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A Framework for Analyzing Legal Policy Towards Proxy Contests

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A Framework for Analyzing Legal Policy Towards Proxy Contests

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In this Article, the authors develop a framework for analyzing the desirable legal policy towards proxy contests and apply this framework to assess the rules governing the allocation of costs in proxy contests. The authors' normative standard is the maximization of social wealth. Proxy rules affect social wealth in three ways: they influence who will engage in proxy contests, they have an impact on who wins proxy contests, and they affect ex ante managerial behavior. Taking these effects into account, the authors examine how the three main dimensions of choice in the design of proxy rules—success contingency, neutrality, and the level of reimbursement—can be varied to make allocation rules more efficient. The authors conclude that the present rules, which provide full reimbursement to incumbents but reimburse challengers only if they gain control of the company, should be modified in three ways: to give incumbents less than full compensation and make it contingent on success, to make challenger compensation contingent on the fraction of votes received rather than on whether they gain board control, and to provide for more generous compensation to challengers in contests over matters other than the election of directors. The authors further argue that companies should be free to adopt rules more favorable to challengers, and less favorable to incumbents, than the standard proxy rules; however, companies should be restrained from opting for rules favoring incumbents over challengers.

Introduction

Voting rights of shareholders are a major element in the structure of corporate law; a shareholder vote is required to elect the board of directors and to approve fundamental corporate changes.[1] But shareholder

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1. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 212, 242(b)(1), 251(c), 271(a), 275 (1983 & Supp. 1988). For a general discussion of the importance of voting rights, see R. CLARK, CORPORATE LAW 357-400 (1986).

voting rights are meaningful only as long as a real possibility exists that shareholders will vote against the incumbent management. Because the ownership of shares in public corporations is for the most part widely dispersed, managers do not have to fear a defeat in a shareholder vote unless a challenger instigates a proxy contest, that is, actively tries to convince other shareholders to vote against management's recommendations.[2] When such organized opposition arises, it may garner sufficient support to defeat the incumbent managers.[3]

In most proxy contests, challengers oppose the slate of nominees proposed by the incumbents for election to the board of directors.[4] We will refer to these contests as "control contests," since in them the challengers generally try to wrest from incumbent management full or partial control over the management of the corporation.[5] The other subjects over which proxy contests are waged concern "fundamental" corporate changes such as proposed mergers[6] or anti-takeover charter amendments.[7] We will refer to the latter kind of contests as "issue contests."[8] In total, about twenty-five to thirty major proxy contests have been

2. Most shareholders do not personally vote their shares, but rather issue proxies to their favored contestant—hence the term *proxy contest*. *See* R. CLARK, *supra* note 1, at 360.

3. Typically, the requisite vote for electing directors is a plurality of the votes cast at the shareholder meeting. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216(3) (Supp. 1988); N.Y. BUS. CORP. LAW § 614(a) (McKinney 1989). Mergers and like transactions generally require higher approval thresholds. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c) (Supp. 1988) (majority of outstanding shares); N.Y. BUS. CORP. LAW § 903(a)(2) (McKinney 1986) (two-thirds of outstanding shares).

4. *See* R. SCHRAGER, CORPORATE CONFLICTS: PROXY FIGHTS IN THE 1980s 11, table 3 (1986) (from 1981 to June 1985, 81 of 129 proxy contests concerned the election of directors).

5. In election contests, challengers will generally contest a majority of the seats on the board of directors, giving the challengers effective control over the company if they win the contest. Even if challengers do not contest a majority of the seats, their long-term objective generally is to obtain full control over the company. *See* R. SCHRAGER, *supra* note 4, at 44-45 (partial control contests often occur in companies with staggered boards as part of long-term strategy to gain control); *id.* at 114-16 (describing 1984 proxy contest over Mutual Real Estate Investment Trust, in which one board member not up for reelection ran an alternative slate against three candidates who were up for reelection). Furthermore, even challengers who do not ultimately seek full control generally intend to increase their influence over the way the company is managed. *See id.* at 153-54 (describing 1984 proxy contest over Thriftimart, Inc., in which challengers sought board representation to influence management policies).

6. *See, e.g.*, Penn Central Shareholders' Committee, Proxy Statement 11 (Oct. 15, 1981) (opposing management's proposal to acquire Colt Industries, Inc.).

7. *See* POUND, SHAREHOLDER ACTIVISM AND SHARE VALUES, (Kennedy School of Government, Harvard Univ., Discussion Paper 169D, 1988) (anti-takeover proposals often precipitate proxy contests).

8. In issue contests, victorious challengers will generally not obtain control over the management of the corporation. Rather, issue contests merely prevent some particular action, such as a merger or the adoption of a charter amendment.

Note that by issue contests we mean the corporate governance issue contests described above, but not social policy contests (such as proposals relating to equal employment or to doing business in South Africa). *Cf.* R. CLARK, *supra* note 1, at 374-83 (general summary of trends concerning shareholder proposals). Social policy proposals are beyond the scope of this Article.

fought each year in the United States.[9]

Proxy contests are already an important element of the corporate structure and are likely to become even more so. Control contests are the only alternative to hostile takeovers for replacing management. As the impediments to takeovers have grown, control contests have become increasingly common.[10] In the first three months of 1990, proxy contests have been initiated or threatened with respect to companies with such household names as Lockheed, United Airlines, and USX.[11] Indeed, in the aftermath of the recent Delaware Supreme Court opinion in *Paramount Communications, Inc. v. Time, Inc.*,[12] the widely shared view among acquisition experts is that proxy fights will assume new stature as the takeover method of choice.[13] Furthermore, issue contests have increased in significance as institutional investors have become more interested in the question of corporate governance.[14]

In spite of its importance, legal policy towards proxy contests has not yet been subjected to a systematic economic analysis.[15] This Article

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9. R. SCHRAGER, *supra* note 4, at 11, table 3; Franklin, *1988 Proxy Season: New Players, Rules May Aid Institutional Investors,* 199 N.Y.L.J., Jan. 7, 1988, at 5, col. 2 (30 resolutions submitted to vote in 1987).

10. *See, e.g., Proxy Contests: Oasis For Dissidents—Or A Mirage?,* CORP. CONTROL ALERT, May 1990, at 1, 10; *Wall Street and the Proxy Fight: Paper Tigers,* ECONOMIST, Apr. 14, 1990, at 89; *Proxy Battles Assuming Critical Role as Takeover Tool,* MERGER MGMT. REP., Feb. 1990, at 1; Hylton, *Advisers in Forefront of New Proxy Wars,* N.Y. Times, Mar. 30, 1990, at D1, col. 4; Smith & Hilder, *Raiders, Shorn of 'Junk,' Gird for Proxy Fights,* Wall St. J., Mar. 7, 1990, at C1.

11. Smith, *Storming the Barricades with a Proxy,* Wall St. J., May 10, 1990, at C1 (other companies subject to proxy contests during 1990 included American General, Great Northern Nekoosa, Norton, National Intergroup, Armstrong World Industries, Pic'n'Save, and Xtra).

12. Fed. Sec. L. Rep. (CCH). ¶94,938 (Mar. 1, 1990).

13. *See Delaware Supreme Court's Decision in Time-Warner Gives Board an Edge in the Corporate Governance Tug-of-War,* CORP. CONTROL ALERT, Mar. 1990, at 1, 4-5. For example, the law firm of Skadden, Arps, Slate, Meagher & Flom expressed the opinion in a memorandum to its clients that "one legacy of the *Time* decision may ultimately prove to be an increase in proxy contests reminiscent of the 1960s and 1970s." *Id.* at 5 (citing firm memorandum); *see also* sources cited *supra* note 10.

14. *See, e.g., CalPERS Fights Companies in Effort to Create Shareholder Committees,* MERGERS & CORP. POL'Y, Feb. 12, 1990, at 3 (major pension fund-sponsored shareholder resolution calling for creation of special shareholder advisory committees); *Institutional Shareholders Get Their Hands Dirty,* MERGERS & CORP. POL'Y, Jan. 15, 1990, at 5 (observing greater activism by institutional investors on corporate governance proposals); *Raiders Aren't the Only Ones Using Proxies,* MERGERS & CORP. POL'Y, May 14, 1990, at 3-4 (institutional investors make increasing use of proxy process to propose corporate governance resolutions); Block & Hoff, *Emerging Role of the Institutional Investor,* 203 N.Y.L.J., Apr. 12, 1990, at 5, 35 (institutional investors expected to influence issues relating to corporate governance); Wayne, *As Proxy Use Widens, New Rules Are Urged,* N.Y. Times, June 15, 1990, at D1, col. 4 (chart showing increase in number of corporate governance shareholder proposals and in percentages of votes gained by such proposals).

15. The few works examining proxy contest rules include J. HEARD & H. SHERMAN, CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM (1987); G. MOODY & C. BAGLEY, PROXY CONTESTS (1983); R. SCHRAGER, *supra* note 4; Dodd & Warner, *On Corporate Governance: A Study of Proxy Contests,* 11 J. FIN. ECON. 401 (1983); Easterbrook & Fischel, *Voting in Corporate Law,* 26 J.L. & ECON. 395 (1983); Pound, *Proxy Contests and the Efficiency of Shareholder Oversight,* 20 J.

provides such an analysis, and puts forward a general framework for analyzing legal policy towards proxy contests. We use this framework to evaluate the rules governing company reimbursement of the substantial campaign expenditures generally incurred by incumbents and challengers. The general framework that we provide, however, can be used to analyze any aspect of the rules governing proxy contests.

While we analyze both control contests and issue contests, our initial focus will be on control contests. Part I discusses the importance of control contests in the context of the governance structure of the corporation. We first identify control contests as the only alternative to hostile takeovers for changing control of a company over the opposition of incumbents. We then compare the relative advantages and disadvantages of control contests and hostile takeovers as means for effecting changes in control.

In Part II, we identify the choices involved in designing "cost allocation" rules—that is, rules governing the extent to which the costs incurred by incumbents and challengers are reimbursed by the company (rather than being borne by the contestants themselves). Cost allocation rules play a major role in potential contestants' decisions and consequently have a substantial impact on the incidence and outcome of contests. The three most important choices we identify are whether the rules should be neutral as between incumbents and challengers, the extent to which reimbursement should be contingent upon success in the contest, and finally, whether reimbursement should be partial or full. We describe and explain the significance of each of these choices.

Part III provides a framework for analyzing proxy rules in general and rules governing contest expenditures in particular. We divide the effects of proxy rules into three categories: effects on potential contestants' decisions whether to enter contests (and thus on the incidence of contests), effects on contestants' spending decisions (and thus on the outcome of contests), and ex ante effects on managerial behavior. For each category, we investigate when such effects are socially desirable, and then explain how they are shaped by the choices in the design of proxy rules.

In Part IV, we apply our general framework to the rules governing reimbursement of expenses in control contests. Presently, incumbents are generally reimbursed for all their expenditures whether they win or lose, but challengers generally receive compensation for their expenses only if they take control of the board of directors. We will argue that the

FIN. ECON. 237 (1988); Schulman, *The Cost of Free Speech in Proxy Contests for Corporate Control,* 20 WAYNE L. REV. 1 (1973). A recent comprehensive article on regulation of the proxy process is Black, *Streamlining the Proxy Process: The Promise and Limits of Shareholder Voice,* 89 MICH. L. REV. (forthcoming 1990). None of these articles, however, provides the systematic and comprehensive economic analysis we offer.

present practice is inefficient and should be changed. Incumbents should not automatically receive full reimbursement; instead, compensation of both incumbents and challengers should be made contingent upon receiving a threshold percentage of votes.

In Part V, we turn our attention to issue contests. After identifying the differences between issue contests and control contests, we discuss the implications of these differences on the desirable legal policy toward issue contests. We conclude that challengers in issue contests should be reimbursed more generously than challengers in control contests. This conclusion implies that the existing rules, which provide no reimbursement to challengers in issue contests, are substantially deficient.

Finally, Part VI assesses the degree to which companies should be allowed to opt out of proxy rules by adopting appropriate charter provisions. We show that privately adopted proxy rules would tend to be less favorable to challengers and more favorable to incumbents than is efficient. In light of this tendency, we propose certain restrictions on the freedom of companies to opt out of proxy rules.

I
Control Contests and the Structure of the Corporation

The discussion in this Part places control contests within the broader context of the corporate control structure. We explain briefly the nature of such contests as a means for changing control against the will of the board of directors. Then we contrast the relative merits of control contests and hostile takeovers as means for achieving such changes.

As a preliminary matter, one should note that who controls a company is of great importance to shareholders as well as to society. The value of a company's assets depends significantly on who manages the company. Thus, it is generally desirable to hire those as managers who will deploy these assets in a way that maximizes company value.

Incumbent management, however, may be disinclined to relinquish control even to better managers. Incumbents tend to have self-interested motives for maintaining control: they want to retain the private benefits (such as high salaries and perks) that are associated with exercising control. Their interests in preserving their own control might exceed any interests they have in letting better managers run the company.

Thus, it is important to facilitate beneficial control changes in spite of incumbent opposition. From a social perspective, facilitating such changes will have two desirable consequences: the beneficial change itself will increase the value of the company ex post, and the threat of losing control may well provide ex ante incentives for incumbents to

increase the value of the company.[16]

Changes in control against incumbent opposition can occur in basically two ways: proxy contests for control and hostile takeovers.[17] By hostile takeovers, we mean the acquisition of a controlling interest without approval of the incumbents, whether through a tender offer or through a series of open-market or privately negotiated share purchases.

Control contests and hostile takeovers employ different mechanisms for transferring control. In control contests, the challenger tries to *persuade* existing shareholders that she would manage the company better than the incumbents. In hostile takeovers, the raider offers to *buy* the shares of the other shareholders. As we will show, the relative advantages and disadvantages of control contests and hostile takeovers stem from this difference.

If control contests could be relied on to work perfectly,[18] they would, for a number of reasons, generally be the superior tool for replacing managers.[19] First, hostile takeovers tend to involve higher transaction costs than do control contests.[20] Hostile takeovers, unlike control contests, necessitate a significant change in the ownership (as opposed to merely the management) of the company. As there is no inherent reason to acquire a company whenever one attempts to effect a change in its control, the transaction costs involved in acquiring a controlling interest (and to arrange the financing for the acquisition) are generally wasted.[21]

Second, the changes in property rights involved in hostile takeovers can distort shareholder choice of whether to sell shares to a raider. This distortion can take two forms: shareholders may attempt to take a "free

16. *See* Manne, *Mergers and the Market for Corporate Control,* 73 J. POL. ECON. 110, 113 (1965) (takeover threat encourages efficient management); Scharfstein, *The Disciplinary Role of Takeovers,* 55 REV. ECON. STUD. 185, 185 (1988) (takeover threats exercise disciplinary role on management); Schulman, *supra* note 15, at 31-32 (possibility of proxy contest makes management more concerned about shareholder support); *see also infra* Part III(C) (discussing these issues in detail). *But see* Lipton, *Corporate Governance in the Age of Finance Corporatism,* 136 U. PA. L. REV. 1, 20-25 (1987) (responses to takeover threat may be undesirable).

17. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers,* 57 TEX. L. REV. 1, 5 (1978). Hostile takeovers and control contests are the only ways to effect control transfers of solvent companies. Creditors can obtain control of insolvent companies by instituting bankruptcy proceedings.

18. By perfect operation we mean that proxy challenges arise, and succeed, whenever a replacement of the incumbents by the challengers through a successful proxy contest would increase social wealth.

19. Even if proxy contests operated perfectly, takeovers might be superior tools to effect changes in control with the potential for synergies. In such cases, a merger of the raider and the target is often necessary to increase company value.

20. R. SCHRAGER, *supra* note 4, at 7 (proxy contests have historically been cheaper than tender offers).

21. Where a merger of two companies involves synergies, though, the transaction costs of effecting a change in ownership of the target may be necessary in order to produce the synergic gains. *See supra* note 19.

ride" (and refuse to tender their shares) or they may be pressured to tender their shares when they would not otherwise do so. Free riding attempts can occur when a shareholder is faced with a bid by a raider under whose control the value of the shareholder's shares would increase. In such a case, a shareholder may reject a bid and retain her shares even though the offered price is above present share value, hoping to "free ride" on even larger increases in the value of her shares when the raider takes control.[22] By contrast, pressure to tender can arise when a shareholder is faced with a bid by a raider under whose control the value of shares would decline.[23] Shareholders may find themselves pressured to accept such a bid even at a price below the present share value if this price exceeds the expected value of minority shares after the raider has taken control.[24] Thus, free riding can lead to the failure of desirable takeover bids, and pressure to tender to the success of undesirable takeover bids.

A third shortcoming of hostile takeovers is that acquiring sufficient shares to stage a hostile takeover can trigger anti-takeover devices.[25] For example, "poison pills," which grant shareholders other than the raider the right to buy treasury shares at a substantial discount, could greatly reduce the value of a raider's holdings.[26] Or anti-takeover charter provisions could restrict the ability of raiders to gain control of a company or use their control to effect changes in the corporate structure.[27] Because such devices make acquiring a controlling interest against the will of incumbents more expensive or less profitable, they both lower the incentives for raiders to attempt hostile takeovers and reduce the likelihood of success of those hostile bids that are launched.[28]

Transaction costs, distorted choice, and anti-takeover devices constitute significant drawbacks to hostile takeovers. But control contests,

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22. *See* Grossman & Hart, *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation,* 11 BELL J. ECON. 42, 42 (1980) (discussing effects of such free riding on takeover bids).

23. The raider may find it profitable to make such a bid if she can divert significant value from minority shareholders to herself.

24. *See* Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers,* 98 HARV. L. REV. 1693, 1708-09 (1985) (possibility that value of minority shares is less than bid price can coerce shareholders to tender their shares).

25. *See, e.g.,* V. ROSENBAUM, TAKEOVER DEFENSES: PROFILES OF THE FORTUNE 500 (1987) [hereinafter TAKEOVER DEFENSES]; V. ROSENBAUM, TAKEOVER DEFENSES: PROFILES OF THE FORTUNE 500, 1987 UPDATE (1988) [hereinafter TAKEOVER DEFENSES UPDATE]. Under Delaware law, defensive tactics are permitted if they are reasonably related to a perceived threat. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

26. Delaware courts have upheld the legality of poison pills. *See, e.g.,* Moran v. Household Int'l, 500 A.2d 1346, 1356-57 (Del. 1985).

27. *See generally* TAKEOVER DEFENSES, *supra* note 25 (providing an overview of such provisions); TAKEOVER DEFENSES UPDATE, *supra* note 25 (same). State anti-takeover statutes may also inhibit takeovers. *See, e.g.,* DEL. CODE ANN. tit. 8, § 203 (Supp. 1988) (making it more difficult for certain large stockholders to merge with a target corporation).

28. Anti-takeover devices do not constitute an *inherent* shortcoming of hostile takeovers.

too, suffer from severe imperfections. There are two main causes for these imperfections: inadequate incentives to acquire information and inadequate incentives to lead contests. We present below a systematic analysis of how these imperfections affect control contests.[29]

Proxy contest outcomes are imperfect primarily because shareholders have inadequate incentives to ascertain which contestant is superior. This lack of proper incentives is caused, in two distinct ways, by the dispersion of share ownership.[30] First, shareholders who own only a small fraction of the company's shares will not be affected greatly by the outcome of the contest. That is, even a large increase in company value could result in only a small increase in wealth for such shareholders. Second, these shareholders will consider it unlikely that their few votes will affect the outcome of the control contest. For both these reasons, such shareholders will have little reason to acquire information about the contestants.[31] As a result of shareholders' lack of incentive to become

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Rather, they are a shortcoming because, under the present state of the law, incumbents are free to use such devices, with few legal constraints, to fend off takeover attempts.

To be sure, companies may also adopt defensive devices designed to fend off proxy challenges. *See, e.g.,* Articles of Incorporation of Kysor Industrial Corporation 6-8 (requiring 120-day prenotification of nominations for directors by shareholders). For two reasons, however, the legal constraints on anti-proxy contest devices will probably be more significant than those on anti-takeover devices. First, state law fiduciary duties are likely to impose greater restrictions on anti-proxy contest devices than on anti-takeover devices. *See* Block & Hoff, *Defensive Tactics in Proxy Contests,* 202 N.Y.L.J., Nov. 16, 1989, at 5-7 (courts less deferential to management actions designed to manipulate voting process). Second, federal securities regulations protect several aspects of shareholder voting rights in proxy contests and may preempt some anti-proxy contest devices. DEL. CODE ANN. tit. 8, § 203(c)(8)(ii) (Supp. 1988) (Delaware anti-takeover statute de facto does not apply to proxy contests); 17 C.F.R § 240.14a-9 (1990) (barring false or misleading statements in proxy materials); *see also* Wayne, *supra* note 14, at D1, col. 4 (SEC is considering new proxy regulation that could make it easier to replace incumbents); *SEC May Seek to Overrule Pennsylvania Takeover Law,* MERGERS & CORP. POL'Y, May 7, 1990, at 2-3 (SEC questions whether states can regulate proxy contests); *Witnesses at Hearing Split Over Confidential Proxy Voting,* [July-December] Sec. Reg. & L. Rep. (BNA) No. 31, at 1179 (Aug. 4, 1989) [hereinafter *Witnesses at Hearing*] (Congress considering confidential voting requirement). *See generally* R. Breeden, U.S. Equity Markets in the 1990s, Remarks at the Annual Meeting of Council of Institutional Investors 6-11 (Apr. 2, 1990) (SEC News Release) (proxy regulation concerns have important place on SEC agenda).

29. *See infra* Part III.

30. Public corporations generally have a large number of shareholders. *See, e.g., Listing and Delisting of Securities,* 2 N.Y.S.E. GUIDE (CCH) ¶2501 (1990) (NYSE generally lists only companies with at least 2,000 shareholders); *see also* D. VAGTS, BASIC CORPORATION LAW 363 (3d ed. 1989) (AT&T has over 2,782,000 shareholders). Presumably, most of these shareholders own only a small percentage of the outstanding shares. Of course, to the extent that some corporations have shareholders who own a substantial fraction of the outstanding shares, the information incentive problems are ameliorated. *Cf.* Black, *supra* note 15 (growth of shareholding by institutional investors reduced collective action problems). However, only a shareholder who owned all of a company's shares would have optimal incentives to acquire information on how to maximize company value.

31. *Cf.* Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments,* 102 HARV. L. REV. 1820, 1836-40 (1989) (investors have less incentive to make an informed vote than to make an informed decision whether to buy or sell stock).

informed, inferior contestants will often emerge from proxy contests as winners.[32]

By contrast, information incentive problems have less of an impact on hostile takeovers. One reason is that shareholders need less information to decide whether to tender than to decide how to vote: rather than having to evaluate the management abilities of incumbents and challengers, they merely have to compare the bid by the raider with the current value (and share price) of the company. In addition, shareholders will face greater incentives to acquire information. To be sure, the outcome of a tender offer may not greatly affect shareholder wealth, and an individual shareholder's decision to tender may not greatly affect whether the offer succeeds. But whether a shareholder tenders her shares will be significant to her even if it does not determine the success of the bid (and thus provide an incentive to acquire information). If the bid succeeds, a tendering shareholder will receive the price offered by the raider; a non-tendering shareholder, on the other hand, will retain her shares.[33]

Inadequate incentives to acquire information and the resulting imperfection in the outcome of control contests, pose a second, and related, problem. The possibility that a good contestant may lose the contest makes it less worthwhile for that contestant to enter the contest. But the possibility that a bad contestant may win the contest makes it more worthwhile for the bad contestant to enter. That is, contestants will be subject to imperfect incentives to enter contests. As a result of these imperfect incentives, proxy challenges do not always arise whenever they are desirable, and sometimes arise when they are undesirable.

Moreover, good contestants are not always compensated for the costs of leading control contests. If so, they bear all the costs of waging a contest but must share proportionally with all other shareholders any increase in company value resulting from a successful contest.[34] The risk of not being reimbursed further reduces incentives for good contestants to wage proxy contests.

In fact, during the 1980s the number of control challenges

32. Empirical evidence confirms that shareholders do not always vote in a way that maximizes firm value. *Cf.* Jarrell & Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980,* 19 J. FIN. ECON. 127, 129-31, 154-55 (1987) (shareholders approve antitakeover amendments even though such amendments reduce firm value).

33. Hostile bids often include cash-out provisions for shares that are not tendered initially. *See, e.g.,* Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (tendering shareholders to receive $54 per share in cash and non-tendering shareholders to receive securities purportedly worth $54 per share). In that case, the decision to tender affects the shareholder because the consideration given to tendering shareholders may turn out to be different from the one given to non-tendering shareholders. Shareholders may also be uncertain about whether non-tendering shareholders will, in fact, be cashed out.

34. Easterbrook & Fischel, *supra* note 15, at 413.

declined,[35] and tender offers became the prime vehicle for effecting changes in corporate control.[36] But the trend towards tender offers seems to be reversing.[37] As takeover defenses continue to proliferate[38] and grow in sophistication,[39] it becomes more difficult for hostile bids to succeed. By contrast, the growth in institutional investment has reduced the dispersion of share ownership and ameliorated the information incentive problems of proxy contests.[40] Thus, proxy contests have reemerged as an important tool for acquiring control.

In light of the renewed significance of proxy contests, it is important to stress that their imperfections are only in part inherent in the nature of proxy contests. Additionally, the extent of these imperfections is a function of the legal rules governing proxy contests. For the remainder of this Article, we will examine how the imperfections in proxy contests relate to these rules. In particular, we will endeavor to provide a framework for analyzing legal policy towards proxy contests. In applying this framework, we will focus on how the rules governing expense allocation should be structured in order to transform proxy contests into a more viable means for inducing beneficial control changes.

II
ALTERNATIVE LEGAL RULES

Proxy contests are governed by a blend of federal regulation, state law, and corporate charter and by-law provisions. These rules regulate matters such as the type of information required to be disclosed in proxy statements,[41] fraud in proxy solicitation materials,[42] revocability of proxies,[43] access by shareholders to corporate information,[44] and time and place of shareholder meetings.[45]

35. R. SCHRAGER, *supra* note 4, at 9-11 (average number of control contests declined from about 25 in the years 1958 to 1962 to about 16 in the years 1981 to 1984).

36. Machtinger, *Proxy Fight Expenditures of Insurgent Shareholders,* 19 CASE W. RES. L. REV. 212, 213 (1968); Pound, *supra* note 15, at 237 (citing empirical evidence); *cf.* R. SCHRAGER, *supra* note 4, at 12 (in 1980s, tender offers "remained primary means of contesting control").

37. *See* sources cited *supra* note 10.

38. *See* TAKEOVER DEFENSES, *supra* note 25, at 1-2.

39. *See* R. CLARK, *supra* note 1, at 571-77 (overview of defenses and how they have changed).

40. *See* Brancato, The Pivotal Role of Institutional Investors in Capital Markets 19 (1990) (Columbia Center for Law and Economic Studies, Institutional Investor Project) (institutional investors estimated to hold more than 45% of total equity securities in U.S.); *see also* Black, *supra* note 15 (institutional investors have grown large enough that a limited number of institutions own a substantial percentage of the shares of most public companies).

41. *See, e.g.,* 17 C.F.R. § 240.14a-3 (1990).

42. *See, e.g., id.* § 240.14a-9 (1990).

43. *See, e.g.,* DEL. CODE ANN. tit. 8, § 212(c) (1983).

44. *See, e.g., id.* § 220.

45. *See, e.g., id.* § 211(a)-(b). For a more detailed overview of the subjects covered by the rules governing proxy contests, see Black, *supra* note 15.

In this Article, we will focus on cost allocation rules, the rules governing allocation of expenses in proxy contests. By cost allocation rules we mean the set of conditions that determines whether a contestant bears the costs of a proxy contest herself, or whether she is reimbursed for the expenses by the company. As we show in Parts III and IV, allocation rules have a significant impact on the incidence and outcome of proxy contests, as well as on ex ante managerial behavior. The rules thereby determine the efficacy of proxy contests as means for furthering changes in control.[46] Furthermore, the alternative ways of designing allocation rules merit a full and systematic analysis.

The purpose of this Part is to provide a matrix of the dimensions of choice in the design of allocation rules. For purposes of this Article, we will confine our analysis to the three main dimensions of choice: whether incumbents and challengers are reimbursed neutrally, whether reimbursement is contingent upon success, and whether reimbursement—when granted—is full or partial.[47] As we will show in Part IV, the design of allocation rules along these dimensions has important consequences for the efficacy of proxy contests.

A. *Neutrality Among Contestants*

One dimension of each cost allocation rule is the degree to which it is neutral. By neutral, we mean that the availability of compensation does not depend on whether the contestant is an incumbent or a challenger. By contrast, differential rules set different standards for the reimbursement of incumbents and challengers. For simplicity, we will for the most part assume that differential rules provide more generous

46. Other aspects of proxy contest rules that may have a significant effect on the efficacy of proxy contests include the extent of the shareholder proposal rule, 11 C.F.R. § 240.14a-8 (1990); whether proxy voting is confidential, *Witnesses at Hearing, supra* note 28, at 1179; and whether contestants are permitted to buy votes, *see, e.g.,* Chew v. Inverness Mgmt. Corp., 352 A.2d 426, 430 (Del. Ch. 1976) (buying votes from shareholders is against public policy).

