

6-1-1995

Regulatory Competiton, Regulatory Capture, and Corporate Self-Regulation

William W. Bratton

Joseph A. McCahery

Follow this and additional works at: <http://scholarship.law.unc.edu/nclr>Part of the [Law Commons](#)

Recommended Citation

William W. Bratton & Joseph A. McCahery, *Regulatory Competiton, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995).Available at: <http://scholarship.law.unc.edu/nclr/vol73/iss5/3>

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

REGULATORY COMPETITION, REGULATORY CAPTURE, AND CORPORATE SELF-REGULATION

WILLIAM W. BRATTON[†]

AND

JOSEPH A. MCCAHERY^{††}

In this Article, Professors Bratton and McCahery explore, in the larger framework of corporate governance, the positioning of legal barriers to shareholder action regarding corporate charters. The authors first trace the problems inherent in the management-shareholder agency relationship and clarify the arguments supporting and criticizing the two prevailing "deterrent" strategies for regulating corporate management—fiduciary control and market control. The authors adopt the view that a third strategy—enforced self-regulation through institutional shareholder participation—can be more effective, but stress economic limitations on the class of situations in which shareholder initiative can be expected to yield concrete governance benefits. The Article contends that, given these limitations, the present allocation of state and federal authority over corporate governance should be adjusted in order fully to realize the potential benefits of institutional shareholder participation. In the authors' view, regulatory competition among the states causes state law unduly to constrain the field of action for shareholder initiative in much the same way that it already impairs the operation of the fiduciary and market deterrents. To support this view, the Article offers a public-choice analysis of the charter competition system. Under this, the system operates to embed the capture of state political decisionmakers by corporate managers and only intermittently promotes innovation and assures legal responsiveness to the preferences of investors. This analysis leads the authors to propose a federally mandated privilege of shareholder access to

[†] Kaiser Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University.

^{††} Lecturer in Law, School of Law, University of Warwick. The authors would like to thank Ian Ayres, Gerry Bean, Victor Brudney, David Carlson, Bill Carney, Larry Cunningham, Jeffrey Gordon, Morten Hviid, Arthur Jacobson, Marcel Kahan, Michael Klausner, David Millon, Larry Mitchell, Andrew Reeve, and Roberta Romano for their comments on earlier drafts of this paper, and to acknowledge the support of the Samuel and Ronnie Heyman Center for Corporate Governance of the Cardozo Law School.

state corporate charters to approve amendments on matters of process and structure. They argue that this proposal is well-suited to the background of incentives that determine the level and character of institutional shareholder participation, and that its enactment would not impede the operation of charter competition systems in its beneficial aspect.

INTRODUCTION

Corporate law currently faces the problem of effectuating contractual governance in an agency system that insulates agents from market constraints.¹ This governance discussion focuses on possibilities for strengthening the shareholders' role in the ongoing negotiation of incomplete corporate contracts. Proponents of institutional shareholder participation have taken the lead by mapping out shareholder-driven strategies for monitoring and compensation systems that will more effectively control the costs of management influence activities within the firm.² These strategies force proponents to confront long-standing economic and legal barriers to shareholder action.

In this Article, we carry this legal confrontation to subject matter so far largely exempted from the discussion—state corporate law and the system of incentives that forms it. More particularly, we recommend partial federal preemption of state law's allocation to management of agenda control over corporate charter amendments. We argue that this intervention will ameliorate some of the cost and incentive barriers that impede shareholder action.

This recommendation requires us to confront the theory of regulatory competition that legitimates the state system. We base our challenge to this theory on a reinspection—conducted without the use of a general equilibrium lens³—of the internal negotiating structure that forms corporate law. This reinspection reveals that charter competition results in state laws that inhibit the negotiation of contract terms that could both alleviate problems of informational

1. Cf. Jason Scott Johnston, *The Influence of THE NATURE OF THE FIRM on the Theory of Corporate Law*, 18 J. CORP. L. 213, 241-44 (1993) (noting that contractarian firm theories that rely on market constraints provide no account of the mechanisms that will lead to long-run efficiencies) (citing PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 192-94, 277-79 (1992)).

2. See Paul Milgrom & John Roberts, *An Economic Approach to Influence Activities in Organization*, 94 AM. J. SOC. S154, S156 (Supp. 1988).

3. That is, we do not assume that competition among the states in the production of corporate law, taken alone, over time will assure the evolution of an optimal legal regime.

asymmetry between managers and monitors and help to realign incentives to reduce the costs of management influence.⁴ This Article depicts a self-regulatory system, composed of firms and state lawmaking institutions, in which competition among the states ensures the system's capture by corporate management influence. It then draws on political theory to provide a guide for dealing with the problem. This learning from the field of public regulation highlights the formative role that process and structure rules play in capture's amelioration. We adapt it to the private corporate governance situation and conclude that removing some of the states' mandatory process rules would create opportunities for shareholder participation in contract negotiation and for shareholder influence on the formation of state law.

Part I provides an overview of our proposal for agenda access for shareholder-proposed amendments to the firm's contract. This discussion examines the objectives and strategies of the shareholder participation movement in the context of corporate law's historic debates over governance strategies and state lawmaking systems.

Part II critically reviews the market-based justification of the charter competition system and the historic alternative of fiduciary-based blanket federal preemption. It asserts that the market perspective is infirm in two respects. First, it understates the effects of regulatory capture because it fails to recognize that the system does not provide shareholders with either an effective exit route, or, in the alternative, an adequate opportunity to register political demands.

4. Cf. Paul Milgrom & John Roberts, *Bargaining Costs, Influence Costs, and the Organization of Economic Activity*, in *PERSPECTIVES ON POSITIVE POLITICAL ECONOMY* 57, 82 (James A. Alt & Kenneth A. Shepsle eds., 1990) (noting the role of distorted information in the decision-making process of central authorities). Under Milgrom and Roberts's "influence cost" model of the firm, the firm must confront problems of informational asymmetry if it is to make and support efficient choices. The problem is that decision-makers must obtain and rely upon information generated by others. Employees and other players, by virtue of their place within the organization, possess information that could have a significant impact on decisions made by principals. Absent sufficient incentives to release these information rents, the agents will use this information to influence the decisions of those above them in the hierarchy. According to Milgrom and Roberts, the problem for an actor higher in the hierarchy attempting to monitor these agents is this asymmetric information—the asymmetry "prevents easy determination of whether a particular observed action or outcome corresponds to desirable behavior and thus renders the problem nontrivial." Milgrom & Roberts, *supra* note 2, at 156.

Shareholder participation strategies seek to alleviate the asymmetric information problem in the public corporation with devices such as process reforms (which take the initiative in the design of internal incentive schemes away from management) and direct placement of independent monitors in the boardroom. See *infra* notes 148-241 and accompanying text.

Second, the market perspective offers an overly simplistic picture of the incentives that determine the behavior in Delaware, the leading chartering state. In the capture model presented here, state-federal political instability emerges as a positive force that occasionally forces Delaware to confront conflicting demands of managers and shareholders and effect a somewhat more even-handed mediation between the two groups. The model also suggests caution in the selection of a legal corrective to the capture problem: Discrete federal intervention to facilitate shareholder participation in corporate contracting emerges as preferable to blanket preemption. In our view, federal preemption that institutionalizes an opportunity to register conflicting demands on state lawmakers would not sacrifice the relational advantages that flow from corporate law production in a small, market-sensitive jurisdiction.

Part III examines the theories, accomplishments, and open agenda items of the institutional shareholder movement. The discussion describes and evaluates three participatory modes: discrete issue-based voting contests, coalition-based voting for board seats, and relational investment in large share blocks. Only the first mode clearly passes the tests of cost-benefit feasibility and insusceptibility to management capture. In practice, discrete voting contests have occurred because they require low out-of-pocket costs and serve as vehicles for reputational gain by a narrow segment of institutional agents. These agents' reputational interests make them unlikely candidates for capture. At the same time, reputational interests render managers vulnerable to the institutions' dialogic activities and, therefore, prone to make concessions. Contractual modifications have resulted. The second participatory mode, coalition-based board voting, holds out the promise of high-intensity monitoring with little chance of capture due to absence of capital investment by, and reputational profiles of, the hypothesized monitors. However, federal regulation impedes experimentation, and there are substantial cost and incentive barriers. The third mode, relational investing, solves the problems of coalition-building by making the volunteer monitor a substantial equity investor. In theory, this volunteer recoups its costs as its equity block increases in value due to its input into the firm's governance. Also in theory, this volunteer's public-regarding⁵ profile renders it impervious to the free ride taken by the rest of the shareholders. Practical feasibility presents no problem in the sense

5. That is, activated by the interests of the shareholders as a group.

that large block investments and attendant governance engagements have long occurred in practice. However, a practical problem does follow from the magnitude of the actor's investment. Large financial stakes make sustained public-regarding relational engagements unstable. Both capture by management in exchange for separately negotiated rents and defection into the camp of a hostile offeror remain structural possibilities.

Part IV asserts that practical barriers to experimentation with the second and third modes of shareholder participation make it worthwhile to recommend federal intervention against state-mandated agenda control. This discussion details the restrictive effects of state law's agenda mandate, describes the central role of charter competition in the mandate's evolution, and proposes limited federal intervention to ensure a shareholder privilege to initiate charter amendments. We recognize that shareholder initiative could lead to rent-seeking and the emergence of voting cycles. To ameliorate the rent-seeking problem, the proposal limits access to matters of process and structure. To cut off the cycling activity, the proposal includes a set of ancillary process rules.

I. INTERNAL AND EXTERNAL GOVERNANCE STRATEGIES AND STATE CORPORATION LAW

A. *Deterrent Governance Strategies and State Charter Competition*

An unsatisfactory organizational incentive scheme hampers the performance of large corporations. Opportunistic managers often exert excessive influence over their governance mechanisms, exploiting a collective action barrier to effective monitoring by dispersed equity owners. Solving this management-shareholder agency problem is corporate law's long-standing, unperformed assignment. Historically, debate over the appropriate solution has centered on two competing deterrent strategies. The first, the "fiduciary" strategy, is the corporate version of command and control regulation. It follows from assertions by Berle and Means that shareholders lack any effective means to monitor the firm themselves, that no adjustment of shareholder incentives will cure the problem, and that therefore the state must intervene to pick up the slack by imposing mandatory rules.⁶ Under the strict regime envisioned,

6. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 219-21, 241-52 (Harcourt, Brace & World, Inc. 1968) (1932).

process rules that provide entrepreneurial lawyers with financial incentives to enforce fiduciary norms address the shareholders' collective action problem. The competing approach, the "market" strategy, seeks to deter management shirking by clearing the field for the operation of markets for products, management employment, and corporate control. According to this view, economic actors in free markets can be relied upon to protect themselves, and over time collective action problems solve themselves as fit competitors survive in a competitive environment. Here a different sort of entrepreneur, the hostile tender offeror or proxy contestant, plays the critical enforcement role.⁷

Most observers agree that an effective legal model must draw on both modes of deterrence, but proponents of the two strategies dispute the appropriate weighting of the legal mix. Proponents of fiduciary control question the market's effectiveness in protecting shareholders from management opportunism and see mandatory fairness norms as necessary supports for systemic confidence. Market proponents see fiduciary regulation as a barrier to the market's operation in some cases, and otherwise as an unnecessary deadweight cost, except where intervention proves necessary to facilitate the operation of free transfers of corporate control.

This debate repeats itself when attention turns to the political structure of corporate lawmaking. The federal system⁸ leaves matters of corporate organizational structure and fiduciary standards to the states; corporations remain free to choose their states of incorporation.⁹ Since corporate charters produce rents for the states, the states compete to attract charters. Proponents of fiduciary regulation see this regulatory competition as a "race to the bottom": Since the managers have captured the governance mechanisms of the states' corporate customers, competition for charters by the states devolves on the provision of special benefits to managers, weakening the

7. Compare Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 *passim* (1982) (applying market strategy to sales of control) with Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganization*, 71 CAL. L. REV. 1072 *passim* (1983) (applying fiduciary strategy to sales of control).

8. American corporate law has evolved with the national government assuming responsibility only for regulation of information flow in the securities markets; it imposes a mandatory disclosure regime on public corporations with a combination of administrative and entrepreneurial enforcement techniques.

9. American conflict of laws rules respect the law of a corporation's nominal domicile. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971).

fiduciary regime. Therefore, a preemptive, fiduciary-based federal corporate law regime is the recommended remedy.¹⁰ Market proponents counter that market controls ensure that efficient governance structures result as the states respond to the managers' demands. This "race to the top" obviates any need for federal intervention.¹¹

B. Institutional Investor Participation and a Strategy of Enforced Self-Regulation

These debates over deterrent strategies and charter competition have been complicated in practice by two developments, one negative and the other positive. First, the negative: During the 1980s, state lawmakers took an active role in impairing the market deterrent, contributing to the collapse of takeover activity. This prompted reappraisal of the race to the top and race to the bottom views of charter competition and the emergence of an intermediate view recognizing that competition has both positive and negative effects. Next, the positive development: The collapse of the takeover market coincided with the advent of active institutional investor participation in corporate governance.¹² This prompted the articulation of a third strategy for dealing with the agency problem: enforced self-regulation.¹³ Under this third strategy, shareholders can avoid the

10. The most prominent advocate of this view was William Cary. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 696-705 (1974).

11. The most prominent advocate of this view is Ralph Winter. See Ralph W. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 *passim* (1977).

12. These events had profound implications for corporate legal theory. It became apparent that the theoretical resources of neoclassical economic analysis of law could not adequately describe the events taking place. The result was a renewed interest in both the politics of domestic corporate law and the comparison of foreign institutions. For discussion of the break and the shortcomings of the comparative inquiry, see Richard M. Buxbaum, *Comparative Aspects of Institutional Investment and Corporate Governance*, in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 3 *passim* (Theodor Baums et al. eds., 1994).

13. IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 101-04 (1992). Ayres and Braithwaite distinguish between "enforced self-regulation" and "coregulation" in administrative law. *Id.* at 102. Under the former, the state and the regulated firm negotiate over standards tailored to the firm. The latter, which prevails in the U.S. securities industry, involves self-regulation by an industry association with some oversight or ratification by the government. Ayres and Braithwaite explore possibilities for enforced self-regulation on the theory that the subcontracting of the regulatory function to private actors under ultimate government supervision could lead to greater flexibility in the formulation of the terms of regulation and effectiveness of

need to rely on legal and market deterrents to the extent that they effectively negotiate the corporate contract themselves and monitor its performance.

Self-regulatory strategies are not new to corporate governance. Indeed, self-regulation by means of a legally mandated shareholder vote for the board of directors is the system's historic base point. Commentators have debated plans to improve this self-regulatory structure's performance for decades. However, since those earlier proposals all followed from the Berle and Means assumptions, no one expected that independent internal monitors could be imposed on management by unilateral shareholder directive. Instead, the proponents sought *voluntary* acceptance by management of oversight by independent directors and pursued a dialogic implementation strategy. The proponents advocated a norm of majority independent board membership and attempted to have such a requirement inserted into the canon of proper business practices.¹⁴ Success was achieved in form but not in substance: The norm found its way into the canon only to be subverted in practice by management influence. By the

enforcement. *Id.* at 102-32.

We think the concept usefully describes the mode of corporate governance envisioned by proponents of participation by institutional investors. The context is different, of course. Here the enforcing actor is not a government agency but the firm's shareholders; no immediately available sovereign mandate skews bargaining positions when the parties negotiate over governance terms. Thus we do not employ the self-regulation concept to import a "public" coloration into a "private" contractual matter. However, we do take the position that state mandates are already inextricably bound up in the determination of the potential scope of enforced self-regulation by shareholders and that their readjustment is an appropriate subject matter for corporate law reform.

14. Mandatory independent board structure was proposed in the first draft of the American Law Institute's Corporate Governance Project, but was cut back to precatory status in later versions at the insistence of management representatives. Compare PRINCIPALS OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03 (Tentative Draft No. 1, 1982) (proposing mandatory majority of independent directors) with 1 PRINCIPALS OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (1994) (recommending majority of independent directors as practice suggestion); see also MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 170-85 (1976) (recommending mandate). For a review of the politics of the ALI Corporate Governance Project proceedings, see Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212 *passim* (1993).

Proponents of both fiduciary and market deterrence strategies took a dim view of mandatory independent boards. Compare Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597, 609-12 (1982) (emphasizing that the directors' duty of vigilance would be constrained by their need to interact with other directors) with Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1280-86 (1982) (arguing that use of independent directors is detrimental to profit maximization).

end of the 1980s, almost three-quarters of American directors were outsiders; management nevertheless retained control of the selection process, and sixty-three percent of the outside directors selected were chief executive officers of other public companies.¹⁵

Institutional investor participation changes this picture, holding out a prospect of self-regulation *enforced* by the shareholders themselves. The theory posits that concentrated institutional equity ownership¹⁶ makes joint shareholder action cost effective.¹⁷ Practice has begun to validate the theory's prediction, as institutional shareholders have used their voting power to get results. Successful publicity and issue-based proxy campaigns against underperforming companies have prompted management concessions on governance provisions, and in the most dramatic cases, boardroom shakeups.¹⁸ Theorists, however, ask for more thoroughgoing engagements than these discrete and relatively inexpensive exercises can provide. They have mapped strategies for sustained relationships between managers and institutional monitors, looking to the use of institutional votes to nominate and elect expert outside monitors, and the placement of substantial blocks of shares with public-regarding institutional owners. These more ambitious and costly proposals have not yet been tested in practice.

Shareholder participation strategies are an attractive alternative to the two deterrent strategies. The payoff for costly action by shareholder volunteers comes from improved investment policy and day-to-day management. This expands on the payoff of the fiduciary deterrent and promises governance benefits formerly in the market's exclusive preserve. Corporate law's duty of loyalty focuses on a limited class of moral hazard¹⁹ problems; its duty of care avoids

15. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 17-18 (1989).

16. This proportion passed 50% during the 1980s. See CENTER FOR LAW & ECON. STUDIES, *Institutional Investors and Capital Markets: 1991 Update*, COLUM. INSTITUTIONAL INVESTOR PROJECT, at Table 19 (1991).

17. See *infra* notes 154-58 and accompanying text. For an excellent review of the proposals on the table, see Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513, 593-612 (1993).

18. See *infra* notes 162-80 and accompanying text.

19. Milgrom and Roberts define moral hazard in terms of "postcontractual opportunism that arises when actions required or desired under the contract are not freely observable." See MILGROM & ROBERTS, *supra* note 1, at 167; see also Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1044 (1994) (suggesting that moral hazard "stems from the agent's 'hidden action'"). This framework can be used to describe corporate law's garden variety conflict of interest transaction: A board with insufficient information respecting incentives is more likely to approve one-

inquiry into the adverse selection²⁰ problems that lead to unsuccessful business plans. This limited scope follows from limited enforcement resources: Judges intervening *ex post* can untangle conflict-of-interest transactions and structure remedies, but informational complexities put investments and operations outside their competence.²¹ The takeover, in contrast, addresses all of these agency problems and, at least in theory, creates value for shareholders through their elimination. However, its widespread employment during the 1980s gave rise to a perceived problem of perverse effects. It appeared that prospects for short-term gain could induce the takeover of a well-managed firm, thereby chilling productive long-term investment. It also appeared that readily available debt financing could lead to speculative overbidding and subsequent bankruptcy costs.

Shareholder participation strategies promise to avoid these problems. They seek a competency payoff by placing effective monitors inside the firm. There, with access to the full set of information, the monitors will effect necessary changes through

sided deals; rationally apathetic shareholders will take no action in response.

20. Milgrom and Roberts define adverse selection in terms of the kind of *postcontractual opportunism* that arises when one party to a bargain has private information about something that affects the other's net benefit from the contract and when only those whose private information implies that the contract will be especially disadvantageous for the other party to agree to the contract.

MILGROM & ROBERTS, *supra* note 1, at 595. In this context, adverse selection stems from the agent's hidden information. A board with inadequate information cannot fully evaluate the agent's capabilities and performance, making it difficult to ensure the selection of the most able agents. See Ayres & Cramton, *supra* note 19, at 1044.

More generally, fiduciary law is ill-suited to the control of managers' influence activities that have negative consequences for the firm. In the Milgrom and Roberts model, influence activity is the time and effort spent by rational, self-interested actors in firms to influence decisions. Some of this activity may benefit the firm, but it also results in questionable pay increases, unnecessarily large budgets, acceptance of suboptimal projects and proposals, and rejection of worthwhile proposals. See Milgrom & Roberts, *supra* note 2, at S155-56.

21. This limitation of scope, embodied in the business judgment rule, stems from a recognition of informational constraints on the process of judicial enforcement. The risk-return calculations prevailing at the time of initial investment cannot be reconstructed *ex post*; the fact of failure invites the ascription of incompetence to conduct better described as considered risk-taking. Aggressive fiduciary inquiry into investment policy would overdeter risky investment. The corporate duty of care, accordingly, strikes only at extreme cases of incompetence. See *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); *Barnes v. Andrews*, 298 F. 614, 615 (S.D.N.Y. 1924). The Delaware Supreme Court has created an exception by strictly scrutinizing the process employed in the boardroom of the acquired firm in a friendly merger. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368 (Del. 1993); *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985).

cooperation and persuasion. The deterrent strategies, in contrast, lead to punishment payoffs. The more widespread their use, the more a management subculture of resistance to outside regulation becomes entrenched.²²

This picture of productive relational engagement by shareholders is still largely aspirational. So far, institutional victories in discrete engagements have followed from the efforts of agents of public pension funds. These actors take the role of political entrepreneurs and act from motivations more reputational than financial. Although agents of private pension funds, mutual funds, banks, and insurance companies control the overwhelming portion of institutional equity holdings, they have not emerged as leading players in the game.²³ It remains unclear whether concrete cash payoffs can be realized from the loose cost-benefit projections that support the relational strategies.

A number of sticking points impede testing of the relational models. First, no one has devised an incentive scheme that integrates investment in governance participation with the range of agency arrangements that obtain in the different investment institutions.²⁴ Second, substantial legal impediments to shareholder collective action remain on the books. Early pressure for reform has resulted in some significant changes—paternalistic barriers to coordinated institutional action in issue contests have been removed from the federal proxy rules, but full-scale testing of relational models of shareholder participation awaits the implementation of a broader program to curtail the scope of the federal securities laws.²⁵ Third, a nascent incentive problem lies unresolved in the interplay between self-

22. See AYRES & BRAITHWAITE, *supra* note 13, at 19-20. The participation strategy also looks reasonable in a loose comparative cost survey. The institutional volunteers do, of course, incur the up-front costs of campaigning, coalition building, or direct investment. That investment does not occur, however, absent the prospect of a greater performance payoff, and that payoff ultimately benefits the shareholders as a group. Meanwhile, significant costs attending the deterrent strategies are avoided. Fiduciary law carries the deadweight cost of corporate subsidy of hostile, labor-intensive judicial processes even in the meritorious case, and additional costs from nonmeritorious cases stemming from the unsolved problem of process incentives to plaintiffs' lawyers to hold up firms for quick settlements. Takeovers, although said to create shareholder value overall, *see, e.g.*, Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 152-54 (1992), do not necessarily benefit the shareholders of the acquiring firm, *see, e.g.*, Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 614-15 (1989); Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 *passim* (1986), and entail enormous transaction costs.

23. See *infra* notes 198-208 and accompanying text.

24. See *infra* notes 229-40 and accompanying text.

25. See *infra* note 244 and accompanying text.

regulation by shareholders and market deterrence by takeover. The institutional participation movement has proceeded during a cyclical low in merger and acquisition activity. An upturn in the merger cycle and resurgence of hostile activity²⁶ would reweight the institutions' payoff pattern away from patient engagement in favor of defection and short-term gain. That, in turn, would diminish management's incentive to cooperate.²⁷

C. *A Federally Mandated Privilege of Shareholder Initiative*

Recent commentaries on shareholder participation focus on barriers to the realization of the full relational models. This Article, in contrast, examines the legal landscape that channels discrete institutional interventions and explores possibilities for expanding the menu of contractual reforms attainable through shareholder initiative. In so doing, it constructs a theoretical case for a reform proposal made in passing many times in the past:²⁸ federal preemption of state law's allocation to management of an exclusive privilege to initiate corporate charter amendments. We revive this proposal with two consequences in mind. First, recent institutional accomplishments suggest that levelling of the state law playing field could lead to

26. An upturn in the merger cycle has occurred during the last two years, but hostile takeover activity remains sporadic. See *infra* note 236.

27. At the same time, new incentives to defect to the management side would arise in a case in which the shareholder volunteer holds a substantial block of stock and state fiduciary law proves incapable of policing a side deal. See *infra* notes 232-40 and accompanying text.

28. See, e.g., Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 582 (1990) (proposing a federal requirement for public companies that a majority of shareholders elect to be governed by changes in state law that affect the division of power between management and shareholders); Cary, *supra* note 10, at 701-03; John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 774-77 (1987) (proposing shareholder initiative by the use of proxy statement to opt out of state rules, amend the charter and change the state of incorporation); see also SEC Concept Release on Takeovers and Contests for Corporate Control, Exchange Act Release No. 34-23486, 51 Fed. Reg. 28,096, 28,100-02 (1986) (suggesting self-governance exemptions to specific tender offer rules); SEC Advisory Committee Report on Tender Offers, Fed. Sec. L. Rep. (CCH), Special Report No. 1028, at 37-41 (July 8, 1983) (recommending annual shareholder advisory votes on golden parachutes, standstill agreements, and supermajority and disenfranchising charter provisions); cf. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 83-84 (1993) [hereinafter ROMANO, GENIUS OF CORPORATE LAW] (proposing change of statutory defaults from opt-out to opt-in at the state level); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 944 (1994) (proposing that Congress should preempt state antitakeover statutes, leaving shareholders to make decisions respecting takeover defenses).

patterns of corporate contracting that begin to resemble those resulting between actors at arms' length. Second, the combination of institutional leadership and shareholder access to the charter could invigorate the charter market. Given a path for the effective registration of shareholder demands, states would have an incentive to take shareholder preferences into account in the construction of corporate law's mandatory provisions.

