Shareholder Initiative: An Informal Social Choice and Game Theoretic Approach

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Abstract

Current arguments to increase shareholder power in the large public U.S. corporation need to take account of the well-established historical practice of extensive delegation by shareholders of business decision-making and agenda-control to management and the board, what might be characterized as an "absolute delegation rule." This practice sharply limits the power of shareholders to put either business or governance proposals to the shareholders for dispositive resolution. The paper, originally published in 1991 but newly relevant, argues that the rule is based on potential pathologies in shareholder voting rather than the inherent information asymmetry between shareholders and managers. Rational shareholders who know of this asymmetry (and know that others know) would simply vote against most shareholder proposals. But shareholder voting gives rise to potential cycling problems, as shifting shareholder majorities vie for preferred policies, and potential opportunism, as shareholders engage in side deals with management and other shareholders to extract rents in corporate decision-making. Since shareholding patterns are in part a response to control rights, deviations from the absolute delegation rule will predictably lead to greater block ownership, for defensive and offensive reasons. These concerns need to be addressed in arguments for the expansion of shareholder power.

Keywords: Shareholder voting, Delegation, Management, Cycling, Shareholder Opportunism

JEL Classifications: D70, G30, G34, G38, K22, M14, N22, N42, N80, N82, O16

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SHAREHOLDER INITIATIVE: A SOCIAL CHOICE AND GAME THEORETIC APPROACH TO CORPORATE LAW

*Jeffrey N. Gordon**

After two decades in which shareholder "exit" through a hostile tender offer played the largest role in the corporate governance debate, shareholder "voice" has once again taken center stage. Two factors account for this change. The first is the dramatic decline in the number of hostile takeover bids, the result of new antitakeover sentiments by courts[1] and state legislatures,[2] as well as a sharp contraction in the availability of takeover finance following the recent failure of high profile LBO's. The second is the dramatic increase in institutional ownership of large publicly held corporations, which has reduced the collective action barriers to concerted shareholder activity.[3]

I have profited from conversations with Ian Ayres, Bernie Black, Chuck Cameron, David Epstein, John Ferejohn, Ron Gilson, Marcel Kahan, David Leebron, Barry Nalebuff, Julie Nelson, Andy Rutten, Scott Shapiro, Martin Shubik, and especially Lewis Kornhauser, all of whom have the usual transactional immunity. I also received helpful comments from participants at a conference on "The Future of Corporate Governance" sponsored by the Columbia University Center for Law and Economic Studies, and of course, from participants at the University of Cincinnati Law Review conference on game theory in corporate law. Joseph Brosnan, Andrew Dominus, and Arthur Haywoode provided valuable research assistance.

This is a paper that purports to be game theoretic, but as you will see, has none of the matrices or diagrams that usually say "game theory." Instead, I have tried to capture the sense of the strategic interaction of the parties, rather than to try to present it formally. In this spirit, I recommend AVINASK K. DIXIT & BARRY J. NALEBUFF, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS AND EVERYDAY LIFE (1991), and DAVID M. KREPS, A COURSE IN MICROECONOMICS (1990).

1. The key cases are CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 94 (1987), which opened the way for state antitakeover legislation by permitting state measures that were cast as regulation of internal corporate governance rather than regulation of offers themselves, and Paramount Communications v. Time Inc., 571 A.2d 1140, 1151 (Del. 1990), which sounded the Delaware court's retreat from enhanced business judgment scrutiny of target defensive maneuvers in favor of a more deferential stance. *See* Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931 (1991).

2. By a recent count, 42 states have adopted significant antitakeover legislation that permits target management to employ a wide variety of tactics to deter and fend off a hostile bid. *See 42 States Currently Have Antitakeover Laws, ABA Group Told*, 22 Sec. Reg. & L. Rep. (BNA) 1216 (Aug. 17, 1990); McGurn, Pamepinto, Spector, *State Takeover Laws*, Investor Responsibility Research Center (Sept. 1989).

3. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Edward B. Rock, *The Logic and Uncertain Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); John C. Coffee, *Liquidity vs. Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991).

Shareholder voting has, of course, never left the agenda, but now the questions are different. Not long ago, the inquiry focused on the puzzle of shareholder acquiescence to management-proposed anti-takeover charter amendments that reduced the value of the firm.[4] Now the inquiry is beginning to focus on whether shareholders can be organized to act against management to effect corporate change. The most immediate concern is whether shareholders can use their power to change the composition of the board of directors through the election process, thus to monitor corporate activity more closely.[5] A second concern is whether shareholders can transform the corporate governance relationship, through rolling back anti-takeover measures like poison pills and golden parachutes and obtaining confidentiality for shareholder voting. Now that shareholder exit has been constrained, questions about shareholder voice loom large.

At the far edge is this difficult question: whether shareholders can participate directly in the firm's business decision-making, to cause the firm to adopt one set of business plans instead of another. A recent case is Carl Icahn's struggle to get USX to separate its steel business from its oil business, on the view that creating two non-diversified companies would increase shareholder value. Icahn fought this battle the old-fashioned way, that is, through a proxy battle to elect directors favorable to his view. But this only raises the next issue: why was Icahn unable to put the question directly to USX's shareholders for binding shareholder action?[6]

The answer provided by the legal system is that directors are responsible for managing the business and affairs of a corporation and that direct shareholder initiative would encroach impermissibly on that power. This conclusion is embedded in the common law of cor-

4. This question seemed most acute in the case of dual class common stock recapitalizations, in which shareholders approved capital structures that gave insiders voting control over the firm. *See* Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988).

5. *See* Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

6. This paper will use Icahn and USX as a stylized example of the problems raised by a binding shareholder initiative requiring a specific business decision. The actual facts are more complex. In spring 1990 Icahn, who then owned approximately 13% of USX common stock, proposed a non-binding shareholder resolution for USX to separate the steel business from the oil business and to sell or spin off to shareholders at least 80% of the steel equity. His claim was that the separation would produce a 30% increase in value. The shareholder resolution was subsequently defeated by a 57% to 43% vote. Icahn continued to lobby for a major restructuring at USX, and in the spring of 1991 undertook a proxy battle to elect new directors to the USX board. Before the annual meeting Icahn apparently ended his multi-year dispute after USX agreed to set up a separate steel subsidiary with a separate class of USX stock.

porations as well as in many statutory codes.[7] Even with language in modern statutes that appears to permit the charter to alter this delegation of power, the practice stands unchanged for the large public corporation.[8]

Shareholders do not delegate all power irrevocably to management, of course. Most importantly, directors stand for election at meetings that must be held at least annually, and, depending on the charter arrangements, directors may be removed by shareholders

7. *See* 5 WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2097 (perm. ed. rev. vol. 1990). The principle of director control has evolved over time. An early view regarded the power to undertake corporate action as residing in shareholders, who delegated such power as seemed convenient to their agents, the directors. *See* Union Pac. Ry. Co. v. Chicago, Rock Island & Pac. Ry. Co., 163 U.S. 564, 596, 600 (1896); 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 (2nd ed. 1888). As states came to adopt general enabling statutes that established the board of directors as a part of the standard corporate form, courts construed these statutes as requiring a total delegation and rejected virtually any shareholder effort to assert inherent authority (except by annual elections), such as through agreements to elect certain officers or removal without cause or other restriction on director conduct. *See* Robert A. Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696, 696-702 (1960); ADOLPH A. BERLE, JR. & GARDENER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 138-40 (1932). This view was criticized as too rigid, and, in particular, as raising difficult problems with the management of close corporations. *See generally* Kessler, *supra*. When corporation codes were revised in the 1960's and 1970's, not only was special statutory freedom provided for close corporations, but the general delegation to the board was often made subject to contrary charter provision. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141 (1988 & Supp. 1990); ERNEST L. FOLK III, FOLK ON THE DELAWARE GENERAL CORPORATION LAW 21 (2d ed. 1990); REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1984). Nevertheless, in the absence of such charter provisions (which seem to be non-existent for public corporations), the shareholder delegation is taken as absolute. Directors are free to disregard precatory shareholder resolutions under the protection of the business judgment rule. *See* Speigel v. Buntrock, 571 A.2d 767, 775-76 (Del. 1990).

One of the important elements of this evolution has been the tension between "voluntaristic" (or contractual) and "concessionary" theories of the corporation. The concession theory regards corporate existence and power as granted by the state, as opposed to the state's mere recognition of a preexisting voluntary association. Thus in a jurisdiction like New York, in which the concession theory was historically quite influential, courts frequently regarded shareholder efforts to assert authority over directors as impermissible interference with agents of the state. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 207, at 562 (1983). Most contemporary corporate laws provide shareholders with considerable flexibility in altering the standard form of corporate arrangement, indicating the triumph of the contractual theory. Nevertheless, the legal pattern of director protection against shareholder encroachment persists. Perhaps this persistence shows the vestigial influence of the concession theory, but this article argues that the pattern and its persistence has a functional explanation.

8. Small corporations may follow a somewhat different pattern. Under Delaware law, for example, a corporation with less than 30 shareholders may organize as a "close" corporation under specific statutory authority that permits management of the business by the shareholders in lieu of directors. *See* DEL. CODE ANN. tit. 8, §§ 342, 351 (1983).

even without cause in the interim.[9] But outside of control contests, it seems that reserved shareholder power is quite limited. Even in matters where formal shareholder approval is required, management sets the agenda. Specifically, charter amendments can be adopted only after board approval,[10] which precludes shareholder power to initiate amendments or to modify amendments proposed by the board. Given the contemporary sanctioning of triangular mergers, shareholder approval in mergers is generally required only on the target-side.[11] In any event, a merger can be entered into only after board approval, and even after a positive shareholder vote, the board has the power to call off the transaction.[12] A potentially expansive source of shareholder power is concurrent authority with the board to amend the by-laws,[13] but this power may be constrained by the board's ability to adopt by-laws or take other action that may undercut, if not contradict, the shareholder measure.[14]

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9. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k) (1983) (permitting removal without cause unless board is classified or, in some cases, if board is elected by cumulative voting); REVISED MODEL BUSINESS CORP. ACT § 8.08(a) (1984) (permitting removal without cause unless charter otherwise specifies); N.Y. BUS. CORP. LAW § 706(b) (Consol. 1991) (permitting removal without cause if provided for in charter).

10. *E.g.*, DEL. CODE ANN. tit. 8, § 242(b)(1) (1983); REVISED MODEL BUSINESS CORP. ACT § 10.03(b) (1984); N.Y. BUS. CORP. LAW § 803(a) (Consol. 1991).

11. *See, e.g.*, Note, *Three-Party Mergers: The Fourth Form of Corporate Acquisition*, 57 VA. L. REV. 1242, 1244-45 (1971); REVISED MODEL BUSINESS CORP. ACT § 11.03 Cmt. 2 (1984). The statement in the text assumes that the consideration is in cash, property, or acquiror stock whose issuance has been previously authorized and which amounts to less than 20% of the acquiror's outstanding stock, the threshold set by the New York Stock Exchange listing agreement for shareholder approval of a transaction. NYSE LISTED COMPANY MANUAL § 313.03(c) (1990). Shareholder approval of target side mergers and charter amendments provide barebones protection against opportunistic behavior in circumstances where that risk is greatest. See text accompanying note 53 *infra*.