The effect of some of these other rules is discussed in Black, *supra* note 15 (discussing several aspects of proxy regulations); Letter from United Shareholders Ass'n to Jonathan G. Katz, Secretary of the SEC (Mar. 20, 1990) [hereinafter United Shareholders Ass'n Letter] (proposing revisions of federal proxy rules to provide for confidential voting and increased shareholder access to the proxy machinery); Letter from Calif. Pub. Employees' Retirement Sys. to Linda S. Quinn, Dir. of the Division of Corp. Finance of the SEC (Nov. 3, 1989) (proposing 48 revisions of federal proxy rules, including a clarification of the definition of *solicitation*, adoption of a requirement of confidential voting, and various modifications in the disclosure requirements).

47. Other conceivable dimensions include differentiating between contests over policy and contests over personnel, *see infra* Section IV(A), or tying contestants' reimbursement to their stake in the company, *see, e.g.,* 17 C.F.R. § 240.14a-8(a)(1) (1990) (only shareholders holding at least 1% or $1,000 worth of shares are eligible to make shareholder proposals); United Shareholders Ass'n Letter, *supra* note 46, at 45 (proposing proxy regulation requiring compensation of challengers' expenses only if challenger is beneficial owner of at least 3% of voting power or of voting securities with a market value of at least $1 million). We believe, however, that the dimensions discussed in this Article represent the most fundamental ones.

compensation to incumbents than to challengers.[48] Providing more generous reimbursement to incumbents obviously benefits incumbents and harms challengers.

There are two ways in which an allocation rule can lack neutrality: by tying compensation directly to the status of a contestant as incumbent or challenger, or by tying it to board approval. As an example of the former, take a rule that provides for reimbursement of only incumbents, but not of challengers. A rule that gives the board of directors discretion to grant or deny reimbursement would fall in the latter category.[49] Even though reimbursement is not directly tied to the status of the contestant, the de facto result of such a rule is to grant compensation to all incumbents, but only to those challengers who take control of the board.[50]

It is worth noting that, even under neutral allocation rules, institutionalized advantages will favor incumbents. Incumbents generally set the date for the shareholder meeting and the record date for determining voting rights.[51] Their immediate access to the shareholder list and to corporate information gives incumbents an informational edge over challengers, who have only limited access to that information.[52] The incumbent board will usually have established goodwill among shareholders through glossy annual reports or other promotional literature[53] and may have created collateral motives for institutional investors to vote with management[54] (for example, by hinting to banks and insurance companies that they might lose the company's business if they do not).[55] In addition, incumbents could use their present control to issue shares to

48. This assumption appears reasonable since the current compensation rules favor incumbents, *see infra* Part IV, and since, to our knowledge, no commentator has argued that rules should be biased in favor of challengers. Analytically, rules biased in favor of challengers will have effects opposite of, but analogous to, those favoring incumbents.

49. This is the current legal rule. *See infra* note 129 and accompanying text.

50. *See infra* notes 130-58 and accompanying text. Boards can grant reimbursement either during or after the contest. Thus, incumbents can reimburse themselves during a contest, while challengers can reimburse themselves only if they take power.

51. *See, e.g.*, Pound, *supra* note 7, at 8. While most proxy contests occur at annual meetings, challengers can occasionally use a special shareholder meeting as a forum for the proxy contest. For an example of this practice, see Florida National Banks of Florida, Proxy Statement 207 (Special Meeting of Shareholders Called for December 17, 1981) [hereinafter Florida National Banks Proxy Statement].

52. *See* G. MOODY & C. BAGLEY, *supra* note 15, at A-29; Yoran, *Restraints on Incumbent Directors in Intracorporate Battles for Control*, 7 U. RICH. L. REV. 431, 435-39 (1973).

53. *Cf.* G. MOODY & C. BAGLEY, *supra* note 15, at A-35 (management may use annual and other reports to keep shareholders "conditioned to its point of view"); Pound, *supra* note 15, at 242-43 (management has advantage since it has often developed relationships with, and thus gained the loyalty of, relatively uninformed shareholders).

54. *See* J. HEARD & H. SHERMAN, *supra* note 15, at 50-53; *cf.* Black, *supra* note 15 (analyzing conflicts of interest of various types of institutional investors and proposing legal reforms addressing these conflicts).

55. *See, e.g.*, Brickley, Lease & Smith, *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267, 276-79 (1988) (presenting empirical evidence that institutions

holders friendly to management or to fund payments of greenmail. Lastly, in issue contests, incumbents have the additional advantage of controlling the voting agenda (that is, in what order and combination proposals are presented).[56]

B. *Success Contingency*

A second important dimension of cost allocation rules is success contingency: whether, and to what extent, reimbursement of a contestant is conditioned on attaining some measure of "success." Success may, of course, be defined as the individual contestant's actually being elected.[57] One can also define success as the contestant's receiving votes in excess of a certain threshold—for example, more than 15%.[58] Lastly, success could be the contestant's team's acquisition (or retention) of control of the majority of seats on the board.[59]

Tying compensation to "success" influences proxy contests by benefiting the contestants likely to receive sufficient votes to make them "successful." The number of votes a contestant expects to receive will depend on two factors: the number of shares held by the contestant[60] and the number of votes expected from other shareholders. The larger these numbers, the greater the chances of success and thus of receiving compensation.[61]

C. *Full or Partial Reimbursement*

The last significant dimension of any allocation rule is whether compensation, if granted, is full or partial. By full compensation we mean that a contestant is reimbursed for all the costs of the proxy contest. There are several ways in which the amount of compensation can be circumscribed. We will discuss briefly the four basic methods: upper limits, deductibles, fractional reimbursement, and itemized reimbursement.

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less subject to management influence are more likely to oppose management than, for example, banks and insurance companies that do business with the company).

56. *See* Black, *supra* note 15.

57. Easterbrook and Fischel favor this definition of success. *See* Easterbrook & Fischel, *supra* note 15, at 413-14.

58. *See, e.g.*, Friedman, *Expenses of Corporate Proxy Contests*, 51 COLUM. L. REV. 951, 963 (1951); Latcham & Emerson, *Proxy Contest Expenses and Shareholder Democracy*, 4 CASE W. RES. L. REV. 5, 16 (1952) (both articles suggesting a 10 to 15% threshold).

59. Alternatively, rather than tying compensation to attaining a success threshold, the amount of compensation could be varied continuously with the fraction of votes received. *Cf.* Emerson & Latcham, *Proxy Contests: A Study in Shareholder Sovereignty*, 41 CALIF. L. REV. 393, 436 (1953) (suggesting that challengers should receive same dollar amount per vote received as incumbents, who should be fully reimbursed).

60. *But cf.* Schulman, *supra* note 15, at 37 (suggesting that votes cast by the challengers themselves not be counted in determining whether the success threshold is met).

61. The effects of success-contingency on challenger incentives to run are discussed in detail at *infra* Section IV(B)(2).

First, if an upper limit is imposed on reimbursable expenses, a contestant will only be compensated for expenses up to that amount. The portion of expenses exceeding that ceiling would be borne by the contestant. Under such a scheme, expenses could be limited to a fixed dollar amount, to a "reasonable amount of expenses,"[62] to the amount of expenses incurred by the opposing contestant,[63] or to an amount determined by some formula.[64]

Deductibles are the mirror image of upper limits. Any contestant would bear the "initial" costs of the contest up to the deductible, but would receive compensation for all expenses in excess of the deductible. Like upper limits, deductibles can be expressed as fixed amounts or be based on a combination of factors (such as the value of shares owned by the contestant or the size of the company).

Another method for limiting reimbursement is to provide for reimbursement of only a specified fraction of the expenses. A simple fractional reimbursement rule could limit reimbursement to a fixed percentage (such as 50%) of expenditures. A more complex rule might provide for graduated reimbursement (for instance, 50% of expenses up to $100,000, and 25% of expenses above that amount).

Compared to full reimbursement, each of these methods would provide disincentives both to initiating a contest and to escalating its costs, since either entails costs to contestants. But the relative power of these incentives will vary. For one, the significance of any limitation will depend on its degree (for example, whether the upper limit is high or low). Furthermore, the effects of a limitation depend on the way compensation is limited. For example, a properly set upper limit will tend to have stronger effects on incentives not to increase expenditures than on incentives not to initiate a contest, since the contestant who initiates a contest can spend up to the upper limit and still get full reimbursement. In contrast, a properly set deductible will create more powerful incentives against initiation of a contest than against escalation of its costs since additional expenditures are reimbursed once the deductible is reached.

Finally, an allocation rule can treat expenses on different items differently. That is, whether an expense item is reimbursed could depend on the nature of the expense. Expenses in proxy contests include the

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62. Barnhill, *The Corporate Raider: Contesting Proxy Solicitations and Take Over Offers,* 20 BUS. LAW. 763, 779 (1965).

63. *See, e.g.,* United Shareholders Ass'n Letter, *supra* note 46, at 24-25, 45 (proposing proxy regulation requiring compensation of expenses of certain challengers up to amount of expenses incurred by board).

64. *See, e.g.,* Stifel, *Shareholder Proxy Fight Expenses,* 8 CLEV-MAR. L. REV. 339, 346-47 (1959) (suggesting possibility of formula based on company size, industry, and number and distribution of shares, or, alternatively, proposing fixed annual amount for campaign expenditures).

costs of designing the campaign literature (including fees to accountants, securities analysts, lawyers, public relations experts, and professional proxy solicitors), travel, telephone, and entertainment expenses in connection with the solicitation of proxies from important shareholders, the costs of printing and mailing proxy statements to shareholders, and expenses for advertisements,[65] speeches, and similar campaign activities.[66]

Itemized reimbursement provides incentives to spend more on items that are compensated and less on items that are not. For example, if the cost of mailing proxy statements to shareholders is compensated but the cost of oral communications is not, a contestant would tend to mail more materials to shareholders, but make fewer speeches and telephone calls. Thus, itemized reimbursement may have significant effects on the composition of proxy contest expenditures.

D. Concluding Remarks

Any rule on cost allocation necessarily involves conditioning reimbursement along the dimensions of neutrality, success contingency, and reimbursement level. As there are numerous choices along each dimension, a large number of different legal rules are conceivable. For example, one could compensate both incumbents and challengers for all expenses up to a reasonable amount if they win at least twenty percent of votes cast; one could compensate incumbents for all expenses but challengers for printing and mailing expenses only; or one could fully compensate the contestant who receives more votes, and compensate the other contestant for only half of her expenses. After setting out in Part III the framework for our analysis of the effects of proxy rules, we will revisit in Part IV each of these dimensions of choice, exploring how cost allocation rules should be designed along each dimension.

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65. For an example of the cost of advertisements in a recent proxy contest, see *Wall Street Meets Madison Avenue in the Lockheed Simmons Proxy Battle,* CORP. CONTROL ALERT, Apr. 1990, at 1 [hereinafter *Wall Street Meets Madison Avenue*] (parties to Lockheed proxy contest spent about $2 million on full-page newspaper advertisements).

66. Some other costs normally incurred by management, such as the cost of giving notice of the meeting to shareholders, conducting the meeting and the voting procedure, and taking other actions necessary to obtain a quorum are more aptly characterized as corporate expenses. As such, they should always be borne by the corporation. *See, e.g.* Rosenfeld v. Fairchild Engine & Airplane, 309 N.Y. 168, 175, 128 N.E.2d 291, 294 (1955) (Desmond, J., concurring) (cost of giving routinely necessary notice is, "of course, chargeable to the corporation"); *cf.* Friedman, *supra* note 58, at 954 (expenses for proxy solicitors should be reimbursed only if they were necessary to obtain quorum). Some expenses, however, may be both corporate and campaign expenses, for example the cost of mailing the notice of the shareholder meeting together with campaign literature. These costs should be allocated between the company and the incumbents.

III
A FRAMEWORK FOR ANALYSIS

In this Part, we provide a framework for analyzing the effects of proxy rules and determining whether these effects are desirable. The normative objective we use in this Part is efficiency.[67] By efficiency we mean the maximization of social wealth. Social wealth in turn consists of the net benefits accruing to *all* parties affected by proxy contests.[68] We will proceed to apply the framework we develop to allocation rules, but it can also be employed to assess other elements in the legal policy towards proxy contests.[69]

In determining whether a proxy rule is efficient, one must take into account all its various consequences. As these consequences are highly complex, for analytical purposes we divide them into three categories and examine each one separately.

In Section A, we discuss the effects of proxy rules on the decisions of potential contestants to enter proxy contests and on the resulting incidence of proxy contests. At the outset, we model the conditions under which it is socially desirable for contestants to enter a proxy contest; then we address the conditions under which contestants will find it privately profitable to do so. Next, we discuss why contestants make inefficient entry decisions. Finally, we conclude Section A by sketching the connection between allocation rules and entry decisions.

Section B considers the effects of proxy rules on contestants' spending decisions and consequently on the outcome of contests. After reviewing why the outcome of proxy contests is imperfect in that the better contestant may still lose,[70] we delineate the relation between campaign expenditures and the outcome of proxy contests. We then examine the circumstances under which it is efficient and those under which it is privately profitable to incur additional campaign expenditures. Finally, we explore briefly the effect of cost allocation rules on the amount of campaign expenditures and on the outcome of contests.

In Section C, we address the effects of proxy rules on ex ante managerial behavior. Proxy rules generate ex ante incentives to reduce the

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67. In Part VI, we will reexamine proxy rules from a different perspective: the maximization of private wealth of the parties to the corporate contract. Unlike efficiency, this standard does not take into account costs and benefits to those who have a stake in proxy contests but were not present when the corporate contract was designed—in particular, potential challengers. We will argue in Part VI that companies face incentives to adopt rules that maximize this private wealth even if such rules are not efficient.

68. For a discussion of the elements of social wealth, see Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980).

69. For example, see *infra* Section IV(C) discussing the extent to which other elements of proxy rules favoring incumbents over challengers may be desirable.

70. *See supra* note 18 and accompanying text.

probability of ouster since such rules affect both the incidence and outcome of proxy contests. We will examine the desirability of the two kinds of managerial responses to these incentives—increasing shareholder support or adopting defensive measures—relative to the risk-bearing costs created by the probability of ouster.

A. *Entry Decisions and Incidence of Proxy Contest*

In this Section, we discuss the decisions of challengers and incumbents to enter into proxy contests.[71] By entering into a proxy contest we mean, for challengers, initiating the contest, and for incumbents, defending against proxy challenges.[72] A proxy contest ensues only if both challengers *and* incumbents decide to enter.[73]

This Section is divided into four Subsections. In the first Subsection, we model the circumstances under which it is socially desirable to enter contests. In the second Subsection, we examine when entry is privately profitable. Then, we explore in detail how privately profitable entry decisions deviate from socially optimal ones. Finally, we delineate the effects of cost allocation rules on entry decisions.