It is possible that rent-seeking by shareholder coalition-builders could lead to perverse effects if an access mandate were extended to matters of investment and other business decisions.²⁹ Our goals are modest, however, and their satisfaction does not require unlimited shareholder access. Accordingly, we would limit the subject matter scope of mandatory shareholder access to charter terms bearing on governance process and structure. To prompt the reorientation of the political calculations of state lawmakers, our operative concept of permitted amendments would extend to the decision as to state of incorporation.

This proposal also has a theoretical goal. The program to restructure corporate law to accommodate the economic possibility of shareholder-enforced self-regulation implies the adjustment of prevailing notions of corporate federalism. An inconsistency has developed in the commentary. On the one hand, no one questions that state law's grant of control of the corporate voting agenda to management restricts shareholder enforcement opportunities.³⁰ On the other hand, the law reform movement tends to press against only the federal side of a two-sided system, foregoing consideration of the state law (and federalism) implications of shareholder participation strategies.³¹ This imbalance is surprising given the consensus view that the competition-driven state system imposed excessive constraints on the operation of the market deterrent during the 1980s.

Two explanations for the imbalance suggest themselves, one practical, the other theoretical. First, proponents of shareholder participation formulate their agenda with the urgency of activists,

29. On this point we follow Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 376-81 (1991) [hereinafter Gordon, *Shareholder Initiative*].

30. See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 825-26 (1992) [hereinafter Black, *Agents*].

31. The exception is Gordon, *Shareholder Initiative*, *supra* note 29, at 357-59, which concludes that the system confirms the prediction of the market efficiency story.

either selecting immediately attainable improvements³² or confronting unavoidable barriers to full realization. Charter access for process and structure amendments fits neither profile. The complicated politics of federal intervention give it a low rank on the feasibility list,³³ and, in any event, access promises incremental rather than fundamental improvement in the agency relationship. Second, conceptual barriers impede reappraisal of the regulatory allocation between national and state governments. The reform agenda reflects the view that shareholder-enforced self-regulation is perversely impeded by federal regulations promulgated long ago by actors under the influence of Berle and Means.³⁴ Historically, suggestions for federal preemption have followed from the same, discredited³⁵ set of assumptions. More recent arguments for federal preemption have taken steps to cure this infirmity by bringing to bear both a relational contract perspective and the economic presuppositions of the market deterrent approach.³⁶ However, the cure is incomplete because these new calls for preemption continue to include the Berle and Means remedy of a state-mandated fiduciary deterrent.³⁷ Still unaddressed is the central federalism concern that federal intervention imports a risk of blanket preemption that destroys the responsive benefits of jurisdictional competition.³⁸ As a result, the market competition

32. See John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 900-02 (1994) [hereinafter Coffee, *Half-Time Report*] (suggesting implementation by SEC rulemaking); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865, 883-84 (1991) [hereinafter Gilson & Kraakman, *Institutional Agenda*] (proposing institutional board monitors by means of shareholder self-help); Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 903-08 (1993) (recommending purely dialogic strategy).

33. See ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 50, 75-84.

34. Or, more generally, it follows from early twentieth century populism. See, e.g., Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 32-45 (1991).

35. Here we speak from the point of view of others. In our view, the Berle and Means description may or may not carry force in the future, depending on the success of the shareholder participation movement.

36. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1458-67 (1992); David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423, 442-53 (1991).

37. See Bebchuk, *supra* note 36, at 1500-07.

38. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 82-83.

model of state law still carries sufficient validating force to discourage consideration of structural adjustments.³⁹

The federalism discussion should be disaggregated and the benefits and burdens evaluated in light of the regulatory strategy that informs a specific proposal for intervention. That step accomplished, a powerful case emerges for minimal intervention to increase the menu of subjects for shareholder initiative. The recent, unprecedented success of the shareholder activists invites reexamination of legal restrictions on shareholder voice for the first time since the restrictions appeared in state law a century ago.⁴⁰ The charter competition system prevents states from undertaking this review because it effects the capture of state lawmakers by management interests. There is, of course, nothing intrinsically unacceptable about a captured sovereign, as the political theory undergirding the market justification of the system teaches. Nevertheless, nothing in that theory also dictates the conclusion that this particular situation of capture enhances economic welfare. Previously, that conclusion was reached only on two assumptions: market constraints in any event cure the capture's negative effects; and state-mandated agenda control is irrelevant because collective-action constraints prevent shareholders from availing themselves of an opportunity to voice preferences internally. Neither assumption is safe today; state lawmakers undercut the first during the 1980s, and institutional shareholders thereafter rendered the second obsolete.

Thus, the legal terms that perpetuate the one-sided capture of state law need no longer be accepted as the best available, provided that the proposed adjustment makes both the captured sovereign and the regulated firm more responsive to the excluded shareholder interest. However, any proposed federal adjustment also must leave unimpaired such benefits of responsiveness to the preferences of actors in economic organizations as the state system does provide. The minimal intervention suggested here meets that burden.⁴¹

39. For a manifestation of this thinking in a federal lawmaking context, see S. REP. NO. 265, 100th Cong., 1st Sess. 46 (1987) (observing that state corporate laws work well and that Congress has always decided against federalization).

40. See *infra* notes 275-83 and accompanying text.

41. To keep the discussion manageable, we avoid mentioning the problem of constituency participation. We acknowledge, however, that this corporate governance problem is closely related to that of shareholder access and ultimately must be confronted as corporate law evolves to accommodate institutional investor initiatives. Accordingly, our focus on the shareholder interest should not be taken to presuppose adherence to the shareholder primacy norm implicit in much of the governance literature. Richard M.

More broadly, a strictly market-based theory of regulatory competition provides an inadequate framework for appraising the law's role in facilitating effective organizational incentive schemes.⁴² The market-based model understates the distortions that result from the interplay of multiple sovereigns and interest groups in the resolution of corporate commitment, information, and enforcement problems. These problems stem in part from the capture of a sovereign mandate by one contracting group and in part from the absence of a contractual avenue for realignment of the sovereign's incentives by the competing group. This mixed problem of economics and politics calls for a mixed political and economic solution. Ideally, the political solution should be shaped to leave the ultimate resolution of the corporate agency problems to the economic actors themselves, and leave sovereign actors with incentives to make balanced responses when their preferences conflict. Federal intervention would facilitate that result if it refrained from displacing the states' role in corporate law creation and instead realigned the positions of the three parties to the corporate contract—management, shareholders, and state government—to allocate shareholders a seat at the bargaining table.

II. CORPORATE CHARTER COMPETITION AND THE PROBLEMS OF REGULATORY CAPTURE AND REGULATORY RESPONSIVENESS

This part of the Article reconsiders the debate between critics and proponents of charter competition and proposes a modified description of the system. From the critics' perspective, the charter market facilitates managerial capture of state lawmakers and prevents the evolution of an effective fiduciary deterrent. The proponents, in contrast, applaud market impediments to the development of fiduciary controls and describe a mechanism that assures state responsiveness to the preferences of economic actors. We assert that neither position remains viable in the present environment. The critics tend to overstate the problem: Capture, taken alone, does not delegitimize

Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 41 (1991), notes that institutionalized labor-management cooperation along European lines need not be a zero-sum game, and we agree. We also think that Buxbaum, *id.* at 42-45, plausibly looks to governance innovations stemming from institutional initiatives as a potential beginning point in the evolution of American analogues to codetermination.

42. Such schemes allow opportunistic actors to overcome collective action problems in pursuit of the gains of trade, promoting mutual compliance *ex post* and allowing for credible commitments *ex ante*. See Terry M. Moe, *Politics and the Theory of Organization*, 7 J.L. ECON. & ORGS. 106, 122 (Special Issue 1991).

a regulatory regime. They also tend to overplay the solution: By displacing Delaware courts from their position as corporate law's leading center of dispute resolution, mandatory federal fiduciary standards would impair and possibly terminate the operation of a useful repository of information and expertise. The proponents tend to understate the problem: They describe a relational contract without fully exploring its political and process characteristics. This relational contract contains not only normative mandates, but also process mandates that govern the alteration of default terms. Furthermore, the capture of the mandating sovereign by one of the parties has prevented the evolution of both optimal mandates and effective ground rules for opting out. The proponents also tend to avoid sustained consideration of solutions: The federal mandate can be directed to the process side, not only to level the playing field for corporate contracting, but also to destabilize a structure that affords the states the comfort of having to respond to the demands of only one affected interest group.

A. The Corrupt Sovereign Versus the Responsive Sovereign

The original case for federal intervention against state charter competition combined a public interest theory of regulation with a fiduciary strategy for improving corporate law. Professor William L. Cary's leading article denounced Delaware, the leading corporate domicile,⁴³ as a corrupt sovereign. He undertook a general review of its courts' pronouncements and concluded that there appeared to be "no public policy left in Delaware corporate law other than the objective of raising revenue."⁴⁴ To Cary, the "public policy" at stake was the integrity of corporate managers, and the revenue objective had led a single state to "grant management unilateral control untrammelled by other interests,"⁴⁵ thereby sacrificing the national interest. He looked to federal intervention to eliminate the firms' incentives to incorporate in Delaware.⁴⁶

43. Delaware is home to one-half of the largest American corporations, and is the new domicile of 80% of reincorporating firms. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGS. 225, 244 (1985) [hereinafter Romano, *Law as Product*].

44. Cary, *supra* note 10, at 684.

45. *Id.* at 698.

46. *Id.* at 702. His proposal included not only federal fiduciary standards, but shareholder access to the charter and by-laws, the abolition of nonvoting shares, and mandatory indemnification rules. *Id.*

Cary assumed that regulation could and should pursue a notion of the general good. By the time he published his thesis in 1974, however, that theory of regulation had already fallen from favor in the social sciences⁴⁷ and was replaced by capture theories of regulation.⁴⁸ Capture theories described regulation as an arena in which special interests compete to use government power for advantage. They also debunked the public interest story of regulatory motivation—now regulators should be expected to behave no differently than actors in private economic relations.⁴⁹ This shift in political theory, coupled with the emerging market deterrent view of corporate law, permitted Cary's race to the bottom to be reversed into a race to the top.⁵⁰

The "race to the top" story drew on the central assertion of regulatory competition theory—that jurisdictional competition ameliorates the distortions that result as interest groups compete for, and win, political favors. Under this theory, competition for domiciliaries leads to the matching of government policies with diverse citizen preferences, and thus fosters innovation.⁵¹ Citizens signal their preferences respecting legal goods and services when they migrate from regime to regime. Their ability to exit disempowers government actors, whose welfare diminishes as citizens depart, taking with them votes and revenues.⁵² Given competition, law production goes forward without losing time on the task of reconciling competing preferences. The theory also implies a preference for state over national lawmaking. Since the revenue enhancement constraint on the national government is less intense,⁵³ the national lawmaking

47. See Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORGS. 167, 167 (1990).

48. Mancur Olson attacked the optimistic public interest orthodoxy of American political science as built on a misguided conception of the logic of group action. MANCUR OLSON, JR., *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 16-22, 117-31 (1965). Olson claimed that the liberal view that groups formed organizations based on common goals ignored free riding by members of the group. *Id.* at 15-16. Since most of the gains from group formation could be captured by all, there was very little incentive for groups to organize. *Id.* at 14-16.

49. Levine & Forrence, *supra* note 47, at 168-69.

50. See Winter, *supra* note 11, at 254-62.

51. See ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 4-6.

52. See Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 142-43 (1991).

53. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 4-6, 48-51.

process will be slower, less responsive to productive concerns, and more susceptible to the influence of organized interest groups.⁵⁴

Regulatory competition theory applies to corporate law on the assumption that state corporation codes may be viewed as products consumed by corporations.⁵⁵ In the resulting description, competition for the legal business of firms forces the states to adapt the law to the dynamic conditions in which the firms operate.⁵⁶ State lawmaking emerges as a trial and error process suited to the accurate identification of optimal corporate arrangements.⁵⁷

Reincorporating firms are this market's marginal consumers. They seek a predictable legal regime that reduces their costs. Delaware provides this with comprehensive case law, well-specified indemnification rules, and an expert judiciary.⁵⁸ The firms also seek a guaranty that the new state of domicile will maintain the desirability of its code, because the reincorporating firm and the target jurisdiction enter into a relational contract that entails a risk of opportunistic breach. Even as the firm invests to gain access to the target's favorable legal regime, the target remains free to change its politics and transform itself into an unresponsive jurisdiction.⁵⁹ The com-

54. *Id.* at 5. In a federal system, the allocation of lawmaking power to the competing states also protects individuals from the power of the national government; private organizations provide an additional check by counterbalancing the power of state governments. National regulation of corporations would impair this corporate function and thus detract from individual liberty. See Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 753 n.97 (1987).

55. ROMANO, GENIUS OF CORPORATE LAW, *supra* note 28, at 6.

56. Delaware, the leading corporate law state, excels in this process. *Id.* at 9.

57. Romano's study of the spread of innovation in corporation codes found that innovations spread rapidly in a pattern resembling the S-shaped diffusion curve of technological innovations. Romano, *Law as Product*, *supra* note 43, at 234-35. Her study of state responsiveness, *id.* at 237-40, found that the more responsive states gain more and lose fewer incorporations, and that state responsiveness bears a significant positive correlation to the proportion of state revenues derived from franchise taxes, *id.*

58. ROMANO, GENIUS OF CORPORATE LAW, *supra* note 28, at 32-40. Romano has backed this cost-reduction assertion with a study of public corporation domicile changes between 1960 and 1982. See Romano, *Law as Product*, *supra* note 43, at 242. The study shows that corporations tend to change domiciles in advance of either a public offering, an acquisitions program, or the promulgation of antitakeover measures. *Id.* at 250. They incur substantial costs in so doing, including the one-time costs of the move, the possibility of appraisal claims, and, in the case of corporations moving to Delaware, the present negative value of an additional layer of high franchise taxes. ROMANO, GENIUS OF CORPORATE LAW, *supra* note 28, at 34-35. The benefits mostly stem from the threat of litigation—all three of the identified transactional occasions for changes of domicile entail litigation risks.

59. New Jersey did this early in the twentieth century, precipitating a mass movement of corporations across the river to Delaware. Joel Seligman, *A Brief History of Delaware's*

petitive jurisdiction has to reduce this possibility by offering a credible commitment. Delaware's commitment stems from its dependence on franchise tax revenues.⁶⁰ These revenues are an "intangible asset" that emerges from the combination of a large number of incorporations and a small population. Delaware also invests in real assets specific to its incorporation business—its case law and its judicial and administrative expertise. These, together with Delaware's code, constitute reputational capital. Delaware protects this storehouse of capital by imposing internal process and structure rules that deter political disruption.⁶¹ This store of capital bolsters the state's market position. Other states cannot credibly precommit to offer superior service, and thus are deterred from incurring the necessary start-up costs. A first-mover advantage in Delaware results.⁶²

As originally articulated, this market-based race to the top validation of state law bypassed the problem of the shareholders' lack of influence over state lawmaking with a reference to the control market deterrent. The assertion, in effect, was that the managers'

General Corporation Law of 1899, 1 DEL. J. CORP. L. 249, 265-70 (1976).

60. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 38-39. Franchise taxes amounted to 17.7% of Delaware's total tax revenues in 1990. *Id.* at 10.

61. These include its direction of corporate matters to a specialized chancery court, its practice of appointing rather than electing its judges and limiting them to 12-year terms, and its requirement of two-thirds majorities in both houses of its legislature for the approval of corporation code amendments. *Id.* at 38-42.

62. *Id.* at 40-44. The store of capital also fosters reciprocal dependencies between Delaware and its customers. The lawyers who recommend reincorporation to client corporations invest in Delaware expertise, and thus have incentives to recommend it as a destination. Their clients need to economize on legal costs, and thus tend to stay in place. For competing explanations, see RICHARD A. POSNER & KENNETH E. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 111 (1980) (finding that large firms go to Delaware); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 190 (1985) (finding that firms with concentrated ownership do not go to Delaware).

The basic model of the "first-mover advantage" is that of Michael Spence. See Michael A. Spence, *Entry, Capacity, Investment and Oligopolistic Pricing*, 8 BELL J. ECON. 534, 534-44 (1977). Under it, an oligopolist must commit resources to a certain level of production; a potential entrant can observe this, and must decide whether to enter and produce at a certain level. *Id.* at 534. Spence's entry deterrence model assumes a two-stage game in which one firm may enjoy a first-mover advantage if it can choose its quantity first: Because firm one uses its excess capacity to deter firm two's entry, quantity has a commitment value. *Id.*; see also JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 317-22 (1988) (reviewing the Spence-Dixit model and interpreting it as a double capacity game, with production as the first capacity constraint and selling capacity as the second); Avinash Dixit, *A Model of Duopoly Suggesting a Theory of Entry Barriers*, 10 BELL J. ECON. 20, 20-32 (1979) (finding that "a great absolute advantage in demand (or cost) for established firms makes entry harder, but lower cross-price effects with potential entrants' products make entry easier").

option of exit adequately disciplined the states, while the possibility of shareholder exit by tender to a hostile offeror adequately disciplined the managers. This story lost its persuasiveness as managers and state politicians collaborated⁶³ to hamper the market deterrent with the antitakeover legislation of the 1980s.⁶⁴ This manifest case of charter market failure⁶⁵ reinforced the opponents' assertion that management capture of the states leads to suboptimal lawmaking. Following the lead of Roberta Romano,⁶⁶ the market deterrent school moved to a middle ground position on charter competition.⁶⁷ From that perspective, they defend the state system, except to the extent that it inhibits the control market.

Others, principally Lucian Bebchuk, returned to the attack.⁶⁸

63. Although this is interest group legislation, it did not result from the efforts of a centrally-organized management lobbying effort. Romano's case study of the state legislative process here suggested that the statutes are initiated by threatened managers of local corporations and their assistants in the local corporate bar rather than by broad coalitions of business, labor, and community leaders. See Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 n.11 (1988).

64. The statutes evolved in succeeding generations. The first generation submitted tender offers to substantive review by state securities administrators; those statutes were held unconstitutional under the Commerce Clause in *Edgar v. MITE Corp.*, 457 U.S. 624, 640 (1982). The second generation limited the subject matter scope to regulation of internal corporate affairs. These statutes tend either to condition the voting right of bidders on the approval of the shareholders as a whole, impose freeze periods on combinations between bidders and targets, or require that an equal price be paid in the second stage of a two-tier acquisition. Some statutes combine these elements. These statutes survived constitutional challenge in *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987). Another variety confirms the legitimacy of board consideration of the constituents' interests other than shareholders in takeover defense situations. For a summary, see ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 53-57.

65. A large body of empirical work confirms that the antitakeover statutes had a harmful effect on shareholder value. This empirical result emerges from a complex picture that encompasses the negative price effects of contractual antitakeover provisions such as poison pills. For a summary of this work, see ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 60-75.

66. See Romano, *Law as Product*, *supra* note 43, at 281.

67. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 222 (1991) (concluding that the race to the top stands as refuted, but the proposition that competition creates a "powerful tendency" to enact shareholder beneficial laws remains vital); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1528 (1989) (expressing more confidence in the view that Cary was wrong than in the view that state competition results in a race to the top).

68. Bebchuk, *supra* note 36, at 1458-75; see also Charny, *supra* note 36, at 456 (promoting "harmonization," the promulgation of corporate rules by a central authority); Roberta S. Karmel, *Is It Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 91-96 (1991) (endorsing the promulgation of uniform federal corporate law); Joel Seligman,

Bebchuk argued that the middle ground⁶⁹ result stems from a structural defect in the competitive system that disables the production of a maximizing legal regime. The market leads the competing states to focus on the variables that influence reincorporation decisions.⁷⁰ There follows from this a concern for management preferences rather than shareholder value itself. Accordingly, nothing deters the states from pursuing policies of management accommodation with regard to the fiduciary and market deterrents.⁷¹ Bebhuk concluded that because of this oversight, federal fiduciary standards should preempt most state takeover regulation.⁷²

The renewed debate on the desirability of federal intervention continues among those occupying different middle-ground views of charter competition. At the foundation of this debate lies the allocation of the theoretical burden of proof for or against intervention, the assumption being that the side bearing the burden loses the game. Several points are sharply controverted. Opponents of intervention point to a body of event studies showing that reincorporation in Delaware does not reduce shareholder value; proponents argue that convergence among the states on the basic points of corporate law denudes the results of persuasiveness.⁷³ Opponents

The Case for Minimum Corporate Law Standards, 49 MD. L. REV. 947, 971-74 (1990) (same); Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 60-63 (1993) [hereinafter Seligman, *New Corporate Law*] (same).

69. Bebhuk, *supra* note 36, at 1440-41. Bebhuk began his analysis of the problem by stating his assumption that, absent reasons to the contrary, state competition is more likely to produce an efficient rule than federal regulation. *Id.*

70. *Id.* at 1452-54.

71. Bebhuk identified a category of "insignificantly redistributive," management-favorable rules that always escape the market constraint. *Id.* at 1462. Bebhuk hypothesized a transaction undertaken by a \$1 billion firm that reduces shareholder value by \$1 million for the purpose of returning \$200,000 to management. *Id.* at 1463. The transaction is too small to excite a takeover, but as long as state law opens the door, management has every incentive to undertake it. *Id.* In addition, competition can cause the states to use their lawmaking power to impair the strength of market discipline even further, as the proliferation of antitakeover statutes demonstrates. *Id.* at 1467-68; *see also* Coffee, *supra* note 28, at 770-72 (discussing the impact of state antitakeover legislation); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471 (1987) (same).

72. Bebhuk, *supra* note 36, at 1494-95.

73. Roberta Romano conducted the leading event study showing that reincorporating firms experience an increase in value or no significant stock price declines. *See* Romano, *Law as Product*, *supra* note 43, at 279-80. Proponents of intervention respond with a number of standard questions about the shareholder vote on which reincorporation is conditioned. Even though Delaware has value-decreasing rules, the shareholders may approve a move for several reasons: because the move on the whole increases shareholder value, the shareholders have inadequate information, or management has tied the move

draw on a contractual theory of the firm and point out that new federally mandated fiduciary deterrents would retard the evolution of contractual corporate arrangements;⁷⁴ proponents respond that the consensus view on contracting out continues to favor fiduciary mandates in view of the rational apathy that impedes shareholder choices of governance terms.⁷⁵ Opponents argue that the federal political landscape remains as hostile as that of the states, making perverse effects a likely result of a federal law-reform movement,⁷⁶ proponents respond that the federal venue is marginally more hospitable and that centralized politics facilitate shareholder collective action.⁷⁷

to another corporate action they desire. Bebchuk, *supra* note 36, at 1471. These problems limit the normative force of the event studies: The stock prices may reflect the market's reaction to the developments signalled by the reincorporation rather than the reincorporation itself, and managers may systematically choose to reincorporate at moments when such information exists. *Id.* at 1449-50; *see also* Coffee, *supra* note 28, at 767-68 (offering a critique of Romano's analysis); Macey & Miller, *supra* note 71, at 482 (same); Romano, *Law as Product*, *supra* note 43, at 267 (discussing the implications of reincorporation). Romano, who recognizes the former possibility, responds that it is improbable that information tied to the move could swamp an otherwise negative stock price effect; rather, if management were manipulating the process, price-negative rather than price-neutral results should obtain for firms reincorporating for management-favorable purposes. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 18. Bebchuk, following others, anticipates this point: Given convergence among the state codes, the absence of negative returns may only mean that the legal rules of the original and destination state are equally harmful. Bebchuk, *supra* note 36, at 1449; *see also* Coffee, *supra* note 28, at 767-68 (discussing the logical inferences to be derived from "statistical noise"); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1508 (1989); Macey & Miller, *supra* note 71, at 482-83 (discussing the market signals produced by relocation to Delaware). Furthermore, the fact that reincorporation does not decrease value overall does not prove that competition produces desirable results on all corporate issues. Bebchuk, *supra* note 36, at 1450.

Bebchuk, in sum, argues that the event studies must be seen in temporal perspective. *Id.* at 1448-51. They do contradict Cary's picture of an ever-lowering race to the bottom with Delaware in the lead. However, once we accept that point and join Romano on the middle ground, the probative force of the studies diminishes. The race, in effect, bottomed out before the studies were undertaken. *Id.* The prospective question is whether intervention can cause the numbers to improve. *Id.* at 1509-10.

In Romano's view, acknowledging disproof of the race to the bottom decides the debate over intervention. Given agreement on the beneficial effects of competition, she said, the burden is on advocates of intervention to demonstrate "empirically which particular code provisions harm shareholders and why national legislation would be more likely to alleviate the problem." ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 19.

74. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 90-91.

75. Bebchuk, *supra* note 36, at 1496-99.

76. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 50, 75-84.

