1997

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Recommended Citation
Macey, Jonathan R. and Holdcroft, James P., "Flexibility in Determining the Role of the Board of Directors in the Age of Information" (1997). Faculty Scholarship Series. 1450.
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FLEXIBILITY IN DETERMINING THE ROLE OF THE BOARD OF DIRECTORS IN THE AGE OF INFORMATION

James P. Holdcroft, Jr. & Jonathan R. Macey*

INTRODUCTION

Corporate law allocates to the board of directors the central role in the management of the American corporation. Three legal principles, taken together, coalesce to focus legal attention on corporate boards of directors. First, most states require board approval for important decisions. For example, organic changes to the corporate form such as mergers, sales of control, and sales of all or substantially all of a corporation’s assets all require board approval. Second, by law, corporations are run by or under the direction of the board of directors. Courts have traditionally interpreted this requirement narrowly, and many board decisions are therefore considered nondelegable. Finally, at least in theory, boards of directors are ultimately responsible for corporate performance. Not only do directors owe shareholders a fiduciary duty of loyalty, they also owe shareholders a fiduciary duty of care. In essence, this means that directors must not only refrain from stealing from the corporation, but they must also attempt to maximize the economic value of the firm.

Despite these legal requirements, the boards of directors of modern corporations meet only episodically. Typically, a board of directors is comprised of a number of corporate managers and a majority of part-time outsiders who are nominated, and are sometimes under the influence and control of the very same corporate managers they are supposed to monitor. Corporate law recognizes

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2 See id.
3 See McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934).
4 See RMBCA § 8.30 (a)(2).
6 See RMBCA § 8.01 cmt. (“[I]n large and complex publicly held corporations it is generally recognized that the board of directors may delegate to appropriate officers those powers not required by law to be exercised by the board of directors itself.”). The Historical Background to section 8.01 states: “Indeed, such involvement is probably neither practical nor feasible for even inside directors in many large modern corporations.”
the very generalized powers of boards, and the lack of active involvement in management is reflected in the modern legal doctrine.\(^7\)

Thus there is a basic tension in U.S. corporate law. The legal system imposes broad obligations on directors, while simultaneously recognizing the practical reality of their distance from the corporation in many cases. For years this tension between the theoretical requirements of corporate law and the reality of corporate governance has been resolved by the business judgment rule, which blunts the practical significance of the formal legal requirements relating to board conduct.\(^8\) In effect, the business judgment rule insulates directors from liability for decisions that are not tainted by a conflict of interest.

However, there are a few minimum requirements that must be met before a corporate director can avail himself of the protection of the business judgment rule. First, the transaction must not involve a conflict of interest. Second, a director who approved a challenged transaction must have used the same degree of care that an ordinarily prudent businessperson in the same circumstances would have used.\(^9\) Finally, directors must have a basic understanding of the business of the corporations on whose boards they sit.

In this Article we argue that shareholders should be able to contract around the necessity of board oversight of managerial decisionmaking. For certain firms, board oversight is a myth that should be abandoned. Some of the authority and responsibility previously delegated to the board should be returned to the shareholders. We do not argue this because we think that boards of directors serve no useful function and are therefore obsolete. Rather, we argue for limiting the legal authority and responsibility of the board because we think that, at times, for some firms the cost of maintaining the legal fiction that boards of directors are unbiased and knowledgeable representatives of shareholders’ interests is greater than its benefits. We propose to permit boards of directors to serve shareholders more directly when shareholders choose to structure their firms this way. In particular, we propose that corporate law be clarified to allow shareholders: (1) to direct their boards to replace incumbent management; and (2) to allow shareholders to put up for sale the firms in which they own stock without the necessity of obtaining prior approval from the board.

\(^9\) See RMBCA § 8.30(a)(2).
In our view, boards should continue to provide managers with advice and guidance and to monitor basic conflict of interest transactions. But shareholders should be empowered to adopt a corporate governance structure that would require boards to replace poorly performing managers when shareholders direct them to do so. Shareholders should have the power to elect to require directors to conduct a search for new managers. And shareholders also should be able to insert provisions in the corporate charter that would permit them to vote to require directors to put their company up for sale, rather than simply to ratify a proposed merger or sale that has been approved or recommended by the board.

In other words, our proposal would allow shareholders to elect to change current corporate governance in two fundamental ways to reflect the realities of modern business practice within a widely held firm. First, shareholders could elect to take more direct power to control management. Second, as the true parties in economic interest, shareholders would be able to organize their firms so as to enable themselves to realize the possibility of a control or takeover premium whenever the holders of a majority of such shares determine a sale of the company to be in their best interest. In pursuit of this goal, shareholders would be able to strip directors of the power to block fundamental corporate changes, such as mergers, over the objections of shareholders. Instead, shareholders would be able to elect to have the absolute right to vote on such transactions. We do not believe that shareholders should be able to micromanage the firms in which they own shares. Nor do we propose changing the law to automatically give shareholders the new rights we are discussing. Rather, in the normal course, corporate managers and boards of directors would typically continue to function as they currently do.

It is our view that shareholders should be given the ability to “opt out” of the current structure of corporate governance. Specifically, we propose that shareholders should have the right to organize their corporations so as to give themselves the right to give incumbent managers a vote of “no confidence” at their annual meeting. For example, shareholders should be allowed to vote to terminate the employment of existing management and require the board immediately to initiate a search for a new management team. Second, we propose that shareholders should be able to contract for the right to sell the company in which they own shares. Shareholders still currently have no automatic power to initiate transactions. Instead, they simply have the right to approve or re-
ject a proposed transaction typically negotiated by the corporate managers and approved by the board of directors.

Our perspective is reflected, to some extent, by Warren Buffett, whose managerial approach is showcased in this symposium. Like Mr. Buffett, we propose changing corporate law to permit shareholders to be treated a bit more like partners when they elect to be so treated. Mr. Buffett has observed, with respect to the Berkshire Hathaway corporation:

> Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners . . . . We do not view the company itself as the ultimate owner of our business assets but instead view the company as a conduit through which our shareholders own the assets.¹⁰

In this Article we argue that this is the way that at least some publicly held firms should be run. In modern practice, boards of directors of public corporations sometimes do not adequately represent the interests of shareholders. As a practical matter, certain corporate boards often serve primarily to insulate management from market forces. Shareholders should be able to curtail this phenomenon.