As we demonstrate, the same factors determine for both challengers and incumbents when it is socially desirable, and when it is privately profitable, to enter contests. Therefore, for most of this Section, we focus on entry by challengers and do not repeat the identical analysis for incumbents. We stress, however, that the results we derive for socially desirable and privately profitable decisions with respect to challengers apply equally to incumbents.

1. *Efficient Entry Into Proxy Contests*

For an entry by a challenger to be efficient, it is necessary (though not sufficient) that a victory by that challenger would result in social

71. In analyzing the decision to enter, we take the costs and outcomes of contests as given. Costs and outcomes will be analyzed at *infra* Section III(B).

72. Incumbents' *not* defending against proxy challenges would mean, in control contests, withdrawing as nominees for election to the board and, in issue contests, retracting incumbent proposals or implementing challenger proposals. Contestants could also decide to settle a contest or unilaterally to offer a compromise, for example by electing some of the challenger nominees or by modifying an incumbent proposal. For analytical purposes, we will disregard settlements and compromises and assume that contestants either enter or withdraw from a contest.

73. Many commentators have implicitly assumed that incumbents will always defend against proxy challenges. Therefore, they have paid little or no attention to the effect of proxy rules on entry decisions by incumbents. *See, e.g.,* Friedman, *supra* note 58, at 951; Latcham & Emerson, *supra* note 58, at 5 (failing to analyze the connection between cost allocation rules and incumbents' decisions to defend). *But see* Machtinger, *supra* note 36, at 216 (reimbursement of insurgents will encourage proxy contests). But incumbents, like challengers, will only enter proxy contests if proxy rules make it privately profitable for them to do so. Thus, proxy rules influence not only whether challengers initiate contests, but also whether incumbents defend against challenges.

gains. That is, social wealth must be higher if the challenger wins the contest than if the incumbent wins. If victory by a challenger decreases social wealth (and thus results in social losses), it is never desirable for that challenger to initiate a contest.

Social wealth principally consists of the value of the company to the shareholders, which we term "company value." Company value will, of course, depend on who controls the company. Changes in company value, as a result of a shift in control from one to the other contestant, are generally reflected by changes in the company's stock price.[74] Social wealth also includes any value captured by those controlling the company after the contest (and not shared among shareholders at large). We will refer to such value as the private benefits of control.[75] Private control benefits may include high salaries, benefits from self-dealing or looting,[76] power to tailor company policy to one's personal interests,[77] or psychological utility from running the company. Ordinarily, the level of private benefits that a particular challenger would derive from capturing control will differ from those accruing to the incumbent. Social wealth thus equals company value plus the private benefits of control derived by those running the company.[78]

We will denote those challengers whose victory would result in social gains (that is, an increase in social wealth) as "good" challengers, and those whose victory would result in social losses as "bad" challengers. Similarly, we will refer to incumbents as "good" incumbents and "bad" incumbents, and to contestants in general as "good" and "bad" contestants.[79]

Assume, for example, that challenger *A* will derive private benefits of $1 million if she wins the contest and that company value under her control will be $50 million. If incumbent *B* wins, *B* will derive private benefits of $1.5 million, but the company will only be worth $45 million. Social wealth would then be $51 million under *A* and $46.5 million under *B*, and so victory by *A* would result in social gains of $4.5 million. *A*

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74. *See* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (information about a company will be reflected in its price).

75. Other commentators have recognized the existence of private control benefits. *See* Grossman & Hart, *supra* note 22, at 42-43 (private control benefits may be desirable since they can serve to overcome free rider problems); Harris & Raviv, *Corporate Control Contests and Capital Structure*, 20 J. FIN. ECON. 55 (1988) (private control benefits impact resistance strategy and choice of takeover method).

76. *Cf.* Perlman v. Feldmann, 219 F.2d 173, 178 (2d Cir.) (minority shareholders can recover from incumbent who loots corporation), *cert. denied*, 349 U.S. 952 (1955).

77. *Cf.* Dodge v. Ford Motor Co., 204 Mich. 459, 507-08, 170 N.W. 668, 684-85 (1919) (directors have wide discretion over dividend policy).

78. We assume, for simplicity, that no other constituents (such as creditors, employees, or suppliers) are affected by who controls the company.

79. A good challenger will necessarily be paired against a bad incumbent, and vice versa.

would be a good challenger and *B* a bad incumbent.[80]

As we indicated, for entry to be desirable, victory by the challenger must result in social gains. However, even if this necessary condition is met, entry will not always be desirable. Rather, entry will only be desirable if one other condition is met: *expected* social gains must exceed social costs. We will refer to contestants for whom expected social gains exceed social costs as "desirable" entrants.

Expected social gains from entry equal the social gains from winning weighted by the probability of winning. Take our preceding example in which the social gains of *A* taking control from *B* were $4.5 million. Further assume that *A* has a 40% chance of winning if she initiates a contest. Expected social gains from *A* initiating a contest would then be $1.8 million: $4.5 million social gains times her 40% chance of winning.

Social costs consist of all costs of all parties engaged in the proxy contest. Thus, social costs will include the costs of the contest borne by the company as well as those borne by the contestants. To continue our example, further assume that a contest would result in expenses to the company of $300,000, expenses to *A* of $200,000, and expenses to *B* of $100,000. As shown, expected social gains from *A* initiating the contest were $1,800,000. Social costs are the sum of the costs to *A*, *B*, and the company, in this case $600,000. As expected social gains exceed social costs, it is desirable for *A* to initiate the contest. (Entry by *B*, of course, is not desirable.)

Thus, to summarize this Subsection, entry into proxy contests is desirable if social gains weighted by the probability of winning exceed social costs. Social gains consist of the difference between social wealth if the contestant wins and social wealth if she loses. Social wealth, in turn, is the sum of the company value and private control benefits. Social costs consist of the proxy contest expenditures borne by each contestant and by the company.

2. *The Private Decision to Enter Contests*

In this Subsection, we shift our attention to the conditions under which entry into proxy contests is privately profitable.[81] Challengers will

80. Note that if two contestants derive similar private benefits from control, social wealth will generally be greater under the contestant who produces higher company value. Similarly, if the impact of control on the amount of private benefits (in our example, $500,000) is less than the impact on company value (in our example, $5 million), it will be desirable to elect the contestant under whom company value would be higher.

81. The model on entry we develop is similar to the model used by Harris and Raviv. *See* Harris & Raviv, *supra* note 75, at 55-56.

initiate (or incumbents defend) a contest whenever the expected gains accruing to *them* exceed the costs accruing to *them*.

If a challenger wins the proxy contest, she will derive private gains from two sources. First, as explained in the preceding Subsection, she will derive the private benefits from controlling the company. Second, *to the extent she holds stock of the company,* she will share, proportionally with all other shareholders, any resulting change in company value.[82] We will refer to this difference between the value of a contestant's shares if she wins the contest and the value if she loses the contest as "stock appreciation gains" (or "losses").[83] If taking control results in a decline in company value, and if the resulting stock appreciation losses are higher than the private control benefits, a challenger would never initiate a contest.

Take our example from the preceding Subsection in which *A* would derive $1 million in private control benefits from winning, and company value would increase by $5 million. Assume *A* owns 10% of the shares of the company. Her private gains from winning the contest would then be $1.5 million: $1 million in private control benefits, and $500,000 in stock appreciation gains.

A contestant will find it privately profitable to enter a contest if *expected* private gains from entry exceed private costs. Expected private gains from entry are the product of the private gains to a contestant if she wins and the probability of winning. In our example, as *A* has a 40% chance of winning, her expected private gains amount to $600,000.

The private costs to a contestant primarily consist of her unreimbursed costs of waging the contest. But the contestant will also bear a part of the expenses borne by the company proportional to her fraction of company shares. Total private costs will then be the sum of

82. In efficient markets, the increase in company value will be reflected in an increase in stock price. *See* Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work,* 25 J. FIN. 383, 383 (1970).

83. We assume that the value accruing to a contestant if she loses a contest is the same as the value if she does not engage in the contest. But note that Dodd and Warner find that even unsuccessful contests generally increase company value. *See* Dodd & Warner, *supra* note 15, at 435. Easterbrook and Fischel explain this phenomenon by arguing that unsuccessful contests increase the prospect of future monitoring and thereby lead to improved performance by the incumbents. Easterbrook & Fischel, *supra* note 15, at 413. *But cf.* DeAngelo & DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations,* 23 J. FIN. ECON. 29, 40 (1989) (stock price gains from proxy contests generally disappear if company not subsequently sold or liquidated). Another possible explanation is that positive information about company value disseminated during the proxy contest caused both the share price increase and the incumbents' success.

To the extent that even unsuccessful contests increase corporate value, and thus social wealth, they are beneficial. Our model can be adapted to include this possibility by adding to the expected gains of initiating a contest these gains from the challenger's losing—weighted by the probability of losing.

uncompensated costs personally incurred by the contestant and a pro rata portion of the costs borne by the company.

Take our example from the preceding Subsection. Recall that a contest would involve expenses of $300,000 to the company, expenses of $200,000 to *A*, and expenses of $100,000 to *B*. The private costs to *A* would then be $230,000: $200,000 in unreimbursed expenses and 10% of the expenses paid by the company. As expected private gains are $600,000, *A* will initiate a contest.[84]

To recapitulate, whether a contestant enters contests depends on whether her expected gains exceed her costs. The gains from winning consist of private control benefits and stock appreciation gains; weighting these gains by the probability of winning yields expected gains from entering a contest. The costs consist of unreimbursed expenses incurred by the contestant and a pro rata share of the costs borne by the company.

3. *The Divergence of the Private Decision From Optimality*

We now explore in greater detail the divergence of the private decision from the socially optimal one. As we noted, whether entry is efficient is a function of social gains and social costs, while the profitability of entry depends on private gains and private costs. As we proceed to show, there are three reasons why the private decision to enter can diverge from the socially desirable one. Two relate to divergences between private gains and social gains; the third to diverging private and social costs. We will examine each of these three grounds separately.

First, as other commentators have noted,[85] entry decisions might be skewed because contestants do not internalize the full change in company value. Rather, any change in company value will accrue to a contestant only to the extent that she owns stock of the company. That is, stock appreciation gains (or losses) by the contestant amount to only a fraction of the change in company value. If the contestant expects company value to increase if she wins, her stock appreciation gains will fall short of gains to society from an increase in company value; thus she may not enter the contest even when it would be efficient for her to do so. If,

84. Note that even a contestant who experienced losses from decreases in company value would decide to enter a contest if her private benefits from obtaining control were large enough. Easterbrook & Fischel, *supra* note 15, at 413 ("These insurgents gain more in perquisites and side payments than they lose in diminution of the value of their stock."); Harris & Raviv, *supra* note 75, at 63 ("[W]e assume that . . . the [private] benefits of control are sufficiently large in relation to any capital losses the incumbent and the rival may suffer on their shares . . . that each prefers to vote for himself.").

85. *See, e.g.*, A. HIRSCHMAN, EXIT, VOICE AND LOYALTY 39 (1970) (decisionmaker will act only on private benefits calculus); Easterbrook & Fischel, *supra* note 15, at 413 (because challenger often lacks significant ownership shares, successful contestants may gain more from the victory than the loss in value of their shares).

on the other hand, she expects company value to decline, she would lose less from the decline in her stock value than society would from the decline in the value of the company; as a result, she may enter the contest (if her private gains outweigh the decline in the value of her stocks), even if her entry is inefficient.

Assume that company value is $5 million higher if challenger *A* wins the contest than if incumbent *B* wins, and that their respective chances of winning are 40% and 60%.[86] If *A* owns 10% of the shares and enters the contest, her expected stock appreciation gains amount to $200,000—less than the $2 million expected increase in company value. In this case, if the costs to *A* and to society of leading the contest are $1 million (and *A* and *B* derive private control benefits of the same amount), *A* will not initiate a contest even though a contest is socially desirable.

The second ground for divergence between actual and efficient entry decisions also relates to gains. Private control benefits accruing to the contestant differ from *net* control benefits accruing to society: unlike private control benefits to the contestant, net control benefits to society include the *other* contestant's loss of (or failure to gain) control benefits. In our previous example, *A*'s taking control would result in control benefits to *A* of $1 million, but (since *B* loses $1.5 million in control benefits) in a net decrease of $500,000 in net control benefits to society. If company value will be the same under *A* as under *B*, the cost of the contest is $200,000, and *A*'s chances of winning are high enough, *A* will initiate the contest even though a contest is socially undesirable.

The third ground for divergence between the private decision and optimality relates to expenditures. As explained, the private and social costs of waging a contest differ. Any contestant will bear only her own unreimbursed costs of leading a contest and a fraction of the costs borne by the company. Society, on the other hand, will bear the costs of both contestants and all the costs borne by the company. As a result, even if private gains equal social gains, undesirable contests may be initiated if these gains exceed the private costs of leading a contest, but are less than its social costs.

Note that the degree of divergence between private and social gains on account of changes in company value depends on the fraction of shares owned by each contestant. The larger the fraction, the closer is the match between private stock appreciation gains and changes in company value. Similarly, a greater fraction of share ownership causes a con-

86. If the probability of *A* winning if she initiates a contest is 40% and there is a positive probability that *B* will not defend, the probability of *B* winning the contest if she defends would actually have to be higher than 60%.

testant to internalize more of the costs paid by the company.[87] On the other hand, the degree of divergence on account of private control benefits in no way depends on the percentage of shares owned by the contestant.

The divergence on account of changes in company value could cause desirable contestants not to enter (when victory increases company value) or cause undesirable contestants to enter (when victory decreases company value, but the contestant suffers losses only to the extent of the stock ownership). The divergences on account of private control benefits and of the costs of contests, on the other hand, will always provide an incentive for contestants to *enter* a contest. Private control benefits will always exceed net control benefits accruing to society, as only the latter take account of the losses to the other contestant from not gaining control. Similarly, private costs will always be less than social costs since private costs do not include costs borne by the other contestant and include only part of the costs borne by the company.

As an illustration, take a contestant who is fully reimbursed for her expenses and owns only a small percentage of the company's shares. Such a contestant would decide to enter almost every contest for which gaining control bestows significant control benefits, including those contests for which entry is not socially desirable. She would tend to derive considerable expected private control benefits, but even if her victory caused a substantial reduction in company value, she would experience hardly any resulting losses since her equity interest in the company is low.

On the other hand, take a contestant who is not reimbursed for her expenses and who would derive only small private control benefits from winning. Unless such a contestant owns a significant portion of the company's shares, she will be strongly inclined not to enter a contest, even when entry is highly desirable. The reason is that the contestant would have to bear the full costs of leading the contest, but her private gains in control benefits and stock appreciation would tend to be small even if she wins.