12. *See* DEL. CODE ANN. tit. 8, § 251(d) (Supp. 1990); REVISED MODEL BUSINESS CORP. ACT § 11.03(c) (1984); N.Y. BUS. CORP. LAW § 903(b) (Consol. 1991).

13. *E.g.*, DEL. CODE ANN. tit. 8, § 109 (1983); REVISED MODEL BUSINESS CORP. ACT § 10.20 (1984); N.Y. BUS. CORP. LAW § 601 (Consol. 1991).

14. For example, there has been talk in institutional investors circles of by-law proposals that would limit executive compensation, set performance standards, and prohibit certain compensation devices such as golden parachutes. Kevin Salwen, *Executive Pay May Be Subject to New Scrutiny*, WALL ST. J., May 16, 1991, at, A3; *SEC Should Give Shareholders More Voice in Executives' Compensation, Panel Told*, 23 Sec. Reg. & L. Rep. (BNA) 757 (May 17, 1991). Unless the courts are prepared to police these by-laws very vigorously, *compare* Nomad Acquisition Corp. v. Damon Corp., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040 (Del. Ch. Sept. 20, 1988) (permitting management to adopt by-law requiring 90 day advance notification of shareholder intention to nominate director at annual meeting) *with* Hubbard v. Hollywood Park Realty Enterp., Inc., No. 11779, 1991 Del. ch. LEXIS 9 (Del. Ch. Jan. 14, 1991) (requiring board to waive similar by-law in particular case), management is likely to succeed in devising payment devices functionally equivalent to the forbidden ones, to add new sources of compensation, and through supplementation and definition of specified terms, to undercut the constraining effects of the shareholder by-law.

When it comes to specific business matters, it seems that an objecting shareholder can do no more than offer a "precatory" resolution that provides shareholder advice on the issue.[15] Adoption of such a resolution obviously sends a strong signal to management, as do informal contacts by important shareholders, that a management seeking to avoid a control contest may be well-advised to heed. Nevertheless, management can ignore such expressions of shareholder preference and, indeed, can pursue policies and extraordinary transactions that it knows shareholders would reject.[16] Thus for the large public corporation the pattern of delegation gives management virtually unbounded decisionmaking authority over business matters and agenda control over significant changes in the management-shareholder relationship. The shareholders' power consists almost exclusively of the power to revoke the delegation through a control contest, or more problematically, through acceptance of a hostile tender offer.[17] There is no power of shareholder

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Shareholders may be more successful with by-laws that delegate all compensation questions for senior executives to a committee of outside directors.

15. One conceivable bypass of the state law barrier to other than precatory resolutions is the by-law amendment route, as to which shareholders have concurrent power with managers and presumably have superior power in the event of a management effort to repeal a shareholder-enacted by-law. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT § 10.20 (1984). In addition to management efforts to evade, see discussion at *supra* note 14, another problem is what counts as a "by-law"? A Delaware court, for example, could easily regard a specific business proposal as interfering with the statutory delegation to directors of power and responsibility to "manage" the corporation's business and affairs pursuant to DEL. CODE ANN. tit. 8, § 141(a) (1983); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990). Thus, such a proposal would not be a "by-law" whose adoption by shareholders would be permitted.

Proponents have two means of presenting precatory resolutions to fellow shareholders. The first, low cost but with low probability of success, is through a shareholder proposal on the management proxy, pursuant to Rule 14a-8. 17 C.F.R. § 240.14a-8. Management can exclude such proposals not only on the ground that they are impermissible subjects for shareholder action under state law (even though precatory), but also if they relate to ordinary business operations, involve election of directors, or are in opposition to a management proposal. The proponent's statement in the management proxy in support of the proposal is limited to 500 words; management is under no such limitation. The alternative is a full blown proxy battle whose substantial costs would be borne by the proponent. Icahn's effort on behalf of his 1990 non-binding resolution was estimated to cost $5 to $10 million, against the approximately $1.2 billion of his USX holdings.

16. In a famous recent example, Time's management recast its proposed combination with Warner from a merger, on which Time shareholders would vote, to a tender offer for Warner, on which Time shareholders had no vote, on the belief that Time shareholders would reject the merger in favor of a competing bid from Paramount. *See generally* Gordon, *supra* note 1.

17. Recent court decisions, especially in Delaware, have made it clear that shareholders do not have the right to receive hostile bids and have countenanced

initiative. This pattern of shareholder-manager relations may be called the "absolute delegation rule."

The question is why this pattern has arisen and persisted and the circumstances under which it might be changed. Why shouldn't Carl Icahn be able to take to shareholders for resolution the question of whether USX would be more valuable if broken up into two separate corporations? There is a substantial argument that the conglomeration of oil and steel was the result of an agency problem: management pursued diversification to protect its jobs against the bankruptcy risks of the steel business at the expense of shareholders, who could have obtained such diversification at the portfolio level more cheaply, since common ownership entails the potential cross-subsidization of steel losses from oil profits. Such agency problems could more easily be controlled were shareholder initiative available as an alternative to a full-scale control contest.

Alternatively, on some particular business matters, shareholders may believe their perceptions and judgement are superior to management's. Carl Icahn may in fact have had a better view of the long term comparative futures of steel and oil than the USX management. In both cases it may be that the incumbent management otherwise ably runs the enterprise, but is tempted to serve its particular interests or makes a mistaken prediction about the future. Why leave shareholders with only one avenue — an election contest aimed at the board of directors — to force a particular change in business strategy?

The question has particular force because a control contest is not well-targeted to effect a limited business change. A shift in control via election of a new board opens all of the firm's business strategies to change and may force the replacement of management whose performance shareholders otherwise would approve. Shareholders will also question the motives of a control insurgent, whose goal may be the perquisites of control rather than the maximization of the value of the firm. Shareholder initiative, which isolates a single business matter and leaves control unchanged, solves the commitment problems of the shareholder proponent: how to assure other shareholders of her limited objectives and good faith. Shareholder initiative will thus be far more attractive than a control contest as a mode of collective shareholder decisionmaking. Why is it, then, that this avenue of shareholder expression is closed in favor of a strong rule of shareholder delegation to management?

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preclusive target defense tactics in many situations. Recent state antitakeover statutes are to similar effect. *See generally id.*

This paper argues that the two standard justifications of the absolute delegation rule are incomplete, the first, based on management's informational advantage; the second, based on the management/agent's success in maintaining power over the shareholder/principal. I argue on behalf of a third explanation: that the absolute delegation rule avoids several sorts of pathologies that would emerge in the strategies of shareholder voting. Shareholders give away power because, in many circumstances, the effects of the shareholder initiative would be wealth-reducing. In particular, shareholder initiative would produce strategic behavior designed to maximize private gains at the expense of common gains. I hope to demonstrate these points with analysis drawn from the social choice and game theory literatures.

STANDARD EXPLANATIONS FOR ABSOLUTE DELEGATION

A. Management's Informational Advantage

The standard accounts of the absolute delegation rule fall into the familiar dichotomy of explanations for corporate law rules that aggrandize management power vis-a-vis shareholders, namely, that the particular rule either increases shareholder wealth because it is an efficient delegation, or reduces shareholder wealth because it represents a management power grab. The wealth-increasing explanation for the absolute delegation rule focuses on management's superior information about the firm and the economic environment in which it operates. The story goes as follows: in the large public corporation, managers ordinarily have a large informational advantage over shareholders in evaluating any particular business decision. The very structure of the large public corporation, with its separation of ownership and control, contemplates a division of function in which shareholders supply capital for a business run by management experts. Shareholders are interested in overall results, and generally have no interest in or particular qualification for the time-consuming and difficult task of acquiring and evaluating the vast amount of detail necessary to make sound business judgments for the firm. Moreover, shareholders lack particularized information about the firm and the business environment in which the firm operates to translate a given idea into a workable business plan. Shareholders dissatisfied with the firm's results can simply sell their stock, or, in the extreme case, can replace the management team. In other words, even if shareholders have or can obtain enough information to evaluate bottom-line performance, they will be poorly situated to participate in business decisions.

This account shows why shareholders ordinarily would delegate business decisions to management, but it does not explain why the delegation would be absolute. It does not explain why shareholders would not reserve concurrent power for those occasions, probably rare, when they might wish to assert their business judgment over a particular decision without replacing the board. Assume that a shareholder proponent believes that business strategy *X* would substantially increase the value of the firm, formulates a plan based on strategy *X*, and launches a shareholder initiative. Shareholders who do not want to incur the expense of detailed information gathering and evaluation, including the evaluation of whether strategy *X* is presented in a workable business plan, can adopt a strong presumption against all such initiatives. This would mean that a shareholder initiative would be launched only in cases when the instigating shareholder(s) had a significant block of stock to justify the expense and raise the odds of success, and where the matter in question had potential for a significant impact on firm value. Since each shareholder can decide for herself to vote against the initiative, the absolute delegation rule is desirable for shareholders only if it plausibly protects against the possibility that *other* shareholders will mistakenly vote for a misbegotten shareholder initiative. Thus, the information argument requires a claim that not only is management ordinarily better situated to make correct business decisions, but also that other shareholders will systematically overrate the benefits of alternative shareholder proposals. In other words, each shareholder believes himself individually rational, having the judgment, among other things, to decide when an erroneous business decision warrants sale of the stock, but also believes shareholders as a group to be collectively irrational, so as to make desirable a hands-tying measure such as the absolute delegation rule.

One contemporary context in which management's informational advantage is invoked to deny shareholder decisionmaking power is the hostile takeover. Defenders of management prerogative frequently emphasize the likelihood that shareholders could be deceived by a premium hostile bid, either through misapprehension of the target's intrinsic value or because of competitive factors that constrain management's ability to disclose information affecting the value of the firm. The target's vigorous defensive tactics may then be defended as protection against the possibility that a majority of shareholders will irrationally or mistakenly tender shares. Even assuming that this argument carries sufficient weight to justify target

defense tactics,[18] it would not account for the absolute delegation rule. Shareholders considering whether to vote for a shareholder initiative face very different consequences than shareholders deciding whether to tender into a takeover bid at a substantial premium over market. The tendering shareholder exits the corporation with a substantial immediate premium. At worst, she forgoes the possibility of an even greater payoff at some future time. The voting shareholder is a continuing participant in the firm and bears the negative consequence of mistaken adoption of a shareholder initiative. The loss is out of pocket, not simply the loss of a prospect of future gain. Moreover, the shareholder proponent is offering only a theory as to how the value of the firm may be increased, not his payment for shares as a bond. All of this will produce an inherent conservatism regarding shareholder initiative not seen in the response to premium takeover bids. Shareholders will tend to trust management's judgment ahead of most shareholder proposals and will simply follow a default rule to vote in favor of management. This follows for many of the same reasons that lead rationally apathetic shareholders to return the management proxy on most occasions of shareholder voting.[19] More importantly, there is no reason for shareholders to disbelieve that other public shareholders will follow this same strategy.[20] This means that the hands-tying entailed by adoption of the absolute delegation rule would not, on this account, increase shareholder wealth.[21]

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18. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1193 (Del. 1990) (accepting information argument). Of all the issues raised by hostile takeovers, the plight of target shareholders should cause the least concern. Economic studies of target shareholder gains uniformly show large premiums over prevailing market prices, on the order of 50% during the 1980's. *See* Bernard S. Black, *Bidder Overpayment in Takeovers,* 41 STAN. L. REV. 597, 601-05 (1989) (comprehensive survey). *See also* Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980,* 2 J. ECON. PERSP. 49 (1988). This suggests that assertions about the shareholder information problem serve as screens for objectives other than shareholder welfare, such as protection of incumbent managers or other non-shareholder corporate constituencies.