Our idea, then, is to give shareholders the opportunity to contract for a greater voice precisely in the area of changes in corporate control, where boards of directors are faced with the most important and fundamental decisions. Often, these are the decisions that present the most severe and subtle conflicts of interest.

We make three points in support of our argument that shareholders in some firms might value the alternative contractual framework we are proposing. First, many corporations, particularly in the field of financial services, have become so complex, and modern business practice so sophisticated, that boards cannot realistically be expected to understand, much less monitor and control the firms on whose boards they sit. The recent conflicts over derivatives transactions involving Bankers Trust, Gibson Greetings, and Proctor and Gamble illustrate this point well.¹¹ Because these businesses have simply become too complex, we doubt that the directors of these companies were able to satisfy even the minimum requirement that they have a basic understanding of the business

of the corporations. Ironically, in these high profile examples involving the sale and use of financial derivatives, none of the boards appear to have had a clear understanding of the businesses in which they were engaged or the manner in which management pursued corporate profits. This is particularly true of certain outside directors who spend only a few hours each month reviewing only summary materials. Importantly, these conflicts also illustrate that shareholders bear the economic risk of a failure of managers and directors to understand fully non-fundamental but financially charged aspects of the businesses that they oversee.

Our second point relates to the proper scope of corporate law. We observe that in its current incarnation, corporate law performs very well in certain contexts. That is, the legal system performs well both in situations involving palpable conflicts of interest, and in cases involving ordinary business judgments about relatively mundane events. Our proposal addresses the large gray area between these two extremes. Our recommendations are designed to bolster the performance of corporate law as a mechanism for monitoring and controlling management where the conflicts of interest may be more subtle. In these contexts, the legal system at times has performed poorly. And shareholders of some firms may be in a better position to judge their own interests. As the true parties in economic interest, shareholders have both the strongest motivation to monitor corporate performance and the strongest claim to make the most fundamental decisions affecting those interests. However, we recognize that shareholders may lack the expertise to evaluate a particular issue.

Finally, we note that technology has changed to make communications between firms and shareholders easier. Thus much of the information routinely communicated to boards by management can now also be communicated to shareholders at very low cost. This, coupled with the increasingly sophisticated securities markets, should for some firms mitigate the need for boards of directors to intercede between shareholders and management. As the costs of exchanging information and of collective action are reduced through the use of investment intermediaries and electronic communication, a principal justification for the broad agency powers of the board of directors as representatives of shareholders' interests is weakened.

Sometimes, the legal powers retained by boards of directors—such as recommending sales of assets and mergers—should be devolved in part to the shareholders. Moreover, shareholders should
be able to elect to revise the directors' traditional role in appointing corporate officers. We recognize that directors should continue to have the power to appoint management because collective action problems and rational ignorance\(^{12}\) make it too costly for shareholders to nominate their own slates of managers. However, giving shareholders the right to register a vote of no confidence would mitigate the conflict of interest problem without delegating to shareholders responsibilities that are unrealistic in light of their capacities.

Part I will describe the basic contours and purposes of the legal rules affecting boards of directors and explain where the rules work and where they do not. Part II will explain and defend our proposal for substituting board leadership with more direct shareholder involvement. Part III will address the politics of our proposal. Part IV will address certain shareholder voting issues.

I. The Purpose of Corporate Law

Corporate law and corporate lawyers help society by facilitating capital formation, reallocating capital to its highest valuing users, and insuring that resources are utilized in an efficient manner. Corporate law helps capital formation in a number of ways: (1) by shifting the risks of investing in the firm to people and firms better situated to bear such risks (limited liability); (2) by providing standard contractual terms that reduce the transaction costs of investing, and (3) by reducing agency costs, i.e., by reducing the costs to shareholders of monitoring and controlling the behavior of their agents, who, in this context, are both corporate managers and directors.

As Professor Melvin Eisenberg has observed, the divergences of interest between managers and shareholders can be divided into three categories: (A) shirking; (B) positional conflicts of interest; and (C) traditional conflicts of interest.\(^{13}\)


A. Shirking

Garden-variety shirking consists of everything from being incompetent or lazy ("working at a slack pace"),\textsuperscript{14} to allocating corporate resources for things that are of high value to the manager and of little or no value to the firm (i.e., corporate sponsorship of artistic events and athletic contests, corporate jets, plush executive suites, and extra personnel).

Corporate law currently does almost nothing to deal with this sort of agency cost. Instead, solutions to this problem are essentially left to market forces, particularly to the markets for corporate control and the managerial labor market. The problem with these solutions is that they are what might be referred to as "lumpy." This means that a firm's value must fall by quite a lot before it becomes cost-effective to launch a hostile takeover, particularly in light of the assistance state anti-takeover statutes provide to incumbent management. For example, in 1990, General Motors, plagued by chronically bad management, declining market share, declining profits, and declining employment, was able to rebuff efforts by large shareholders to reform the firm.\textsuperscript{15} The business judgment rule serves as a sensible—and powerful—barrier to legal action that would act to second-guess corporate managers' own judgment.

In essence, the business judgment rule permits managers to insulate themselves from liability for shirking. Moreover, corporations often can opt out of the fiduciary duty of care.\textsuperscript{16} The point here is not that shirking is a colossal problem within the large, publicly held corporation. Rather, the point is that to the extent that shirking is controlled within such firms, it is market forces, rather than legal rules, that constrain managers' proclivities to shirk. Further, the efficiency of market forces to control shirking is directly related to the costs associated with marshaling and directing such forces. The relationship of these costs to the interest and behavior of the individual shareholder is discussed in more detail below.

B. Positional Conflicts of Interest

In a wide variety of contexts, managers have an incentive to use their positions to benefit themselves at the expense of shareholders. An older CEO manager might know very well that a

\textsuperscript{14} Id. at 1471.


younger colleague would do a better job at the helm of the corporation, but the older manager, in most cases, will refuse to step down. A board of directors may refuse to accept an outside offer for the company, or to make changes to enhance shareholder value, even though it knows the outside bidder would enhance shareholder value, either because the directors owe personal debts of loyalty to the incumbent managers, or because the directors do not want to be replaced. Here again, corporate law does not always do a very good job in controlling agency costs. The costs of shareholder action are significant, and provide a de facto safe harbor for a significant amount of shirking by managers and directors.

