THE CASE FOR LIMITED SHAREHOLDER VOTING RIGHTS

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Recent years have seen a number of efforts to extend the shareholder franchise. These efforts implicate two fundamental issues for corporation law. First, why do shareholders—and only shareholders—have voting rights? Second, why are the voting rights of shareholders so limited? This Article proposes answers for those questions.

As for efforts to expand the limited shareholder voting rights currently provided by corporation law, the Article argues that the director primacy-based system of U.S. corporate governance has served investors and society well. This record of success occurred not in spite of the separation of ownership and control, but because of that separation. Before making further changes to the system of corporate law that has worked well for generations, it would be prudent to give those changes already made time to work their way through the system. To the extent additional change or reform is thought desirable, it should be in the nature of minor modifications to the newly adopted rules designed to enhance their performance rather than radical and unprecedented shifts in the system of corporate governance that has existed for decades.

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INTRODUCTION

Shareholder voting can serve three distinct purposes, depending upon the nature of the firm in question. In the first category are closely held corporations with a small number of shareholders, all of whom have ready access to information about the business and homogeneous preferences. In such a corporation, voting is effectively an exercise of managerial power. Because both strategic and tactical business decisions can be made efficiently through voting, there is no need to incur the costs of retaining specialized managers. Accordingly, such a firm usually will lack the separation of ownership and control that is characteristic of public corporations.

The second category includes those publicly held corporations in which there are controlling shareholders. Such firms display partial separation of ownership and control. The controlling shareholders of such corporations have substantial access to firm information and retain incentives to cast informed votes. Although the corporation likely will have a professional managing body, the managers face a real possibility of being voted out of office by the controlling shareholder if their performance is subpar. Hence, voting in such corporations has both managerial and oversight functions.

In the final category, the corporation is publicly held, the numerous shareholders have diverse preferences, and the shareholders lack both the knowledge and the incentives necessary to exercise an informed vote. In such a corporation, we observe complete separation of ownership and control. These are the corporations with which this Article is concerned.

Despite the separation of ownership and control in public corporations, many observers believe that shareholder voting is an integral component of corporate governance. Even sophisticated corporate law experts, such as those on the Delaware courts, say so: "The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[1]

A similar theory of shareholder voting rights presumably motivates the many recent efforts to extend the shareholder franchise. Some of these so-called reforms have already been adopted. The major stock exchanges, for example, have implemented new listing standards expanding the number of

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

corporate compensation plans that must be approved by shareholders.[2] Other proposals remain on the drawing board. As of this writing, for example, the Securities and Exchange Commission (SEC) is still at least nominally considering a proposal to permit shareholders, under limited circumstances, to nominate directors and have their nominees listed in the company's proxy statement and on its proxy card.[3] The American Bar Association is considering amending the Model Business Corporation Act to require a majority vote—rather than the current plurality—to elect directors.[4] In the meanwhile, institutional investors are using Rule 14a-8 to propose amendments to corporate bylaws requiring a majority vote.[5]

Such efforts to extend the shareholder franchise are fundamentally misguided. In public corporations of the sort with which this Article is concerned, shareholder voting has very little to do with corporate decisionmaking. To the contrary, the separation of ownership and control observed in such firms is inherent in the basic structure of the law of corporate governance. Under Delaware General Corporation Law section 141, for example, the corporation's business and affairs are "managed by or under the direction of a board of directors."[6] The vast majority of corporate decisions accordingly are made by the board of directors acting alone, or by persons to whom the board has properly delegated authority. Shareholders have virtually no right to initiate corporate action and, moreover, are entitled to approve or disapprove only a very few board actions. The statutory decisionmaking model thus is one in which the board acts and shareholders, at most, react.

We are thus presented by two puzzles. First, why do shareholders—and only shareholders—get the vote? Second, why are shareholder voting rights so limited? This Article takes up those questions sequentially.

I. WHY SHAREHOLDERS AND ONLY SHAREHOLDERS?

Is it curious that only shareholders get the vote? What about all of the corporation's other constituencies, such as employees, creditors, customers, or suppliers? Why do they not get a voice in, say, the election of directors?

2. *See, e.g.*, NYSE, Inc., Listed Company Manual § 312.00 (2002).
3. Security Holder Director Nominations, 68 Fed. Reg. 60,784 (Oct. 23, 2003).
4. Press Release, Committee on Corporate Laws of the Section of Business Law of the American Bar Association, Corporate Law Committee Nears Completion of Recommendations on Director Voting (Dec. 5, 2005), *available at* http://meetings.abanet.org/webupload/commupload/CL270000/otherlinks_files/CCL-Release5.pdf.
5. *Id.*
6. DEL. CODE ANN. tit. 8, § 141(a) (2001).

The traditional answer was that shareholders own the corporation. Ownership typically connotes control, of course. Consequently, since Adolf Berle and Gardiner Means's day, we have used the phrase "separation of ownership from control" to describe the predominant corporate governance system.[7] Yet, this view is deeply erroneous.

To be sure, shareholders own the residual claim on the corporation's assets and earnings. At bottom, the ownership of that claim is why the set of contracts making up the corporation treats the shareholders as the beneficiaries of director accountability. Ownership of the residual claim, however, is not the same as ownership of the corporation itself.

In order for shareholders to own the corporation, the corporation would have to be a thing capable of being owned. It is not. The corporation is just a legal fiction, albeit a highly useful one, for the nexus of explicit and implicit contracts between a wide array of stakeholders, of whom shareholders are but one among many.[8] Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The corporation is a legal fiction representing the complex set of contractual relationships between these inputs.

Contractarianism also has implications for the way in which we think about intracorporate relationships. Take, for example, the commonly held assumption that shareholders own the corporation. Under traditional theories, the corporation is a thing, so it can be owned. In other words, traditionalists reify the corporation: They treat the firm as an entity separate from its various constituents. Nexus of contracts theory rejects this basic proposition. Because shareholders are simply one of the many stakeholders bound together

7. *See, e.g.*, ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932).

8. There is an extensive debate in the academic literature as to the validity of the nexus of contracts model (a.k.a. contractarianism). Defenses of the contractarian understanding of the corporation include Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique on Eisenberg*, 89 COLUM. L. REV. 1530 (1989); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318–28 (1993). For criticism of contractarianism, see, for example, Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989). In this work, I do not rehash that debate, but simply assume the validity of contractarianism. After all, as prominent scholar and jurist Bill Allen has opined, contractarianism is now the "dominant legal academic view." William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993).

by this web of voluntary agreements, ownership is not a meaningful concept in contractarian theory. Someone owns each input, but no one owns the totality. Instead, the corporation is an aggregation of people bound together by a complex web of contractual relationships. (The validity of this insight becomes apparent when one recognizes that buying a few shares of IBM stock does not entitle me to trespass on IBM's property—I do not own the land or even have any ownership-like right to enter.)

The implications of the foregoing may not seem as staggering as they actually are. Consider, for example, the traditional corporate law principle of shareholder wealth maximization. According to a significant line of corporate precedents, the principal obligation of corporate directors is to increase the value of the residual claim—namely, to increase shareholder wealth.[9] In its traditional guise, this shareholder-primacy norm derives from a conception of the corporation as a thing capable of being owned. The shareholders own the corporation, while the directors are merely stewards of the shareholders' property.

The nexus of contracts model squarely rejects this conception of the corporation. As such, the shareholder wealth maximization norm is transformed from a right incident to private property into a mere bargained-for contract term.[10] The contractarian account of this norm thus rests not on an outmoded reification of the corporation, but on the presumption of validity a free market society accords voluntary contracts.

Taken to its logical extreme, this insight allows us to transform the traditional notion of shareholder primacy into one of director primacy. The latter perspective regards the corporation as a vehicle by which the board of directors hires capital by selling equity and debt securities to risk-bearers with varying tastes for risk. Ownership of the residual claim thus differs little from ownership of debt claims. In turn, by throwing the concept of ownership of the firm out the window, this insight eliminates the obvious answer to our starting question—why are only shareholders given voting rights?

A better answer to that question is suggested by Kenneth Arrow's analysis of the two basic ways in which organizations make decisions: consensus and authority.[11] Consensus requires that each member of the organization have identical information and interests so that preferences can be aggregated at

9. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 181–84 (Del. 1986); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

10. *See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 418–29 (2002) (explaining that the basic corporate law principle that directors have a fiduciary duty to maximize shareholder wealth arises not out of shareholder ownership of the corporation but rather out of the terms of the shareholders' contract with the corporation).

11. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 63–79 (1974).

low cost. In contrast, if group members have different interests and information, authority-based decisionmaking structures arise.

Accepting Arrow's claims as true suggests an analysis proceeding in three steps. First, why do corporations not rely on consensus-based decisionmaking? In answering that question, we begin by imagining an employee-owned firm with many thousands of employee-shareholders. (Employees are used solely for purposes of illustration—the analysis would extend to any other corporate constituency.) After demonstrating that Arrow's conditions cannot be satisfied in such a firm, we then turn to the more complex public firm in which employees and shareholders constitute separate constituencies to demonstrate that Arrow's conditions are even less likely to be met in this type of firm. We then ask why corporations do not permit multiple constituencies to elect directors. Finally, we examine why shareholders are the favored constituency.

