SOME SKEPTICISM ABOUT INCREASING SHAREHOLDER POWER

Iman Anabtawi*

This Article challenges the claim of shareholder primacists that reapportioning corporate governance power away from boards of directors and toward shareholders will benefit shareholders as a class. This claim is premised on the assumptions that shareholders have harmonious interests and that they will pursue those interests by disciplining managers and increasing shareholder value. I argue that the pursuit of common shareholder interests is unlikely to dominate the actions of shareholders. The largest modern shareholders—those most likely to exercise shareholder power—have private interests that are both substantial and in conflict with maximizing overall shareholder value. As a result, it is misleading to assume that increasing shareholder power will benefit shareholders generally. Instead, it is more plausible that shareholders will use any incremental power conferred on them to benefit their private interests at the expense of the firm and other shareholders. I contend that this concern poses a sufficient threat to shareholder wealth to warrant caution before implementing corporate governance reforms that would increase shareholder power.

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* Acting Professor of Law, UCLA School of Law. J.D., Stanford Law School; M.A., B.A., Oxford University; B.A., Pomona College. I thank Rick Abel, Steve Bainbridge, Steve Bank, Dan Bussel, Ann Carlson, Lauren Freedman, Michael Heller, Bill Klein, Dan Lowenstein, Steve Munzer, Troy Paredes, Kathy Smalley, Clyde Spillenger, Lynn Stout, Alex Taborrok, and Steve Yeazell for advice, and Kevin Gerson and Jeremy Jones for research assistance, in connection with this Article.

INTRODUCTION

In the shareholder-power debate over how best to apportion corporate decisionmaking between officers and directors, on the one hand, and shareholders, on the other hand, shareholder primacists are gaining ground. According to shareholder-primacy theory, shareholders of the modern publicly held corporation are principals, and managers are their agents in running the firm. Shareholder primacists contend that shareholders would like managers to maximize the long-term value of their shares,[1] but that managers are unlikely to do so because their interests are insufficiently aligned with those of shareholders. According to shareholder primacists, increasing shareholder power would go a long way toward solving the agency problem between managers and shareholders.[2]

On the other side of the debate are director primacists—those who argue in favor of vesting primary decisionmaking authority in a firm's board

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1. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005) ("[E]ffective corporate governance, which enhances shareholder and firm value, is the objective underlying my analysis."). Later in the article, Professor Bebchuk refers only to the enhancement of shareholder value as his metric for effective corporate governance. *Id.* at 892 ("I have thus far discussed how giving shareholders the power to make rules-of-the-game decisions would improve corporate governance and increase shareholder value."); *see also id.* at 908 ("I have argued that making shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value.").

I refer to this objective as maximizing "shareholder value" or "shareholder wealth." This is a narrower objective than that of maximizing "firm value," which incorporates the preferences of nonshareholder constituencies of the firm, such as lenders. *See* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 IOWA J. CORP. L. (forthcoming 2006) (observing that although "empirical scholars have largely equated firm value with shareholder value, the two concepts are not identical"). For a general discussion of possible corporate finance objectives, see ASWATH DAMODARAN, CORPORATE FINANCE: THEORY AND PRACTICE 11–14 (2d ed. 2001).

2. *See generally* Bebchuk, *supra* note 1, at 833 (arguing that shareholder intervention would reduce agency costs between managers and shareholders); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) (setting forth a favorable account of shareholder oversight); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992) (advancing arguments for greater institutional voice); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991) (discussing the benefits of increasing board of director accountability to shareholders).

of directors. In Stephen Bainbridge's director-primacy theory, for example, the board of directors is a mechanism for solving the organizational design problem that arises when one views the firm as a nexus of contracts among various factors of production, each with differing interests and information.[3] The board of directors serves as an efficient, central decisionmaker within this scheme. Centralizing corporate decisionmaking in a board of directors necessitates conferring upon it considerable discretion, which, in turn, implies limiting shareholder power.[4]

Margaret Blair and Lynn Stout take a different approach in justifying director primacy.[5] Their "team production" model of corporate governance argues that corporate law must address the economic problem of encouraging nonshareholder corporate constituencies, such as executives, rank-and-file employees, creditors, and sometimes the local community, to make firm-specific investments in corporations. According to Blair and Stout, one way to do so is to place control of the corporation in the hands of a board of directors that is insulated from shareholder control and enjoys the freedom to take actions that improve the joint welfare of all the firm's team members.[6] Thus, the proper focus of corporate governance should, in their view, be on designing and implementing incentives for board behavior that do not involve enhancing shareholder disciplining. Instead, team production theory treats directors as "mediating hierarchs" whose job is to balance the interests of all the corporation's constituencies, thereby serving the interests of the entire firm.[7]

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3. *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) (emphasizing the value of authority-based decisionmaking structures in large organizations).

4. *See id.* at 604; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. (forthcoming 2006) (replying to Bebchuk, *supra* note 1); *see also* Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003) (contending that managers have available to them means of evading shareholder oversight in the takeover context through unregulable or unobservable actions and that such behavior could destroy shareholder value to a greater extent than shareholder oversight enhances it).

5. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 286 (1999) (emphasizing the role of a firm's board of directors as mediating conflicts among the firm's various "team members"); *see also* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 18 (2004) ("As a normative matter, the overall objective of corporate law—as of any branch of law—is presumably to serve the interests of society as a whole."); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205 (1991) (endorsing a model of the corporation in which the interests of "stockholders, managers, and other constituencies" are relevant).

6. *See* Blair & Stout, *supra* note 5, at 288.

7. *Id.* at 291.

In this Article, I advance a third rationale for vesting primary decisionmaking authority in the board of directors—the need for mediating the various and often conflicting interests of shareholders themselves. I claim that shareholder primacists either ignore or underplay deep rifts among the interests of large blockholders, those shareholders most likely to exercise shareholder power. Instead, they continue to regard shareholders as a monolith with a single, overriding objective—maximizing shareholder value.

This Article disputes the characterization of shareholders as having interests that are fundamentally in harmony with one another.[8] While that conception of shareholders may once have been an accurate generalization, it does not reflect the existing pattern of share ownership in U.S. public companies. Pitted against shareholders' common interest in enhancing shareholder value are significant private interests.[9] Take, for example, a hedge fund that is a shareholder in a company and that is about to raise capital for a new fund. As part of its marketing effort, it wants to show impressive returns on its prior fund. To generate such returns, the hedge fund is likely to favor policies by the firms in which it invests that produce short-term gains, even if a more patient investment orientation would generate higher returns over the long term. In contrast, a pension fund or life insurance company shareholder is more likely to be concerned about the long-term value of its investments, which will allow it to meet its future obligations. Shareholders have numerous other private interests, some of which have emerged relatively recently, and these are described in detail in Part II of this Article. On close analysis, shareholder interests look highly fragmented.

Once we recognize that shareholders have significant private interests, it becomes apparent that they may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class. As a result, transferring power from boards to shareholders will not necessarily

8. Corporate law recognizes that "controlling" shareholders have incentives to engage in self-dealing and thus imposes fiduciary duties on them to minority shareholders. *See* Zahn v. Transamerica Corp., 162 F.2d 36, 44 (3d Cir. 1947). Noncontrolling shareholders, on the other hand, are presumed to be unable to exercise their power to advance their private interests. *See, e.g.*, Weinstein Enters., Inc. v. Orloff, 870 A.2d 499, 507 (Del. 2005); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989); Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del. Ch. 1984), *aff'd*, 575 A.2d 1131 (Del. 1990). The leading exceptions in the academic literature to the foregoing generalization are the explorations by Jeffrey Gordon and Edward Rock into the possibility that noncontrolling shareholders will assert their influence in a self-serving manner. *See* Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994).

9. By "private" interests, I mean those interests of a shareholder that are not shared by shareholders generally. *See infra* note 76.

benefit all shareholders. Indeed, it could reduce overall shareholder welfare. This outcome, of course, is the opposite of that predicted by proponents of increasing shareholder power.

The remainder of this Article proceeds as follows. Part I briefly reviews the case for increasing shareholder power as a means of keeping managers from straying too far from serving shareholders. It then presents two contrasting models of shareholder action—one in which shareholder interests are homogenous, and the other in which shareholders have divergent interests. The message of Part I is that the assumption that additional shareholder power will be used to advance the common interests of all shareholders may no longer hold when shareholders have significant private interests. Part II catalogues the various fracture lines that divide modern shareholders. Part III addresses the objection that shareholders will be unlikely to use their enhanced power opportunistically because they are checked from doing so by the corporate law voting principle of majority rule. I conclude by using the analytic framework presented in this Article to shed additional light on the long-standing puzzle of why corporate law vests broad managerial discretion in a board of directors.

I. SHAREHOLDERS AS A POTENTIAL CONSTRAINT ON AGENCY COSTS

The paradigmatic corporate governance structure that characterizes the large U.S. firm is one of "strong managers" and "weak owners."[10] Separating ownership from control, however, gives rise to an agency problem.[11] Because managers generally own only a small percentage of their companies' stock and are heavily exposed to firm-specific risk, due to their large human capital investment in the firm, they face incentives to trade off the private costs of their decisions against the profits that such decisions generate at a different level than shareholders would choose. The central

10. I take this characterization from MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 54–145 (1994) (discussing the historical relationships among shareholders, boards of directors, and senior executives).

11. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); *see also* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983). For the classic exposition of the agency problem in the law literature, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

concern of agency theory is how to minimize the costs associated with this gap. In this part, I describe traditional mechanisms for controlling these so-called agency costs and their limitations. I then specify the narrow conditions under which transferring power away from managers and toward shareholders will be effective in doing so.

A. Controlling Agency Costs

To control agency costs, agency theory prescribes constraining managerial discretion such that it deviates from shareholder value-maximizing behavior as little as possible. This objective can be targeted through a variety of means. The primary mechanisms used to reduce agency costs are (1) incentive pay arrangements and (2) the market for corporate control.[12] Each of these approaches has the potential to discourage managers from pursuing objectives in running the firm that do not enhance shareholder value. On the other hand, each has been criticized for failing to deliver on its promise to align the interests of managers and shareholders.

Incentive compensation contracts can induce managers to act more closely in line with the interests of shareholders as a class. A manager who is interested in pursuing a pet project that is personally valuable to the manager, but unprofitable for the firm, would think twice if the manager owned a significant equity stake in the company. On the other hand, such contracts expose managers to risk by conditioning their pay on performance measures that are not fully within their control. Requiring managers to bear risk in their compensation arrangements involves a cost. This cost arises because risk-averse managers must be paid a premium in exchange for agreeing to accept an element of their compensation in risk-based form.[13] Firms that use incentive compensation contracts expect to recoup the foregoing cost in the form of enhanced managerial performance.[14]

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12. *See* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 884–89 (describing various economic constraints on management discretion and their limitations).

13. PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 207 (1992). The amount of the risk premium is a function of a manager's risk aversion, initial wealth, and diversification. *See* Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 6, 15–16 (2002).

14. Performance-based compensation is generally thought to help align the interests of managers and shareholders in two distinct ways. First, it encourages managers to commit more effort to their tasks by requiring them to internalize a portion of the costs and benefits of their actions. Second, it encourages managers to undertake riskier investments. MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 145–47 (2000).

Critics of pay-for-performance schemes have argued that while tying pay to performance can, in theory, discipline managers, the process by which pay arrangements are determined is skewed to favor managerial, not shareholder, interests.[15] According to this view, executive compensation contracts do not exhibit a strong link between pay and performance largely because boards of directors are not in fact bargaining with managers at arm's length to maximize shareholder value. Rather, boards systematically favor managers, who exert undue influence over directors through a variety of mechanisms.[16] As Lucian Bebchuk and Jesse Fried put it, the executive pay-setting process is itself the product of an agency problem between managers and shareholders.[17] Thus, so long as shareholders are unable to exert influence over the pay-setting process, incentive compensation arrangements are unlikely to provide much of a solution to the agency problem.

In addition to incentive compensation arrangements, the market for corporate control offers the potential to align managerial and shareholder interests.[18] The theory behind this mechanism is that firms performing poorly will be more susceptible to a hostile takeover, threatening management with being ousted.[19]

The market for corporate control is not, however, a perfect constraint on managerial behavior for several reasons. First, poor management is not the sole reason for hostile takeovers. There is considerable evidence that short-term share prices deviate from their fundamental values for extended periods of time.[20] Thus, a company's shares may be undervalued, and provoke

15. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (contending that executive compensation arrangements are by and large the product of board capture by managers). *But see* Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557 (taking issue with the view that pay-for-performance schemes are the most effective means of motivating executives and advancing the view that tournament models may play an important role in incentive arrangements at large corporations); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1656–57 (2005) (reviewing BEBCHUK & FRIED, *supra*) (pointing out that outside directors have countervailing incentives that encourage them to oversee management); Anwar Boumosleh, *Director Compensation and Board Effectiveness* (unpublished manuscript, on file with author) (finding evidence consistent with the view that stock options for outside directors increase monitoring by directors).

16. *See* BEBCHUK & FRIED, *supra* note 15, at 62.

17. *Id.* at 61–62.

18. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (presenting an early exposition of the potential for the corporate control market to discipline managers).

19. *Id.* at 112–13.

20. For a discussion of evidence undermining the proposition that markets are efficient, see Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 653–54 (2003).

a tender offer, for reasons other than corporate mismanagement. Conversely, the market may overvalue the shares of a poorly managed firm, thereby discouraging a takeover. Such randomness in whether a poorly managed firm will be the target of a hostile bid weakens the disciplinary effect of takeovers on managers.[21] Second, there are often "golden parachute" clauses in an executive's employment contract, which provide for large private benefits if the company is acquired and the executive's employment is terminated. These provisions cushion the impact of an executive's ouster from office, diminishing the effectiveness of hostile takeovers as a threat to corporate mismanagement. Finally, takeover bids are expensive to launch and may not succeed. This is especially true given the numerous defenses—ranging from staggered boards[22] to poison pills[23]—that may protect incumbent management from unwanted takeovers. Not surprisingly, therefore, one recent study of takeover defenses found that during the second half of the 1990s only about 1 percent of publicly traded companies received a hostile bid, and most of those companies remained independent or were acquired by a friendly bidder.[24]

Recent corporate fiascos—Enron, WorldCom, and Adelphia, to name a few—convinced many students of corporate governance that incentive pay and the corporate control market were inadequate devices for disciplining corporate managers.[25] In response, attention has shifted to revisiting the *structure* of corporate governance to address the agency problem between

21. *See* Dent, *supra* note 12, at 888 ("[T]he randomness of tender offers blunts their effectiveness in deterring managerial slack."). *See generally* John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984) (questioning the extent of the disciplinary effect of the market for corporate control).

22. Generally, proxy votes are held for the annual election of directors to the board. If the board is "staggered," then only a portion of the seats are up for election each year. As a result, a hostile acquirer may have to wait more than one election cycle before it can vote in a majority of directors. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW § 13.6, at 576 (1986).

23. A poison pill is "a plan by which shareholders receive the right to be bought out by the corporation at a substantial premium on the occurrence of a stated triggering event." Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986). Although there are numerous types of poison pills, they all have the intended effect of discouraging a hostile bidder from obtaining control of a target company by making acquisition of a control percentage of shares prohibitively expensive. *See* CLARK, *supra* note 22, § 13.6, at 574–75. *But see* William J. Carney & Leonard A. Silverstein, *The Illusory Protections of the Poison Pill*, 79 NOTRE DAME L. REV. 179 (2003) (arguing that poison pills are less effective than conventional wisdom suggests at deterring hostile bidders).

24. *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890 (2002).

25. *See, e.g.*, Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1246–47 (2002); *cf.* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002).

managers and shareholders.[26] Current reform efforts, often referred to as proposals for "corporate democracy," would reapportion power away from boards and toward shareholders, to some extent "reunifying" ownership and control in the modern public corporation.[27]

Indeed, the U.S. system of corporate governance leaves ample room for increasing shareholder power. Shareholders have only limited involvement in corporate decisionmaking. The management of a firm is vested formally in its board of directors, subject only to specific shareholder voting rights.[28]

Corporate statutes typically grant shareholders the right to: (1) nominate and elect directors;[29] (2) adopt, amend, and repeal bylaws;[30] (3) approve fundamental corporate changes, such as mergers,[31] sales of all or substantially all of the firm's assets,[32] dissolutions,[33] and amendments to the firm's certificate of incorporation;[34] and (4) request board action through shareholder resolutions included in a company's proxy statement.[35]

In practice, however, the foregoing rights give shareholders little power over corporate decisionmaking. To begin with, the right of shareholders to nominate and elect directors is restricted by their inability to call special shareholder meetings.[36] Shareholders must wait until the next regular annual meeting to present and vote on a proposal to replace the company's existing board of directors, by which time it may be too late to implement any policy supported by the shareholders. Moreover, if a board of directors is staggered, it could take shareholders more than one annual election cycle to replace a majority of the board.[37] Dissident shareholders contemplating putting forward their own director slate must also incur significant costs to

26. *See infra* notes 46–47 and accompanying text.

27. Although the phrase "corporate democracy" has been associated with a variety of meanings, I use it here to refer to a greater role for equity investors in corporate governance and more management accountability to shareholders. *See* Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 900 (1994).

28. *See* DEL. CODE ANN. tit. 8, § 141(a) (2001). The typical corporate statutes discussed subsequently in the text above are based on the Delaware General Corporation Law, which applies to the majority of U.S. publicly traded companies. *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 391 tbl.2 (2003).

29. tit. 8, § 141(k).

30. § 109(a).

31. § 251(c).

32. § 271(a).

33. § 275(b).

34. § 242(b).

35. 17 C.F.R. § 240.14a-8 (2005).

36. tit. 8, § 211(d).

37. *See* CLARK, *supra* note 22.

do so.[38] Waging an expensive proxy contest for control of the board is therefore unlikely except with respect to the most significant business decisions.

Similarly, shareholders' power over bylaws is weaker than it appears. While corporate statutes that grant shareholders the right to amend bylaws permit those bylaws to address business decisions—so long as such bylaws are consistent with state law and a corporation's charter[39]—those statutes also vest authority to manage the corporation in the board.[40] In attempting to accommodate the foregoing provisions, courts have resisted attempts by shareholders to use bylaws to mandate directors' business decisions.[41]

With respect to the right of shareholders to approve fundamental board decisions, it is important to note that this is merely a veto power—shareholders cannot initiate such decisions.[42] Thus, shareholders can block extraordinary board actions, but they cannot initiate any. In addition, very few business decisions fall into this category.[43]

Finally, because shareholder resolutions are merely precatory if they do not relate to a proper subject for action by shareholders under applicable state law, boards are entitled to disregard them.[44] To be sure, resolutions that garner substantial shareholder support are likely to get management's attention. Still, boards commonly decline to implement precatory resolutions that obtain support from even a majority of shares.[45]

These limitations on the effectiveness of shareholder participation in corporate decisionmaking suggest that shareholders presently have the potential to operate as only a weak constraint on managers. Proponents of increasing shareholder power claim that doing so would reduce agency costs and enhance shareholder value.[46] They recommend implementing dramatic measures that

38. Because a corporation's board of directors generally has discretion over whether to pay for the campaign costs of dissident shareholders, shareholders challenging incumbent directors are likely to be reimbursed for their expenses only if they succeed in gaining control over the board of directors. *See* Lucian Ayre Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1106–10 (1990).

39. tit. 8, § 109(b).

40. § 141(a).

41. *See* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 608 (1997).

42. *See* Bebchuk, *supra* note 1, at 846–47.

43. *See supra* notes 31–34 and accompanying text.

44. 17 C.F.R. § 240.14a-8(i)(1) (2005).

45. *See* Randall S. Thomas & James F. Cotter, *Shareholder Proposals Post-Enron: What's Changed, What's the Same?* 14–18 (Sept. 2, 2005) (unpublished manuscript, on file with author).

46. *See, e.g.*, Bebchuk, *supra* note 1, at 908 ("[M]aking shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value."); *see also Donaldson Assures Leading House Democrats About Shareholder Access Proposal*, 22 CORP. SECRETARY'S GUIDE: CORP. DIRECTIONS 65 (2005) (reporting Congressional

would fundamentally reapportion the current balance of corporate decision-making power between managers and shareholders. These reforms include allowing shareholders to vote (1) to amend a corporation's charter and change the state in which it is incorporated and (2) to grant themselves through charter provisions the power to initiate and adopt binding resolutions with respect to specific business decisions.[47] A corporate governance regime that incorporated the foregoing features would recast dramatically the role of shareholders in corporate governance. It is far from certain, however, that increasing shareholder power would, as its proponents claim, reduce agency costs and increase shareholder value.

Three basic assumptions underlie the case for increasing shareholder power. The first is that the proper role of the corporation is to serve shareholders rather than stakeholders generally.[48] Second, the case for increasing shareholder power assumes that shareholders would overcome collective action problems to make use of the power being transferred to them.[49] Third, it assumes that shareholders would use their incremental power to discipline managers, thereby benefiting shareholders as a class, as opposed to furthering their private interests.[50] If any of these assumptions is not satisfied, then shifting corporate governance power from boards to shareholders may be undesirable.[51]

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sentiment that the "lack of accountability on the part of boards of directors remains one of the most glaring deficiencies in corporate governance today"). *See generally* Bernard S. Black, *Institutional Investors and Corporate Governance: The Case for Institutional Voice*, 5 J. APPLIED CORP. FIN. 19 (1992) (describing the potential benefits of invigorating institutional monitoring of corporate managers).

