

The Myth of the Shareholder Franchise

Lucian Bebchuk

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Main Points

- Raise questions about whether the shareholder franchise is now playing the role it is supposed to play in corporate governance.
- Put on the table for discussion ideas for reforming corporate elections and increasing shareholder power to improve board accountability.

The critical role of elections in state law

“[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”

- *Chancellor Allen, Blasius*

The role of boards

Boards play a key role:

- Select, monitor, compensate, and fire executive.
- Make major corporate decisions.

The shareholder franchise is supposed to ensure:

- That directors are well chosen
- That directors will focus on shareholder interests
 - Especially important because other potential mechanisms are weak or non-existent.

Market for corporate control?

- Weak constraint because boards have power to use defensive tactics.
- Courts use the shareholder franchise as basis for allowing boards to block takeover bids:

“If the shareholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.”

 - The Delaware Supreme Court, *Unocal*

Judicial review?

- Courts generally do not review the merits of directors' decisions and actions (makes sense given informational problems)
- In insulating boards from liability, courts have relied on the shareholder franchise:
“The redress of failures ... must come ... through the action of shareholders ... and not from this Court.”
- Chancellor Chandler, *Disney*

Director independence?

- Recent reforms that strengthen director independence are beneficial – rule out some “bad” directors and some “bad motives” directors could have. But:
- Do not ensure that directors are well chosen among the vast number of potential independent directors.
- Do not provide selected directors with affirmative incentives to focus on shareholder interests.

Shareholder power to replace directors is said to be viable and regularly used:

“[S]hareholders do run election contests on a regular basis under the existing rules.”

- Wachtel, Lipton Rosen, & Katz, June 2003

“Under the existing proxy rules, running an election contest is a viable alternative and a meaningful threat, and election contests occur regularly.”

- The task force of the New York Bar Association, June 2003

The Reality of Corporate Elections

Contested Proxy Solicitations 1996 – 2004

Year	Number of Contested Solicitations	Contested Solicitations <u>Not</u> “[O]ver the Election of Directors”	“Director Contests Focusing on Takeover of Company”	“Director Contests Focusing on Opening or Restructuring a Closed End Fund”	“Contests Focusing on Alternate Team for Governing Company”
2004	27	8	3	1	15
2003	37	5	13	3	16
2002	38	5	13	6	14
2001	40	8	15	1	16
2000	30	7	13	4	7
1999	30	10	4	2	13
1998	20	4	5	1	13
1997	29	10	12	1	5
1996	28	9	8	0	9
Total	279	76	86	19	108

Size Distribution of the Targets of Electoral Challenges 1996 – 2004

Market Capitalization	Number	Percentage of Total
\$0 - \$50M	59	55.66%
\$50M - \$100M	17	16.04%
\$100M - \$200M	13	12.26%
> \$200M	17	16.04%
Total	106	100.0 %

Successful Electoral Challenges 1996–2004

Market Capitalization	Number	Percentage of Total
\$0 - \$50M	23	39%
\$50M - \$100M	6	35%
\$100M - \$200M	6	46%
> \$200M	2	12%
All Cases	37	65.09%

Plans for further study

- Identify the incidence of cases in which a significant fraction of directors is replaced without a contested solicitation (director replacement behind the scenes?)
- The wealth effect of contests during the period of the contest as well as subsequently.

Interpreting the Data

- Perhaps shareholders are universally satisfied with incumbents' performance?
[But can there be so few cases of shareholder dissatisfaction among the hundreds of companies that are at the bottom 10% of their industry or restated their earnings or elected not to follow majority-passed shareholder resolutions?]
- An alternative explanation:
There are structural impediments to electoral challenges.

Impediments

(1) Costs and the free-rider problem

- A challenger will share the benefits of a contest with other shareholders.
- But will fully bear the costs of:
 - Sending and getting back proxies (cannot place candidates on the corporate ballot)
 - Filing and defending proxy statement
 - Campaigning
 - ↳ Challengers will “under-invest.”

(2) Incumbents' financing advantage

- Incumbents' expenses will be fully financed by the company.
 - ↳ Incumbents will “over-invest” – which will further operate to discourage challenges.

(3) Difficulty of credibly conveying a rival's superiority over incumbents

- Willingness to run is not a credible signal because an inferior rival might still like to gain control to obtain the private benefits associated with it.
- Difficulty of credibly communicating the rival's plans for the CEO position.

(4) Staggered boards

- Require winning two elections, one year apart, to gain control.
- Increase costs, requires patience and perseverance
- Makes difficult winning the first round even if rival is viewed by shareholders as somewhat superior – first round is not a choice between the incumbent and rival teams but rather between (i) the incumbents and (ii) incumbents with opposition on the board.