A. The Necessity of Authority

1. Information

Assume an employee-owned corporation with 5000 employee-shareholders. Could such a firm function as a sort of participatory democracy, using some form of consensus-based decisionmaking? Not if each participant is expected to make informed decisions. Our hypothetical employee-shareholders necessarily will have differing degrees of access to information. Assuming at least some employees serve in managerial and supervisory roles, for example, they will tend to have broader perspectives, with more general business information, while line workers will tend to have more specific information about particular aspects of the shop floor.

These information asymmetries will prove intractable. A rational decisionmaker expends effort to make informed decisions only if the expected benefits of doing so outweigh its costs. In a firm of the sort at bar, gathering information will be very costly. Efficient participatory democracy requires all decisionmakers to have equal information, which requires that each decisionmaker have a communication channel to every other decisionmaker. As the number of decisionmakers increases, the number of communication channels within the firm increases exponentially.[12]

The requisite communication channels will inevitably suffer certain disabling pathologies. First, the employee-shareholders of such a corporation

12. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 46 (1975); Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LIT. 1382, 1384 (1992).

could not credibly bind themselves to reveal information accurately and honestly or to follow prescribed decisionmaking rules. Second, bounded rationality makes it doubtful that anyone in a firm of any substantial size could process the vast number of resulting information flows. Finally, the opportunity cost entailed in making informed decisions is also high and, even more important, readily apparent. In contrast, the expected benefits of becoming informed are quite low, as an individual decisionmaker's vote will not have a significant effect on the vote's outcome. Our employee-shareholders thus will be rationally apathetic. Under such conditions, Arrow's model predicts that the corporation will tend toward authority-based decisionmaking.

Now introduce the complication of separating capital and labor. Nothing about such a change economizes on the decisionmaking costs outlined above. Instead, as described below, labor and capital can have quite different interests, which increases decisionmaking costs by introducing the risk of opportunism. In particular, capital and labor may behave strategically by withholding information from one another. Accordingly, the case for authority-based decisionmaking becomes even stronger in such a corporation.

2. Interests

Again, begin by assuming an employee-owned firm with 5000 employee-shareholders. Is it reasonable to expect that the similarity of interest required for consensus-based decisionmaking will exist in such a firm? Surely not. In some cases, employees will differ about the best way in which to achieve a common goal. In others, individual employees will be disparately affected by a proposed course of action. Although the problems created by divergent interests within the employee block may not be insurmountable, such differences at least raise the cost of using consensus-based decisionmaking structures in employee-owned firms.

Both the existence of such divergent interests within the employee group and the resulting costs are confirmed by the empirical evidence. Labor-managed firms tend to remain small, carefully screen members, limit the franchise to relatively homogeneous groups, and use agenda controls to prevent cycling and other public choice problems.[13] All of these characteristics are consistent with an attempt to minimize the likelihood and effect of divergent interests.

13. Gregory Dow & Louis Putterman, *Why Capital (Usually) Hires Labor: An Assessment of Proposed Explanations*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 17, 18–23 (Margaret M. Blair & Mark J. Roe eds., 1999).

Now again complicate the analysis by separating capital and labor. Although employee and shareholder interests are often congruent, they can conflict. Consider, for example, the downsizing phenomenon. Corporate restructurings typically result in substantial reductions in force, reduced job security, longer work weeks, more stress, and diminished morale.[14] From the shareholders' perspective, however, the market typically rewards restructurings with substantial stock price increases. The divergence of interests suggested by this example looms large as a bar to the use of consensus in capitalist firms.

B. The Inefficiency of Multiple Constituencies

The analysis to this point merely demonstrates that corporate decisionmaking must be made on a representative, rather than a participatory, basis. As yet, nothing in the analysis dictates the U.S. model in which only shareholders elect directors. One could plausibly imagine a board of directors on which multiple constituencies are represented. Indeed, imagination is not required, because the supervisory board component of German codetermination provides a real world example of just such a board.[15] Empirical evidence, however, suggests that codetermination does not lead to efficiency or productivity gains.[16]

Why not? In Arrow's terminology, the board of directors serves as a consensus-based decisionmaking body at the top of an authority-based structure. Recall that for consensus to function, however, two conditions must be met: equivalent interests and information. Neither condition can be met when employee representatives are on the board.

The two factors are closely related, of course. Indeed, it is the potential divergence of shareholder and employee interests that ensures employee representatives will be deprived of the information necessary for them to function. Because of the board's position at the apex of the corporate

14. MICHAEL USEEM, INVESTOR CAPITALISM 164–65 (1996).

15. Codetermination statutes typically mandate, inter alia, a dual board structure. A supervisory board appoints and oversees a managing board, with the latter actively operating the firm. In theory, employees and shareholders are equally represented on the supervisory board. In practice, however, the board often is controlled either by the firm's managers or a dominant shareholder. One of the employee representatives must be from management, and shareholders are entitled to elect the chairman of the board, who has the power to break tie votes. If push comes to shove, which reportedly it rarely does, shareholders thus retain a slight but potentially critical edge. *See generally* Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT'L REV. L. & ECON. 203, 204 (1994).

16. *See generally* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 676–78 (1996) (summarizing studies addressing the relationship between employee codetermination and productivity gains).

hierarchy, employee representatives are inevitably exposed to a far greater amount of information about the firm than is normally provided to employees. As the European experience with codetermination teaches, this can result in corporate information leaking to the work force as a whole or even to outsiders. In the Netherlands, for example, the obligation of works council representatives to respect the confidentiality of firm information "has not always been kept, causing serious concerns among management which is required . . . to provide extensive 'sensitive' information to the councils."[17]

One sure result of lost confidentiality will be worker demands for higher wages. Perhaps the best anecdotal example of this problem is the famous observation made by Rick Dubinsky, head of United Airlines' pilots union: "We don't want to kill the golden goose. We just want to choke it by the neck until it gives us every last egg."[18] This amusing anecdote is confirmed by an empirical study finding that provision of financial and other business information to employees of nonunionized firms had a negative effect on firm profitability, which was attributed to higher wages demanded by the informed employees.[19] In unionized firms, moreover, management will be especially reluctant to inform union members on the board of information that might aid the union in collective bargaining.

Given that providing board-level information to employee representatives appears clearly contrary to shareholder interests, we would expect managers loyal to shareholder interests to withhold information from the board of directors in order to deny it to employee representatives, which would seriously undermine the board's ability to carry out its essential corporate governance roles. This prediction is borne out by the German experience with codetermination. German managers sometimes deprive the supervisory board of information, because they do not want the supervisory board's employee members to learn it.[20] Alternatively, the board's real work may be done in committees or de facto rump caucuses from which employee representatives are excluded.[21]

17. Tom R. Ottervanger & Ralph M. Pais, *Employee Participation in Corporate Decision Making: The Dutch Model*, 15 INT'L LAW. 393, 399 (1981).

18. Roger Lowenstein, *Into Thin Air*, N.Y. TIMES, Feb. 17, 2002, § 6 (Magazine), at 40.

19. Morris M. Kleiner & Marvin L. Bouillon, *Providing Business Information to Production Workers: Correlates of Compensation and Profitability*, 41 INDUS. & LAB. REL. REV. 605, 614–15 (1988); *see also* Stuart Ogden, *The Limits to Employee Involvement: Profit Sharing and Disclosure of Information*, 29 J. MGMT. STUD. 229, 229 (1992) (stating that U.K. employers are reluctant to provide disclosure of financial information for fear of stimulating workers to make demands respecting pay and working conditions).

20. *See* Hopt, *supra* note 15, at 206.

21. Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. & SEC. REG. 155, 166 (1982).

As a result, while codetermination raises the costs of decisionmaking, it may not have much effect on substantive decisionmaking.[22]

Although Arrow's equality of information criterion is important, in this context the critical element is the divergence of shareholder and employee interests. The interests of shareholders will inevitably differ among themselves, as do those of employees, but individual constituents of the corporation nevertheless are more likely to share interests with members of the same constituency than with members of another constituency. Allowing board representation for employees thus tends only to compound the problem that gives rise to an authority-based hierarchical decisionmaking structure by bringing the differing interests of employees and shareholders directly into the boardroom. The difficulty, of course, is not merely that the interests of employees and shareholders diverge, but also that different classes of employees have divergent interests. As we have seen, this seriously compounds the problem of aggregating constituency preferences.

The resulting conflicts of interest between shareholders and employees inevitably impede consensus-based decisionmaking within the board of directors. Worker representatives on corporate boards tend to prefer greater labor advocacy than do traditional directors, no doubt in large part because workers evaluate their representatives on the basis of labor advocacy, which also results in role conflicts.[23] This conflict is exacerbated in heavily unionized industries, as representatives of a single union might sit on the boards of multiple firms within the industry. In the extreme case, the demise of one firm might redound to the greater good of the greatest number by benefiting union members who work at competing corporations. This creates the potential for perverse incentives on the part of union representatives on the board.