The most significant manifestation of this category of agency cost involves resistance to takeovers.\textsuperscript{17} In this context, courts are supposed to impose an intermediate standard of review on directors' actions. This intermediate standard of review will maximize shareholder value in some contexts but not others. In particular, it is important that shareholders be able to contract to impose restrictions on directors' ability to defend against takeovers. While such contractual protections will not always be necessary, sometimes they will be.\textsuperscript{18}

Following the Delaware Supreme Court's decision in Paramount Communications Inc. v. Time Inc.,\textsuperscript{19} many practicing lawyers advise their corporate clients that in the context of stock-for-stock mergers, a board is not required to conduct an auction to obtain the highest consideration, or to pursue its so-called "Revlon duties"\textsuperscript{20} if the board avoids seeking a competing bid. This case and its progeny also provide the legal basis for practitioners to advise corporate boards that in the context of a stock-for-stock merger offer, the board should not make its decision on the basis of the current market value of the shares being offered, but should instead evaluate all the elements involved in the offer over a time frame that it considers to be appropriate. The basic rationale underlying these decisions is, of course, sound and consistent with the business judgment rule. We also support the practical implications of these decisions, which give corporate boards very broad leeway to accept or reject many merger proposals. However, we also think that shareholders should, if they wish, be able to elect to opt out of

\textsuperscript{17} See Eisenberg, supra note 13, at 1472 n.47.
\textsuperscript{19} 571 A.2d 1140 (Del. 1989).
the corporate governance framework created by these decisions. In this context, we find it significant that these proposals often are not made public by either the proposing or target company. Potential acquirers do not want to spark interest in the target and initiate a bidding war. They could lose to another bidder or end up winning but at a higher cost. Ironically, target companies often do not announce the receipt of a proposal for the same reason.

C. Traditional Shirking

Beyond garden-variety shirking and potential conflicts of interest, managers sometimes will have actual conflicts of interest with their firms. The sale by a manager of personal property or other assets to the firm he manages, for example, presents a conflict of interest. The manager would like to receive a high price for the assets, but at the same time he has a responsibility to the firm to secure as low a price as possible. Here the legal system has met with more success, largely because conflict of interest transactions are concrete events that the legal system can identify and deal with procedurally.

II. Empowering Shareholders

In this part we will explain and defend the specifics of our proposal for improving shareholder democracy. The specifics of our proposal are simple. We believe that shareholders should be able to elect to have a corporate charter that allows them to register a vote of no confidence at the annual meeting of shareholders. Charter provisions could, for example, provide that such a vote would cause the termination of existing management. The charter could further provide that this vote of no confidence would immediately require the board of directors to initiate a search for a new management team, to be completed, say, not later than one year from the date of the no confidence vote. We also believe shareholders should be able to contract ex ante for the right to put the company in which they own shares up for sale. It is not enough that shareholders have the opportunity simply to sell their shares if they think that corporate managers are not pursuing the correct strategy. Often, fundamental transactions such as mergers and sales involve significant premiums to the current market value of the target company. This premium may be derived from any number of sources, including the acquirer’s superior management ability, anticipated consolidation savings, or projected increases in revenues resulting from cross marketing. What is important, how-
ever, is that this premium may not be available to shareholders unless the company is sold as a whole or is merged into another company. In industries of significant excess capacity, capturing this takeover premium may represent the best alternative for shareholders and also the worst alternative for displaced managers and directors who may have limited expertise in a shrinking industry.

On the other hand, certain shareholder groups may be susceptible to abusive or coercive two-tiered tender offers and may prefer to give their managers a free hand to defend against such takeovers. Shareholders in these firms should have the right to empower the directors to take particularly aggressive steps to protect their shareholders' interests.

We identify three issues raised by our proposal. First, we recognize that utilization of our proposal by some firms may actually exacerbate the collective action problems of rational ignorance and free-riding that plague shareholders, preventing them from making intelligent decisions about the fate of the firms in which they have invested.

In light of these problems and in the face of overwhelming evidence demonstrating that enabling rules are far superior to mandatory rules, we conclude that our proposed new rule should be a default rule, rather than a mandatory rule. We identify situations in which particular firms would be better off if our rule were imposed. And we stress that the optimal time for implementation of our rule is ex ante, rather than ex post, when an annual meeting is approaching. We also argue that opting into the rule that we propose should have certain implications for the potential legal liability of corporate directors.

Second, we discuss the possible objection that firms that adopt our rule will find it more difficult to recruit and retain top management because of the lack of job security for such managers in firms that opt into a legal regime in which dismissing managers can be accomplished directly by shareholder vote. Finally, we discuss an entirely practical objection to our proposal. Specifically, as noted above, it seems likely that our proposal will not be wildly popular with incumbent management. In an age when managers have successfully persuaded state legislators to pass antitakeover laws with significant mandatory components that sometimes reduce shareholder welfare, it seems unlikely that state legislators will be enthusiastic about voting for legislation that implements our proposal.

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Instead, we argue that firms should implement our rules via charter amendments, and that courts could provide managers with incentives to adopt our proposal by insulating managers and directors from liability for violating their fiduciary duties of care when they manage firms that are organized along the lines we propose here. We also note that golden parachutes and other executive compensation arrangements could be used to make our proposal more palatable to management.

A. Collective Action Problems

An important issue to be evaluated by shareholders considering whether to implement our proposal is that the widely dispersed and fragmented shareholders that characterize the American public corporation may not be sufficiently well informed to make considered, informed decisions about the future of the firms in which they have invested.