19. *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law,* 89 COLUM. L. REV. 1549, 1573-1585 (1989).

20. Moreover, any residual shareholder anxiety could be addressed through a supermajority rule or other less restrictive alternative to the absolute delegation rule.

21. A related argument is that the absolute delegation rule reduces the cost of shareholder evaluation of proposals (including the chance that bad proposals would be adopted) that on average, shareholders, if informed, would reject. But shareholders can adopt a low cost default strategy of an uninformed "no" vote, while reserving the option to become informed in extraordinary cases and perhaps vote "yes." The only risk is if shareholders who choose to become informed systematically err on the side of the shareholder initiative, which seems improbable. Moreover, shareholder costs, if any, will be offset by the deterrent effect of shareholder initiative in reducing agency costs.

A related information argument points to the burden on management in responding to sundry shareholder initiatives, the cost to the firm in informing shareholders about the issue in question, and the distraction of management throughout the process.[22] The argument is that these costs, which are incurred in every shareholder initiative, outweigh the gains from the relatively few shareholder initiatives that may succeed. But there are many ways of policing these costs, which are easy to overstate, short of barring shareholder initiatives altogether. For example, a firm could require a proponent to show a certain percentage of shareholder support before launching the initiative, much like the minimum percentage requirement for the call of a special shareholders' meeting often found in the bylaws. Or the corporation could limit the number of proposals from any single proponent. Adoption of various rules that now apply to control contests would screen out shareholder initiatives that are less likely to produce gains — for example, the requirement that the proponent organize an independent proxy solicitation rather than piggy-back on the management proxy. Reimbursement rules present another way of reducing costs below expected gains. For example, firms might adopt an equivalent to the English attorney's fee rule, in which the shareholder proponent receives reimbursement if successful (which can be defined in terms of prevailing or of obtaining a specified percentage of votes), but reimburses the firm if not successful.

A separate counterargument looks to the deterrent effect of shareholder initiative against agency problems in managerial decisionmaking. As in the case of hostile takeover bids, the real benefit of shareholder initiative may derive from improved management decisions.[23] The best use of shareholder initiative is in the case where prior management action has obviated the need. Shareholder initiative could be likened to the board's power to reject or refashion management plans. Boards rarely take such initiatives, but their power to do so presumably invigorates management's decisionmaking process. In some cases, the threat of a shareholder initiative may produce the same benefits as the threat of a hostile bid, but at a much lower cost. In sum, the information arguments explain why

22. These costs could also be styled as transaction costs, and the argument would be that if most shareholder initiatives fail, but generate significant transaction costs in the process, shareholders might be better off foregoing the occasional initiative that would be beneficial for the firm and that, in fact, succeeds.

23. This is not to say that hostile bids and shareholder initiative are fungible. Shareholder initiative, which is much cheaper for the proponent and for the firm, can be targeted as specific management decisions whose economic consequence would not necessarily justify a hostile bid. Thus the deterrent effects will intersect but not overlap.

shareholders would ordinarily delegate to management, not why shareholders have not reserved concurrent power over the making of business decisions.

B. Managerialism

The information arguments contend that an absolute delegation rule benefits shareholders and thus increases the value of the firm. By contrast, the second standard explanation of the rule is that it serves management interests to the detriment of shareholders, but given managerial choice over the state of incorporation and influence over the shape of state law, such a provision is a natural consequence. In other words, the absolute delegation rule reduces shareholder wealth but shareholders are essentially powerless to object. This manageralist explanation raises the familiar debate over whether states are engaged in a race to the bottom, top, or middle in the fashioning of their corporation codes.[24] Whatever the status of that argument in particular contexts,[25] it seems unlikely that the delegation rule has a pure managerialist tilt. The race-to-the-bottom side of the state competition argument turns on the view that stock prices do not significantly respond to managerialist provisions, in part because the provisions have only a small expected impact on firm cash flows.[26] Managers can therefore extract governance rents that are significant to them but not significant to the firm. For ex-

24. For a good discussion, see Roberta Romano, *The State Corporation Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) (discussing implications of state corporation debate).

25. Two recent examples of state legislation protective of managers seem to point in different directions. In the wake of the potential expansion of director liability for breach of the duty of care in Smith v. Van Gorkham, 488 A.2d 858 (Del. 1985), most states adopted statutes that in various ways eliminated or capped director exposure in such cases. *See* James J. Hanks, Jr., *Evaluating Recent State Legislation on D&O Liability Limitation*, 43 BUS. LAW. 1207 (1988). Yet most commentators probably agree that this sort of management protection increases shareholder welfare, at least in the case of the public corporation, through its encouragement of appropriate risk-taking in a business setting. *See, e.g.*, AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 (Tent. Draft. No. 11, 1991). In contrast is the widespread adoption of increasingly restrictive state anti-takeover legislation, which most commentators believe significantly reduces shareholder welfare by denying access to hostile bids at a premium over market and by reducing the monitoring of management performance. *See, e.g.*, Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second Generation State Takeover Legislation*, 25 J. FIN. ECON. 291, 321 (1989).

26. *See* RONALD J.GILSON, *The Law and Finance of the Business Judgment Rule*, in THE BATTLE FOR CORPORATE CONTROL 156 (Arnold W. Sametz ed., 1991); Elliot J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551 (1987); Merritt B. Fox, *The Role of the Market in Corporate Law Anaysis: A Comment on Weiss and White*, 76 CAL. L. REV. 1051 (1988).

ample, relaxed fiduciary duty rules that permit management more readily to engage in transactions with a conflict of interest may permit, on average, some augmentation of managerial compensation, but would not be material for most firms. A rule like the absolute delegation rule that altogether eliminates a particular level of potential shareholder participation in firm governance is, by contrast, likely to have a non-trivial effect on shareholder wealth. If the effect were significantly negative, some state regime is likely to respond with an alternative. The way states responded with statutory innovations that permit shareholder engagement in the management of a close corporation is illustrative,[27] and so is the diversity of antitakeover measures among various states. Even more important in evaluating the managerialist explanation is that many state statutes now permit alteration of the absolute delegation rule in the charter, as part of a general enabling approach toward corporate law norms. But despite the competition in capital markets, and despite the lack of state prohibition, firms have not offered shareholders a package of governance rights that included shareholder initiative.

In other words, the absolute delegation rule is a long-standing feature of corporate governance. Its effects have been impounded into share prices from the firm's inception. This is unlike the recent wave of state antitakeover statutes, in which management's ability to extract legal change came at the expense of existing shareholders. If the delegation rule were managerialist, then entrepreneurs selling stock to the public would bear the cost, as with all other elements of the corporate governance structure that increase agency costs.[28] Perhaps private gains to entrepreneurs outweigh the costs, but the universality and the duration of the delegation rule argue that the rule provides net shareholder benefits.

In sum, the absolute delegation rule cannot be accounted for by the two standard explanations, although the persistence of the rule in corporate organization suggests shareholder advantage. This suggests the need for a different perspective, one that accounts for desirable properties of the absolute delegation rule in terms of the potential pathologies in shareholder voting and in the new incentives that shareholder initiative power would create. From this perspective, there are three major problems: first, the potential for cycling in shareholder voting that would lead to costly delay or

27. *E.g.*, DEL. CODE ANN. tit. 8, § 351 (1983).

28. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (arguing that cost and benefits of governance structure are borne by entrepreneur); Gordon, *supra* note 19, at 1550.

waste of economic resources; second, the potential for side-deals between shareholders that would lead to the choice of suboptimal projects by the firm; and third, the potential for strategic behavior in which shareholders use the threat of initiative power to obtain a pay-off from incumbent managers, much like greenmail. This analysis not only provides a more complete understanding of existing corporate governance arrangements, but may also sound a cautionary note with respect to the expansion of the shareholder activism of institutional investors. The collapse of the takeover boom and the growing self-consciousness of institutional investors have produced calls for "voice." But as we face choices about whether that voice should be amplified or muffled through legal rules, we should try to understand how voice will operate in context and the conditions under which voice will increase the value of the firm.

CYCLING AND OTHER VOTING PATHOLOGIES

What is the point of shareholding voting? A simple theory would say that the point is to aggregate the preferences, or judgments, of shareholders so that the firm follows the policies believed best by shareholders owning a majority of the firm's stock. At present, this policy is embodied through the mechanism of director elections, but in theory, it could be expressed in other institutions of shareholder voting as well.[29] Note that shareholder voting aggregates preferences on a per share basis, not per capita. This principle can be justified on two grounds. First, tying votes to economic interest is a commitment strategy that protects investors against expropriation. Under a contrary rule, a numerical majority might well reallocate to itself cash flows claimed by the economic majority, both in particular cases and through revision of charter provisions requiring distribution on a per share basis. Second, per share voting increases the likelihood that shareholder voting will lead to correct decisions and thus increases the value of the firm. This is because shareholder incentives to collect and analyze information are an increasing function of both economic stake and potential impact on the outcome.[30]

Over the past forty years, political scientists and economists have made increasingly vivid the frailties of voting as a mechanism of social choice.[31] In particular as the size of the electorate increases and

29. Shareholders, of course, vote on charter amendments and some fundamental changes. *See* text accompanying notes 54-55, *infra*.

30. The most detailed account of shifting shareholder incentives is given by Black, *supra* note 3, at 575-91.

31. For introductions, see generally WILLIAM H. RIKER, LIBERALISM AGAINST POPULISM (1982) (arguing that social choice by voting leads to inconsistency because

the number of issues expands, the chances of "cycling" under a system of majority rule becomes very great. "Cycling" refers to a process in which each option selected by majority vote is in turn defeated by another option preferred by another majority coalition. The pessimism is most fully expressed by the Arrow Impossibility Theorem, which shows that a restricted set of conditions for a normatively desirable social choice mechanism cannot be generated through a democratic voting process. The theorem indicates that the electorate will have to choose between "rationality" — making choices in a consistent manner so that if x is preferred to y, and y to z, then x will be preferred to z — and "dictatorship" — meaning that one actor's preferences determine the outcome. Armed with this insight, political scientists have focused attention on institutions that structure social choice, observing in particular the importance of agenda influence on ultimate outcomes. The most astonishing result is this: a party with control over the agenda and with knowledge of the preferences of the other parties can generate virtually any outcome he wishes despite a majority voting process.[32]

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different voting procedures produce different results even though preferences remain same; voting process may be manipulated by strategic voting, agenda arrangement, and vote trading); DENNIS C. MUELLER, PUBLIC CHOICE II 43-122 (1989) (indicating that, under theory of public choice, outcomes of various voting rules may be arbitrarily determined by institutional details or nonarbitrarily determined by cunning agenda setter); PETER C. ORDESHOOK, GAME THEORY AND POLITICAL THEORY 53-96 (1986) (stating that since manipulation and strategy are pervasive in voting, social outcomes follow from individual preferences in complicated fashion). A helpful sketch of this and other public choice literature is provided by DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE 47-56 (1991) (suggesting that older conclusions regarding instability and incoherence resulting from voting procedures are inconsistent with observations in recent public choice literature, and that various institutional features of legislatures may indeed promote stability and coherence). Much of what follows in the text is based on these works; specific citation will be omitted.

