursement arrangement that I propose does fall within the class of such sched-

⁴¹ See Bebchuk & Kahan, *supra* note 29, at 1096–100.

⁴² Such an arrangement was discussed in Eisenberg, *supra* note 39, at 123–24, and a similar approach was suggested in Comment, *supra* note 39, at 691–92.

ules, there are other schedules that fall within this class, and I do not wish to claim that the proposed reimbursement arrangement is the best within this class; I am putting it forward merely as a simple rule that has certain attractive features the optimal rule must have, and I leave the examination of whether and how this rule could be refined and improved to future work.⁴³

4. Replacement of All Directors

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

Note that this proposal would not eliminate certain advantages cited by supporters of staggered boards.⁴⁴ Such supporters believe that electing independent directors for a term longer than one year protects them from insiders and thus bolsters their independence. Such supporters also argue that a staggered board ensures that the roster of directors changes only gradually, thus ensuring stability.

The elections system that I support is consistent with largely maintaining these advantages. A company could still have a bylaw (or a company policy) requiring that the composition of the company's slate—that is, the slate put forward by the incumbent directors—be structured in the same way as it would be under a staggered board. Under such an arrangement, independent incumbent directors would know that their place on the company's slate would be reassessed only once every three years, and they would thus be fully protected from earlier replacement by the incumbent team. They could be removed earlier if shareholders revolt, but this possibility would certainly not undermine their independence from insiders.

⁴³ Among other things, whereas the proposed arrangement shifts from no reimbursement to full reimbursement at a certain threshold level of support, one could consider arrangements under which the percentage of reimbursed expenses moves up from zero to one hundred gradually over a certain range.

⁴⁴ See Richard H. Koppes et al., *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 *Bus. Law.* 1023, 1051–54 (1999).

Furthermore, with such a company bylaw (or policy), stability in the composition of the company's board of directors would be ensured absent a shareholder revolt. Replacement of more than one-third of the board would occur only in the rare event of shareholder revolt, when dissatisfaction with the incumbent team as a whole should take precedence. Thus, the proposed system would be consistent with maintaining whatever advantages might flow from commitment by the incumbent board to maintain stability in the composition of its slate. However, it would not insulate incumbents from ever losing control of the board in one election.

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

B. Arrangements Applying to All Elections

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

1. "Withhold" and "Against" Votes

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

Under existing default arrangements, shareholders do not have any meaningful power to veto candidates put forward by the board in an uncontested election.⁴⁵ To begin with, under the existing default arrangements established by state law, whether a candidate is elected is determined according to a plurality standard: the candidate with the most votes is elected, which means that a candidate placed on the ballot by the board will be elected in an uncontested election as long as the candidate obtains one “for” vote. Furthermore, if no one is elected to fill a board seat, the incumbent remains in place. Both arrangements make it possible for a director to serve on the board even following an election in which that director failed to obtain support from most voting shareholders.

This state of affairs has attracted a great deal of shareholder criticism.⁴⁶ This shareholder opposition has led to changes that facilitate the adoption of bylaws that establish “majority voting”—that is, prevent or constrain the election of candidates who failed to gain the support of a majority of the shareholders—both in the Delaware Code and in the Model Business Corporation Act.⁴⁷ Given that majority voting has been extensively discussed, and that my interest is in majority voting as one element of a comprehensive reform of corporate elections, I will limit my discussion of the subject to four general points.

First, given the clear and widely accepted flaws of plurality voting, majority voting should be the default arrangement. Although Delaware and the Model Business Corporation Act have now moved to facilitate opting into majority voting arrangements, they have not made majority voting the default arrangement. Although there is room for reasonable disagreement about which of the variations of majority voting should be adopted as the default,

⁴⁵ For a description and discussion of these arrangements, see Comm. on Corporate Laws, ABA Section of Bus. Law, Voting by Shareholders for the Election of Directors (June 22, 2005) (unpublished discussion paper, on file with the Virginia Law Review Association), available at <http://www.abanet.org/buslaw/committees/CL270000pub/directorvoting/20050621000000.pdf>.

⁴⁶ For discussions about the growing support for majority voting among shareholders, see, for example, the corporate governance blog of Institutional Shareholder Services (“ISS”), at http://blog.issproxy.com/majority_voting/; Memorandum from Wachtell, Lipton, Rosen & Katz, Majority Voting—A Look Back at the 2006 Proxy Season (June 12, 2006), available at http://www.realcorporatelawyer.com/pdfs/wlrk061306_02.pdf.

⁴⁷ See S.B. 322, 143d Gen. Assem. (Del. 2006).

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there is little basis for continuing to maintain a default arrangement that enables directors to hold office even after an election in which they obtained, say, a single shareholder vote.

Second, shareholders should be able to cast “against” votes, and director candidates should be viewed as voted down only if a majority of the votes are cast against them. Shareholders now generally have the choice only between a “for” and a “withhold” vote, and majority voting proposals therefore seek to prevent or constrain the election of directors who receive more “withhold” than “for” votes. The problem with this approach, however, is that shareholders withholding support from a candidate might be seeking to register a signal of dissatisfaction rather than prevent the candidate’s election.

Given that “withhold” votes might currently reflect two very different preferences, it is desirable to enable shareholders to express clearly each of these preferences. If both “withhold” and “against” votes are permitted, shareholders wishing to register dissatisfaction but willing to allow the candidate to serve will cast a “withhold” vote, whereas shareholders who prefer to block the director’s election will cast an “against” vote. Under the proposed arrangement, directors will be prevented from serving only when a majority of the voting shareholders clearly prefers that outcome over merely sending a warning signal to the board.

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

other arrangements discussed in this Part, shareholders will not obtain the viable power to replace incumbents with a new team that is necessary for corporate elections to perform their critical role.

Finally, while majority voting is hardly a substitute for the adoption of arrangements that facilitate electoral challenges, it is a useful complement to them. Even with such arrangements, challengers will not have sufficient incentive to mount a contest in all cases in which shareholder dissatisfaction might be substantial. Majority voting provides shareholders with an inexpensive and decentralized way to discipline directors without any shareholder having to bear the cost of mounting a challenge.

Furthermore, even though majority voting cannot adequately address situations in which shareholders are dissatisfied with the board and its decisions in general, it can be effective with respect to problems limited to a small subset of the directors or to a specific board decision. For example, the ability to use majority voting to block the election of the chair of the compensation committee might make that committee and its chair more attentive to shareholder interests—and thereby discourage the adoption of pay packages likely to outrage shareholders.

2. Confidential Voting

All voting on directors, in both contested and uncontested elections, should be by secret ballot. At present, although precatory resolutions calling for confidential voting have long attracted substantial support,⁴⁸ voting is not confidential in the lion's share of public companies.⁴⁹ This lack of confidentiality distorts voting decisions by some institutional investors in favor of incumbents.