77. William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L. J. 401, 432 (1994).

B. Charter Competition as Regulatory Capture

This middle ground discussion of federal intervention takes on the binary quality of the old race to the top/race to the bottom discussion as its participants iterate positions from the historic debate over market and fiduciary deterrent strategies. However, as the replay continues, each side has recognized possibilities for both market success and market failure. This more open-ended theoretical framework allows more flexibility in the diagnosis of the problem, and the stronger assertions of regulatory competition theory have dropped out of the picture for the most part. The 1980s antitakeover alliance between the states and the managers has dispelled the notion that identification of a market phenomenon at a significant stage in the lawmaking process, taken alone, assures the ideal result of legislation based solely on the exogenous preferences of individuals. It has become clear that imbalanced interest group influence in this market-driven lawmaking process prevents that result, divesting regulatory competition theory of a legitimating effect.

Regulatory competition matches individual preferences and legal results because actors have the opportunity to exit cheaply from an unsatisfactory jurisdiction. The charter system, of course, does allow for exit from an unsatisfactory jurisdiction, but, because the exit privilege applies to firms rather than to shareholders, it does nothing to ameliorate the agency problem. Corporate law has evolved under charter competition to block shareholder access to the determination of reincorporation decisions.⁷⁸ Existing market disciplines offer no way around that barrier because they create no incentives to encourage the development of a shareholder-favorable jurisdiction.⁷⁹ Successful control contests, whether by takeover or proxy fight, displace one group of managers with another. The new management, unless it has taken the firm private, remains in an agency relationship with the firm's shareholders and thus has no reason to look for a jurisdiction favorable to the shareholder interest.⁸⁰ In addition, due

78. See *infra* notes 275-83 and accompanying text.

79. Cf. Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1249 (1992) (arguing that the charter competition process is not defective in itself, but that the unresolved principal-agent problem respecting the selection of the state of incorporation makes locational decisions defective).

80. The displacing group that plans to make further acquisitions with the target has an interest in the removal of state law antitakeover barriers. However, reincorporation to a hypothetical shareholder-favorable jurisdiction would not help with this problem, since

to the peculiarities of America's constitutional structure, the competing jurisdictions—which lack a balancing incentive—have national lawmaking power over the shareholders of domiciliary corporations. In this variant of regulatory competition, then, exit from one jurisdiction provides no remedy for the dissatisfactions of the disadvantaged interest group.

1. Capture Theories of Regulation

The mixed framework invites a retelling of the charter competition story in terms of both the economic and governmental politics of interest groups and organizations. In this story, charter competition becomes the mainspring of a uniquely stable arrangement of regulatory capture.

Under capture theories of regulation, interest groups and political decisionmakers enter into jointly maximizing relationships. The simple demand model of capture asserts that lawmaking follows the lawmakers' responses to demand patterns.⁸¹ Particular responses depend on interactions between the lawmakers' risk profiles and the projected benefits of legislative action.⁸² The lawmaker, being risk averse, tries to avoid conflicts—given no demand for legislation, nothing is done; given organized demand, the lawmaker attempts to satisfy the interest group making the demand with beneficial legislation.⁸³ In addition, interest groups desiring to influence legislation encounter collective action problems.⁸⁴ Different groups have

the law of the target jurisdiction applies in a takeover. The only solution to the acquiring firm's problem, then, is interest group pressure to work against antitakeover legislation nationwide. Yet, at this point, conflicting interests among acquiring firms enter into the picture. Today's acquirer may be tomorrow's target; the managers of large acquirers can afford to be patient and work around state barriers in making hostile acquisitions, meanwhile enjoying the prerogatives of the state law regime.

81. See Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339, 343-44 (1988); see also Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265-68 (1982) (discussing the interest-group theory).

82. Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 214 (1976). Benefits can come in the form of resources or favorable consequences for reelection. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 10-13 (1971). With corporate law, the benefit tends to be rents from corporate business.

83. See Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 1983 Q.J. ECON. 371, 394-96 (discussing the impact on the political redistribution of income resulting from competition among political pressure groups vying for political favors).

84. Olson's fundamental insight is that in a large, heterogeneous community, individuals will prefer not to pay the full cost of the provision of nonexcludable public

different abilities to overcome them—the smaller the group and the higher the per capita stake of its members, the greater the likelihood that the members will work out a collective arrangement and enjoy the benefits of governmental influence.⁸⁵ This activity results, according to the theorists of the Virginia School, in a social loss from rent-seeking.⁸⁶ Legislators create rents for the benefit of successful interest groups, distributing them based on a self-seeking vote calculus.⁸⁷

An additional body of capture theory supplements this demand model with a supply-side story. Exclusively demand-based models of law production tend to treat the political process as a black box and, as a result, do not attempt to describe how legislative trades are accomplished and enforced.⁸⁸ This is a problem, since legislative

goods and that, as a result, they will be undersupplied. A free-rider problem must be overcome if public goods are to be supplied, and voluntary compliance can be secured only by introducing selective incentives (such as fees) or sanctions. OLSON, *supra* note 48, at 50-51, 133-34. The result is that rational individuals are motivated to join interest groups based on individualized selective incentives. *Id.* at 60-65. Given the free-rider problem, large groups will have difficulty achieving their goals. *Id.* at 35-36.

85. It seems to follow that, in a case in which more than one interest group manages to compete to achieve influence, the risk-averse legislator will delegate ultimate regulatory authority to an agency. Once that occurs, the agency becomes the venue of interest group activities. See JAMES WILSON, *THE POLITICS OF REGULATION* 388-89 (1980).

86. The Virginia School concentrates on the economic theory of legislation. The idea is simple: Government creates rent that is captured by interest groups. Politicians pass legislation that benefits the interest groups that are better organized, and rents are distributed based on the welfare maximization of the political decisionmakers. The cost of supplying rents to well-organized groups is passed on to poorly organized groups.

The upshot is a waste of consumer surplus. Governments create rents and can appropriate them, and they are likely to squander the rents they capture; as a result, everyone is worse off. Under this view, the political process is justified only if lawmakers produce legislation obtained without influence. The task of politics, then, is to create legislation based on the exogenous preferences of individuals. See Richard S. Higgins et al., *Free Entry and Efficient Rent-Seeking*, in *THE POLITICAL ECONOMY OF RENT-SEEKING* 127, 128 (Charles K. Rowley et al. eds., 1988); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, in *TOWARD A RENT-SEEKING SOCIETY* 39, 46-47 (James Buchanan et al. eds., 1980).

87. Policies are evaluated in terms of the distribution of costs and benefits based on the assumption of a level of votes for each dollar expended. See William C. Mitchell, *Interest Groups: Economic Perspectives and Contributions*, 2 J. THEORETICAL POL. 85, 98-99 (1990); Tollison, *supra* note 81, at 339-50; Barry R. Weingast, *The Congressional Bureaucratic System: A Principal-Agent Perspective (With Applications to the SEC)*, 44 PUB. CHOICE 147, 147-48 (1984).

88. Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress; or, Why Legislatures, Like Firms, Are Not Organized as Markets*, 96 J. POL. ECON. 132, 133 (1988); see also Tollison, *supra* note 81, at 347-66 (summarizing supply-side research). Such models also leave unexplained such phenomena as simultaneous provision of policy benefits to multiple diverse interests. See Daniel A. Farber, *Politics and Procedure in*

trades, unlike well-drafted private contracts, can be undone at the subsequent behest of a competing group. For example, an interest group deal, obtained in the legislature through logrolling and other trading mechanisms and then embodied in a legislative directive, can be undercut later by an administrative agency responding to a competing interest group. In the alternative, representatives can amend or repeal a piece of legislation later at the request of a competing group. Supply-side explanations of interest-group dealmaking confront this problem of political insecurity by drawing on organizational economics to show that institutional arrangements have an impact on outcomes. This body of work disaggregates the government into a complex of principal-agent relationships.⁸⁹ In these stories, legislatures develop process and structure machinery to control the opportunistic conduct of both career bureaucrats and legislators.⁹⁰ These devices include the legislative committee system, which helps to overcome problems of asymmetric information between legislative principals and bureaucratic agents through *ex post* monitoring, and process requirements for rulemaking, which provide advance notice of noncomplying conduct.⁹¹ The processes of the

Environmental Law, 8 J.L. ECON. & ORGS. 59, 65 (1992) (concluding that the special interest model fails to explain environmental legislation).

89. Matthew D. McCubbins et al., *Administrative Procedures as Instruments of Political Control*, 3 J.L. ECON. & ORGS. 243, 243-44 (1987); Weingast, *supra* note 87, at 148.

90. Matthew D. McCubbins et al., *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431, 441 (1989). A related, and more abstract, line of discourse considers the effects of given modes of voting process on the ordering of preferences among elected representatives, refuting the chaos scholars predicted under early social choice theory. See, e.g., PETER C. ORDESHOOK, *GAME THEORY AND POLITICAL THEORY: AN INTRODUCTION* 266-301 (1986) (discussing agenda control and outcome); David P. Baron & John A. Ferejohn, *Bargaining in Legislatures*, 83 AM. POL. SCI. REV. 1181, 1189-98 (1989) (considering closed and open rules of legislative amendment); Jules Coleman & John Ferejohn, *Democracy and Social Choice*, 97 ETHICS 6, 8-9 (1986) (finding that the particular content and contour of institutions determines the extent to which electoral outcomes reflect popular preferences).

91. For a formal agency model of information asymmetries and capture relationships between legislatures and agencies, and between producer groups and public interest groups, see JEAN-JACQUES LAFFONT & JEAN TIROLE, *A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION* 480-500 (1993). But cf. Andrei Shleifer & Robert W. Vishny, *Politicians and Firms* (1994) (Harvard Institute of Economic Research Discussion Paper No. 1686) (unpublished manuscript on file with the authors) (claiming that approach turning on a complete information model is not plausible in cases where the problem of inefficiency is essential to the politicians' performance, such as in state-run enterprises; therefore, corruption is central to the operation of the firm).

For an application of this approach keyed to legal policymaking, see Jonathan R. Macey, *Organizational Design and the Political Control of Administrative Agencies*, 8 J.L.

legislature also contribute to transactional stability: Legislative procedures and committee jurisdictions give the congressional gatekeeper the ability to resist short-term internal pressures.⁹²

2. Charter Competition as a Form of Capture

These capture theories of legislation and administration provide a useful basis for explaining the success of the charter competition system and the preeminence of Delaware. Exit through reincorporation provides a potent *ex post* enforcement device to the managers who purchase legislation from the target state, particularly a small state dependent on charter revenues. *Ex ante*, the code the managers purchase provides them with control of the enforcing exit decision by blocking shareholder access to the charter.⁹³ The state's incentive to collect rents from new incorporations assures that the process legislation securing the exit route will not be amended in the future to make exit more difficult. Thus the state's rent incentive joins the deterrent of possible reincorporation to assure the managers that the deal will stick. The combination does more than that, however. It also mitigates any collective action problems the managers might encounter in getting the future legislation. Should desired legislation not be obtained, exit can be effected unilaterally, and there will remain up to forty-nine states from which to choose. Furthermore, the chartering state's rent flow includes fees to practicing lawyers in addition to franchise taxes. This assures an identity of interests between management and key actors on the supply side. In this scheme, the organized bar in the chartering state can be expected to act as an effective advocate for the management interest, without forcing management to organize a trade association to enter into a formal lobbying relationship. Delaware practice confirms this prediction.⁹⁴ Delaware delegates to its bar association

ECON. & ORGS. 93, 99-103 (1992). Macey contends that legislators are able to capture higher rents only if they can surmount the agency problem. *Id.* at 100. In Macey's view, *ex post* monitoring and punishments may not be sufficient to solve the agency problem. *Ex ante* structuring or "hard-wiring" of the agency works better, and the interest groups that pay for the legislation can be expected to attempt to secure it. *Id.* at 100-03.

92. Kenneth A. Shepsle, *Congress is a "They," Not an "It": Legislative Intent as Oxymoron*, 12 INT'L REV. L. & ECON. 239, 245 (1992). Moe, *supra* note 42, at 122-23, criticizes this literature for its adherence to a model of motivation grounded in strategic rationality, asserting that a thick description of the motivations of different types of actors provides knowledge about authority that the principal-agent models do not offer.

93. See *infra* notes 259-74 and accompanying text.

94. It should be noted that the interests of the bar and management diverge on the matter of litigation incentives. For discussion, see *infra* text accompanying notes 126-37.

both agenda control and drafting responsibility for any amendments to its corporate code. The bar and legislature have a long-standing "understanding"—amendments to the corporations code must first be drafted and approved by the bar association's corporate law section and the bar association itself.⁹⁵

Capture by charter competition exacerbates the shareholders' collective action problem even as it reduces that of management. State law not only blocks shareholder access to the charter, it provides only management with routine compensation for expenses incurred in voting contests.⁹⁶ Meanwhile, the bar emerges as the only interest group within the chartering state with an incentive to advance the shareholders' interest in lawmaking processes. Litigating lawyers promote shareholder welfare as an incident to making a living as enforcers of the fiduciary deterrent. Unfortunately, this confluence of interests results in a strictly limited set of shareholder benefits. The lawyers have an incentive to promote lawmaking that strengthens the market deterrent only if the change would lead to additional litigable disputes. The same applies to lawmaking that enhances the possibilities for shareholder-enforced self-regulation. Such incentives seem unlikely to arise in practice. Fiduciary breaches that bring rents to lawyers stem from excess management influence; any market or self-regulatory governance strategy that has a cognizable chance of working well in practice ultimately threatens to diminish those rents by reducing the numbers of unproductive influence activities. In addition, the bar's interest diverges from the shareholders' even within the sphere of fiduciary enforcement, with the bar favoring a

95. See Andrew G.T. Moore II, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 780-81 (1987). Active drafting and discussion is limited largely to the corporate law section. See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 888-92 (1990). The section itself performs the legislative function of sifting the comments of interested parties. Each of the three largest corporate servicing firms have representatives to the section. *Id.* at 888-92, 910.

The legislature rubber stamps the bar's recommendations; the executive branch's role is limited to representation at bar association meetings on invitation. *Id.* at 888-92; see also David S. Schaffer, Jr., *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J.L. & PUB. POL'Y 665, 682-84 (1987) (discussing the 1967 revision of Delaware corporate law).

96. It compensates only shareholder winners in board control contests and provides no compensation at all to shareholders who oppose management positions in issue contests. See *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955). For discussion, see Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071 *passim* (1990).

system that trades substantial money judgments to shareholders for substantial attorneys' fees.⁹⁷

In short, no interest group in the chartering state has a rent incentive linked to the shareholders' interest in minimizing influence costs within the firm. The shareholders, then, must self-organize⁹⁸ to advance an agenda in state lawmaking processes. Unfortunately, the charter competition system structurally limits prospects for payoffs that would justify the costs of organization. Furthermore, any sustained shareholder effort would have to be pursued in multiple jurisdictions. By default, then, federal law emerges as the preferred venue for organized shareholder efforts to alter legal structures to make firms operate more effectively.⁹⁹ Federal lawmakers, unlike their counterparts in the states, have not been captured by the management side pursuant to a deal with sticking power. This is, of course, only a negative qualification that by no means implies probable success for a shareholder influence campaign. Process costs still loom large at the federal level, and management retains both organizational advantages and well-worn paths of influence. But the turf at least is open. There are no rent incentives tied to chartering decisions, and a large number of players, each making complex and political calculations in a dynamic environment, makes it easier to contest management influence.¹⁰⁰

C. *Conflicting Demands on the Captured State*

We draw no race to the bottom conclusions from this capture model of corporate lawmaking. Rather, the model serves to explicate the theoretical implications of the middle ground framework, putting a different gloss on the same practices purveyed as productive relational contracting in the race to the top story. Since many areas

97. For discussion of the role that the lawyers' interest plays in shaping Delaware law, see *infra* text accompanying notes 131-37.

98. Shareholders also may rely on independent allies such as academics.

99. This conclusion obtains even though Delaware's compact and relatively informal lawmaking processes, see *supra* note 95 and accompanying text, hold out significant process cost advantages. For a discussion of the relative advantages and disadvantages of the federal venue, compare ROMANO, GENIUS OF CORPORATE LAW, *supra* note 28, at 75-81, with Bratton, *supra* note 77, at 430-33.

100. The SEC embodies this possibility: Historically, its actors tend to satisfy the demands of neither the shareholder nor the management side. In addition, they bring an inherited, albeit limited ideology of shareholder protection to their ongoing mediative activities. Recent amendments to the proxy rules promulgated at the instance of institutional shareholder activists, see *infra* note 180, concretely demonstrate this agency's continuing receptiveness to shareholder agenda items.

of state corporate law find shareholder and management interests in alignment, it complicates, but does not displace, the relational contract reading.

The capture model does suggest exploration of strategies of federal intervention designed to diminish state law's imbalanced supply-side incentives and imbalanced opportunities to make demands. However, it does not thereby imply that federal fiduciary standards are the most desirable mode of intervention. Federal fiduciary standards would ameliorate both the supply and demand-side problems by imposing shareholder-favorable norms. They also would entail a difficult trade off, because process infirmities could follow from the appointment of the federal judicial system to the shareholder guardian role. The infirmities lie in the possibility that a preemptive change in the venue of corporate common lawmaking from the Delaware courts to the federal courts would so materially alter the composition of the product sold in the charter market as to denude Delaware of significant relational capital. The loss of the first-mover role in common lawmaking would leave Delaware marketing a product of diminished value and weaken its relational tie with firms. The rents that support Delaware as a center of information on corporate governance disputes could dissipate, possibly leading to corporate lawmaking on a level of diminished sophistication.

Thus, one assertion of regulatory competition theory—that national lawmaking procedures carry process infirmities that are avoided when the subject matter is left to the competing states—continues to bear on the debate. The captured state system can enhance economic welfare to the extent that its competitive element causes the lawmaker to weigh the regulations' benefit and harm to the firm as a whole.¹⁰¹ Arguably, then, the preferred solution to the corporate agency problem leaves the subject matter with the states but finds a means to interpose the shareholder interest

101. See AYRES & BRAITHWAITE, *supra* note 13, at 63-66 (providing a prisoners' dilemma model of agency capture).

into state lawmakers' demand picture.¹⁰² This would render the capture benign.¹⁰³

Past practice provides a base point from which to begin this reordering of incentives. Shareholder demands have, in fact, figured into the existing competitive regime in a secondary posture, influencing the shape of Delaware's fiduciary case law. This result appears surprising if we view state law under the pure product competition model. To account for it, the model must be expanded to encompass the political instability that results from the national attention that Delaware lawmaking attracts because of its dominant market position.

1. Delaware Lawmaking and the Threat of Federal Intervention

The deal struck between the chartering state and management can never be entirely secure because the possibility of removal of corporate lawmaking to the federal level inheres in the constitutional structure of the United States. Delaware, as the entity most dependent on corporate law revenues, is the contracting state most prone to view that possibility as a threat. This structural constant suggests that Delaware lawmakers may have secondary incentives to respond to shareholder interests.¹⁰⁴

It can be plausibly hypothesized that Delaware actors remain averse to possible destructive exercises of federal preemptive power and have incentives to avoid exciting its application.¹⁰⁵ Federal law

102. This point can be expanded by analogy to the literature on legislative control of agencies, under which the question of political control has been addressed in terms of the economic principal-agent problem. See generally, e.g., McCubbins et al., *supra* note 89. A federally imposed fiduciary regime would restrict opportunities for this beneficial engagement because it would remove the lawmaker from an immediate agency relationship with the firm.

103. Restating this point, the charter competition problem stems from the same incentive problems and barriers to collective action that create the corporate agency problem in the first place.

104. A number of commentators have recognized this possibility. See Bebchuk, *supra* note 36, at 1455; Cary, *supra* note 10, at 688; Eisenberg, *supra* note 73, at 1512.

105. This dual demand model's plausibility depends on three assumptions. First, actors in Delaware must perceive that their activities have the potential to excite political action at the national level. Second, Delaware actors must perceive that the shareholder interest finds a voice among the actors and groups that influence federal law. Third, the projected federal political action must have a negative impact either on the charter competition system as a whole or on the relative place of Delaware in the system to reduce Delaware's rent flow.

As to the first assumption, periodic calls for federal intervention have, over the years, given Delaware reasons for concern. Although federal intervention has not been a present prospect since the late 1970s, see *infra* note 114, the subject has remained a staple of corporate law discourse. Anecdotal evidence shows that Delaware lawmakers keep it in

reform discussions of the past two decades have given Delaware actors cause for concern because the often-proposed remedy of federal fiduciary standards would have an adverse impact on their interests. This vulnerability stems from the competitive evolution of corporate statutory law. Competition has caused state corporate codes to converge in their broad outlines. As a result, Delaware's case law, judges, and speedy process figure prominently in its line of legal products.¹⁰⁶ Federal intervention might deprive Delaware of

mind when they take politically sensitive steps. The Delaware bar's concern about federal responses is confirmed in accounts of its deliberations on new legislation. When the bar first considered (and rejected) an antitakeover statute, it received comment letters from Martin Lipton and Joseph Flom warning that enactment might excite federal intervention. Such worries were expressed at the committee meeting on the proposal. *See Alva, supra* note 95, at 906-08.

The second assumption has been the subject of debate. Professor Romano argues that management replicates its dominant influence in the states at the federal level. She inspected the federal corporate law reform politics of the 1980s to show that management voices were heard the most often. Romano surveyed the content of both federal takeover legislation proposed during the period 1969-87 and of interest group representation in the accompanying legislative processes. She found that the overwhelming majority of bills had an antibidder aspect and that management voices appeared much more frequently than shareholder or labor voices. ROMANO, *GENIUS OF CORPORATE LAW*, *supra* note 28, at 76-81. Romano also showed, however, that bureaucratic, political, and academic voices were heard in quantity during the 1980s. *Id.* at 77. In any event, to the extent that large stakes in the *status quo* make Delaware's lawmakers risk averse, any active federal politics with possible adverse consequences might prompt them to make a preemptive response.

Regarding the third assumption, the gravity of a federal threat will vary with the particular form of federal intervention proposed. A discrete provision might impair Delaware's position only incidentally, blocking a particular management accommodation, but applying the block to all 50 states. As examples, consider (1) the all holders rule, Rule 14d-10 under section 14(d) of the Securities Exchange Act of 1934, 17 C.F.R. 240.14d-10 (1994), providing that any tender offer must be open to all holders of the subject class of securities, preempting the defensive tactic sustained in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); and (2) the special tax on greenmail profits, I.R.C. § 5881 (1991), enacted in 1987, which imposes a 50% excise tax on profit realized in a greenmail transaction. In either case, Delaware no longer can take a competitive lead on the subject matter regulated, but neither can any other state. The overall field of subject matter for competition shrinks slightly, but not enough cognizably to impair Delaware's position. Furthermore, a federal provision might even result in a short-term enhancement of Delaware's position. Consider, as an example, the proposals for national antitakeover legislation made during the mid-1980s. At that time, worries about federal responses contributed to Delaware's hesitancy to initiate takeover defense legislation. Federal intervention on either side would have settled the matter, removing a threat of competition from other states.

106. In addition to a large collection of past decisions, Delaware sells a unique, technically qualified judiciary and speedy determination of new disputes. Bayless Manning identified Delaware's judiciary as its prime attraction, comparing Delaware to the medieval law merchant. Bayless Manning, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 784-85 (1987). For confirmation of this point from a game theory perspective, see Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59

the principal justification for its premium price, resulting in an outbreak of price competition in the market and the erosion of Delaware's position as an informational center. Recognition of a perceived federal threat implies a model in which Delaware faces conflicting demands, each threatening potential negative consequences. First, the management interest must be satisfied to prevent corporate migration out of the state and entry into competition by competing states. Second, federal actors, as proxies for the shareholders, must be satisfied to avoid destructive intervention. The conflicting demands complicate the business of response: Professor Eisenberg has suggested that the conflict leaves Delaware with an incentive to avoid taking the lead in adopting rules favoring managers at the shareholders' expense. Other states have a different incentive. If they offer innovative management-side payments, they may siphon business from Delaware; if the federal government intervenes to stop them, they lose little. So long as a given state has a small market share, its actions attract little attention. Delaware, in contrast, cannot take any significant steps without close scrutiny nationwide.¹⁰⁷ It remains under pressure to follow new developments elsewhere, but emerges in a mediative role.

A question arises as to how Delaware, alone in this competing demand situation, can structure a mediative response without losing business, given a market still keyed to management preferences.¹⁰⁸ Two factors make this picture plausible. First, no full-service alternative domicile exists, and only a handful of other jurisdictions have strong incentives to incur the start-up costs to market a full-service operation. But a potential competitor has no assurance that a third jurisdiction will not duplicate its efforts,¹⁰⁹ and given the low

U. CHI. L. REV. 1391, 1414-15 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991)).

107. Eisenberg, *supra* note 73, at 1512-13; *see also* Bebchuk, *supra* note 36, at 1455 (pointing out that there remains a range within which states can maneuver without fear of federal intervention).

108. Delaware's mediative output can be explained in terms of the interests of managers as a group. Well-timed interventions to protect shareholders serve to defuse the federal threat and to make Delaware a buffer state that protects corporations from federal intervention. However, the benefits of a mediative jurisprudence are more questionable from the point of view of individual managers seeking an optimal environment. They have an apparent incentive to cause their firms to migrate to states adopting less equivocal antitakeover policies, free riding on the firms that stay. Of course, if a large number of firms surmounted this collective action barrier and successfully shopped for a more responsive jurisdiction, federal intervention would become more likely. The same might occur if a large number of firms left Delaware, starting a new race to the bottom.

109. *See* Daniels, *supra* note 52, at 182.

cost of reincorporation,¹¹⁰ no assurance that its new customers will remain. Second, the shareholders' newly discovered capability of self-protective collective action may effectively deter management reincorporation proposals. Beginning in the late 1980s, incidents of shareholder resistance caused managers to drop the assumption of automatic shareholder approval of antitakeover proposals requiring charter amendment.¹¹¹ Thus, departure from Delaware may not be the open option it used to be.