47. Bebchuk, *supra* note 1, at 865–75, 892–98. More limited measures to increase shareholder power that have been advanced recently include: (1) granting shareholders the right to have their director nominees placed on the company's proxy statement and ballot under certain circumstances (Security Holder Director Nominations, Exchange Act Release No. 34-48626, Investment Company Act Release No. 26206 (proposed Oct. 14, 2003)), *available at* http://www.sec.gov/rules/proposed/34-48626.htm (last visited Dec. 14, 2005); (2) electing directors by majority, rather than plurality vote, *see* James J. Hanks, Jr., *It's All in the Numbers—"Majority Voting" for Directors*, INSIGHTS, Mar. 2005, at 2; (3) eliminating staggered boards, *see* Steven Syre, *Directors Feel the Heat*, BOSTON GLOBE, Dec. 23, 2004, at C1; and (4) requiring shareholder approval of poison pills, *see A New Corporate Governance World: From Confrontation to Constructive Dialogue*, 2004 POSTSEASON REPORT 7–8 (Institutional S'holder Servs., Rockville, Md.), *available at* http://www.issproxy.com/pdf/2004ISSPSR.pdf.

48. *See* Bebchuk, *supra* note 1, at 842.

49. *See id.* at ("My analysis indicates that the considerable weakness of shareholders in U.S. companies is not a necessary consequence of the dispersion of ownership. This weakness is at least in part due to the legal rules that insulate management form shareholder intervention.").

50. *See id.* at 908 ("I have argued that making shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value.").

51. This Article does not address the first assumption above—the debate over whose interests the corporation should serve. Not only has that subject been discussed thoroughly, *see supra* notes 4–5, it also seems clear that if one believes that stakeholder interests are entitled to weight in corporate governance, then shifting power to shareholders is per se undesirable. Instead, the primary aim of this Article is to explore whether shareholders are likely to make use of any incremental power conferred upon them, and, if so, to what end they will deploy that power.

B. Shareholder Action Under Conditions of Convergent Interests

The public corporation, which raises capital from widely dispersed, or atomized, shareholders, presents both the need for, and the difficulty of, disciplining corporate managers. As mentioned above, when shareholders own relatively small interests in a firm and the firm must hire outside managers to run it, managers' incentives cease to be aligned with those of shareholders because managers do not internalize fully the costs of their actions.[52] Shareholders, in turn, underdiscipline managers because each shareholder must bear the full costs of its actions but has little to gain if its efforts succeed.[53]

Shareholders could surmount the collective action problem through coordination, but coordination generally is impractical to achieve in the context of widely dispersed ownership.[54] In other words, it is *individually rational* for a shareholder to undertake the costs of disciplining management only if its proportionate share of the expected collective benefits from doing so exceeds its expected costs. On the other hand, it is *collectively desirable* for the shareholder to discipline management if the expected collective benefits from the disciplining efforts exceed their expected costs.

In the context of a firm owned by a single shareholder, the collectively desirable level of disciplining takes place because that shareholder captures all of the benefits of its disciplining efforts. An atomistic shareholder will not discipline to the collectively desirable level, however, because its expected costs of disciplining will almost surely exceed its proportionate share of the benefits from doing so. In a world of dispersed shareholdings, increasing shareholder power would not be likely to produce any substantial increase in shareholder disciplining. To be sure, granting shareholders more power can increase the expected benefits of shareholder action for a given level of disciplining expenditures. Nevertheless, because an atomistic shareholder would still confront substantial disciplining costs and could expect to receive only modest benefits from its activities, increasing shareholder power in this context is unlikely to generate much incremental shareholder action.

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52. *See supra* note 11.

53. *See generally* RUSSELL HARDIN, COLLECTIVE ACTION (1982); MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (2d ed. 1971); TODD SANDLER, COLLECTIVE ACTION: THEORY AND APPLICATIONS (1992). The resulting disincentive to act is compounded by the free-rider problem: Any one shareholder may decide to save itself the cost of acting in the belief that another shareholder will do so. *See* CLARK, *supra* note 22, § 9.5, at 392 (discussing the free-rider problem).

54. *See* CLARK, *supra* note 22, § 9.5, at 394–400 (discussing mechanisms for overcoming the collective action problem).

The likelihood that the collective action problem will interfere with shareholder incentives to discipline management is substantially reduced when a company's shares are held by one or more large blockholders. The larger a shareholder's stake in a firm, the greater will be its expected proportionate share of the benefits from disciplining activities, and thus it is more likely to undertake such activities. Moreover, as shareholder concentration in a firm increases, it will be easier for shareholders to coordinate with one another to share the costs of providing discipline.

In the mid-1980s, the number of firms with large blockholders began rising. Surveying ownership patterns of "relational investors"—outside investors who work with management to improve firm performance[55]—over the sample period 1983–1993, Bhagat, Blair, and Black documented a "significant secular increase in large-block shareholding . . . with sharp percentage increases in these holdings by mutual funds, partnerships, investment advisors, and employee benefit plans."[56] As Bernard Black put it in his 1990 article, *Shareholder Passivity Reexamined*,[57] "the model of public companies as owned by thousands of anonymous shareholders simply isn't true. There are a limited number of large shareholders, and they know each other."[58]

With shareholdings becoming increasingly concentrated in institutional hands, many believed shareholder passivity would no longer act as a bar to effective shareholder oversight of corporate managers. This was thought to be especially true with respect to issues exhibiting economies of scale, such as process and structural issues, in contrast to firm-specific issues, because institutional shareholders generally own shares in many companies.[59] Black summarized the potential of shareholder activism that large blockholdings permitted as follows:

> [C]ollective action problems, while important, seem manageable for the large institutions who are today the dominant shareholders. . . .

55. *See* Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, 2 CONTEMP. FIN. DIG. 10, 11–12 (1998). In their empirical study of whether relational investing affects firm performance, Bhagat et al. also require a minimum stake and holding period for an investor to qualify as "relational." *See* Sanjai Bhagat et al., *Relational Investing and Firm Performance*, 27 J. FIN. RES. 1, 9 (2004).

56. Bhagat et al., *supra* note 55, at 2.

57. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

58. *Id.* at 574.

59. For example, some monitoring issues, such as choice of state of incorporation and whether shareholders should vote to approve poison pills, cut across companies. In contrast, decisions such as whether to recapitalize or make a particular acquisition are unique to a particular firm. *Id.* at 580–84.

> . . . Shareholder monitoring *might* work, *might* become an important part of the larger web of legal and market constraints on corporate managers, *if* legal rules permit. Shareholder voice is an idea that hasn't been tried, not one that has failed.[60]

The foregoing remarks encapsulate the belief that increased concentration of shareholdings has provided large blockholders with the incentives to discipline management absent legal impediments.[61] It is now time to turn from the possibility to the desirability of increased shareholder intervention in corporate governance. The next section develops an account of how increasing shareholder power might not motivate shareholders to discipline management. To the contrary, it might encourage shareholders to use their greater voice to advance their private interests at the expense of their common shareholder interests. Under this account, increasing shareholder power carries with it the risk of destroying shareholder value.

C. Shareholder Action Under Conditions of Divergent Interests

Shareholders can influence management not only to enhance common shareholder value but also to obtain private benefits. This possibility arises whenever shareholders have private interests that diverge from the interests of shareholders generally. In these circumstances, shareholders have an incentive to act in the common interests of all shareholders only when two conditions are satisfied. A shareholder will undertake the costs of disciplining management if its proportionate share of the expected collective benefits from its actions exceeds its expected costs. In addition, the shareholder's stake in the firm must align that shareholder's interests with the interests of other shareholders more than its private interests conflict with the interests of those shareholders. In the absence of either condition, (1) there will be no single maximand with respect to which shareholders as a class desire managers to run the firm, and (2) it might be rational for any given shareholder to deploy its power to promote its private interests at the expense of common shareholder interests.

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60. *Id.* at 608.

61. *But see* Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 12–17 (UCLA School of Law, Law & Economics Research Paper Series, Research Paper No. 05-20, 2005), *available at* http://ssrn.com/abstract=796227 (advancing the view that institutional shareholders are rationally apathetic, except for union, state, and local pension funds, which are the institutions most likely to engage in self-dealing).

1. The Absence of a Single Maximand When Shareholders Have Private Interests

A single shareholder, or multiple shareholders with homogeneous preferences, would in theory be able to specify a single objective for running the firm. Shareholders with private interests, however, might prefer the firm to pursue those interests at the expense of the interests they have in common with other shareholders. This will be true whenever the expected private benefits to the shareholder exceed the total expected costs to it of securing the managerial decision in question.

Thus, when shareholders have divergent private interests, it is no longer accurate to think of shareholder action as a collective good. That conception depends on there being a uniform maximand for all shareholders.[62] Once shareholder action encompasses the goal of maximizing a shareholder's private benefits, however, shareholders may use their power as shareholders opportunistically. Put another way, how a shareholder would like the firm to be managed becomes a function of who the shareholder is and what its private interests are.

2. Rent Seeking

When shareholders do not agree on a common objective in managing the firm, it may be privately rational for them to engage in rent-seeking activities. "Rent seeking" is the socially costly attempt to obtain wealth transfers.[63] Such behavior can reduce shareholder value.

Rent seeking by shareholders gives rise to two types of "influence costs."[64] One involves distortions to decisionmaking[65] and the other, which is more traditionally associated with rent seeking, relates to the resources spent in reallocating wealth.[66] The first type of influence cost consists of the diminution in shareholder value that results whenever the rent seeker succeeds in persuading the firm's managers to make a decision that is privately beneficial to the rent seeker but detrimental to the common interests of shareholders. I refer

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62. *See* Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1453 (1989) ("In the absence of unanimity, the joint wealth maximization criterion at best loses its appeal; at worst it becomes undefined.").

63. *See generally* Robert D. Tollison, *Rent Seeking*, *in* PERSPECTIVES ON PUBLIC CHOICE: A HANDBOOK 506 (Dennis C. Mueller ed., 1997) (discussing the development of the theory of rent seeking).

64. *See* MILGROM & ROBERTS, *supra* note 13, at 270.

65. *See id.* (referring to such influence costs in terms of "distorted decisions").

66. *Id.* This type of rent seeking is also sometimes referred to as "directly unproductive profit seeking." *Id.*; *see also* Tollison, *supra* note 63, at 506.

to this type of influence cost as an "interest cost" because it involves a distortion of managerial decisionmaking away from shareholder-value maximization and toward advancing the private interests of the rent-seeking shareholder.

