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Agency Capitalism: Further Implications of Equity Intermediation

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Abstract

This chapter continues our examination of the corporate law and governance implications of the fundamental shift in ownership structure of U.S. public corporations from the Berle-Means pattern of widely distributed shareholders to one of Agency Capitalism – the reconcentration of ownership in intermediary institutional investors as record holders for their beneficial owners. A Berle-Means ownership distribution provided the foundation for the agency cost orientation of modern corporate law and governance – the goal was to bridge the gap between the interests of managers and shareholders that dispersed shareholders could not do for themselves. The equity intermediation of the last 30 years gives us Agency Capitalism, characterized by sophisticated but reticent institutional shareholders who require market actors to invoke their sophistication. We examine here three implications of this shift in ownership distribution. The first addresses a proposal to turn back the clock in the regulation of ownership disclosure under the Williams Act to a time when shareholders were small and dispersed rather than large and concentrated as they are today. The next two share a common theme: that the allocation of responsibility between directors, shareholders and courts can no longer be premised on a paternalism grounded in an anachronistic belief concerning the distribution and sophistication of shareholders. We show that the Chancery Court has recognized that Agency Capitalism counsels different rules concerning the roles of shareholders and the court in policing freezeouts. And we argue that the Supreme Court will come to realize what the Chancery Court has recognized for some time – that the doctrine of substantive coercion as a basis for takeover defense must give way as Delaware corporate law adapts to the very different shareholder distribution the capital market has now given us.

Keywords: agency capitalism, agency costs, activist investors, hedge funds, governance, mutual funds, public pension funds

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ABSTRACT

This chapter continues our examination of the corporate law and governance implications of the fundamental shift in ownership structure of U.S. public corporations from the Berle-Means pattern of widely distributed shareholders to one of Agency Capitalism – the reconcentration of ownership in intermediary institutional investors as record holders for their beneficial owners. A Berle-Means ownership distribution provided the foundation for the agency cost orientation of modern corporate law and governance – the goal was to bridge the gap between the interests of managers and shareholders that dispersed shareholders could not do for themselves. The equity intermediation of the last 30 years gives us Agency Capitalism, characterized by sophisticated but reticent institutional shareholders who require market actors to invoke their sophistication. We examine here three implications of this shift in ownership distribution. The first addresses a proposal to turn back the clock in the regulation of ownership disclosure under the Williams Act to a time when shareholders were small and dispersed rather than large and concentrated as they are today. The next two share a common theme: that the allocation of responsibility between directors, shareholders and courts can no longer be premised on a paternalism grounded in an anachronistic belief concerning the distribution and sophistication of shareholders. We show that the Chancery Court has recognized that Agency Capitalism counsels different rules concerning the roles of shareholders and the court in policing freezeouts. And we argue that the Supreme Court will come to realize what the Chancery Court has recognized for some time – that the doctrine of substantive coercion as a basis for takeover defense must give way as Delaware corporate law adapts to the very different shareholder distribution the capital market has now given us.

In prior work we documented a fundamental change in the ownership of US equity securities over the past 50 years.[1] This is the shift in equity ownership from dispersed individual owners to concentrated institutional owners, specifically investment intermediaries such as pension funds, mutual funds, and bank trust departments, a "reconcentration" of ownership through equity intermediation. These investment intermediaries now own over 70 percent of the stock of the largest 1000 U.S. public corporations, and in many corporations the ownership position of as few as two dozen institutional investors is large enough for substantial

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[1] Gilson and Gordon (2013): 863, 916.

influence, if not effective control. "Agency capitalism" aptly describes a capital market structure in which agents as record owners hold equity ownership of a large share of the economic base on behalf of beneficial owners.

These ownership changes have produced a characteristic sort of agency costs: "the agency costs of agency capitalism." This refers to the way that institutional intermediaries engage in own-goal pursuit at the expense of ultimate beneficiaries. In practical terms, the agents' business model stands between the record and beneficial owners. Institutional intermediaries compete and are rewarded on the basis of "relative performance" metrics that give them little incentive to engage in shareholder activism that could address shortfalls in managerial performance; such activity can improve absolute but not relative performance. We argued that activist hedge funds and other specialized shareholder activists should be seen as complements to these ownership patterns. Rather than take control positions, such activists tee-up strategic business choices for decision by "reticent" institutional shareholders and in that way serve as a catalyst for the expression of institutional shareholder voice. In a stock market dominated by institutional investment intermediaries, these activists make governance markets more complete by taking advantage of governance rights that are not valuable to the institutional shareholders.

We also took sides on an important theoretical corporate governance debate: that capital market conditions and capital market innovations drive the efficient structure of corporate governance; the causal arrow moves from ownership to governance. Although governance choice may influence ownership structure,[2] ownership is determined principally by factors outside the pre-existing governance set-up.[3] Governance regulation works best when it is accommodative, by which we mean helps reduce governance slack.

Two main external developments gave rise to the current ownership pattern and the associated agency costs, neither of which was motivated by corporate governance concerns. The first was the set of post-World War II decisions to augment retirement security though private pensions rather than through an expansion of social security. This in turn produced various funded pension schemes that pursued large scale equity investments to enhance returns, rather than further Social Security Trust Fund investment in US Treasury securities. The second was the triumph of "modern portfolio theory" (MPT) as the dominant investment paradigm. MPT teaches that portfolio diversification is the ownership pattern that optimally balances the pursuit of highest expected return with the avoidance of unnecessary risk. Portfolio theory came to guide the investment behavior not only of pension funds but also of individuals, who turned to diversified investment vehicles -- mutual funds – for equity investing. Moreover, MPT taught that the risk of a particular investment should be evaluated on a portfolio basis, meaning that no investment was per se imprudent. This led to federal and state legislation revising the "prudent investor rule," which in turn led to greater equity

[2] *See* Laporta et al. (1997): 1131-1132; Laporta et al. (1998): 1113, 1151; Djankov et al. (2008): 430, 463.
[3] Coffee (2001): 75.

investing by pension funds and private trustees.[4]

Several policy implications follow from the reconcentration of equity ownership, the characteristic "agency costs of agency capitalism," and the resulting "reticence" – a generally reactive, low cost activism -- that follows from the pursuit of superior relative returns. We have argued that the SEC should exercise the discretion in its rule-making authority granted by Section 13(d) of the Securities Exchange Act (and reaffirmed by Section 766 of the Dodd-Frank Act) to avoid rule changes that would undercut the incentives of shareholder activists whose activities overcome institutional investor reticence. But our more general point is this: that rule- making by the SEC and, more controversially perhaps, judicial doctrine, especially as fashioned by the Delaware courts in their leadership role, should take account of current capital market conditions, at least as reflected in something so fundamental as the underlying structure of equity ownership. Governance rules ought to adapt to changes in ownership patterns.