For an interesting application of social choice theory to explain the costs of so-called stakeholder or constituency laws for the public corporation, see William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 419-24 (1990) (arguing that managers will use agenda control over presentation of proposals to contending factions to obtain outcomes favoring itself). For representative application of the theory in the constitutional realm, *compare* Frank Easterbrook, *Ways of Criticizing the Court*, 95 HARV. L. REV. 802 (1982) *with* Lewis A. Kornhauser & Lawrence G. Sager, *Unpacking the Court*, 96 YALE L. J. 82 (1986). For a critical discussion of the general approach, see Richard H. Pildes & Elizabeth S. Anderson, *Slinging Arrows at Democracy: Social Choice Theory, Value Pluralism, and Democratic Politics*, 90 COLUM. L. REV. 2121 (1990).

32. *See* Richard D. McKelvey, *Intransitivities in Multidimensional Voting Models and Some Implications for Agenda Control*, 12 J. ECON. THEORY 472 (1976) (using Euclidean example to prove that social outcome can be manipulated through agenda control). This result depends on participants voting their true preferences in a series of pair-wise comparisons of choices. If the voters are "sophisticated" — that is, misstate their true preferences in anticipation of the consequences — then the agenda setter's absolute power can be avoided. *Id.*

What is the relevance of these observations for shareholder voting in corporate law? It is that the institutions of shareholder voting matter greatly and may indeed be outcome determinative.[33] In one sense this is no surprise; the influence of management agenda control is a staple of strategic analysis of control contests. But these insights also help us to understand *why shareholders are not permitted to vote* in most circumstances. At one level, the absolute delegation rule could be understood as a selection of term-limited dictatorship to avoid the economic losses of inconsistent choices that would result from shareholder voting. But there is another level: the rule may control potential misbehavior by shareholders acting individually, not collectively. Shareholder voting on per share, not per capita basis means dominant coalitions will be formed by shares, not by holders. This means that shareholder voting, if given unrestricted domain, could easily become the means of promoting corporate policies that maximize private gains rather than common gains.[34] That is, in pursuit of their economic interests, shareholders would push for corporate action that maximized the sum of their individual wealth and shareholder wealth, rather than shareholder wealth alone. But this would undoubtedly lead to a less productive corporation overall. Following the backwards induction taught by game theory, we can see how institutional structures arose that would exclude shareholder voting in most situations, in particular, that would bar shareholder initiative.

A. Cycling as a Problem

This thumbnail sketch might be illuminated by an example. In the USX case noted above, let us assume that there are three large shareholders, Ucahn, Dickens, and Muffett, each of whom owns

33. This is parallel to explanations that political scientists offer for stability in the legislative process rather than cycling among various proposals; the equilibrium is "structure induced" rather than "preference induced." The most important such structure in the legislature is the committee system; in the corporation, it is the board. *See, e.g.*, Kenneth A. Shepsle & Barry R. Weingast, *Structure-induced Equilibrium and Legislative Choice*, 37 PUB. CHOICE 503 (1981) (arguing that restrictions placed on pure majority rule promote structure-induced equilibrium); Kenneth A. Shepsle, *Institutional Arrangements and Equilibrium in Multidimensional Voting Models*, 23 AM. J. POL. SCI. 27 (1979) (arguing that institutional structure and distribution of preferences co-determine characteristics of equilibrium states of collective choice processes).

34. Voting by shares rather than holders reduces the coordination problems that would otherwise make action by widely dispersed shareholders of disparate views more difficult. For example, assume a firm with 1,000,000 shares where shareholders *A*, *B*, and *C* each hold 20% of the stock. Voting per share greatly increases the chance of private gain seeking by the *A-B-C* coalition versus a regime of voting per holder, in which *A*, *B*, and *C* need to attract the support of a majority of holders, including many small holders.

26% of the outstanding stock of USX. Each of them has a different opinion about what to do with the steel business, but all three have as their objective to maximize the value of USX stock. Assume that there are three viable business options: a spinoff of the steel business to present USX holders; sale of the steel business; and retention of the steel business, the status quo. Ucahn's first choice is the spinoff, which lets each shareholder choose whether to hold the stock or dispose of it. Her second choice is to sell the steel business, on the argument that USX is most highly valued as a "pure play" and that shareholders who want steel represented in their portfolios can acquire steel stocks in the market. Dickens' first choice is to sell the steel business to raise cash for other energy investments. Unless USX can sell at an attractive price, however, he would prefer to maintain the status quo rather than simply spin off the steel business to shareholders. Muffett's first choice is to keep the present USX intact, because he believes the business is well run and he has confidence in the present strategy; otherwise he would never have invested. If steel is to be divested, however, he would prefer a spinoff rather than a sale, because he likes the shareholder hold-or-sell option and because he is concerned that USX management might squander the cash on wasteful energy investments. The preferences, or judgments,[35] of the three can be described by the following table:

Ucahn	Dickens	Muffett
Spinoff	Sale	Status quo
Sale	Status quo	Spinoff
Status quo	Spinoff	Sale

Inspection of the table reveals a serious problem: spinoff defeats sale; sale defeats status quo; but status quo defeats spinoff. In pairwise majority rule voting none of the choices commands a stable majority.[36] Were shareholder initiative available in unrestricted form, it is easy to imagine a destructive cycle arising at two possible stages, the proposal stage and the implementation stage. Ucahn proposes a spinoff, which prevails on a majority shareholder vote, but Dickens thereupon proposes a sale, which then wins, but subse-

35. Voting in the political science models is taken to aggregate "preferences," which are not required to be rationally based (so long as preference orderings are consistent). Shareholder voting will aggregate judgments about wealth maximization and ought to be rationally based, hence "judgments." But throughout the rest of the text, "preference" is used to follow the convention. Finance sophisticates may at this point ask where do these different judgments or preferences come from, given that shareholders in a complete market will have the same objective: to maximize the value of the firm's shares. This point is addressed at text accompanying notes 48-49 *infra*.

36. This cycle is a classic Condorcet paradox.

quently loses to Muffett's proposal to retain the status quo and so on. The corporation risks paralysis in the face of this cycling, which reduces its value to shareholders who also face the deadweight costs associated with successive proxy battles.

On a somewhat different set of facts, one could also imagine a cycle at the implementation stage. Assume a similar disagreement among shareholders on the benefits of diversification at the firm level. One shareholder majority favors diversification, which the firm undertakes, but another majority can be assembled of shareholders who oppose either the particular diversification or diversification generally. This second majority insists on a transaction substantially reversing the first. Yet a third majority will insist on yet another course. These successive actions consume real economic resources and reduce the value of the firm.

It would be a mistake to focus on the USX example too literally. It vividly illustrates a problem, but its assumptions can be relaxed. For instance, instead of three shareholders, we imagine that within the shareholder body there are general positions represented by the views of Ucahn, Dickens, and Muffett. Moreover, the example presents a genuine cycle, which has especially nasty properties, but the significant disruption would arise from a series of shareholder votes that lead in inconsistent directions but are not, strictly speaking, a cycle. The array of preferences that produce this result is far less restrictive.

The absolute delegation rule is one way to avoid the destructive effects revealed in the cycling example, and, more generally, the costs of inconsistent plans adopted through shareholder voting. On the assumption that shareholders would foresee the cycling possibilities and other inconsistencies that would emerge from shareholder initiative, adoption of the delegation rule would increase the *ex ante* value of the firm.

B. Preliminary Objections

This argument warrants testing from many directions, in particular, the possibility of alternative rules, the nature of shareholder expectations, and the likelihood of cycles in shareholder voting. Alternative rules that preserve the key element of shareholder choice yet avoid the risks of cycling may be impossible to devise. For instance, consider a rule under which shareholders submit proposals but then management sets the agenda. Inspection of the USX hypothetical reveals that control over the agenda amounts to control over the outcome. Any particular result — spinoff, status quo, and sale — can be obtained, depending on the order of presen-

tation coupled with some notion of *res judicata*. In other words, if the goal is to give shareholders some ready way to overcome a managerial policy, a rule that "merely" gives managers agenda control would produce the same outcome in most cases as the absolute delegation rule, while imposing the additional costs of voting.[37] In cases in which managerial agenda control falters, for example, upon a division in management ranks, the cycling possibility remains open.

Why would shareholders with rational expectations fall into a cycling dilemma? That is, why would shareholders not simply follow management's advice in voting on shareholder initiatives to avoid the foreseeable cycling possibility? A number of factors militate against the sustainability of such a rule of deference: cycling arises only on particular structures of shareholder preferences, which would exist only episodically; shareholders would ordinarily not know the potential for cycling before they voted;[38] in situations without cycling, a deference rule is costly for shareholders who believe the shareholder initiative presents a better decision for the firm. Thus shareholders who favored the initiative would defect from a default rule of deference. A second reason derives from the sequential nature of the play. Even assuming that the shareholders knew of the possible existence of a cycle, they would also know that if they succeeded with a shareholder initiative, it would increase the likelihood that their preferred alternative prevailed. This is because the next possible shareholder proponent may calculate that she loses more from a possible cycle than her own initiative. The net effect will be to make a simple rule of deference to management impossible to sustain. A legal rule like absolute delegation will be necessary to avoid initiatives.

How likely is cycling in shareholder voting? In the USX hypothetical, the cycle arises only because of particular, and perhaps unusual, array of preferences. A rare phenomenon is unlikely to explain such a strong limitation on shareholder power. The likelihood of cycling may be significantly affected by the number of dimensions of shareholder choice. If the "policy space" of shareholder choice has only a single dimension, cycling would be relatively rare, assuming shareholders voted rationally. If, however, the policy space has sev-

37. For elaboration of the importance of agenda control, *see generally* Michael E. Levine & Charles R. Plott, *Agenda Influence and Its Implications*, 63 VA. L. REV. 561 (1977).

38. On the other hand, the circumstances where disagreement with management is sharp enough to generate a shareholder initiative are likely to trigger pre-vote consultations among shareholders that might reveal the possibility of a cycle.

eral dimensions, the chances of a cycle, even for a small number of shareholders, is high.

Let us put this abstract proposition in terms of the USX hypothetical. Assume that shareholders are permitted to vote on the unbundling of steel and oil, but that the only factor relevant to the choice is the shareholder's attitude toward conglomeration — that is, diversification at the corporation level. This is an example of a one-dimensional policy space. In this case, a shareholder vote will lead to disposal of steel assets, whether by spinoff or sale, but not the status quo, because a clear majority favors a solution that would reduce conglomeration.[39] Assuming that the proposals were now mapped on this single dimension of conglomeration, in almost all cases a unique outcome would be given by the preferred degree of conglomeration of the median voter.[40]

However, the original hypothetical suggests that there were at least two dimensions that affected a shareholder's vote: not only her views of conglomeration, but also her attitude toward management's autonomy in disposing of the steel assets, including application of potential proceeds. Should shareholders have the choice over ultimate disposition (the spinoff) or should management (the sale)? The cycle is generated when this second dimension is added.[41] In other words, as the number of dimensions of shareholder choice increases, the chance that the diversity of preferences will produce a cycle becomes increasingly large.[42] The number of rele-

39. *See* table at text accompanying notes 35-36 *supra*. For ease of exposition, the hypothetical simplifies several issues of importance. It may not be the case, for example, that the preference profiles in the table translate into a majority against conglomeration. All we really know is that Dickens disfavors conglomeration, conditional on disposal by a sale. More generally, the hypothetical raises the question of the nature of the voting mechanism in use. At the time the shareholders vote on "conglomeration," do they understand the voting procedure and the full set of choices?