The story of the du Pont Company's investment in General Motors (GM) is a classic example of how an influential shareholder with private interests can generate interest costs within a firm. In 1917, John Raskob, du Pont's treasurer, recommended that du Pont increase substantially its equity interest in GM.[67] One of the reasons he gave for doing so was to obtain for du Pont the bulk of GM's artificial leather, polyimide, paint, and varnish businesses.[68] After purchasing a large block of GM stock in 1917, du Pont used its influence over GM to achieve its objective of becoming the primary supplier of the foregoing products to GM.[69] By 1921, GM had yielded to du Pont's sales pressure.[70] Reflecting on du Pont's supply relationship with GM, the Supreme Court noted:

> The inference is overwhelming that du Pont's commanding position was promoted by its stock interest and was not gained solely on competitive merit.
>
> . . . [D]u Pont purposely employed its stock to pry open the General Motors market to entrench itself as the primary supplier of General Motors' requirements for automotive finishes and fabrics.[71]

The du Pont case is an instance of a large shareholder in a company using its influence to skew the firm's business decisions in favor of its private interests, even when doing so harms firm profitability. Du Pont had an interest in becoming the dominant supplier to GM, but doing so increased GM's costs of production. Because the former interest dominated du Pont's interest as a shareholder in its GM shares, du Pont found it privately beneficial to use its influence to cause GM to use du Pont as its primary supplier. As a result, du Pont's behavior generated an interest cost for shareholders as a class because it caused GM to enter into a suboptimal supply relationship with du Pont.

The second type of influence cost that rent seeking produces involves the expenditures that shareholders undertake in trying to influence the distri-

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67. United States v. E.I. du Pont de Nemours & Co., 126 F. Supp. 235, 241 (N.D. Ill. 1954), *rev'd*, 353 U.S. 586 (1957).

68. *Id.* at 242–43.

69. *Id.*

70. Du Pont's interest in General Motors (GM) gave rise to an antitrust case, which resulted in the eventual divestiture of its GM holdings. *See du Pont*, 353 U.S. at 586 (holding that du Pont's investment in GM violated the antitrust laws); United States v. E.I. du Pont de Nemours & Co., 366 U.S. 316 (1961) (ordering divestiture).

71. *Du Pont*, 353 U.S. at 605–06 (footnote omitted).

bution of firm resources. I refer to this category of influence cost as "squabbling costs." Drawing on the above example, assume that a large hedge-fund shareholder opposed du Pont's efforts and sought to influence GM's management to use multiple suppliers. Then, even if neither du Pont nor the hedge fund had any impact on GM's decision, the two shareholders would have incurred squabbling costs in trying to bring their influence to bear on GM. Although only those shareholders who squabble bear squabbling costs, squabbling consumes resources that have a positive opportunity cost elsewhere in the economy simply by attempting to shuffle wealth among shareholders. Thus, even assuming that squabbling does not affect firm value, it reduces the welfare of the shareholders involved.

Transferring power to shareholders likely will exacerbate rent-seeking behavior. The reason for this is that any meaningful expansion of shareholder power would increase the expected benefits to shareholders with private interests of undertaking a given level of activism. As shareholders step up the pursuit of their private interests, interest costs would rise as corporate managers—weakened by shareholder-empowerment measures—increasingly satisfy those interests. In addition, increased efforts to obtain private benefits (or to counteract the efforts of other shareholders to capture them) would raise total squabbling costs.[72]

Thus, increasing shareholder power when shareholders have private interests could both reduce the size of the shareholder pie and increase the resources spent competing over how to share it. Part II shows that there are, indeed, deep rifts among the interests of modern shareholders. These divisions, in turn, imply that increasing shareholder power carries with it the real risk of reducing shareholder value.

II. DIVERGENT INTERESTS AMONG SHAREHOLDERS

Shareholders, to paraphrase William Chandler III, come in different flavors.[73] Most observers of corporate governance law nevertheless regard divergences in the interests of shareholders as either insignificant[74] or checked

72. Albert O. Hirschman remarked that dissatisfied members of an organization face a choice between promoting their interests (voice) and deserting the enterprise (exit). ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY 30–31 (1970). In effect, increasing shareholder power subsidizes voice, thereby encouraging shareholders to use more of it before exercising their exit option.

73. William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1092 (1999).

74. To the extent attention has been given to investor conflicts of interest, it has addressed *intra*shareholder conflicts of interest within institutional shareholders; that is, the second-order

by the corporate law voting principle of majority rule.[75] This part catalogues five schisms among modern shareholders.[76] Part III then turns to the likelihood that these divisions will cause shareholders to promote their private interests at the expense of their common shareholder interests.

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agency problem between the managers of institutional shareholders and their beneficiaries. These conflicts diminish the disciplining role of institutional shareholders because the managers of institutional investors often face incentives to side with corporate managers, on whom they may rely for business, against the interests of the institutional shareholders' beneficiaries. Consequently, intrashareholder conflicts of interest raise a separate source of concern about the efficacy of relying on shareholders to discipline corporate managers. *See, e.g.*, Black, *supra* note 57, at 595–608; John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1321–28 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 469–76 (1991). *But see* Gordon, *supra* note 8 (raising concerns about opportunistic shareholder behavior); Rock, *supra* note 8 (same).

75. *See, e.g.*, Bebchuk, *supra* note 1, at 883–84; Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1082–84 (1998). *But see* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 557–58 & 558 n.53 (2003) (pointing out that, under conditions of uncertainty, shareholder opinions are likely to diverge over how best to maximize the company's share value); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611 (1995) (arguing that investor disagreement is an important and powerful force that explains many business phenomena and should be taken into account by policymakers).

76. Shareholders' private interests fall into two, sometimes overlapping, categories. First, certain shareholder private interests are separate from, or "external" to, the shareholder's investment interest in its shares. In other words, such interests are not related to share value. An example of such an external interest is a union pension fund's interest in organizing workers or influencing collective-bargaining negotiations. While a shareholder in the union pension fund may have an interest in how a firm deals with these matters, that interest is external to its interest as a pure shareholder. *See infra* text accompanying notes 154–158.

The second category of shareholder division involves differences of opinion over how to maximize shareholder value given an investor's peculiar characteristics, such as its investment horizon or tax status. Such private interests are "internal" to a shareholder's investment interest in its shares in that even if the shareholder had no external interests, its peculiar characteristics would still affect how it desired the firm to be run. Thus, a diversified shareholder would want the firm to undertake riskier projects than would a shareholder with a disproportionately high investment in the firm. *See infra* text accompanying notes 117–121.

Both types of shareholder division have the potential to generate interest costs and squabbling costs. Shareholders with external or internal private interests may generate interest costs vis-à-vis all other shareholders who do not share such interests to the extent they successfully distort firm decisionmaking toward their own interests. The likelihood that internal private interests will generate interest costs is mitigated, however, by the clientele effect—the notion that investors with similar preferences are attracted to similar types of stocks. *See* Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CAL. L. REV. 1053, 1065–66 (1991) (noting that "[a]lthough the taxation of dividends is commonly used to illustrate the clientele effect, it is not the only factor that may attract a particular investor to a particular stock"). When shareholders expend resources to further their external or internal private interests, or to counteract those of other shareholders, they also incur squabbling costs.

A. Short-term Versus Long-term Shareholders

One axis of division among shareholders is the time horizon over which they expect to hold their shares. Heterogeneity among shareholders with respect to their expected holding periods can lead to differences in shareholder preferences over corporate decisionmaking. This conflict focuses on whether managers should make decisions for long-term or immediate profits.[77] A short-term shareholder is viewed as one who seeks to buy and sell stocks with high frequency in an endeavor to profit from market movements.[78] By contrast, a long-term investor is seen as buying and holding stocks, usually without regard to short-term developments.[79] Short-term shareholders prefer managers to maximize short-run share price, while long-term shareholders prefer to forego immediate gains in favor of maximizing long-run shareholder value. Thus, the distinction between a short-term and a long-term shareholder turns mainly on whether the shareholder seeks to profit from fluctuations in stock price, without regard to whether those fluctuations will become permanent.

Continuing growth in mutual fund[80] and hedge fund holdings[81] has generated a significant focus on short-term stock prices. Neither mutual funds nor hedge funds are typically concerned with the long-term success of the companies whose stocks they trade. Instead, they tend to focus on the current market price of a company's stock. "Active funds" alter their investment positions with high frequency.[82] The average turnover rate among stock mutual funds was 117 percent in 2004.[83] Hedge funds trade their stockholdings nearly three times that much.[84] As one commentator has

77. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

78. Hart v. Comm'r, 73 T.C.M. (CCH) 1684 (1997).

79. Purvis v. Comm'r, 530 F.2d 1332, 1334 (9th Cir. 1976) (per curiam) (quoting Chiang Hsiao Liang v. Comm'r, 23 T.C. 1040, 1043 (1955)).

80. *See* NYSE Factbook Online, Institutional Investors, Holdings of Corporate Equities in the U.S. by Type of Institution, http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=2673&category=12 (last visited July 18, 2005).

81. *See* Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission 2–3 (Sept. 29, 2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf.

82. In contrast, "index funds" are passively managed—there is no stock picking, or active management, involved. Rather, index funds attempt to match the returns of some market index, such as the S&P 500, as cost-effectively as possible. *See* ROBERT C. POZEN, THE MUTUAL FUND BUSINESS 211–12 (1998).

83. *See* Brian Reid & Kimberlee Millar, *Mutual Funds and Portfolio Turnover*, RES. COMMENT. (Inv. Co. Inst., Washington, D.C.), Nov. 17, 2004, at 2, *available at* http://www.ici.org/statements/res/rc_v1n2.pdf. A turnover rate of 50 percent, for example, indicates that half of all securities in the portfolio changed hands during the year. *Id.* at 1.

84. *See* Press Release, Hennessey Group LLC, Hennessey Releases 11th Annual Hedge Fund Manager Survey (May 31, 2005) (on file with author).

described such shareholders, "they are primarily financial engineers interested in the largest possible profit in the shortest period of time."[85]

Mutual funds are financial intermediaries through which investors pool their money for collective investment, usually in marketable securities.[86] Investors in mutual funds can readily liquidate their shares at the market price of the funds' holdings.[87] This liquidity, coupled with widespread availability of information on fund performance, has led to pressure on mutual fund managers to maximize short-term returns at the expense of any longer-term focus in order to attract and retain investors.[88]

Hedge funds, like mutual funds, hold pools of assets. Unlike mutual funds, they engage in a wide variety of investment strategies, including investing in distressed securities, illiquid securities, securities of companies in emerging markets, derivatives, and arbitrage opportunities.[89] Hedge funds have been characterized as "[t]he principal paradigm of the market-driven institution."[90] They have a "relatively shorter life span than that of other investment vehicles," and must return periodically to the capital market to raise additional funds.[91] Thus, there is a strong relationship between the performance of a hedge fund and its sponsor's continuing ability to attract capital, which contributes to a preoccupation with short-term results.[92]

Both mutual funds and hedge funds have time horizons that are substantially shorter than those of longer-term investors, such as insurance companies and pension funds. The latter investors are less concerned with quarterly or annual performance, and so they have greater incentives to pursue the long-term prospects of the companies in which they invest. They can, for example, more easily resist the temptation to bolster short-term earnings by foregoing research and development expenses or capital expenditures whose expected benefits lie in the future.