Part I of this paper summarizes our prior account of the reconcentration of ownership through investment intermediaries. Part II elaborates on the agency costs that arise from this reconcentration, in particular, the devaluation of governance rights. Part III argues that activist shareholders help overcome these agency costs by providing investment intermediaries with a meaningful governance role that fits their business model. Part IV develops the implications of the emergence of agency capitalism for three important policy issues. First, we offer a cautionary admonition against SEC rule-making concerning disclosure by activist shareholders who serve to counteract the institutional investors' undervaluation of governance rights. Second, we argue that changing ownership patterns should now lead the Delaware courts to turn away from "substantive coercion" as a legitimate "threat" that would justify strong-form target defensive tactics. Whether or not the doctrine's assumptions about investors' decision-making capacity was justified in the 1980s when the doctrine took root, changes in ownership structure and institutional behavior call for a change. Doctrinal change would be responsive to what the Delaware Supreme Court has identified as the inherent dynamism in corporate law.[5] Third, we show how judicial notice of changing ownership patterns has already begun to shape the governance decisions of the Delaware courts, reflected most recently in an important decision on the court's oversight role in parent-subsidiary freeze-out mergers, *In re MWF Shareholders Litigation.*[6] Here we see the updating principle in action.

Part I. The Reconcentration of Equity Ownership in Institutional Investor Intermediaries

The canonical Berle-Means account of the rise of managerialism and its consequences

[4] Gordon (1987): 52, 87; Longstreth (1986).

[5] *Unocal Corp. v. Mesa Petroleum,* 493 A.2d 946, 957 (Del. 1985) ("[O]ur corporate law is not static. It must grow and develop in response to, indeed anticipation of, evolving concepts and needs."); accord, *Moran v. Household Int'l, Inc*., 500 A.2d 1346, 1351 (Del. 1985). *See also* Jacobs (2012): 31. ("the new shareholder profile is an irrefutable reality that justifies inquiring into whether courts should take that into account in formulating and applying fiduciary duty principles").

[6] 67 A.3d 496 (Del. Ch. 2013), aff'd sub. nom.,*Kahn v. M&F Worldwide Corp.,* -- A.3d --, 2014 WL 996270 (Del. Sup. Ct. March 14, 2014).

depends on an empirical fact: that equity ownership of the largest firms had dispersed among disaggregated owners, so that for these firms "control" had shifted from shareholders to managers by default.[7] Elaborating on this mechanism some decades later, Robert Clark explained that the "rational apathy" of such dispersed shareholders flowed inexorably from the logic of free-riding and a corresponding lack of skills and incentives.[8]

In 1950, the Berle-Means description of a pattern they observed in the 1920s remained accurate. Equities were still held predominately by households; institutional investors, including pension funds, held only approximately 6.1% of U.S. equities.[9] By 1980, however, the distribution of shareholdings had begun to shift away from households toward institutions. At that time, institutional investors held 28.4% of U.S. equities.[10] By 2009, institutional investors held 50.6% of all U.S. public equities, and 73% of the equity of the thousand largest U.S. corporations.[11] Table 1 sets out the institutional ownership of different-size cohorts of U.S. public corporations in 2009.

TABLE 1: INSTITUTIONAL OWNERSHIP OF LARGEST U.S. CORPORATIONS IN 2009[12]

Corporations Ranked by Size	*Average Institutional Holdings*
Top 50	63.7%
Top 100	66.9%
Top 250	69.3%
Top 500	72.8%
Top 750	73.9%
Top 1000	73.0%

Thus, for the largest U.S. corporations, institutions control the great majority of outstanding shares. Put graphically but not metaphorically, representatives of institutions that collectively represent effective control of many large U.S. corporations could fit around a boardroom table. For example, Table 2 sets out the percentage of the outstanding stock held in 2009 by the twenty-five largest institutions in the ten largest U.S. corporations in which there was not a controlling owner.

[7] Berle and Means (1967).
[8] Clark (1986): 390-392. He was of course channeling Mancur Olson (1965).
[9] Tonello and Rabimov (2010): 22, table 10.
[10] *Id.*
[11] *Id*. For a time series of institutional ownership between 1950 and 2004, *see* Gordon (2007): 1465, 1568.
[12] Tonello and Rabimov (2010): 27, table 13.

TABLE 2: PERCENTAGE OF OUTSTANDING STOCK IN TEN LARGEST U.S. CORPORATIONS WITHOUT A CONTROLLING SHAREHOLDER HELD BY TWENTY- FIVE LARGEST INSTITUTIONS IN 2009

Corporation (in order of market value)	*Percentage of Stock Held by Twenty-Five Largest Institutions*
Exxon Mobil Corp.	25.0%
Microsoft Corp.	31.9%
Apple Inc.	37.0%
Wal-Mart Stores, Inc.	17.2%
Berkshire Hathaway Inc.	19.2%
General Electric Co.	24.8%
Procter & Gamble Co.	29.1%
Bank of America Corp.	28.9%
Google Inc.	44.1%
JP Morgan Chase & Co.	35.8%

This reconcentration of equity through intermediation resulted from two different developments. The first was a series of decisions about how retirement security in the United States would be funded. The second was the triumph of modern portfolio theory as a guide to investing.

A. *Savings for Retirement.* Retirement saving in the United States could have been socialized: Social Security could have been expanded beyond a Depression-era social safety net program into a more robust government-funded retirement plan as would become the continental European pattern. Instead, unions and managements worked to create a private pension system, providing (some fortunate) workers with a form of deferred compensation that both shared enterprise profits and encouraged loyalty to the firm. Many firms began to set aside funds to cover these future claims, which were expressed contractually in terms of employees' salary, "defined benefits." This private pension system increased the flow of funds to capital markets rather than to the Social Security Trust Fund.

After some notable failures of unfunded pension plans,[13] Congress adopted the Employee Retirement Income and Security Act of 1974 (ERISA), which required companies to set up pension trusts to hold pension assets that were managed by trustees under a fiduciary duty running solely to the beneficiaries.[14] ERISA and the regulations promulgated thereunder promoted reconcentration in three distinct ways. First, ERISA required corporations to make annual payments as actuarially necessary to fulfill the promises of their defined benefit plans; this led to a rapid build-up of investable funds, increasing over the 1980-1990 period from $871 billion to $3.02 trillion. Second, ERISA adopted MPT's conception of risk and speculation, which freed pension trustees from the bias toward fixed income investments dating from the "legal list" era and permitted large scale equity investing.[15] Third, given the funding requirement, company sponsors realized that increasing pension fund returns would reduce their required cash pay-ins. Since equities enjoyed historically higher returns, companies were eager for their pension funds to tilt portfolios toward equity investing.