Reforming Corporate Elections

- What is the optimal incidence of challenges is a difficult question – but is it equal to the current, extremely low level?
- If enhancing shareholder power to remove directors is desirable, how should it be accomplished?

(1) Frequency

- It's not how often but how real!
- It would be OK to provide shareholders with a meaningful opportunity to replace directors only every two or three years.

(2) Access to the Ballot

- For all shareholders (or groups of shareholders) satisfying minimum ownership requirements.
- Since company is bearing the cost of sending the ballot anyway, denying access to the ballot operates as “tax” on challengers.

(3) Cost reimbursement

Reimburse rivals obtaining sufficient support – e.g., one third of the votes.

- Lower threshold might encourage challengers that have little or no chance of succeeding.
- Higher threshold might discourage good challengers – even a challenger that would in fact win if it were to run cannot be certain of winning.

(4) Power to replace all directors at one point in time

- If desirable to provide longer horizon, have elections less often than once a year.
- If wish to protect independent directors from removal by nominating committee, bind nominating committee to re-nominate.
 - But there should come a point in which dissatisfied shareholders are able to replace the full board in one up-or-down vote.

(5) Opting out

- One size does not fit all.
 - But opting out should be done by shareholders – boards should not be able to make contests more difficult, or to veto shareholder desire to make them easier.

Objections to reforms

(1) Disruption and Waste

Claim: contested elections would become the norm, leading to disruption and waste.

But:

- Contests would likely occur only in a limited fraction of cases (where dissatisfaction is widespread and performance especially poor)
- The possibility of electoral challenge would have a beneficial impact on accountability in a much larger set of companies.

Objection 2: Special Interests

Claim:

Barbarians at the gate: special interests with ‘collateral interests’ will be able to elect representatives to the board – or extract concessions by threatening to do so.

But:

- Because electing directors will require majority support, “special interest” directors will not be able to get elected.
- In past voting, precatory proposals focusing on special interests have not even come close to passing – the only proposals with much support were ones viewed by institutions as value-enhancing.
- Shareholder power to remove directors would make directors less willing to sacrifice shareholder value, not more willing.

Objection 3: Deterring Potential Directors from Serving

Claim: good directors would be discouraged from serving.

But:

- In the business sector, individuals holding positions generally may be replaced to provide incentives and improve selection -
Is there no way to run the system without the people at the very top facing little risk of challenge even when performance is dismal ?

Objection 4: Cost to Long-Term Shareholders

Claim: Increased shareholder power pressures management to focus on short-term results.

But:

- At most, critics should argue that shareholders should not be given power to replace directors each year – but why never?

Objection 5: Costs to Stakeholders

Claim: Board insulation is needed to enable boards to protect stakeholders.

But:

- Directors' interests are hardly aligned with those of stakeholders
 - ↳ Board insulation reduces accountability to shareholders but does not create accountability to stakeholders
 - ↳ Can facilitate and protect poor performance by incumbents that could hurt both shareholders *and* stakeholders.

Beyond Elections

- Reforming elections would not obviate the need to provide shareholders with the power to make rules-of-the-game decisions.
- Election reform should be accompanied by limiting the control that boards have long had under US state corporate law over any changes to the corporate charter or state of incorporation.

The rules-of-the-game problem

- Companies live a long life in dynamic environments –
- [70% of S&P 500 companies went public more than 30 years ago]
 - ↳ require over time adjustments to their governance arrangements.
- Board control over the rules of the game distorts the evolution of governance arrangements against ones disfavored by management.

Solved by reforming elections?

- Election reform does not eliminate the rules-of-the-game problem.
- Management cannot be induced to initiate all desirable governance changes by the threat of being replaced by a new team promising to make the change.
- Bundling problem: voting for the new team bundles together:
 - (i) change in governance arrangement, with
 - (ii) change in the director team.And shareholders that prefer not to (i) might not vote for the bundle (ii).

Solving the Rules-of-the-Game Problem

- Problem can be addressed by permitting shareholders to make rules-of-the-game decisions (Bebchuk, 2005).
- Accompany Election Reform with Shareholder Power to Make Rules-of-the Game decisions.
- To prevent changes caused by transient circumstances and majorities, require majority approval of shareholder-initiated changes in two consecutive annual meetings.
- Similar reimbursement rule to the one proposed for contests over director elections – reimburse expenses if proposal attracts sufficient support.

Conclusion

- It is far from clear that boards are now sufficiently accountable.
- Reforms based on removing existing limitations on shareholder power are worth considering.