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85. Robert G. Kirby, *Should a Director Think Like a Shareholder? (It Depends on Who the Shareholder Is)*, DIRECTORSHIP, June 1996, Supp., at 6-1.

86. *See* POZEN, *supra* note 82, at 3 (1998).

87. *See* JOHN C. BOGLE, BOGLE ON MUTUAL FUNDS: NEW PERSPECTIVES FOR THE INTELLIGENT INVESTOR 53–54 (1994).

88. *See* Chandler, *supra* note 73, at 1093 ("Increasingly, mutual fund managers . . . are faced with the harsh reality that millions will flow in or out of their funds based on sometimes very short-term performance ratings. As with risk arbitrageurs, mutual fund managers have learned that, because of mounting pressure to perform by their fundholders, short-term gains sometimes come at a cost to long-term performance.").

89. *See* Implications of the Growth of Hedge Funds, *supra* note 81, at 4.

90. K.A.D. Camara, *Classifying Institutional Investors*, 30 J. CORP. L. 219, 229 (2005).

91. *See* Implications of the Growth of Hedge Funds, *supra* note 81, at ix.

92. For a full-length discussion of the role of hedge funds in the merger and acquisition setting, see Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control (Sept. 28, 2005) (unpublished manuscript, on file with author).

The contention that differences in the time horizons of shareholders can lead to divergent preferences for how a corporation is managed calls for elaboration. According to the efficient capital markets hypothesis (ECMH), the price of a firm's stock at any given time accurately reflects all available information about the company.[93] If the ECMH accurately described stock prices, then short-term stock prices would reflect investors' fully informed mean estimates of the fundamental, or long-term, value of securities. The maximization of short-term value would then be consistent with long-term value maximization. Thus, in an efficient stock market, the time horizon of a shareholder should not affect how that shareholder would like to see the firm managed.

The ECMH, however, is no longer regarded as an accurate description of the real world.[94] Although there is still believed to be some relationship between short-term stock prices and fundamental value, that relationship is now understood to be extremely loose.[95] In other words, short-term stock prices may deviate from fundamental values for extended periods of time.[96]

This recognition presents the possibility of conflicts of interest among shareholders with divergent time horizons. For example, shareholders with a short timeframe will favor the inflation of current share prices at the expense of long-run value. On the other hand, long-term investors will be willing to sacrifice immediate profits for future appreciation. One example of why short-term stock prices might deviate from their long-term values involves the valuation of a company's earnings. Numerous studies have shown that the stock market places a disproportionately high value on a company's near-term earnings by placing an excessively high discount rate on its future expected earnings.[97] Short-term investors will therefore have a bias for increasing current earnings at the expense of future earnings. This result can be achieved by, for example, moving expenses from the current year to the future or by moving revenues from future years to the current

93. For a full elaboration of the efficient capital markets hypothesis, see Eugene Fama's seminal article on the subject, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). *See also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554–58 (1984).

94. *See* Stout, *supra* note 20, at 667.

95. *See, e.g.*, Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J. ECON. LIT. 1583, 1616 (1989) (citing evidence that large discrepancies between price and fundamental value regularly occur).

96. *See id.*

97. *See id.*

year.[98] Such actions can enhance (or avoid depressing) a company's current share price but reduce long-run shareholder value.[99]

The takeover setting is another example of how the preferences of short-term and long-term shareholders may diverge. Takeover law has long recognized the tension between short-term and long-term interests in the decision whether—and at what price—a company should be sold. For example, in making this decision, the law generally permits a company's board of directors to reject a potential acquirer's bid or to accept an offer that is not the high bid if the board determines that doing so is in the firm's long-run strategic interests.[100] The narrow exception to giving boards such discretion occurs when a company is selling control or being broken up.[101] In both of these instances, which impose so-called "*Revlon* duties" on the board, the selling company's shareholders are viewed as having their last opportunity to obtain a premium for their shares, and the duty of the board becomes that of obtaining the highest possible short-term price for their stock.[102] Unless *Revlon* duties are triggered, however, the board of directors of a company has discretion in balancing the interests of both short-term and long-term investors.

Both the operating and takeover contexts above illustrate that short-term and long-term shareholders may have different preferences with respect to certain corporate decisions. The efforts of hedge-fund investors in MCI, Inc., to influence the board of directors of the firm to sell the company to Qwest Communications International, Inc., are a case-in-point. Qwest was the higher bidder, but the MCI board contended that rival Verizon Communications, Inc., offered MCI shareholders better long-term synergies.[103] The hedge funds, however, were indifferent to the potential for increasing future shareholder value.[104] They aggressively urged MCI's board to take Qwest's offer.[105] Ultimately, the MCI board entered into a merger agreement with Verizon, defending its decision as in the best long-term interests of the shareholders,[106] but the attempt by MCI's hedge-fund shareholders

98. Michael C. Jensen, *Paying People to Lie: The Truth About the Budgeting Process*, 9 EUR. FIN. MGMT. 379, 387 (2003).

99. *See* Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 181–82 (1991).

100. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1150–51 (Del. 1989).

101. Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 47–48 (Del. 1994).

102. *Id.* at 43.

103. *See* Almar Latour & Jesse Drucker, *Qwest, Revising Its Bid, Puts MCI Board on Spot*, WALL ST. J., Feb. 25, 2005, at C1.

104. *See* Almar Latour & Henny Sender, *Hedge Funds Push MCI on Sale Price*, WALL ST. J., Feb. 23, 2005, at A3.

105. *Id.*

106. *See* Shawn Young, *MCI's Net Loss in Quarter Narrowed*, WALL ST. J., May 6, 2005, at B3.

to influence the firm's board to take Qwest's offer illustrates the potential for short-term shareholders to pursue their interests at the cost of long-term shareholder value.

Recently, Carl Icahn, a corporate raider during the 1980s,[107] raised his own hedge fund and has actively sought to establish coalitions with other hedge funds to use shareholder activism to promote his corporate agenda for the firms in which his fund holds a stake.[108] In his role as a hedge-fund manager, Icahn is using the clout of his hedge fund and his hedge-fund allies to pressure companies to make dramatic structural changes.[109] To further his efforts to influence business decisions, Icahn has in the past waged proxy battles to obtain representation on the board.[110] In communicating with other shareholders, Icahn typically uses as his mantra the claim of wanting to make sure that the board is "focused on maximizing shareholder value."[111] However, the short investment horizon of hedge funds and Icahn's history of reaching "peaceful" solutions with existing management that involve greenmail-type payments or other substantial concessions to him,[112] raises questions about whether such hedge-fund activism benefits shareholders in the long run.

B. Diversified Versus Undiversified Shareholders

Another fault line separating shareholders is the extent to which their portfolios are diversified. James Hawley and Andrew Williams have advanced the argument that the institutionalization of U.S. shareholdings created a new category of shareholders, "universal owners," who are characterized by their holdings across a wide spectrum of the stock market.[113] Because their investment portfolios are so diversified, universal owners are thought of as "owning the economy."[114] As Hawley and Williams point out, "the quintessential universal owners are the largest of the public and private pension

107. Susan Pulliam & Martin Peers, *Once a Lone Wolf, Carl Icahn Goes Hedge-Fund Route*, WALL ST. J., Aug. 12, 2005, at A1.

108. *See id.* (stating that Icahn "began to think that a fund with an activist bent might look good to institutional investors").

109. *Id.* (noting that Icahn, who has historically operated as a "lone wolf," is now deploying the capital of investors in his hedge fund and allying with other hedge funds).

110. *Id.*

111. *Id.*

112. *Id.* "Greenmail" is the repurchase of stock by a company from an unwanted suitor at a premium to end the threat of a takeover. *See, e.g.*, David Manry & David Stangeland, *Greenmail: A Brief History*, 6 STAN. J.L. BUS. & FIN. 217, 224 (2001).

113. *See* JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 3 (2000); *see also* Simon Deakin, *The Coming Transformation of Shareholder Value*, 13 CORP. GOVERNANCE 11, 16 (2005).

114. HAWLEY & WILLIAMS, *supra* note 113, at 21.

funds," which have investment portfolios that consist of a broad cross-section of the economy.[115] Universal owners can be contrasted with undiversified shareholders, such as inside shareholders[116] and founding-family shareholders,[117] who have their wealth disproportionately invested in a given company.

The interests of diversified and undiversified shareholders are likely to conflict in two arenas—risk preferences and concern over externalities. First, the investment opportunities that a firm has available to it vary with respect to risk characteristics. For example, a pharmaceutical company may be faced with the choice of making a significant investment in one of two competing projects: Project A and Project B. Suppose that Project A will yield a steady return of 5 percent a year. Project B, on the other hand, has a 50 percent chance of generating a 40 percent annual return and a 50 percent chance of generating no return. Which project a shareholder may prefer the firm to choose depends on that shareholder's risk profile.

A diversified shareholder can eliminate firm-specific risk.[118] Firm-specific risk is the risk that a given company will experience an individual shock that is uncorrelated with the performance of the market as a whole.[119] The possibility that a firm's CEO will die or that one of the firm's investments will fail is an example of firm-specific risk. By investing in a large array of companies, shareholders become indifferent to such risk because, on average, the risk of a negative firm-specific shock occurring at one firm will be offset by the risk of a favorable firm-specific shock occurring at another. A diversified shareholder would therefore favor Project B because it has a higher expected return (20 percent versus 5 percent for Project A).

By contrast, an undiversified shareholder cares deeply about firm-specific risk because that shareholder cannot, by definition, eliminate it through diversifying its holdings. That shareholder's fortunes are highly sensitive to the

115. *Id.*

116. *See generally* Chamu Sundaramurthy & Douglas W. Lyon, *Shareholder Governance Proposals and Conflicts of Interests Between Inside and Outside Shareholders*, 10 J. MANAGERIAL ISSUES 30 (1998) (exploring the conflict of interest between internal and external shareholders within the context of shareholder-sponsored proposals to repeal antitakeover provisions). For a more detailed discussion of the private interests that characterize insiders, see *infra* text accompanying notes 122–136.

117. *See generally* Ronald C. Anderson & David M. Reeb, *Board Composition: Balancing Family Influence in S&P 500 Firms*, 49 ADMIN. SCI. Q. 209 (2004) (examining the influence of founding families on firm performance). Anderson and Reeb note that "founding families have substantial stakes in roughly one-third of the largest U.S. companies." *Id.* at 209.

118. *See* RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 95–97 (1993).

119. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 168 (7th ed. 2003).

fortunes of the firm. Thus, a top executive of the firm would risk losing not only his financial capital investment but also his human capital investment in the firm if the firm were to perform badly. Similarly, a founding family with a concentrated percentage of its wealth invested in the firm is exposed to firm-specific risk. Undiversified investors would trade off a higher return in exchange for reducing risk and, accordingly, favor Project A.

The extent of a shareholder's diversification also matters with respect to how that shareholder regards externalities, or spillover effects, that firms generate. One consequence of "owning the economy" is that, unlike less well-diversified investors, universal owners can be expected to feel the impact of actions by one company in their portfolio on their other portfolio companies. In other words, through its extensive holdings, the universal shareholder internalizes many of the externalities generated by the companies in which it invests. Universal owners are thus likely to favor activities of firms in which they own shares that minimize negative externalities (and maximize positive ones) to the extent that those activities impose costs on (or can be captured by) other firms in which they own an interest.

Corporate takeovers are a good example of a type of business decision that can have spillover effects for universal owners. While takeovers generally produce gains for the target company, they also often have a negative impact on the bidder's shares.[120] A universal investor who owns stock in both companies must assess the net effect of the transaction on its portfolio in deciding whether to support it. Another implication of takeovers for universal owners is their potential impact on the target company's customers. When Oracle Corporation acquired the business applications software company PeopleSoft, Inc., in 2005, for example, investors in PeopleSoft received a large premium for their shares.[121] On the other hand, customers of PeopleSoft were left at risk that Oracle would stop supporting PeopleSoft's products. That risk would have diminished the value of the acquisition to a joint owner of both the stock of PeopleSoft and of PeopleSoft's customers.

In deciding how to exercise their power as shareholders, universal owners must make decisions in light of their substantial diversification. This diversification shields them from firm-specific risk and exposes them to spillover effects. For both reasons, universal shareholders are likely to have objectives for corporate decisionmaking different from their less-diversified counterparts.

120. *See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 623–28 (1989).

121. Steve Hamm & Andy Reinhardt, *Larry, You Picked a Nasty Fight; In Taking on Heavyweight SAP, Oracle Faces Very Long Odds*, BUS. WK., Apr. 4, 2005, at 42.

C. Inside Versus Outside Shareholders

One of the most frequently noted conflicts of interest over the management of a firm arises between inside and outside shareholders.[122] Inside shareholders are shareholders who are firm employees—either senior executives or rank-and-file workers. Insiders possess firm-specific human capital and therefore have heavy exposure to firm-specific risk. As a result, in making project-selection decisions, for example, insiders seek to minimize firm-specific risk, which they (unlike outside shareholders) cannot diversify away, by underinvesting in projects that increase firm risk and overinvesting in risk-reducing activities.[123] In contrast, outside shareholders invest in the firm only externally.

Conventional wisdom holds that insider equity ownership can mitigate the agency problem of insiders pursuing their own interests at the expense of outside shareholders.[124] Even when an insider's interests are tied to those of outside shareholders through equity holdings, the insider may still find it beneficial to pursue his private interests at the expense of shareholder value. Such incentives exist whenever the benefit (or cost) to the insider, as a shareholder, of pursuing the superior (or inferior) project is outweighed by the cost (or benefit) to the insider, as an employee, of pursuing the project.

Insiders also have conflicts of interest with outside shareholders in the acquisition context. Specifically, insiders may frustrate or reject attractive acquisition offers that would increase shareholder value but possibly cost them their jobs. In addition, they might be motivated to entrench themselves by adopting (or resisting the repeal of) antitakeover provisions, such as poison pills. Conversely, top executive insiders may have golden parachutes in place. If these benefits are sufficiently large, they may encourage managers to support an acquisition that is not in the best interests of outside shareholders.

In their study of inside and outside shareholder voting on shareholder-sponsored proposals to repeal antitakeover provisions, Chamu Sundaramurthy and Douglas Lyon found that greater managerial stock ownership was associated with lower levels of support for such proposals.[125] The authors' data suggests that the incentive-alignment effect of increased managerial equity ownership is overwhelmed by managers' self-interest in resisting takeovers.[126]

122. *See, e.g.*, sources cited *supra* note 11.
123. *See* JENSEN, *supra* note 14, at 144–45.
124. *See id.* at 140.
125. *See* Sundaramurthy & Lyon, *supra* note 116, at 38–39.
126. *See id.* at 39–40.

They conclude that managers use their voting power against the interests of outside shareholders by not supporting shareholder proposals to repeal anti-takeover provisions.[127]

Employee stock ownership plans (ESOPs)—which are tax-qualified employee benefit plans designed to invest primarily in employer stock[128]—often side with management in protecting their firms against hostile takeovers. Like managers, rank-and-file employees make firm-specific investments in their jobs. Thus, they, too, have a private interest in maintaining the status quo.[129] ESOPs have been an important ally of management in several cases of failed hostile takeover bids.[130] The attempt by Shamrock Holdings, Inc., to acquire Polaroid Corporation is a case-in-point.[131] At the time, Polaroid stock was trading at between $30 and $40 per share.[132] After Shamrock contacted Polaroid to discuss its interest in the company, Polaroid erected an array of defenses to Shamrock's anticipated tender offer, including establishing a "defensive" ESOP that purchased 14 percent of its shares.[133] Shamrock then made a tender offer, eventually offering $47 per share conditioned upon judicial invalidation of the ESOP.[134] Shamrock ultimately reached an

127. *See id.* at 40.

128. The Employee Retirement Income Security Act (ERISA) of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1461 (2000) and in several sections of 26 U.S.C. (tax code)), defines an employee stock ownership plan (ESOP) as "an individual account plan . . . which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified, under section 401 of the Internal Revenue Code of 1954, and which is designed to invest primarily in qualifying employer securities . . . ." ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6). The Internal Revenue Code defines an ESOP similarly. *See* I.R.C. § 4975(e)(7) (2000). An ESOP must also meet the requirements of I.R.C. section 409(h) (repurchase obligations), I.R.C. section 409(o) (voting requirements of section 409(e) for employers holding registration-type securities), and I.R.C. section 409(n) (tax-free rollovers described in I.R.C. section 1042). I.R.C. § 4975 (e)(7)–(8).

129. *See* Michael J. Nassau et al., *ESOPs After Polaroid—Opportunities and Pitfalls*, 15 EMP. REL. L.J. 347, 348 (1989) (describing employees as being "more concerned with the immediate benefits of job security than with the potential increase to the value of their future retirement benefits that will result from tendering their ESOP shares to a hostile acquiror").

130. *See, e.g.*, Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989); Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

131. *See Shamrock Holdings*, 559 A.2d 278.

132. *See* Lawrence J. DeMaria, *Dow Jumps 32.89 More, to 2,064.01*, N.Y. TIMES, June 2, 1988, at D1; Steve Dodson, *Week in Business; Disney Group Puts Polaroid Into Play*, N.Y. TIMES, July 24, 1988, § 3, at 16; Phillip H. Wiggins, *Dow, Reversing 2-Day Slide, Gains 13.34*, N.Y. TIMES, July 21, 1988, at D8.

133. *See Shamrock Holdings*, 559 A.2d at 281.

134. *See* Floyd Norris, *Market Place; The Polaroid Defense: A Potential Classic*, N.Y. TIMES, Feb. 24, 1989, at D1.

accord with Polaroid and abandoned its takeover bid.[135] After the agreement was announced, Polaroid stock plunged to $36 per share.[136]

As the foregoing example illustrates, the interests of outside investors, who generally have well-diversified portfolios, may conflict with those of insiders, whose assets are less diversified because of heavy investment in firm-specific human capital. When insiders pursue risk-minimizing strategies, or seek to entrench themselves, they benefit themselves at the expense of outside shareholders. Thus, insiders' preferences do not always align well with those of outside shareholders.

D. Public and Union Pension Funds Versus Economic Shareholders

Sometimes, shareholders have targeted, noneconomic, interests. The most influential shareholders in this category are public pension funds and labor-union pension funds.[137] These groups have incentives to consider objectives apart from shareholder value in exercising their influence as shareholders.

Public pension funds, which held $937 billion in assets (representing roughly 40 percent of the pension fund sector) as of the third quarter of 2002,[138] are the pension funds of the public employees of state and local governments. The management of public pension fund assets is commonly governed by a general state law "prudent person" fiduciary standard requiring funds to be managed with "prudence, discretion, and intelligence" under the circumstances.[139] State law also establishes the composition of the boards of trustees of public pension funds. Typically, trustees fall into one of three categories: gubernatorial appointees, representatives elected by fund beneficiaries, and individuals named by virtue of their office, such as financial experts, government officials, or state or local employees. A significant number of trustees are political officials.[140]

The combination of the broad investment discretion accorded to, and the composition of, their boards of trustees, makes public pension funds vulnerable to pressure by other state officials.[141] As Roberta Romano has argued,

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135. *Business Digest*, N.Y. TIMES, Mar. 28, 1989.

136. Robert J. Cole, *Polaroid Payout Plan Helps It Reach Shamrock Accord*, N.Y. TIMES, Mar. 28, 1989, at D1.

137. *See* Thomas & Cotter, *supra* note 45, at 16–17 (comparing levels of shareholder support according to type of shareholder proponent).

138. *See* NYSE Factbook Online, *supra* note 80.

139. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 800 (1993) (citation omitted).

140. *Id.* at 801.

141. *Id.*

there is widespread political pressure on public funds to engage in "social investing"—investments that foster in-state economic development.[142] Emphasizing such considerations as an investment criterion places the interests of public pension funds at odds with those of "economic investors," whose investment preferences are more financial in nature.

Like public pension funds, labor-union pension funds have become increasingly significant shareholders.[143] These funds are private pension plans that pool the pension fund money of union members for investment.[144] Union pension funds are subject to the Taft-Hartley Act,[145] which mandates the joint management of union pension funds by trustees appointed by both corporate managers and unions.[146] While the Taft-Hartley Act imposes a fiduciary duty on plan trustees, mandating that all payments be held in trust for the "sole and exclusive benefit of the employees . . . and their families and dependents,"[147] it does not directly regulate the investment activities of pension funds.

Union pension fund trustees are also subject to the fiduciary duties of the Employee Retirement Income Security Act of 1974 (ERISA),[148] which requires "diligence . . . that [would be used] in the conduct of an enterprise of a like character and with like aims,"[149] and requires trustees to diversify, unless it is clearly prudent not to do so.[150] The Department of Labor has given union pension funds leeway in pursuing socially or economically targeted investments. Thus, as Stewart Schwab and Randall Thomas have stated, "within bounds, ERISA—and certainly Taft-Hartley—allows union pension funds to invest in projects that benefit workers, so long as the risk and return is similar to other projects."[151]

As with other investors with private interests, the preferences of union pension funds parallel those of investors generally in many circumstances.[152]

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142. *Id.* at 803.
143. *See* Schwab & Thomas, *supra* note 75, at 1019.
144. *See* Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL'Y J. 97, 110 n.21 (2000).
145. Labor-Management Relations (Taft-Hartley) Act, Pub. L. No. 80-101, 61 Stat. 136 (1947) (codified as amended at 29 U.S.C. §§ 141–196 (2000)); *see also* O'Connor, *supra* note 144, at 110 n.21.
146. 29 U.S.C. § 186(c)(5)(B).
147. *Id.* § 186(c)(5).
148. ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. §§ 1001–1461 and in several sections of 26 U.S.C. (tax code)).
149. 29 U.S.C. § 1104(a)(1)(B).
150. *Id.* § 1104(a)(1)(C).
151. *See* Schwab & Thomas, *supra* note 75, at 1080.
152. *Id.* at 1035.