A somewhat different but complementary story explains the accumulation of funds by public pension funds, including their large-scale equity investments. Public sector pension plans were first established in the late 19th century, applying first to public safety employees, fire and police, then expanding to cover teachers and eventually most state employees.[16] Historically most plans have been at least partially funded; the funding source is commonly a mix of public and employee contributions.[17] State and local employees initially were not covered by the Social Security Act, in large part because of uncertainty about the federal government's constitutional authority to tax the states to fund public employee participation. In 1950 the states and localities were given the right to opt into the Social Security system and subsequent enactments have broadened Social Security's reach for state and local employees.[18] A recent survey indicates, however, that integration of Social Security benefits has not substantially replaced state and local plans, which means that public pension funds have continued to accumulate both substantial funds and substantial deficits.[19]

Like private counterparts, public pension funds have moved significantly into public equities via diversified portfolios, to a now roughly equivalent extent. Until the 1980s, state law's traditional prudent investor constraints sharply limited equity investing by public pension plans.[20] ERISA explicitly carved out public plans from its scope, but eventually state law changes permitted a significant shift to equities. In California, for

[13] Wooten (2001): 683, 732.
[14] ERISA also applies to Taft-Hartley plans that are commonly found in multi-employer unionized settings and are jointly-trusteed by union-side and management-side trustees. Taft-Hartley plans are hybrid defined contribution plans, in that employers agree to contribute a fixed amount to the plan, not on behalf of individual employees; plan assets are then managed by the trustees. *See* Schwab et al. (1998): 1018, 1075-1080.
[15] Gordon (1987): 52, 87.
[16] *See generally*, Clark et al. (2009).
[17] *See* Achenbaum (1986). The extent to which public pension funds are adequately funded is a major current issue, with assessments highly sensitive to assumptions about future returns. *See, e.g.* Munnell et al. (2001): 247; Beerman (2013): 3, 10-16; GAO (2007):4; Nation (2011).
[18] Crane. 2001:122-23; Mitchell (2001): 12-13; Munnell (2005): 32.
[19] Clark et al. (2011): 78-79.
[20] Jacoby (1998): 46.

example, a 1983 constitutional amendment relieved a 25 percent equities cap for CalPERS.[21] Similarly, New York and Minnesota adopted equity-permissive legislation in the mid-1990s.[22]

ERISA's pre-funding requirement and subsequent accounting changes that required companies to reflect unfunded pension plan liabilities on the balance sheet eventually produced a shift from defined benefit plans, in which the company bore the investment risk, to defined contribution plans, in which such risk was borne by employees. Companies commonly contributed a defined amount, their employees could contribute additional amounts, companies arranged for a menu of investment choices generally styled as a choice among pre-screened mutual funds, and employees could allocate investments among these funds. This set-up produced significant equity investment through investment intermediaries.

B. *Modern Portfolio Theory*. The past thirty-five years have seen a sharp increase in U.S. household ownership of equities, but the vehicle has been equity mutual funds not ownership of individual stocks. Approximately 50 percent of US households now own equity, in marked contrast to 1977, when the comparable figure was 20 percent. Much of this increase has occurred through participation in defined contribution pension plans through which individuals direct their retirement savings through a menu of mutual funds or other similar managed investment vehicles. Increased non-retirement plan equity investment has taken place through the same vehicles. This behavior is a puzzle, in light of: i) the end of fixed commissions, which reduced the costs of direct stock ownership, and ii) the tax-inefficiency of mutual funds, which are required to pass-through capital gain realizations that can result from forced sales to fund shareholder redemptions and as well as from trading by the fund.

A capital market innovation supplies the link: the application of Markowitz's Nobel Prize-winning theory on the efficiency of mean-variance investing, which gives rise to Modern Portfolio Theory.[23] The lessons were (i) diversification improves risk-adjusted returns; (ii) the broader the portfolio, the greater the diversification; and (iii) since secondary markets in seasoned equities are highly efficient, research that adds value is expensive and its fixed cost is best spread across large portfolios. All of this argues for investing through investment intermediaries that can assemble diversified portfolios as the low-cost way to follow this strategy. Index investing is the limit, but the debate over whether households should exclusively invest through such lowest-cost vehicles may obscure the major change, which is that households increasingly invest – whether retirement or other savings -- through diversification-providing intermediaries, mutual funds.

Part II. Why Institutional Ownership Will Undervalue the Vote and Create New Agency Costs

In theory the increase in institutional ownership should mitigate the managerial agency

[21] *See* Gelter, (2013): 958-959.; Hess (2005): 187-195.
[22] *Id.*
[23] Markowitz (1958); Markowitz (1952): 77.

cost problems of the Berle-Means corporation. Fewer owners, larger positions over which to spread the cost of investing, more sophistication—the combination should reduce coordination costs and spontaneously generate more active monitoring. In short, reconcentration would mean passivity would no longer be rational.

Reality, however, turned out to be more complicated. A different kind of agency cost intervened, the agency costs of agency capitalism. The intermediaries' business model came between the record and beneficial owners. The evidence is that with occasional exception, institutional investors exhibit a peculiar form of passivity: not "apathy" but "reticence." We observe that direct institutional activism is commonly limited to "good governance" issues -- "governance activism" -- rather than firm strategy or implementation -- "performance activism."[24] Governance initiatives are undertaken principally by the Taft-Hartley funds and a few public pension funds. Mutual funds and other for-profit investment managers may vote for these proposals though they are unlikely to initiate them. For example, of the shareholder proposals during the 2007-2009 proxy seasons, only 0.9% were proffered by mutual funds; however, mutual funds frequently voted in favor of such proposals.[25]

One way to frame the question then is to ask why institutions place so little value on the vote that, despite their collective majority holdings, they largely choose to be responsive to the initiatives of others rather than craft their own. More engaged firm-specific activism could reduce managerial slack at specific firms; perhaps, more grandly, it could improve performance across an entire portfolio and, in theory, enhance social welfare by improving resource allocation throughout the economy. What accounts for the missed gains that would come with the full use of the governance rights that institutions have? One suggestion is that many institutions are disabled by external conflicts of interest, such as a mutual fund adviser that administers defined contribution plans and wants to avoid alienating potential corporate clients. Without denying such considerations for particular institutions, we think that the breadth and pervasiveness of the behavior is rooted in the institutions' core business model: their desire to deliver competitively superior performance, as opposed to absolute performance, for their beneficiaries (pension funds) or shareholders (mutual funds) while minimizing costs.

Increasingly, fund choice is made as part of an asset allocation strategy: weights are assigned to market sectors and the best funds in each sector are chosen. Because of large economies of scale, fund profitability is driven in important measure by relative- performance driven flows of funds. This competitive pressure will lead institutions to focus externally and internally on relative performance. Such performance metrics do not readily accommodate much shareholder activism, especially performance activism, even though it would be in the beneficiaries' (shareholders') interest for the institutions to pursue value generation in this way

[24] We explore some of the specific details of institutional engagement in Gilson and Gordon (2013).
[25] Gilson and Gordon (2013): 887.

since absolute returns would increase.