Many institutional investors, including mutual funds, banks, insurance companies, and other money managers, have an interest in being on good terms—or at least not on adversarial terms—with management in public companies. Such good terms might facilitate

⁴⁸ See, e.g., Roberta Romano, *Does Confidential Proxy Voting Matter?*, 32 *J. Legal Stud.* 465, 466 (2003).

⁴⁹ In 2002, eighty-nine percent of the companies in the large (1500+) dataset of the Investor Responsibility Research Center ("IRRC") did not have confidential voting. See Lucian Bebchuk et al., *What Matters in Corporate Governance?* 39 (John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 491, 2004), available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_et%20al_491.pdf.

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

There is empirical evidence that institutions' voting decisions may be influenced by their other business interests. One study divided institutions into those that are "pressure-sensitive" (because of their interest in public firms' business, such as insurance companies and banks), "pressure-resistant" (because of the absence of such dealings, such as public pensions funds, endowments, and foundations), and "pressure-indeterminate."⁵⁰ The study found that the percentage of votes cast against antitakeover provisions was positively correlated with the ownership stake of pressure-resistant and pressure-indeterminate institutions, but not with the ownership stake of pressure-sensitive institutions.⁵¹

While the above study contrasted the voting behavior of different categories of institutions, a recent study investigated differences among institutions belonging to the same category.⁵² In particular, the study examined whether mutual funds that vary in the weight they place on obtaining pension business differ in how they vote. It found a positive correlation between the volume of pension business that a mutual fund family does and its propensity to vote with incumbents.

Finally, a recent study provides direct evidence that confidentiality matters and that lack of confidentiality could discourage some

⁵⁰ James A. Brickley et al., Ownership Structure and Voting on Antitakeover Amendments, 20 *J. Fin. Econ.* 267, 276–80 (1988).

⁵¹ *Id.* A related study found that CEO pay was positively correlated with pressure-sensitive institutions and negatively correlated with the presence of pressure-resistant institutions. See Parthiban David et al., The Effect of Institutional Investors on the Level and Mix of CEO Compensation, 41 *Acad. Mgmt. J.* 200, 206 (1998).

⁵² Gerald F. Davis & E. Han Kim, Business ties and proxy voting by mutual funds, *J. Fin. Econ.* (forthcoming).

shareholders from voting against incumbents.⁵³ Examining director elections during 2003 and 2004, the study finds that lack of confidential voting had a negative and statistically significant effect on the percentage of shares casting “withhold” votes in director elections. In particular, lack of confidentiality reduced the number of withhold votes on average by about 1.5–2.0% of outstanding shares.⁵⁴

Recognizing the problem of potential conflicts of interest, the SEC adopted in 2003 a rule requiring mutual funds to disclose their votes.⁵⁵ However, because investors in mutual funds base their choices on investment performance and not on how funds vote, the adopted requirement cannot be expected to eliminate the pro-incumbent bias of mutual funds that have a significant interest in obtaining business from public companies. The best approach, therefore, is not to make the funds’ voting decisions in proxy contests transparent to *both* incumbents and outside investors, but to keep them secret from both incumbents and outside investors. Similarly, confidentiality is the best way of dealing with potential conflicts of interest on the part of institutions other than mutual funds.

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

⁵³ Jie Cai, Jacqueline L. Carter & Ralph A. Walkling, *Electing Directors 17* (Sept. 14, 2006) (unpublished manuscript, on file with the Virginia Law Review Association), available at <http://ssrn.com/abstract=910548>.

⁵⁴ *Id.* at 37.

⁵⁵ See *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, Securities Act Release No. 8188, Exchange Act Release No. 47,304, 68 Fed. Reg. 6564 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270, 274), reprinted in [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,826 (Feb. 12, 2003).

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C. Opting Out of Default Arrangements

The system put forward in Sections A and B is proposed as a default arrangement. One size does not fit all, and companies should be able to opt into different arrangements. I therefore now turn to discussing the process through which such opting out should take place.

Whatever set of default arrangements public officials choose to adopt with respect to corporate elections, shareholders should play a decisive role in any opting out of these default arrangements. The election system is in place to provide a check on the board and to ensure its accountability to shareholders. Therefore, it would be desirable to prevent directors from having control over changes in the arrangements governing how difficult it would be to replace them.⁵⁶ In particular, it would be desirable for public officials (1) to facilitate shareholder initiation and adoption of election bylaws, and (2) to constrain directors from adopting election bylaws that make it more difficult for them to be replaced by shareholders.

1. Facilitating Stockholder-Initiated Bylaws

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

To facilitate shareholder adoption of election arrangements, shareholders should be permitted to place on the corporate ballot any proposed bylaw concerning elections that would be valid under state law if adopted. Under SEC Rule 14a-8, companies may exclude from the ballot any proposals relating “to an election for

⁵⁶ For arguments in support of limiting boards’ control over the adoption of corporate governance arrangements in general, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005) [hereinafter *Bebchuk, Shareholder Power*]; Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 Harv. L. Rev. 1784 (2006) [hereinafter *Bebchuk, Shareholder Rules*].

membership on the company's board of directors."⁵⁷ And the SEC Division of Corporation Finance has in recent years interpreted this provision as allowing exclusion of proposals to adopt a bylaw provision providing shareholders with access to the corporate ballot on grounds that such proposals relate to an election. In the recent *AFSCME* case, the United States Court of Appeals for the Second Circuit prohibited American International Group from excluding such a proposal from the corporate ballot.⁵⁸ The court reached its decision on the narrow basis that the SEC has not provided an explanation for switching from an earlier policy of opposing such exclusion to one that supports it.⁵⁹ Immediately following the decision, the SEC announced in September 2006 that it will consider amending Rule 14a-8 to secure "consistent national application" of the rule.⁶⁰ The SEC subsequently deferred its consideration of such an amendment and, as this Essay went to print, the SEC has not yet acted.

Together with colleagues, I filed an amicus curiae brief in the *AFSCME* case opposing exclusion of shareholder bylaw proposals concerning corporate elections.⁶¹ Allowing shareholders to place election bylaws on the corporate ballot is in my view necessary to advance the policy goals of Rule 14a-8 and called for by a reasonable interpretation of the rule. The provision allowing exclusion of a proposal that "relates to an election for membership on the company's board of directors" should be understood as permitting the exclusion of proposals that relate to the election of a particular individual to membership on the board of directors. It should not be understood as permitting the exclusion of "rules-of-the-game" provisions that relate to the procedural and substantive rules governing the elections process.

⁵⁷ 17 C.F.R. § 240.14a-8 (2006).

⁵⁸ See *Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc.*, 462 F.3d 121 (2d Cir. 2006) [hereinafter *AFSCME*].

⁵⁹ *Id.* at 129–31.

⁶⁰ See Press Release, SEC, Commission Calendars Proposed Amendment to Rule 14a-8 Governing Director Nominations by Shareholders (Sept. 7, 2006), available at <http://www.sec.gov/news/press/2006/2006-150.htm>.