4. *Allocation Rules and the Decision to Enter*

Allocation rules affect the decision to enter contests in two major ways: through their impact on the cost of leading a contest and through their influence on the probability of success.[88] In this Subsection, we briefly sketch the relationship between allocation rules and the private

87. To the extent the other contestant bears the proxy contest cost, however, the degree of divergence does not depend on how many shares one owns.

88. Cost allocation rules could also affect proxy contests to the extent that they impact the benefits from success. These benefits mainly depend on factors like management abilities and are

costs of leading contests. (The connection between allocation rules and the outcome of contests will be the subject of the next Section.)

In general, a higher degree of reimbursement lowers the private costs of entering a contest,[89] and the lower the private costs of entering a contest, the greater the number of contestants who will find it privately profitable to enter. Thus, any increase in compensation will lead to a greater number of proxy contests.

But as we showed above, an increase in the number of contests is efficient only to the extent that *desirable* entrants are encouraged to engage in contests.[90] As we have seen, undesirable entrants may also find it profitable to enter contests.[91] To the extent reimbursement lowers the costs of, and induces entry by, such undesirable contestants, such reimbursement is not desirable.

It remains to be seen whether cost allocation rules (and proxy rules in general) can be designed to promote entry by only desirable contestants. In particular, it is pertinent to investigate how the dimensions of choice in the allocation rules can be structured to achieve such a result. We will resume this inquiry in Part IV, after we complete our examination of the effects of proxy rules.

B. Expenditure Decisions and the Outcome of Proxy Contests

In the preceding Section, we analyzed the decision to enter a contest, taking as given the likelihood of winning and the social costs of the contests. In this Section, by contrast, we take as given that a contest ensues, and focus our analysis on expenditure decisions and the outcomes of contests. At the outset, we briefly restate the reason why better contestants do not always win proxy contests. We continue by delineating the relationship between expenditures and the outcome of proxy contests. We then examine the optimal and the privately profitable amount and allocation of expenditures. Finally, we delineate briefly the general effect of cost allocation rules on the outcome of contests.

1. Imperfections in the Outcome of Proxy Contests

If a contest ensues, it is obviously preferable that the better contestant win the contest. For a variety of reasons, however, the contestant under whom social wealth is higher does not always win. The most significant factor contributing to inefficient outcomes in proxy contests is

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mostly independent of allocation rules (except for secondary effects such rules might have on the probability of the victorious contestant's being replaced in subsequent contests).

89. As noted above, the correspondence is not exact, since a contestant who owns shares will incur some costs when the company uses its funds to reimburse any contestant.

90. *See supra* notes 78-80 and accompanying text.

91. *See supra* notes 85-87 and accompanying text.

that shareholders are insufficiently informed. If shareholders had perfect information and voted rationally, the contestant under whom company value was higher would generally win the proxy contest. However, as we explained in Part I, shareholders lack adequate incentives to expend time and money in acquiring and evaluating information on proxy contests.[92]

Imperfectly informed shareholders may elect the contestant under whom company value is lower. To be sure, contestants who would increase company value possess certain advantages in waging proxy campaigns. For one, shareholders obtain some information from relatively objective sources like stock prices, earnings figures, or reports by independent analysts.[93] Such information will tend to favor the superior contestant. Moreover, good contestants can generally make more convincing arguments about why they should be elected, and thus they potentially have more effective proxy materials. Nonetheless, these advantages are insufficient to ensure that the contestant under whom company value is higher always wins.

Even with perfect information, the better contestant might not win the contest in two peculiar circumstances. First, though perfectly informed impartial shareholders will vote for the contestant under whom *company* value is higher, that contestant might not be the one under whom *social* value is higher. That is, contestant *A* may derive private benefits from control that are so much larger than *B*'s that, even though company value is higher under *B*, social wealth is higher under *A*.[94] Second, shareholders who are partial towards one of the contestants might hold a majority of the votes.[95] If so, that contestant may win even if all shareholders recognize that company value is lower under her control. Partial shareholders are primarily the contestants themselves (who obtain private control benefits if they win) and, secondarily, shareholders who derive commercial advantages from having a certain contestant exercise control (such as banks and insurance companies doing business with the company).[96] Such groups will tend to vote for the contestant towards whom they are partial, even if company value (and social wealth) under her opponent is higher.

Several factors, then, contribute to the phenomenon of better contestants losing contests. Most often, shareholders may vote against the

92. *See supra* notes 29-32 and accompanying text.

93. *See, e.g., Wall Street Meets Madison Avenue, supra* note 65, at 1, 4 (institutional investors rely on in-house analyses and reports from independent analysts in deciding how to vote).

94. We will not devote attention to this problem both because it is unlikely to be empirically important and because it is unlikely that cost allocation rules can effectively alleviate it.

95. By *partial*, we mean a shareholder who derives benefits or losses from having a certain contestant exercise control—which benefits and losses are unrelated to her ownership of shares.

96. *See* Brickley, Lease & Smith, *supra* note 55, at 276-79 (detailing the support such institutions provide to incumbents with whom they do business).

better contestant because they lack perfect information. Less frequently, shareholder voting may produce an inefficient outcome because company (but not social) value is higher under the worse contestant or because a sufficient number of shareholders are partial towards her.

2. *Expenditures and the Outcome of Proxy Contests*

The bulk of proxy contest expenditures are incurred in formulating and transmitting information to shareholders.[97] The information so provided constitutes a large part of the total mix of information available to shareholders in deciding how to vote. Proxy contest expenditures affect information—and thereby, voting—in two ways. The *total amount* of expenditures will influence how much information shareholders receive. And the amount spent by each party influences to what degree this mix of information is objective.

Each contestant will try to use the information she provides to shareholders to induce them to vote in her favor. Naturally, a higher level of expenditures enables a contestant to provide more information to shareholders. As a contestant provides more information, she slants the total mix of information in her favor; thus, a contestant's chances of winning increase if only she increases the amount of her expenditures (or if only her opponent decreases the amount of *her* expenditures).

The amount of expenditures also affects the *total* amount of information available to shareholders. The more accurate and complete the information shareholders have, the more likely they are to vote for the better contestant. If both sides increase their expenses by the same amount, shareholders are likely to become better informed, thus improving the better contestant's chances of winning.

Assume, for example, that incumbent *I* is a better contestant than challenger *C*. If only *I* (or only *C*) increased her expenditures by $100,000, her chances of winning would increase: the increased information she would make available to shareholders would tend to induce some additional shareholders to vote for her. But if *both I* and *C* spent an extra $100,000, the total new information provided by them, taken on the whole, would tend to be relatively objective and accurate. Shareholders would thus be better informed and more likely to vote for the better contestant. As a result, if both *I* and *C* increased their expenditures, *I*'s chances of winning would still improve (though by less than if only *I* increased her expenditures).

97. We use the term *information* to mean both *hard* information such as facts and figures, and *soft* information, which includes plans for managing the company, criticism of past managerial actions, and so forth.

3. *The Efficient and Privately Profitable Amount and Allocation of Proxy Contest Expenditures*

The social costs of proxy contests include both the costs borne by the company and the costs borne by the parties. Since proxy contest expenditures constitute social costs, increasing expenditures to improve contest outcome is efficient only if the social gains exceed the increase in these social costs. The amount of these marginal social gains is the product of two factors: the increase in the likelihood that the better contestant will win, and the difference between social wealth under the two contestants. (This difference is generally independent of the amount of expenditures.) We will refer to gains resulting from increased expenditures as the "improved outcome gains." An increase in proxy contest expenditures is desirable if it results in improved outcome gains that exceed the increase in expenses.

Assume, for example, that social wealth under contestant *A* is $100 million and under contestant *B*, $70 million. Further assume that increasing the amount of expenditures by $1 million will increase *A*'s chances of winning from 60% to 65%. The improved outcome gains from spending the extra million are then $1.5 million: a $30 million difference in social wealth weighted by a 5% improvement in *A*'s chances of winning. As improved outcome gains exceed the additional costs, it is desirable to have *A* spend the extra $1 million. Obviously, from the social perspective, *any* expenditures by the worse contestant *B* are undesirable. Such expenditures are not only costly in themselves but also create social losses by increasing the likelihood that the worse contestant will win.

From the perspective of an individual contestant, it will be desirable to increase expenditures only if her resulting gains—private gains weighted by the increase in the probability of winning—exceed the increase in her costs. Assume that, in the previous example, private gains to *A* are $10 million and *A* would bear the full cost of the $1 million increase in expenditures. In that case, *A* would not find it profitable to spend the extra $1 million. Her expected gains are only $500,000 ($10 million weighted by the 5% increase in the probability of winning), while her costs are $1 million.

In short, the reasons contestants may spend too little or too much are equivalent to the reasons why the wrong contestants may enter contests.[98] First, private control benefits exceed net control benefits to society; second, private costs of increasing expenditures may be less than the added social cost; third, stock appreciation gains differ from changes in company value. The first two reasons provide incentives to overspend,

98. *See supra* notes 85-87 and accompanying text.

while the divergence between stock appreciation gains and changes in company value provides incentives for some contestants—those under whom company value is higher—to underspend, and others to overspend. Whether, on the whole, contestants will spend more or less than the efficient amount will depend on the relative strength of these factors.

4. *Allocation Rules, Expenditures, and the Outcome of Contests*

Cost allocation rules have a direct impact on the expenditures incurred in proxy contests and therefore on the outcome of proxy contests. As the proportion of reimbursed expenses increases, the cost *to the contestant* of incurring additional expenditures decreases, and the level of her expenditures will generally increase. Thus, other things being equal, granting more compensation to a contestant will increase her chances of winning.[99]

Assume, for example, that if contestant *A* wins the contest, she will derive private control benefits and stock appreciation gains of $500,000. Assume further that if she spends $100,000 on the contest, her chances of winning will be 30%; if she spends $200,000 on the contest, her chances increase to 40% (and thus her expected gains increase by $50,000). *A* will not spend the additional $100,000 if she is not compensated for her expenditures, since the increased value to her ($50,000) is less than her extra expenditures ($100,000). But if the company compensates her fully, she will spend the second $100,000 and have a higher chance of winning.

The implications of this Section then, are that spending by bad contestants is always undesirable, while a limited amount of spending by good contestants is desirable. We thus face the question whether proxy rules can be designed both to discourage any spending by bad contestants, and to encourage good contestants to spend up to the efficient amount. Later in Part IV, we will examine whether, and how, allocation rules can be structured to achieve this purpose.[100] For now, we will continue with our examination of the effects of proxy rules.

C. *Ex Ante Managerial Behavior and Risk*

So far, we have examined the ex post effects of proxy rules: when we have a potential contestant, will she engage in a contest, and if she does, how much will she spend and how likely is she to win? We now turn to how *the prospect* of proxy contests—that is, the possibility of being ousted and the conditions under which an ouster is likely—influences ex

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99. For an analysis of the relationship between increased expenditures by a party and contest outcomes, see *supra* note 97 and accompanying text.

100. *See infra* notes 184-86 and accompanying text.

ante managerial behavior before a potential contestant appears. We first discuss the effects of proxy rules on managerial incentives to reduce the probability of ouster. We then address the effects of proxy rules on costs associated with risk.

1. Ouster and Managerial Incentives

Managers faced with the potential of proxy contests must confront the possibility of being ousted and thus losing their private benefits of control.[101] This prospect will create incentives to act in a manner which reduces the probability of being ousted. Typically, any change in proxy rules that increases the likelihood of a successful challenge will tend to lead managers to intensify these ouster-preventive activities.[102]

Ouster-preventive activities generally fall into two categories. The first includes activities that increase the level of shareholder support,[103] that is, that make it less likely that otherwise disinterested shareholders would want to replace management. The second category consists of defensive devices which, given the level of shareholder support, make it less likely for challengers to win a contest.

a. The Level of Shareholder Support

Shareholder support for a contestant, and thus the degree to which disinterested shareholders would be inclined to vote for challengers rather than incumbents, depends primarily on shareholder perceptions of the relative quality of management.[104] Management's efforts to enhance shareholder perception of its quality can result in greater company value and thus be desirable. But efforts to increase shareholder support may, under certain circumstances, also lead to undesirable behavior.

The most straightforward way to increase shareholder support is to

101. In addition, if incumbents are not fully compensated, contests could create risk to incumbents of having to spend personal funds on proxy campaigns. This risk is analytically similar to the risk of ouster, except that these costs will be incurred any time a contest arises, and the risk does not directly depend on whether the challenger wins the contest. Thus, if incumbents are not fully compensated, the effects described in this Section with respect to the risk of ouster will be enhanced by the effects of the risk of having to spend personal funds.

102. We assume that management's efforts to prevent ouster intensify as the risk of ouster increases. This assumption presupposes that such efforts become more effective as the underlying risk increases. By more effective, we mean that the impact of such efforts on the probability of losing a contest is stronger if the a priori risk of losing—the risk of losing if no such efforts are made—is higher. For example, a measure that eliminates the risk of losing is more effective if the a priori risk is higher than if it is lower. However, a measure that decreases the risk of losing by a constant amount (e.g., by 2% such that, if the a priori risk is 10%, the a posteriori risk is 8%; if the a priori risk is 9%, it is 7%; and so on) would not become more effective when the a priori risk increases.

103. *See* Schulman, *supra* note 15, at 30-32 (threat of proxy contest stimulates management to be more concerned with shareholder satisfaction).

104. Other factors that may affect shareholder support include management's political views and ethical behavior.

improve the actual quality of managerial performance.[105] Shareholders may learn about this improvement through a variety of sources—the earnings or stock price of the company may increase; stock analysts may report favorably on management; or shareholders may read about the improvement in business publications.

As shareholders observe improvements in management, the risk of ouster declines for two reasons. First, shareholders will be less inclined to vote for challengers, thus reducing the likelihood that challengers will win. Second, independent of their chances of winning, challengers will have less opportunity to earn stock appreciation gains (since company value under incumbent management is higher), and thus less of an incentive to initiate contests.[106]

Increasing shareholder support through improved actual performance generally also increases social wealth. Better management increases company value, but in most cases does not lead to a commensurate decline in private control benefits. Therefore, increasing shareholder support through improved performance is likely to be efficient.

Another way to increase shareholder support is to enhance shareholder *perceptions*[107] of the quality of management without improving actual performance.[108] In particular, management may try to enhance shareholder perception by myopically increasing short-term earnings[109] (for example, by underinvesting in research and development or other long-term projects[110]); management may also try boosting short-term distributions to shareholders[111] (for example,[112] by raising additional

105. *Cf.* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 HARV. L. REV. 1161, 1173-74 (1981) (threat of hostile takeovers leads to management improvements); Manne, *supra* note 16, at 112 ("high positive correlation between the corporate managerial efficiency and the market price of shares of that company").

106. *Cf.* Duvall & Austin, *Predicting the Penalty of Proxy Contests,* 20 J. FIN. 464, 471 (1965) (empirical evidence that proxy contests are begun in firms with relatively low rates of return).