Take first the case of mutual funds (including separate accounts managed by mutual fund advisors) and other private wealth managers. Fundamental analysis, which identifies poor governance that affects performance or a poor business strategy, has a dual use: It could be used as the premise for a shareholder intervention to improve the situation or to provide a trading opportunity. A successful intervention will produce an increase in absolute returns -- benefits enjoyed by all shareholders, including the mutual fund's competitors. But such a shared gain -- using the information to fix a problem rather than to motivate a trade -- provides little competitive advantage to the proactive investment manager whose portfolio products and services are chosen in comparison to competitors offering similar products or services. In an environment in which fund managers are evaluated in relative terms, absolute performance will play a secondary role. If its research identifies a problem with a portfolio company, the fund does best by selling the stock before the market wises up. Investment managers thus have little private incentive to address proactively strategy and performance problems at portfolio companies and *therefore do not develop the expertise to engage in that activity, even if such activity would benefit their beneficiaries*. This gap between the beneficiaries' and the investment managers' interests represents a particular kind of agency cost that is of special concern because it interacts with the more familiar species of agency cost: This agency cost locks in managerial slack at the portfolio companies. Together these are the "agency costs of agency capitalism."

Take next the case of pension funds. Pension funds do not have to compete for funds because their beneficiaries are locked in -- California public employees cannot opt out of CalPERS. Thus, state pension fund overseers are not subject to the dual incentives of relative performance-driven cash flows and scale-driven profitability. Yet assuming those overseers are acting in good faith, pension fund beneficiaries will be in roughly the same position as mutual fund shareholders. The pension fund trustees will be looking for internal or external portfolio managers who deliver superior relative returns at the lowest cost. And these agents – the portfolio managers -- will face the same strong disincentives to make investments in governance or performance activism that will not redound to their competitive advantage. As a result, asset managers chosen by pension funds will be rationally reticent just as are mutual funds.

In contrast, internal public pension fund managers, free of the burden of relative performance measures, may have greater freedom to pursue absolute performance. Self managed public pension funds need not be discouraged from engaging in activism simply by the fact that others will share in the benefit from their effort, subject to an important caveat: that the returns from activism exceed the fund's required return. Firm-specific performance activism is costly; for a diversified shareholder, the benefit-cost calculus will rarely be positive. By contrast, the calculus may be favorable for activism on behalf of governance changes that will, on average, improve performance

and thus produce gains across a diversified portfolio. In sum, the good-faith monitoring by state pension funds of the relative performance of their portfolio managers reinforces the agency costs of agency capitalism and leads to the observed pattern: pension funds may engage in some governance activism but, like mutual funds, are rationally reticent about performance activism. The analysis of union-based pension funds is similar, subject to the claim that the unions' efforts to obtain economic advantage for current members may bleed into their investment judgments with respect to current beneficiaries.[26]

We can now turn to our central claim: The agency costs of agency capitalism will result in the chronic undervaluation of governance rights. Effective use of governance rights requires firm-specific investigation and firm-specific activism, both of which are costly and will be undersupplied by the typical institutional investor intermediaries This will be particularly evident for the maximally diversified index investor, but it will be an inhibitory factor for all diversified investors. The success of an intervention is probabilistic, both in terms of whether the objective is attained (e.g., board turnover or the sale of a division) and whether the performance effect will be positive. Yet the costs incurred will, with certainty, reduce the fund's returns. A benefit-cost calculation typically will point to de minimis activism expenditures by the diversified intermediary institution. Further, even if the intervention is successful and cost-justified, it still may degrade *relative* performance. Start with an index fund. The gains will be enjoyed by all other index investors, except that the activist fund will have incurred costs that lower its net relative performance. Next take an actively managed fund. In order to benefit relatively, it must overweight a company it has identified as poorly managed. If it succeeds, it will earn some positive returns (net of costs) that may give it some edge relative to *some* of its competitors (especially those who underweighted the stock), but diversification limits the relative gains. On the other hand, if the initiative fails, it may be facing losses on its overweight holdings in a company it has credibly identified as poorly managed. These losses come on top of the costs for the campaign—not a very promising calculus. This begins to sound like a brief for the Wall Street Rule with a mutual fund corollary: If the issuer turns out to be badly run, sell the stock and fire the portfolio manager.

Next, the institution's internal mechanisms for monitoring portfolio performance, based on bench-marking or performance relative to peers, cut against high valuation of governance rights. This is not the result of institutions' misunderstanding what investors actually want. For-profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly. Pension funds also follow relative performance in selecting and monitoring portfolio managers, whether in-house or external. Such relative performance evaluation, falls out of contemporary portfolio theory. Factors that ramify market wide – for example, the recent financial crisis to pick an extreme recent example -- affect a portfolio "systematically." Such risks are not

[26] Schwab et al. (1998): 1018, 1075-1080.

readily diversifiable, if at all. So the performance question is comparative: given the state of the economy, how does this portfolio compare to "unmanaged" portfolios in the same "space." A portfolio manager can outperform by omitting or underweighting (relative to market capitalization) a stock from his/her otherwise diversified portfolio.

This has obvious implications for shareholder activism (the use of governance rights). In this set-up, a portfolio manager does not focus on identifying opportunities when activism can improve company strategy. Rather, the mission is to determine the relation between current stock price and the manager's best estimate of future stock price; that judgment determines a buy/sell/hold decision. Information comes in continuously; the comparative evaluation occurs continuously. A diagnostic thought process –what sort of governance exercise would improve performance – is simply a different inquiry. Now assume the portfolio manager decides that a portfolio company is underperforming. The most assured way to grab the value of that insight is by selling the stock rather than incurring the costs and speculative future benefits of a governance intervention. That is, the fact of poor governance or poor management at a portfolio company may be an element in comparative evaluation, but the indicated action for the institution, but not its beneficiary, may be to "sell," not "intervene."

Finally, the institutions' compensation structures have a complicated relationship to activism. For mutual funds, the 1940 Act sharply limits the types of incentive-based compensation that shareholders can pay the fund's investment adviser – i.e., the incentive structure of the fees that Fidelity mutual funds pay to Fidelity.[27] It would be very difficult to reward the fund with an incentive-based fee tied directly or indirectly to the returns from a particular kind of investment management activity. On the other hand, superior relative performance is the major driver of a fund's profitability. Superior performance draws new assets that can be charged a fixed fee (no incentives), yet the funds' largely fixed investment costs mean that the fund's profits are sharply increasing in fund size.[28] Thus *there is a powerful incentive to engage in activism (the exercise of governance rights) but only if it delivered returns that would improve the relative performance of the fund.* The dearth of this activity suggests that while potential gains from activism may well exist – there is ample evidence of managerial slack – the institutional investor's business model makes it an unlikely candidate to pursue those gains.

Intermediary institutional investors, then, present a problem for corporate governance. This efficient risk transfer and management structure – delivering low cost, high-powered diversification and scale economies in active management – gives rise to significant problems in

[27] *See* Elton and Gruber (2003): 779. (describing Investment Company Act limits on mutual funds incentive arrangements to a "fulcrum" fee that must reward good performance and penalize bad performance symmetrically).
[28] That is, the decision costs associated with a particular portfolio investment are mostly fixed. Size determines the assets over which those costs will be distributed. As assets increase, costs as a percentage of assets and as a percentage of the management fee paid by the investor will decrease. The firm's profit margins increase in size and so does its profitability.

the efficient assignment of governance rights. As in the standard Berle-Means analysis, beneficial owners are rationally passive; governance rights are of little value to them. In turn, institutional owners who are not seeking private benefits of control are rationally reticent; they also will assign a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends. As a result, institutions can be expected to be skilled at managing portfolios, not at developing more profitable alternatives to a portfolio company's business strategy; strategic management is not the institution's business. The institutions' performance, and hence their success in attracting funds and earning profits, is evaluated by the performance of their portfolios, measured in comparative terms. In light of the mismatch between skills and incentives with respect to active company management, as opposed to portfolio management, governance rights will be chronically undervalued.