The problems of direct shareholder involvement in corporate affairs are well known. Indeed, Mark Roe has written an entire book in which he suggests that politics has impeded American corporations from reaching a truly efficient system of corporate governance in which managers share power with institutional investors as a means of overcoming "some of the problems afflicting firms with dispersed ownership."\(^{22}\)

Roe observes that:

Dispersion in small holdings creates a collective action problem for shareholders, making managers less accountable in a way that can hurt performance, particularly when the firm faces unusual problems.

\[\ldots\]

If scattered shareholders cannot understand complexity, and if managers cannot be rewarded for what shareholders cannot understand, firms may abandon some long-term, technologically complex projects.\(^{23}\)

In our view, the problem often is not that shareholders cannot understand complexity. Rather, the problems are three-fold. First, the collective action problems of free riding and rational ignorance often create conditions in which it is not within shareholders' interests (as opposed to competence) to become informed about the merits of a particular transaction. Second, even when shareholders know what is best for their firms, collective action problems may

\(^{22}\) Roe, supra note 15, at 9.

\(^{23}\) Id.
create conditions under which shareholder voting to further their own private objectives results in an election outcome that makes the shareholders as a group worse off.

Finally, of course, is the problem that shareholders' preferences sometimes simply do not count for much with management. Managers, on occasion, have too much freedom to pursue their own ends because widely dispersed shareholders cannot effectively monitor and control them. Further, managers and directors have a keen appreciation, based upon experience, for how difficult and costly it is to persuade shareholders to vote their shares in support of a particular position. Examples of shareholder activism, such as the efforts of Michael Price to prompt changes at Michigan National and Chase, are noteworthy in part because of their rarity. These examples are also illustrative of the tremendous expense involved in influencing the board and management without resorting to a proxy contest. Few shareholders are capable of accumulating an economic stake sufficient to cause management to give them more than a perfunctory hearing, and fewer still have the resources to present a real threat to corporate control.

The market for corporate control is a powerful device for aligning the interests of managers and shareholders. But in recent years managers have succeeded in enacting laws that make hostile takeovers more difficult to accomplish. Such laws can harm shareholders in several ways, particularly if they are mandatory rather than enabling. On the other hand, where such rules are enabling, they can enhance shareholder value by resolving the collective action problem that plagues shareholders in the face of a coercive two-tiered takeover.

Mandatory state anti-takeover laws can prevent shareholders from profiting by transferring their shares to rival management teams. Second, state anti-takeover laws discourage outside monitoring by potential hostile bidders, thereby reducing the value of all firms by increasing the incumbent management's ability to shirk. Finally, such antitakeover laws lower managerial incentives to maximize firm value as a means of reducing the probability of hostile takeover bids.

Our proposal is a means of partially compensating for the weaknesses in the market for corporate control caused by state anti-takeover laws. Under our proposal, even in the absence of a formally announced outside takeover bid, shareholders could unilaterally force directors to put the firm up for sale. Such a vote
would automatically nullify the effects of poison pills and other antitakeover devices within the firm.

We fully acknowledge, however, that there is some merit to the argument that shareholders face a daunting collective action problem that impedes their ability to inform themselves fully about the nature of the problems within the firms in which they have invested. One of these problems is a rational ignorance problem. The other is a free-rider problem.

The concepts of rational ignorance and free-riding describe the idea that often it is not in a shareholder’s individual interest to invest the personal resources necessary to monitor and evaluate the performance of the managers of the firms in which they have invested. This is true despite the fact that it will be in the shareholders’ collective interest that such money be invested. A simple example illustrates this point.

Suppose that a firm has one hundred shareholders, each of whom owns one share of stock. Suppose further that each share of stock is currently valued at $1.00 per share, so the aggregate market value of the firm’s capital is $100. Suppose further that an investment of $50 would reveal that management is diverting sums with a present value of $100 to its own uses. Such an investigation would result in a net increase in the value of the firm’s equity from $100 to $150, and in the value of each shareholder’s shares from $1.00 to $1.50. But, while it clearly would be in the interests of all shareholders that this investment be made, it does not make sense for any individual shareholder to make the investment himself. This is because an individual shareholder would have to pay the entire $50 necessary to uncover the managers’ actions, but would only capture 50¢ of the gain, resulting in a net loss of $49.50 on the investment.

The collective action problems described in the above example are easy to identify. First, it is rational for each individual shareholder to remain ignorant of the information that would be uncovered by the search because its benefits are not worth the costs when calculated on an individual basis. This example also makes clear the relationship between the size of an investor’s stake and her motivation to take action. Free riding is simply the other side of the same coin. The fact that the shareholders who do not pay the costs of the investigation are nonetheless able to benefit from a general rise in the share price that the investigation triggers is known as free riding. The nonpaying shareholders take a free ride on any investment in monitoring made by the other shareholders.
Where free riding is possible, there will be a suboptimal amount of production in the goods (here, information) that are subject to the free riding.

The point, of course, is that the widely dispersed, small stake shareholders that characteristically invest in American corporations are plagued by rational ignorance and free rider problems. A problem with our proposal is that these rational ignorance and free riding problems prevent shareholders from being able to inform themselves sufficiently about what is going on in corporations to know when to oust incumbent management, and when to put the company that they own up for sale.

Our response is simple. We acknowledge that free rider and rational ignorance problems exist. These problems prevent shareholders from micromanaging corporations. However, as Easterbrook and Fischel have pointed out, rational ignorance and free riding problems are much more acute for small problems within firms than for larger problems. As problems within a firm become larger, it becomes rational for shareholders to make the investments necessary to solve the problems despite the existence of rational ignorance and free riding. This is why shareholders are allowed to vote on important issues, such as changes to the corporate form—i.e., mergers, sales of control, and sales of all or substantially all of a corporation’s assets. These are big issues, about which small stake shareholders are likely to be sufficiently well informed to make rational judgments. Admittedly, however, even in the case of the example above, in which a net increase in shareholder value equal to 50% is described, one can see that it may still be rational for a shareholder not to take action despite the significant potential gains, if the cost of realizing those net gains is still quite large. This is particularly true when the costs are ex ante. Our proposal is intended to lower the costs of realizing gains, thereby increasing both the net gain and any impediment to funding the costs in advance of receipt of the gain.

Moreover, under our proposal, rival management teams would find it in their best interests to help shareholders overcome free rider problems by informing shareholders when incumbent management is doing a bad job. In other words, the rational ignorance and free riding problems can be overcome not only where there are

big stakes issues, but also where there are individuals or firms with a disproportionate amount to gain from gathering and disseminating information. This group would include not only rival management teams, but also large block shareholders, stockbrokers, and financial analysts, all of whom stand to gain from identifying incompetent management teams.