Evidence of the dual demand model's robustness can be found in the recent pattern of Delaware lawmaking. Given statutory convergence among the states and the dominance of the management interest, the problems of conflicting demand rarely show up in corporate legislative process. Antitakeover legislation is the principal recent instance, and Delaware's corporate bar moved late and with caution in putting an antitakeover statute before its legislature.¹¹² The conflict becomes more apparent in the adjudication of fiduciary cases, particularly those dealing with corporate control transfers.¹¹³ Here the shareholder interest has found Delaware intermittently responsive. The Delaware judiciary abruptly changed a long-standing habit of monolithic fidelity to management interests in 1977,¹¹⁴ and

110. See Black, *supra* note 28, at 551, 574, 586-90.

111. See *infra* notes 162-80 and accompanying text. Romano contributed some evidence of this phenomenon with a report on the behavior of public corporations subject to the 1990 Pennsylvania takeover statute. The Pennsylvania statute, like most takeover statutes, included a default rule that applied the statute to all corporations that failed to take affirmative action to opt out. See PA. CONS. STAT. §§ 2571-75 (1994). Despite this, pressure from institutional investors resulted in opting out by the boards of 127 firms; only 72 firms stayed in. ROMANO, GENIUS OF CORPORATE LAW, *supra* note 28, at 68-69. Presumably, opportunistic reincorporation proposals would excite similar shareholder attention.

112. See Alva, *supra* note 95, at 906-08.

113. This is analogous to the allocation of responsibility between legislatures and agencies. Legislators faced with a conflicting demand problem can avoid confrontation with the competing interest groups and resort to the expedient of delegating lawmaking authority to an agency; with state corporate law, the judiciary tends to assume this function. Delaware, as it responded to sensitive developments in the corporate control market of the 1980s, kept open its options by employing equivocal judicial rules in preference to clear cut legislation.

114. See *Singer v. Magnavox Co.*, 380 A.2d 969, 976-80 (Del. 1977) (imposing strict fiduciary standards on parent firms in cash-out mergers). The *Singer* rule was in turn rejected for a looser, process-based approach in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 704, 715 (Del. 1983). Oddly, *Singer* was decided after the immediate threat of federal preemption of state fiduciary rules under the antifraud rules of the securities laws had been removed by the Supreme Court in *Santa Fe Indus. v. Green*, 430 U.S. 462, 479-80 (1977). The story told at the time was that the brush with preemption at the hands of the federal judiciary and the wider critical atmosphere provoked by Cary and others had

Cary's 1975 article has been accorded a role in the break.¹¹⁵ The federal threat, thus crystallized, impressed upon the Delaware courts the practical importance of solicitude to shareholder interests.¹¹⁶ This post-Cary behavior pattern has persisted and still yields headlines as highly publicized cases articulate surprising new shareholder-protective applications of basic fiduciary rules.¹¹⁷ The pattern has been volatile,¹¹⁸ however, and shareholder protective intervention has not been a constant theme. The Delaware courts' indulgence in this back-and-forth at apparent cost to a reputation for certainty, predictability, and management responsiveness confirms the presence of competing demands.

Two caveats must be noted. First, the federal threat does not play an exclusive causative role in this conflicting demand model. Courts and judges sell reputations for speed, dependability, and predictability, but they also stake reputational capital in their working

prompted the Delaware Supreme Court to reverse its direction and become more accommodating to the interests of investors to diminish the threat of intervention.

115. The federal threat, and Cary's association with it, appears in accounts of these events. See, e.g., Coffee, *supra* note 28, at 764-66; Eisenberg, *supra* note 73, at 1511-13.

116. Prior to *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), there was a cognizable chance that much conduct covered by state fiduciary law would be found to be "manipulative" or "fraudulent" conduct violative of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. The antimanageial political climate of the time also resulted in the introduction of preemptive legislation in Congress. See S. 2567, 96th Cong., 2d Sess. (1980).

117. See *Paramount Comms., Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46-48 (Del. 1993) (holding that management has an obligation to achieve the best value reasonably available for shareholders); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 366-71 (Del. 1993) (applying a heightened duty of care scrutiny of boardroom merger decision and suggesting an expanded remedial concept inclusive of post-merger gain); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (inventing a duty of management that changed from defending against a tender offer to auctioning the company in limited circumstances); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) (applying an expanded review of tender offer defensive tactics under a proportionality test); *Smith v. Van Gorkom*, 488 A.2d 858, 873-81 (Del. 1985) (suddenly expanding the duty of care to cover board approval of arm's length merger).

118. Equally famous cases often appear to restrict the application of the new rules. See *Paramount Comms., Inc. v. Time Inc.*, 571 A.2d 1140, 1150-54 (Del. 1989) (limiting application of *Unocal* and *Revlon*); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356-57 (Del. 1985) (sustaining "poison pill defense" under *Unocal*); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703-04 (Del. 1983) (overruling *Singer* in favor of a less restrictive process scrutiny of cash-out mergers).

The legislature, prompted by the corporate committee of the Delaware state bar, entered in on management's side in one famous instance. After *Smith v. Van Gorkom*'s application of the duty of care caused nervousness in boardrooms and a substantial increase in insurance premiums, the legislature amended the code to permit firms to opt out of the duty of care by charter amendment. See DEL. CODE ANN., tit. 8, § 102(b)(7) (1991) (permitting opting out of personal liability of directors for duty of care violations).

roles. This gives the judges an independent incentive to protect the legitimacy of the system¹¹⁹ by balancing the satisfaction of interest group demands with public-regarding results. Delaware judges, responding to Cary's well-publicized allegations of corruption,¹²⁰ have declared a commitment to this role integrity.¹²¹ They describe themselves as mediators between management and shareholders—protectors of market risk-taking who nevertheless impose ethical constraints.¹²²

Second, the identification of competing demands should not be taken to predict a pattern of even-handed mediation. Although the federal threat holds out the potential of substantial injury, it remains an unlikely event. Potential impairment of competitive position and loss of incorporations is a more immediate problem for Delaware, and also amounts to a competing reputational concern for Delaware judges, given limitations on their tenure.¹²³ If we look at the pattern the Delaware courts took during the 1980s in charting a course between competing demands on sensitive corporate control matters, we can infer that the Delaware courts took advantage of an informational slack¹²⁴ to develop a body of case law that gave an ap-

119. See Eric Rasmusen, *Judicial Legitimacy as a Repeated Game*, 10 J.L. ECON. & ORGS. 63, 72-74, 78-80 (1994) (offering a repeat-game model of judicial motivation with infinite time horizons). As occurs with repeat games, the model results in a multiplicity of equilibria in which the outcome depends on the players' expectations. *Id.* at 74. In Rasmusen's model, judges follow precedent if there is a self-enforcing system based less on compulsion than on the need to uphold systemic legitimacy. *Id.* at 72-74. In the case of Delaware, of course, systemic legitimacy has pointed in the opposite direction. See also Thomas J. Miceli & Metin M. Cosgel, *Reputation and Judicial Decision-making*, 23 J. ECON. BEHAV. & ORG. 31, 42-49 (1994) (modelling the preferences of judges on a utility function that includes both a private and a reputational component, with the decision as to whether to follow precedent turning on a trade-off between the two components, and the equilibrium rate of adherence to precedent depending on the distribution of preferences across the population).

120. Cary, *supra* note 10, at 684, 696-98.

121. See Coffee, *supra* note 28, at 764-65.

122. See Moore, *supra* note 95, at 779-800 (written while Moore was a Delaware Supreme Court Justice). They also have acknowledged the federal threat. See William T. Quillen, *The Federal-State Corporate Law Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 129 (1993) (author is former Delaware Chancellor and Supreme Court Justice).

123. The recent refusal of Delaware's judicial nominations committee to recommend the reappointment of Justice Andrew Moore, a judge with a reputation for solicitude for the shareholder interest, arguably confirms this point. See Richard B. Schmitt, *Delaware Judge Is Seen as Investors' Friend*, WALL ST. J., July 7, 1994, at B2.

124. Slack results from monitoring costs that prevent interested parties from observing all actions taken by a regulator. To the extent slack is present, a regulator is more likely to be captured by an interest group; a self-interested regulator pursues public regarding

pearance of greater weight to shareholder interests than was justified by the actual payoffs. In highly publicized cases, the Delaware courts announced vague standards that held out the prospect of enhancing shareholder value. But in the less well-publicized cases that followed, they took the opportunity held out by complex facts to refrain from applying the standards in management-constraining ways.¹²⁵ The full set of results tallied by the lawyers who make reincorporation decisions signalled considerably more room for management maneuver than did the public profile signalled by the leading cases.

2. The Litigation Anomaly

Full description of the complex of incentives that shape Delaware law requires further consideration of conflicting interests on the supply side. We have already suggested that managers implicitly rely on the Delaware bar to represent their interests in the state. However, the bar's interests are far from perfectly aligned with management's, since litigation against managers also provides a source of income. Delaware has a unique collection of process rules that advance this local interest. These encourage derivative litigation,¹²⁶ making sure that the local bar gets a share of the action by requiring Delaware lawyers to make appearances and filings.¹²⁷ Competing demands also result in some systemic concessions to managers,¹²⁸ but the concessions hardly counter Delaware's reputation as a fee-generating center for corporate lawyers. The litigation rules thus stand as the great anomaly in the charter competition discussion,

policies only when little or no slack is present. See Levine & Forrence, *supra* note 47, at 183.

125. For a reading of the post-*Unocal* cases along these lines, see VICTOR BRUDNEY & WILLIAM W. BRATTON, BRUDNEY & CHIRELSTEIN'S CASES AND MATERIALS ON CORPORATE FINANCE 1087-95, 1129-30 (4th ed. 1993).

126. Delaware differs from many jurisdictions in not requiring plaintiffs in shareholder derivative actions to post security for expenses. See DEL. CT. C.P.R. 23.1. Delaware facilitates service of process on nonresident directors with a broad consent to service statute. See DEL. CODE ANN. tit. 10, § 3114 (1993). It also is liberal in its fee awards to derivative plaintiffs' lawyers: Under its nonpecuniary settlement practice, defending managers can trade a high fee for a small overall recovery. *Coffee*, *supra* note 28, at 763.

127. See DEL. SUP. CT. R. 12(a) (1); DEL. CH. CT. R. 170.

128. Delaware ameliorates the litigation rules' immediate impact on managers by allowing for liberal indemnification. Its courts also have been inventive in recent years in placing procedural barriers in the way of a trial on the merits of derivative claims. See *Aronson v. Lewis*, 473 A.2d 805, 813-14 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 781-86 (Del. 1981). For criticism of these and subsequent cases, see Seligman, *New Corporate Law*, *supra* note 68, at 23-26. These defendant-friendly procedures do discourage litigation.

synchronizing with neither the race to the top¹²⁹ nor the race to the bottom.¹³⁰

Jonathan Macey and Geoffrey Miller have explained the litigation rules with a supply-side account that highlights the impact of internal interest group politics on the production of Delaware law.¹³¹ In their account, all groups within the state have a common interest in producing a marketable legal regime, but the groups differ on the relative proportions of costs imposed and revenues earned. The taxpayers have an interest in higher direct costs (franchise tax revenues) and lower indirect costs (legal fees). The lawyers' interest in fees would be served by lower direct costs leading to a greater number of incorporations, and by higher indirect legal costs even sacrificing some incorporations when the legal fees paid exceed those lost. Macey and Miller assert that, unlike Delaware, a state acting as a pure profit maximizer would limit indirect costs to maximize direct costs.¹³² Delaware fails to conform to the product model's predictions because the bar acts as a small, cohesive interest group that extracts special concessions from the legislature at the expense of the general public.¹³³

Macey and Miller rightly emphasize the organized bar's political power. Yet two factors that align the interests of the bar with those of the rest of the state need to be added to their description. First, the federal threat may temper the incentive of Delaware's lawyers to lobby for a reduction in direct charges to customers. Increasing Delaware's market share substantially above the level of one-half of public incorporations¹³⁴ would make Delaware even more of a "national" lawmaking center, enhancing its visibility and vulnerability

129. Cary, who favored strict fiduciary-law control of management conduct, explained the rules as a special exception keyed to the interests of the Delaware bar. Cary, *supra* note 10, at 687.

130. Since the rules expand the zone of legal control of corporate actors for the benefit of lawyers, they arguably derogate from shareholder interests, viewed from the market deterrent point of view. See Macey & Miller, *supra* note 71, at 510-11.

131. *Id.* at 472.

132. *Id.* at 498, 502-04.

133. *Id.* at 506-09. Macey and Miller add an asymmetric information component to this market imperfection story. They draw on Romano's finding that lawyers (and to a lesser extent investment bankers) play key roles in reincorporation decisions and favor Delaware. *Id.* at 486-87 (citing Romano, *Law as Product*, *supra* note 43, at 273, 275 n.72). They note that information problems on the clients' part may present a barrier to competition among the lawyers. *Id.* If the clients have an information problem, then we can account for Delaware's litigation rules as a shrewd marketing move—a boon to those responsible for making reincorporation decisions. *Id.* at 487.

134. See *supra* note 43.

to challenge at the national level. Given a state with a monopoly position, traditional federalism objections to intervention carry less weight. Second, rules that encourage litigation in Delaware play a secondary role in production. Delaware's case law and judges figure prominently in its substantive law product line.¹³⁵ Its code's advantages are less distinct than those of its cases, given statutory convergence among the states, but Delaware does not completely control the production of case law. The first option on the choice of the forum for new disputes tends to lie with the plaintiff, and in many instances Delaware law questions can be litigated in other states or in federal courts. This gives Delaware a reason to offer incentives to plaintiffs. Their cooperation gives Delaware the opportunity to apply its own law, preserving the first-mover advantage and generating a flow of cases. These, in turn, are products sold in the charter market.

The need to satisfy the demands of the national plaintiff's bar reinforces the internal bargaining position of Delaware's bar, further explaining the state's delegation to the bar of the corporate legislative function.¹³⁶ However, the delegation to the bar also helps to stabilize the capture arrangement with management.¹³⁷

D. From Threatened Federal Intervention to Shareholder Intervention—The Strategy of Countervailing Interest Empowerment

The foregoing survey of the charter competition system highlights three points. First, although the system can be described as one of voluntary exchanges, that description does not by itself justify the system because these exchanges entail the capture of public authority. The states here effectively sell the coercive exercise of their authority on behalf of a purchasing group.¹³⁸ The system thereby lacks not only the exit possibilities presupposed by regulatory competition theory, but also the exit possibilities present when actors freely make contracts. Although the system affords relational benefits, it also channels distributions within the firms that enter into contracts with the states, making losers of the principals and winners of the agents. Second, the relative stability of the charter market cannot be completely accounted for with a relational contract model

135. See *supra* note 61 and accompanying text.

136. See *supra* note 95 and accompanying text.

137. Thus, it may be that the conflict between Delaware's taxpayers and attorneys is either more nascent than actual or more settled than active.

138. See Moe, *supra* note 42, at 123.

that recognizes only one possible route of defection by the state—defection to anticorporate interests opposed to the interests of both shareholders and managers. Contracts in the charter market are also structured to guard against state defection to the shareholder interest. In addition, in a federal system, state public authority, once captured, can be recaptured by a competing interest that manages to invoke federal authority.¹³⁹ Potential federal intervention makes this recapture a constant possibility in corporate law. Third, federal-state political instability can have wealth-enhancing properties. Under the conflicting demand model of Delaware law, the federal threat reinforces the shareholder voice, moving Delaware in the direction of shareholder value enhancement. The stronger the threat, the more pronounced the move.

Taken alone, however, the federal threat does not provide a workable basis for solving the corporate agency problem. Substantial political barriers to shareholder capture of federal authority keep the threat distant and make it possible for Delaware to defuse it with minimal concessions to the shareholders, while providing management with maximum feasible protection of its own prerogatives. Nor does this threat lend itself to institutionalization as a component of a federal intervention strategy designed to intensify the conflicting demands on the states. Institutionalization implies the congressional mandate of a prospective and graduated scheme that ripens into preemptive mandates only to the extent that some background normative standard remains unsatisfied.¹⁴⁰ Such a carrot-and-stick approach also implies a fully articulated federal corporate law policy. It is hard to imagine how such a scheme, once implemented on a national basis, would amount to anything short of blanket preemption that sacrifices the relational benefits of the state system.

Federal intervention nonetheless could help to place a stronger quantum of shareholder demand before state lawmakers. In regulatory theory, one expedient for the problem of agency capture by a producer group is consumer empowerment through the grant of standing in regulatory processes to public interest groups.¹⁴¹ This

139. *See id.* at 124.

140. Under this "big stick" theory of regulation, the regulatory authority makes self-regulation generally available, but holds out a graduated threat of command and control regulation and punishment for uncooperative parties, thereby building in an incentive to comply. *See* AYRES & BRAITHWAITE, *supra* note 13, at 39-40 (discussing the theory in the administrative law context).

141. In Ayres and Braithwaite's model of "tripartitism," the public interest group receives the same information as the regulator, a seat at the negotiating table, and equal

tripartite¹⁴² strategy follows from the insight that the structuring of conflicts between agents, including third parties, can assist in the collection of information and the reordering of incentives in a desired direction.¹⁴³ Empowerment brings the representatives of the countervailing interest inside the system. Once inside, they assist legislative principals in overcoming the problem of asymmetric information in agency control. The countervailing interest generates information about the agency, supplementing the costly process of direct supervision.¹⁴⁴ Empowerment also reorders the incentives of the agents of the countervailing interest. Their inside position holds out an incentive to abandon obstructionist strategies and develop cooperative relationships with both regulators and producers. Ideally, they assist the evolution of win-win outcomes in the ongoing regulatory bargaining game.¹⁴⁵ Finally, since these public interest figures attain their status as agents in the world of grassroots politics, they are relatively unsusceptible to capture. Since their guardianship positions are contestable, reputational incentives make defection to competing interests unlikely.¹⁴⁶

The strategy of countervailing interest empowerment shares objectives with the strategy of regulatory competition. Both seek regulatory flexibility and balanced control of regulatory structures that deter the capture of regulators.¹⁴⁷ The choice between the two may depend in part on the situation. Regulatory competition theory assumes that competition provoked by exit frees the regulator from interest group control. Interest group empowerment addresses the capture problem where competition either has been blocked by regulatory coordination, or, as has occurred in the case of corporate law, has served as a mechanism to enforce the capture arrangement.

standing. AYRES & BRAITHWAITE, *supra* note 13, at 57-58.

142. "Tripartite" is used *id.* at 57-60.

143. LAFFONT & TIROLE, *supra* note 91, at 611.

144. Mathew D. McCubbins & Thomas Schwartz, *Police Patrols v. Fire Alarms*, 28 AM. J. POL. SCI. 165, 166 (1984), distinguished between "police patrol" oversight, direct monitoring of the agent by the principal, and "fire alarm" protection, a passive form of oversight in which third parties bear the bulk of the cost of providing information. This model was extended in Arthur Lupia & Mathew D. McCubbins, *Learning from Oversight: Fire Alarms and Police Patrols Reconstructed*, 10 J.L. ECON. & ORGS. 96, 105 (1994), with a model of a multistage, single-shot two-person game involving a principal and an agent, showing how the principal learns from fire-alarm oversight.

145. AYRES & BRAITHWAITE, *supra* note 13, at 71-73.

146. *Id.* at 73.

147. *See id.* at 59, 71.

The often-suggested corporate law reform that we revive here—shareholder initiative to amend the charter and effect reincorporation—is the corporate law equivalent of an interest group empowerment strategy. The avenue of shareholder initiative makes it possible for the shareholders to make competing demands on the states themselves, and thereby gain a seat at the table when state laws are formulated. The problem with this strategy, of course, is the problem of shareholder collective action. However, as the next part shows, the gravity of that problem has diminished.

III. STRATEGIES FOR ENFORCED SELF-REGULATION THROUGH SHAREHOLDER PARTICIPATION

Concentrated institutional ownership holds out the possibility that shareholders can surmount collective action barriers keeping them from governance participation. Shareholder participation, in turn, holds out the possibility of a transition from voluntary to enforced self-regulation as shareholders use their votes to revise the process terms of corporate contracts or to place capable and independent monitors on the board. Enforced self-regulation, in turn, holds out the possibility of cooperative gain through relational engagement. The short-term, arm's length engagement of the shareholder under a deterrent regime evolves into the long-term, patient commitment of an equity partner.¹⁴⁸ In theory, this resolves governance conflicts of the 1980s: Effective monitoring reduces the gap between market and intrinsic value that triggers hostile intervention by market means.¹⁴⁹

This relational model's realization depends in part on the alignment between governance benefits and the incentives of institutional agents. This part describes these incentive problems and identifies the strategies for their solution. In theory, financial benefits themselves provide sufficient incentives, given the removal of legal barriers to group action. In practice, shareholder intervention has been effected by a group of political entrepreneurs, the agents of public pension funds, who appear to be pursuing reputational gain.

148. See Ayres & Cramton, *supra* note 19, at 1038; Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 129 (1994) [hereinafter Gordon, *Cumulative Voting*].

149. See Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 1006-09 (1993) [hereinafter Gilson & Kraakman, *Investment Companies*].

A. *The Collective Action Problem, the Cost-Benefit Solution, and the Counter Story*

Historically, shareholders of public companies are an Olsonian latent group.¹⁵⁰ That is, a collective good—active monitoring of management—would make them better off given proportionate distribution of its costs, but the law provides no cost-sharing mechanism, and the free-rider problem prevents the emergence of a volunteer or group of volunteers with an incentive to provide the good.¹⁵¹ Given dispersed shareholdings, the nontrivial costs of active monitoring, and the alternative of exit through sale, the benefits obtainable without investment in monitoring exceed the benefits obtainable from investment.¹⁵² In addition, rational apathy prevails when the system mandates that matters be presented for shareholder approval. The rational small shareholder does not invest in information about governance matters, given the likelihood that the collective action problem inhibits an effective group response.¹⁵³

Collective action theory allows for the possibility that a subgroup of a latent group will organize and provide the public good if the benefits from action to each member of the subgroup exceed the costs incurred.¹⁵⁴ The increased concentration of shareholdings in institutional hands makes it conceivable that institutional subgroups might find investment in monitoring cost beneficial.¹⁵⁵ Concentration of shares also promises to mitigate the rational apathy problem. The shareholders' decision of whether to seek information about the governance issue depends on the costs and expected benefits of the effort and the initiative's probabilities of success. The cost is independent of the number of shares held. With individual shareholders holding larger proportionate stakes in the firm, the

150. See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 455-59 (1991) [hereinafter Rock, *Shareholder Activism*] (working the models of Olson and Hardin through the corporate fact pattern).

151. Each member of the group rationally prefers that others in the group incur the costs of providing the public good.

152. Rock, *Shareholder Activism*, *supra* note 150, at 455-56.

153. See Grundfest, *supra* note 32, at 910.

154. Rock, *Shareholder Activism*, *supra* note 150, at 457-59 (citing RUSSELL HARDIN, *COLLECTIVE ACTION* 41 (1982)).

155. *Id.* at 459. As Black argues, shareholder passivity may be historically contingent, the result of a combination of legal obstacles and past dispersed ownership patterns. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 525 (1990) [hereinafter Black, *Shareholder Passivity*].

expected returns from a given information investment go up, as does the proponent's chance of success.¹⁵⁶

Subgroup formation depends on the size of the group, the cost of action, and the magnitude of the benefit the subgroup seeks. Proponents of law reform designed to facilitate shareholder participation direct most of their attention to the first two factors. Since the number of members needed to form a subgroup declines as ownership concentration goes up, the proponents argue for a relaxation of the regulatory barriers that impede the accumulation of large holdings in given firms by single investors or organized groups of investors.¹⁵⁷ The proponents also circulate blueprints for cheap strategies, since, as the costs of a given initiative go down, subgroup formation can go forward with a lower level of concentration and a lower projected probability of success.¹⁵⁸

In sum, the proponents assert that, given certain legal adjustments, prospects for financial gain by themselves will induce governance initiatives by institutional investors. Yet there is a counter story. This asserts that, even with legal adjustments, governance initiatives realizing the full promise of cooperative gain through enforced self-regulation cannot be expected. Two points are emphasized. First, agency relationships within investment institutions create disincentives that prevent subgroup formation, even assuming a projection of a positive return to the subgroup from an investment in governance. Since the individual manager's performance is measured against the performance of the market as a whole and subgroup investment benefits the market as a whole, successful governance investments do not necessarily improve the individual manager's performance profile.¹⁵⁹ Second, the benefits of cost-intensive relational investment remain underspecified. In theory,

156. According to Black, the incentive to become informed increases as the holder's share ownership level is squared. *Id.* at 585-89.

157. *Id.* at 578.

158. See Grundfest, *supra* note 32, at 908-13 (examining the minimum cost strategy of the "just vote no" campaign). Proponents of reform also stress that scale economies lie in the application of a single governance device to multiple companies, Black, *Shareholder Passivity*, *supra* note 155, at 584, and argue for rules that transfer the cost of shareholder initiatives to the firm, *see id.* at 579-80.