⁶¹ See Brief of Amicus Curiae Harvard Law School Professors Lucian Bebchuk et al. in Support of Appellants, *AFSCME*, 462 F.3d 121 (No. 05-2825-cv), available at http://www.law.harvard.edu/faculty/bebchuk/Policy/AmicusCuria_Brief.pdf. The discussion below draws on this amicus curiae brief.

The elections exclusion aims, and should be interpreted in light of this aim, at allowing companies to omit proposals involving matters for which it is necessary to require the proposing shareholders to make disclosures in a proxy statement. In such a case, the 500 words allotted by Rule 14a-8 to shareholder proposals do not enable shareholders to cast an informed vote without a proxy statement. When a proponent seeks to elect a particular individual to the board, an informed shareholder vote requires a proxy statement that would supply particularized information about the characteristics and plans of the proposed individual. This is not the case, however, when the proposal concerns not the board membership of a particular individual or individuals but rather a governance arrangement—whether one regulating the election process or pertaining to some other aspect of corporate governance.

Furthermore, without the ability to place proposed election bylaws on the ballot, shareholder power to initiate bylaw amendments would lose much of its practical significance. To be sure, a shareholder that would like to see a bylaw amendment pass could, in theory, solicit proxies from fellow shareholders and file the proxy statement required in connection with such proxy solicitation. But shareholders have little incentive to incur the costs of such a contested solicitation. The proposing shareholder would have to bear the significant costs involved but would capture a limited fraction of the benefits from the bylaw amendment.⁶² Allowing shareholders to place a proposed bylaw amendment on the corporate ballot is essential for overcoming this collective action problem. Thus, having the right to place proposed election bylaws on the ballot is critical for shareholders to be able to opt into alternative election arrangements—and for an effective private ordering in this area.

2. Constraining Board-Adopted Bylaws

While it is desirable to facilitate private ordering through shareholder-adopted bylaws, it is also desirable to constrain board-adopted election bylaws. In particular, it is necessary to constrain

⁶² Indeed, the incentives for a shareholder to engage in a contested solicitation over a proposed bylaw are usually even smaller than the incentive to engage in a contested solicitation over directors. See Bebchuk & Kahan, *supra* note 29, at 1126–29.

board-adopted election bylaws that opt out of the provided default arrangement to make it more difficult to replace incumbent directors. Given that the corporate elections system is intended to make directors accountable, allowing directors to make it more difficult to replace them is counterproductive.

One way to deal with this problem is for the legal rules that establish default arrangements concerning corporate elections to allow opting out only through a bylaw adopted by shareholders. This approach is not unfamiliar to drafters of corporate codes: under the Delaware code, a bylaw establishing a staggered board must be adopted by a vote of the shareholders.⁶³ This provision is presumably intended to prevent boards from adopting unilaterally a bylaw establishing a staggered board and thereby making director replacement more difficult. The same logic should be extended to aspects of the election system other than board classification.

If board-adopted bylaws that make replacement more difficult are not categorically ruled out, boards should, at a minimum, be prevented from repealing or amending election bylaws adopted by shareholders. A recent amendment to the Delaware code prohibits boards from repealing shareholder-adopted bylaws that prescribe majority voting.⁶⁴ It is difficult to see any reason for prohibiting directors from undoing election bylaws adopted by shareholders concerning majority voting and at the same time allowing directors to undo shareholder-adopted election bylaws concerning other aspects of the directors' reelection process.

Furthermore, if the law elects not to categorically rule out board adoption of some bylaw amendments that make it more difficult to replace directors (whether or not such amendments undo provisions adopted earlier by shareholders), then directors' decisions to adopt such amendments should be subject to demanding judicial scrutiny. In *Blasius Industries, Inc. v. Atlas Corp.*, Chancellor Allen invalidated a board decision that he viewed as disenfranchising shareholders and lacking a compelling justification.⁶⁵ In my view, a compelling justification test should be applied to any board deci-

⁶³ See Del. Code Ann. tit. 8, § 141(d) (2001).

⁶⁴ See tit. 8, § 216 (prohibiting a board from amending or repealing a stockholder-adopted bylaw prescribing a specific voting percentage—such as majority vote—for the election of directors).

⁶⁵ 564 A.2d 651, 659 (Del. Ch. 1988).

sion to adopt a bylaw that makes it more difficult to replace directors even if the bylaw does not make such replacement practically impossible.⁶⁶

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

III. OBJECTIONS TO REFORM

Thus far I have argued that the shareholder franchise is largely a myth, and I have proposed a set of arrangements that would make shareholder power to replace the board real. But some opponents of reform believe that, even if the shareholder franchise is now largely a myth and shareholders lack a real power to remove directors, this state of affairs is in fact optimal and should be maintained. On this view, giving shareholders effective power to replace boards—the power that they are assumed to have under the accepted theory of the corporation—would operate to the detriment of shareholders and the economy. This Part therefore examines a wide range of possible objections and concerns. I conclude that they do not provide a basis for opposing election reform.

A. Is There Empirical Evidence in Support of Reform?

Opponents of election reform might argue that corporate arrangements, even those serving as defaults, should not be significantly changed without empirical evidence indicating that such changes would increase shareholder value.⁶⁷ In the case under con-

⁶⁶ In *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906, 914 (Del. Ch. 1980), the court invalidated a board-adopted bylaw that was adopted sixty-three days before the annual meeting and mandated seventy days' advance notice of opposition. While the invalidated bylaw completely precluded an electoral challenge in the subsequent meeting, I would go further and subject to the compelling justification test any bylaws that make challenges less likely or more difficult to win.

⁶⁷ See Letter from Michael J. Holliday, Chairman, Comm. on Sec. Regulation, Bus. Law Section of the N.Y. State Bar Ass'n, to Jonathan G. Katz, Sec'y, SEC (June 13, 2003), available at <http://www.sec.gov/rules/other/s71003/scrblsnysba061303.htm>.

sideration, there is a significant body of empirical evidence that is relevant to assessing the proposed reform, and this body of evidence is consistent with the view that making boards more accountable by invigorating corporate elections would tend to increase shareholder value.

To begin, empirical studies consistently found that proxy fights are associated with accompanying increase in shareholder wealth.⁶⁸ These studies focus only on the ex post effects of proxy contests (their effects on shareholder wealth once a proxy contest takes place) and do not attempt to assess the ex ante effects of proxy contests (the effects of the prospect of a proxy contest on boards in general). But even though these studies focus only on a subset of the effects of proxy contests, their results are clearly consistent with a favorable view of such contests.