In this context, it is critically important to note that our proposal does not expand either the incidence or risk of rational ignorance or free riding, nor does it expand the set of issues about which shareholders are currently permitted to vote. Under present law, shareholders vote annually for the firm's board of directors. In theory, shareholders can always replace current management with an outside management team. Unfortunately, rival management teams do not always present themselves to shareholders for approval. And, of course, under present law and corporate practice, shareholders can always decide whether they wish to sell their shares to an outsider in order to help effectuate a change in corporate control. Shareholders also are entitled to vote on merger proposals by outsiders. While these elements of corporate law provide shareholders with some measure of relief, as we have stated previously, a sale of one's shares, even to a potential acquirer, rarely will capture the full premium that a sale of the company may provide to shareholders. Moreover, shareholders will not have the opportunity to vote on a merger proposal unless the board has already approved the transaction presented by management.

Thus, we emphasize that our proposal does not expand the set of issues about which shareholders are expected to be informed under current law. Our proposal simply expands shareholders' power to do something about their conviction that incumbent management is unsatisfactory. Finally, we also argue that the implementation of our proposal presents an important additional incentive for corporate management and boards to inform themselves and to make decisions more closely aligned with the interests of shareholders. Neither the management nor the board is likely to want to expose itself to the public embarrassment that a vote of no confidence or a vote to sell the company is likely to engender. Because these actions by shareholders are essentially a public announcement that shareholders do not believe the managers and board are doing their jobs properly, there will be significant motivation for these parties to steer well clear of actions that would reasonably cause such votes to take place. Because the vote of no confidence and the vote to put the company up for sale could be
effected more easily and cheaply than taking control of the corporation and voting in a new board, the threshold of what constitutes egregious behavior would be moved significantly lower.

B. Mandatory Versus Permissive Legal Rules

As set forth above, we think it is preferable that any changes made to corporate charters implementing our proposal be done on a voluntary basis. We also think it is preferable for any such changes to have a long enough duration to make it likely for an adoption of any such change to take place in the midst of a challenge for control or during a contested corporate restructuring. In order to ensure a fair consideration of our proposal, and to balance the right of shareholders who are more likely to favor our proposal with the interests of managers and board members who are more likely to favor the status quo (and who have the full resources of the corporation at their disposal), we think it is necessary that the implementation of our proposal take the form of a default provision in corporate law. Using the “opt in” model commonly used in corporate and partnership laws, we suggest that the individual firms could amend their articles of incorporation and that the shareholders would be required to adopt affirmatively the provisions proposed prior to the end of the opt out period by a majority vote.

Under our proposal, shareholders could contract for the right to deliver a vote of no confidence at either the annual meeting or at any special meeting of shareholders. This would do more than a simple vote against the proposed slate of directors or an abstention from voting. Neither of these alternatives gives shareholders much real authority. In the first instance, the vote vis-à-vis the board members up for election is a blunt and inefficient tool for changing the senior management of the corporation. Secondly, assuming that the proposed slate of directors is not elected, it is not altogether clear what authority the board would have pending the election of acceptable candidates. In the case of staggered terms this is less troublesome. However, in the case of a single class of directors, it would present a potentially risky position for the corporation. Almost invariably, too, shareholders have little information

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25 See, e.g., RMBCA § 3.02 (“Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs.”); UNIF. PARTNERSHIP ACT § 18 (1914) (“The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules.”).
available to them to allow them to assess whether the directors who are up for reelection to the board are the ones who have failed to represent shareholders’ interests properly. Proxy statements typically give no information about the attendance or positions taken by individual board members. As a result, shareholders are most often forced to vote blindly for change or no change, as opposed to “for” or “against” an individual who supports or opposes their interests.

Abstention from voting offers a similarly perverse result. Simply not voting increases the relative value of all those who do vote directly or more commonly through proxy. Candidates can thereby be elected with fewer affirmative votes. Neither alternative gives shareholders a meaningful or satisfying remedy for poor board performance. Our proposal would allow for a more direct expression of shareholders’ interests when a majority believes that the board is not adequately pursuing these interests. Instead of voting to change the board in the hope that a newly configured board might take action to replace the managers who actually run the corporation, a vote of no confidence creates a shortcut to that process and tells the board that it is time to hire new managers. Similarly, a directive by the shareholders that they want the board to pursue a sale is a clear and simple message that they believe the board and senior management are not fully exploring these options on their behalf. Blindly configuring the board or abstaining from voting sends, at best, an ambiguous message.

Once a vote of no confidence has been given, or once the shareholders have directed the board to sell the corporation, the board would be relieved of its normal obligations under corporate law and would not have to rely on the business judgment rule with respect to those specific decisions. However, the board would continue to be obligated to exercise its reasonable business judgment with respect to the implementation of the shareholders’ directives. For example, if the shareholders of a corporation delivered a vote of no confidence at the corporation’s annual meeting, the board would be obligated to initiate an immediate search for replacements for the corporation’s executive officers. The board would not be legally responsible for damages to the corporation arising from the shareholders’ decision to terminate and replace the existing management team. All other actions and decisions by the board with respect to retaining new managers would still be subject to the normal application of the business judgment rule. The board would be obligated to conduct a search reasonably calculated to
find the best qualified managers for the corporation. The board also would be obligated to use its reasonable business judgment to retain the best available managers on terms that would be in the shareholders' best interests.

The more difficult case is presented by a vote to put the corporation up for sale; however, on balance, we think that our proposal presents an improvement to the current practice. As we envision it, a directive by shareholders to put the company up for sale would not necessarily result in a sale of the company. Such a vote by shareholders would simply require that the board and appropriate members of senior management immediately explore the market for a sale or merger, negotiate the best alternative, and present that proposed transaction to the shareholders for approval. Although in most cases we would anticipate that shareholders who vote to put the company up for sale will accept the proposed transaction (absent a significant change in market conditions during the pendency of this process), it would not always be the case. Price expectations may not be fulfilled or other terms may be unacceptable to shareholders. We anticipate, however, that with respect to ultimate approval, the experience with shareholder initiated mergers and sales will be substantially similar to the experience of board initiated and recommended mergers and sales.