Part III. The Role of Activist Investors: Arbitraging the Value of Governance Rights.

To this point, we have shown that in an Agency Capitalism world, intermediary institutional investors will be rationally reticent; they will undervalue governance rights and forgo active efforts to improve the strategy of underperforming portfolio companies. But instead of pushing institutional investors into roles for which they may be unsuited, we might anticipate and facilitate specialization. Addressing the governance gap—the agency costs of agency capitalism—plausibly requires a new set of actors to complement the diversified investment and portfolio optimization in which intermediary institutional investors now engage. Such actors would develop the skills to identify strategic and governance shortfalls with significant valuation consequences, to acquire a position in a company with governance-related or strategy-related underperformance, and then to present reticent institutions with their value proposition: a specified change in the portfolio company's strategy or structure.

It is at this point that activist investors enter the picture – they arbitrage the value of governance rights. Their business model, symbiotic with that of the intermediary institutions, involves identifying companies whose business strategies could be significantly improved, buying a toe-hold stake, and then going public with a plan to convince the company in the first instance, or the institutional shareholders if the board disagrees and a proxy constant proves necessary, of the wisdom of the activist's strategic proposal. If intermediary institutional owners agree and if the proposal turns out to be sound, everyone makes money, including especially the beneficiaries of many of the intermediary institutions – those of us saving for retirement. And if institutions do not think the proposal sound, it is voted down. The activist investor does not itself control sufficient stock to control the outcome; their pre-disclosure holdings seem to be stable at around 8 percent.[29] And the results of their effort seem to be long-term; the gains from their efforts remain in place for at least five years.[30]

[29] Bebchuk, et al.(2013*a*).
[30] Bebchuk et al. (2013*b*).

In an Agency Capitalism world, then, the activist investor proposes and the institutional investors dispose, a kind of market stewardship that combines the complimentary attributes of two very different capital market participants. The intermediary institutional investors will vote against the activist if, as Martin Lipton said recently in a client letter, the company presents the institutions "with a well-articulated and compelling plan for the long-term success of a company, [that can] cut through the cacophony of short-sighted gains promised by activists touting short-term strategies."[31] But if the company does not persuade institutional investors that the activist investor's proposal would be unwise, they will vote for the activist. Consistent with our analysis and Lipton's confirming observation, large mutual funds plainly choose when they are going to support activists' proposals. Between July 1, 2009 and June 30, 2013, five large mutual funds voted in favor of activist board candidates some of the time: T. Rowe Price voted with activists in 52 percent of the contests, Fidelity in 44 percent, Blackrock in 34 percent, State Street in 31 percent, and Vanguard in 11 percent.[32]

The nature of the mechanism bears emphasis: activist investing on this model ultimately depends on potentiating institutional voice; the revaluation of governance rights is a central part of the story. The mechanism also provides internal incentives for the offering-up of quality proposals, because the activist investor's repeat-play business model continually puts reputation at risk. On balance, this seems to be a sensible market-based evolution to the dramatic change in equity distribution that has occurred over the last several decades.

Part IV. Implications of Agency Capitalism and Institutional Investors for Corporate Law

In this Part, we consider three implications of the reconcentration of equity and the emergence of Agency Capitalism for corporate and securities law. The first is a current proposal to amend the rules under Section 13(d) of the Securities Exchange Act of 1934 to require earlier disclosure of the activist's position in a target company's stock in a fashion that would negatively affect the activist investor's business model. In this respect, the proposal tracks steps already taken in Europe and the United Kingdom, and similar recent proposals in Canada. The second concerns an increasingly anomalous element of Delaware takeover law as developed by the Supreme Court – that the board of directors has the discretion to try to block shareholders from accepting a hostile takeover bid if the board believes that the shareholders will make a mistake in their valuation of the target company, a threat that the Supreme Court refers to as "substantive coercion."[33] The anomaly arises from the pattern of increasingly concentrated equity ownership through sophisticated institutional investors – think Fidelity,[34]

[31] Lipton (2013).
[32] Benoit & Hoffman (2014).
[33] As will become apparent, one of the authors bears significant responsibility for that very ill-turned phrase.
[34] $1.76 trillion in total assets under management, of which $885 billion are equity assets, FIDELITY, http://www.fidelity.com/inside-fidelity/fidelity-facts/fidelity-assets (as of June 30, 2013).

BlackRock,[35] or the California Public Employees Pension System[36] -- which undermines the basis for board paternalism towards shareholders on the ground of their purported susceptibility to coerced decisions. The third implication is we should expect the Delaware courts, especially the Chancery Court, to integrate the core facts about the changing ownership structure into its decisions. A recent powerful example is *In re MWF Shareholders Litigation*,[37] in which the Chancery Court structured the standard of review for going private transaction explicitly so as to make use of the decision making capacity of institutional investors in determining whether the transaction was fair. This decision may be a harbinger of future doctrinal accommodation to changing ownership patterns.

A. *Amending Section 13(d) Rules under the Williams Act in Response to Activist Investors*

The current proposals to accelerate the timing of beneficial ownership disclosure under Section 13(d) of the 1934 Securities Exchange Act and to broaden the definition of beneficial ownership to include derivative positions that provide economic exposure to stock price movement but not a right to vote or acquire stock, gets the problem precisely backwards. The mismatch of problem and solution is apparent when we focus on two dates: 1968, when the Williams Act adding Section 13 was adopted, and 2010, when Section 766 of the Dodd-Frank legislation gave the SEC the authority, but not the obligation, to consider whether derivative positions should be treated as beneficially owned stock for purposes of disclosure under Section 13(d).

We were all different in 1968 – the Beatles had released the Sgt. Pepper's Lonely Hearts Club Band album just before Congress enacted the Williams Act. One critical difference relates to capital markets. In 1968, U.S. stock ownership still resembled the Berle-Means image of equities held by widely dispersed individual investors, presumably buying and selling stock based on their own analysis. As we saw in Part I, when the Beatles sang "Lucy in the Sky with Diamonds," institutions owned roughly 17 percent of U.S. public equities. In contrast, when Congress adopted Dodd-Frank in 2010, institutions owned roughly half of the equity of U.S. public companies, and over 73 percent of the equity of the top 1000 U.S. public companies. Mutual funds alone hold over 25 percent of U.S. equities, roughly 75 percent of which are held by the 25 largest mutual funds. Even these numbers understate the voting power of mutual fund advisors. When the separate accounts managed by the fund advisors are included in the calculation, the percentage of the equity market they represent goes up significantly.