The problem with codetermination thus is not only that the conflict of employee and shareholder interests impedes the achievement of consensus, but also that it may result in a substantial increase in agency costs. The most obvious concern is the possibility that employee representation will permit management to pursue its own self-interest at the expense of both shareholders and employees by playing worker and shareholder representatives against each other. Legal and market accountability mechanisms constrain this tendency, but because they are not perfect there remains the possibility that self-interested

22. Tove H. Hammer et al., *Worker Representation on Boards of Directors: A Study of Competing Roles*, 44 INDUS. & LAB. REL. REV. 661, 663 (1991) (finding that the Scandinavian experience with codetermination shows it has little substantive effect on corporate decisionmaking).

23. JOHN L. COTTON, EMPLOYEE INVOLVEMENT: METHODS FOR IMPROVING PERFORMANCE AND WORK ATTITUDES 128 (1993).

managers may throw their support behind the side of the board whose interests happen to coincide with those of management in the issue at hand.

This conflict is well-known, of course, but there is a more subtle problem that is often overlooked. Corporate employees have an incentive to shirk[24] so long as their compensation does not perfectly align their incentives with those of the firm's shareholders. In turn, knowing of this phenomenon, the firm's shareholders should expect management to reduce the compensation of the firm's employees by the amount necessary to offset the expected degree of employee shirking. Because ex ante wage adjustments rarely are fully compensatory, due to bounded rationality and the resulting use of incomplete contracts, the firm's shareholders should expect management to monitor the employees and punish ex post those who shirk.

Would it thus not seem odd that those who are to be monitored should be allowed to choose the monitors? One of the accountability mechanisms that aligns managerial and shareholder interests is monitoring by the board of directors. Allowing employee representation on the board necessarily reduces the likelihood that the board will be an effective monitoring device. Because shareholders "could seek profits by getting highly motivated managers who sweat the labor force,"[25] workers have an interest in supporting rules that free management from accountability to shareholders. Managerial shirking of its monitoring responsibilities thus will often redound to the workers' benefit, which suggests that employee representatives on the board of directors are less likely to insist on disciplining lax managers than are shareholder representatives. If employees are entitled to voting representation on the board of directors, monitoring by the board and its subordinate managers will be less effective, which will cause agency costs to rise.

The validity of this prediction is confirmed by the German experience with codetermination. Conflicts of interest faced by employee representatives on the supervisory board remain a serious, but unresolved concern. Employee representation slows the finding of a consensus on the supervisory board

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24. Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983). In turn, shirking is defined to include any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes. Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 465 (1992). In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships.

25. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 44 (1994).

and creates a built-in polarization problem.[26] Hence, as already noted, it is standard practice for employee and shareholder representatives to have separate premeeting caucuses.[27]

Although it is sometimes asserted that employee representation would benefit the board by promoting "discussion and consideration of alternative perspectives and arguments,"[28] the preceding analysis suggests that any such benefits would come at high cost. In addition, there is reason to doubt whether those benefits are very significant. Workers will be indifferent to most corporate decisions that do not bear directly on working conditions and benefits.[29] All of which tends to suggest that employee representatives add little except increased labor advocacy to the board.

C. Why Only Shareholders?

The analysis thus far demonstrates that public corporation decision-making must be conducted on a representative rather than participatory basis. It further demonstrates that only one constituency should be allowed to elect the board of directors. The remaining question is why shareholders are the chosen constituency, rather than employees. Answering that question is the task of this section.

One plausible answer rests on the divergence of interests within constituency groups. Although investors have somewhat different preferences on issues such as dividends and the like, they are generally united by a desire to maximize share value. Board consensus therefore will be more easily achieved if directors are beholden solely to shareholder interests, rather than to the more diverse set of interests represented by employees and other stakeholders.

A related but perhaps more telling point is the problem of apportioning the vote. Financial capital is fungible, transferable, and quantifiable. Control rights based on financial capital are thus subject to low cost allocation and valuation. In contrast, the human capital of workers meets none of these criteria. While one-person/one-vote would be a low-cost solution to the allocation

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26. Hopt, *supra* note 15, at 207.

27. *Id.* at 208.

28. Robert Howse & Michael J. Trebilcock, *Protecting the Employment Bargain*, 43 U. TORONTO L.J. 751, 769 (1993).

29. *See* Michael P. Dooley, *European Proposals for Worker Information and Codetermination: An American Comment*, *in* HARMONIZATION OF LAWS IN THE EUROPEAN COMMUNITIES: PRODUCTS LIABILITY, CONFLICT OF LAWS, AND CORPORATION LAW 126, 129 (Peter E. Herzog ed., 1983) ("As to the vast majority of managerial policies concerning, for example, dividend and investment policies, product development, and the like, the typical employee has as much interest and as much to offer as the typical purchaser of light bulbs.").

problem, it appears highly inefficient given the unequal distribution of reasoning power and education. If the most competent people and/or those with the most at stake should have the most votes, some more costly allocation device will be necessary.

The standard law and economics explanation for vesting voting rights in shareholders, however, is that shareholders are the only corporate constituent with a residual, unfixed, ex post claim on corporate assets and earnings.[30] In contrast, the employees' claim is prior and largely fixed ex ante through agreed-upon compensation schedules, as are the claims of other stakeholders. This distinction has two implications of present import. First, as noted above, employee interests are too narrow to justify board representation. In contrast, shareholders have the strongest economic incentive to care about the size of the residual claim, which means that they have the greatest incentive to elect directors committed to maximizing firm profitability.[31] Second, the nature of the employees' claim on the firm creates incentives to shirk, and vesting control rights in the employees would increase this incentive. In turn, the prospect of employee shirking lowers the value of the shareholders' residual claim.

At this point, it is useful to invoke the hypothetical bargain methodology central to the contractarian approach to corporations. If the corporation's various constituencies could bargain over voting rights, to which constituency would they assign those rights?[32] In light of their status as residual claimants and the adverse effects of employee representation, shareholders doubtless would insist upon control rights, so as to ensure a corporate decisionmaking system emphasizing monitoring mechanisms designed to prevent shirking by employees.

Granted, collective action problems preclude the shareholders from exercising meaningful day-to-day or even year-to-year control over managerial decisions. Unlike the employees' claim, however, the shareholders' claim on the corporation is freely transferable. As such, if management fails to maximize

30. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 66–72 (1991).

31. The superiority of shareholder incentives is a relative matter. Shareholders may have better incentives than other constituencies, but the phenomenon of rational apathy nevertheless limits the extent to which shareholders can be expected to act on those incentives.

32. According to the Coase Theorem, rights will be acquired by those who value them most highly, which creates an incentive to discover and implement transaction cost-minimizing governance forms. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15–19 (1960). Although shareholders and employees obviously do not bargain, a basic premise of the law and economics account is that corporate law provides them with a set of default rules reflecting the bargain they would strike if they were able to do so.

the shareholders' residual claim, an outsider can profit by purchasing a majority of the shares and voting out the incumbent board of directors. Accordingly, vesting the right to vote solely in the hands of the firm's shareholders is what makes possible the market for corporate control and thus helps to minimize shirking. As the residual claimants, shareholders thus would bargain for sole voting control, in order to ensure that the value of their claim is maximized.[33] In turn, because all corporate constituents have an ex ante interest in minimizing shirking by managers and other agents, the firm's employees have an incentive to agree to such rules.[34] The employees' lack of control rights thus can be seen as a way in which they bond their promise not to shirk. Their lack of control rights not only precludes them from double-dipping, but also facilitates disciplining employees who shirk. Accordingly, it is not surprising that the default rules of the standard form contract provided by all corporate statutes vest voting rights solely in the hands of common shareholders.

To be sure, the vote allows shareholders to allocate some risk to prior claimants. If a firm is in financial straits, directors and managers faithful to shareholder interests could protect the value of the shareholders' residual claim by, for example, financial and/or workforce restructurings that eliminate prior claimants. All of which raises the question of why employees do not get the vote to protect themselves against this risk. The answer is two-fold. First, as we have seen, multiple constituencies are inefficient. Second, as addressed below, employees have significant protections that do not rely on voting.

Suppose a firm behaves opportunistically towards its employees. What protections do the employees have? Some are protected by job mobility. The value of continued dealings with an employer to an employee whose work involves solely general human capital does not depend on the value of the firm because neither the employee nor the firm have an incentive to preserve such an employment relationship. If the employee's general human capital suffices for him to do his job at Firm A, it presumably would suffice for him to do a similar job at Firm B. Such an employee resembles an independent contractor who can shift from firm to firm at low cost to

33. To be sure, the existence of takeover defenses sharply constrains the exercise of shareholder control via the market for corporate control. The legitimacy of such defenses rests on considerations akin to those described in Part II.B, and is developed more fully in STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS § 7.2, at 340–86 (2003).