107. Increasing shareholder support by merely changing shareholder perceptions is, of course, only possible because shareholders lack perfect information.

108. To the extent shareholder support is a function of the stock price, increasing shareholder support in this manner will only be possible if stock markets are informationally inefficient.

109. *See* Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior,* 104 Q. J. ECON. 655 (1989) (myopic managerial behavior may occur in rational stock market); Stein, *Takeover Threats and Managerial Myopia,* 96 J. POL. ECON. 61 (1988) (myopic stock market may lead to myopic managerial behavior).

110. For a description of such an effect, see Lipton, *supra* note 16, at 23-25 (managers may reduce long-term planning and research and development to satisfy shareholders).

111. Note that increasing leverage may enhance efficiency by reducing agency costs of free cash flows. *See* Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,* 76 AM. ECON. REV. 323 (1986).

112. *See, e.g.,* Lipton, *supra* note 16, at 20-23 (risk of ouster can cause companies to incur huge amounts of debt as a defensive measure).

debt to finance a special dividend).[113]

Increasing shareholder support by manipulating shareholder perception of management quality can be socially costly and reduce company value without offering offsetting benefits. The myopic behavior noted above can involve particularly high costs. For example, in order to raise quarterly earnings, management may decide to cancel the development of a promising new product line. Alternatively, a high debt burden taken on to finance special dividends may, in a minor business downturn, force companies into bankruptcy even if they are earning substantial operating profits.[114] Thus, whether an increased threat of ouster has desirable ex ante effects on incumbents will, to a large extent, depend on whether managers find it more effective to improve their actual performance or to manipulate shareholder perceptions.

Note, in this respect, the parallel to hostile takeovers. It is generally recognized that an increased threat of a hostile takeover creates managerial incentives to increase the share price. To increase the share price—like to enhance shareholder support—management could either try to increase the actual value of the company or to manipulate the perception of that value, for example, by myopically increasing short-term earnings. That is, the potential alternatives for enhancing shareholder support in order to reduce the likelihood of a proxy challenge, and their desirability, are analogous to the alternatives for increasing the stock price in order to reduce the likelihood of a hostile takeover.

b. Defenses Against Proxy Contests

Besides increasing shareholder support, managers can reduce the threat of ouster by adopting defensive measures.[115] They could, for example, recapitalize with nonvoting stock,[116] provide for a staggered

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113. Other ways to enhance shareholder perception of management quality include distributing self-promotional literature or changing accounting standards to increase book earnings.

114. *See, e.g.,* Schwadel & Anders, *Interco Threatens a Chapter 11 Filing to Pressure Bondholders on Debt Plan,* Wall St. J., May 18, 1990, at A2, col. 2 (Interco, which in 1988 borrowed $2 billion to pay special cash dividend in order to defend against hostile takeover bid, is close to bankruptcy filing). *Compare* Easterbrook & Fischel, *supra* note 105, at 1161 (threat of takeovers leads to desirable improvements in management) *with* Lipton, *supra* note 16, at 20-28 (threat of takeovers leads to undesirable short-term responses and overleverage).

115. *See* R. SCHRAGER, *supra* note 4, at 42 (threat of proxy contests is one reason for adoption of anti-takeover charter amendments).

116. *See, e.g.,* Jarrel & Poulsen, *Dual Class Recapitalizations as Antitakeover Mechanism,* 20 J. FIN. ECON. 129, 129 (1988) (suggesting that dual-class stock offers make this relatively easy); Ruback, *Coercive Dual Class Exchange Offers,* 20 J. FIN. ECON. 153, 153 (1988) (same). Note that in 1988, the SEC adopted Rule 19c-4 (commonly known as the "one share, one vote" rule), which severely limited the ability of companies with listed stocks to recapitalize with nonvoting stock. 17 C.F.R. § 240.19c-4 (1990). However, the District of Columbia Circuit Court of Appeals held that the SEC did not have statutory authority to promulgate Rule 19c-4 and accordingly vacated the rule. The Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

board (that is, for the election in each year of only one-third of the board),[117] otherwise modify the charter provisions governing elections of directors,[118] grant special favors to large shareholders in exchange for their support in proxy contests,[119] or issue shares to "friendly" shareholders who would tend to vote for them in a contest. These measures are not designed to increase shareholder support, but rather to make it harder for challengers to succeed, regardless of the level of support by disinterested shareholders.[120]

By making it harder to stage a successful challenge, defensive devices relieve managers from pressure to increase shareholder support. In addition, some of these measures may be wasteful in themselves. For example, management may offer the company's business to a bank that owns stock in the company, and which is expected to support management in a proxy contest, even if a different institution could provide the same services at lower rates. That is, management would be willing to have the company pay the additional charges to the bank in order to secure the bank's support in a proxy contest, thus reducing the likelihood of being ousted.[121] The desirability of a defensive measure thus depends both on the desirability of its alternatives and on the wastefulness of the defensive tactic itself.[122]

2. *Risk-Bearing Costs*

The prospect of ouster also creates uncertainty for managers. In the presence of proxy contests, managers have to face uncertainty over the amount of private control benefits they will be able to derive in the future. The more significant the risk of ouster, the greater the uncertainty borne by managers.[123]

Since managers are generally risk averse,[124] this uncertainty constitutes a cost to managers. By risk averse, we mean that, given a specified

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117. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(d) (Supp. 1988).

118. *See generally* TAKEOVER DEFENSES, *supra* note 25; TAKEOVER DEFENSES UPDATE, *supra* note 25.

119. *See, e.g.*, Brickley, Lease & Smith, *supra* note 55, at 276-79 (presenting empirical evidence that such institutional alliances occur).

120. Note that while some of these measures could be prohibited by law, others cannot be dealt with adequately. For example, it would, in practice, be difficult to distinguish between incumbents who exchange equity for debt in order to secure control and those who seek the tax benefits from deductible interest payments. I.R.C. § 163(d) (West 1990).

121. Some managerial actions which reduce company value may be rejected by incumbents because of their potential liability as fiduciaries. The extent to which the fiduciary duty impedes defensive tactics is beyond the scope of this Article.

122. Defenses instituted in response to an increased threat of ouster also affect social wealth by impacting incidence and outcome of actual contests.

123. If uncertainty costs are proportional to the variance in expected private benefits, they will increase with an increase in the probability of ouster as long as this probability is less than 50%.

124. That managers, as other individuals, are risk averse, explains the existence of risk premia

amount of expected gains, managers prefer to receive this amount for certain in all cases, rather than to receive more than expected in some circumstances and less in others. We will refer to the cost created by increasing uncertainty over the expected amount of private control benefits as risk-bearing costs. These risk-bearing costs constitute a cost to society independent of whether they are ultimately borne by managers or whether managers are compensated for bearing these costs (for example, by a higher salary).

Take, for example, incumbent *B* who is to derive private control benefits of $1.5 million unless ousted in a proxy contest. Assume that a change in the proxy rules increases the risk of ouster from 0% to 10%. Under the new rule, *B*'s expected private benefits are $1.35 million:[125] $1.5 million in the 90% of cases where she stays in control; nothing in the 10% of cases where she does not. Further assume that, since *B* is risk averse, she would be indifferent as between receiving $1.3 million for certain or $1.5 million if not ousted and $0 if ousted. The $50,000 between the uncertain expected control benefits of $1.35 million under the new proxy rule and the certainty equivalent of $1.3 million is a measure of the risk-bearing costs imposed by the proxy rule.

Assume that, to offset the risk of ouster created by the change in proxy rules, *B* receives an additional $30,000 in salary. Thus, *B* would only suffer a net loss of $20,000 as a result of the change in the proxy rules: $50,000 in risk-bearing costs, less $30,000 in additional salary. But the amount of risk-bearing costs to society would nevertheless be $50,000: $20,000 in net risk-bearing costs to *B*, and $30,000 in costs to shareholders for compensating *B* for her risk-bearing.[126]

3. *Concluding Remarks*

In summary, then, whether proxy rules that increase the risk of ouster have desirable ex ante effects will depend on the kind of responses managers adopt and on the relative magnitude of risk-bearing costs. If the overall response is undesirable (for example, one which enhances shareholder perceptions but reduces company value), the corresponding

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for risky investments. *See, e.g.*, T. COPELAND & J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 85-93, 185-222 (2d ed. 1983).

125. Obviously, a rule that increases the risk of ouster also reduces the expected amount of private control benefits to incumbents (and increases those to challengers). The respective efficiency implications of this have already been analyzed at *supra* Section III(A).

126. In addition to leading to a higher average salary, an increase in the risk of ouster will also tend to decrease risk-bearing costs inflicted by other salary items (such as bonuses or stock options) and to reduce incentives correspondingly. If increasing the threat of contests is efficient (that is, if gains from incentives exceed risk-bearing costs), the net effect would tend to consist of an increase in incentives, and either an increase or a decrease in risk-bearing costs. If increasing the threat is inefficient, the net effect would tend to consist of an increase in risk-bearing costs, and either an increase or a decrease in incentives.

rule is inefficient from an ex ante perspective. If the overall response is desirable (for example, if managers improve their performance), the corresponding rule is efficient from an ex ante perspective if the net benefits from increased company value exceed the risk-bearing costs.[127]

IV
ANALYZING THE EXISTING RULES

In this Part, we will use the proposed framework to analyze the existing legal rules governing the allocation of proxy contest costs. In Section A, we describe the present state of the law and the current reimbursement practice. Then, we evaluate the current rules, focusing in Sections B and C on the allocation of costs incurred by challengers and incumbents, respectively. In these Sections, we seek to assess how cost allocation rules can be structured to enhance efficiency; to identify the desirable elements of the existing legal rules; and to determine how (if at all) these rules should be modified.

A. The Current Legal Rules and Practice

Only a few reported cases have dealt with reimbursement of proxy contest expenses. Courts largely have left the decision of whether to reimburse[128] contestants to the discretion of the board of directors.[129] Consequently companies generally pay all the expenses for the reelection campaign of incumbents, but reimburse challengers only if they gain control over the board of directors. We now examine in greater detail the case law on compensation of incumbents and challengers.

1. Conditions for Reimbursing Incumbents

The power of the board to award reimbursement to incumbents

127. Note that the ex ante effects we have described in this Section are lessened if managers obtain private benefits from *losing* control; for example, golden parachute payments triggered by termination after losing a proxy contest. To the extent that managers have such golden parachute contracts, they are subject to fewer incentives to engage in ouster-preventive activities and thus bear fewer risk-bearing costs. However, as long as golden-parachute payments are not so high that managers will be indifferent to being ousted, changing the risk of ouster has the results described in this Section.

128. Using the term *reimbursement* to describe the compensation practice of incumbents is technically incorrect. Most contest expenditures for the benefit of incumbents are paid directly by the company, so that incumbents are not literally reimbursed.

129. *See, e.g.,* Grodetsky v. McCrory Corp., 49 Misc. 2d 322, 324, 267 N.Y.S.2d 356, 359 (Sup. Ct. 1966) (court cannot direct compensation but may merely determine whether corporation may pay compensation). *But see* Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 343 (Del. 1983) (incumbent directors entitled to reimbursement even though expenses not explicitly authorized by board).

under both New York[130] and Delaware[131] law is nominally subject to two conditions. First, incumbents may only be reimbursed if the proxy contest involved a question of policy, rather than personnel. Second, reimbursement is limited to expenses which are both reasonable in amount and reasonably necessary to inform the stockholders.[132] But reimbursement is rarely, if ever, denied on account of these limitations. Thus, as incumbents control the board during the contest, they are largely free to authorize the company to pay for their proxy campaign, and can generally count on full reimbursement.

Both courts[133] and commentators[134] have asserted that the distinction between contests over policy and contests over personnel is spurious and unworkable since almost all contests will involve some question of policy. Moreover, even in proxy contests that are, in truth, exclusively about questions of personnel, incumbents would have no difficulty couching the issues in terms of policy if their reimbursement depended on it.[135] Predictably, reimbursement has rarely been denied because a proxy contest did not involve a question of policy.[136]

Courts have also declined to use the "reasonable expense" requirement to restrict incumbent reimbursement significantly. Several commentators have suggested that the use of proxy solicitors,[137] last-minute

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130. *See* Levin v. Metro-Goldwyn-Mayer, 264 F. Supp. 797, 801 (S.D.N.Y. 1967); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 173, 128 N.E.2d 291, 293 (1955); *Grodetsky,* 49 Misc. 2d at 324, 267 N.Y.S.2d at 358; Begleiter v. Moreland, 33 Misc. 2d 118, 119, 225 N.Y.S.2d 577, 579 (Sup. Ct. 1961).

131. Steinberg v. Adams, 90 F. Supp. 604, 607 (S.D.N.Y. 1950); Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D. Del. 1944); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 81, 171 A. 226, 227 (1934).

132. *Steinberg,* 90 F. Supp. at 607; *Begleiter,* 33 Misc. 2d at 119, 225 N.Y.S.2d at 579; Campbell v. Loew's, Inc., 36 Del. Ch. 563, 582, 134 A.2d 852, 864 (1957); *Hall,* 20 Del. Ch. at 81, 171 A. at 227; *Rosenfeld,* 309 N.Y. at 173, 128 N.E.2d at 293.

133. *See, e.g., Steinberg,* 90 F. Supp. at 608; *Hall,* 20 Del. Ch. at 84-85, 171 A. at 228.

134. *See, e.g.,* Barnhill, *supra* note 62, at 779; Easterbrook & Fischel, *supra* note 15, at 413; Friedman, *supra* note 58, at 952; Latcham & Emerson, *supra* note 58, at 10; Machtinger, *supra* note 36, at 215. *But cf.* Note, 31 N.Y.U. L. REV. 825, 838 (1956) (policy/personnel distinction should be retained to allow just disposition of cases in which contestants care only about their own interests).

135. *See Rosenfeld,* 309 N.Y. at 183, 128 N.E.2d at 299 (dissenting opinion) ("[N]either the 'ins' nor the 'outs' ever say that they have no program to offer to the shareholders, but just want to acquire or to retain control . . . . As in political contests, aspirations for control are invariably presented under the guise of policy or principle."); *see also* Easterbrook & Fischel, *supra* note 15, 413 n.45.

136. *See* Friedman, *supra* note 58, at 952; Latcham & Emerson, *supra* note 58, at 10 (both noting that only one case from 1907 disallowed expenses for that reason); Stifel, *supra* note 64, at 343 (citing two cases in which expenses were disallowed because the proxy contest did not involve a policy issue). We are not aware of any later decisions disallowing expenses on this ground.