Furthermore, there is substantial evidence that the general direction in which the proposed reform would go—reducing incumbents' insulation from removal—has an overall beneficial ex ante effect on the management of public companies. To begin, there is evidence that insulation of boards from replacement via a hostile takeover leads to increase in managerial slack. A study by Marianne Bertrand and Sendhil Mullainathan and a study by Gerald Garvey and Gordon Hanka found that the passage of anti-takeover statutes is accompanied by increases in managerial slack.⁶⁹ Another study found that companies whose managers enjoy more protection from takeovers (as measured by a governance

⁶⁸ See Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, 21 *Fin. Mgmt.* 22 (1992); Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 *J. Fin. Econ.* 29, 30 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 *J. Fin. Econ.* 401, 402 (1983); David Ikenberry & Josef Lakonishok, *Corporate Governance through the Proxy Contest: Evidence and Implications*, 66 *J. Bus.* 405, 432–33 (1993); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 *J. Fin. Econ.* 279, 280 (1998).

⁶⁹ See Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 *RAND J. Econ.* 535, 545 (1999) (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 *J. Fin.* 519, 520 (1999) (reporting that antitakeover statutes "allow managers to pursue goals other than maximizing shareholder wealth").

index taking into account both corporate arrangements and state antitakeover provisions) are associated with poorer operating performance—including lower profit margins, return on equity, and sales growth.⁷⁰ This study also found that companies with stronger antitakeover protection are more likely to engage in empire-building.⁷¹ Yet another study found that acquisitions made by companies with stronger antitakeover protection are more likely to be value decreasing.⁷²

There is also evidence that insulation from removal results in greater consumption of private benefits by executives. Kenneth Borokhovich, Kelly Brunarski, and Robert Parrino found that executives with stronger antitakeover defenses enjoy higher compensation levels.⁷³ Marianne Bertrand and Sendhil Mullainathan obtained similar findings for executives who are more protected due to antitakeover statutes.⁷⁴ And a study by Olubunmi Faleye found that antitakeover protection is associated with lower compensation incentives in the CEO's compensation as well as with lower sensitivity of CEO turnover to firm performance.⁷⁵

Finally, there is evidence of a correlation between antitakeover protections and lower firm value. Alma Cohen and I found that staggered boards, with the substantial protection from removal they provide, are correlated with an economically significant reduction in firm value.⁷⁶ In a subsequent study, Alma Cohen, Allen Ferrell, and I found that firm value is negatively correlated not

⁷⁰ See Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. Econ. 107, 111, 129 (2003).

⁷¹ See *id.* at 136–37.

⁷² Ronald W. Masulis, Cong Wang & Fei Xie, *Corporate Governance and Acquirer Returns*, 62 J. Fin. (forthcoming 2007), available at <http://www.afajof.org/afa/forthcoming/2893.pdf>.

⁷³ See Kenneth A. Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 J. Fin. 1495, 1515 (1997).

⁷⁴ See Marianne Bertrand & Sendhil Mullainathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation* (Nat'l Bureau of Econ. Research, Working Paper No. 6830, 1998), available at <http://papers.nber.org/papers/W6830.pdf>.

⁷⁵ See Olubunmi Faleye, *Classified boards, firm value, and managerial entrenchment*, 83 J. Fin. Econ. 501, 503 (2007).

⁷⁶ See Bebchuk & Cohen, *supra* note 33, at 430. The study investigates the connection between firm value and staggered boards during the period from 1995 to 2002 and uses Tobin's Q, a standard measure used by financial economists, as a proxy for firm value.

only with staggered boards, but also with several other provisions associated with greater takeover protection, as well as with an entrenchment index based on these provisions.⁷⁷

To be sure, empirical evidence about the effects of insulation from removal via a takeover does not directly identify the effects of reducing insulation from removal via a proxy fight. But the evidence indicates clearly that current levels of board insulation are costly to shareholders and the economy. It thus provides support for reforms, such as the one under consideration, that would reduce the insulation of boards from removal.⁷⁸

B. Market Forces Provide Sufficient Accountability

There are some who believe that viable shareholder power to remove directors is unnecessary because market forces provide a sufficient source of accountability.⁷⁹ As explained below, however, even though market forces impose some constraints on boards, they do not obviate the need for the power to replace directors.⁸⁰

⁷⁷ See Bebchuk et al., *supra* note 49, at 3. This study also finds that these “entrenching provisions” and the “entrenchment index” based on them were negatively correlated with stock returns during the period from 1990 to 2003. *Id.* Paul Gompers, Joy Ishii, and Andrew Metrick earlier identified a correlation between a broader index of antitakeover provisions and firm values as well as stock returns during the 1990s. See Gompers et al., *supra* note 70, at 144–45.

⁷⁸ While the evidence that bears on the particular reforms considered in this Essay generally supports them, opponents of reform could advance certain “generic” objections that have been used over the years against a wide range of proposed or adopted investor-protection reforms. First, opponents of governance reforms argue that no arrangement not already offered in the marketplace through IPO charters can be value enhancing. I explain the problems with this “Panglossian” argument and why firms going public cannot be expected to include generally in their IPO charters all optimal arrangements in Bebchuk, *Shareholder Power*, *supra* note 56, at 888–90, and, more fully, in Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 *U. Pa. L. Rev.* 713 (2003).

Second, those opposing corporate governance reforms sometimes argue that the performance of the U.S. economy and stock market over time provides evidence that no such reform is necessary. However, this performance does not rule out the possibility that reform would be beneficial for reasons discussed in Bebchuk, *Shareholder Rules*, *supra* note 56, at 1791–92.

⁷⁹ See, e.g., Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 *Harv. L. Rev.* 1735, 1741 (2006).

⁸⁰ For a fuller analysis of the limits of the various market forces that boards face, see Bebchuk & Fried, *supra* note 11, at 53–58; Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1435, 1461–67 (1992); Bebchuk, *supra* note 30, at 1840–46.

1. *The Market for Corporate Control.* Many economists and economically inclined legal scholars have looked to the market for corporate control to provide boards with incentives to perform well.⁸¹ However, under existing legal rules, boards have the power to resist and block hostile takeover bids. As a result, a hostile takeover is possible only if the bidder is willing to offer a high premium and to be sufficiently patient and determined, a situation that leaves a lot of room for slacking off in board performance.⁸² Thus, under the existing arrangements governing hostile bids, the threat of such bids cannot prevent even significant deviations from maximizing shareholder value.⁸³

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

3. *The Product Market.* It might be argued that companies whose boards do not maximize shareholder interests would suffer a substantial disadvantage in competitive product markets, or even fail in such markets and be forced to exit, which in turn would discourage boards from deviating from shareholder interests in the first place. However, deviation from shareholder interests does not necessarily result in increased product prices or a reduced market share. It might simply result in lower profits and cash flows for shareholders without worsening the company's product market performance. Furthermore, even if a given deviation from share-

⁸¹ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1169 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 112 (1965).

⁸² See Lucian Arye Bebchuk et al., *supra* note 33, at 912–14.

⁸³ As will be discussed in Section III.E below, reform that would dismantle takeover defenses, which I support, would still not make reforming corporate elections unnecessary; the two reforms are complements, not substitutes.

holder interests were to produce an increased likelihood of business failure, that might not be enough to discourage such a deviation if the directors' *private* benefits from such a deviation exceed the costs resulting from this increased risk of failure.