34. Although agents ex post have strong incentives to shirk, ex ante they have equally strong incentives to agree to a corporate contract containing terms designed to prevent shirking. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 778 n.2 (1972); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

either employee or employer.[35] Mobility thus may be a sufficient defense against opportunistic conduct with respect to such employees, because they can quit and be replaced without productive loss to either employee or employer. Put another way, because there are no appropriable quasi-rents in this category of employment relationships, rent-seeking by management is not a concern.

Corporate employees who make firm-specific investments in human capital arguably need greater protection against employer opportunism, but such protections need not include board representation. Indeed, various specialized governance structures have arisen to protect such workers. Among these are severance pay, grievance procedures, promotion ladders, and collective bargaining.[36]

In contrast, shareholders are poorly positioned to develop the kinds of specialized governance structures that protect employee interests. Unlike employees, whose relationship to the firm is subject to periodic renegotiation, shareholders have an indefinite relationship that is rarely renegotiated, if ever. The dispersed nature of stock ownership also makes bilateral negotiation of specialized safeguards difficult. The board of directors thus is an essential governance mechanism for protecting shareholder interests.

If the foregoing analysis is correct, why do we nevertheless sometimes observe employee representation? An explanation consistent with our analysis lies close at hand. In the United States, employee representation on the board is typically found in firms that have undergone concessionary bargaining with unions. An analysis of the bargaining settlements in 1982–1983 shows that concessionary bargaining, on average, results in increased share values of 8–10 percent.[37] The stock market apparently views union concessions as substantially improving the value of the residual claim, presumably by making firm

35. This is not to say that exit is costless for either employees or firms. All employees are partially locked into their firm. Indeed, it must be so, or monitoring could not prevent shirking because disciplinary efforts would have no teeth. The question is one of relative costs.

36. As private-sector unions have declined, the federal government has intervened to provide through general welfare legislation many of the same protections for which unions might have bargained. The Family and Medical Leave Act of 1993, 29 U.S.C. § 2601 (2000), grants unpaid leave for medical and other family problems. The Occupational Safety and Health Act of 1970, 29 U.S.C. § 651, mandates safe working conditions. Plant-closing laws require notice of layoffs. 29 U.S.C. § 2101. Civil rights laws protect against discrimination of various sorts. *See, e.g.*, 42 U.S.C. § 1983 (2000). Even such matters as offensive horseplay have come within the purview of federal sexual harassment law. *See* Hamm. v. Weyauwega Milk Prods., 332 F.3d 1058, 1064 (7th Cir. 2003) (explaining that "we do not mean to suggest that the presence of horseplay in a workplace precludes a claim of sexual harassment").

37. Brian E. Becker, *Concession Bargaining: The Impact on Shareholders' Equity*, 40 INDUS. & LAB. REL. REV. 268, 268 (1987).

failure less likely. While the firm's employees also benefit from a reduction in the firm's riskiness, they are likely to demand a quid pro quo for their contribution to shareholder wealth. One consideration given by shareholders (through management) may be greater access to information, sometimes through board representation. Put another way, board of director representation is a way of maximizing access to information and bonding its accuracy. The employee representatives will be able to verify that the original information about the firm's precarious financial situation was accurate. Employee representatives on the board also are well-positioned to determine whether the firm's prospects have improved sufficiently to justify an attempt to reverse prior concessions through a new round of bargaining.

II. WHY NOT SHAREHOLDER DEMOCRACY?

Our analysis to this point has explained why only shareholders, among the corporation's many stakeholders, are endowed with control rights through the voting process. Now we must turn to the second question with which we began; namely, why are those rights so sharply constrained?

A. The Limits on Shareholder Control

The separation of ownership and control characteristic of public corporations is enforced both directly and indirectly. Direct limitations on shareholder control are created by the statutory assignment of decisionmaking authority to the board. Shareholders essentially have no power to initiate corporate action and, moreover, are entitled to approve or disapprove only a very few board actions.

1. Direct Limits on Shareholder Control

In U.S. corporate law, shareholder control rights in fact are so weak that they scarcely qualify as part of corporate governance. Under the Delaware Code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution.[38] As a formal matter, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible.[39]

38. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 174–77 (1995) (summarizing state corporate law on shareholder voting entitlements).

39. DEL. CODE ANN. tit. 8, §§ 109(a), 211(2)(b) (2001).

In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board.[40]

2. Indirect Limits on Shareholder Control

Corporation law's direct restrictions on shareholder power are supplemented by a host of other rules that indirectly prevent shareholders from exercising significant influence over corporate decisionmaking. Three sets of statutes are especially important: (1) disclosure requirements pertaining to large holders; (2) shareholder voting and communication rules; (3) insider trading and short swing profits rules. These laws affect shareholders in two respects. First, they discourage the formation of large stock blocks.[41] Second, they discourage communication and coordination among shareholders.

a. Disclosure Requirements Relating to Large Holders

Securities Exchange Act section 13(d) requires that any person who acquires beneficial ownership of more than 5 percent of the outstanding shares of any class of equity stock in a given issuer must file a report within ten days of such acquisition with the SEC, the issuer, and the exchanges on which the stock is traded.[42] Persons required to file a Schedule 13D must provide extensive disclosure. Those disclosures impinge substantially on investor privacy and thus may discourage some investors from holding blocks greater than 4.9 percent of a company's stock. Section 13(d) also discourages collaboration by groups of investors because it applies the disclosure obligation to two or more persons acting as a group for the purpose of acquiring, holding, or disposing of stock whose aggregate holdings exceed the 5 percent threshold.

40. *See generally* Bayless Manning, Book Review, 67 YALE L.J. 1477, 1485–89 (1958) (reviewing J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958)) (describing incumbent control of the proxy voting machinery).

41. Large block formation also may be discouraged by state corporate law rules governing minority shareholder protections. Under Delaware law, a controlling shareholder has fiduciary obligations to the minority. *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947). A controlling shareholder who uses his power to force the corporation to enter into contracts with the shareholder or his affiliates on unfair terms can be held liable for the resulting injury to the minority. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). A controlling shareholder who uses his influence to effect a freeze-out merger in which the minority shareholders are bought out at an unfairly low price likewise faces liability. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983).

42. Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m (2000).

b. Shareholder Communication Rules

Because of the separation of ownership and control mandated by U.S. corporate law, even quite substantial shareholders are relatively powerless. Instead, to the extent they exercise any control over the corporation, they do so only through control of the board of directors. As such, it is the shareholder's ability to affect the election of directors that determines the degree of influence he will hold over the corporation. The proxy regime under Securities Exchange Act section 14(a) not only discourages large shareholders from seeking to replace incumbent directors with their own nominees, but also discourages shareholders from communicating with one another.[43] Anyone who solicits a proxy must go to the expense of preparing and disseminating both a proxy card and a proxy statement. The definition of solicitation for this purpose is quite broad. The federal proxy rules "apply not only to direct requests to furnish, revoke or withhold proxies, but also to communications which may indirectly accomplish such a result or constitute a step in a chain of communications designed ultimately to accomplish such a result."[44] Hence, shareholders who communicate with one another run some risk of being deemed to have solicited proxies. The risk of liability and being put to the expense of conducting a proxy solicitation doubtless chills shareholder communication. To be sure, the SEC's 1992 amendments to the proxy rules modestly liberalized the proxy regime with the avowed intention of allowing greater shareholder activism. Experience teaches that these changes, however, were far too modest to have any significant effect.[45] The barriers to collective action by institutional investors and other large shareholders remain high enough to substantially deter shareholder activism in the electoral arena.[46]

c. Insider Trading Rules

Full treatment of the complex federal securities laws governing insider trading is well beyond the scope of this section.[47] Yet, it is important to

43. Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n.
44. Long Island Lighting Co. v. Barbash, 779 F.2d 793, 796 (2d Cir. 1985).
45. *See, e.g.*, Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233, 235 (2000).
46. In lieu of conducting a full-blown proxy contest (or engaging in conduct that might be deemed a proxy solicitation), institutional investors sometimes avail themselves of the option provided by Securities and Exchange Commission (SEC) Rule 14a-8 to place a shareholder proposal on the company's proxy statement. *See* 17 C.F.R. § 240.14a-8 (2005). As a governance device, however, the shareholder proposal rule is a relatively weak instrument.
47. *See generally* STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING (1999).

acknowledge that those laws substantially impinge the ability of shareholders holding large blocks to affect corporate policy and governance. Large block holders frequently get greater access to nonpublic information than do other investors. Where the large shareholder has board representation, this will inevitably be true. Even where the large holder lacks formal board representation, however, it may often benefit from selective disclosures by management. In either case, disclosure of information to large block shareholders raises serious insider trading concerns.

In addition, the short swing profits provision of Securities Exchange Act section 16(b) provides a substantial deterrent to holding large blocks of stock.[48] An institutional investor (or any other shareholder) who owns more than 10 percent of a public corporation's stock will find its liquidity substantially reduced. If market developments make it desirable to sell some or all of the investor's holdings, the investor may lose some or even all of its gains on that sale. Because reduced liquidity equates to enhanced risk, investors are discouraged from holding blocks greater than 9.9 percent.