137. Friedman, *supra* note 58, at 954; Latcham & Emerson, *supra* note 58, at 11; Machtinger, *supra* note 36, at 215; *see also In re* Zickl, 73 N.Y.S.2d 181, 185 (Sup. Ct. 1947) (authorizing use of corporate funds to pay proxy solicitors).

telegrams,[138] long distance telephone calls,[139] or corporate employees[140] is unreasonable as these methods are unfair, pressuring rather than informing shareholders. Courts, however, so far have not disallowed any of these expense items;[141] in the one reported case in which reasonableness of certain expenses was at issue, the court found nothing wrong with the incumbents' employing two proxy solicitation firms, one consultant, one public relations firm, and 150 corporate employees who made telephone calls to shareholders "on their own time."[142] Nevertheless, it would seem that some expense items, like "solitary wining and dining a trustee or broker entrusted with a substantial number of proxies in an attempt to influence his decision,"[143] might be found unreasonable.

Courts also have not defined what constitutes an unreasonable total amount of expenditures. It has been suggested that the test for reasonableness should take into account the type of contest, the number of shareholders, and the level of expenditure by the challengers.[144] Although we know of no reported decisions in which expenses were found excessive, it is conceivable that the existence of the reasonableness requirement restrains incumbents to some extent.[145] But whatever restraints incumbents may feel, in practice they are reimbursed for all their proxy contest expenses.[146]

2. *Conditions for Reimbursing Challengers*

Reimbursement of challengers is subject to somewhat greater legal limitations than reimbursement of incumbents. However, the primary reason why challengers, in practice, receive compensation far less often than incumbents is that there is no affirmative entitlement to reimbursement. This lack of affirmative entitlement does not present a problem to incumbents, who by definition control the board at least during the contest, and thus can have the company authorize reimbursement of their expenditures. Challengers, however, control the board only if they win

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138. Latcham & Emerson, *supra* note 58, at 11; Machtinger, *supra* note 36, at 215.

139. Latcham & Emerson, *supra* note 58, at 11; Machtinger, *supra* note 36, at 215.

140. Friedman, *supra* note 58, at 954.

141. Proxy solicitors have been employed in several cases in which compensation was granted. *See, e.g.,* Steinberg v. Adams, 90 F. Supp. 604, 606 (S.D.N.Y. 1950); Begleiter v. Moreland, 33 Misc. 2d 118, 118, 225 N.Y.S.2d 577, 578 (Sup. Ct. 1961); *see also* Stifel, *supra* note 64, at 343 (noting the reluctance of courts to disallow expenditures unless clearly beyond the scope of business judgment).

142. Levin v. Metro-Goldwyn-Mayer, 264 F. Supp. 797, 801-03 (S.D.N.Y. 1967).

143. Note, *supra* note 134, at 836.

144. Barnhill, *supra* note 64, at 779.

145. If such restraints exist, they may be very weak. Despite the existence of the reasonableness requirement, the board of Lockheed Corporation apparently did not hesitate to spend approximately $8 million of corporate funds on its reelection (compared to approximately $6 million spent by the challengers). *Wall Street Meets Madison Avenue, supra* note 65, at 1, 2.

146. Telephone conversations with Georgenson & Co., a major proxy solicitation firm, (Fall 1988) [hereinafter Georgenson & Co.].

the contest. Thus, challengers who lose the contest do not have the power to award themselves compensation even though the company may be permitted by law to reimburse them.

The legal limitations on reimbursement of challengers distinguish between those who win the proxy contest and those who do not. Victorious challengers are subject to the same reimbursement conditions as incumbents: the contest must have been over policy, and the expenses must have been reasonable.[147] It is, however, unclear whether reimbursement of challengers requires shareholder approval[148] or whether authorization by the board of directors is sufficient.[149] But note that even challengers who win a contest are not automatically entitled to reimbursement. Thus, for example, challengers who defeated a merger proposal would still need the approval of a presumably hostile board to obtain reimbursement.[150]

No reported cases have decided whether shareholders may reimburse challengers who lost. The cases permitting reimbursement of successful challengers placed great weight on the fact that the challengers benefited the corporation by "ridding [the] corporation of a policy frowned upon by a majority of the stockholders";[151] this rationale would not apply to unsuccessful challengers.[152] Some commentators, however, have argued that there is no reason not to permit shareholders to reimburse a challenger who lost if they find that she has rendered a beneficial service to the corporation.[153]

The practical effect of these rules is what one would expect:

147. *See* Steinberg v. Adams, 90 F. Supp. 604, 607-08 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine & Airplane Corp. 309 N.Y. 168, 173, 128 N.E.2d 291, 293 (1955). Note that *Rosenfeld* was only a plurality decision and that the concurring opinion by Judge Desmond is ambiguous as to what expenses may be reimbursed. Still, subsequent decisions have followed the plurality's approach. Grodetsky v. McCrory Corp., 49 Misc. 2d 322, 324, 267 N.Y.S.2d 356, 358-59 (Sup. Ct. 1966); Begleiter v. Moreland, 33 Misc. 2d 118, 118-19, 225 N.Y.S.2d 577, 579-80 (Sup. Ct. 1961).

148. *Steinberg,* 90 F. Supp. at 608 (reimbursement permissible at least where board and majority of shareholders approve); *Rosenfeld,* 309 N.Y. at 173, 128 N.E.2d at 293 (stockholders have right to reimburse successful contestants).

149. E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 573 (1968) (if reimbursement lawful, shareholder approval should be unnecessary; if unlawful, less than unanimous approval would be of no avail); *Steinberg,* 90 F. Supp. at 607-08 (successful challengers should be treated in same manner as incumbents); *see also* Machtinger, *supra* note 36, at 217; Yoran, *supra* note 52, at 469-70 (if shareholder ratification is required to compensate challengers, shareholder ratification would also be required to compensate incumbents); Chock Full O'Nuts, Proxy Statement 6 (Oct. 27, 1982) (question of reimbursement of challengers not to be submitted to shareholder vote).

150. *Grodetsky,* 49 Misc. 2d at 323-24, 267 N.Y.S.2d at 358.

151. *Steinberg,* 90 F. Supp. at 607-08; *Rosenfeld,* 409 N.Y. at 173, 128 N.E.2d at 293 (shareholders may vote to reimburse "successful contestants for achieving the very end sought and voted for by them as owners of the corporation").

152. *Cf.* Machtinger, *supra* note 36, at 217-18 (noting, however, that other rationales may support reimbursement of losing challengers).

153. E. ARANOW & H. EINHORN, *supra* note 149.

Challengers who gain control of the corporation, that is, win a majority of the seats on the board, receive reimbursement for their expenses.[154] Challengers who try but fail to gain control receive reimbursement only in rare circumstances.[155] In contests for partial control, that is in contests where less than a majority of the seats on the board were contested, victorious challengers sometimes receive full or partial compensation.[156] In proxy contests that are settled,[157] challengers also sometimes receive full or partial reimbursement.[158]

One should also note that federal proxy rules contain some procedural provisions pertinent to reimbursement of contestants. In all proxy contests, the proxy statement must disclose the identity of the persons who will bear the costs of the solicitation.[159] In proxy contests about the election of directors, the statement must also disclose the estimated total cost of the solicitation, the total expenditures to date, the fees to be paid to proxy solicitation firms, and, if the contest was settled, the terms of the settlement.[160] Finally, the statement must show whether reimbursement of the expenses will be sought from the corporation and, if so, whether the question will be submitted to a shareholder vote.[161]

B. Assessing the Rules for Reimbursement of Challengers

In this Section, we analyze the extent to which companies should reimburse challengers for expenses incurred in control contests. First, we explain why giving full unconditional reimbursement to challengers is not desirable. We then show why it may be appropriate to provide *some* reimbursement to challengers. We continue by arguing that this intermediate reimbursement should be made contingent on success. Finally, we discuss the appropriate success threshold for challenger reimbursement. For purposes of this Section, we assume that incumbents receive at least

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154. Georgenson & Co., *supra* note 146. We also obtained information from 11 companies who had proxy contests between 1981 and 1985. In all the four contests where the challengers won, they received reimbursement, although in one contest some ongoing litigation remains. In the seven contests where the incumbents maintained their majority, the challengers were not reimbursed.

155. *Id.* Challengers sometimes received compensation where they gained representation on but not control of the board. *See, e.g.,* American Bakeries Corp., Proxy Statement (Aug. 18, 1981) (shareholder approval sought for reimbursement of expenses to challenger for up to $1.1 million after challenger won 4 of 12 board seats).

156. Informal survey of seven contests for partial control.

157. About 25% of all proxy contests are settled before the shareholder vote. R. SCHRAGER, *supra* note 4, at 173.

158. *See* G. MOODY & C. BAGLEY, *supra* note 15, at A-2 n.10 (settlement of 1982 Pabst Brewing Co. proxy contest and of 1983 Bradford National Corp. contest included provision for reimbursement of challenger expenses of $7.5 million and $800,000, respectively).

159. 17 C.F.R. § 240.14a-101, item 4(a)(4) (1990).

160. *Id.* item 4(b).

161. *Id.* item 4(b)(5).

as much reimbursement as challengers. Reimbursement of incumbents will be considered in the next Section.

1. Should Challengers Receive Full Reimbursement?

In this Subsection, we first argue that full reimbursement is likely to lead to a large number of undesirable entry decisions and to excessive spending on proxy campaigns. We then briefly consider the ex ante effects of providing full reimbursement.

If challengers received full reimbursement, they would face only two possible limited disincentives to entry. First, to the extent that challengers own stock in the company, they will bear part of the contest expenditures borne by the company. Second, if they win the contest, they could, to the extent that they own stock in the company, suffer losses from a decline in company value. Thus, under full reimbursement, potential challengers who own only minimal amounts of company stock would have virtually no motivation not to initiate contests.

At the same time, almost all challengers derive private control benefits if they win a contest. Control benefits accrue to victorious challengers regardless of the number of shares owned, the costs of the contest, or the effect on company value. Thus, as long as potential challengers have any chance of winning, control benefits provide a stimulus for entering contests.

As a result, if challengers are fully reimbursed, many undesirable challenges will be initiated. A large number of potential contestants who own hardly any shares (and thus bear infinitesimal costs of entering) will find it profitable to enter a contest—even if they have only a low chance of winning. But entry by such challengers is, for two reasons, generally inefficient. First, since potential challengers will not personally suffer from a decline in stock value if they take control, bad contestants will not be deterred from initiating contests. Second, even many good challengers with small chances of winning may be undesirable entrants, because the *expected* gains of entry may be less than the cost of the contest.

Providing full reimbursement will also lead to inefficiently high proxy contest expenditures. This is obviously true if the challenger is undesirable. Any amount of expenditures by an undesirable contestant is inefficient. But even desirable challengers will uniformly overspend if fully reimbursed.

As discussed, it is only efficient for a contestant to increase expenditures if social gains from her victory, weighted by the resulting increase in the probability of winning, exceed the increased costs. But contestants will find it profitable to increase expenditures as long as their private gains, weighted by the increase in the probability of winning, exceed the cost to them.

Assume that the cost to challengers of spending $1 million more is $500,000 (half of the $1 million cost to society). It is easy to see that challengers will spend the efficient amount only if private gains amount to exactly the same fraction (50%) of social gains. Assume, for example, that private gains are $5 million and social gains $10 million. It would be both efficient and privately profitable to spend the extra million if the chances of winning increase by 10% or more. Otherwise it would be both inefficient and unprofitable. If private gains were more than the pertinent fraction of social gains, challengers would tend to overspend; if they were less than that fraction, they would tend to underspend.

Under full reimbursement, the only cost challengers would face by increasing expenditures is the portion of the expenditures which they indirectly pay as shareholders of the company. That is, the private costs to a challenger of increasing expenditures is the social costs times the fraction of the shares of the company owned by her. Thus, the challenger would spend an efficient amount if her private gains equalled social gains times the fraction of shares she owned. Correspondingly, if private gains exceed that fraction of social gains, she will overspend.

Now consider the relationship of private gains (stock appreciation gains plus private control benefits) and social gains (changes in company value and net social control benefits). First take stock appreciation gains and company value. As explained, stock appreciation gains will equal gains from an increase in company value times the fraction of shares owned by the challenger. If, to continue our example, victory by the challenger increases company value by $5 million, and she holds 5% of the company's stock, her stock appreciation gains would be $250,000 (5% of $5 million). Next, take private control benefits and net social control benefits. As explained, private control benefits exceed net control benefits to society since the latter include the loss of control benefits by the opponent.

The implication of these relationships is that challengers will overspend since under full reimbursement private gains exceed the pertinent fraction of social gains. Private costs equal social costs times the fraction of shares owned by the challenger. Stock appreciation gains equal changes in company value times the fraction of shares owned by the challenger. Thus, challengers would spend the efficient amount if private control benefits equalled net social control benefits times the fraction of shares owned by the challenger. But private benefits *exceed* net social control benefits (and, a fortiori, any fraction of net social control benefits)—causing fully reimbursed challengers to spend too much.

While the ex post effects of full reimbursement are unequivocally undesirable, we cannot say for certain whether providing full reimbursement might have positive or negative effects on ex ante managerial

behavior. As we noted, full reimbursement would lead to more challenges and higher spending by challengers and thus increase the risk of ouster. This will generally lead to increased efforts to enhance shareholder support. Whether the ex ante effects on managerial behavior are desirable will, to a large degree, depend on how managers increase shareholder support. Neither theory nor empirical studies enable us to infer which path management will choose. But even if managers choose desirable behavior, such as improving their performance, the ex ante gains may easily be dwarfed by the ex post losses described above.

2. *Should Challengers Receive Any Compensation?*

In the preceding Subsection, we argued that it would be inefficient to give challengers full compensation. In this Subsection, we discuss why it may be more efficient to give challengers *some* compensation than it is to give them *no* compensation at all. For most of the Subsection, we present theoretical and empirical arguments for why intermediate compensation is more likely to lead to more efficient entry decisions. Then we discuss briefly intermediate compensation from the perspective of spending decisions and ex ante managerial behavior.

a. *Entry Decisions By Challengers*

In this Subsection, we first argue that the lower the level of reimbursement, the higher the expected gains must be in order for a challenger to enter a contest. Second, we will argue that contestants with higher expected gains are, on average, better contestants than those with lower expected gains. Therefore, each decrease in the level of reimbursement will cause relatively better contestants to drop out.

These two relations have important implications. Decreasing the level of reimbursement from full reimbursement is initially desirable as it leads contestants with the lowest expected gains (that is, on average, the worst contestants) not to engage in contests. But any further decrease in the reimbursement level leads contestants with ever-increasing expected gains—increasingly desirable contestants—not to enter contests. That is, as the level of reimbursement falls, the average quality of the contestants who as a result decide not to enter rises. At some point, further decreases in the level of reimbursement become undesirable—when entry by those contestants who as a result decide not to enter would have been desirable.