40. For example, assume that 'status quo' entailed greatest conglomeration, 'sale' an intermediate amount (because of the possibility of a subsequent conglomerate acquisition by USX with the proceeds), and 'spinoff' the least. Assume that Ucahn, Dickens, and Muffett had "single-peaked" preferences on the conglomerate dimension; i.e., given a particular taste for conglomeration, they would rank the choices in the same way. (This is usually the case for rational actors.) Then a unique solution would emerge that would represent the preferences of the median voter. So if Ucahn strongly disfavored conglomeration, Dickens was somewhat opposed, and Muffett in favor, the winning choice under a simple majority vote would reflect Dickens' preferences, as the median voter.

41. This dimension might actually be separated into several other dimensions of choice, including shareholder attitudes about agency problems in the particular firm, alternative potential investments by the firm, and alternative potential investments by the shareholder.

42. For a table describing the likelihood of a cycle as an increasing function of the number of alternatives and number of voters, see ORDESHOOK, *supra* note 31, at 58

vant dimensions in a corporate decision is in fact very high. Consider the price issue, for example: along a continuum of possible sale prices, shareholders might have different judgments about disposing or holding steel assets, and if disposing, through which technique.[43]

There is another way to think about the cycling problem. One of the teachings of public choice theory is that a party who might lose on a particular vote may introduce a new dimension of choice to try to shift the outcome. In the legislative arena, this is the so-called "killer amendment" that successfully splits the constituency for a bill so that the status quo, initially the choice favored only by a minority, will prevail.[44] The killer amendment succeeds by revealing a new dimension of choice that creates a cycle. The cycle does not fully manifest itself in the legislative arena because of parliamentary rules that limit the order of presentation and privilege of the status quo.[45]

The USX hypothetical shows similar possibilities for strategic behavior in the corporate arena that would lead to cycling in the absence of structural restraints like the absolute delegation rule.

(arguing that adding dimensions will increase the number of alternatives). Critical to the cycling argument is significant heterogeneity among voters. If voters have identical tastes, then their preference profiles will be the same despite the addition of new dimensions and a cycle will not arise. The standard assumption in the political science literature is that preferences are randomly distributed among voters. Thus the likelihood of cycling — i.e., the percentage of voter preference profiles in a given population that will produce a cycle — is an increasing function of the number of voters and the number of dimensions. By contrast, the standard assumption in the finance literature is that shareholders have identical preferences, which would eliminate the threat of cycling. This argument about "shareholder unanimity" is discussed below.

43. For example, USX Chairman Charles Corry apparently favored selling USX's steel assets in 1988, but was overruled by then chairman David Roderick. By the time of Icahn's 1990 shareholder proposal, Corry had changed his mind, because of a much lower expected sale price. *See* Thomas F. O'Boyle, *Icahn Forces the Issue at USX: Is it Time to Get Out of Steel?*, WALL ST. J., March 9, 1990, at A1.

44. Riker gives an example of proposed legislation to provide federal aid to education in the 1950's, where the proposed amendment would have limited payouts to states deemed in compliance with Brown v. Board of Education, 347 U.S. 483 (1954). (The amendment was proposed by Rep. Adam Clayton Powell (D. N.Y.)). Given the alignment of factions, those who favored the status quo were able to kill the legislation by strategic voting (i.e., by misstating their preferences rather than voting sincerely). They voted with those whose first choice was the bill as amended, knowing that Southern Democrats who supported federal school aid but were even more strongly opposed to desegregation would defect from the amended bill. Thus the status quo prevailed, despite a clear majority in favor of the original bill. In other words, the party who would lose on the single dimensional question of whether the federal government should provide aid to education generated a cycle by injecting a new dimension of choice, school desegregation. *See* RIKER, *supra* note 31, at 152-56.

45. *See* Saul Levmore, *Parliamentary Law, Majority Decisionmaking, and the Voting Paradox*, 75 VA. L. REV. 971, 986 (1989).

Assume that Ucahn put a very simple proposal to USX shareholders: USX should dispose of the steel business. Assume that a majority of shareholders favors this proposal and that it will pass. Muffett, who favors the status quo, makes a new proposal or amends the original proposal to dispose of the steel business through a spinoff. This injects into the shareholder choice process a second dimension, the issue of management autonomy in disposing of the proceeds. If we assume the preference profiles as described above, spinoff defeats disposal by sale (the alternative), assuming all parties vote sincerely, but then status quo defeats spinoff. In theory the cycle can repeat itself indefinitely, assuming that the shareholders retain their preference rankings and continue to vote sincerely. But of course we do not see evidence of such cycles in corporate behavior and the costly instability that would result, any more than we see cycles in legislative action. This is because we have adopted institutions that restrict choice. For corporations, these institutions are the various rules that give the board authority to act and to set the agenda even on matters that go to the shareholders,[46] and that otherwise constrain shareholder initiative. In other words, the equilibria we see in the on-going governance relationship between the shareholders and their agents, the managers, may be "structure-induced" rather than "preference induced."[47] The absolute delegation rule may be understood as part of that structure.

In examining the plausibility of cycling as a serious problem in corporate law, we have made the simplifying assumption that each shareholder is acting for the common goal of shareholder wealth maximization, rather than the maximization of private wealth. A simple example shows how quickly cycling can emerge if that assumption is relaxed. Assume a specific amount of money must be divided among *A*, *B*, and *C*. *C* proposes a 50-50 split with *A*, leaving *B* out; *B* proposes a 40-60 split with *A*, leaving *C* out; *C* proposes a 50-50 split with *B*, leaving *A* out. Each proposal obtains majority approval over the previous one. Shareholder initiative obviously opens the way to vote-trading among shareholders over pie-splitting issues in ways that may be very difficult to police. Cycling is one

46. On the matters that the board must submit to shareholders, such as approval of a charter amendment or a merger proposal, the vote is a pairwise comparison between the board-approved alternative and the status quo. Shareholders do not have the opportunity to amend the proposal. This undoubtedly permits opportunistic behavior by managers, *see, e.g.*, Gordon, *supra* note 19, at 1577-78 (discussing sweeteners and "chicken" tactics), but does eliminate the possibility of cycles.

47. The concept of a "structure-induced equilibrium" as opposed to a "preference based equilibrium" is drawn from the political science literature. See discussion *supra* note 33.

danger that emerges when private wealth maximization is considered; other dangers are discussed below. The absolute delegation rule restrains the expression of private wealth maximization, along with divergent judgments about common wealth maximization, and thus avoids cycling.

C. *Finance Theory Objections*

Cycling depends upon voters having different preferences (or judgments). A common assumption in the finance literature is that shareholders have the same preference, namely, the maximization of shareholder wealth, expressed through the share price. This of course excludes the possibility that shareholders will receive investment returns from individual gains rather than common shareholder gains. More importantly, it also means that differences in shareholder time horizons, risk preferences, and beliefs about future states of the world are irrelevant to the choice of the firm's investment projects and strategies. Shareholders want one thing, the same thing — the maximization of share price. Thus the basis for shareholder disagreement is substantially eliminated. There is no potential cycling problem.

This argument for "shareholder unanimity" is complicated and depends crucially on the existence of "complete markets" that "span" relevant contingencies.[48] For example, suppose shareholder *A* needs a payout in period one, but the project that will maximize the share price pays out in period two. Rather than vote for a lower valued project with an earlier payout, in a complete market the shareholder can borrow in period one and repay in period two with firm's period two payout, or sell in period one all or part of her holdings in the stock at the price that reflects the advantage of the project with the period two payout. Alternatively, assume shareholder *B* is risk averse but the project that maximizes shareholder value is risky. Rather than vote for the less risky project, in a com-

48. For a discussion of shareholder unanimity theorems, *see, e.g.*, Harry DeAngelo, *Competition and Unanimity*, 71 AM. ECON. REV. 18 (1981). It is possible to generate a system in which spanning is not necessary for unanimity. *See* Louis Makowski & Lynne Pepall, *Easy Proofs of Unanimity and Optimality Without Spanning: A Pedagogical Note*, 40 J. FIN. (1985). *But see* Louis Makowski, *Competition and Unanimity Revisited*, 73 AM. ECON. REV. 329 (1983) (arguing that spanning is necessary to guarantee unanimity if short sales are permitted); S. Ingersoll, *Spanning in Financial Markets*, *in* 1 THEORY OF VALUATION: FRONTIERS OF MODERN FINANCIAL THEORY 27 (Sudipto Bhattacharya & George M. Constantinides eds., 1989).

Another way to describe shareholder unanimity theorems is that they describe the conditions under which all shareholders derive the same utility from decisions of the firm, for example, the conditions under which the risk averse shareholder experiences utility changes identical to the risk neutral shareholder.

plete market the shareholder can reduce risk to the desired level through diversification or by buying and selling a combination of put and call options that reduce risk. In other words, a complete market permits a shareholder to construct his preferred synthetic security around the actual security, whose value he will therefore want to maximize.

In a third case, assume shareholder *C* believes that a particular state of the world will be realized, although the projects that maximize the share price depend on the realization of a different state of the world (that is, most people disagree with *C*). For example, assume *C* believes in global warming, but most do not, so that the maximizing decision for USX in planning a new facility is not to pursue an expensive new technology to reduce CO_2 emissions that would be optimal if global warming occurs. In a complete market, *C* can sell her USX stock and purchase a security of similar payoff and risk characteristics, or construct a synthetic security with high payoff upon global warming to hedge losses in USX, or sell USX short against the subsequent price drop that she anticipates.

Shareholder unanimity fails as an antidote to cycling for two reasons: first, the incompleteness of present markets and second, agency costs. Shareholder unanimity would require frictionless movement among financial claims that is not now possible: parties cannot borrow at the risk free rate, so as to smoothly shift payouts between periods; transaction costs for the purchase and sale of securities are positive and significant; short selling is relatively complex, illiquid, and expensive; and synthetic securities to equalize payouts in all states of the world to accommodate different risk preferences or beliefs about the future are expensive to construct and also present liquidity problems. Markets are not complete and thus shareholders may disagree about the objective of the firm.

The problem of agency costs also explains why shareholders may disagree. The finance account of shareholder unanimity assumes that managers will undertake measures to maximize shareholder value.[49] Indeed, on this account, shareholder voting is unnecessary because even if shareholders disagree with the firm's business decisions, they can use markets to protect themselves and still profit. But managers are not always faithful agents. They may pursue projects, such as diversifying acquisitions, that may increase their

49. In truly complete markets, where securities representing all states of the world were available, then shareholders could hedge even against managerial self-dealing. Since managers are unlikely to sell shares in their gains from misappropriation, however, markets will not be complete in this respect. *See* Gordon, *supra* note 19, at 1595.

welfare at the expense of shareholders, and, similarly, may hold onto office despite evidence that their business judgment is inadequate. Shareholder voting is therefore necessary. With it will come disagreement about whether managers have acted to maximize shareholder value, including whether bad outcomes resulted from managerial incompetence or bad luck in the realization of plans that were *ex ante* optimal.[50]

Thus, the risks of cycling in shareholder voting are real and costly, and the adoption and the maintenance of the absolute delegation rule can be understood as a structure that produces a consistent corporate policy. The agency costs thereby entailed are less than the costs of voting pathologies.