159. Rock, *Shareholder Activism*, *supra* note 150, at 473-74; *see also* Jill E. Fisch, *Relationship Investing: Will it Happen? Will it Work?*, 55 OHIO ST. L.J. 1009, 1020-25 (1994) (arguing that competitive pressures on institutional performance must be accounted for in cost-benefit models of institutional monitoring); Helen Garten, *Institutional Investors and the New Financial Order*, 44 RUTGERS L. REV. 585, 630-32 (1992) (arguing that it is difficult to increase institutional activism).

these lie in informational access and ongoing constructive criticism by the institutional monitor.¹⁶⁰ In practice, underperforming companies are publicly identified in the ordinary course, and standard remedies respecting investment policies, incentive schemes, and governance structures are part of the conventional wisdom. To the extent that institutions can cheaply tie the communication of these points to credible threats against target managers, they can secure the available set of governance benefits through a discrete engagement. Incentives for more substantial investments in ongoing relationships remain speculative, absent a special technical capability on the part of the particular monitor. As a result, risks of perverse incentives and commitment problems come to the forefront of the relational picture. A strategically placed institutional holder could opt for side payments from management in preference to public-regarding informational development, or, given a hostile tender offer, the institutions in the subgroup could defect from an implicit undertaking by management to be patient.¹⁶¹

The practice has tended to fulfill the counter story's predictions. Relational engagements have been discrete, cheap, and focused on the short term. In contrast to the proponents' prediction that financial incentives by themselves will induce subgroup formation, the selective incentive of reputation seems to drive the practice. This implies that contractual renegotiation of governance terms will dominate over direct monitoring of investment decision-making as the means to enhance value through shareholder participation.

B. Selective Incentives and the Pattern of Shareholder Participation

1. The Pattern of Discrete Intervention

Institutional investor activism is the successful grassroots political movement of American big business. It began during the late 1980s when institutions became dissatisfied with expanding legal constraints on takeover activity. The access route was the precatory shareholder

160. See *infra* note 217. It comes as no surprise that the results of empirical studies of returns on monitoring activities are inconclusive. See Fisch, *supra* note 159, at 1035 (citing LILLI A. GORDON AND JOHN POUND, ACTIVE INVESTING IN THE U.S. EQUITY MARKET: PAST PERFORMANCE AND FUTURE PROSPECTS, REPORT FOR THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM 44 (Jan. 11, 1993)).

161. For exploration of these problems, see Ayres & Cramton, *supra* note 19, at 1036-39; Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 989-99 (1994) [hereinafter Rock, *Dark Side*].

proposal,¹⁶² a medium for nonbinding, shareholder-initiated voting proposals made available by preemptive mandate under the federal proxy rules.¹⁶³ The first generation of proposals concerned poison pills, and urged management to exercise its privilege of redeeming them or to submit them to shareholder approval.¹⁶⁴ The first sustained assault on the pills came in 1987, when a group of public pension funds discovered the economy of scale and submitted proposals at forty firms. The proposals received more than twenty percent of the votes cast—significant returns given the historic pattern of overwhelming votes against shareholder proposals.¹⁶⁵

162. Management must include in the annual proxy statement precatory shareholder proposals that meet Rule 14a-8 process and suitability guidelines. Proxy Solicitation Rules, 17 C.F.R. § 240.14a-8 (1994).

The process guidelines, set out in Rule 14a-8(a)(2) to (4), are strict—the proponent is allowed only one proposal, submission must occur months before the meeting, and the supporting statement is limited to 500 words. 17 C.F.R. § 240.14(a)-8(a)2 to 3 (1993). The suitability guidelines are stricter. They were drafted at a time when shareholder proposals were envisioned as a medium for expression of concern on social issues related to corporations, and exclude many business topics of prime concern to governance activists. To wit, under Rule 14a-8(c), matters of “ordinary business operations,” “election[s] to office,” proposals counter to management proposals, and “specific amounts of cash . . . dividends” are unsuitable; at the same time, a social proposal “not . . . significantly related” to the business also is unsuitable. 17 C.F.R. § 240.14a-8(c)5, 7-9 & 13 (1994).

The SEC alters its interpretations of these rules from time to time, opening the door to issues concerning the operation of the business if it determines that the particular topic has taken on substantial policy import. The Commission has not been notably consistent in these determinations. Compare *Cracker Barrel Old Country Store, Inc.*, SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,418, at 77,284-87 (Oct. 13, 1992) (finding unsuitable a proposal recommending policy of nondiscrimination respecting sexual preference in hiring), with *Eli Lilly & Co.*, SEC No-Action Letter [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,629, at 77,682 (Feb. 25, 1993) (finding suitable a proposal recommending adoption of price restraint policy by drug company suitable) and *AT&T*, 1990 SEC No-Act LEXIS 20, *2-3 (Jan. 5, 1990) (finding proposal for elimination of affirmative action programs suitable). This sort of nonsense has gotten the agency into difficulties with certain courts. See *New York City Employees' Retirement Sys. v. SEC*, 843 F. Supp. 858 (S.D.N.Y. 1994) (enjoining the agency from acting inconsistently with its own stated policy in respect to the *Cracker Barrel* proposal), *rev'd*, Fed. Sec. L. Rep. (CCH) ¶ 98,493 (2d Cir. Jan. 3, 1995).

Observers tend to see these suitability rules as manifestly unsatisfactory. See, e.g., Black, *Shareholder Passivity*, *supra* note 155, at 541; Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1155-62 (1993).

163. Under Rule 14a-8, the proponent bears the expense of making the proposal, including legal expenses in the event of a management challenge to its suitability, but the corporation bears the expense of including the proposal in the proxy statement. Proxy Solicitation Rules, 17 C.F.R. § 240.14a-8 (1994).

164. Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 867-68.

165. Rock, *supra* note 150, at 402. The players were the College Retirement Equities Fund, the California Public Employees Retirement System, and the Wisconsin Investment Board, loosely organized through the Council of Institutional Investors. Jayne W.

The activists thereafter broadened the range of their proposals to cover other takeover defenses¹⁶⁶ and, with proposals for confidential voting, the voting process itself.¹⁶⁷ By 1990, the voting pattern had changed. In that year, 160 shareholder proposals received more than twenty percent of the votes, and nineteen received more than fifty percent¹⁶⁸—the largest number of successful proposals in the entire history of the device.¹⁶⁹ The voting pattern respecting management proposals also had changed.¹⁷⁰ Although the overwhelming majority management submitted in 1990 were approved, ten were defeated and two were withdrawn to avoid defeat.¹⁷¹ Antitakeover charter amendments, overwhelmingly approved in the early 1980s, now passed with only fifty to sixty percent of the votes.¹⁷²

Institutional activists had arrived, led by agents of the California Public Employees Retirement System (CalPERS) and other public pension funds. After 1990, the subject matter of their proposals broadened again, to include process and structure proposals designed to make boards more effective in monitoring and designing incentive

Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1153 (1991).

Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE, *supra* note 11, at 201-02, makes a counter suggestion. Given the present control market in which takeovers tend to be strategic moves made by larger players in a given industry, they argue that the shareholders' interest lies in leaving the pills in place to facilitate lower-cost friendly transactions. *Id.* at 212. They thus ascribe institutional pressure for pill redemption entirely to selective incentives. *Id.* at 211-22.

166. The proposals suggested prohibition (or requirement of shareholder approval) of greenmail payments, opting out of antitakeover statutes, and requiring shareholder approval of placements of large blocks of stock with management-friendly holders. See Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 868.

167. See Black, *Agents*, *supra* note 30, at 825-26. Confidential voting assists shareholder participation in two ways. First, confidentiality prevents management from punishing private investment institutions that vote against it in the product market. *Id.* Second, under the usual procedures, management's proxy solicitors are free to count the proxies as they come in, identify no-voting shareholders, and resolicit their votes. If the vote seems destined to go against management, management can withdraw its proposal. Shareholder proponents do not have this privilege. *Id.*

168. Rock, *Shareholder Activism*, *supra* note 150, at 483.

169. Barnard, *supra* note 165, at 1156. Poison pill proposals received an average vote of 42%. Black, *Agents*, *supra* note 30, at 828.

170. Management must submit charter amendments and fundamental corporate changes, including liquidation, substantial asset sales, and some mergers for a shareholder vote. See DEL. CODE ANN. tit. 8, §§ 242, 251, 271, 275 (1994). Executive compensation plans must be submitted to the shareholders pursuant to exchange listing rules.

171. Rock, *Shareholder Activism*, *supra* note 150, at 484.

172. Black, *Shareholder Passivity*, *supra* note 155, at 571.

arrangements.¹⁷³ More importantly, success caused the set of cheap strategies to expand. It turned out that managers, once confronted with majority or near majority votes for the institutions' nonbinding proposals, or confronted with even the prospect of such a vote, proved willing to open negotiations and make concessions,¹⁷⁴ either by voluntarily adopting responsive measures or by accepting other policy changes in exchange for the withdrawal of a proposal.¹⁷⁵ Proponents took this advantage and gained negotiating access by generating bad publicity without making specific proposals. They publicized lists of underperforming companies¹⁷⁶ with the suggestion that shareholders "just vote no" in that year's board election.¹⁷⁷

173. Suggested improvements included the separation of the functions of board chairman and chief executive officer and outside director membership for the compensation committee. Proposals respecting executive pay also appeared, after the SEC reversed a position in 1992 and declared the subject matter to be proper under its rule. *See Staff Advises Shareholder Proposals on Pay Includible in Proxy Materials*, 24 SEC. REG. & L. REP. (BNA), No. 8, at 250 (Feb. 21, 1992). Shareholder intervention has resulted in changes in compensation practices at ITT, IBM, Cincinnati Bell, and Avon. Grundfest, *supra* note 32, at 931.

Institutional shareholder proposals continue to increase in number. *See* 9 CORP. COUNS. WKLY (BNA), No. 22, at 4 (June 22, 1994) (reporting a slight increase in 1993 and 1994). In the 1994 annual meeting season (according to Georgeson & Co.), institutions sponsored 69 proposals, up from 65 in 1993. *Id.* Of the 1994 proposals, 11 sought to repeal classified boards, 10 concerned executive compensation, 7 sought poison pill redemption, and 14 advocated confidential voting. '93-'94 Proxy Seasons Said to Show Slight Increase in Shareholder Activism, 9 CORP. COUNS. WKLY (BNA), No. 24, at 4 (June 22, 1994) [hereinafter '93-'94 Proxy Seasons]. There has been a change in the sponsorship pattern, however. Labor unions have appeared as sponsors, backing 32 proposals in 1994 versus 9 in 1993. John C. Wilcox, chairman of Georgeson & Co., characterizes the unions as "gadflies," because they repeat their proposals and do not seek to negotiate with management before submitting them. *Id.* In another recent development, CalPERS, citing an independent consultant's stock price study, has indicated an interest in encouraging management to adopt "high performance" workplace strategies that accord workers more rights and feedback. *See id.* at 1.

174. *See* Rock, *Shareholder Activism*, *supra* note 150, at 483. For example, K-Mart accepted two proposals in 1990 and seven firms instituted confidential voting in exchange for withdrawal of proposals. *Id.*

175. Grundfest, *supra* note 32, at 932 (stating that in 1992, 31 firms confronted with shareholder proposals negotiated their withdrawal). Institutional successes also have had a noticeable deterrent effect on management proposals for self-protective charter amendments. *See* Black, *Agents*, *supra* note 30, at 828-29.

176. *See CalPERS Lists 12 Companies in Effort to Focus Attention on Corporate Reform*, 24 SEC. REG. & L. REP. (BNA), No. 13, at 420 (Mar. 27, 1992).

177. Grundfest, *supra* note 32, at 933. The New York State Common Retirement Fund, the Public Employees Retirement Fund of Colorado, the New York State Local Retirement Funds, the New York City Retirement Systems, and CREF have joined CalPERS in these campaigns. *Id.* at 867 & n.37.

Grundfest notes the cost advantages of these dialogic campaigns. The analysts collect the basic information on performance and the costs of drafting and compliance costs of

Proponents then would meet with management to voice their criticisms and concerns. Results followed¹⁷⁸ — chief executives were terminated at two of CalPERS' 1992 targets, IBM and Westinghouse; another target, Sears, took the institutions' advice about concentrating on the core business and dismembered itself.¹⁷⁹ A change in the SEC proxy rules, promulgated in 1992 as a result of institutional pressures, facilitated the new approach by permitting shareholders to publish their views in the media without prior agency approval.¹⁸⁰

2. Explaining and Evaluating the Pattern

The institutional shareholders' record, thus outlined, confirms that concentrated shareholders are not passive and can coordinate votes to achieve results. Specifically, the rational apathy problem has diminished substantially, reputational threats against managers have

14a-8 proposals are avoided. CalPERS estimates that a 14a-8 proposal can cost up to \$500,000, where a "just vote no" campaign costs \$100,000. *Id.* at 911-12. However, the device is not necessarily more effective than the alternative of a precatory shareholder proposal directed to a matter of process and structure; the latter gained stronger support than the former at the 1995 annual meeting of Philip Morris, a current institutional target. *See infra* note 296.

178. *Id.* at 933. Heads also have rolled at Goodyear, Allied Signal, Tenneco, Shearson, and Kodak. *Id.* at 882-94.

179. This sort of institutional pressure continued to be exerted through 1994, with different results in different firms. K-Mart and Philip Morris were two leading institutional targets. At K-Mart, institutions pressuring for the separation of non-core retailing divisions caused the defeat of a company proposal (presented for approval at the annual meeting) deemed not to go far enough. Months later, the board removed the embattled C.E.O. from the chairmanship, but it retained him as president. *See* Joann S. Lublin & Christina Duff, *Management: How Do You Fire a CEO? Very, Very Slowly*, WALL. ST. J., Jan. 20, 1995, at B1. Philip Morris experienced similar institutional pressure for division of the company, but the internal politics worked differently. *See infra* note 296.

180. *See* Proxy Solicitation Rules, 17 C.F.R. § 240.14a-2(b)(1) (1994). The earlier rules prohibited solicitation of more than 10 other shareholders without advance clearance. The revised rules also cut back on management agenda control in the proxy solicitation itself by (1) permitting shareholders to vote in board elections for a combination of management nominees and outside challengers, and (2) allowing shareholders to oppose a single management proposal without being required to vote for or against an entire slate of proposals. 17 C.F.R. § 240.14(a)-4(b) (1994). The former change facilitates the possibility of campaigns for select numbers of institutionally nominated directors. *See* Ronald J. Gilson et al., *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. CORP. L. 29, 33-42 (1991). The latter change prevents the bundling of a proposal to which shareholders might object with an advantageous proposal. It does not, however, prevent management from conditioning the approval of a proposal on the approval of one or more other proposals. *See* Fisch, *supra* note 162, at 1169-70.

The revised rules have had some effect on the pattern of proxy contests. Institutions now solicit proxies from one another when opposing mergers or corporate restructurings. *See '93-'94 Proxy Seasons, supra* note 173, at 2.

proved effective, and capture of institutional proponents has not been a problem. Diverse incentives among the institutions, however, make the wider attack on the collective action barrier a tentative one.

a. The Rational Apathy Problem

The rational apathy calculation broke during the 1980s when newly concentrated holders encountered takeover-related voting issues with substantial financial implications.¹⁸¹ Institutions thereafter made at least minimal investments in information on governance issues and showed some discrimination in their voting.¹⁸² The network of activist institutions also became a point of information exchange. Their public suggestions that votes in selected firms be tied to performance entail the sorting of financial information for rechanneling into the voting arena. This ameliorates a problem of informational slack¹⁸³ in addition to securing leverage for negotiations. Finally, the activists' success at extracting governance concessions provided the wider institutional community with ongoing incentives to stay informed, even as takeover-related incentives declined in importance after 1989.

b. The Reputational Threat

The record also suggests a revision of the standard list of corporate governance deterrents. As yet, most shareholder initiatives have not employed threats of direct intervention in the form of mandatory proposals¹⁸⁴ or opposing slates of directors.¹⁸⁵ Instead,

181. On this point, then, Black's "critical mass" has been reached. See Black, *Shareholder Passivity*, *supra* note 155, at 588-89.

182. The institutions articulate voting policies in advance by type of proposal. See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 831-39 (1993) [hereinafter Romano, *Pension Fund Activism*] (comparing public and private fund voting policies). But cf. Louis Lowenstein, *Why Managements Should (And Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1, 19-20 (1991) (surveying the guidelines of one bank and finding that they crudely fail to discriminate between well and badly run companies to avoid an appearance of favoritism to bank customers).

183. See Levine & Forrence, *supra* note 47, at 185-91. CalPERS's list of underperforming firms amounts to a "fire alarm" mode of oversight that supplements the "police patrolling" of the independent directors. See McCubbins et al., *supra* note 89, at 273-74. The fire alarm realigns the outside directors' incentives to make them more inclined to challenge the managers. *Id.*

184. These are prohibitively costly under state law, and the extent to which the proxy rules allow for them under Rule 14a-8 is unclear. See *infra* note 274 and accompanying text.

action is communicative. The shareholders as a group are invited to join in a nonbinding request and their cooperation indicates dissatisfaction with performance.¹⁸⁶ In the alternative, the proponent announces performance dissatisfaction directly and invites others to concur. None of these initiatives entails a takeover threat in the present climate. Nevertheless, they result in preemptive negotiations and concessions by managers,¹⁸⁷ and, in some cases, prompt the termination of the chief executive by the outside directors.

These shareholder threats appear credible because they impact on the reputational interests of chief executives and independent board members. The campaign declares that the target executives possess undesirable characteristics,¹⁸⁸ detracting from their standing in the business community¹⁸⁹ and, in some cases, from their marketability. It can be expected that managers will be extraordinarily risk-averse to such reputational impairment if, as seems reasonable, we can assume that employment contracts are incomplete and do not fully compensate for tenure insecurity and the costs of changing jobs.¹⁹⁰ Preemption by negotiation serves the managers' interest by defusing the threat and providing them with some control over the settlement process.¹⁹¹

More broadly, the appearance of a vocal shareholder interest group changes the manager's institutional environment. The institutions articulate a normative challenge to the manager's conduct of the business.¹⁹² Their challenge has a more destabilizing effect

185. Dissident investors have successfully conducted proxy contests for board seats in a handful of cases. See John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1047-50 (1993).

186. It is not clear how discriminating the institutional voters are in this regard. Confidential voting, once placed as a yes vote in a guideline presumably results in yes votes in both well and badly managed companies. See Lowenstein, *supra* note 182, at 19-20. The value of the signal depends on the discrimination of the activist gatekeeper. At least one writer has assured managers that shareholder initiatives can be avoided through good financial performance over the long run and direct explanation of any short-term problems to the institutions. Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV. 141, 147-49 (Jan.-Feb. 1994).

187. Pound, *supra* note 185, at 1057-61.

188. Grundfest, *supra* note 32, at 927-28.

189. See James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 MGMT. SCI. 1404, 1413 (1987) (stating that managers are concerned about their reputations for risk-taking and are eager to discuss the deficiencies of others).

190. See Milgrom & Roberts, *supra* note 2, at 158-62.

191. See Gilson et al., *supra* note 180, at 45.

192. Firms are, from a sociological perspective, normative environments. Institutional norms are rationalized prescriptions that identify social purposes as technical ones and specify rule-like means to pursue these technical rationalities. John W. Meyer & Brian

than ordinary external criticism, due to their equity investments, long term presence, and ability to marshal votes respecting both present and future matters for shareholder action. They represent an unstable sector in the larger domain of institutional relationships with which the manager deals.¹⁹³ By negotiating, the risk-averse manager¹⁹⁴ seeks to stabilize and influence the relationship.

The shareholder threat can also destabilize the relationships of inside managers and outside directors by reorienting the outsiders' incentives. Ordinarily, the outside directors, being corporate players themselves,¹⁹⁵ see that their interests lie in cooperation with management. However, shareholder intervention gives rise to a public question about the outsiders' effectiveness, creating a dual demand that has an impact on different components of the same reputation. If the conflict becomes severe, the outsiders resolve it by forming a coalition and exercising their board voting power to oust the chief executive. Thus, publicity and reputational interests combine to effect a transfer of control.

The occurrence of a number of such transfers in practice bolsters the activists' credibility. These cases also represent an important achievement: Since managers become psychologically invested in their past strategies, chief executive turnover plays a crucial role in prompting disinvestment in those strategies.¹⁹⁶ Furthermore,

Rowan, *Institutional Organization: Formal Structure as Myth and Ceremony*, 83 AM. J. Soc. 340, 343-44 (1977).

193. See WALTER W. POWELL & PAUL J. DIMAGGIO, THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS 30 (1991) (looking to extra-institutional sources of institutional change as a complement to the internal interest group story of the firm).

194. See March & Shapira, *supra* note 189, at 1410-14 (suggesting that extreme risk aversion can be expected). March and Shapira survey empirical studies on attitudes to risk and conclude (1) that the managers do not see uncertainty about positive outcomes as an important part of risk, and rather understand risk in terms of negative outcomes; and (2) that managers do not understand risk as a probability concept, instead understanding risk in terms of how much they might lose rather than the probability of loss. *Id.* at 1407. See generally KENNETH R. MACCRIMMON & DONALD A. WEHRUNG, TAKING RISKS: THE MANAGEMENT OF UNCERTAINTY 77-274 (1986) (reporting on a comprehensive survey of senior business executives and studying their willingness to take risks).

195. See *supra* text accompanying note 15.

196. See Theresa K. Lant et al., *The Role of Managerial Learning and Interpretation in Strategic Persistence and Reorientation: An Empirical Exploration*, 13 STRATEGIC MGMT. J. 585, 588, 603 (1992) (stressing that heterogeneity of top management induces strategic change and that managers in environments with constant change are more likely to change than others in less complex circumstances); see also Paul C. Nystrom & William H. Starbuck, *To Avoid Organizational Crises: Unlearn*, ORGANIZATIONAL DYNAMICS, Spring 1984, at 53-60 (explaining that faulty cognitive structures developed by top managers contribute to an organization's inability to deal with crisis, often requiring an infusion of

organizational tenure has been accorded a principal role in explaining the informational diversity, risk, and status quo preferences of the teams of managers that run corporations. Long-term executives tend to employ unchanging strategies and rely on customary information sources. Teams with short tenures are more inclined to adopt diverse strategies, look for new sources of information, and develop new plans.¹⁹⁷

c. Financial and Selective Incentives

Shareholder engagements have followed a discrete, single-shot pattern. Agents of public and not-for-profit funds take the initiative, select targets, and make investments in communication and legal compliance. Private sector agents of mutual funds, private pension funds, management firms, banks and insurance companies follow the leaders,¹⁹⁸ taking a selective, cost-sensitive approach. Larger private players join in the dialogue when prominent underperforming companies become successful targets. Otherwise, they discriminate among specific issues according to projected short-term financial consequences. A proposition with significant bearing on short-term returns, such as a management proposal for a merger with a low payout, might prompt an initiative. Other issues will not, with the extent of participation in the initiatives diminishing with the payoff: Poison pills rank above compensation plans, which in turn rank above more general process and structure improvements.¹⁹⁹

This division of functions between public and private institutions follows from differences in the agents' financial incentives and the institutions' product market vulnerabilities. Public pension funds tend to be internally managed by civil servants who have relative immunity to threats by managers. These agents' bureaucratic positions also lead them to pursue risk averse financial strategies, since the public sector

new ideas in the form of new managers).

197. See Sydney Finkelstein & Donald C. Hambrick, *Top Management-Team Tenure and Organizational Outcomes: The Moderating Role of Managerial Discretion*, 35 ADMIN. SCI. Q. 484, 486-88 (1990); see also Jeffrey Pfeffer, *Organizational Demography*, in 5 RESEARCH IN ORGANIZATIONAL BEHAVIOR 299, 320-26 (L.L. Cummings & Barry M. Staw eds., 1983) (examining the effects of organizational demography on innovation, adaptation and performance). But see Andrew M. Pettigrew, *On Studying Managerial Elites*, 13 STRATEGIC MGMT. J. 163 *passim* (1992) (providing a methodological critique of this literature).

198. In 1990 public pension funds owned 8.3% of the equity market; private pension funds owned 19.9%; mutual funds owned 7.2%. All of these percentages had increased by 1992. See Coffee, *Half-Time Report*, *supra* note 32, at 848-49.

199. Pozen sets out this pattern of response. Pozen, *supra* note 186, at 145-46.

provides no special rewards for exceptional financial performance, while financial failure can lead to punishment.²⁰⁰ These funds, as a result, are heavily indexed.²⁰¹ Private sector agents, in contrast, run the risk of management punishment for uncooperative conduct.²⁰² They also have stronger incentives to pursue upside gain, which leads them to trade more actively and worry about liquidity.²⁰³ Some also work under tight cost constraints that stem from fee arrangements structured on the assumption of governance passivity.²⁰⁴

The different behavior patterns of public and private institutions reverse the assertion of the financial incentive theory of shareholder participation. In theory financial gain provides the incentive, while in practice the less intense the financial pressures on the agent, the greater the likelihood that the agent will take the governance initiative.²⁰⁵ This odd result dovetails with the more general point that inevitable sharing of governance gains with free riders makes governance investment irrational in a world in which the agent's individual performance evaluation proceeds against the performance of the market as a whole.²⁰⁶ Together these points confirm the prediction that shareholder initiative will follow from selective incentives. Public sector actors, as civil servants, are unimpeded by the private actors' cost, product market, and reputational disincen-

200. See Lowenstein, *supra* note 182, at 17-18.

201. See Coffee, *Half-Time Report*, *supra* note 32, at 860.

202. See, e.g., Grundfest, *supra* note 32, at 913-24. Corporations, particularly corporate pension funds, are a significant source of business for private managers. A well-publicized confrontation with one management group can chill a business relationship with a similarly situated group. *Id.*

203. Private pension funds tend to be "defined benefit" plans, giving the corporate sponsor an incentive to maximize plan return to minimize the need for corporate contributions. Public plans sometimes follow a "defined contribution" pattern, with no connection between performance and contribution. Coffee, *Half-Time Report*, *supra* note 32, at 859. Romano suggests that possibilities for external political pressures on public pension fund agents would diminish if all took the defined contribution form. Romano, *Pension Fund Activism*, *supra* note 182, at 844-51.