Although it may be argued that our proposal would result in the shareholders of most corporations voting to place their corporations up for sale to capture whatever acquisition premium could be obtained, and that this would present an unacceptable social cost, we think this is unlikely to happen. First, we suggest that shareholders have the potential to be every bit as rational and capable as the directors who represent them and who currently have such authority. We do not think that shareholders would place their corporations up for sale simply to test the market. In the normal course, shareholders will—and should—continue to rely upon the judgment of the corporation's executive managers and its board of directors to determine the corporation's future. This is because corporate boards can do a lot of things—particularly in the context of a hostile takeover—that increase shareholder value. This remedy would only come into play in those cases in which it appeared to a majority of shareholders that the interests of management and the board were not closely aligned with those of shareholders. Individual shareholders would continue to have the right to sell their shares in the market and to terminate their relationship with the corporation. However, it would only be rational
for shareholders as a group to vote to sell the corporation if a majority in interest reasonably expected that a sale of the corporation would produce a higher price, after adjusting both for the time delay and risk of execution, including the possible adverse effect on price that may result from a public declaration of the interests of shareholders to seek a buyer, and the possible adverse impact on employee morale and retention. We do not think that shareholders are likely to "cry wolf." Even if they do, we think it is their right as owners to sell even at less than optimal prices.

It may also be argued that anticipated consolidation savings would almost invariably produce higher acquisition prices for shareholders who vote to sell their corporations and that, accordingly, the implementation of our proposal would result in an unacceptable concentration of control and ownership of America's corporations, resulting in potentially significant social implications. In response, we offer that we are not proposing the wholesale restructuring of all laws affecting corporations. Antitrust and other laws regulating investment would, of course, continue in full effect. By itself, our proposal would not result in a concentration of control or ownership greater than that which could otherwise result if only boards could initiate mergers and sales. Moreover, we think shareholders are likely to recognize the antitrust risk when considering the probable results of a sale and when deciding whether to direct the board to pursue a transaction. Additionally, we suggest that if boards are knowingly or unknowingly supporting a populist agenda not required by law and avoiding transactions that would benefit shareholders because of these social concerns, our proposal is all the more necessary.

C. Recruiting and Retaining Top Managers

Another potential concern with our proposal is the possible adverse impact on the ability of corporations that have adopted our Proposal (either affirmatively or by default) to attract and retain top quality managers. We think the practical impact on executive compensation would be negligible. United States corporate executive compensation is already at a comparatively high level, both from a historic and a national perspective. Moreover, many corporate executives receive a significant portion of their compensation in equity and equity-related forms. Many are also employed pursuant to agreements, with generous additional compensation for termination following a change of control. Accordingly, in the event of a shareholder initiated merger or sale, these executives
would receive additional compensation just as they would in the event of a director initiated transaction. In any event, the question becomes whether or not the risk of a transaction would materially increase as a result of our proposal, causing better executives to require greater compensation for that increased risk. Assuming that the increased risk would exist and would not be compensated by existing arrangements, we think this is simply a direct cost that shareholders would have to bear to avail themselves of the benefits of our proposal. We think that the benefits sometimes will outweigh the costs in this regard, even if shareholders never actually exercise their rights and do not deliver a vote of no confidence or direct the board to pursue a sale of the company. We think that lowering the threshold for shareholder action sometimes will limit shirking and other wasteful behavior that will more than offset any additional compensation that is required. If our proposal does, in fact, result in more transactions and greater consolidation, demand for executives will be correspondingly reduced, resulting in additional downward pressure on compensation packages. Furthermore, if shareholders think that the costs in terms of retaining top-flight managers and directors are greater than the benefits, they are always free to reject our proposal. Our point is not that all, or even most, corporations would—or should—adopt our proposal. Rather, our point is simply that shareholders should have the option of organizing themselves in the way we describe here.

III. THE POLITICS OF OUR PROPOSAL

Although properly viewed, our proposal represents an opportunity for shareholders to achieve rebalancing of the rights between shareholders and their representatives, we would anticipate considerable resistance to our proposal both by managers and board members. Most corporations would probably actively oppose our proposal. Successful corporate managers have become successful in large part because of their success in managing the members of the board. Board members likewise have learned that the best way to ensure continuity is to avoid disputes with management. Both parties can comfort themselves that their mutually beneficial relationship provides shareholders with the best value. Indeed, shareholders of such firms are likely to decline to give themselves the new rights we are outlining anyway, because they would prefer to continue to delegate decisionmaking to the board where the board is acting in their interests. To the extent that the management and board are in fact functioning in the best interests
of shareholders, however, our proposal represents no real change. To the extent that the actions of the board and management do not reasonably reflect the interests of shareholders, our proposal represents a significant threat to the continued relationship of the executive management, the board, and the shareholders.

Notwithstanding that most managers and board members would not be affected directly by our proposal, we suspect that the vast majority would oppose our proposal out of concerns that irrational shareholders might either force a turnover in management or place the company up for sale, either for no good reason or for their own economic interests. The ever-increasing percentage of corporate shares owned by mutual funds, pension funds, and institutional investors makes it increasingly unlikely that such irrational behavior is a risk, however. Individual investors are significantly better informed today than they were when the structural foundations of our corporate law were put in place. Wall Street firms have focused on the individual investor, providing the product of their well-educated and well-informed research departments to their clients for the asking (and perhaps a small fee). These developments reduce the policy reasons underlying our somewhat paternalistic form of corporate governance, which does not allow the customization of the corporate contract that we propose here.

Most recently, the virtual explosion of the telecommunications and computer industries has made the rapid dissemination of information and analysis commonplace. The EDGAR filing system,\(^{26}\) combined with the Securities and Exchange Commission internet web site,\(^{27}\) allow anyone with a browser, a modem, and a telephone line the opportunity to obtain all of a corporation’s electronic public filings with that agency within twenty-four hours of its filing, and most other filings within a few days. Electronic mail and secure networks have combined with expanded financial news coverage to provide today’s shareholder with communications and information resources that often rival those available to the board of directors. We think these structural and technological changes will ultimately produce changes in corporate governance procedures along the lines that we are proposing today, despite the opposition of various interest groups in the interim.