4. *The Market for Shares and the Wall Street Rule.* Defenders of the current state of corporate affairs argue that shareholders dissatisfied with incumbent directors can "vote with their feet" by selling the company's stock," and that "[t]he purest form of corporate suffrage takes place in the capital markets."⁸⁴ The ability of shareholders to sell their shares on the market, however, is hardly a substitute for a viable route for replacing directors.

Consider shareholders who believe that their board is and has been underperforming and that, as a result of this poor performance, the company's stock price is only \$40 per share rather than the \$60 per share it would be with adequate board performance. If the board performance cannot be improved, being able to sell shares on the market would not address the shareholders' problem: selling would still provide them with only \$40 per share. Thus, for shareholders concerned that poor board performance is reducing the value of their investment, the freedom to sell their shares is hardly an adequate remedy.⁸⁵

5. *Pressure from Institutional Investors.* Finally, one could look to institutional investors and large outside blockholders to monitor board performance and put pressure on those that perform inadequately. There is evidence that the presence of such shareholders has a beneficial influence on how firms are governed.⁸⁶ The influence that institutions and large outside shareholders have, however, critically depends on the power that the background rules of

⁸⁴ See, e.g., Business Roundtable, Proposed Election Contest Rules, *supra* note 12, at 24–25.

⁸⁵ Indeed, to the extent that the company's share price already reflects poor governance, a shareholder's concern about this poor governance could well *not* lead to the selling of shares. Shareholders will have a reason to sell when they view the market price as higher than the company's true value. Thus, a shareholder believing the company to have good governance might elect to sell shares if the shareholder also believes that the market overappreciates the company's good governance. Conversely, a shareholder believing the company to have poor governance might elect to buy additional shares if the shareholder also believes the market overestimates the extent to which the company's governance is poor.

⁸⁶ See, e.g., Marianne Bertrand & Sendhil Mullainathan, Are CEOs Rewarded for Luck? The Ones Without Principals Are, 116 Q.J. Econ. 901, 920–21 (2001).

corporate law give them. In particular, this influence is likely to depend on the extent to which institutional investors are able to vote out directors if the latter decline to follow the institutions' recommendations and requests. The less meaningful shareholders' voting power is, the less clout institutions and other holders of large blocks of stock have with boards.

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

C. The Proposed Reform Would Not Have Practical Significance

The proposed reform, it might be argued, would have little practical significance. On this view, institutional investors tend to be passive and therefore cannot be expected to make much use of arrangements making it easier to challenge incumbent directors.⁸⁷

Most money managers indeed cannot be expected to initiate or to sponsor a dissident slate even after the adoption of the proposed reforms. Most mutual funds are "reluctant activists" and active involvement in corporate governance is not part of their business model.⁸⁸ It is reasonable to expect, however, that challenges would come from individuals, family firms, and activist mutual funds and hedge funds that have or will acquire significant blocks in companies with boards that fail to maximize shareholder value. When such shareholders launch a contest whose success would likely raise share value, money managers that are unwilling to be active themselves could well vote for this slate. The past voting patterns of private money managers indicate that they commonly do not vote

⁸⁷ Letter from Robert T. Lang & Charles Nathan, Co-Chairs, Task Force on S'holder Proposals, to Jonathan G. Katz, Sec'y, SEC 11 (June 13, 2003) ("New mechanisms to increase on a routine basis shareholder participation in director selection will not be worth their costs because they will not likely result in significant numbers of shareholder-nominated directors being elected.").

⁸⁸ Pozen, *supra* note 26, at 140; Robert C. Pozen, Institutional Perspective on Shareholder Nominations of Corporate Directors, 59 *Bus. Law.* 95, 95 (2003).

against management on social issues, but they do occasionally vote against management when its position appears to be value decreasing.

Finally, suppose that election reform would have only a limited effect on the viability of an electoral challenge and thus on the accountability of incumbents. Such a conclusion could justify lowering one's expectations of what the proposed reform would accomplish, as well as considering more expansive reforms, but it could not provide a basis for *opposing* the proposed changes. To provide a basis for such opposition, opponents must argue that making it easier to replace directors would have significant negative consequences. I therefore now turn to such arguments.

D. Adverse Effects on Shareholders

1. Waste and Disruption

This objection runs in the opposite direction of the preceding one. Rather than claim that election reform would have little practical significance, this objection suggests that it would lead to large-scale disruption of corporate management. Making it easier to run a competing slate, opponents of reform worry, would make contested elections the norm.⁸⁹ The Business Roundtable opposed even the SEC's modest proposal for a limited access to the ballot by shareholders on the grounds that it "has the potential to turn every director election into a divisive proxy contest."⁹⁰ Such contests, it is argued, would not only require companies to incur substantial out-of-pocket costs, thereby wasting corporate resources, but also (and more importantly) divert management's effort and attention.

However, the proposed reform should not be expected to lead to full-scale contests becoming the norm. To begin with, in companies that are adequately governed and lack widespread shareholder dissatisfaction, incumbents would largely remain secure in their board

⁸⁹ See, e.g., Letter from David M. Silk to SEC, *supra* note 14, at 3–4.

⁹⁰ Letter from Henry A. McKinnell, Chairman and CEO, Bus. Roundtable, to Jonathan G. Katz, Sec'y, SEC 4 (June 13, 2003), available at <http://www.sec.gov/rules/other/s71003/brt061303.htm>.

seats and challenges would continue to be unlikely.⁹¹ The past voting patterns of institutional investors indicate that their voting en masse against incumbents is the exception, occurring only in the presence of some strong reasons for doing so. Without broad shareholder dissatisfaction resulting from a poor record, an electoral challenge would be futile. While the proposed reform would provide cost reimbursement to challengers, it would do so only when they attract a sufficiently substantial number of votes, and thus it would provide no encouragement to futile challenges.

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

Granted, some boards might fail to improve performance even in the face of viable shareholder power to remove them. In such cases, the proposed reform is likely to increase the incidence of contests somewhat from its current low level. However, the small number of companies in which contests would occur in any given year would not be randomly drawn from the set of all companies. Rather, they would be concentrated among companies with high shareholder dissatisfaction and sub-par performance. Although these contests would involve some costs, these costs would be a price worth paying for a process that could improve corporate governance in these companies as well as produce system-wide benefits.⁹²

It should be stressed that, by appropriate adjustment of the parameters of the system, it should be possible to permit the inci-

⁹¹ For evidence that targets of proxy challenges tend to be companies that prior to the contest had negative abnormal stock returns and poor operating performance, see Ikenberry & Lakonishok, *supra* note 68, at 414–17.