204. Pozen cites 70 basis points per year plus a maximum performance fee of 10 to 20 basis points for external managers, and notes that all costs of dealing with the proxy process come out of this compensation pool. Pozen, *supra* note 186, at 144.

205. There is a counter story to the effect that the indexed investor must invest in systemic governance improvements due to the absence of the alternative of exit through sale. See Barnard, *supra* note 165, at 1151-52; Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 866-67. The problem with this incentive story is that it neither accounts for the behavior differential between the public and private sectors nor recognizes that inactivity might nevertheless be a more rational alternative from the point of view of a particular private sector agent.

206. See *supra* text accompanying notes 151-52.

tives. At the same time, governance activity seems to suit them as a mode of reputation enhancement. Given this phenomenon of reward for power exercised over business actors rather than for financial performance,²⁰⁷ they are political entrepreneurs in both the traditional and Olsonian senses.²⁰⁸

d. Credibility and Possibilities for Capture

A number of factors make public pension fund agents suitable for this "public-regarding" entrepreneurship. The credibility of a shareholder who proposes a cooperative engagement with management is enhanced by a concrete commitment to a long-term investment in the firm. The public agents' indexed portfolios give them a long-term posture as a structural proposition. Their interventions, accordingly, hold out no possibility of a hidden defection strategy keyed to exploiting the management vulnerability that follows from public targeting.²⁰⁹ Nor, given indexing and the multiplicity of institutional holders, is it likely that a proponent or group of proponents could use voting power or the opportunity of access to management to defect from the wider shareholder interest in exchange for rents from the target. A particular pension fund agent has reputational concerns that limit such a possibility to an end period.²¹⁰ The agent's ability to exercise a reputational threat

207. If the career patterns of the most prominent actors are any guide, job shifts over to the private sector also seem to be a possible reward.

208. A second type of political entrepreneur also has appeared. This is a professional intermediary who makes the good governance case to management from an inside position. The intermediary argues that voluntary acceptance of a program of internal monitoring procedures minimizes the possibility of becoming an institutional target. Two prominent lawyers, Martin Lipton and Ira Milstein, take the prominent roles in this capacity. See Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 67-75 (1992) (recommending the separation of the chief executive and board chairman functions, longer and more frequent board meetings, smaller boards, use of outside consultants, periodic evaluation of the C.E.O.'s performance, and an annual meeting with the company's largest shareholders); see also Jay W. Lorsch, *Empowering the Board*, HARV. BUS. REV. 107 (Jan.-Feb. 1995) (describing activist board strategies).

The General Motors Board adopted a set of "guidelines" in 1994, drafted by Milstein. These provide for annual evaluation of the C.E.O. but little else. See *The GM Board Guidelines*, DIRECTORS & BOARDS, Summer 1994, at 5.

209. Conflicts over short term gain and long term strategy are entailed in these engagements. These conflicts are discussed publicly, particularly where the issue is the unbundling of a conglomerate.

210. That is, when termination of a particular relationship is contemplated. Presumably, an end period results only when a given agent has decided to leave the field of money management. Cf. Black, *Agents*, *supra* note 30, at 851 (observing that

against management depends ultimately on the agent's ability to rally votes from the wider institutional community.²¹¹ Since votes against management remain the exception rather than the rule, the proponent must husband its reputation to continue to play, selecting targets carefully and representing the interests of the entire group of shareholders in the engagement with management. Informational slack seems unlikely to open up any room for self-seeking maneuvers. The institutions operate in an informal network, and the managers themselves remain ready to publicize any misconduct.²¹² In short, guardianship here is easily contested.

Competing demands on, and the possible capture of, agents of public pension funds can more plausibly be hypothesized from a different direction. The bureaucratic positions of public pension fund agents make them vulnerable to pressure from constituency interests frequently opposed to shareholder interests. Management is one of those constituencies. These actors are, after all, agents of the same governments that managers already have captured, at least within the production of corporate law. Accordingly, political contestability makes it imprudent to predict that this form of entrepreneurship will remain vital indefinitely.

Roberta Romano has suggested that state-based concerns, such as political pressure to support local firms and engage in other forms of locally directed social investing, could limit the freedom of action of pension fund agents.²¹³ Certainly a close tie between a state and a particular firm would create a conflict for that fund agent. As Romano also suggested, however, these conflicting demand situations are geographically specific rather than systemic. They therefore differ from the more general threat of management pressure that still controls private actors. Given a multiplicity of players, the conflicts can be worked out within the network: The agent disabled by the dual demand employs the professional's device of recusal, and the other agents go forward. Romano points to a more systemic threat to the leadership of the public pension funds when she recounts pro-management political maneuvers to place pension fund control in the

shareholder engagement is a repeated game, retaliation against cheaters can be expected, and money managers will rarely be in an end period with respect to one another).

211. Romano conducted a comparative survey of the voting policies of public and private funds and found no statistically significant differences in voting patterns on process and structure issues, and a common pattern on most social issues. Romano, *Pension Fund Activism*, *supra* note 182, at 831-39.

212. See Black, *Agents*, *supra* note 30, at 817.

213. Romano, *Pension Fund Activism*, *supra* note 182, at 814-20.

governors' offices in New York and California.²¹⁴ These maneuvers did not succeed, but they underscore the important point that managers know how to organize themselves and make state governments responsive to their wider agenda. Increased fund activism, predicts Romano, will cause a concomitant increase in political pressure on the funds' governance decisions.²¹⁵

It is hard to gauge the likelihood and prospects of a management political initiative to break the pattern of public fund leadership. Such a campaign would face several barriers. Here, unlike charter competition, the employee beneficiaries provide a countervailing interest. In addition, the funds with the most active postures come from states, such as California, New York, and Wisconsin, with long-standing antimanAGERIAL political traditions.²¹⁶ Finally, an initiative would have to succeed on a multistate basis. On the other hand, since the number of key states is small, it would be possible to knock out the core players that provide essential resources to the network with an initiative pointed to the leading jurisdictions. The likelihood of such an attack would increase if takeovers returned as an issue in a political posture replicating that of the 1980s.

C. *Relational Modes of Shareholder Participation*

1. Institutional Coalitions and Board Membership

Discrete engagements led by public pension funds only begin to realize the benefits projected by the proponents of shareholder participation. More significant results would follow if the institutions formed coalitions and engaged with management to influence the selection of board candidates, or, if necessary, proposed and elected their own minority slates. This strategy's objective is not the acquisition of board control, but the placement of clusters of monitors whose reputational interests are tied to meeting the demands of the shareholder interest. These inside shareholder representatives would work to include performance incentives in compensation schemes, develop additional sources of information and analysis, bring

214. *Id.* The governors presumably also had an interest in controlling the funds to be able to draw on them in closing budget deficits. See Garten, *supra* note 159, at 639.

215. Romano, *Pension Fund Activism*, *supra* note 182, at 852. She concludes that pension fund activities cannot replace an active control market as a disciplining force. *Id.*

216. CalPERS enlisted the press in fighting off the attack against it, charging that the state was attempting to silence the funds' attacks on management. See Garten, *supra* note 159, at 639.

heterogeneity of opinion to board deliberations, watch the managers closely, and, in cases of persistent failure, build boardroom coalitions to replace the managers.²¹⁷

This strategy could be implemented in either of two ways. First, the institutions could voluntarily subscribe to a clearing house that would select candidates and solicit proxies for them.²¹⁸ Second, the concentration of institutional holdings could increase to a level that would make the formation of informal institutional voting coalitions more feasible.²¹⁹ Unfortunately, no movement toward the realization of either strategy seems to exist in practice. No volunteers have come forward to organize a governance association, nor have the proportionate holdings of individual institutions risen to a point that small subgroups have a stronger voting influence.²²⁰ The present disposition of institutional incentives heralds no change. All the cost

217. See Gordon, *Cumulative Voting*, *supra* note 148, at 133-42. Gordon does not think that these institutional monitors should be selected with a view to competing with management in the creation of investment and management policy. The hypothesized monitors do not possess company specific expertise; aggressive intervention for structural changes like downsizing could lead to adverse political consequences. *Id.* at 134-42; see also Barnard, *supra* note 165, at 1165-68 (explaining that institutional investors and shareholders lack necessary expertise to play an effective role in corporate governance); Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 880 (arguing that since institutional investors lack the expertise for monitoring management, they must delegate this function to outside directors).

218. Gilson and Kraakman propose an institutional clearinghouse that would develop a pool of candidates. See Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 883-88. The amendment of the proxy rules permitting shareholders to split their votes between the management slate and an opposing slate, see *supra* note 180, facilitates this strategy by making it possible to run a slate for a small number of seats.

219. An intermediate strategy, the permanent shareholder advisory committee, has not met with enthusiasm from either the commentators, see Barnard, *supra* note 165, at 1165-68; Gilson & Kraakman, *Institutional Agenda*, *supra* note 32, at 871-72, or the shareholders themselves. A proposal for an advisory committee made by Mr. Robert Monks at Exxon received only 8% of the vote. See Charles F. Richards, Jr. & Anne C. Foster, *Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee*, 48 BUS. LAW. 1509, 1511 (1993).

220. The top 20 institutions hold 21% of American equities, and concentration falls off thereafter. See Coffee, *Half-Time Report*, *supra* note 32, at 852. The holders of the 21% hold sole voting authority as to only three-quarters of their blocks. *Id.* at 854. Furthermore, the number of mutual funds continues to increase. *Id.* at 855.

A helpful contrast may be Britain, where the largest 25 institutions hold an absolute majority of the shares. *Id.* at 854. A somewhat more active pattern of shareholder participation follows from the higher level of concentration. In the case of a seriously underperforming company, the four or five largest institutional holders of British firms consult informally. The largest holder takes the organizing lead and takes the group's concerns to the managers in the case of poor performance. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2046-53 (1994).

and reputational disincentives that leave the public institutions in a secondary role in discrete engagements also deter special investment in monitoring. Additional disincentives deter the taking of larger positions: Institutions continue to value liquidity,²²¹ and performance pressures deter risky long-term commitments.²²² The same financial concerns deter the extension of public pension fund entrepreneurship to the board membership politics. Given the nonspecific, long-term financial gains of effective monitoring, the disincentives make it unlikely that institutions will invest in board election campaigns in the foreseeable future.

2. Monitoring by Block Holders

Recognition of the difficulties with the coalition strategy has led proponents of shareholder participation to reconsider the possibilities of an historically tested mode of relational investing, large block ownership.²²³ The model block owner is the legendary Warren Buffett, a fundamental value investor who takes large, underdiversified, long-term positions; monitors carefully; but does not attempt to interfere with the formulation or implementation of the business plan, except in a crisis.²²⁴ This model actor's large equity investment plainly provides an incentive for active monitoring. It is less clear, however, whether there are any incentives that might induce existing investment institutions to make these large block investments. Relational investors of this type appear only rarely in American capitalism.²²⁵ When they do, they are either individual entrepreneurs; specialized, privately held venture capital firms; or other large corporations.²²⁶ Gilson and Kraakman, drawing on the venture capital model and a Swedish precedent, suggested a vehicle for expanding the set of these players. They proposed that closed-end investment companies be formed to take ten to thirty-five percent positions in a number of salvageable companies. These firms would

221. Coffee, *Half-Time Report*, *supra* note 32, at 851.

222. *See id.* at 867.

223. Black cites studies showing a positive relationship between Tobin's Q (the ratio of asset replacement value and market value of equity) and the size of ownership blocks where the blocks are between 5% and 20%. Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. Rev. 815, 918 (1992).

224. *See* Gordon, *Cumulative Voting*, *supra* note 148, at 129-30. Note that the monitoring strategy duplicates that envisioned with coalition-based board voting.

225. *See* Louis Lowenstein, *Opening Remarks, Columbia University Institutional Investor Project Conference on Relational Investing New York, N.Y., May 6, 1993: "More Like Whom?"*, 18 J. CORP. L. 697, 704 (1993).

226. For examples, see Rock, *Dark Side*, *supra* note 161, at 990-99.

monitor actively and hold for long periods but eventually would turn over their positions to cash in on the gains of effective influence.²²⁷ This proposal arouses standard institutional skepticism about the projected financial returns: Absent any firm-specific expertise on the part of the investor, competitive gains seem unlikely as a systematic proposition.²²⁸

3. Credibility and Possibilities for Capture

Possibilities of capture and defection raise questions about block ownership's ordinary course suitability as a mode of shareholder participation. Coalition-based board voting, in contrast, suggests neither problem.

With coalition-based board voting, as with public pension fund activism, the combination of cross-monitoring, reputational interests, and contestability of guardianship provides a circumstantial guarantee that participants will remain faithful to the shareholder interest.²²⁹ Yet circumstantial guarantees of fidelity to the relational ideal of patience and cooperation are less clear cut. It seems unlikely that members of such coalitions could, or would, bond themselves to long-term cooperation by committing, implicitly or explicitly, to reject a tender offer. Their legal duties and reputational interests lie in value maximization for beneficiaries, with no fine distinctions being made about short or long-term means to the end. Even with an implicit commitment to the firm and institutional internalization of a norm of patience, the incentive to defect from the coalition and accept an attractive tender offer would be powerful.²³⁰

This element of short- versus long-term instability does not completely undercut the cooperative possibilities of the board voting

227. See Gilson & Kraakman, *Investment Companies*, *supra* note 149, at 995-96. They hope for a 50% increase in the stock price over the holding period. The closed-end form is necessary to secure a long-term commitment; the gain must, of course, be net of the closed-end discount. *Id.* at 1005-06.

228. See Pozen, *supra* note 186, at 148.

229. See Black, *Agents*, *supra* note 30, at 817, 851, 855; Gordon, *Cumulative Voting*, *supra* note 148, at 171.

230. Lowenstein reports that during the 1980s major British funds responded to tender offers by holding collegial inquiries into the integrity and efficiency of target managers, and, in fact, rejected a few tender offers as a result. American fund managers, pressed by competition and fiduciary duty, always tendered. Lowenstein, *supra* note 182, at 10-11.

Another possible route of defection should be mentioned. The holder can threaten a tender offer himself, as Mr. Kirk Kerkorian recently did with Chrysler. See Steven Lipin & Dave Kanas, *Offer for Chrysler May Signal Return of the Corporate Raider*, WALL ST. J., April 13, 1995, at C1.

strategy, however. The coalition, by hypothesis, has the votes to insert its monitors whether or not management consents in advance. Thereafter, the structural possibility of a hostile attack gives management an incentive to cooperate to the extent that doing so decreases the likelihood of attack.

The block-owning monitor has a similar incentive to abandon management when faced with a tender offer, but the monitor is also more susceptible to capture by management. In this situation, management can compete with the offeror by offering the holder a side deal, exchanging additional returns on invested capital for a binding commitment not to tender.²³¹ The holders' substantial equity commitment creates an incentive to defect to the management side, and at the same time it undercuts any reputational concerns about serving the wider shareholder interest. Given financial rather than political entrepreneurship, the incentives would appear to lie in the opposite direction.

In the proponents' story, the block owner charts a course between these alternative defections. It makes an implicit commitment to management to reject an offer that lacks a basis in fundamental value analysis.²³² Thereafter, it plays a tit-for-tat cooperative game, holding to its commitment to the extent management performs, but standing ready to defect to an outside offeror if management fails to deliver.²³³ Meanwhile, a successful cooperative relationship makes a hostile offer unlikely. Since the block owner plays this cooperative game with multiple firms as a going business, it develops a reputational interest for exercising its judgment in a discriminating way when faced with a tender offer.²³⁴ It becomes a gatekeeper for good and bad tender offers.

The problem with this story lies in the complicated mix of elements that figure into economic accounts of the sources of merger gain. Tender offer premiums of the 1980s had multiple sources. Under Kraakman's "joint gains" explanation, the offeror pays a

231. In the standard deal, the block holder receives preferred stock in exchange for a stand-still, or gives management a call option. Indirect payments can come from investment banking fees, other product contracts, or access to inside information. Rock, *Dark Side*, *supra* note 161, at 1004-06.

232. See Ayres & Cramton, *supra* note 19, at 1041.

233. Cf. AYRES & BRAITHWAITE, *supra* note 13, at 26-38 (hypothesizing a tit-for-tat cooperative game between government agency and regulated firm).

234. Ayres & Cramton, *supra* note 19, at 1060-61; cf. Gilson & Kraakman, *Investment Companies*, *supra* note 149, at 1005 (concluding that the block investor that becomes too activist loses friendly access and cannot sustain the business).

premium to make up a discount between the equity's market value and the intrinsic value of the going concern. Given a competitive market, the offeror must make up the discount. Its profit comes after the acquisition, from either (or a combination of) synergistic gains, better management, or the resale of parts of the target in the market for going concern assets.²³⁵ Let us assume that all tender offers correctly are typed as motivated by the pursuit of gains through one of the three strategies, and consider the position of the block holding gatekeeper as to each.

The tender offer motivated by synergistic possibilities does not seem well suited to the block holder's business judgment, absent particular expertise in the given production function. This leads the block holder to a difficult reputational choice: Its relational monitoring role, narrowly defined, does not require it to forego a share of the synergy-motivated premium. Unfortunately, management might view a commitment to patience and cooperation more broadly. A side payment in exchange for refusal to tender would provide a neat resolution of the holder's conflict, so long as the holders' reputational interest lies more with cooperation with managers rather than with a public-regarding appearance in the wider institutional community.²³⁶

The block holder's gatekeeper role would seem better suited to tender offers motivated by gain through better management or resale of going concern assets. In this case, the holder's superior information about company practices enables it to appraise prospects for management improvement; chances for gain through dismemberment presumably will have been explored in the course of the relationship. Even here, the holder's loyalty to the cooperative strategy will be

235. See Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 925-30 (1988). Kraakman followed financial economic theory in accounting for the discounts, attributing them to either management misinvestment of free cash flows or systematic imperfections in market pricing. *Id.* at 907-11. Other commentators abandon the limiting assumptions of finance theory and cite downward-sloping demand in stock market pricing. See Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CAL. L. REV. 1053, 1095-97 (1991); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1259-75 (1990).

236. We note that hopes for synergistic gains and other management-driven objectives figure prominently in the recent revival of merger and acquisition activity. A few transactions have entailed hostile bids, but most have been friendly. See Randall Smith & Greg Steinmetz, *Mergers Surge as Firms Find a Rising Economy and Cheap Financing*, WALL ST. J., Mar. 16, 1994, at A1; *Mergers in America: Something in the Waves*, THE ECONOMIST, Nov. 16, 1993, at 89.

tested if, as Kraakman asserts, most of the premium comes from the making up of the discount.²³⁷ If we open up the valuation theory to admit a likelihood of overbidding by the offeror,²³⁸ the conflict becomes even more severe. The overbidding offeror leaves the block holder with a choice between (a) cooperation and a payoff through speculative governance gains that cannot, in any event, make up the discount between intrinsic value and the market price of the stock, and (b) a single-shot payoff that not only makes up the discount but, given overbidding, clearly offers a greater return than that held out by patient monitoring. Even given a reputational interest in integrity in the gatekeeper role, the blockholder's temptation to defect and take end period gains would be strong, particularly if a trend of stepped-up tender offer activity held out possibilities of short-term gain in similar investment positions. This scenario invites a restatement of the two choices above: (1) defect, abandon cooperation, and go into an end period,²³⁹ or (2) adhere to the cooperative commitment and take a side payment.²⁴⁰

D. Summary

The foregoing discussion of capture risk respecting block holders dovetails with the discussion of capture risk respecting agents of public pension funds: The availability or effectiveness of either mode of participation may be limited by historical contingencies, with the likelihood of hostile takeover activity being a salient one. It is hardly a coincidence that relational investing models found their way into circulation after the lapse of hostile takeover activity in 1989. The disappearance of the market deterrent both ensured an absence of countervailing interest group demands that might have impaired the public pension funds' freedom to take a leadership role in discrete participation and made plausible the projections of long-term cooperative participation by private institutions. The new cycle of

237. Kraakman, *supra* note 235, at 925-27.

238. Kraakman discounts this possibility. *Id.* at 893-905. Others take the opposite view. See Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 614-15 (1989).

239. The mid-1980s experience of bondholders holding portfolios of covenantless paper in reliance on management's reputational interest in capital market access provides a good example of this risk.

240. Ayres & Cramton, *supra* note 19, at 1059-61, recognize these problems in suggesting that relational investing might help to forestall bad tender offers. We are less sanguine than they about the possibility that the problems can be resolved for the benefit of the shareholders as a group.

acquisition activity that commenced in 1993 could, but need not, materially change this favorable climate.²⁴¹ Another salient contingency is the relative level of concentration of institutional equity holdings. Absent a marked increase of concentration in the industry, we may not see the emergence of circumstances conducive to the appearance of coalition-based relational participation.

IV. FEDERALLY MANDATED SHAREHOLDER INITIATIVE

The law reform agenda surrounding the institutional investor movement tends to look in the federal direction. This is partly because the proxy process is heavily federally regulated. Reform initiatives already have prompted the SEC to remove barriers to shareholder initiative.²⁴² However, the reformers would like to see additional changes that would shift more of the costs of shareholder initiatives from the proponents to the firms. The primary agenda item here is mandatory inclusion of shareholder board nominees in the firm's proxy statement.²⁴³

241. So far, the new cycle is management-driven and friendly in most cases; see sources cited *supra* note 236, indicating no significant change.

242. See *supra* note 180.

243. Without such a reform, the proponent must invest in its own proxy solicitation, a prohibitively expensive process absent a control acquisition objective. For a recent suggestion that this reform be undertaken by SEC rulemaking, see Coffee, *Half-Time Report*, *supra* note 32, at 900-02. Coffee argued that multiple slates are unlikely, given the instability of institutional voting coalitions, and noted that a minimum support threshold could be imposed to deter overutilization. He also suggested that access be opened for proposals counter to management proposals. *Id.*

Access proposals such as this have a long history. See, e.g., Securities and Exchange Commission Proxy Rules, Hearings Before House Comm. on Interstate and Foreign Commerce on H.R. 1493, H.R. 1821 & H.R. 2019, 78th Cong., 1st Sess. 17-19, 34-43 (1943) (proposal for shareholder nomination in issuer proxy statement); Proposed Tender Offer Reform Act of 1987, H.R. 2172, 100th Cong., 1st Sess., § 6 (1987) (holders of 3% or \$500,000 worth of equity to have right to include own proxy materials and board candidates); see also EISENBERG, *supra* note 14, at 117-21 (proposing that shareholders holding 5% have the power to nominate directors in proxy statement); LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209-11 (1988) (proposing that shareholders have right to nominate one-fifth to one-fourth of entire board); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907-08 (proposing that a committee of 10 or 20 largest holders have exclusive access to proxy machinery).

"Access" implies cost shifting. Cost shifting, however, could be directed without access, on the assumption that the subsidized proponent proceeds with its own solicitation. Bebchuk and Kahan recommend compensation for challengers both in board voting contests and issue contests, with compensation for both board incumbents and challengers made contingent on receipt of a threshold percentage of votes, and more generous compensation for challengers in issue contests. See Bebchuk & Kahan, *supra* note 96, at

A broader federal law reform agenda also follows from the financial theory of shareholder participation. This asserts that present levels of institutional concentration could give rise to financial incentives sufficient to induce subgroup formation if the federal government removed ancillary legal constraints that increase the costs and risks of collective action.²⁴⁴ We have no basis for controverting this prediction, but, looking to the counter story and the practice, we note a substantial possibility that the present economic structure of the industry may, by itself, deter the appearance of the requisite financial incentives. In the latter event, institutional shareholder participation can be expected to persist only in a discrete form, with reputational incentives figuring in significantly as inducements. The possibility that the future framework for action will be thus limited implies expansion for the law reform agenda—to increase the benefits attainable through discrete action in addition to reducing the costs of relational shareholder participation. Toward this end, we present the following case for an incremental levelling of the field that state law provides for shareholder initiative.

We propose a federally mandated privilege of direct shareholder access to amend the corporate charter at the annual meeting of shareholders, with cost-shifting to be effectuated through access to the proxy statement for the making of proposals.²⁴⁵ We would limit this

1077.

244. The targets are: (1) disclosure requirements imposed on holders of more than 5% of a class of securities under section 13(d) of the Williams Act, 15 U.S.C. § 78m(d) (1988); (2) liability of controlling persons for securities law violations of controlled persons under section 15 of the Securities Act, 15 U.S.C. § 77o (1988), and section 20(a) of the Exchange Act, 15 U.S.C. § 78t (1988); (3) short-swing liability for trading profits of 10% holders under section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1988); (4) restrictions on capital structures and incentive compensation for advisors of investment companies under sections 18(d) and 23 of the Investment Company Act, *see* 15 U.S.C. §§ 80a-18(d), 80-23(a)-(b) (1988); and (5) portfolio diversification requirements under ERISA. *See* Roe, *supra* note 34, at 26-27.