3. Net Effect: The "Wall Street" Rule

Many investors, especially institutions, rationally prefer liquidity to activism. For fully diversified investors even the total failure of a particular firm will not have a significant effect on their portfolio, and may indeed benefit them to the extent they also hold stock in competing firms. Such investors might prove less likely to become involved in corporate decisionmaking and are more likely to simply use an activist's call for action as a signal to follow the so-called "Wall Street" Rule (it's easier to switch than fight—a play on an old cigarette advertisement) and switch to a different investment before conditions further deteriorate.

B. The Survival Value of the Separation of Ownership and Control

Do the restrictions on shareholder activism matter? The 1932 publication of Adolf Berle and Gardiner Means's *The Modern Corporation and Private Property* began the modern era of corporate governance scholarship. Berle and Means demonstrated that public corporations were characterized by a separation of ownership and control—the firm's nominal owners, the shareholders, exercised virtually no control over either day-to-day operations or long-term policy. Instead, control was vested in the hands of professional

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48. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p.

managers, who typically owned only a small portion of the firm's shares. Separation of ownership and control occurred, according to Berle and Means, because stock ownership was dispersed among many shareholders, none of whom owned enough shares to materially affect the corporation's management. Berle and Means believed that this separation of ownership and control was both a departure from historical norms and a serious economic problem.[49] They were wrong on both counts.

According to Berle and Means's version of economic history, dispersed ownership arose as a consequence of the development of large capital-intensive industrial corporations during the late nineteenth century. These firms required investments far larger than a single entrepreneur or family could provide, which could be obtained only by attracting funds from many investors. Because small investors needed diversification, even very wealthy individuals limited the amount they would put at risk in any particular firm, further fragmenting share ownership. The modern separation of ownership and control was the direct result of these forces, or so the story goes.

Professor Walter Werner aptly referred to Berle and Means's account as the "erosion doctrine."[50] According to their version of history, there was a time when the corporation behaved as it was supposed to:

> The shareholders who owned the corporation controlled it. They elected a board of directors to whom they delegated management powers, but they retained residual control, uniting control and ownership. In the nation's early years the states created corporations sparingly and regulated them strictly. The first corporations, run by their proprietors and constrained by law, exercised state-granted privileges to further the public interest. The states then curtailed regulation . . . and this Eden ended. The corporation expanded into a huge concentrate of resources. Its operation vitally affected society, but it was run by managers who were accountable only to themselves and could blink at obligations to shareholders and society.[51]

The erosion doctrine, however, rested on a false account of the history of corporations. Werner explained that economic separation of ownership and control in fact was a feature of American corporations almost from the beginning of the nation:

> Banks, and the other public-issue corporations of the [antebellum] period, contained the essential elements of big corporations today: a tripartite internal government structure, a share market that dispersed shareholdings

49. BERLE & MEANS, *supra* note 7, at 6–7.
50. Walter Werner, *Corporation Law in Search of Its Future*, 81 COLUM. L. REV. 1611, 1612 (1981).
51. *Id.* at 1612.

> and divided ownership and control, and tendencies to centralize management in full-time administrators and to diminish participation of outside directors in management.[52]

In contrast to Berle and Means's account, which rested on technological changes during the nineteenth century, this alternative account rests on the early development of secondary trading markets. Such markets existed in New York and Philadelphia by the beginning of the nineteenth century. The resulting liquidity of corporate stock made it an especially attractive investment, which in turn made selling stock to the public an attractive financing mechanism. Stocks were purchased by a diversified and dispersed clientele,[53] including both institutions and individuals. The national taste for speculation also played a part in the early growth of the secondary trading markets and, in turn, to dispersal of stock ownership. As a result of these economic forces, ownership and control separated not at the end of the nineteenth century, but at its beginning.

If this version of history is correct, there never was a time in which unity of control and ownership was a central feature of U.S. corporations. To the contrary, it appears that ownership and control separated at a very early date. In turn, this analysis suggests that the separation of ownership and control may be an essential economic characteristic of such corporations.

Economists Armen Alchian and Harold Demsetz famously claimed that the firm "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people."[54] Hence, Alchian and Demsetz argued, an employer's control over its employees differs not at all from the power of a consumer over the grocer with whom the consumer does business.

If fiat is not an essential attribute of "firm-ishness," the firm would be nothing more than a quasi-market arena within which a set of contracts between various factors of production are constantly renegotiated. It is not. Power exists within firms, and it matters. The corporation has a nexus—and

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52. *Id.* at 1637.

53. A slightly different version of this story is told by Herbert Hovenkamp, who argues that separation of ownership and control is less a function of firm size than of firm complexity. Under this model, neither technological change nor corporate financing was the dispositive factor. Rather, ownership and control separated when, because of a high degree of vertical integration, firms became sufficiently complex to require professional managers. HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836–1937, at 357–60 (1991). Notice the close fit between this interpretation and the economic model advanced here. Under both, the unique attribute of modern public corporations is a hierarchical decisionmaking structure adopted as an adaptive response to organizational complexity.

54. Alchian & Demsetz, *supra* note 34, at 777.

that nexus wields a power of fiat different from that of a consumer over a grocer. Indeed, fiat is the chief characteristic that distinguishes firms from markets. As economist Ronald Coase explained long ago, firms emerge when it is efficient to substitute entrepreneurial fiat for the price mechanisms of the market.[55] One team member is empowered to constantly and, more importantly, unilaterally rewrite certain terms of the contract between the firm and its various constituents. By creating a central decisionmaker—a nexus—with the power of fiat, the firm thus substitutes ex post governance for ex ante contract.

Granted, coordination can be achieved without fiat, as demonstrated by the more-or-less democratic decisionmaking processes of many partnerships and other small firms. In the public corporation, however, fiat is essential. As we saw in Part I, all organizations must have some mechanism for aggregating the preferences of the organization's constituencies and converting them into collective decisions. As we also saw there, such mechanisms fall on a spectrum between "consensus" and "authority." Recall that authority-based decisionmaking structures—characterized by the existence of a central office empowered to make decisions binding on the firm as a whole—arise where the firm's constituencies have different interests and access to information. The necessity of a literal nexus—a center of power capable of exercising fiat—within the corporation thus follows as a matter of course from the asymmetries of information and interests among the corporation's various constituencies. Shareholders care about the value of the residual claim on the corporation. Customers care about the quality and quantity of the goods produced by the corporation. Workers care about salary and conditions of employment. And so on. Under such conditions, efficient decisionmaking demands an authority-based governance structure.

Insofar as shareholders are concerned, at the most basic level, the mechanical difficulties of achieving consensus among thousands of decisionmakers impede shareholders from taking an active role. Put another way, in large corporations, authority-based decisionmaking structures are desirable because of the potential for division and specialization of labor. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize. Directors and managers specialize in the efficient coordination of other specialists. In order to reap the benefits of specialization, all other corporate constituents should prefer to specialize in functions unrelated to decisionmaking, such as risk-bearing (shareholders) or labor (employees), delegating

55. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386, 393–94 (1937).

decisionmaking to the board and senior management. This natural division of labor, however, requires that the chosen directors and officers be vested with discretion to make binding decisions. Separating ownership and control by vesting decisionmaking authority in a centralized nexus distinct from the shareholders and all other constituents is what makes the large public corporation feasible.

Even if one could overcome the seemingly intractable collective action problems plaguing shareholder decisionmaking, active shareholder participation in corporate decisionmaking would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information. Although neoclassical economics assumes that shareholders come to the corporation with wealth maximization as their goal, and most presumably do, once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course would maximize share value. To be sure, as noted in Part I, shareholder interests are less fragmented than those of the corporation's multiple constituencies taken as a whole, but as Professor Iman Anabtawi nevertheless observes: "On close analysis, shareholder interests look highly fragmented."[56] She documents divergences among investors along multiple fault lines: short-term versus long-term, diversified versus undiversified, inside versus outside, social versus economic, and hedged versus unhedged.[57] Shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, for example, which in turn is likely to result in disagreements about corporate strategy. Even more prosaically, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as are shareholders who disagree about the merits of allowing management to invest the firm's free cash flow in new projects.

As to Arrow's information condition, shareholders lack incentives to gather the information necessary to actively participate in decisionmaking. A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs. Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have significant effect on the vote's outcome. As seen in Part I, corporate shareholders thus are rationally apathetic.

56. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006).
57. *Id.* at 579–92.