Schwab and Thomas, for example, have emphasized those goals of union shareholder activity that benefit all shareholders, such as attacks on poison pills and excessive executive compensation.[153] Union pension funds, however, often also have an interest in furthering the special labor interests of union members, even at the expense of shareholder wealth. For example, a union pension fund might be seeking union recognition[154] or desire concessions in collective-bargaining negotiations. The latter scenario unfolded last year in connection with a strike by the United Food and Commercial Workers (UFCW), one of California's most powerful private-sector unions, against Safeway, Inc. The strike began when the UFCW and Safeway could not agree on terms for a new contract.[155] At the time, the California Public Employees' Retirement System (CalPERS) owned over $75 million in Safeway stock.[156] CalPERS is a public pension fund overseen by a board of trustees, the former president of which was also the UFCW's regional executive director. CalPERS exerted pressure on Safeway to accede to union demands while the strike was in progress.[157] After the strike was over, CalPERS announced that it would withhold support for the board reelection of Safeway CEO Steven Burd. Although CalPERS justified its opposition to Burd by a desire to enhance overall shareholder value, many observers concluded that it was designed to respond to Burd's hardline stance in his negotiations with the UFCW.[158]

E. Hedged Versus Unhedged Shareholders

Continuing innovation in the financial products market is giving rise to yet another tension among shareholders. There are now numerous techniques, including the use of equity derivatives and other financial contracts, that allow shareholders to alter the economic characteristics of their ownership interest in a firm's shares relative to pure shareholders (shareholders that have not engaged in any derivative transactions with respect to their shares). The result is that shareholders can effectively decouple their voting rights in a firm from their economic exposure to the firm's performance.[159]

153. *Id.*

154. *See* O'Connor, *supra* note 144, at 114.

155. *See* Nancy Cleeland & James F. Peltz, *2-Tier Plan Is Crucial to Grocery Pact*, L.A. TIMES, Feb. 28, 2004, at A1.

156. *See* Jonathan Weil & Joann S. Lublin, *Gadfly Activism at Calpers Leads to Possible Ouster of President*, WALL. ST. J., Dec. 1, 2004, at A1.

157. *Id.*

158. *See* Louis Lavelle, *CalPERS: Too Fierce?*, BUS. WK., June 7, 2004, at 114.

159. *See* Shaun P. Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 778–79; Henry T.C. Hu & Bernard Black, Empty and Hidden Voting: Shareholder Voting Rights and Coupled Assets 6–9 (2005) (unpublished manuscript, on file with author).

Consider a shareholder that purchases one share of a firm's stock at the market price of $10 per share and simultaneously purchases an at-the-money put option on the stock. The put option entitles the shareholder to sell, or "put," the stock to the option counterparty at $10 per share for a designated period of time. As a result, during the term of the option contract, the shareholder is insulated from the risk that the firm's share price will decline. If the share price falls to $9, the value of the share that the shareholder owns goes down by $1, but the shareholder has the right to sell one share to the put-contract counterparty at $10. Because this latter right is worth $1, the shareholder has insulated itself, or hedged, against the economic consequences of a decline in the firm's stock price.

As a result of entering into the put contract, the shareholder in the foregoing example does not have the same economic interests as a pure shareholder. Specifically, until the option agreement expires, the shareholder will be indifferent to a decline in the value of the firm's shares. Indeed, if the shareholder purchased additional put options, its profits would *increase* directly with *decreases* in the firm's stock price. The economic impact of share price movements on the hedged shareholder would be in direct conflict with that on a pure shareholder, whose interest is to maximize share price.

Despite the fact that the hedged shareholder in the above example has altered the economic incentives associated with pure share ownership, that shareholder retains the right to vote its shares.[160] The default rule of shareholder voting allocates one vote to each common share.[161] The "one-share/one-vote" rule is not affected by hedging transactions in which a shareholder engages.[162] Thus, shareholders can exercise voting rights with respect to shares in which they have a positive, zero, or negative net economic interest.

The case of *High River Limited Partnership v. Mylan Laboratories, Inc.*,[163] illustrates how the interests of hedged and unhedged shareholders can diverge. *High River* involved the proposed acquisition by Mylan Laboratories, Inc. (Mylan), of King Pharmaceuticals, Inc. (King). The acquisition was to be accomplished through a merger transaction, in which the merger consideration represented a 61 percent premium over the market price of King shares as of the day before the deal was announced.[164] The price of

160. *See* Martin & Partnoy, *supra* note 159, at 778.
161. *Id.* at 780–86.
162. *See id.* at 777–78.
163. High River Ltd. P'ship v. Mylan Labs., Inc., 353 F. Supp. 2d 487 (M.D. Pa. 2005). This case was settled and voluntarily dismissed.
164. Complaint ¶ 19, *High River*, 353 F. Supp. 2d 487 (No. 04-2677).

Mylan's shares fell on the announcement of the merger, reflecting market sentiment that Mylan was overpaying for King.[165]

The merger was subject to the approval of a majority of the outstanding shares of each of Mylan and King. Both Perry Corp. (Perry), a hedge fund, and High River Limited Partnership (High River), a private investment vehicle controlled by Carl Icahn, owned large blocks of stock in Mylan.[166] Unlike High River, however, Perry had fully hedged its economic exposure to Mylan. Thus, while Perry's Mylan stock was registered in Perry's name and could be voted by Perry, Perry retained no economic interest in the shares. In addition, Perry owned a significant interest in King common stock, while High River had sold King short.[167]

Predictably, High River and Perry found themselves at odds with respect to the proposed merger. Because Perry had no economic exposure to Mylan but owned stock in King, its incentives were to vote its shares in favor of the merger.[168] By contrast, High River opposed the merger, which would have depressed the value of High River's short position in King. High River sought in its lawsuit to enjoin Perry from voting its stock in favor of the merger. Its arguments for doing so included the contention that because Perry had hedged its investment in Mylan such that "its only purchase was of Mylan voting rights, it can exercise those voting rights *against* the interests of the company, without any effect on the value of its position in the Mylan shares, to profit at the expense of Mylan shareholders through its investment in King."[169] As the facts of *High River* illustrate, shareholders who enter into derivative transactions can find their interests opposed to those of pure shareholders.

165. *Id.* ¶ 5.

166. *Id.* ¶¶ 12, 30.

167. A "short" sale occurs when an investor borrows stock from, for example, a brokerage firm in order to sell it to a third party. After the investor has sold the stock, it must buy the stock on the open market in order to replace the borrowed stock. If the price of the stock declines when the investor makes its open market purchase, the investor purchases shares at a price lower than the price it sold the stock, thereby realizing a profit. If the price of the stock increases instead, the investor must purchase it at a higher price, thereby incurring a loss. *See* Jones v. Intelli-Check, Inc., 274 F. Supp. 2d 615, 618 (D.N.J. 2003).

168. Perry Corp. stood to make over $28 million if the merger were consummated, based on the closing price of King Pharmaceuticals' shares as of December 1, 2004. Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. TIMES, Dec. 2, 2004, at C1.

169. Complaint, *supra* note 164, at ¶ 4 (emphasis added).

F. Summation

This part highlighted five schisms that place the interests of some shareholders in conflict with those of other shareholders.[170] To be sure, shareholders also have common interests. All shareholders would benefit, for example, from reducing managerial slack. The presence of private interests among shareholders, however, raises the possibility that some shareholders will prefer to pursue those interests over their common shareholder interests.

III. INCREASING SHAREHOLDER POWER WHEN SHAREHOLDERS HAVE PRIVATE INTERESTS

The rationale for shareholder activism is grounded in the desire to constrain the interest costs that arise from the separation of ownership and control in the large corporation. The rise of institutional shareholdings offered incentives for shareholders to discipline corporate managers. In Part I.C, I identified the conditions under which shareholders with private interests would rationally sacrifice overall shareholder value for private gain: Whenever shareholders expect to earn greater returns from advancing their private interests than it costs them as shareholders to do so, they will derive net benefits from using their shareholder power opportunistically. Part II set forth numerous divisions among the interests of shareholders. Whether such interests will drive the actions of shareholders, however, depends in large part on the constraints on shareholders of pursuing self-serving behavior.[171]

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170. Although there are numerous other axes that divide shareholders, such as preferences for income versus growth and tax status, the ones that I discuss apply to some of the largest corporate shareholders, which are those most likely to be able to surmount the collective action problem as a result of their concentrated shareholdings or their ability to enter into coalitions with other large shareholders.

171. Shareholders are not presumed generally to have fiduciary duties to one another. *See supra* note 8. Shareholders acquire fiduciary duties only when they exert a sufficient level of control over the corporation. *See* Weinstein Enters., Inc. v. Orloff, 870 A.2d 499, 507 (Del. 2005). The point at which a shareholder becomes a controlling shareholder varies with the facts and circumstances of each case. There is, for example, no minimum percentage ownership requirement that confers controlling status on a shareholder. Rather, a shareholder is deemed controlling and becomes a fiduciary with respect to other shareholders when that shareholder "steps out of [its] role as a stockholder and begins to usurp the functions of director in the management of corporate affairs." *See* Gottesman v. General Motors, 279 F. Supp. 361, 383–84 (S.D.N.Y. 1967); *see also Weinstein*, 870 A.2d at 507 (holding that a minority shareholder must have "*actual exercise* of control over the corporation's conduct" in order to acquire fiduciary obligations). In other words, a controlling shareholder is one that can dictate corporate policy. While special interest shareholders employ a variety of means to influence corporate policy, they are typically not in a position to set firm policy. Their relationship with the corporations in which they hold shares is therefore unpoliced by fiduciary duty law. In other words, they are free to trade off overall shareholder value for private gain.