Thus, over the 42 years between the Williams Act and Dodd-Frank, the character of the

[35] $3.86 trillion in total assets under management, of which $1.93 trillion are equity assets, https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-blackrock-worldwide-leader-in-asset-management.pdf. (as of August 2013).

[36] $258 billion in total assets under management, of which $134 billion are equity assets, https://www.calpers.ca.gov/eip-docs/about/facts/facts-at-a-glance.pdf (as of June 30, 2013).

[37] 67 A.3d 496 (Del. Ch 2013), aff'd sub. nom., *Kahn v. M&F Worldwide Corp.*, __ A. 3d __, 2014 WL 996270 (Del.Sup.Ct. March 14, 2014).

U.S. capital markets and the resulting structure of U.S. corporate governance changed radically.[38] Over this period, the U.S. has moved from a Berle-Means structure in which shareholders were dispersed, unsophisticated, and rationally passive, to a system of Agency Capitalism, an intermediated system where between the company and the beneficial owners of its equity stand institutional intermediaries, the vehicles through which we all save for retirement by holding diversified portfolios. These institutions are rationally reticent – they will act when activist investors arbitrage governance rights by proposing strategic initiatives at target companies whose shares are owned by the institutions.

In 1968, roughly 83 percent of equities were held directly and 17 percent were held through institutions; by 2010, those numbers were reversed. Wayne Gretsky, one of the best hockey players in history, when asked why he was so good, responded that he "goes to where the puck is going to be." The petition to the SEC proposing changes to the operation of Section 13(d), stated that "[t]he purpose of the proposed rulemaking is solely to preserve the status quo …."[39] And that is the proposal's central problem. It purports to improve the operation of today's capital market by restoring a balance that once existed 45 years ago with respect to a radically different pattern of stock ownership. Gretsky got it better than did Wachtell Lipton, the proponents of the rule change.

So what is the problem with the 13(d) proposal? Put simply, the proposal before the SEC would require earlier disclosure of the activist's ownership, both by changing the way beneficial ownership is calculated to include derivative positions and by accelerating the time the activist must disclose its holdings after crossing the more inclusive ownership threshold. The proposal is thus a clever, in a craft-like sense, defensive response to activists: go after the activists' business model. Earlier disclosure limits pre-disclosure stock acquisition and, it follows, the activist's ability to make money by arbitraging the value of governance rights. The justification for more stringent limits is the claim that such reform is necessary to vindicate the legislative purpose behind the adoption of the Williams Act in 1968.[40] But that brings us back to Wayne Gretsky –we have to go where the puck is. It cannot make sense to regulate by reference to an ownership and capital market structure that has not existed for years.

To be sure, at this point the proponents can and do invoke disclosure as the core value of U.S. securities law as justifying earlier and broader disclosure by posing what they see as a rhetorical question: who could oppose giving exiting shareholders more information? While the full explanation for why this question is anything but rhetorical is longer than we need for now, it is worth noting just how unusual Section 13(d) is. Disclosure is commonly required of sellers; rarely by open-market buyers. The Williams Act was adopted to correct what was perceived to be a takeover market gone awry to the detriment of dispersed small shareholders. Where is the argument that in today's market, not the retail-shareholder dominated market of

[38] To get a sense of the span of time we are talking about, here is a different comparison. The Williams Act was passed 39 years after Wyatt Earp, the center of the gunfight at the OK Corral, died in Los Angeles.
[39] Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Mar. 7, 2011)
[40] Emmerich et al. (2013): 150-151.

1967, even further disclosure is required? We also wonder about the call for international harmonization on a two-day disclosure rule in the absence of an international rule proscribing poison pills or other managerial defensive measures or harmonized rules setting forth other elements of the shareholder/manager balance. It is worth noting that what has become the standard U.K. call for institutional investors to act as "stewards" is flatly inconsistent with restrictions on activist investors whose efforts combine with those of rationally reticent institutions to generate market stewardship. The point is precisely that Section 13(d) needs to be understood in its corporate governance context, not just as free-floating piece of securities regulation, and implemented in today's market; not that of Sgt. Pepper.

As our discussion makes apparent, we do not think that the argument that underlies the Section 13(d) revision proposal survives examination. Yet we do not mean to understate the lawyerly imagination that underlies the proposal. As we will discuss in the next section, the emergence of the hostile takeover posed the question of who had the authority to decide whether the bid went forward: the board or the shareholders. The same firm that has offered up the Section 13(d) proposal also was responsible for devising the "poison pill." The genius of the pill was not in imagining that a target corporation could change its governance structure to make a hostile takeover more difficult or impossible; the articles of incorporation could be amended in a variety of ways to accomplish this result. But there was a rub. A charter amendment requires a shareholder vote; giving the shareholders decision rights over a hostile bid through a required vote for a proposed restrictive amendment created the problem rather than solving it. The key to the pill and its audacity was that it did not require shareholders to approve it. The point was to entrench the board's authority, if not necessarily to entrench a particular board.

Now fast forward some 38 years. From the perspective of protectors of the existing order against the Schumpeterian creative destruction,[41] activist shareholders are today's threat. And while the poison pill could be adapted to disrupt activists' strategy, today there is a different rub – now the board of directors, whose view of their own role has evolved, is unlikely to adopt a pill draconian enough to put off activists. So the challenge is to avoid a board vote, much as in the 1980s, it was to avoid a shareholder vote. And here is the cleverness of the Section 13(d) proposal. If the SEC adopts it, neither the shareholders nor the board will have to make a decision. The outcome will be imposed on both by the SEC.

B. Agency Capitalism and the "Substantive Coercion" Doctrine

Assumptions about the distribution of equity and the sophistication of shareholders figures prominently in the most intense corporate law debate of the last thirty years and perhaps the entire history of corporate law: the allocation of authority between shareholders and the board of directors to determine whether a hostile takeover bid would go forward. The issue is presented in terms of judicial deference to a board of director's decision to defend against a hostile takeover and thereby restrict the shareholders' ability to accept the offer. Over this period, Delaware law evolved to give a board wide discretion when it determines there is a risk of "substantive

[41] Gilson and Kraakman (2005): 1419, 1431.

coercion" – that the shareholders may mistakenly accept a tender offer that the board believes undervalues the corporation. Understanding how the emergence of Agency Capitalism calls for reconsideration of the substantive coercion doctrine requires a brief detour over a well-trodden path – the development of Delaware takeover law.