IV. SHAREHOLDER VOTING

Corporate law promotes the formation of capital by permitting the directors to manage the affairs of the corporations for which they serve. In public corporations there is a separation of stock ownership from management for a good reason. The reason for this separation is that it permits specialization in the economy. Shareholders can enjoy the benefit of enhanced shareholder value without bearing what would be for them the impossible burden of managing the firm. Various aspects of traditional corporate law place the principal responsibility and authority for corporate actions on the shoulders of the directors. For practical and logical reasons, the corporate governance tools generally available to shareholders are overly blunt instruments, well suited only for the most extreme cases of misconduct. From a corporate governance perspective, shareholder voting provides more benefits in certain contexts than in others. That is why shareholders do not have the right to vote on all significant corporate decisions. As Easterbrook and Fischel have observed:

[S]hareholders express views by buying and selling shares; they have no reason to hamstring their firms or impose other costs that make their firm less effective competitors. They are unlikely to know better than the managers how to run the firms and thus cannot either make good decisions or recognize bad ones. 28

Moreover, we recognize that for shareholders, shareholder democracy is a means to an end. The end is maximization of share value.

We think that, in general, the current state of corporate law is quite efficient. However, for a few firms, the current system does not serve shareholders well. We think that for those firms, shareholders should be able opt out of the traditional corporate governance pattern in which the directors have broad powers to run the firm, and to opt into a radically new corporate governance framework. But we caution that this should be done sparingly. In particular, we suggest that shareholders be given the ability to amend the articles to accomplish two objectives.

First, we propose that shareholders be given the right to deliver to the board of directors a vote of no confidence in senior management, requiring the board to take immediate action to replace the existing executive management team. Additionally, we propose that shareholders be given the right to direct the board to

initiate a review of possible sale or merger alternatives, and to present the best alternative to shareholders for their consideration. Because these proposed changes to corporate law would make it substantially easier for shareholders to convey their dissatisfaction with the business judgments of management and the board, and because this expression of dissatisfaction would be publicly disclosed, we think these corporate governance tools would have significant impact, even though we anticipate that they would be used only in highly unusual circumstances, such as persistent managerial abuse of power, and where shareholders are unusually sophisticated and mistrustful of management. The desire to avoid public embarrassment would provide considerable motivation for managers and directors to act on behalf of shareholders' interests.

One of the reasons we think our proposal may be of value for some firms is that we think that there may well be occasions where executive management and the board have acted reasonably (and within the broad safe harbor of the business judgment rule) but not in a manner consistent with what the majority of shareholders may have wanted.

We further recognize that sometimes when these divergences occur, the directors will be correct. Therefore, sophisticated shareholders may not want to purchase shares in a corporation governed by articles of incorporation that reflect our proposal because they do not want to be outvoted by a majority of unsophisticated public shareholders. We acknowledge that this will limit the usefulness of our proposal.

We also wish to stress that shareholders in publicly traded firms often will find themselves the targets of coercive two-tiered hostile takeovers in which shareholders are pressured into accepting a low-ball, front-end bid in order to avoid winding up as shareholders in a merged firm that they do not think is competently run by the acquirers or being "taken out" in the back-end merger at an artificially low-price. Thus, shareholders may wish to tailor the articles of incorporation specifically to empower their directors strongly to resist these sorts of coercive acquisition proposals.

Finally, we emphasize that we are not proposing that shareholders be given the right to micromanage the corporations in which they invest. Instead, we are proposing that the myths of director infallibility and shareholder incapacity should be set aside in favor of direct voting by shareholders only with respect to the most important and fundamental decisions that a corporation makes.
Under current corporate law, a merger or sale proposal is typically presented to shareholders only after it has been approved by the board of directors, and often by the executive management as well. In the normal course, boards of directors should be entitled to approve merger proposals and to present to shareholders only those proposals that they deem worthy of their attention. But some shareholder groups may want to allocate more power to themselves. Under current law, even if a majority of shareholders thinks it is appropriate to seek a buyer for the company, they may find it extremely difficult to compel their directors to attempt to realize the acquisition premium that they think is available. Practical considerations often insulate the board and result in shareholders simply selling their shares and moving on.

One example of a situation in which shareholders might want to allocate to themselves the power to put their firm up for sale can be derived from a brief review of the recent decisions by the board of Apple Computer Company, Inc.

After several years of successfully challenging the dominance of the personal computing market by Intel-DOS based computers, Apple went through a period of turmoil with the ouster of two high profile CEOs. Commentators and analysts questioned whether Apple could develop a strategy to realize the value of what was generally regarded as a computer operating system that was, at worst, the equal of Microsoft’s newest system.\(^{29}\) The trading price of Apple’s shares suffered accordingly, falling from $44.00 per share on January 2, 1995 to $32.125 per share on January 2, 1996. As prospects for Apple soured, rumors began to circulate that rival UNIX operating system-based computer company Sun Microsystems, Inc. was interested in acquiring Apple.\(^{30}\) SunWorld Online reported on its internet web site numerous newspaper reports of Sun’s rumored interest in paying approximately $23 per share for 100% of Apple’s stock in a 1-for-1 stock exchange. Apple closed at $31.375 on January 23, 1996, following publication of the rumor. On February 2, 1996, the board of Apple met at an emergency meeting, and replaced Chairman and CEO Michael Spindler with National Semiconductor Corp. CEO Gilbert F. Amelio.\(^{31}\)


\(^{30}\) See Janet Rae-Dupree & Eddie Yandle, Valley Companies Won’t Comment As Rumors Swirl Sun, Apple Are in Talks, SAN JOSE MERCURY NEWS, Jan. 24, 1996, at 1A.

\(^{31}\) See Mike Langberg & Dean Takahashi, Apple Dumps Spindler, Picks Amelio As CEO, SAN JOSE MERCURY NEWS, Feb. 2, 1996, at 1A.
was recognized as a technology turnaround specialist, but received as part of his compensation arrangement a commitment by Apple to pay him a $10 million dollar bonus if Apple were acquired within a year of his joining.