The efficient capital markets hypothesis provides yet another reason for shareholders to eschew active participation in the governance process. If the market is a reliable indicator of performance, as the efficient capital markets hypothesis claims, investors can easily check the performance of companies in which they hold shares and compare their current holdings with alternative investment positions. An occasional glance at the stock market listings in the newspaper is all that is required. Because it is so much easier to switch to a new investment than to fight incumbent managers, a rational shareholder will not even care why a firm's performance is faltering. With the expenditure of much less energy than is needed to read corporate disclosure statements, he will simply sell his holdings in the struggling firm and move on to other investments.[58]

Consequently, it is hardly surprising that the modern public corporation's decisionmaking structure precisely fits Arrow's model of an authority-based decisionmaking system. Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly, of course. Even if one could do so, moreover, shareholders lack both the information and the incentives necessary to make sound decisions on either operational or policy questions.[59] Under these conditions, it is "cheaper and more efficient to transmit all the pieces of information once to a central place" and to have the central office "make the collective decision and transmit it rather than retransmit all the information on which the decision is based."[60] Accordingly, shareholders will prefer to irrevocably delegate decisionmaking authority to some smaller group, as, in the long run, this will maximize shareholder wealth.

58. Finally, portfolio theory offers yet another justification for separating ownership and control. By virtue of their nondiversified investment in firm specific human capital, managers bear part of the risk of firm failure. As the firm's residual claimants, however, shareholders also bear a portion of the risk associated with firm failure. Portfolio theory tells us that individual shareholders can minimize that risk through diversification, which managers cannot do with respect to their human capital. *See* Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 IOWA J. CORP. L. 565, 574 (2003) ("Portfolio theory teaches that shareholders can and should diversify. Corporate managers, however, often have considerable firm-specific human capital, and much of their financial wealth is likewise often tied up in the firm.") Separating ownership and control thus unbundles the risks associated with the firm and allocates each of those risks to the party who can bear it at the lowest cost. I regard this explanation as somewhat problematic, however, due to its managerialist overtones.

59. As seen in Part I, similar analyses apply to other corporate constituents on whose behalf claims to control of the decisionmaking apparatus might be made, such as employees or creditors.

60. ARROW, *supra* note 11, at 68. In the dominant M-form corporation, the board of directors and the senior management team function as that central office. *See* Bainbridge, *supra* note 16, at 671 (discussing M-form corporations).

What is that group? The Delaware Code, like the corporate law of virtually every other state, gives us a clear answer: The corporation's "business and affairs . . . shall be managed by or under the direction of a board of directors."[61] Hence, as an early New York decision put it, the board's powers are "original and undelegated."[62]

To be sure, the separation of ownership and control creates a principal-agent problem, as Berle and Means explained: "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge . . . ."[63] As we have seen, associated with the shareholders' purchase of the residual claim on the corporation's assets and profits is an obligation on the part of the board of directors and managers to maximize shareholder wealth.[64] Will the board of directors use its control of the corporation to further the selfish interest of the board members rather than the best interests of the corporation's shareholders and other constituencies? To ask the question is to answer it. Given human nature, it would be surprising indeed if directors did not sometimes shirk or self-deal. Consequently, much of corporate law is best understood as a mechanism for constraining agency costs.

A narrow focus on agency costs, however, can easily distort one's understanding. In the first instance, corporate managers operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents.

Secondly, agency costs are the inescapable result of placing ultimate decisionmaking authority in the hands of someone other than the residual claimant. Neither the power to wield discretionary authority nor the necessity to ensure that power is used responsibly can be ignored, because both promote values essential to the survival of business organizations.[65] Unfortunately,

61. DEL. CODE ANN. tit. 8, § 141(a) (2001). For a summary of comparable state corporation code provisions, see MODEL BUS. CORP. ACT ANNOTATED § 8.01, at 8-9 to 8-10 (3d ed. Supp. 2002).

62. Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918). This line of argument is developed in more detail in my articles on the director primacy model of corporate governance, especially Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003). For a constructive critique of my director primacy model, see Wayne O. Hanewicz, *Director Primacy, Omnicare, and the Function of Corporate Law*, 71 TENN. L. REV. 511, 512 (2004). For an instructive application of the model to shareholder voting, see Harry G. Hutchison, *Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm*, 36 LOY. U. CHI. L.J. 1111 (2005).

63. BERLE & MEANS, *supra* note 7, at 6.

64. *See supra* text accompanying note 10.

65. *Cf.* Dooley, *supra* note 24, at 471.

however, they also are antithetical.[66] Because the power to hold to account differs only in degree and not in kind from the power to decide, one cannot have more of one without also having less of the other. As Kenneth Arrow explained:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[67]

Hence, directors cannot be held accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question.

The central argument against shareholder activism thus becomes apparent. Active investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, as some have suggested, but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."[68] While some argue that shareholder activism "differs, at least in form, from completely *shifting* authority from managers to 'bankers,'"[69] it is in fact a difference in form only. Shareholder activism necessarily contemplates that institutions will review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel. For the reasons identified above, giving investors this power of review differs little from giving them the power to make management decisions in the first place. Even though investors probably would not micromanage portfolio corporations, vesting them with the power to review board decisions inevitably shifts some portion of the board's authority to them. This remains true even if only major decisions of A are reviewed by B. The board directors of

66. *Id.*
67. ARROW, *supra* note 11, at 78.
68. *Id.* at 69.
69. ROE, *supra* note 25, at 184.

General Motors, after all, no more micromanages GM than would a coalition of activist institutional investors, but it is still in charge.

If the foregoing analysis has explanatory power, it might fairly be asked, why do we observe any restrictions on the powers of the board of directors or any prospect for them to be ousted by shareholders via a takeover or proxy contest? Put another way, why do we observe any right for shareholders to vote?

In the purest form of an authority-based decisionmaking structure, all decisions would be made by a single, central body—here, the board of directors. If authority were corporate law's sole value, shareholders in fact likely would have no voice in corporate decisionmaking. As we have seen, however, authority is not corporate law's only value, because we need some mechanism for ensuring director accountability with respect to those rights for which shareholders and other constituencies have contracted. Recall that director primacy views the corporation as a vehicle by which directors bargain with factors of production. All corporate constituencies thus end up with certain bargained-for contractual rights, including the shareholders. Chief among the shareholders' contractual rights is one requiring the directors to use shareholder wealth maximization as their principal decisionmaking norm.[70] Like many intracorporate contracts, however, the shareholder wealth maximization norm does not lend itself to judicial enforcement except in especially provocative situations.[71] Instead, it is enforced indirectly through a complex and varied set of extrajudicial accountability mechanisms, of which shareholder voting is just one.

Importantly, however, like all accountability mechanisms, shareholder voting must be constrained in order to preserve the value of authority. As Arrow observes: "To maintain the value of authority, it would appear that [accountability] must be intermittent. This could be periodic; it could take the form of what is termed 'management by exception,' in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations . . . ."[72] Accordingly, shareholder voting is properly understood not as an integral aspect of the corporate decisionmaking structure, but rather as an accountability device of last resort to be used sparingly, at best. Indeed, as Robert Clark observes, the proper way in which shareholder voting rights are used to hold corporate directors and officers accountable is not through

70. *See* BAINBRIDGE, *supra* note 10, at 419–29 (explaining why shareholder wealth maximization would emerge from hypothetical bargaining between directors and shareholders even in the director-primacy model).

71. *See id.* at 422 (noting that "the business judgment rule (appropriately) insulates directors from liability" in this context).

72. ARROW, *supra* note 11, at 78.

the exercise of individual voting decisions, but rather collectively in the context of a takeover.[73] Because shares are freely transferable, a bidder who believes the firm is being run poorly can profit by offering to buy a controlling block of stock at a premium over market and subsequently displacing the incumbent managers, which presumably will result in an increase in firm value exceeding the premium the bidder paid for control. Hence, just as one might predict based on Arrow's analysis, shareholder voting properly comes into play as an accountability mechanism only "when [management] performance is sufficiently degraded from expectations" to make a takeover fight worth waging.[74]

In sum, given the significant virtues of discretion, one ought not lightly interfere with management or the board's decisionmaking authority in the name of accountability. Indeed, the claim should be put even more strongly: Preservation of managerial discretion should always be the default presumption. Because the separation of ownership and control mandated by U.S. corporate law has precisely that effect, by constraining shareholders both from reviewing most board decisions and from substituting their judgment for that of the board, that separation has a strong efficiency justification.

C. The Rise of Institutional Investors

In the 1990s, a number of academics began arguing that shareholder activism could become an important constraint on agency costs within the firm.[75] Acknowledging that the rational apathy phenomenon would largely preclude small individual shareholders from playing an active role in corporate governance, even if the various legal impediments to shareholder activism were removed, these scholars focused their attention on institutional investors, such as pension and mutual funds.

Institutional investors, at least potentially, may approach corporate governance quite differently than dispersed individual investors. Because they own large blocks and have an incentive to develop specialized expertise in

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73. ROBERT CHARLES CLARK, CORPORATE LAW 95 (1986).

74. Space does not permit an evaluation here of whether shareholders therefore ought to have unfettered rights to accept any takeover offer or, to put it another way, whether the board of directors properly has a gatekeeping function even with respect to corporate takeovers. I argue in favor of such a board function in BAINBRIDGE, *supra* note 10, at 805–17.