A hostile takeover bid, made to the shareholders and not to the board, poses a straightforward but, at the time it was urgently framed by the 1980s takeover wave, difficult question for the Delaware courts, whose understanding of corporate law was premised on the centrality of the role of the board of directors. The question was, who decided whether the offer went forward, and the challenge was to apportion responsibilities for the decision among directors, shareholders, and courts.[42] As corporate law developed, the breadth of the board's discretion to constrain shareholders from approving a hostile offer came to depend upon the court's assessment of the board's belief that the offer presented a "threat."[43] An important element of the potential threat was whether shareholders, even with full information, would mistakenly (in the board's view) tender their shares to a hostile bidder. The threat that fully informed shareholders would make this mistake is termed, awkwardly, "substantive coercion."[44]

The modern law of takeovers in Delaware began with the Supreme Court's decision in *Unocal v. Mesa Petroleum*[45]. There the court resolved the conflict between the two contending positions over who decided whether a hostile takeover would succeed: should the shareholders decide whether to accept a hostile bid (and so the board would be prevented from interfering with the offer), or should the board have the power to prevent shareholders from making that choice.[46] In *Unocal*, the court rejected both positions in favor of creating for itself what appeared to be a regulatory role: the court would decide whether the hostile offer presented a threat and, and if so, whether the board's response was proportional to the threat identified.

Following *Unocal*, a law review article by Gilson and Kraakman appeared that, for better or worse, influenced the further evolution of Delaware takeover law.[47] Anticipating the potential that the Delaware Supreme Court might be too sympathetic to a board's claim that it knew better than the shareholders, the authors sought both to provide the court a framework for that response and at the same time to cabin it. Thus came the awful term "substantive coercion": the risk that even in the face of full disclosure, target shareholders still might mistakenly accept a hostile bid that was lower than the company's fundamental value."[48] To make a claim of substantive coercion credible, the authors called for a good deal more than just management's predictable assertion that the market price undervalued the company's shares. The board also would have to

[42] Gilson (2001): 491, 494-95. ; Gilson (1997): 914, 915.
[43] *Unocal v. Mesa Petroleum*, 439 A.2d 946 (Del.1985).
[44] It will be apparent that the allocation of authority to respond to a hostile takeover is influenced by the extent to which market price relatively efficiently reflect the corporation's long term value. For an evaluation of the substantive coercion doctrine from the perspective of asset pricing and market efficiency theory, *see* Fox et al. (2014).
[45] 439 A.2d 946 (1985).
[46] *Compare* Gilson, (1981): 819 with Lipton (1979): 104.
[47] Gilson and Kraakman (1989): 247. Chancellor Chandler assesses the article's impact on Delaware takeover law in *Air Products and Chemicals, Inc. v. Airgas, Inc*., 16 A3d. 48, 97 -101, 108 (Del. Ch. 2011).
Gilson and Kraakman (1989): 267.

state clearly the source of the mispricing and the management's plans for correcting it.[49] The thought was that requiring discipline in demonstrating the presence of substantive coercion would require management to specify the metric by which their performance going forward should be measured if the offer were defeated.

In *Paramount Communications, Inc. v. Time, Inc.*[50], the "Supreme Court addressed the concept of substantive coercion head on …."[51] As the *Time* court put it subsequently, the "board of directors had reasonably determined that inadequate value was not the only threat Paramount's all cash for all shares presented, but was *also* reasonably concerned that the Time shareholders might tender to Paramount in ignorance or based upon a mistaken belief, i.e., yield to substantive coercion."[52]

The result, it is fair to say, greatly diminished *Unocal* as a serious restriction on a board's authority to block a hostile takeover by turning substantive coercion into an assumption rather than a matter requiring actual proof. Now, 23 years after *Time*, the reconcentration of equity and the emergence of Agency Capitalism call for reconsideration of the unexamined premise that underlay the Supreme Court's open armed acceptance of an expansive construction of substantive coercion. First, the concept requires that the board have information that the

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[49] Gilson and Kraakman (1989): 268. Then Vice Chancellor (now Chief Justice) Strine highlighted the problem that an unconstrained claim of substantive coercion would present and how Gilson and Kraakman's formulation of the term addressed that problem:

> "As a starting point, it is important to recognize that substantive coercion can be invoked by a corporate board in almost every situation. There is virtually no CEO in America who does not believe that the market is not valuing her company properly. Moreover, one hopes that directors and officers can always say that they know more about the company than the company's stockholders—after all, they are paid to know more. Thus, the threat that stockholders will be confused or wrongly eschew management's advice is omnipresent. …Professors Gilson and Kraakman—from whom our courts adopted the term substantive coercion—emphasized the need for close judicial scrutiny of defensive measures supposedly adopted to address that threat:
>
> 'To support an allegation of substantive coercion, a meaningful proportionality test requires a coherent statement of management's expectations about the future value of the company. From the perspective of shareholders, substantive coercion is possible only if management plausibly expects to better the terms of a hostile offer—whether by bargaining with the offeror, by securing a competitive bid, or by managing the company better than the market expects. To make such a claim requires more than the standard statement that a target's board and its advisers believe the hostile offer to be "grossly inadequate." In particular, demonstrating the existence of a threat of substantive coercion requires a showing of how—and when—management expects a target's shareholders to do better.
>
> * * *
>
> The discipline imposed by requiring management to state clearly just *how* it intends to cause the price of the company's shares to increase is a critical check on knee-jerk resort to assertions that a hostile offer's price is inadequate. For example, if management believes that the price of a hostile offer is inadequate because the market undervalues the company[ ] ... an acceptable statement of the threat to shareholders would require management to describe the steps that it planned to correct the market's valuation.'"

Chesapeake Corporation v. Shore, 771 A. 293, 327-330 (Del. Ch. 2000) (quoting Gilson and Kraakman (1989): 268-69, 274).

[50] 571 A.2d 1140 (Del. 1990).

[51] *Air Products and Chemicals, Inc. v. Airgas, Inc*., 16 A3d. 48, 98 (Del. Ch. 2011).

[52] *Unitrin, Inc. v. American General Corp*., 651 A.2d 1361, 1384 (Del. 1995) (emphasis in the original).

shareholders do not. But a second element is necessary, because the board can make private information public if they like. It also requires that the shareholders lack the sophistication to assess the company's future and the market's pricing. The *Time* court may have taken the dispersed small shareholders of the Berle-Means account as the modal ownership pattern. Whatever the facts at the time of *Time*,[53] a fundamental change of ownership pattern is now beyond dispute. Can it be seriously contended that major institutional equity investors such as BlackRock ($3.8 trillion), Fidelity ($1.7 trillion), or CalPERS ($258 billion) are not competent to evaluate a hostile bid? Indeed, Mr. Lipton, in the client letter to which we refer earlier, acknowledged that institutions will respond sensibly to the quality of the company's argument in responding to an activist investor's proposal.[54] Is the value proposition of a hostile bid so different?

The key point is that the doctrinal construction of "substantive coercion" was expressive of the dynamic structure of Delaware corporate law, which attempts to take account of new transactional forms and the applicable ownership structure in the continual updating of corporate law. As the Delaware Supreme Court said in *Unocal Corp. v. Mesa Petroleum*, "[O]ur corporate law is not static. It must grow and develop in response to, indeed anticipation of, evolving concepts and needs."[55] The board's fiduciary power and duty in facing an unsolicited control transaction remains constant: to protect the corporation and its shareholders. But an ownership change that results in a transformed shareholder base -- a change that significantly improves the capacity of shareholders to make independent judgments when faced with such a proposal -- should change the reasonableness of a paternalistic approach to shareholder choice. "Substantive coercion" no longer is a useful doctrinal account of the circumstance faced by today's shareholders in the large public companies domiciled in Delaware.