⁹² Recall in this connection the empirical evidence indicating that the initiation of contests is accompanied by increases in shareholder wealth. See studies cited *supra* note 68.

dence of contests to grow somewhat without their becoming too common. In particular, the incidence of contests will likely increase as (1) the (ownership and holding) thresholds that must be passed to gain access to the ballot are lowered and (2) the (support) threshold that must be passed to gain reimbursement decreases. Conversely, the more demanding these thresholds, the lower the expected incidence of contests. Setting these thresholds at zero would likely result in a very high incidence of contests, whereas setting them at a very high level would result in no change compared with the existing state of affairs. By moving the thresholds along the continuum in between, the incidence of contests can be reduced or raised.

Thus, if election reform initially produces an increase in the incidence of contests that is deemed to be too high, the thresholds set in the default arrangement could be tightened. More importantly, because the proposed system would be a default, firms themselves would be able to tighten the default thresholds if their shareholders find the likelihood of a contest too high and therefore are willing to approve such tightening. Thus, as long as the existing incidence of electoral challenges is viewed as too low, the desirability of reform is not undermined by concerns that it will result in too many electoral challenges.

2. Shareholders with Special Interests

Increases in shareholder power are also opposed on grounds that they would be used by a shareholder or a shareholder group that has a “special interest” not shared by other shareholders to advance this interest at the expense of long-term share value.⁹³ In this view, a shareholder might, for example, seek to protect labor interests, advance a “social” agenda, or extract “greenmail” benefits. The proposed reform, it might be argued, would enable shareholders with special interests to get one or more representatives on the board or to extract concessions from the board by threatening to mount challenges.

⁹³ See, e.g., Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 *UCLA L. Rev.* 561, 564–65 (2006); Bainbridge, *supra* note 79, at 1754–55; Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 *Bus. Law.* 67, 82–83 (2003).

While the proposed reform would make it easier for directors not nominated by the board to be elected if they are supported by a majority of shareholders, directors still could not be elected without majority support.⁹⁴ A slate proposed by a special-interest shareholder to advance its particular agenda would have no meaningful chance of obtaining the majority of votes necessary to be elected. Given the tendency of most money managers to focus on shareholder value and to support incumbents absent some strong reason to the contrary, a special-interest candidate would not be able to attract their votes.

The patterns of shareholder voting on shareholder precatory resolutions support this prediction. The only resolutions that systematically obtain majority support are those calling for changes that are viewed as value-enhancing by a wide range of financial institutions—such as destaggering the board or rescinding poison pills.⁹⁵ In contrast, proposals that focus on social or special-interest issues uniformly fall far short of a majority. For example, in 2003, while precatory resolutions to expense options obtained an average of forty-six percent support, precatory resolutions to abolish stock options obtained an average of only six percent, and precatory resolutions seeking to highlight the ratio of highest to lowest compensation paid by the company obtained an average of only twelve percent of shareholder votes.⁹⁶

Another concern is that, by threatening to run a competing slate, special-interest shareholders would be able to obtain “leverage” and pressure the board into actions that serve the special interest but not shareholder value; labor unions, for example, could in this way extract concessions for workers.⁹⁷ However, given that a labor union’s candidates will generally be unable to win electoral con-

⁹⁴ Note that the reform I support does not include cumulative voting. With cumulative voting, a special-interest candidate who appeals only to a minority of the shareholders might be elected. The approach I support, however, would not involve any departure from a majoritarian approach to filling each and every slot on the board.

⁹⁵ See Georgeson S’holder, *Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests 7–8* (2003), <http://www.georgesonshareholder.com/pdf/2003%20a.wrapup.pdf>.

⁹⁶ See *id.* at 7, 22.

⁹⁷ See John J. Castellani & Amy L. Goodman, *The Case against the SEC Director Election Proposal*, in *Shareholder Access to the Corporate Ballot* (Lucian Bebchuk ed., forthcoming 2007).

tests, the electoral reform under consideration would not provide unions with any significant “extortion” power. Indeed, because the threat to incumbents’ continued service would come *only* from losing the support of a majority of the shareholders, the proposed reform would make boards more reluctant, not more willing, to take actions that serve the special interests of one shareholder or shareholder group at the expense of shareholder value.⁹⁸

3. *Bad Choices*

Reform may also be opposed on the grounds that shareholders seeking to enhance share value would still misuse any increase in their power to remove directors by making uninformed and poor choices. Shareholders, it might be argued, simply do not have the full information available to the board’s nominating committee.⁹⁹ Consequently, they could make bad choices, electing directors who would not be as well qualified as candidates selected by the board.

The question, however, is not whether board nominating committees or shareholders have better information about candidates. Granting that the former commonly have superior information does not resolve the issue at hand. First, however informed the members of board nomination committees are, they do not always have adequate incentives to replace fellow directors or themselves when desirable. Accountability is important precisely because, given the divergence between directors’ and shareholders’ interests, directors may choose not to act in a certain way even if they recognize that it would likely increase share value.

⁹⁸ Professor Iman Anabtawi has advocated limiting shareholders’ power on grounds that shareholders have heterogeneous interests and that a substantial fraction and perhaps a majority of shareholders have some “special” interests not shared by other shareholders. See Anabtawi, *supra* note 93. Anabtawi argues that, given the heterogeneity of shareholder interests, the outcome supported by a majority of shareholders could differ from the one that would serve the aggregate welfare of the company’s shareholders. Although this is theoretically possible, Anabtawi does not provide reasons to expect it to be practically significant and does not explain why an insulated board can be relied on to pursue generally the outcome that would serve the joint welfare of the company’s shareholders. Further, she does not discuss why the considerations she stresses as a basis for the existing rules insulating boards of companies with dispersed shareholders from shareholder intervention do not equally provide a basis for changing existing rules to insulate boards of companies with a controlling shareholder from removal by this shareholder.

⁹⁹ See, e.g., Lipton & Rosenblum, *supra* note 93, at 92–93.

Furthermore, although institutional shareholders may not have the same information as the board, there is no reason to assume that they are unaware of the informational advantages possessed by the board and its nominating committee. Indeed, institutional shareholders usually display a substantial tendency to defer to boards. They would likely continue to display substantial deference to the board's choices after the adoption of the proposed reform. Thus, the question is whether shareholders, in the infrequent cases in which they prefer to do so, should have the real power not to elect the board's candidates.

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

4. Short-Termism

The strongest objection to election reform comes from concerns about short-termism. The fear of being replaced, it might be argued, could lead boards seeking to please shareholders to take actions that improve short-term results but are not optimal from a long-term perspective.¹⁰⁰

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

¹⁰⁰ For an analysis of the possible distortions in the choice between long-term and short-term projects that could result from a "short horizon," see Lucian Arye Bebchuk & Lars A. Stole, *Do Short-Term Managerial Objectives Lead to Under- or Over-Investment in Long-Term Projects?*, 48 *J. Fin.* 719, 719-20 (1993); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 *Q.J. Econ.* 655, 655-56 (1989).