Although Sun never went public with an offer for Apple, Apple acknowledged that discussions had taken place with several other potential acquirers, including Oracle, IBM, Canon, and Motorola. No proposals were ever presented to Apple’s shareholders for consideration. During the remainder of 1996, Apple pursued its new strategy of narrowing its product line and cutting costs. The price of Apple shares continued to slump throughout the year, however, as seen below in Chart 1. By January 17, 1997, the price of a share of Apple had fallen to $16.75.

Ironically, 1996 proved to be a banner year for computer stocks generally, and for Sun in particular. Adjusting for splits in its stock price, Sun’s shares moved up steadily from $22.375 per share on January 2, 1996, to $31.188 by January 17, 1997, as seen below in Chart 2. Had the rumored exchange offer by Sun been effected, Apple’s shareholders would have realized a gain of 39% during the twelve month period instead of a loss of 52%.

We think this experience with Apple illustrates the potential benefits to be derived from our proposal. The Apple board acted within its safe harbor and exercised its reasonable business judgment. Shareholders had access to large amounts of information regarding the company and its prospects, and several parties were interested in acquiring Apple. However, without a practically useful means of initiating a merger, shareholders who disagreed with the decision of the board had no reasonable alternative other than to sell their shares and move on. By selling their shares at prices lower than Sun’s rumored offer (not accounting for the effect to the tax deferral value embedded in that offer), Apple’s shareholders in effect indicated that an offer in the rumored range would have been acceptable to them. Obviously, this analysis is speculative, and we will never know what the Apple shareholders were actually thinking at that time or what they actually would have done if they had been able to choose. However, at a time when shareholders had a significant issue of value to consider, and when it would have been easy to determine their interest, the board was

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32 See id.
33 See Apple’s New Chief Could Get in Excess of $10 Million a Year, SAN JOSE MERCURY NEWS, Feb. 14, 1996, at 1C.
34 See Dupree & Yandle, supra note 30, at 1A.
not obligated to find out what shareholders wanted and so it simply did not do so.

On the other hand, sometimes our proposal should not be adopted because it might harm shareholders’ interests. For example, where a bidder makes a coercive, front-end loaded two-tiered bid for a target company that is intended to coerce stockholders to tender their shares into the offer to avoid being squeezed out in the second stage at a low price, shareholders would likely be seriously disadvantaged by our proposal. Any shareholder vote to sell the company would be tainted by the collective action problems facing shareholders. Along these lines, we are well aware of the conflict of interest problems that exist between shareholders and bidders. While incumbent boards and management sometimes lack the incentives to maximize shareholder value, outside bidders always lack the incentives to maximize shareholder value in the firms they are acquiring because such bidders clearly want to acquire target firms as cheaply as possible. Therefore, in these sorts of cases, target firms can maximize share value by resisting, and a shareholder vote to sell the company would benefit acquirers rather than target shareholders. That is why we think our proposal should only be used in exceptional circumstances.

Conclusion

Corporate boards of directors are given discretion to oversee the affairs of the firms on whose boards they sit for two reasons. First, directors have expertise and experience that the shareholders lack. Second, shareholders in large, publicly held companies often are too widely dispersed to be able to make a properly informed decision because of collective action and free rider problems.

The reason corporations have boards of directors is to permit the separation of ownership from management in public corporations. The separation of ownership and management is efficient because it permits specialization in the economy. Shareholders can enjoy the benefit of enhanced shareholder value without bearing what would be for them the impossible burden of managing the firm.

We also recognize that, in a wide variety of situations, defensive tactics, particularly corporate restructurings in the face of a hostile takeover threat, can enhance shareholder value, both by realizing important efficiencies within the firm, as well as by raising the price of any ultimate change in control. Thus, unlike certain scholars, we do not categorically disfavor defensive tactics, and we
reject the school of thought that holds that firms always should remain passive in the face of a hostile bid.\textsuperscript{35}

At the same time, we strongly favor an expanded approach to choice in corporate law. In particular, we are of the view that corporate law rules in general should follow a contractual pattern in which shareholders are free to opt out of the standard form, default rules provided by an existing statutory paradigm. In this Article we have advocated expanding the standard set of corporate charter provisions to permit shareholders to customize their corporate charters so as to permit shareholders to register a vote of no confidence in management, and/or to put their companies up for sale by forcing the directors to conduct an auction for the firm. In the spirit of the contractual paradigm in which we are operating, we have repeatedly emphasized that our proposal will be good for some firms, and bad for others. Thus, we do not propose changing the long-standing, existing default rule in any way. Under our proposal, firms would still be managed by or under the direction of boards of directors, who would enjoy not only widespread discretion, but also the full protections of the business judgment rule, in the management of their firms. Only shareholders of firms who amended their corporate charters in order to opt into the corporate governance arrangement we have described would have the new voting rights we are describing.

We wish to make two concluding observations. First, this Article has stressed the agency cost problem within the U.S. corporation. Sometimes the interests of managers and shareholders do diverge, and when the divergence becomes sufficiently large, our proposal may serve the interests of shareholders in some firms. We also recognize that some shareholders in other firms may want to give their directors extraordinary powers even beyond those that directors currently wield in the management of the firm. Thus, for example, if shareholders wished, they should be able to provide for the quinquennial election of directors, as some have proposed.\textsuperscript{36} And, in certain takeover situations, directors clearly should be empowered to “just say no” to certain offers, particularly those they regard as coercive or destructive of shareholder value, or of long-standing corporate strategies. In other words, we do not view expanded choice as a one way proposition, in which all choice leads

\textsuperscript{35} See Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 252 (7th Cir. 1986); Easterbrook & Fischel, The Proper Role, supra note 24.

to expanded shareholder voting rights. Rather, we view expanded choice as a mechanism for providing firms with additional flexibility in every direction. Sometimes this flexibility will lead to new rights for shareholders, and sometimes to fewer rights for shareholders.

Finally, we note that it seems to be increasingly easy for shareholders to second-guess the business decisions made by managers and directors, and to litigate to challenge those decisions. Our proposal should have the effect of stemming this litigation explosion because it should be much more difficult to challenge the legitimacy of directors of firms that have elected not to adopt the proposal we are describing. In other words, our proposal should enhance and clarify the authority of directors and managers in firms whose charter provisions did not create the voting rights we have discussed here. This, in our view, would be an added benefit from our proposal.

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37 See Macey & Miller, supra note 18.