C. Agency Capitalism and Freezeout Mergers

The Delaware Chancery Court has recently grappled with the implications of the reconcentrated ownership pattern in the context of going-private transactions, "freezeouts." In *In re MWF Shareholders Litigation*,[56] the court decided that "business judgment" rather than "entire fairness" would be the appropriate standard of review for such a transaction where the controller had both empowered the special committee to refuse the controller's proposal ("just say no") and conditioned the transaction on approval by a majority of the disinterested minority shareholders ("majority of minority"). In light of dicta in a prior Delaware Supreme Court

[53] *See* Gilson and Kraakman (1989): 1,4, 2, 8-29

[54] Former Chancellor Chandler reached much the same result recently in the *Airgas* case. Although stating that he felt constrained by the Supreme Court, Chancellor Chandler noted that substantive coercion made little sense in the context of the case, where "given [that] Airgas[has had] more time than any litigated poison pill in Delaware history— enough time to show stockholders four quarters of improving financial results, demonstrating that Airgas is on track to meet its projected goals." *Air Products and Chemicals, Inc. v. Airgas, Inc*, 16 A.3d 48, 57 (Del. Ch. 2011).

[55] 493 A.2d 946, 957 (Del. 1985); accord, *Moran v. Household Int'l, Inc*., 500 A.2d 1346, 1351 (Del. 1985). *See also* Jacobs (2012): 19, 31. ("the new shareholder profile is an irrefutable reality that justifies inquiring into whether courts should take that into account in formulating and applying fiduciary duty principles").

[56] 67 A.3d 496 (Del. Ch 2013).

decision, *Kahn v. Lynch Communications Systems*,[57] which previously had been thought to reward adoption of this rigorous process only with a shift of the burden of proof rather than a downshift down from fourth to first in the standard of review, this result required some fancy footwork by the nimble then-Chancellor Strine. But the motivation for his exertions falls directly out of the consequences of the reconcentration of ownership into the hands of reticent investment intermediaries.

The court notes that the present transactional structure for freezeouts commonly empowers the special committee but almost never includes a majority-of-minority condition. Why? Because the giving the minority such a veto simply increases the ex ante risk to the transaction with no apparent change from the ex post heightened standard of review.[58] The court's solution is to use less stringent ex post review, business judgment, to give incentives to transaction proponents to build in a majority-of-minority approval condition. From the proponents' perspective, the greater risks from minority veto will be offset by greater certainty to a transaction so approved. The Chancellor asserts that the minority shareholders will be better off because they will have the customary double protections of an arm's length transaction: a bargaining agent working exclusively on their behalf and the checking function of a majority vote.[59] But the superior protections of this transactional/legal standard package over the judicial scrutiny of an "entire fairness" regime critically depend on an affirmative assumption about the decisional capacities of the public minority shareholders.

The Chancellor provides an account of the current ownership structure that mirrors the account we have provided of reconcentration.[60] He then explains the ways that such institutional owners have asserted their shareholder prerogatives to pursue governance activism and, acting as the "reticent" owners of our construction, have also voted down management merger proposals or have used the threat of "no" votes to obtain higher prices.[61] The Chancellor concludes that shareholder voting on proposals fashioned by others is a value-increasing substitute for enhanced judicial review of going private transactions.[62] The predicate for this belief is the "increasing concentration of institutional investors and the demonstrated willingness of stockholders to vote against management's recommended course of actions."[63]

In short, the Chancery Court in *MFW* takes direct account of the current ownership pattern and the change in shareholder decisional capacities and proclivities that it has produced. In reshaping part of the doctrine of going-private transactions, the Chancellor invoked the dynamic elements of Delaware corporate law.[64] The court's modification to corporate law doctrine is modest: an (arguable) change in the standard of review of going-

[57] 638 A.2d 1110, 1117 (Del. 1994).
[58] MFW, 67 A.3d at 525.
[59] *See* Gilson and Gordon (2003): 785. (urging business judgment rule treatment of freezeouts where the decision structure mirrored that of an arm's length merger).
[60] *Id.*, at 530 & n. 164 (citing ownership studies).
[61] *Id.*, at 530-31 & n. 167 (citing instances of shareholder rejection of management-supported merger proposals).
[62] *Id.*, at 532
[63] *Id.*, at 533.
[64] *Id*., at 531-32 (citing *Unocal* and *Moran*).

private freezeouts in which the shareholders are called upon to evaluate the work of their bargaining agent, the special committee. The Supreme Court affirmed the Chancery Court's decision in *MFW*, although without highlighting institutional investors' dominant ownership.[65] Given that former Chancellor Strine had become Chief Justice of the Delaware Supreme Court by the time the Supreme Court's opinion in MFW was issued, we would not make much of the absence of this analysis, especially since Justice Jacobs has himself written about this phenomenon.[66] In all events, the two opinions, taken together, show two principles that are important: first, reconcentrated shareholders should be respected for their capacity to vote on appropriately teed-up decisions about the firm's strategy and future; and second, even broader, governance should accommodate itself to fundamental changes in the ownership pattern. Both of these principles may auger further governance change to accommodate the new ownership pattern.

Part V. Conclusion

This chapter continues our examination of the corporate law and governance implications of the fundamental shift in ownership structure of U.S. public corporations from the Berle-Means pattern of widely distributed shareholders to one of Agency Capitalism – the reconcentration of ownership in intermediary institutional investors as record holders for their beneficial owners. A Berle-Means ownership distribution provided the foundation for the agency cost orientation of modern corporate law and governance – the goal was to bridge the gap between the interests of managers and shareholders that dispersed shareholders could not do for themselves. The equity intermediation of the last 30 years gives us Agency Capitalism, characterized by sophisticated but reticent institutional shareholders who require market actors to invoke their sophistication. We have examined here three implications of this shift in ownership distribution. The first addressed a proposal to turn back the clock in the regulation of ownership disclosure under the Williams Act to a time when shareholders were small and dispersed rather than large and concentrated as they are today. The next two shared a common theme: that the allocation of responsibility between directors, shareholders and courts could no longer be premised on a paternalism grounded in an anachronistic belief concerning the distribution and sophistication of shareholders. We saw that the Delaware Chancery Court, now with the Supreme Court's implicit blessing, has recognized that Agency Capitalism counsels different rules concerning the roles of shareholders and the court in policing freezeouts. And we expect that the Supreme Court will come to realize what the Chancery Court has recognized for some time – that the doctrine of substantive coercion as a basis for takeover defense must give way as Delaware corporate law adapts to the very different shareholder distribution the capital market has now given us.

[65] *Kahn v. M&F Worldwide Corp.*, __ A. 3d __, 2014 WL 996270 (Del.Sup.Ct. March 14, 2014).
[66] Jacobs (2012).

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