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

5. Detering Directors from Serving

The proposed reform, it might be argued, would deter some potentially good directors from serving on boards of publicly traded companies.¹⁰¹ In this view, some good candidates would not be willing to serve if they faced any meaningful prospect of a contested election or even removal when they stand for reelection.

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

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

Note that, even with reform, directors would face a rather small likelihood of removal relative to those holding other positions in the business world. Thus, it is far from clear that the proposed reform would have any meaningful adverse effect on the attractiveness of the well-paid and highly prestigious positions of directors.

¹⁰¹ See, e.g., Lipton & Rosenblum, *supra* note 93, at 82–83.

Even if reform did make these positions somewhat less attractive, shareholders could well be better off countering this effect with increased pay rather than with reduced accountability. Providing complete job security as a means of attracting directors is counterproductive.

6. *The U.K. Example*

In assessing the claims that a system in which shareholders have more power to replace or remove directors would have adverse effects, it is worth recognizing that the United Kingdom has long had such a system. Under mandatory U.K. rules, shareholders always have the power to replace *all* the directors, they may call a special meeting in order to do so, and they may place a candidate on the corporate ballot.¹⁰²

The U.K. experience disproves some of the doomsday scenarios suggested by those opposing reform of corporate elections in the United States. While the U.K. experience does not prove that such a reform would be positive on balance, it does undermine any warnings that reform would substantially undermine boards' and companies' ability to function.

There is no evidence that the U.K. system leads to contested elections being the norm, discourages good directors from serving, empowers special interests, or leads boards to pursue value-reducing strategies. Rather than lead to frequent contests, shareholders' greater power in the United Kingdom enables them to exert greater influence on boards and make boards more attentive to their interests and wishes. Indeed, a recent study of shareholder activism in the United Kingdom documents how large U.K. shareholders are able to use their power to influence companies to make changes that turn out to have significant value-increasing effects.¹⁰³

¹⁰² See Paul L. Davies, *Gower's Principles of Modern Company Law* 188–93 (6th ed. 1997).

¹⁰³ See Marco Becht et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund 8* (Eur. Corporate Governance Inst., Finance Working Paper No. 138/2006, 2006), available at http://www.ecgi.org/wp/wp_id.php?id=213.

E. Do Hedge Funds Make Election Reform Unnecessary?

Recently, there has been a significant increase in “activism” by hedge funds.¹⁰⁴ A growing number of hedge funds have shown a willingness to acquire blocks in companies and press for changes in the company’s strategy or governance. The funds have used an array of tactics, including mounting or threatening to mount a proxy contest. Recent work on hedge fund activism suggests that, relative to mutual funds, managers of hedge funds have stronger financial incentives to engage in such activism and do not face the same regulatory and conflict-of-interest problems.¹⁰⁵ Some writers question whether hedge funds’ increased activism efforts would generate sufficient returns to be sustainable.¹⁰⁶ Assuming that hedge funds’ increased activism is here to stay, however, the question naturally arises whether it would make the proposed reform of corporate elections unnecessary. As explained below, it would not.

Even with a well-functioning system of corporate elections, challenges would require a pool of players that are willing to hold a block of shares and make the effort involved in mounting a contest. Indeed, for any given set of rules, the larger this pool, the more contests will take place, other things equal. A large number of activist hedge funds thus might well operate to increase the number of contests, but it is not a substitute for a well-functioning election system that does not provide incumbents with large structural advantages.

To begin, while hedge funds holding blocks might sometimes be willing to mount a contest even under the existing rules, the free-

¹⁰⁴ The increase in hedge fund activism is the subject of several recent works, including Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism*, 32 *J. Corp. L.* (forthcoming summer 2007), available at <http://ssrn.com/abstract=911072>; William W. Bratton, *Hedge Funds and Governance Targets* (Eur. Corporate Governance Inst., Law Working Paper No. 80/2007, 2007), available at <http://ssrn.com/abstract=928689>; Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* (Sept. 22, 2006) (unpublished working paper, on file with the Virginia Law Review Association), available at http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge_fund.pdf; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (Inst. for Law & Econ., Research Paper No. 06-16, 2006), available at <http://ssrn.com/abstract=919881>; April Klein & Emanuel Zur, *Hedge Fund Activism* (Eur. Corporate Governance Inst., Working Paper Series in Finance No. 140/2006, 2006), available at <http://ssrn.com/abstract=913362>.

¹⁰⁵ See Kahan & Rock, *supra* note 104, at 3.

¹⁰⁶ See, e.g., Bratton, *supra* note 104, at 7; Brav et al., *supra* note 104, at 4–5.

rider problem produced by these rules can be expected to lead them to underinvest in mounting such contests. A recent study reports that the median stake of a hedge fund engaged in “aggressive” activist strategy is 6.6% of the target’s outstanding shares.¹⁰⁷ Under the existing rules governing corporate elections, a fund with a 6.6% stake would have to bear its full costs in mounting a contest while capturing only 6.6% of the aggregate benefits to the target’s shareholders from the contest. In such circumstances, the prospect of appreciation in the value of the fund’s stake would not be sufficient to induce it to mount a contest whenever such a contest would be beneficial for the target’s shareholders.

This free-rider problem is especially likely to discourage contests in large-capitalization companies. The evidence indicates that hedge funds tend not to choose as targets for their activism firms in the top quintile in terms of market capitalization¹⁰⁸—the companies whose effective governance is practically the most important for the economy’s performance. In such companies, activist hedge funds might have difficulty committing sufficient capital to obtain a substantial stake that would enable them to capture a substantial fraction of the aggregate benefits to shareholders from a contest.

Activist hedge funds do not eliminate the need for the proposed rule providing reimbursement of challengers’ costs, nor for my other proposals for reforming corporate elections. Even with the presence of active and highly incentivized players that might serve as potential challengers, a well-functioning election system requires that shareholders be able to replace all directors at some point in time and that shareholders be able to cast their votes by secret ballot; that, in the large majority of cases in which incumbents run uncontested, “withhold” and “against” votes are not ignored; and that incumbents do not control the choice of the corporate bylaws governing their own election.

The recent work on hedge fund activism documents that hedge funds’ activist efforts are accompanied by increases in the market value of the target companies.¹⁰⁹ Electoral reforms that increase shareholder power would likely increase the number of cases in

¹⁰⁷ Brav et al., *supra* note 104, at 16.

¹⁰⁸ *Id.* at 18.

¹⁰⁹ See, e.g., *id.* at 3; Klein & Zur, *supra* note 104, at 4.

which such benefits are produced directly as well as, perhaps most importantly, the number of cases in which the prospect of an electoral challenge would improve incumbents' performance in the first place. Overall, the expansion of the pool of potential challengers produced by activist hedge funds is a complement, not a substitute, for election reform. With an increased pool of players prepared to use a reformed system of corporate elections, such a reform is likely to begin producing significant benefits quickly.