75. *See, e.g.*, ROE, *supra* note 25; Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For more skeptical analyses, see Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671 (1995) (reviewing ROE, *supra* note 25); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).

making and monitoring investments, they could play a far more active role in corporate governance than dispersed shareholders. Institutional investors holding large blocks have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, will enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lags. Corporations with large blocks of stock held by institutional investors thus might reunite ownership of the residual claim and ultimate control of the enterprise. As a result, concentrated ownership in the hands of institutional investors might lead to a reduction in shirking and, hence, a reduction in agency costs. Or so the story went.

1. The Realities of Institutional Investor Activism

In the early 1990s, it seemed possible that this theory would be realized. Institutional investors increasingly dominated U.S. equity securities markets. They also began to play a somewhat more active role in corporate governance than they had in earlier periods, taking their voting rights more seriously and using the proxy system to defend their interests. They began voting against takeover defenses proposed by management and in favor of shareholder proposals recommending removal of existing defenses. Many institutions also no longer routinely voted to reelect incumbent directors. Less visibly, institutions influenced business policy and board composition through negotiations with management. But while there seemed little doubt that institutional investor activism would have some effect, the question remained whether the impact would be more than merely marginal.

By the end of the 1990s, the answer seemed to be no. A comprehensive survey found relatively little evidence that shareholder activism mattered.[76] Even the most active institutional investors spent only trifling amounts on corporate governance activism. Institutions devoted little effort to monitoring management; to the contrary, they typically disclaimed the ability or desire to decide company-specific policy questions. They rarely conducted proxy solicitations or put forward shareholder proposals. They did not seek to elect representatives to boards of directors. They rarely coordinated their

76. 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). Due to a resurgence of direct individual investment in the stock market, motivated at least in part by the day trading phenomenon and the technology stock bubble, the trend towards institutional domination stagnated. Large blocks held by a single investor remained rare: Few U.S. corporations had any institutional shareholders who owned more than 5–10 percent of their stock.

activities. Most importantly, empirical studies of U.S. institutional investor activism found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions."[77]

Today, institutional investor activism remains rare. It is principally the province of public and union pension funds. The chief exception to that rule, as of this writing, is an apparent increase in the willingness of private hedge funds to exercise the limited control rights granted to shareholders. But while these investors' activities generate considerable press attention, they can hardly be said to have reunited ownership and control.

This conclusion should not be particularly surprising. Because institutional investors generally are profit maximizers, they will not engage in an activity whose costs exceed its benefits. Even ardent proponents of institutional investor activism concede that institutions are unlikely to be involved in day-to-day corporate matters. Instead, they are likely to step in only where there are serious long-term problems. Because it is impossible to predict ex ante which corporations are likely to experience such problems, however, activist institutions will be obliged to monitor all of their portfolio firms.[78] Because corporate disclosures rarely give one a full picture of the corporation's prospects, moreover, additional and more costly monitoring mechanisms must be established.

Monitoring costs are only the beginning, of course. Once a problem firm is identified, the activist institution must take steps to address the problem. In some cases, it may suffice for the activist institution to raise the problem with management. Less tractable problems will necessitate more extreme remedial measures, however, such as removal of the incumbent board of directors.

Outside the unlikely limiting case in which the activist institution controls a majority of the stock, such measures necessarily require the support of other shareholders, which makes a shareholder insurrection against inefficient but entrenched managers a costly and difficult undertaking. Despite the considerable institutionalization of U.S. equity markets, stock ownership of domestic

77. *Id.* at 462.

78. It is for this reason that Professor Black's economies of scale arguments fail. Black contends that activist investors will find that issues of monitoring cut across a wide range of companies, which will permit them to make use of economies of scale by developing standard responses to managerial derelictions, *see* Black, *supra* note 75, at 580–84, while nonactivist investors can obtain economies of scale by developing standardized voting procedures. *Id.* at 589–91. If institutional activism is more likely to take the form of crisis intervention, however, such economies of scale are unlikely to be obtained because different crises will necessitate differing responses. At most, we might expect institutions to adopt standard voting practices on issues such as takeover defenses, which are low-cost techniques consistent with observed institutional behavior. It is also consistent with the thesis that only marginal effects should be expected from institutional activism.

corporations remains relatively widely dispersed. A shareholder insurrection therefore requires support from a relatively large number of investors.

Putting together a winning coalition will require, among other things, ready mechanisms for communicating with other investors. Unfortunately, SEC rules on proxy solicitations, stock ownership disclosure, and controlling shareholder liabilities have long impeded communication and collective action. Even though the 1992 SEC rule amendments somewhat lowered the barriers to collective action, important impediments remain.[79]

Yet even if there were further erosion in the barriers to shareholder communication, coordinating shareholder activism may remain a game not worth playing. Individual investors doubtless will remain passive. Institutions likewise have an incentive to remain passive. Many institutional investors will prefer liquidity to activism. For fully diversified institutions even the total failure of a particular firm will not have a significant effect on their portfolio, and may indeed benefit them to the extent they also hold stock in competing firms.[80] Such investors may prove less likely to join the insurgent coalition than to simply use the activist's call for action as a signal to follow the Wall Street Rule and switch to a different investment before conditions further deteriorate.

79. *See* Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1, 49–52 (1992).

80. *See* Dooley, *supra* note 24, at 526. In addition, note that corporate managers are well-positioned to buy off most institutional investors that attempt to act as monitors. Bank trust departments are an important class of institutional investors, but are unlikely to emerge as activists because their parent banks often have or anticipate commercial lending relationships with the firms they purportedly will monitor. Similarly, insurers "as purveyors of insurance products, pension plans, and other financial services to corporations, have reason to mute their corporate governance activities and be bought off." ROE, *supra* note 25, at 62.

The potential for conflicts of interest becomes especially obvious when we turn to private pension funds. Under current law, private pension funds are essentially disabled from corporate governance activism because "corporate managers dominate pension managers, not the other way around." *Id.* at 225. As Roe has explained in considerable detail, existing law vests management with control over pension fund activities, including their corporate governance activities. *Id.* at 124–38. This gives management a great deal of leverage to prevent governance activism by private pension funds. During the takeover battles of the late 1980s, for example, managers of target corporations not only pressured their own firm's pension fund managers to oppose a hostile raid, but some also enlisted other corporate managers to pressure their pension fund managers to oppose the raid. ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 191–93 (1991). A variety of other rules, such as the prudent investor rule, further incline pension managers to passivity: Is it prudent, for example, to expend resources on governance activities that have an uncertain payoff? ROE, *supra* note 25, at 138–43. Taken together, these factors render private pension funds an unlikely source of investor activism.

Instead, investor activism largely has been confined to union and state and local public employee pension funds. As we shall see, however, those funds have private interests that make them undesirable activists. *See infra* note 88.

Institutions that must compete to attract investor funds will be especially susceptible to the incentive to follow the Wall Street Rule. Activism (or even seeking to free ride on another institution's activism) requires that the institution hold a long position on stocks of underperforming corporations. Doing so will act as a drag on the performance of the institution's portfolio, making it more difficult for the institution to beat the key benchmarks against which its performance will be measured by current and prospective investors. Even if activism occasionally results in long-term gains, institutions under pressure to produce short-term results likely would prefer to switch than fight.

Activism is also inconsistent with prevailing financial theories about investing. Indeed, the logical implication of the efficient capital markets theory and portfolio theory is that the best investment approach is passive indexing, which in fact has become a widely followed strategy among both individual and institutional investors.[81] Because expense minimization is an important aspect of passive indexing strategies, investors following this approach are unlikely to become active governance players.[82] Taken together with the factors mentioned above, all of this will make assembling a winning coalition a difficult and expensive task.

Turning from the cost to the benefit side of the equation, corporate governance activism is unattractive in the first instance because activism is unlikely to produce frequent gains. As we have seen, because many companies must be monitored, and because careful monitoring of an individual firm is expensive, institutional activism is likely to focus on crisis management. In many crises, however, institutional activism is unlikely to be availing. In some cases, intervention will come too late. In others, the problem may prove intractable, as where technological changes undercut the firm's competitive position.

Activism is problematic, in the second instance, because on those occasions in which gains might arise from activism, only a portion of them would accrue to the activist institutions. Suppose that the troubled company has 110 outstanding shares, currently trading at $10 per share, of which the potential activist institution owns ten. The institution correctly believes that the firm's shares would rise in value to $20 if the firm's problems are solved. If the institution is able to effect a change in corporate policy, its ten shares will

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81. BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 422–28 (6th ed. 1996).

82. Two factors are important. First, because index funds hold stock in hundreds or even thousands of firms, monitoring every firm in their portfolio would chew up most of the transaction costs saved by an indexing strategy. Rosenbaum, *supra* note 75, at 182. Second, as just noted, well-diversified institutions have little reason to be concerned about the fate of individual firms. Indeed, for an indexed firm, the failure of one firm in its portfolio may lead to profits if the stock of competing firms rises. *Id.* Indexed funds are thus unlikely to see the costs of activism as worth bearing.

produce a $100 paper gain when the stock price rises to reflect the company's new value. All the other shareholders, however, will also automatically receive a pro rata share of the gains.[83] As a result, the activist institution confers a gratuitous $1000 benefit on the other shareholders.