245. There will be ancillary problems respecting the proposal's preemptive reach. States could nullify a narrow access mandate in numerous ways. For example, a code's system of process and structure default rules could be reconstituted as a system of mandates. Or a state could amend the process provision governing charter amendments to differentiate amendments by source and require a supermajority for shareholder-initiated proposals. We think that the proposal's inclusion of access for reincorporation decisions provides a circumstantial guarantee against the former possibility. As to the latter possibility, two drafting solutions suggest themselves. The preempting legislation could either provide that a simple majority always suffices or provide that the required percentage for a shareholder initiated proposal be no lower than that provided in respect of a management proposal. The latter, less intrusive, approach should suffice, on the assumption that no state would respond by amending its code to require supermajorities

access privilege to matters of process and structure and exclude most business matters allocated to the board by state codes.²⁴⁶ The boundary dividing process and business would have to be drawn in the preempting legislation.²⁴⁷ In drawing it, we would place contract terms relating to management's incentives on the "process" side. Thus, whatever the state law status, the federal law would grant access for poison pill redemption and opting out of any state legislation with an opt out provision, in addition to traditional process matters such as the structure and composition of boards and committees. More tentatively, we also propose access for substantive proposals respecting executive compensation.²⁴⁸ However, cognizant of Professor Jeffrey Gordon's appraisal of shareholder initiative, we would exclude access to formulation of the business plan, in particular matters of investment and disinvestment.²⁴⁹ Gordon has warned that

across the board.

246. See DEL. CODE ANN. tit. 8, § 141(a) (1991) (requiring business of corporation to be managed by or under direction of board).

247. State law draws a working but vague subject matter line between board authority and shareholder authority that accords the shareholders a privilege of initiative respecting by-laws, to the extent consistent with the charter and state law. See DEL. CODE ANN. tit. 8, § 109 (1991). Given the statutory allocation of power over business decisions to the board, see DEL. CODE ANN. tit. 8, § 141(a) (1991), the scheme implies a distinction between business decisions and contract terms respecting process. However, the precise course of this implicit boundary has never been defined. The problem is compounded by the state codes' designation, see *id.*, of default status to the allocation of business decision-making authority to the board—the allocation may be constrained or redirected by charter amendment. As a result, an open-ended mandate of shareholder initiative would hold out the possibility of shareholder direction of all business matters.

248. These proposals carry a deterrent impact that could give the proponent useful maneuvering room in the right case. See *infra* note 298. Yet they also create special risks of abuse. The very maneuvering room they could create increases the risk that a proponent might exchange the withdrawal of the proposal for private rents. In addition, substantive compensation proposals would be particularly attractive to actors with political agendas unrelated to shareholder value. Such a hostile, politically motivated proposal, if directed to an extraordinarily well-compensated but effective manager, could destabilize a valuable working relationship; that deleterious effect need not depend on a high probability of passage.

We put this component of our proposal on the table for discussion based on an appraisal that a big stick, placed in the hands of serious proponents, has a value that outweighs the risks. Shareholders are habitually suspicious of both politically motivated proposals and intervention against board business judgments; serious proponents, accordingly, would employ this big stick only in extraordinary situations.

249. The combination of a green light for poison pill redemptions, compensation matters, and opting out and a red light for other business matters could not be achieved as a drafting proposition simply by excluding from access any amendment that removes authority delegated to the board under the state code's general delegation. The permitted subjects would have to be specified. One candidate for specific exclusion would be the corporate purpose section of the charter. An amendment of the charter to exclude a line

shareholder initiatives could have two perverse effects. First, given diverse preferences, shareholder access could lead to economic losses due to inconsistent choices; second, access could be manipulated by shareholders pursuing private gain.²⁵⁰ We argue that our proposed boundary minimizes these problems.²⁵¹ Any problems of confusion (or inconsistency) resulting from multiple proposals can be avoided with simple process rules and a share ownership qualification. The latter should be low enough to permit a small number of players in the activist network to qualify a proposal and high enough to exclude the gadflies.

On the technical point as to whether this proposal requires new congressional legislation or could be promulgated as a rule by the SEC, we look to legislation as a practical matter. The legislative history of section 14(a) of the Exchange Act provides a basis for a strong argument that the SEC does have the authority to impose shareholder initiative on the states by rule.²⁵² That result depends, however, on the theory of statutory interpretation the observer brings to bear,²⁵³ and a recent, notably restrictive judicial ruling²⁵⁴ of

of business presently conducted by a firm would make all of its contracts *ultra vires*, presumably necessitating the sale of the line of business.

250. See Gordon, *Shareholder Initiative*, *supra* note 29, at 361.

251. See *infra* notes 310-27 and accompanying text.

252. See Fisch, *supra* note 162, at 1170-74 (marshalling the legislative history in arguing for shareholder access by rule); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 146 (1988) (conducting a legislative history of § 14 and concluding that Congress supported "strong and active shareholder participation in corporate enterprise within the general framework of management-shareholder relations established by the general common and statutory law"). For other expansive interpretations, see LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 453 (2d ed. 1988); Roberta S. Karmel, *Qualitative Standards for "Qualified Securities": SEC Regulation of Voting Rights*, 36 CATH. U. L. REV. 809, 824 (1987).

253. For a different reading, see Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1112. Bainbridge read the legislative history to limit § 14(a) to matters of disclosure and leave substantive voting rights unaffected. See also ROBERT C. CLARK, *CORPORATE LAW* 366 (1986) (noting that § 14(a) concerns disclosure and process and does not preempt or add to state law on existence, distribution, or content of voting power).

254. *Compare* SEC v. Transamerica Corp., 163 F.2d 511, 517-18 (3d Cir. 1947) (holding that a corporation could not apply a by-law in such a way as to block a shareholder by-law amendment proposal and implying a federally guaranteed right of access, albeit vaguely), *cert. denied*, 382 U.S. 847 (1948) *with* Business Roundtable v. SEC, 905 F.2d 406, 411-15 (D.C. Cir. 1990) (invalidating the "one share, one vote" provision in Rule 19c-4, placing a limited reading on § 14(a), and distinguishing between procedural and disclosure regulations that facilitate rights to vote granted by state law, deemed to be within § 14(a), and SEC determinations as to when a vote is required, deemed to be outside the scope of the rule).

section 14(a) has left the SEC with cause to be reluctant to experiment with new rules.²⁵⁵ This uncertainty leaves us expecting that any significant alteration of the federal-state balance regarding shareholder voting will come through legislation.²⁵⁶

A. *Management Agenda Control and State Corporate Codes*

1. Description of the System

Political theory tells us that legislative outcomes in electoral democracies depend on the collective choice rule utilized by the legislature—different process rules lead to different outcomes given the same set of electoral preferences.²⁵⁷ It follows that the actor who sets the agenda can control the outcome, and that a particular process institution's constraints on agenda formation have systematic implications for outcomes.²⁵⁸

The agenda-setting procedures for shareholder voting in public corporations have easily-described outcome implications. Control of the proxy machinery gives management working control over the mandatory shareholder board vote.²⁵⁹ Shareholder votes also are mandated for fundamental changes—charter amendments, dissolution, certain mergers, and significant asset sales. Under the process rules of most state codes,²⁶⁰ however, these matters may not be put

255. Cf. Coffee, *Half-Time Report*, *supra* note 32, at 876 (noting that the SEC vacillates on the role of institutional investors).

256. We note that part of what our proposal seeks to achieve could be achieved by rule on a relatively secure statutory basis. Specifically, the SEC could (and we think should) amend rule 14a-8 to include by-law amendments.

In any event, we would recommend that any bill be drafted with specificity to reduce the chance of *ex post* nullification in administrative proceedings. One grey area would of necessity have to be left for case by case determination by the SEC. No complete, self-executing definition of "process and structure" could be drafted as a practical matter. While a concrete list of subject matter can be culled from the existing institutional agenda and the state codes, novel proposals would occur over time, necessitating reliance on agency administration.

257. See WILLIAM K. RIKER, *LIBERALISM AGAINST POPULISM: A CONFRONTATION BETWEEN THE THEORY OF DEMOCRACY AND THE THEORY OF SOCIAL CHOICE* 37 (1982).

258. See Kenneth A. Shepsle & Barry R. Weingast, *Uncovered Sets and Sophisticated Voting Outcomes with Implications for Agenda Institutions*, 28 AM. J. POL. SCI. 48, 64-67 (1985).

259. As the foregoing discussion of barriers to shareholder voting coalitions implies, management's practical control is vulnerable only to a challenger willing to invest in a takeover or full-blown proxy contest.

260. For a survey, see *infra* notes 281-83 and accompanying text.

before the shareholders until the board first approves a resolution.²⁶¹ The condition of board approval amounts to a management veto—to control the agenda one must control the board. The shareholders have a veto in turn, but no access to the agenda. This absolute control²⁶² over the corporation's contractual agenda is subject to two exceptions. One is the section 14(a) precatory shareholder proposal, pursuant to which a shareholder who meets suitability requirements can set an agenda item, but only for a nonbinding vote.²⁶³ The other is a state law shareholder access privilege respecting by-law amendments,²⁶⁴ the utility of which is limited. By-laws may contain any provision relating to the business or its conduct, not inconsistent with the rest of state law or the charter.²⁶⁵ This means that coverage of subject matter in the charter preempts contrary treatment in the by-laws, opening possibilities for strategic tiering of provisions. Management-protective exploitation of this possibility is a basic corporate lawyering skill, extensively put to use in the drafting of the antitakeover charter provisions of the 1980s. Some of the items from the checklist of shark repellent provisions, such as poison pills²⁶⁶ and provisions barring shareholder action without a meeting,²⁶⁷ had to be placed in the charter as a matter of statutory mandate. Others, such as staggered boards²⁶⁸ and supermajority voting requirements,²⁶⁹ might be in the charter or by-laws at the firm's option. Management chose the charter, blocking amendment or repeal at the instance of a shareholder challenger not yet in control of the board but holding a majority of the stock or a majority of the

261. See DEL. CODE ANN., tit. 8, §§ 242(b)(1) (charter amendments), 251 (b)-(c) (mergers), 271(a) (sales of substantially all assets), 275(a) (dissolution) (1991).

262. Management's process advantage in the event of a challenge, whether by proxy fight or shareholder proposal, also remains substantial. It has wide discretion to invest corporate funds on the defensive side, and with the help of proxy solicitors, maintains a substantial informational advantage. See Black, *Agents*, *supra* note 30, at 825-26; Black, *Shareholder Passivity*, *supra* note 155, at 593-94. Despite amendments to the rules under § 14, management still has some room to manipulate shareholder preferences by bundling proposals. See *supra* note 180.

263. See *supra* note 162. There is an exception to the rule of nonbindingness for proposals for new by-laws. See *infra* note 274.

264. See DEL. CODE ANN. tit. 8, § 109(a) (1991).

265. See *id.* § 109(b).

266. See *id.* § 151(a) (providing that preferred stock contract terms go into the charter; charter can provide in advance for "blank check" delegation to management of power to authorize preferred stock and fill in terms).

267. See *id.* § 228(a).

268. See *id.* § 141(d), (k) (charter, initial by-law, or shareholder by-law; staggered board has effect of barring action for removal of directors without cause).

269. See *id.* § 216.

proxies.²⁷⁰ Meanwhile, shareholder preferences respecting such provisions underwent a change between the early and late 1980s—defensive charter amendments were routinely ratified during the early period and resisted later on.²⁷¹ However, the resistance came too late. Defensive charter provisions were widespread by the end of the decade. The new shareholder activists can beg for their removal under Rule 14a-8, but, given the board veto on access to the charter, cannot compel it.

The charter preempts the by-laws only to the extent that it actually covers the subject matter in question. Technical possibilities for shareholder-initiated contracting arise as a result. The charters of public corporations, contrary to the vision of the contractual theorists, did not contain many contract terms before the proliferation of antitakeover provisions. The historic public corporation charter was kept spare to provide management with maximum freedom of action in formulating process rules.²⁷² The charter contained the minimum terms mandated by the code and terms covering any senior equity securities issued by the firm; by-laws contained standardized process provisions; managers relied on state codes to fill in the rest. Firm contracting evolved during the 1980s mostly to load charters with defensive provisions. The shareholder agenda of the 1990s includes new areas of concern, such as compensation schemes, confidential voting, and board and committee structure. As to these, the charter may provide nothing, leaving open a field for shareholder-initiated by-law amendments. Read literally, the suitability rules under Rule 14a-8 permit by-law proposals, making an initiative cost-effective.²⁷³ Some by-law initiatives have gone forward under Rule 14a-8, but, unfortunately, this federal route to contractual access has not proved useful to proponents. Technical questions of federal-state synchronization have arisen as the SEC has dealt with management

270. At some point, procedural maneuvering by management to frustrate exercise of the shareholder franchise violates a norm of Delaware law. That point is extreme. *Compare* *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1121-22 (Del. Ch. 1990) (holding that board action frustrating exercise of shareholder franchise requires a compelling justification) *with* *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 662-63 (Del. Ch. 1988) (retreating from requirement of a compelling justification for such board action).

271. *See supra* note 171 and accompanying text.

272. This is because charter amendments must be ratified by the shareholders, while by-laws may be promulgated by the board. In an environment in which shareholder initiatives respecting contract terms were rare events, it made cost sense to leave the contracting to the board.

273. *See* Rule 14a-8(c)(1), which excludes matters that are not a proper subject for shareholder action under state law.

objections to by-law proposals. State law provides little guidance on these questions, and, at least up to now, management effectively has blown doctrinal dust into the eyes of the SEC.²⁷⁴

2. Explanation of the System

The rule of absolute delegation came into corporate law with the turn-of-the-century shift toward an entity conception of the corporation—a shift that had the incidental effect of affording freedom of action to the managers of new, mass-producing firms.²⁷⁵ Previously, an agency theory of board authority had prevailed and

274. The suitability rules are built on three principles. First, the subject matter must be proper under state law under Rule 14a-8(c)(1). Second, the subject matter must not traverse a long list of specific exclusions devised by the SEC over the years. See Rule 14a-8(c)(2)-(13). Third, following *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954), a proposal on a subject matter reserved to the discretion of the board under the state law delegation of authority is nevertheless proper if phrased as a request. The three principles do not synchronize well. There are two problems. First, a by-law proper under state law might nevertheless traverse the SEC list of unsuitable topics. Second, state lawmakers have never had occasion to draw a clear line between board management authority and shareholder by-law promulgation authority. As a result, the extent to which a by-law may constrain the board management authority is not clear. Nor is it clear whether the board of directors, which also has power to promulgate by-laws, can subsequently repeal a by-law approved by the shareholders. The no-action letters play out these problems with conflicting results. Compare *Exxon Corp.*, 1992 SEC No-Act. LEXIS 281, at *1 (Feb. 28, 1992) (allowing the shareholder proposal to establish a committee to oversee the board of directors to be excluded) with *Pennzoil Company*, 1993 WL 52187 (S.E.C.) at *82-84 (Feb. 24, 1993) (original proposal) and *Pennzoil Company*, 1993 WL 87871 (S.E.C.) at *40-42 (Mar. 22, 1993) (revised proposal) (suggesting that the shareholder proposal that by-laws were to be amended only by shareholders was not proper under state law). For a summary of the *Pennzoil* correspondence, see Charles F. Richards & Anne C. Foster, *Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee*, 48 BUS. LAW. 1509, 1513-18 (1993). In the former case, the SEC took a no-action position respecting a proposal for a by-law mandating a permanent shareholder advisory committee, even though the proposal required funding for the committee, arguably traversing the state law delegation of authority to management. The SEC retreated from the position in the latter case, which also concerned a by-law proposing a shareholder advisory committee. Upon resubmission of the proposal on a precatory basis, the SEC still sanctioned the proposal's omission because it contained a block against repeal by a subsequent board by-law. This, said the agency, created a question as to state law validity.

The SEC's treatment of the *Pennzoil* no-action letter is somewhat counterintuitive as a state law proposition. The state codes, read literally, imply that charter terms trump by-laws, and that shareholder by-laws trump board by-laws, but the point is not clear. The SEC's no-action letters thus have a perverse effect. They invite state courts to determine the issue in management's favor should it come up at the state level. Given the charter competition system, the states have every incentive to decide against the shareholders. For further discussion, see Coffee, *Half-Time Report*, *supra* note 32, at 883-89.

275. See William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1489 (1989).

access had been the rule.²⁷⁶ New Jersey, the early leader in the chartering of large firms,²⁷⁷ conditioned amendment on board approval before 1895.²⁷⁸ Delaware followed in its corporations code of 1899,²⁷⁹ a piece of legislation that manifested its determination to enter into charter competition with neighboring New Jersey.²⁸⁰ Access limitation provisions diffused into the codes of other states during the subsequent decades. By 1960, twenty-five state codes conditioned charter amendment on board approval;²⁸¹ by 1970, twenty-eight state codes did so,²⁸² by 1993, forty state codes did so.²⁸³ Today, only ten state codes leave a door open to shareholder access.

This historical sequence can be read as further confirmation of the capture of state codes by the management interest: It is no accident that this component of management agenda control dates to the first instances of the purchase and sale of corporate codes. Another plausible story has been offered, however. Jeffrey Gordon has set out a functional explanation for absolute delegation, tied to his observations that an open agenda could lead to costly shareholder voting cycles and self-dealing by proponents of initiatives directed to the firm's business.²⁸⁴ The tie led him to a three-part argument that

276. See Gordon, *Shareholder Initiative*, *supra* note 29, at 349 n.7 (citing JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS, AGGREGATE §§ 297-99 (9th ed. 1871); 1 VICTOR MORAWETZ, TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 243-44 (2d ed. 1886)).

277. New Jersey began to liberalize its code after 1890, with considerable financial success. See CHRISTOPHER GRANDY, NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW 43-45 (1993).

278. JAMES B. DILL, THE STATUTORY AND CASE LAW APPLICABLE TO PRIVATE COMPANIES UNDER THE GENERAL CORPORATION ACT OF NEW JERSEY AND CORPORATION PRECEDENTS 42-43 (1899) (reproducing New Jersey General Corporation Act § 27).

279. See Act of 1899, 21 Del. Laws ch. 273, § 135.

280. See RUSSELL CARPENTER LARCOM, THE DELAWARE CORPORATION 11-13 (1937).

281. See 2 MODEL BUSINESS CORP. ACT. ANN. 230-31 (1960).

282. See 2 MODEL BUSINESS CORP. ACT. ANN. (SECOND) 260-61 (1971).

283. See 2 MODEL BUSINESS CORP. ACT. ANN. (THIRD) 1172-73 (Supp. 1993). The MBCA count is 38. We disagree as to two omissions: N.Y. BUS. CORP. L. §§ 803, 804 (McKinney 1986), and UTAH CODE ANN. § 16-10a-1003 (Cumulative Supp. 1994). Of the 10 states that omit the board veto, four allow a stated percentage of shareholders to propose amendments (Idaho, Minnesota, North Dakota, and Pennsylvania); five have no process provisions respecting amendment proposals (Louisiana, Massachusetts, Michigan, Ohio and Wisconsin); California, somewhat ambiguously, requires a board resolution before or after the shareholder vote. CAL. CORP. CODE §§ 902, 904 (West 1990).

284. See Gordon, *Shareholder Initiative*, *supra* note 29, at 357-61. For our discussion of the cycling problem, see *infra* notes 313-27 and accompanying text.

explained the statutory pattern as a result of evolutionary efficiency.²⁸⁵ First, if the absolute delegation rule had a significantly negative effect on value, some states would offer an alternative. Second, although many states do permit corporations to contract around the delegation of business decisionmaking power to the board,²⁸⁶ public corporations have not offered charter terms that take up this option. Third, unlike antitakeover resolutions, which have a negative impact on share prices, the absolute delegation rule has a long historical standing that share prices already reflect. Citing Jensen and Meckling's famous article on agency costs,²⁸⁷ Gordon concluded that if the rule injures shareholders, managers bear the agency costs when they initially sell stock to the public.

In response to the first argument, we note that a number of alternative codes do exist, but we think that inattention by local bar associations and other management representatives is the best explanation for the isolated persistence of shareholder access provisions. Given management agenda control over reincorporation decisions,²⁸⁸ no actively competing jurisdiction would include shareholder access in its product package, even if access were thought to have a positive impact on shareholder value.

We also question the probative value of the second argument's point that public corporations have not exploited opportunities to opt out of the absolute delegation of ordinary business decisionmaking authority to the board. Agenda control follows from process provisions that appear to be mandatory and is analytically distinct from the statutory delegation of business decisionmaking authority.²⁸⁹ Opting out of the board authority delegation came into the codes to facilitate shareholder-level contracting as a means to police opportunism in closely held firms. The charter amendment that makes use of this permission removes decisionmaking authority from the board to the shareholder level. Such a broad-brush removal is neither feasible nor desirable in a publicly held firm. A public

285. See Gordon, *Shareholder Initiative*, *supra* note 29, at 357-59.

286. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991).

287. See Gordon, *Shareholder Initiative*, *supra* note 29, at 358 (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)).

288. See *supra* notes 69-72 and accompanying text.

289. See, e.g., DEL. CODE ANN. tit. 8, § 242(b)(1) (1991) (charter amendments to be approved by the board). This doctrinal distinction is long standing. See HENRY WINTHROP BALLANTINE, *BALLANTINE ON CORPORATIONS* § 97, at 320 (1927) (distinguishing between director and stockholder powers).

corporation conceivably could exploit the permission by expanding the set of transactions that must be submitted for shareholder approval. However, doing so would not open the agenda to shareholder charter amendments; instead, the charter would set the agenda, and management would retain a degree of control over the initiation and timing of the transaction eventually submitted to the shareholders.²⁹⁰

Finally, we question the applicability of Jensen and Meckling's historical *ex ante* pricing model to this case. That model presupposes a complete contract as to which all risk is priced out when the firm initially goes public. We think an incomplete contract model inclusive of *ex post* renegotiation of terms is more appropriate here. In practice, firms go public at an early, entrepreneurial stage of their life cycles. At that point, uncontrolled management influence over decisions creates value, and no one worries about independent directors and other process protections.²⁹¹ The shareholder participation movement deals with firms at a later stage of the life cycle—mature, solvent companies able to pursue failed strategies because of weak capital market constraints.²⁹² To have present contracting processes determined by a risk allocation implied from a public offering of a quarter or half century earlier seems counterproductive.

In sum, state law's evolution to block shareholder access to the corporate contract may raise a presumption of efficiency, but a review of the history rebuts the presumption. At the turn of the century, when the agenda control provisions came into the corporate codes, corporate law was changing to facilitate investments of unprecedented scope by entrepreneurial managers. Today, the picture is more

290. We note the possibility that a charter could be amended to remove to the shareholder level the determination of the charter amendment agenda. Certainly this is the inevitable result in closely held firms that move all business decisionmaking to the shareholder level, as the statute permits. However, again, any blanket removal makes little sense for publicly held firms. In the alternative, the charter could provide that management's agenda power over charter amendments is subject to *pro tanto* limitation in any case in which a shareholder proposes an amendment at a meeting. On the theory that the greater includes the lesser, this provision would be valid. On the other hand, if the agenda control provision were read as strictly procedural and not one of the "business" matters under the basic statutory delegation, it would resist opting out and amount to a mandate. That reading follows from the structure of the state code. Since shareholder approval is mandatory for charter amendments, they are by hypothesis not within the "business" in the exclusive delegation to management.

291. Indeed, a charter loaded with such terms might send a negative signal in an initial public offering.

292. See Black, *Agents*, *supra* note 30, at 832; Lipton & Lorsch, *supra* note 208, at 74-76.

complicated. Some firms fit the paradigm of the productive management firm, but many do not. Until the recent occurrence of successful shareholder initiatives, the shareholder collective action problem made it pointless to question access barriers. The question finally comes up today in an economic environment in which we look to the legal framework to facilitate disinvestment as well as investment.²⁹³ The implication for the state code's access barriers is not efficiency, but obsolescence.²⁹⁴

B. Shareholder Access to the Charter for Process Amendments

1. Benefits

a. Shareholder Participation

We direct our access proposal to the pattern of discrete shareholder participation led by agents of public pension funds. We project beneficial consequences on the following model of engagement, abstracted from the practice pattern.²⁹⁵

Let us start with a proponent who publicly selects a corporate target and either launches a negative voting campaign or makes a precatory proposal. Public targeting indicates the proponent's judgment that the influence costs at the firm are unnecessarily high. If the proponent's determination has credibility, the targeting injures the reputations of the firm's managers and makes it more likely that the shareholders will obstruct future management proposals. The managers have three choices as to their response. First, they can take action amounting to a counter-signal showing that the proponent has selected incorrectly and thereby rehabilitate their reputations.²⁹⁶

293. See generally Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 847 (1993) (arguing that firms able to achieve disinvestment will be successful competitors in the coming era).

294. Gordon, *Cumulative Voting*, *supra* note 148, at 175-79, indirectly confirms this point. Gordon sensibly suggests that cumulative voting could facilitate implementation of institutional board membership. His proposal runs up against the access problem at the implementation stage: Since cumulative voting must be in the charter, and the proponent's only vehicle is the precatory proposal, chances for success are speculative at best.

295. See *supra* notes 181-208 and accompanying text.

296. Recent events at Philip Morris show that this is possible. A board coalition (led by the previous C.E.O., a tobacco division veteran) formed to fight a proposal of the incumbent C.E.O. (a food division veteran backed by the institutions) to split the firm into its food and tobacco segments. This led to the incumbent's resignation and the selection of a new C.E.O. from the tobacco division. The new control group took its strategy to the marketplace, promising a more favorable dividend payout, and met a favorable response

Second, if no such response is available and they are sufficiently risk averse with respect to reputation and shareholder relations, they can indicate responsiveness by starting a dialogue with the proponent. Third, they can do nothing and let the campaign take its course.