F. Invigorate the Market for Corporate Control Instead

There are some who accept that boards are now insufficiently accountable but believe that a better mechanism for restoring accountability is the market for corporate control.¹¹⁰ On this view, instead of reforming corporate elections, we should dismantle the antitakeover defenses that have been erected over the past two decades. A vigorous market for corporate control, it is argued, would be sufficient to discipline boards and ensure that they do not deviate from shareholder interests.

Although I support reforms that would eliminate antitakeover defenses,¹¹¹ I view such reforms as a complement rather than as a substitute for reforming corporate elections. There are some types of board failure that could be more effectively disciplined by the prospect of a proxy fight than by a hostile takeover bid. Consider a board decision whether, say, to grant a CEO pushed out for bad performance an unwarranted golden goodbye in the form of extra payments not required by contract. Such a decision might produce some investor outrage that could hurt the board in a proxy contest, and the board might thus be deterred from making it under a system that facilitates contested elections. However, the decision might not reduce firm value enough to make a hostile takeover bid profitable. Even in a system that facilitates hostile bids, the takeover mechanism would be costly and thus triggered only in cases in

¹¹⁰ See, e.g., Randy Kroszner & Peter Wallison, Remarks at the SEC Roundtable on Proposed Security Holder Director Nominations Rules (Mar. 10, 2004), available at <http://www.sec.gov/spotlight/dir-nominations/transcript03102004.txt>.

¹¹¹ See, e.g., Lucian Arye Bebchuk, The Case Against Board Veto in Corporate Takeovers, 69 U. Chi. L. Rev. 973, 988 (2002).

which the bidder could make substantial profit from taking over the company.¹¹²

Although the British City Code facilitates hostile takeovers by preventing incumbents from blocking hostile offers,¹¹³ U.K. law facilitates the removal of directors by shareholders via the ballot box much more than does U.S. law. These two elements of U.K. law reinforce each other and both operate to make boards more accountable and more attentive to shareholder interests. The United States should follow a similar approach.

G. Adverse Effects on Stakeholders

Finally, increasing shareholder power may be opposed on the grounds that, even if it made directors more attentive to shareholder interests, it could well make them less attentive to stakeholder interests.¹¹⁴ The board, it is argued, should take into account and balance all of the possibly competing interests of shareholders and other constituencies, such as creditors, employees, customers,

¹¹² Not only is facilitating takeovers not a substitute for reforming corporate elections, but the latter is also not a substitute for the former. When a rival team knows that a change in the company's course of action would produce considerable benefits, but cannot credibly signal this to shareholders, the rival would not be able to win a proxy contest and a takeover would be necessary. See Bebchuk & Hart, *supra* note 28, at 1–2.

¹¹³ See Panel on Takeovers and Mergers, *The City Code on Takeovers and Mergers*, at B1–B2 (2005), available at <http://www.thetakeoverpanel.org.uk/code/code.pdf>.

¹¹⁴ In a series of influential articles written over the past decade, Margaret Blair and Lynn Stout have systematically developed such stakeholder-based objections to increases in shareholder power. See, e.g., Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 *Wash. U. L.Q.* 403 (2001); Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 *J. Corp. L.* 719 (2006); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 *Va. L. Rev.* 247 (1999) [hereinafter Blair & Stout, *A Team Production Theory*]; Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 *Stan. L. Rev.* 845 (2002); Lynn A. Stout, *The Shareholder As Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 *U. Pa. L. Rev.* 667 (2003). These works build on earlier work by writers viewing antitakeover defenses as beneficial for protecting stakeholders' ex ante investments in the firm. See, e.g., John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 *Mich. L. Rev.* 1, 23–24 (1986); Lipton & Rosenblum, *supra* note 34, at 188–89; Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in *Corporate Takeovers: Causes and Consequences* 33, 37–41 (Alan J. Auerbach ed., 1988).

and so forth. Indeed, it has been argued that it is in shareholders' ex ante interest to tie their own hands and let boards make decisions that will take into account the interests of stakeholders in order to induce the stakeholders to invest in their relationship with the firm.¹¹⁵

Even if one fully accepts that it would be desirable to provide stakeholders with additional protections, whether as an end in itself or to serve shareholders' ex ante interests in inducing specific investments by stakeholders, it is far from clear that insulating boards from removal provides stakeholders with such protections. For one thing, there is little reason to expect that boards commonly use their discretion to serve stakeholder interests. Under existing rules, directors may sometimes take stakeholders' interests into account, but are generally not required to do so.¹¹⁶ Those who support insulating boards in order to serve stakeholders do not call for requiring boards to take stakeholder interests into account, but rather express hopes that boards will do so.

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

¹¹⁵ See, e.g., Blair & Stout, *A Team Production Theory*, supra note 114, at 253–54. In the view of Blair and Stout, directors should play the role of “mediating hierarchs” who balance the competing needs and demands of shareholders, creditors, customers, suppliers, executives, rank-and-file employees, and the local community. *Id.* at 278–81.

¹¹⁶ The drafters of state constituency statutes have used, in all cases but one, language that authorizes but does not require directors to take into account the interests of nonshareholder constituencies. See *Comm. on Corp. Laws, Other Constituencies Statutes: Potential for Confusion*, 45 *Bus. Law.* 2253, 2261–63 (1990).

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

There is little reason to expect that reduced board accountability to shareholders will translate into increased attention to other stakeholders. Insulating boards from removal does not make them more accountable to stakeholders at the expense of accountability to shareholders. Rather, such insulation makes boards accountable to no one. Directors might use such lack of accountability to serve their own interests rather than to balance the interests of shareholders and stakeholders or give more weight to stakeholder interests. By protecting boards from removal even in the event of consistent poor performance, insulation from removal could well be costly to *both* shareholders and stakeholders.¹¹⁷

¹¹⁷ Finally, as discussed in Bebchuk, *Shareholder Power*, supra note 56, at 909–10, the objection to shareholder power under consideration in this section has a puzzling aspect. Those advancing this objection seek to limit the power of the shareholders of large companies only when the companies have dispersed ownership. They do not seek to limit the power of shareholders in large companies controlled by controlling shareholders or privately held. If it is desirable to limit the influence of shareholders on corporate decisionmaking in publicly traded firms with dispersed ownership in a given industry, then it should also be desirable to limit the influence of the shareholders of other large firms in the industry that are publicly traded but have a controlling shareholder or are privately held (say, by a private equity firm, a family, or a publicly traded parent).

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

CONCLUSION

The shareholder franchise is largely a myth. Shareholders commonly do not have a viable power to replace the directors of public companies. Electoral challenges are rare, and the risk of replacement via a proxy contest is extremely low. To restore accountability and place our corporate governance system on solid foundations, the shareholder franchise should be transformed from a myth into a reality. The reforms put forward in this Essay would provide shareholders with a viable power to replace directors. They would thereby improve the accountability and performance of corporate boards. Such reforms, which would benefit investors and the economy, are long overdue.