D. Institutional Objections

Now it is time to address four institutional objections to the cycling explanation for the shareholder delegation rule: close corporations, boards of directors, proxy battles for control, and the transaction costs of shareholder initiative.

1. Close Corporations

Shareholders typically have much greater latitude for initiative in the close corporation than in the public corporation. A cycling story would predict otherwise, since the opportunities for shareholder exit and adjustment through markets are much reduced (that is, the unanimity conditions are less likely), and thus conditions for intracorporate shareholder disagreement are greatest. Indeed, corporate deadlock is a not-infrequent and very costly outcome in close corporations that might be avoided through an absolute delegation rule, if cycling were the core problem. This objection, however, does not take account of the key organizational difference between

50. Thus, agency costs play a crucial role in rebutting two major separation theorems in modern finance. The first is the separation of the firm's financing decisions from shareholder wealth maximization, that is, the Modigliani-Miller hypothesis that the choice between debt and equity is irrelevant to the value of the firm. Jensen and Meckling, *supra* note 28, showed how the effort to control agency costs dramatically affects the firm's financing decisions and thus why the irrelevancy hypothesis (or the first separation theorem) fails.

The second theorem entails the separation of the firm's operational decisions from individual shareholder goals and beliefs. Shareholder objectives are irrelevant to the operation of the firm because managers will pursue the only objective that matters, the maximization of share value. Shareholders can do nothing with respect to the running of the firm that will make them better off. The existence of agency costs, however, gives shareholders an important role and is a source of disagreement among shareholders rather than unanimity. In other words, the persistence of voting in corporate law is itself a rebuttal to shareholder unanimity theorems.

the close corporation and the public corporation. There is typically little or no separation of ownership and control in the close corporation; the roles of shareholder and manager are intermingled. Thus an absolute delegation rule that may have significant utility for public corporations would not for close corporations. Cycling in the decisionmaking process of a close corporation, whether at the shareholder or board level, is indeed a real problem, which is why potential participants ought to assure themselves that they share most beliefs about the business. This may limit the participants in any particular close corporation and may explain one advantage of the public corporation, which can gather funds from participants of divergent beliefs.

2. Boards of Directors

Even if shareholders do not vote, boards do. If cycling were a problem, why would it not appear at the board level, and why would there not be institutions that limit director voting? One answer, of course, is that there are many such institutions, which operate to make it very likely that directors will have common views on business matters and thus try to exclude the preference arrays that could give rise to cycling. One example is the demise of cumulative voting, which once was a traditional element of mandatory corporate law.[51] Most states have made cumulative voting optional and most public corporations have eliminated it, on the argument that the representation of minority views on the board reduces corporate effectiveness.[52] An even more powerful influence for the relative ho-

51. *See* HENN & ALEXANDER, *supra* note 7, § 189, at 495-97.

52. *See, e.g.*, Charles W. Steadman & George D. Gibson, *Should Cumulative Voting Be Mandatory?: A Debate*, 11 BUS. LAW 9 (1955); Sanjai Bhagat & James A. Brickely, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339 (1984) (pointing out average 1.5% drop in share price upon elimination of cumulative voting, suggesting value of minority directors). The federal proxy rules add to the difficulty of obtaining minority representation on the board. A shareholder cannot undertake a proxy solicitation for a slate that mixes management director nominees with alternative nominees, because of the requirement in Rule 14a-4(d) of director consent to being named in any proxy statement that solicits for her election. Thus the dissident who seeks minority representation must go forward with a partial slate. In addition to the mechanical difficulties for shareholders who need to deal with two proxy cards in order to vote for a combined slate, there is a vote aggregation problem that can result in the failure of the minority slate even where it attracts support from a majority of shareholders. Assume, for example, a ten person board for which the dissident proposes three minority directors. Assume 30% vote for the minority slate alone, 40% vote for the management slate, and 30% vote for the three minority directors and seven directors randomly selected from the management slate. Although a majority apparently favors minority representation, none of the dissident directors is elected. Each management nominee receives 61% of the vote (40% + .7(30)), which prevails over each minority director, who receives 60%. These problems are discussed in

mogeneity of director views has been the means of director recruitment. Inside directors are generally chosen by the chief executive officer and are beholden to him for career advancement. Outside directors are frequently chosen by the chief executive officer directly or by a committee over which he has significant influence. Moreover, outside directors who disagree with the CEO typically leave rather than fight. Finally, even assuming heterogenous preferences, the small group dynamics of a board make cycling less likely. The directors can quickly see the evidence of a cycle and its consequence; they are engaged in repeat play, so that destructive behavior can be retaliated against and cooperation rewarded. Directors also have reputations in the broader business world that are at risk and their boardroom behavior can be reported upon.

3. Proxy Battles For Control

Although shareholders may not vote on specific business matters as such, they can vote for a new set of directors who could implement a desired plan. Combining the shareholder power to remove directors at will with the shareholder prerogative to elect directors could easily accomplish the goals of any particular shareholder initiative. Cycling could as easily occur in elections as with initiatives, goes the argument, yet elections are permitted; how then can cycling have explanatory force? In response, note first the institutional structures that constrain director elections. Normally, elections occur only annually, which would make for a slow moving cycle. Removal at will, which could lead to more rapid elections, can be limited under state corporate law by classifying by the board, or, in certain respects, by cumulative voting.[53] Classification of the board through charter amendment is a common defensive tactic adopted by many public corporations.

Even more significantly, election of new directors is far more drastic than shareholder adoption of a specific business plan through shareholder initiative, entailing a very different cost/benefit calculation for shareholders. The risks of a control shift, including but not limited to the potential opportunistic motives of the insurgent, mean that election contests waged to implement a particular business strategy will rarely succeed. By contrast, shareholder initiative operates as a commitment strategy which permits the proponent to assure shareholders of a limited objective whose value they

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Ronald J. Gilson et al., *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing Minority Directors* (mimeo Dec. 1991) (on file with author).

53. DEL. CODE ANN. tit. 8. § 141(k) (1983); REV. MOD. BUS. CORP. ACT § 8.08(c) (1984); N.Y. BUS. CORP. L. § 706(c) (Consol. 1991).

can more easily calculate. Thus shareholder initiative will be far more attractive to shareholders than an election contest, and thus could present a cycling problem even though election contests do not.

There is a more general way to put the objection raised by this section. How can the existence of shareholder vote on important matters such as director elections, charter amendments, and certain fundamental corporate changes be squared with a concern for cycling? Why not just eliminate shareholder voting altogether? The answer is on three levels. First, the case for shareholder voting on these matters is compelling whereas the case for shareholder initiative is not. Director elections provide some minimally necessary check on managerial performance; voting on charter amendments protects shareholders against midstream opportunism by managers or other shareholders; voting on fundamental corporate changes limits managerial opportunism in a "final period," when management faces the temptation to favor itself at the expense of shareholders in a transaction with another corporation that will be the survivor in a business combination. By contrast, shareholder initiative may well reduce agency costs but is not essential to protect against director misfeasance or opportunism. Second, the shareholder voting that exists is hemmed in by rules that have the effect, if not the design, of eliminating cycling. Management presents charter amendments and merger proposals for a shareholder yes/no vote; counterproposals are not permitted; cycling cannot arise. Elections are structured to occur infrequently, making cycling less likely.

Finally, as argued above, shareholder initiative invites cycling in ways that other moments of shareholder voting would not. Because it permits an apparently low-stakes, focused struggle over particular business matters, as opposed to the general operation of the firm, shareholder initiative will seem an attractive vehicle for shareholder expression and thus cycling is more likely to arise in this context. In other words, shareholder voting has costs, of which the potential for cycling is one, along with the benefits. The institutions of corporate governance can be thought of at least in part as a mechanism for maximizing the net benefits of shareholder voting. This may produce limitations on shareholder voting in certain circumstances.

4. Transaction Costs Of Shareholder Initiative

The argument thus far has been that the expression of shareholder preferences over the firm's business strategies would reveal cycles that the absolute delegation rule usefully suppresses in the

name of shareholder wealth maximization. In a sense the argument has assumed minimal transaction costs to the mounting of a shareholder initiative. But of course transaction costs are significant; what does this do for the relevance of the cycling argument?

First, if corporate shareownership is in the hands of large shareholders, the potential gains to a particular shareholder or group from a shareholder initiative may well outweigh the transaction costs. It is easy to imagine that different shareholder groups could have different beliefs about the means of maximizing shareholder value. An increase in the concentration of shares — for example, through an increase in institutional holdings — may well reduce the transaction costs of concerted activity, including shareholder initiative.[54] But the relevance of cycling does not depend on the empirical question of whether a particular pattern of shareownership that we now observe raises or lowers a transaction cost barrier. The distribution of ownership will be endogenous to the rules that govern shareholder expression. For example, the present pattern, in which it is common for large public firms to have one large shareholder but not two or three,[55] may be partially a function of the present restrictions on shareholder voice. The first-arriving large shareholder has a great advantage in influencing management (indeed, may have installed the management). Other potential large shareholders will be discouraged by the minimal remaining role for influence over the firm's business decisions under the present regime of the absolute delegation rule and will choose a diversification strategy. But, shareholder initiative, which opens the way for competing influences, could change the pattern of share ownership. A rule that permits shareholder initiative may help give rise to the circumstances in which it produces pathological results.

A second way to make this point is this: assume that shareholder initiative can lead to undesirable cycling in certain circumstances. Is it sufficient to rely on the transaction costs hurdle as protection against this undesirable outcome, or should there be a rule — the absolute delegation rule — that offers protection across a broad range of possible transaction costs? Transaction costs are a function of share distribution, which can change. A rule is not sensitive to this specification.

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54. *See* Bernard S. Black, *Agents Watching Agents: The Promise and Limits of Institutional Shareholder Voice*, UCLA L. REV. (forthcoming, 1992).

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

PRIVATE GAINS AND VOTING PATHOLOGIES

Thus far we have generally assumed that shareholders agree on the goal of shareholder wealth maximization but disagree about the means of attaining it. Even on this favorable assumption, shareholder initiative holds the potential for a wealth-reducing shareholder voting pathology — cycling — that would be eliminated by an absolute delegation rule. Once the assumption of a common shareholder goal is relaxed, however, the pathological possibilities of shareholder initiative become more evident. The threat arises along two different dimensions. The first is in respect of bargaining among shareholders, in which shareholders trade for private gains at the expense of common gains. The second is in respect of bargaining between shareholders and managers, in which specific shareholders and managers can trade for private gains at the expense of common shareholder gains. In each case, shareholder initiative opens new possibilities for transactions that reduce the value of the firm.