All of this makes institutional activism a classic example of a situation in which free riding is highly likely. In a very real sense, the gains resulting from institutional activism are a species of public good. They are costly to produce, but because other shareholders cannot be excluded from taking a pro rata share, they are subject to a form of nonrivalrous consumption. As with any other public good, the temptation arises for shareholders to free ride on the efforts of those who produce the good. To be sure, as stock concentrates in the hands of large institutional investors, there will be marginal increases in the gains to be had from activism and a marginal decrease in its costs.[84] A substantial increase in activism seems unlikely, however. Consider that most institutional investors are competing with one another to attract either the savings of small investors or the patronage of large sponsors, such as corporate pension plans. Competition in this context is generally concerned with relative performance rates.[85] This makes institutions and money managers highly cost-conscious.[86] Given that activism will only rarely produce gains, and that when such gains occur they will be dispensed upon both the active and the passive, it makes little sense for cost-conscious money managers to incur the expense entailed in shareholder activism. Instead, they will remain passive in hopes of free riding on someone else's activism. As in other free riding situations, because everyone is subject and likely to yield to this temptation, the probability is that the good in question—here shareholder activism—will be underproduced.

2. The Costs of Institutional Investor Activism

Let us assume, however, that legal change could promote institutional investor activism. Would such reforms be desirable? In short, no. The agency cost-reducing benefits of institutional control come at too high a cost. There is evidence, for example, that bank control of the securities markets has harmed the Japanese and German economies by impeding the development

83. One plausibly could expect institutions to surmount this problem by seeking private benefits, which makes investor activism even less appealing. *See infra* note 88.

84. Rock, *supra* note 75, at 460–63.

85. *Id.* at 473–74.

86. *Id.*

of new businesses.[87] Increased institutionalization of the capital markets thus might impede the active venture capital market that helps drive the U.S. economy.

Because we are concerned with the internal governance of corporations, however, our attention focuses on a different concern: the risk that institutional investors may abuse their control by self-dealing and other forms of overreaching. The interests of large and small investors often differ. As management becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors.

Institutional investors with substantial decisionmaking influence will be tempted to use their position to self-deal; that is, to take a non–pro rata share of the firms assets and earnings.[88] Let us make the heroic assumption, however,

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87. *See generally* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243 (1998); Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865 (1997).

88. It is therefore instructive that the most activist institutions—union and state and local employee pension funds—may have interests that diverge substantially from those of other investors. The pension fund of the union representing Safeway workers, for example, used its position as a Safeway shareholder in an attempt to oust directors who had stood up to the union in collective bargaining negotiations. Stephen M. Bainbridge, *Flanigan on Union Pension Fund Activism*, http://www.professorbainbridge.com/2004/04/flanigan_on_uni.html (Apr. 18, 2004). This is not an isolated example. According to a 2004 news report, for example, union pension funds tried to remove directors or top managers, or otherwise affect corporate policy, at over 200 corporations in that single year. *Id.* Union pension funds reportedly also have tried shareholder proposals to obtain employee benefits they couldn't get through bargaining. *Id.* More generally, at least some of the funds involved are highly politicized and therefore likely to use their position as a vehicle for advancing political or social goals unrelated to shareholder interests generally.

Public employee pension funds are even more vulnerable to being used for such ends. Recent activism by the California Public Employees' Retirement System (CalPers), for example, reportedly is being "fueled partly by the political ambitions of Phil Angelides, California's state treasurer and a CalPers board member, who is considering running for governor of California in 2006." Stephen M. Bainbridge, *Pension Funds Play Politics*, TECH CENTRAL STATION (Apr. 21, 2004), http://www.techcentralstation.com/042104G.html (last visited Dec. 13, 2005). In other words, Angelides allegedly used the retirement savings of California's public employees to further his own political ends.

Using pension fund investments to support so-called socially responsible investments has long been a particularly popular program of politicians and others on the left. Some have gone so far as to suggest that "the road to socialism, or some substantial socialization of the investment process, might lie through an expanded, publicly regulated system of pension finance." William H. Simon, *The Prospects of Pension Fund Socialism*, *in* CORPORATE CONTROL AND ACCOUNTABILITY: CHANGING STRUCTURES AND THE DYNAMICS OF REGULATION 165, 165–66 (Joseph McCahery et al. eds., 1993). Somewhat to the right of that position was President Clinton's call for a "Rebuild America Fund," which would have leveraged federal funding by tapping "state, local, private sector, and pension fund contributions." BILL CLINTON & AL GORE, PUTTING PEOPLE FIRST: HOW WE CAN ALL CHANGE AMERICA 144 (1992). Although that proposal never came to fruition, the Clinton Department of Labor did encourage pension funds to make "economically targeted that institutional investors are entirely selfless. Institutional investor activism would still be undesirable precisely because the separation of ownership and control mandated by U.S. law has substantial efficiency benefits. Nothing about the rise of institutional investors changes the analysis in the preceding section or requires a differing conclusion with respect to the basic director-primacy claim that shareholder voting rights must be limited in order to preserve the board's authority against shareholder challenges.[89]

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investments" in such areas as infrastructure, affordable housing, and job creation. Jim Saxton, *A Raid on America's Pension Funds*, WALL ST. J., Sept. 29, 1994, at A12.

Roberta Romano has voiced similar concerns. She observes that "the empirical studies suggest that [shareholder activism] has an insignificant effect on targeted firms' performance. Very few studies find evidence of a positive impact, and some even find a significant negative stock price effect from activism." Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE. J. ON REG. 174, 177 (2001). Given the lack of evidence for positive effects, she suggests that activism by such investors has private benefits for those who manage the funds:

> It is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. The disparity in identity of sponsors—the predominance of public and union funds, which, in contrast to private sector funds, are not in competition for investor dollars—is strongly suggestive of their presence. Examples of potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, as well as advancements in personal employment . . . . Because such career concerns—enhancement of political reputations or subsequent employment opportunities—do not provide a commensurate benefit to private fund managers, we do not find them engaging in investor activism.

Id. at 231–32 (footnote omitted).

89. The analysis to this point suggests that the costs of institutional investor activism likely outweigh any benefits such activism may confer with respect to redressing the principal-agent problem. Even if one assumes that the cost-benefit analysis comes out the other way, however, it should be noted that institutional investor activism does not solve the principal-agent problem but rather merely relocates its locus.

The vast majority of large institutional investors manage the pooled savings of small individual investors. From a governance perspective, there is little to distinguish such institutions from corporations. The holders of investment company shares, for example, have no more control over the election of company trustees than they do over the election of corporate directors. Accordingly, fund shareholders exhibit the same rational apathy as corporate shareholders. Kathryn McGrath, a former SEC mutual fund regulator, observes: "A lot of shareholders take ye olde proxy and throw it in the trash." Karen Blumental, *Fidelity Sets Vote on Scope of Investments*, WALL ST. J., Dec. 8, 1994, at C1. The proxy system thus "costs shareholders money for rights they don't seem interested in exercising." *Id.* Indeed, "Ms. McGrath concedes that she herself often tosses a proxy for a personal investment onto a 'to-do pile' where 'I don't get around to reading it, or when I do, the deadline has passed.'" *Id.* Nor do the holders of such shares have any greater access to information about their holdings, or ability to monitor those who manage their holdings, than do corporate shareholders. Worse yet, although an individual investor can always abide by the "Wall Street" Rule with respect to corporate stock, he cannot do so with respect to such investments as an involuntary, contributory pension plan.

For beneficiaries of union and state and local government employee pension funds, the problem is particularly pronounced. As we have seen, those who manage such funds may often put their personal or political agendas ahead of the interests of the fund's beneficiaries. Accordingly,

CONCLUSION

The director primacy-based system of U.S. corporate governance has served investors and society well. John Micklethwait and Adrian Wooldridge, for example, recently opined that the company is "the basis of the prosperity of the West and the best hope for the future of the rest of the world."[90]

A comprehensive review of the evidence by Bengt Holmstrom and Steven Kaplan is temperate only by comparison. Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades, including the period since the most recent scandals broke. In other words, the broad evidence is not consistent with a failed U.S. system. If anything, it suggests a system that is well above average.[91]

The thesis of this Article is that this record of success has occurred not in spite of the separation of ownership and control, but because of that separation. Before making further changes of the sort described at the outset, it would be prudent to give the changes already made time to work their way through the system. To the extent additional change or reform is thought desirable, it should be in the nature of minor modifications to the newly adopted rules designed to enhance their performance, rather than radical and unprecedented shifts in the system of corporate governance that has existed for decades.

it is not particularly surprising that pension funds subject to direct political control tend to have poor financial results. Romano, *supra* note 75, at 825.

90. JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA, at xv (2003).

91. Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* (2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441100.