The main objection to the argument that large shareholders are likely to use their power opportunistically is that their ability to do so is checked by the shareholder voting principle of majority rule.[172] In this regard, proponents of increasing shareholder power contend that shareholders will not be able to pursue successfully their private agendas to the detriment of shareholders generally because they will be unable to obtain majority support for such initiatives. According to this view, the only proposals that will succeed are those that increase shareholder value because this objective is the only one that shareholders have in common. Schwab and Thomas have noted, for example, that union-shareholder activity encompasses both initiatives aimed at enhancing shareholder value generally and initiatives designed to further unions' traditional organizing and collective-bargaining goals.[173] They argue, however, that because other shareholders will be skeptical of proposals that favor the special interests of labor, union-shareholders will have difficulty forming coalitions with them.[174]

When shareholders have private interests, however, a simple majority voting rule, in which shareholders vote in a binary "yes" or "no" fashion on issues, cannot be relied on to produce only shareholder value-increasing outcomes. The following table illustrates the point:

TABLE A
BENEFITS OF PROJECT A

Shareholder	*Shareholder Benefit/Private Benefit*	*Net Benefit*
1	5/5	10
2	5/–8	–3
3	5/–8	–3

Assume that each shareholder in Table A owns one-third of the total outstanding shares of a corporation that is considering whether to pursue Project A. Table A specifies the shareholder benefits (the benefits to the shareholder solely in respect of its shareholdings) and private benefits (the benefits to the shareholder solely in respect of its private interests), respectively, of the project for each of Shareholders 1, 2, and 3. Assume the decision whether to go forward with Project A is determined based on a simple majority voting rule.

172. *See, e.g.*, Bebchuk, *supra* note 1, at 883–84; Schwab & Thomas, *supra* note 75, at 1082–84.

173. *See* Schwab & Thomas, *supra* note 75, at 1023.

174. *Id.* at 1082–83.

In the absence of bargaining, Project A receives only one-third of the votes and is not adopted. This is true even though the project would enhance overall shareholder value.

In certain political contexts, "logrolling," or the opportunity to exchange votes, is thought of as offering voters the opportunity to express their preference intensities, thereby bringing society closer to the socially optimal provision of public goods.[175] This is because it provides a mechanism through which side payments can be used to enter into efficient trades. In Table A, for example, Shareholder 1 could use a side payment to obtain the support of either Shareholder 2 or 3 for Project A and still be left better off.[176]

For logrolling to lead to efficient outcomes, however, it must be practical for all voters to bargain with one another.[177] This is most likely to occur when decisions are made in a committee or other small group setting[178] and is very unlikely in shareholder voting. The shareholders who are likely to be aware of, and accessible to, one another are large institutional shareholders. These shareholders can bargain among themselves—without regard to the preferences of more widely dispersed shareholders. Think of such dispersed shareholders as Shareholder 1. In the absence of widespread bargaining, Shareholder 1 will be left out of the bargaining process, and logrolling will not lead to the adoption of Project A.

It is also possible that the purchase of additional shares would produce a shareholder value-maximizing outcome in Table A. Shareholder 1 could purchase Shareholder 2's shares, for example, and vote the majority of the firm's equity in favor of Project A. Shareholder 1 would then be able to realize the gains that Project A would confer upon it. As already noted, however, numerous obstacles confront a shareholder seeking to acquire control of a company, such as the risk that the takeover bid will be unsuccessful.[179] Even a shareholder who seeks to acquire a large block of stock, as opposed to actual control, faces disincentives to doing so. Under the securities laws, any person who acquires beneficial ownership of more than 5 percent of the outstanding shares of any class of a corporation's stock is subject to extensive disclosure

175. James M. Buchanan and Gordon Tullock first noted the positive potential for logrolling. *See* JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY 122–26, 135–40 (1962).

176. Of course, such side payments would be unnecessary if the shareholders were motivated to form a coalition as a result of a shared private interest.

177. *See* BUCHANAN & TULLOCK, *supra* note 175, at 135–40.

178. *See* ROBERT SUGDEN, THE POLITICAL ECONOMY OF PUBLIC CHOICE: AN INTRODUCTION TO WELFARE ECONOMICS 184 (1981).

179. *See supra* notes 18–24 and accompanying text.

requirements that impinge on investor privacy.[180] Large block formation also exposes a shareholder to the possibility that it will be subject to fiduciary duty obligations to other shareholders.[181] In addition, the acquisition of a significant stake in a single firm exposes a shareholder to firm-specific risk, which may conflict with the shareholder's investment strategy.[182] Finally, large shareholdings can be difficult to unload, which conflicts with the liquidity requirements of some investors.[183]

Majority rule may also fail to check opportunistic behavior by shareholders if they can use private negotiations with management to obtain greenmail-type payments in exchange for agreeing to support managerial interests.[184] There are numerous strategies that large investors can employ in their relations with management to further their private interests. In some cases, a large shareholder may submit to a company a shareholder proposal that management opposes. After negotiating directly with the company's management and reaching agreement on an issue of special importance to it, the shareholder withdraws the shareholder proposal.[185] In other cases, a large shareholder may receive a concession from management for agreeing to use its shareholdings to fend off an unwanted takeover.[186] Each of these scenarios involves some payment that enriches one shareholder at general shareholder expense.

There is evidence indicating that shareholders use direct negotiations with corporate management to bargain for their private interests. In a study of direct negotiations between the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), a fund that manages pension money for teachers and other employees of tax-exempt organizations, and companies at which TIAA-CREF made shareholder proposals, 71 percent of the companies reached a negotiated settlement with TIAA-CREF prior to

180. Securities Exchange Act of 1934 § 13(d), 15 U.S.C. §§ 78m(d)(1)–(6) (2000).

181. *See supra* note 171.

182. *See supra* notes 118–119 and accompanying text.

183. *See* Coffee, *supra* note 74, at 1288–89.

184. *See supra* note 112.

185. Of course, a special interest shareholder threatening management may not gain substantial support among other shareholders. The mere prospect, however, that such a shareholder will wage an intense campaign for a proposal that threatens management provides that shareholder with negotiating leverage. In addition, the shareholder may be proposing a shareholder value-enhancing measure that is likely to obtain majority shareholder support but that the shareholder is willing to withdraw if it receives a concession from management. While it is possible that such proposals would be initiated by other shareholders seeking to increase shareholder value, there may be no other shareholder with credible incentives to do so.

186. *See* Rock, *supra* note 8, at 990–95.

the vote on the shareholder proposal.[187] More generally, Institutional Shareholder Services, a consulting firm that advises institutional investors on corporate governance issues, stated recently that constructive dialogue between shareholders and corporations has replaced confrontation, with communications taking place "off stage, the results out of the limelight."[188]

Thus, we cannot rely on majority voting to ensure that only shareholder value-enhancing initiatives will succeed. Large shareholders may form coalitions that further their private interests but reduce overall shareholder value. They may also engage in negotiations with corporate management to achieve their own objectives. These possibilities cast doubt on the view that if shareholders are given increased power, then they will use that power to increase shareholder value.

CONCLUSION

Should we rely on shareholders to act as effective monitors of management? Others have put forth persuasive arguments for director primacy—a board-centered model for the management of public companies—arguing that we should not. In Stephen Bainbridge's director-primacy theory, the board of directors "is a *sui generis* body—a sort of Platonic guardian—serving as the nexus for the various contracts comprising the corporation."[189] Increasing director accountability to shareholders necessarily involves constraining board discretion.[190] From the director-primacy perspective, however, increasing shareholder power undermines the very raison d'etre of boards—to establish a central corporate decisionmaker with authority to contract for the corporation in the context of differing interests and information among the corporation's various factors of production.[191] In these circumstances, consensus-based decisionmaking, the alternative to board primacy, is inefficient.[192]

Margaret Blair and Lynn Stout have taken a different approach to justifying the broad discretion vested in boards. Their "team production" view of corporate governance argues that the ex ante wealth of both shareholders and other corporate constituencies is maximized by rules that give directors freedom to consider the interests of all the groups that make specific

187. *See* Gillan & Starks, *supra* note 55, at 20 (citing study).
188. *See A New Corporate Governance World*, *supra* note 47, at 3.
189. Bainbridge, *supra* note 75, at 550–51 (footnote omitted).
190. *See id.* at 573.
191. *See id.* at 572–73.
192. *See id.* at 558–59.

investments in the corporation.[193] Thus, the proper focus of corporate governance should, in their view, be on designing and implementing incentives for board behavior that do not involve strengthening shareholders. Instead, team production theory treats directors as "mediating hierarchs," whose job it is to balance the interests of all the corporation's constituents, not just shareholders, in serving the interests of the entire firm.[194]

This Article sheds additional light on the shareholder-primacy versus director-primacy debate in that it suggests a further rationale for vesting primary decisionmaking authority in the board of directors. It contends that shareholders have widely divergent interests that may give them incentives to pursue their private objectives at the expense of overall shareholder value. In contrast, directors, who owe fiduciary duties to all shareholders, are more likely to be able to mediate shareholder conflicts and make decisions on behalf of shareholders as a class.

This Article has argued that the connection between shareholder empowerment and improved corporate governance is more tenuous than those who advocate increasing shareholder power assume. In particular, underlying shareholder primacy theory is the belief that shareholders can be counted on to discipline managers. While shareholders are bound together by their common investment interest, they also have significant private interests that shareholder primacists gloss over. A complete account of shareholder action must incorporate both common and private incentives. Once this is done, it becomes clear that we cannot conclude that shareholder action will operate in an unambiguously shareholder value-increasing manner. It may, but it also may result in a net decrease in shareholder value. The more diverse the interests of shareholders, the more likely it is that shareholders will engage in costly rent-seeking behavior that generates interest costs by distorting managerial decisions and wastes productive resources in the course of squabbling over whose interests the firm will advance.

Empirical research could shed light on how various shareholders direct their activism, and more should be done, but our experience thus far with shareholder activism is inauspicious. Today, the aspirations for shareholder activism remain largely unfulfilled. While the level of shareholder activism did rise as shareholdings became more concentrated,[195] the hope that such increased activism would improve corporate performance does not seem to

193. *See* Blair & Stout, *supra* note 5, at 288.
194. *See id.* at 291–92.
195. *See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 175–76 (2001).

have materialized.[196] The absence of a clear relationship between shareholder activism and firm performance is cause for concern.

To redouble our efforts to unleash shareholder power on the assumption that shareholders have an incentive to discipline management seems premature, in light of the conflicting interests that modern shareholders possess. It seems prudent, instead, to consider further the destructive potential of increasing shareholder power.[197] Doing so would reduce the risk of implementing a corporate governance-based cure for the agency problem between managers and shareholders that might prove worse than the disease itself.

196. *See* Bhagat et al., *supra* note 55, at 28; Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 459 (Peter Newman ed., 1998); Gillan & Starks, *supra* note 55, at 19–30; Romano, *supra* note 195, at 177–82.

197. For a corporate governance reform proposal that attempts to take such considerations into account, see Leo E. Strine, Jr., *Towards a True Corporate Republic: A Traditionalist Response to Lucian's Solution for Improving Corporate America*, 119 HARV. L. REV. (forthcoming 2006) (replying to Bebchuk, *supra* note 1).

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