At this point the different shareholder objectives in share ownership should be more carefully described. The most important dichotomy arises between "private wealth maximization" and "common wealth maximization." "Common wealth" refers to returns in respect of share ownership, typically through dividends or an increase in share price — gains common to all shareholders. This is what we customarily think of as "shareholder wealth." "Private wealth" is the sum of "common wealth" and "individual wealth," where "individual wealth" is defined as returns in respect of one's transactions with the firm or externalities derived from the firm's behavior. More broadly, private wealth refers to the sum of returns (i) as shareholder and (ii) as party with other relations with the firm. So, for example, a manager might pursue private wealth maximization by seeking a larger salary, even though that would fractionally reduce the value of her stock; the increased individual returns outweigh the reduced common returns from the firm. Similarly, a shareholder might prefer that the firm not locate a warehouse beside his country house, even though the alternative site is more expensive and will reduce share values; his individual loss from the firm's location decision exceeds the common gain from the optimal location decision. Both of these examples are cases where a shareholder, if given power, would pursue private wealth maximization rather than common wealth maximization.[56]

56. Even "common wealth" is not a pure category. If the conditions for unanimity hold, then all shareholders pursuing returns only in respect of their share ownership

One important benefit of the absolute delegation rule is the way it limits shareholder action to obtain individual returns, rather than common returns, from the firm. If policing shareholders' self-seeking activity is difficult and costly, and if the potential for reducing agency costs by means of shareholder initiative is low, then the benefits of an absolute delegation rule may well outweigh its costs.

A. Private Gains: Bargaining Among Shareholders

Shareholder initiative creates an opportunity for shareholders to pursue private wealth maximization through bargaining with other shareholders. This reduces the value of the firm in three ways. First, shareholder coalitions may form through side payments or reciprocal arrangements that result in the firm adopting suboptimal projects. Second, shareholder bargaining may lead to costly delay. Third, the opportunity to pursue private gains will further undermine shareholder unanimity and increase the likelihood of cycling. An absolute delegation rule avoids all these problems.

1. Suboptimal Projects

The way in which shareholder initiative could foster adoption of suboptimal projects can be illustrated with a simple example. Assume shareholders Hockney and Stella each hold 25% of the voting stock of Omega Corp. Omega is planning to open a plant employing several thousand workers in Cincinnati with annual expected earnings of $10 million. Hockney owns a chain of retail stores in Sacramento, and if Omega located the plant there, the business from the plant's workers would generate additional annual earnings for Hockney of $750,000. Sacramento is not best for Omega because of the greater distance from its primary markets, which adds significant transportation costs and reduces annual earnings to $9 million. Hockney clearly would prefer the Sacramento location, since his $750,000 gain as a retailer exceeds his $250,000 loss as a shareholder.[57] With only 25% of the vote, he obviously would not succeed in a shareholder initiative that called for a plant in Sacramento. But if he makes a side payment to Stella of more than $250,000 (Stella's loss on the Sacramento location), Stella should cast his vote with Hockney and the initiative should succeed. Obviously shareholder wealth has not been maximized; indeed, total

should desire the same goal — share price maximization. But if unanimity does not hold, then private objectives may influence shareholder goals, even when all returns are in respect of share ownership.

57. Hockney's loss is 25% of $1 million.

wealth has not been maximized, since Omega's loss exceeds Hockney's gain.

As an alternative to a direct side payment, Hockney could agree to support a subsequent shareholder initiative with individual returns to Stella (assuming commitment problems could be solved) or present a single initiative that packaged proposals that benefitted each. A more complicated scenario would entail Hockney's assembling a majority shareholder coalition in support of an initiative through a combination of side-payments and other projects with significant individual returns for other shareholders. These sorts of arrangements, like log-rolling in the political arena, are objectionable because they may impose externalities that reduce the common welfare. In the Hockney-Stella hypothetical, the reduction in total wealth was borne by non-participating shareholders. Political log-rolling has some virtues, because it can reflect intensities that are not captured by simple voting; it is possible to construct both welfare-enhancing and welfare-decreasing hypotheticals of vote trading.[58] By contrast, log-rolling in shareholder voting seems indefensible, because intensities can be monetized through side-contracts with the firm. So, for example, if the gains to Hockney from the Sacramento location outweighed the loss to the firm, Hockney could compensate the firm directly; Hockney undertakes the logroll precisely in circumstances where the gains would not be compensatory.[59]

The possibility of shareholder rent-seeking presents itself even in a firm with a widely dispersed shareholder body. For example, assume a majority of shareholders of a pharmaceutical firm are over sixty years old and the shareholder initiative concerns a negative net present value investment in a company that is developing a drug with some promise of lengthening life span. Virtually anytime a substantial portion of the shareholders presents a distinct unity of interest on some dimension, there is positive probability of its expression in a shareholder initiative. Even if success is not likely in firms with many shareholders, the opportunity may well change the pattern of share ownership. There will be additional returns to concentrated ownership versus diversification.

The particular examples are less important than this point. Shareholder initiative opens the way to shareholder pursuit of indi-

58. *See* MUELLER, *supra* note 31, at 82-86 (summarizing literature); RIKER, *supra* note 31, at 160.

59. More generally, rules that establish a criterion of common wealth maximization for shareholder transactions with the firm also serve social wealth maximization. *See* Gordon, *supra* note 19, at 1574 n.79.

vidual gains at the expense of common gains that will reduce the value of the firm — rent-seeking in the corporate realm rather than the political realm. The absolute delegation rule may be seen as a strategic response that makes such activity less likely.

This claim depends on the further argument that the board is more likely to act for common shareholder wealth than shareholders acting through initiative, or, to state the claim in a somewhat weaker form, that it will be more difficult for shareholders to use board action as a mechanism for obtaining individual returns than shareholder initiative. This is true for two reasons. First, it will be easier to hold the board, as opposed to shareholders acting individually or collectively, to a legal rule that requires all actions to serve common shareholder wealth rather than individual shareholder wealth. The board is a deliberative body whose actions must satisfy business judgment scrutiny. The basis for particular actions will become visible in the course of the board deliberations in a way that makes policing easier. By contrast, the behind-the-scenes maneuvering entailed by a shareholder initiative will be relatively hard to track. A legal rule that placed a business judgment burden on the shareholder initiative proponent, for example, would have much less bite in the absence of public deliberation. Thus, policing side-payments among shareholders or possible reciprocal arrangements is harder than insuring that the board does not favor one shareholder group at the expense of others. Second, and perhaps more importantly, a shareholder proponent will be able to assemble a majority shareholder coalition in behalf of an initiative in many circumstances in which board support would be impossible to obtain. A shareholder's ability to extract a particular action from the board ultimately depends upon her potential success in a subsequent election contest — her ability to replace a recalcitrant board with an agreeable one. As was discussed above, other shareholders are much less likely to support an election contest over a particular business issue than a simple initiative. The potential costs of a control shift will almost invariably outweigh the benefits of a small piece of individual rent-seeking. Thus a board will screen out many such measures that might well be adopted were shareholder initiative available. Both of these factors may account for the current legal rule that the board owes a fiduciary duty to all shareholders, while an individual shareholder may generally vote as she pleases; that is, shareholders are not disqualified for interest.[60]

60. *See* Earl Sneed, *The Stockholder May Vote As He Pleases: Theory and Fact*, 22 U. PITT. L. REV. 23 (1960). This rule does not apply in the case where a controlling shareholder uses its control over the board to extract a distribution on a non-pro rata basis. For

It is also interesting to note that the currently increasing concentration of institutional holdings may add to the risk of shareholder rent-seeking. Take the case of union pension funds and public pension funds that own a significant stake of a company facing a union organizational effort. The individual economic gains for the union funds and the individual political gains for managers of the public funds might well lead to a coalition that successfully adopts a shareholder initiative requiring the company to pursue a particular policy on unionization, or location of factories abroad. Another example: a group of bank trust departments may push for a shareholder initiative that requires an industrial firm to divest itself of its consumer credit finance subsidiary, which, free-standing, is a less formidable competitor to banks. Each of these proposals could be defended on shareholder wealth maximization grounds or other public policy grounds that the legal system ought to acknowledge as a valid basis for shareholder expression. This means that a simple legal rule that purports to limit impermissibly motivated shareholder initiatives might be difficult in formulation and application. An absolute delegation rule may have additional importance in this environment.

2. Bargaining And Delay

In cases in which shareholder initiatives are adopted by coalitions held together with side payments, an additional consequence is that bargaining in the process of coalition formation can impose costly delays on the firm. In the Hockney-Stella-Omega hypothetical, it was assumed that Hockney and Stella readily came to agreement about the sharing of Hockney's $750,000 gain. It would be in Stella's interest to agree for any payment above $250,000. But that does not mean that is where the bargain will be struck; after all, it is also in Hockney's interest to agree for any payment less than $500,000. Two issues arise: the division of gains and the time to get there. Recent game theoretic work on bargaining sheds some light on these questions. The division of gains appears to be a function of the respective parties' "patience," or the economic ability to hold

example, in Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971), the court upheld a large pro rata dividend payout made at the behest of the majority shareholder to serve its cash flow requirements, despite arguable disadvantage to the firm. Nevertheless, the court made clear that for a payout other than pro rata, the majority shareholder would have a virtually insuperable burden of justification. *But see* Jones v. H.F. Ahmanson & Co., 460 P.2d 464 (Cal. 1969) (restricting majority shareholders' establishment of holding company structure that disadvantaged minority).

out as measured in terms of a discount rate.[61] Assume that Hockney's retail chain has been suffering economic distress, and that unless he can add at least $250,000 to the firm's cash flow, he risks bankruptcy relatively soon. Stella would add the extra money to his disposable income. On this story, Stella is much more "patient" than Hockney; his discount rate for the future possible profits is lower. On the assumption that each party knows the other's discount rate, the parties will be able to measure the values generated by a successive series of offers and counteroffers over time and then will reason backwards to a division of the gains in terms of the comparative discounts rates. Thus the division will take place, favoring Stella, but the process will occur without delay.

If, on the other hand, the parties do not know each other's discount rate, the bargaining will be much slower. The offers and counteroffers gradually reveal that information so as to make agreement eventually occur. But during this process of shareholder bargaining, the firm will not press forward on the plant, knowing that a shareholder initiative will shortly affect its planning in an important way. Delay is presumably costly to the firm, in the sense of lost customers, lost markets, foregone profits. The absolute delegation rule, of course, stops such bargaining and eliminates the possibility of costly delay.

3. Cycling Redux

The previous discussion of cycling was principally in a context in which shareholders agreed on the goal of shareholder wealth maximization but disagreed about the means of attaining it. The argument was that the greater the number of policy dimensions governing resolution of a particular matter, the more likely the existence of a cycle. If each shareholder is modeled as pursuing private wealth rather than common wealth, however, then we increase the number of dimensions by the number of shareholders. (The number of additional dimensions will be reduced to the extent that some shareholders are similarly situated.) Thus, once we relax the common goal assumption to acknowledge pursuit of individual gains, the threat of cycling will arise very quickly. As the likelihood of cycling increases, so does its potential cost.