Access to the charter gives the proponent more room to maneuver in the second and third cases. In the second case, the proponent gets a significant payoff only if the campaign's reputational effects are severe enough to cause realignment of the firm's internal coalitions and termination of the chief executive. Otherwise, dialogue leads to a payoff in the form of contract concessions. At the negotiations, the proponent has cost and reputational incentives to make a quick deal and take home some sort of contract modification. Management presumably will want to give up as little as possible in the way of concrete terms, consistent with an appearance of responsiveness. Management, in addition, at all times retains the option of noncooperation. The proponent, armed only with a precatory proposal and reputational threats, is not in a particularly strong position to extract meaningful concessions.²⁹⁷ If management has a pending proposal of its own, a credible negative voting campaign could mean a stronger bargaining position. Charter access lets the proponent go past the negative, which depends on management's agenda, and take its own mandatory agenda to the table. Armed with a mandate, the proponent with credible vote-getting ability can close off management's option of noncooperation. Furthermore, the mandatory stick can be wielded directly against the managers' influence within the firm as well as against their reputations: The proponent, for example, could go to the table with a new incentive

in the stock price—a two percent increase against a market decline on the announcement day. See Eben Schapiro, *Philip Morris CEO Resigns Under Pressure*, WALL ST. J., June 20, 1994, at A3; Eben Schapiro, *Philip Morris Will Consider Stepping Up Buybacks or More Aggressive Dividend*, WALL ST. J., June 22, 1994, at A3.

Thereafter, the institutions continued to pressure the firm, with mixed results. Philip Morris withdrew its poison pill in March 1995, responding to a 40% affirmative vote on a 1994 shareholder proposal. At the April 1995 annual meeting, 25% of the shareholders voted in favor of a proposal recommending limitations on benefits to outside directors. A Just Vote No Campaign initiated by CalPERS did less well, however—management's board slate was elected with a 96% vote. The C.E.O., meanwhile, continued to play the dividend card, promising a lower level of earnings retention. See Suein Hwang, *At Philip Morris, 25% of Holders Vote to Slice Benefits of Outside Directors*, WALL ST. J., April 28, 1995, at B4.

297. Grundfest, *supra* note 32, at 932 n.354, noted that the importance of concessions extracted to date can be easily exaggerated. Confidential voting, as conceded by managers, tends not to apply in contested elections; decisions to redeem poison pills do not bar the board from adopting a new pill if the occasion arises.

compensation scheme that reduces the manager's rents.²⁹⁸ In the trade-off surrounding the proposal's withdrawal, the proponent can select from the whole agenda of process reforms.²⁹⁹

Charter access also could be useful in the case of a completely unresponsive firm. Precatory proposals have no governance consequences for managers willing to suffer the reputational consequences of noncooperation and risk the long-term consequences of poor shareholder relationships. Such a refusal to cooperate puts the proponent in a repeat play situation. Charter access lets the proponent raise the stakes in a second round, proposing an incentive compensation scheme, or an amendment that redeems a poison pill and calls for a shareholder vote as a condition of replacement. Such a punishment campaign would, we suspect, have to be carefully targeted,³⁰⁰ with the proponents concentrating resources on a selected firm for a demonstration of enforcement power. A successful demonstration would reinforce the importance of shareholder relations and enhance cooperative incentives among the group of targets as a whole.³⁰¹ Charter access also holds out the possibility of short-term financial gain in some circumstances: Poison pill

298. A negative voting campaign also could have this effect if a compensation package were up for a vote.

We note that the proposal in the example in the text is unlikely to be made in practice. Information costs would deter investment in a full-blown compensation proposal. Even if such an investment were made (or a simpler percentage cut in base salary were proposed), probabilities for passage would appear to be low even with respect to a manifestly underperforming company. Shareholder imposition of compensation terms that materially reduce management rents is tantamount to a no confidence vote, and presumably would be met in kind with reduced management efforts to reverse the fortunes of the firm. The proponent's purposes would be better served in the ordinary case with a proposal for a compensation committee, that is, a proposal packaged in pure process terms. On the other hand, a shareholder privilege to make compensation proposals, even uninvoked, retains a deterrent value. In addition, a substantive compensation proposal conceivably could be useful to a proponent in a case in which management has been recalcitrant, the outside directors have been passive, the shareholders have become noticeably dissatisfied, and no potential challenger for board control has appeared. In such a situation, a proposal might either promote management responsiveness, prompt a shakeup, or induce a control challenge.

299. See *supra* note 208.

300. A problem of information flow should be noted. A negative voting campaign involves minimal informational cost. Mandatory proposals lifted directly from the existing institutional agenda and fitting standing voting policies raise no significant informational problems for the proponent. A more complex proposal, such as a compensation scheme tailored to a particular company, would create more of a problem. Presumably, such a target would have to be selected with care, and the campaign well-publicized.

301. Cf. AYRES & BRAITHWAITE, *supra* note 13, at 45 (suggesting that occasional firing of big enforcement gun by a regulator might be more effective than frequent firing).

redemption can make the stock price go up if a takeover is a likelihood. The chance of gain might favorably alter the economics of subgroup formation, inducing private institutional players into the game on occasion.³⁰²

The utility of a bigger stick that holds out an intermittent financial incentive could increase over time. The current pattern of discrete intervention turns on reputational incentives on both sides. Reputational incentives can change with circumstances from period to period. Pension fund entrepreneurship could diminish in intensity if, as the roster of players changes, the replacements discover that most of the available reputational gain has attached to the departed players of the first generation. Management reputational concerns also could change over time. The activists already have targeted the largest, worst-managed firms. New targets will represent less obvious cases of high influence costs, making noncooperative responses a more likely possibility. Old targets, meanwhile, become repeat play situations over time; as dialogue with institutions becomes an ongoing fact of life for these firms, reputational threats may loom less large and management's long-term concern about shareholder relations matter more. A power to expand the mandatory agenda allows the proponent to be more proactive.

b. State Law

Federally mandated charter access would ride atop the state system, giving the shareholders access to the corporate contract but not otherwise interfering with the production of state law. Taken alone, it would not impair the responsive benefits of the state system: Nor, taken alone, would it ameliorate the system's management bias. Accordingly, our definition of appropriate shareholder "process" amendments would include reincorporation proposals. We would set up the following two-step process for shareholder-initiated reincorporation. First, the proponent's resolution would mandate the convening of a committee of independent directors that would, after consultation with an outside consultant,³⁰³ recommend a best alternative domicile. Second, the following year, the shareholders would vote on a resolution to approve or reject a move to the new jurisdiction. We employ the independent director intermediary to solve the problem of selection. Two proponents could suggest

302. See *supra* notes 198-99 and accompanying text.

303. Here we note possible income for legal academics.

different states; a given proponent's choice could be uninformed or, conceivably, could result from a side-deal with actors in the jurisdiction chosen. In any event, public pension fund agents, being state employees, do not seem well-suited to this particular gatekeeper function. Of course, there remain possibilities for management influence over the independent directors. However, since we make this proposal more with a view to deterrent effects in states sensitive to incorporation business than with expectations of frequent utilization, we think the compromise workable.

The point of the shareholder reincorporation initiative, as stated above,³⁰⁴ is to provide state lawmakers with a long-term incentive to respond to shareholder interests. We doubt that it would result in any short-term disruption of today's charter market.³⁰⁵ No state presently stands out as a candidate for the role of shareholder-sensitive charter monger. Indeed, Delaware's laggard role as an antitakeover jurisdiction during the 1980s makes it a possible shareholder-directed destination for firms located elsewhere. As a practical matter, then, the deterrent of shareholder-directed reincorporation would complement the federal threat,³⁰⁶ reinforcing Delaware's moderate legislative pattern and encouraging its judges in their attempts to mediate between the conflicting interests.

The burden to make use of initiative to invigorate the charter market would be on the shareholder proponents. To make active competition work here, they would have to expand their entrepreneurship to locate a jurisdiction, persuade it to go into competition and invest in an informed judiciary, draft an attractive code for it, and bring it some business. If all of that happened, Delaware would face a dual demand that could produce difficult choices. Moves in the direction of the shareholder interest to counter the threat of exit by established firms could cause the state to lose

304. See *supra* text accompanying notes 141-47.

305. Had a federal reincorporation mandate been on the books in 1980 along with a pattern of active shareholder participation, antitakeover legislation might not have become so widespread. A few well-timed reincorporations might have deterred management representatives from lobbying state legislatures because the shareholder interest would have garnered a more prominent profile in lawmaking processes.

306. We would not expect this form of federal intervention to defuse the ongoing threat. Any congressional move against the state system, however minimal, would break a conceptual federalism barrier and imply the possibility of further intervention in the event of significant state developments attributable to management influence. The short-term effect, then, probably would be one of reinforcement.

new business from entrepreneurial firms on the move to maturity, but such conflicts are the ordinary incidents of active competition.

2. Unintended Consequences

We have designed our proposal to avoid two possible unintended effects of shareholder initiative—rent seeking and vote cycling. Jeffrey Gordon, warning of both, has concluded that initiative is not cost beneficial. We argue that these concerns can be met through a subject matter limitation and a few ancillary process rules.

a. Rent Seeking

On self-dealing, Gordon showed that, given concentrated shareholding and unlimited access to the charter, there would arise a risk of logrolling effected through shareholder side agreements that direct the firm to suboptimal projects benefitting the shareholders' businesses. Given dispersed shareholdings, Gordon projected that the problem might arise whenever a substantial proportion of the group of holders represents a distinct unity of interest—as when union and public pension funds, or members of some political or economic interest group, hold a large proportion of the stock.³⁰⁷ This latter scenario would be unlikely to arise in the present context, given prevailing institutional diversification practices and rational apathy among small holders. However, Gordon also noted that the advent of a regime of unlimited access could cause holding patterns to change. At present, American firms having large block holders tend to have only one such holder. That holder gains influence over management and deters others from accumulating large blocks.³⁰⁸ Unlimited access opens up possibilities for hostile coalition-building by latecomer block holders, inviting a change in the shareholding pattern.

We agree that the risks Gordon described are cognizable and have little confidence that present fiduciary law could effectively limit them. Accordingly, we leave matters of investment and disinvestment out of our access proposal to delimit its utility to actors engaging in governance activity in pursuit of short-term financial gain. The practical cost to the shareholder participation movement, as presently directed, is the foreclosure of direct action respecting disinvestment

307. See Gordon, *Shareholder Initiative*, *supra* note 29, at 376-79.

308. See *id.* at 374 (citing Harold Demsetz & Kenneth M. Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985)).

and corporate unbundling. Here, again with Gordon, we think that dialogue and process reform work better.³⁰⁹

It must be noted that the process and structure limitation diminishes incentives for side deals without ensuring their absence. Return to the above example of a proponent who threatens management with a new, rent-reducing, incentive compensation scheme. Although defined as process and structure, the proposal remains susceptible to withdrawal in exchange for a side-payment.³¹⁰ The guarantee against such a transaction lies not in the subject matter limitation but in the proponent's projected incentive profile. So long as the proponent comes to the role seeking reputational rather than financial capital, trade-offs will be structured with a view to reputational gain. Thus, a pension fund entrepreneur concerned with vote-getting credibility can be expected to structure trades that entail a concrete shareholder-beneficial component.³¹¹ Any additional consideration sought by this actor will more likely take the form of influence within the firm than the form of rent. Influence within the firm, unlike money, gives this actor opportunities for further reputational enhancement and at least holds out a prospect of shareholder benefit. At the same time, even an undisclosed rent deal creates a risk of reputational injury for the proponent.³¹²

309. Interplay between unbundling and process reform can be hypothesized. The proponent wants the firm to divide itself in two or spin off a substantial subsidiary. The proponent is motivated by current conventional wisdom and is ill-informed. Management resists. The proponent threatens management with poison pill redemption or incentive compensation. If management concedes, the firm is unbundled. If management resists, the proposal goes to a shareholder vote.

We do not view this possibility as problematic. In the latter case, the proponent still has the substantial task of persuading the shareholders of the merits of the process proposal. The proponent's inadequate information about unbundling does not bear directly on that matter. In the former case, management will have had an opportunity to inform the financial community of its case. If the case resonates, management has no reason to concede.

310. We thank Jeffrey Gordon for noting this point.

311. Certainly, a secret financial component could be a part of such a trade. But the inclusion of such a component would not necessarily mean that the overall trading process was detrimental to shareholder interests.

312. And for the target making the offer: Third parties report that managers at Philip Morris, a leading institutional target, recently offered a job to Richard Koppes, the Deputy Executive Director of CalPERS. Koppes turned down the offer. See Glenn Collins, *Philip Morris Meeting Subdues Tobacco Protest*, N.Y. TIMES, April 28, 1995, at D3.

This calculus might change during an end period, but the reputational deterrent should still exercise influence. An actor might leave state service for the private money management sector, or leave one state office to assume or run for another. In either case, later exposure of a questionable trade could prove injurious. On the other hand, a pension fund agent looking to a career in state politics might have a reputational incentive to trade

b. Cycling

On the problem of voting cycles,³¹³ Gordon hypothesized corporate versions of a standard Arrowian voting cycle³¹⁴ under unlimited shareholder access. In his base case, we have three shareholders, each of whom owns twenty-six percent. The issue is unbundling. One wants to sell a division; the second wants the *status quo*; and the third wants a spin off. The preferences are ordered, and a majority voting cycle results. The same, of course, could follow with dispersed shareholdings.

for a geographically specific benefit, such as the location of a plant in his home state. But the conflict of interest still bespeaks a need for secrecy, limiting the potential for political reputational enhancement at home. Only an actor building a personal account for a projected retirement seems to present a strong risk.

It also must be noted that a process and structure access privilege could provide the medium for a threat by a financially-motivated actor. For example, a hostile large blockholder could use a management compensation proposal (whatever the identity of the proponent) as the occasion for negotiations keyed to rent extraction. But this possible abuse, like that of rent extraction by a political entrepreneur, exists in the present legal structure. Indeed, the blockholder's opportunities to extract rents follow from the very existence of the shareholder vote. An access proposal limited to process and structure does create additional occasions for rent demands, but we doubt that it would so alter the underlying economics as to induce blockholding in the first instance or provide a blockholder with a rent extraction opportunity that could not arise otherwise. Thus, at the bottom line, our proposal's incremental aspect comes into the appraisal of the self-dealing risk that attends it. Limited shareholder access serves mainly to strengthen the bargaining position of one party in an established bargaining situation. The side deal possibility exists already and is, indeed, intrinsic to any shareholder empowerment strategy.

313. Social choice theory, which began with KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1963), asserts that majority rule can lead to any economically and technically feasible outcome. Even if voters are other-regarding, so long as their preferences differ, voting results will be unstable. Furthermore, there will be no basis for assuming that voting results are connected with the preferences of the electorate. *Id.* at 22-33, 74-120; see also Richard D. McKelvey, *Intransitivities in Multidimensional Voting Models and Some Implications for Agenda Control*, 12 J. ECON. THEORY 472, 480 (1976) (discussing global cycling theorem which shows that when majority rule breaks down, any two points in space will belong in a cycle).

314. Given majority rule, it is possible to cycle through different preferences. Assume that there are three players, A, B, and C, and three alternative outcomes, a, b, and c, and the following preference rankings:

A: abc

B: bca

C: cba

The result is a classic voting paradox, that is, a lack of transitive social ordering.

Cycling occurs by virtue of the actors' preferences remaining fixed over time. With multiple issues to be resolved simultaneously by a large number of decisionmakers, social choice models show that cyclical majorities will occur in two-thirds of the decision contexts, so long as logically ordered preferences are likely to emerge.

However, voting cycles can be contained by process institutions. Critics of social choice theory point out that its models suffer from significant limitations; cycling becomes a problem only in the simplest of majority rule institutions—without agenda controls, without strategic voting, and with an agenda constructed on an ongoing basis; in practice, agenda-setting institutions and agent sophistication constrain majority outcomes.³¹⁵ So long as actors in voting institutions take full advantage of strategic opportunities available to them under those institutional rules, majority-rule voting cycles are unlikely.³¹⁶ Gordon, heeding this literature, acknowledged that the cycling problem attending charter access could be ameliorated with a process device that orders the agenda. He considered the possibility of a rule that lets management set the agenda, as between the three shareholder proposals. He rejected that device on the ground that management ends up controlling the result, effectively returning us to absolute delegation.³¹⁷ We note in response that the device of the independent director committee could be drawn on instead. The procedure would be the same one we propose for reincorporation. The shareholder proposes the formation of a committee to consider the best means of unbundling the firm; the committee reports back with its best proposal; the shareholders vote yes or no, with no being a vote for the *status quo*. Since a choice must be presented, management's agenda control is broken. The special committee

315. See Shepsle & Weingast, *supra* note 258, at 69; see also Kenneth A. Shepsle, *Studying Institutions, Some Lessons from the Rational Choice Approach*, 1 J. THEORETICAL POL. 131, 135 (1989) (arguing that cycling majorities are not a major problem).

For a survey of the anticycling literature containing a useful taxonomy of explanations for stability or induced equilibrium, see DONALD P. GREEN & IAN SHAPIRO, *PATHOLOGIES OF RATIONAL CHOICE THEORY: A CRITIQUE OF APPLICATIONS IN POLITICAL SCIENCE* 114-20 (1994). Green and Shapiro divide the existing accounts into three groups. The first contends that equilibrium results from information costs and legislative specialization caused by the existence of a system of permanent committees. The second school of thought holds that induced stability results from a range of special preference formations—for example, a quasi-concave preference distribution in connection with a supermajority voting requirement. The third group, which includes Shepsle and Weingast, asserts that stability stems from institutional arrangements. Green and Shapiro add a few additional factors to the catalog drawn from outside the confines of rational choice theory—computational difficulty, political infeasibility, and a regime of metapreferences that works to avoid conflict.

316. Ole-Jorgen Skog, 'Volonte Generale' and the Instability of Spatial Voting Games, 6 RATIONALITY & SOC. 271, 282-84 (1994), argue that McKelvey's theory of global cycling depends on the assumption that individuals are able to discriminate between alternatives that are very close. In Skog's view, this assumption is unrealistic; if it is relaxed the general instability of two-dimensional spatial voting games disappears.

317. See Gordon, *Shareholder Initiative*, *supra* note 29, at 363-64.

serves the same cycle-breaking function here as does the legislative committee. Of course, it would not guarantee the result of effective shareholder choice. The committee could resort to subterfuge to get the result management wants, reporting a manifestly unpalatable alternative to the *status quo*. However, the initiative is destabilizing nonetheless. The initial shareholder vote to convene the committee signals that divisions of the firm may be up for sale. If the signal were to attract a third-party offer, suppression by the special committee would be substantially constrained.³¹⁸

Given the availability of a process rule that restricts shareholder choice, we are not at all sure that cycling need be a problem with respect to initiatives on investment and disinvestment. As Gordon also noted,³¹⁹ however, consistency over time might be such a problem: Shareholders could decide to invest in one period and disinvest in the next period, with costly results. Given the problem of asymmetric information, and the possibility of rent-seeking on the side, we conclude that the risks attending initiative on matters of investment and disinvestment are prohibitive.

Cycling could in theory occur with process and structure matters, even though the immediate financial incentives that motivate the shareholders in Gordon's examples would be absent. Conceivably, one proponent could propose a compensation committee, a second could propose a specific, self-executing investment compensation scheme requiring no committee, and a third could propose a compensation scheme resembling the *status quo*. However, no cycling would occur here under our proposal, even though it would open the door to any proponent or group of proponents meeting a threshold percentage ownership requirement. We have included a process rule that prevents cycling.³²⁰ Proposals only may be considered at the annual meeting, and under the proxy voting system, proposals are submitted for a one-round majority vote. The problem stemming from unlimited access would not be cycling but inconsistency of result—for example, both the *status quo* based and the new compensation scheme could be approved. A breaker rule could be included to deal with this problem. If management deems two proposals to be inconsistent, it refers the matter to a third-party adjudicator. If the proposals are then found to be inconsistent, the first in time reaches

318. See cases cited *supra* note 117.

319. Gordon, *Shareholder Initiative*, *supra* note 29, at 364-65.

320. STEVEN J. BRAMS, *THEORY OF MOVES* 187-93 (1994) (showing that there are very simple ways to employ process rules to break voting cycles).

the agenda.³²¹ Two candidates are available for this adjudicatory role—the SEC staff and the independent directors' committee. We prefer the latter in theory, but since any disputed matter would find its way to the SEC staff in any event, the former amounts to the practical choice. In either case, a result is reached and there is no cycling. One problem remains: the possibility of inconsistency over time³²² and attendant costs.³²³

We think the consistency problem is minimal, even absent a breaker rule. We envision a percentage ownership requirement keyed to institutional holding patterns and set high enough so that two or three institutions must coordinate their efforts in support of the proposal. The idea is to rely on the practice pattern to ensure process coherence. The leading players in the shareholder participation movement have been motivated by reputational gain.³²⁴ Process and structure initiatives that lead to conflicts with other institutional players hold out little prospect of reputational enhancement.³²⁵

321. Here, a possibility for management manipulation opens up. If management hears of a proposal, it arranges with a friendly shareholder to propose an inconsistent proposal first. Assume that management wants to block a proposal for a compensation committee. The management nominee would propose that the charter, which says nothing about compensation committees, be amended to say the corporation shall not have a compensation committee. The result is the *status quo* on either a yes or a no vote. To avoid this problem, proposals that have a *status quo* effect would have to be excepted from the first-in-time rule.

322. This problem easily could be treated with a provision that bars, for a period of years, any subsequent shareholder initiative on the subject matter covered by a successful initiative.

323. An extension of our proposal toward the territory of investment and disinvestment should now be suggested. Access could be granted to amend the charter to broaden the statutory list of transactions that must be submitted for shareholder approval. Under such an access permission, shareholders could require voting for acquisitions effected under triangular mergers, large asset purchases, and other significant transactions that presently can be effected in the boardroom in many states. Such an expanded voting regime is extensively discussed as a mandatory proposition in Lynn L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 47-71 (1992); see also Rock, *Dark Side*, *supra* note 161, at 1023 (noting shareholder approval of special issue of preferred stock).

Under a more aggressive form of this extension, the shareholders would have a privilege to legislate not only a veto but a right of initiative. For example, a charter provision might permit initiation of a merger or asset sale. At this point the line between process and structure and substance is breached very clearly.

324. See *supra* text accompanying notes 200-08.

325. Cf. BRAMS, *supra* note 320, at 118-19. Brams notes that reputation and moving power are best understood in the same light: Where a player establishes a reputation and the reputation is acknowledged by an opponent, "it may no longer be necessary for players physically to cycle to 'prove' themselves. Mental moves will then suffice, and a player with recognized moving power may then get its way without suffering the costs of actually

Furthermore, in a case in which a proposal responds to a bargaining impasse with a long-term target or complete noncooperation from a new target, one would anticipate coordination and information sharing among the institutions involved in the campaign.³²⁶ Finally, since reputational gain here ultimately depends on vote-getting ability, we would expect proponents to select their proposals and targets with care.³²⁷

CONCLUSION

This Article began by comparing the regulatory strategy of enforced self-regulation with the historic alternatives of market and fiduciary deterrence, commending self-regulation as a means to cooperative solutions to corporate agency problems. Having surveyed the emerging self-regulatory field, and after making a proposal for its expansion, we close by noting the modesty of the benefits we project. An experiment with process and structure access very well might result in no significant changes, either due to sporadic utilization of the access privilege, or a cooperatively based response by the larger group of shareholders against the forcing of governance terms on managers, except in extreme, end-period situations. In the alternative, extensive and underinformed utilization could conceivably cause incentive or other contractual problems in given firms. However, we think management has sufficient resources and enough of an informational advantage to protect firms from this problem. On

cycling." *Id.*

326. Here we draw by analogy on Shepsle & Weingast, *supra* note 258, at 64-69. Shepsle and Weingast argued that legislative outcomes are not in flux, but display systematic regularities, due in part to the disproportionate influence on outcomes of members of powerful committees. Certain members, by virtue of the control over process derived from their committee positions, are able to translate their preferences into legislative action. Shepsle and Weingast call this "structure-induced equilibrium," which means that an institution can be modelled as an extensive form game due to the combination of process sequence and the identity of the individual players. At the bottom line, the structure-induced equilibrium is an alternative that is invulnerable. The earlier social choice models, in contrast, relied on an atomistic structure lacking the features essential to understanding the nature and distribution of the actors' preferences.

327. We make this proposal for limited federal intervention without an expectation of a favorable political climate. In fact, the proposal contains a takeover-friendly aspect that would make it politically controversial. Shareholders could use it to force poison pill redemption or to opt out of state antitakeover statutes containing open-ended opt-out provisions. See DEL. CODE ANN. tit. 8, § 203(b)(3) (1991).

Since access would facilitate shareholder defection in the event of a takeover, it also would do nothing to ameliorate the problem that takeovers present for relational shareholder participation strategies.

our most sanguine projection, charter access, used responsibly and occasionally, would bring process rules that lower management-influence costs to a small group of mature firms. Our hope is that competitive evolution would then take its course, so that other firms voluntarily adopt the rules that work best. From there, we would hope that responsible and occasional use of charter access encourages ongoing contractual innovation, with all players contributing: institutional agents, managers, and lawyers.

Some years ago, a corporate law debate over the desirability of mandatory and enabling rules came down to simple difference of opinion. The enabling side emphasized the importance of innovation and flexibility; the defenders of mandates emphasized process infirmities. The discussion here goes back to that point of difference. State law has done an excellent job of assuring that firms can draft contracts that accord managers freedom of action to invest and disinvest, but it has not evolved to open up all possibilities for productive firm contracting. State law remains the best vehicle for realizing those possibilities, but a demand-side barrier prevents state law experimentation. An incidental federal intervention taken to facilitate the experiment will not hurt the state system, and it might do the system some good.