The more general point of the social choice approach to corporate voting is this: if shareholder preferences are heterogenous and

61. *See* KREPS, supra note 1, at 556-71; ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 231-243 (1989); Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model,* 50 ECONOMETRICA 97 (1982).

the issues are multi-dimensional, then the concept of "majority shareholder rule" is incoherent, because voting would result in a succession of shareholder proposals each adopted and superseded in turn (unless constrained by an agenda control mechanism, itself arbitrary). Adding the realistic assumptions of individual gain-seeking by shareholders and positive transaction costs shows how serious the problem is. First, with individual gain-seeking, the formal conditions of voting incoherency are more likely to be satisfied, as explained above. Second, the decision process will not just cycle endlessly and/or come to a halt at some ex ante unpredictable point. Rather, the stopping point will be a function of comparative transaction costs of competing shareholder groups. Large shareholders, or well-coordinated groups, will face lower costs in organizing majority coalitions and the outcomes will favor them. This will change the structure of optimal shareownership, toward large blockholdings rather than diversification. The individual gain-seeking assumption means that shareholder initiative may produce not merely arbitrary choices, whose ex ante effect on firm wealth may be unpredictable, but rather choices that will systematically reduce the value of the firm (or otherwise impose costs on investors through reduced diversification). In this light, an alternative rule that protects management's prerogative over business decisions and constrains shareholder choice looks more attractive. All rules that address the domain of shareholder voting entail costs. On the argument above that it will be easier to hold management to common wealth objectives than shareholders, the absolute delegation rule may be the lowest cost alternative.

B. Private Gains: Bargaining Between Shareholders and Managers.

Shareholder initiative also creates an opportunity for shareholders to pursue private wealth maximization through bargaining with managers. Shareholders can threaten to make a shareholder initiative that has some probability of success, or having made the initiative, can suggest a willingness to withdraw it, and thereby induce managers with valuable agency benefits to use the firm's resources to buy them out at a premium over market or make other transfers. In other words, shareholder initiative may make it possible to extract greenmail-like payments from the firm.

The USX hypothetical demonstrates this potential. Assume that USX managers derive substantial agency benefits from the maintenance of USX as a steel and oil conglomerate; their jobs are better protected from bankruptcy risk and they enjoy the economic and psychological perquisites of running a very large firm. A share-

holder initiative for a sale or spinoff threatens these benefits, and management therefore will be tempted to use the corporate treasury to eliminate this threat, for example, by acquiring the shares of a shareholder initiative proponent at a premium over market. The public and legal justification will be that the shareholder initiative will disrupt the firm's business and that the managers are protecting shareholder welfare. This argument has a substantial historical and legal pedigree in the payment of greenmail to hostile bidders.[62] Indeed, in a context similar to a shareholder initiative, General Motors recently bought back at a substantial market premium stock held by Ross Perot, who was raising a principled ruckus about GM's operations; GM management prevailed in the subsequent shareholder derivative suits challenging the buyback.[63]

A numerical example helps illustrate the point. Assume that Ucahn paid $100 per share for her USX stock, that she believes the stock will be worth $150 if the breakup takes place, and that she assesses the chances of a successful shareholder initiative at 20%. Assume that the cost to her of presenting the shareholder initiative amounts to $5 per share, which will be reimbursed if the initiative succeeds. Ucahn's expected gain is $6 a share.[64] For a payment of something less than $106 a share (assuming that Ucahn is risk averse), Ucahn would agree to a buyback of her shares by USX. The buyback extinguishes a significant risk to management welfare; the cost, of course, is borne by the firm's shareholders. Thus, in this particular case, the opportunity for shareholder initiative has reduced the value of the firm. Conversely, an absolute delegation rule, which eliminates a certain kind of shareholder threat to management, may increase the firm's value.[65]

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62. *See, e.g.*, Polk v. Good, 507 A.2d 531 (Del. 1986); Cheff v. Mathes, 199 A.2d 548 (Del. 1964).

63. *See* Grobow v. Perot, 539 A.2d 180 (Del. 1988); Levine v. Smith, 591 A.2d 194 (Del. 1991). It may be that GM had another motive: eliminating an independent voice in the transfer pricing between GM and its EDS subsidiary that was the basis for the dividend on the special class of GM stock issued as consideration for the GM-EDS merger.

64. The computation is as follows: the expected gain on the stock is (.20)($50) = $10, but the expected cost is -(.8)($5) = -$4, for a net expected gain of $6 per share. Strictly speaking, Ucahn's return should also be reduced by her pro rata share of the reimbursement expense. So, for example, if Ucahn owns 26% of the stock, her expected gain should be $5.74. [$6 -(.26)(.2)($5)].

65. There is another element of the problem that this example does not explore — the value to the managers of the agency benefits in question. If the value is less than the cost to shareholders of the payout, which seems likely, then social wealth is reduced, but then it should also be possible for the board to write a compensation contract that makes managers indifferent between accepting the shareholder initiative and preserving their agency benefits, a golden parachute of sorts.

It might be argued that a less restrictive rule could be adopted, for example, a rule that prohibited a buyback in such circumstances. Per se rules against greenmail have not been adopted in most jurisdictions, however, despite the potential abuse, nor have many firms adopted anti-greenmail charter amendments. Moreover, a prohibition is subject to evasion; the shareholder might privately threaten the initiative before formal public action, or gain a reputation as one who brings shareholder initiatives. The payment also can be camouflaged; a special class of stock or stock right might be issued in addition to or in substitution for a cash buyback.[66]

Another objection is that a shareholder owning a large enough block credibly to threaten a shareholder initiative can also threaten a proxy battle to extract a greenmail-like payment, i.e., that a shareholder initiative would not add to the shareholder's existing leverage. This is not the case, however, if one accepts the argument made above that other shareholders are significantly more likely to vote for a proponent's shareholder initiative, which focuses on a discrete business issue, than for a control shift, which affects the business more generally. In the USX hypothetical, assume that Ucahn has a 10% chance of winning a proxy battle, as opposed to a 20% chance of succeeding with the initiative, and all other numbers remain constant. Then her expected gain is only $.50 per share,[67] which will discourage her from proceeding if she is significantly risk averse, and in any event offers a much less attractive option than the shareholder initiative. Another way to understand the point is this: if a shareholder initiative is possible, it will cost the firm $6 per share to buy peace; if not, only $.50 a share. Thus on the agency cost assumptions that have been made, an absolute delegation rule will increase the value of the firm.

Thus shareholder initiative has paradoxical qualities. The best argument on its behalf is that it can reduce agency costs. But close examination of the possible shareholder-management interaction shows that shareholder initiative may generate new agency

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This gives rise to another objection to the argument: why isn't a form of golden parachute a less restrictive alternative to an absolute delegation rule? Contemporary takeover practice demonstrates that golden parachutes do not solve the agency problems associated with hostile bids and proxy battles. Most management teams have such compensation contracts, yet target defense tactics persists. Solving the agency problems associated with shareholder initiative through compensation contracts seems similarly unlikely.

66. *But see* Ronald J. Gilson, *Drafting an Effective Greenmail Prohibition*, 88 COLUM. L. REV. 329 (1988) (describing means of avoiding evasion).

67. The computation is as follows: her expected gain is (.1)($50) = $5 per share; the expected cost is -(.9)($5) = -$4.50 per share, for a net expected gain of $.50 per share.

problems. In many plausible scenarios, shareholder initiative will reduce the value of the firm. Given the possibility for unpoliceable opportunistic management payouts, an absolute delegation rule may be the second best alternative.[68]

CONCLUSION

Three themes emerge out of this paper's analysis of the absolute delegation rule in corporate law. First is the observation that rules have strategic effects, meaning that rules constrain or facilitate certain kinds of strategic interaction among shareholders and between shareholder and managers. Whether rules increase or decrease shareholder wealth cannot be evaluated apart from an understanding of these strategic expressions.[69] This is the insight that game theoretic thinking sharpens for corporate lawyers.[70]

Second is the realization that the ability and desire of shareholders to hold to the common objective of maximizing the firm's stock price may be a product of corporate law rules as well as a consequence of well-functioning securities markets. Because markets are not complete, legal rules are necessary. Shareholders invest to maximize returns, which are the sum of common gains and private gains. Corporate law operates in many contexts to restrain private gain-seeking and to sustain the common objective. Ready examples

68. This argument has many points of contact with a model that Professor Ferejohn has developed to explain how voters discipline incumbent legislators, who may act on their own preferences once in office rather than the platforms on which they campaigned. If voters have diverse preferences, the incumbent can be disciplined only by voter "agreement" to use an aggregate performance criterion to measure incumbent conduct. If voters use an individualistic or subgroup criterion, the incumbent will be able to exploit such differences to escape effective control. *See* John Ferejohn, *Incumbent Performance and Electoral Control*, 50 PUB. CHOICE 5 (1986). Ferejohn explains empirical evidence for the existence of such an aggregate performance measure as reflecting widespread use of "sociotropic" voting rules, e.g., how the economy is doing generally, not whether the particular voter is best off. In the corporate setting, an aggregate performance measure, such as common wealth maximization, is harder to sustain through such a sociotropic mechanism. Rules such as the absolute delegation rule reduce the opportunity for use of an individualistic or group criterion in shareholder behavior and thus help sustain the appropriate discipline of incumbent managers.

69. In that sense, this article generates a "possibility" claim: conditional on certain other facts about the nature of shareholders and the content of legal rules, an absolute delegation rule could increase shareholder wealth *ex ante*. A formal model would provide explicit parameters for these factors to try to show in what states of the world the rule would have such an effect.

70. There is another important point as well; share ownership and management patterns may be affected by legal rules that are chosen. For example, shareholder initiative may encourage shareholders to reduce diversification in favor of more concentrated holdings, if the returns from the exercise of voice increase relative to the returns from a more passive strategy.

are the fiduciary duty of loyalty, the requirement of ratable distributions to shareholders of the same class, and the limits on the use of shareholder agreements that limit the discretionary powers of the board.[71] The absolute delegation rule blocks certain avenues for private gain-seeking and the potential strategic interaction that would arise. For this reason, as well as its effects in preventing cycling, the absolute delegation rule may enhance the value of the firm.

The third theme is that a significant change in the rules that constrain shareholder voice may have unintended consequences. Legal policymakers should, at the least, anticipate that shareholders will use increased voice opportunities for private wealth maximization and try to assess the costs and benefits in light of particular circumstances. For example, given the present limits on institutional ownership of a company's stock, it may be that recent proposals for increased shareholder voice will have minimal costs. The need for institutions to assemble coalitions of other institutions, the fact that institutions hold shares in many other firms and thus are engaged in a repeated play game with significant reputation effects, may limit the potential for rent-seeking behavior. On the other hand, to permit individual institutions to hold control blocks or, short of control, blocks that would reduce the need to assemble coalitions, may raise more difficulties. At the very least, legal rules that permit wide latitude for interested shareholder voting would require close examination. Legal academics commonly regard the shareholders as "the principal" and management as "the agent." A game theoretic perspective heightens awareness that in a world of institutional ownership, shareholders are "multi-principals" and that the corporate governance system must take account of their interaction.[72]

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71. *See* NORMAN D. LATTIN, LATTIN ON CORPORATIONS, § 94 (2d ed. 1971).

72. A fourth, less explicit theme is that the time is coming for a major reconsideration of corporate law norms in light of increasing institutional ownership. It seems unlikely that the same body of corporate law that is appropriate for the corporation of widely-dispersed public shareholders (with perhaps a large insider block) will serve equally well for an institutionally-dominated entity. The advent of close corporation statutes shows that some statutory specialization is possible, if not inevitable. The proposed SEC proxy rule revisions, which take explicit account of institutional ownership and sophistication, are perhaps a forerunner.

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