It is easy to see that higher levels of reimbursement reduce the expected gains necessary to make it profitable to enter a contest. As explained, challengers enter contests if expected gains exceed the costs of leading the contest. Any decrease in the level of reimbursement increases these costs and thus raises the threshold for entry. Thus, any marginal

decrease in compensation causes challengers with marginally higher expected gains not to enter.

Assume, for example, that waging a proxy contest costs $100,000. Decreasing the level of reimbursement from 100% compensation to 80% increases the costs of entry from almost nothing to close to $20,000. Further decreasing the level of reimbursement to 60% increases the threshold for entry to approximately $40,000. That is, the first decrease in compensation makes it unprofitable for contestants with expected gains below $20,000 to enter. The second decrease also makes it unprofitable for contestants with expected gains between $20,000 and $40,000 to enter.

We now address why challengers with higher expected gains are, on average, more desirable. Assume, as an initial matter, that all contestants derive equal private benefits from control. The expected gains of a particular contestant would then depend only on her probability of winning and on her stock appreciation gains if she wins. As we demonstrate, better challengers generally have both a higher probability of winning and derive larger stock appreciation gains than bad challengers.

Consider first the probability of winning. We argued above that even though voting in proxy contests is subject to significant imperfections, the contestant under whom the value of the company is higher tends to have better chances of winning a contest.[162] But if a better contestant has a higher likelihood of winning, her expected gains (both from stock appreciation and from private control benefits) tend to be larger as well. For example, assume that both good and bad challengers realize $100,000 from gaining control and that good challengers have, on average, a 30% chance of winning while bad challengers have, on average, only a 10% chance. Good challengers would then have average expected gains of $30,000, while bad challengers would expect average gains of only $10,000.

Let us now turn to stock appreciation gains. Such gains depend upon the per-share increase in value and on the amount of stock held by the challenger. Obviously, victory by better challengers results in larger increases in company value and share prices. Therefore, better contestants who win contests will experience larger stock appreciation gains per share than worse contestants who win contests. Moreover, as we will argue below, good contestants, on average, own a greater number of shares.[163] Thus, better challengers tend to derive larger stock apprecia-

162. As private benefits do not differ, it will be socially desirable for the contestant under whom company value is higher to win.

163. But note that if the challenger is inferior to the incumbent, a smaller number of shares held will lead to *larger* stock appreciation gains (in the form of smaller losses) from a decline in stock value if the challenger wins.

tion gains if they win.

Up to this point, we have shown that if private benefits are equal, better challengers, on average, have larger expected gains from initiating a contest. This relationship holds even when contestants do not derive equal private benefits from control. In fact, better challengers will have systematically higher expected gains so long as they, *on average,* do not derive lower private benefits from control than do worse challengers.[164] This stems from the fact that as long as better challengers do not generally derive lower private benefits than worse challengers, both their average gains from winning the contest and their average chances of winning remain larger than those of worse challengers. But it is unlikely that better contestants systematically derive lower control benefits than worse ones. To the contrary, since social wealth is higher under better contestants, it is likely that better contestants both derive larger control benefits and generate higher company values than worse contestants.

Nevertheless, the preceding arguments do not definitively prove that a rule of some compensation leads to entry decisions preferable to those made under a rule of no compensation. To be sure, the challengers who would drop out after a move from next-to-no compensation to no compensation would be substantially superior to those who would drop out after a move from full compensation to next-to-full compensation. But the former challengers may still, on average, be undesirable. That is, the point at which further decreases in the level of reimbursement become undesirable may not yet be reached at no compensation. Rather, in order to reach that point, one may have to impose "negative" reimbursement—in effect, a tax on proxy contests.

b. Empirical Evidence on Entry Decisions By Challengers

The empirical evidence on proxy contests, though scant, supports a tentative conclusion that an intermediate level of compensation is efficient. The most significant empirical study on proxy contests concluded that the initiation of proxy contest contests generally leads to an increase in company value.[165] This study, of course, measured the average effect of proxy contests initiated in the present environment (in which challengers receive substantially more than no reimbursement), and not the marginal effect of providing some reimbursement. Some of those contests would have been initiated even at zero reimbursement; others would not have been initiated at any level of reimbursement lower than that presently provided. Nevertheless, the fact that at the reimbursement level

164. Even if better contestants stood to gain less in private control benefits, their expected gains might still be larger as they would tend to derive higher stock appreciation gains and have a higher probability of winning.

165. Dodd & Warner, *supra* note 15, at 402.

presently provided, proxy contests on average lead to an increase in company value, lends empirical support to granting at least some compensation to challengers.

Two other types of studies buttress the argument for providing reimbursement to challengers. One type has found that proxy challenges tend to be initiated in companies with low rates of return,[166] and, if successful, generally result in improved company performance.[167] The other type[168] has shown that managers, in a variety of contexts, do not act in the interest of shareholders. These studies suggest that internal control mechanisms function far from perfectly, that stock appreciation gains can be an important, if not dominant, motive for challengers, and that successful challenges benefit the company. In conjunction with the study on initiation of contests, these studies lead us to conclude tentatively that an intermediate level of compensation causes more efficient entry decisions than no compensation.

c. *Spending Decisions*

We now turn briefly to the effect of an intermediate level of reimbursement on spending decisions and outcome. Clearly, it is not efficient to give intermediate reimbursement to bad challengers, who will spend too much even if they receive no reimbursement, and should not be encouraged to spend even more. However, as explained, if no reimbursement is provided, many challengers are likely to be desirable. Still, we cannot determine whether those good challengers will spend too much or too little if no reimbursement is provided. Therefore, we are unable to conclude whether, from the perspective of spending decisions and outcome, it is preferable to provide no or intermediate reimbursement.

If challengers receive no reimbursement, the cost to them of incurring additional expenditures is equal to the cost to society.[169] As discussed in the preceding Section, when private costs equal social costs, a challenger will underspend if her private gains are less than social gains,

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166. Duvall & Austin, *supra* note 106, at 741.

167. *See generally* Austin, *The Proxy Contest and Corporate Performance,* 33 FIN. EXEC. 20 (1965) (examining the viability of the proxy contest as a vehicle for corporate reform).

168. *See, e.g.,* Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Share Repurchases, and the Market for Corporate Control,* 11 J. FIN. ECON. 275 (1983) (negative effect on non-participating stockholder wealth of standstill agreements); Easterbrook & Jarrell, *Do Targets Gain From Defeating Tender Offers?,* 59 N.Y.U. L. REV. 277 (1984) (finding that managers engage in defensive tactics that decrease company value); Jarrell & Poulsen, *supra* note 32 (same); Malatesta & Walkling, *Poison Pill Securities: Stockholder Vesting Profitability and Ownership Structure,* 20 J. FIN. ECON. 347 (1988) (same).

169. We assume that incumbents will not raise their expenditures in response to an increase in spending by challengers. If incumbents raised their expenditures, social cost would exceed private cost even under no reimbursement. For the effect thereof on the desirability of compensation, see *supra* Subsection II(B)(1).

but she will overspend if her private gains exceed social gains. Private gains and social gains differ for two reasons. First, private control benefits to the challenger exceed *net* control benefits to society, thereby providing an incentive to overspend. But, in the case of most good challengers, private stock appreciation gains are less than the increase in company value, thereby providing an incentive to spend too little. We therefore cannot determine whether, on the whole, social gains are more or less than private gains. Thus, we cannot tell whether providing intermediate rather than no compensation improves proxy contests from the perspective of spending and outcome.

d. *Ex Ante Managerial Behavior*

We also cannot arrive at any firm conclusions as to whether intermediate compensation leads to more efficient ex ante managerial behavior than no compensation. The reasons are substantially the same as the ones discussed in the preceding Subsection on full reimbursement: Compared to no compensation, an intermediate level of compensation increases the threat of ouster; this in turn can cause managers to undertake desirable improvements in performance (to enhance shareholder support), but may also lead to undesirable myopic behavior (for example, if shareholders mistake artificial earnings increases for true improvements) or to wasteful defensive measures (in order to entrench management even if it lacks substantial shareholder support). On the basis of our discussion, we are not able to predict which course managers are likely to choose.

e. *Concluding Remarks*

In this Subsection, we have discussed whether challengers should receive an intermediate level of reimbursement or no reimbursement. After examining theoretical arguments and empirical studies, we have tentatively concluded that an intermediate level of reimbursement would lead to more efficient entry decisions than would no reimbursement. We have not been able to arrive at even a tentative conclusion as to whether intermediate reimbursement or no reimbursement would lead to more efficient outcomes and spending decisions or to more efficient ex ante managerial behavior.

In conclusion, we note that as long as incumbents receive full reimbursement (as they presently do), granting no reimbursement to challengers is decidedly non-neutral. In the next Section, we discuss to what extent it may be justified to give compensation to incumbents on more generous terms than to challengers. Even though we conclude that there may be some reasons for treating incumbents more favorably, providing incumbents with full compensation and challengers with no

compensation appears to be excessively non-neutral. Thus, incumbents' receiving full reimbursement is one more reason to provide an intermediate level of reimbursement to challengers.

3. *Providing Intermediate Reimbursement*

In the previous two Subsections we concluded that challengers should receive less than full but probably more than no compensation. In this Subsection, we examine how this intermediate level of reimbursement should be structured. The first question we consider is whether it is desirable to make reimbursement contingent upon success. Then we briefly examine other features of the allocation rule.

We will argue that it is better to provide a higher level of reimbursement to successful challengers than an equivalent lower level of compensation to all challengers. By equivalent we mean that the total compensation paid to challengers at large would be the same under either regime. Such success-contingent reimbursement lowers the cost of entering contests and reduces a good contestant's marginal cost of expenditures more than it reduces a bad contestant's. By benefiting desirable contestants, success-contingent compensation tends to lead to more efficient entry and spending decisions than does providing the same average level of compensation independent of success.[170]

As we explained in Part II, in a success-contingent regime, reimbursement (and thus the contestant's expected cost) depends on the probability of attaining success, however defined.[171] The probability of meeting the success threshold will be higher for contestants who expect to receive significant outside support or who are themselves large shareholders.[172] Thus, success-contingent compensation leads to relatively more entries and spending by contestants in these categories, and to relatively fewer entries and lower spending by contestants who are small shareholders and do not expect to receive outside support.

It is generally desirable to encourage entry and spending by contestants who are likely to receive significant outside support.[173] As we explained, contestants who raise company value have an advantage in

170. Note also that any rules improving the outcome of proxy contests will by themselves tend to make the incidence of contests more efficient. As we showed in Part III, it will never be desirable for the worse contestant to enter a contest. *See supra* text accompanying note 78. Thus, any decrease in the likelihood of victory for the worse contestant will prompt fewer bad contestants to enter. We also showed that it will often (though not always) be desirable for better contestants to enter a proxy contest. *See supra* text accompanying notes 78-80. Thus, any increase in the likelihood of victory for better contestants will tend to induce more good contestants to engage in contests.

171. *See supra* text accompanying notes 57-61. Unless *success* is defined as gaining control, the probability of success is different from the probability of winning.

172. *See supra* Section II(B).

173. *See* Friedman, *supra* note 58, at 963-64 (getting substantial support is evidence of merit);

campaigning for support of disinterested shareholders. Thus, company value under such contestants tends to be higher than under those who do not receive a large number of votes by disinterested shareholders.[174]

Encouraging large shareholders to enter and spend on proxy contests is also likely to be desirable, since larger shareholders profit more in stock appreciation gains if the value of the company increases, and suffer more stock appreciation losses if it falls. Thus, other things being equal, large shareholders are more likely than small shareholders to participate in a contest if company value increases, and less likely to do so[175] if company value decreases under their control.

As an example, assume that *C* gains private benefits of $100,000 from taking control of *X* but that the value of *X* would drop by $500,000. If *C* owned 20% of *X*'s shares, she would derive no gain from taking control: her private benefits would be eradicated by the drop in the value of her shares. But if she owned only 1% of the shares, her private gains would be $95,000 and she might, in the proper circumstances, initiate a contest.[176]

Success-contingent compensation thus leads to more efficient entry and spending in two ways. By benefiting shareholders who expect more outside support, it encourages those who other shareholders believe will increase company value.[177] By benefiting large shareholders, it encourages those who have a higher stake in the value of the company. Both groups[178] will consist of relatively desirable entrants.[179]

Latcham & Emerson, *supra* note 58, at 16-17 (support important factor in determining benefits of proposal).

174. As is the case with large shareholders, if shareholders who expect to receive outside support generally have lower net private control benefits and higher social costs, they may not tend to be better contestants than shareholders who do not expect to receive outside support—but this is highly unlikely. If it were, we would find ourselves in a somewhat anomalous situation in which entry by contestants who tend to win proxy contests is less desirable than entry by those who would tend to lose them.

175. *Cf.* Easterbrook & Fischel, *supra* note 15, at 413 (small shareholders will not be deterred from leading contests which may decrease corporate value because their ability to siphon profits outweighs their proportional loss of company value).

176. Larger shareholders also bear a greater portion of the cost of proxy contests to the company, and so have greater incentives to limit their expenses than smaller shareholders. Thus, larger shareholders will, on average, be more desirable entrants and better contestants than smaller shareholders.

177. In addition, since incumbents tend to be challenged by desirable contestants, success-contingent compensation creates greater ex ante incentives for managers to improve their performance than non-contingent reimbursement. If managers improve their performance, such potential challengers will have less reason to initiate a control challenge.

178. As explained, neither group will tend to be associated with smaller net private benefits or larger social costs.

179. Providing success-contingent compensation might raise some concerns about those challengers who might be risk averse or who have financing difficulties. However, neither of these concerns is likely to present a major problem for good challengers. For risk-averse challengers, the level of expected compensation necessary to induce them to lead a control contest would have to be

Of course, making compensation contingent on success only partially solves the issue of how to structure intermediate reimbursement. We must still determine the success threshold and whether reimbursement, if awarded, should be full or partial. For the remainder of this Subsection, we discuss briefly what portion of the expenses should be reimbursable once the success threshold is attained; the level at which this threshold should be set will be addressed in the following Subsection.[180]

In Part II, we discussed various ways of providing partial compensation.[181] One way to provide partial compensation is to itemize reimbursement, that is, to compensate for certain expense items, but not for others. Differential rather than uniform treatment of expense items can, at least in theory, improve the outcome of proxy contests. For example, certain items may tend to provide objective information to shareholders, while others may tend to confuse shareholders or to exert undue pressure.[182] The better and more objectively shareholders are informed, the more likely they are to vote for the contestant under whom company value will be higher (who will tend to be the better contestant).[183] Thus, from a social perspective, spending on informative items should be encouraged and spending on disinformative items should be discouraged.

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higher if compensation is contingent rather than fixed. But such higher compensation could be easily achieved by reducing the threshold level of success (the question of the optimal threshold will be discussed at *infra* Subsection (IV)(B)(4)), or by increasing the level of compensation given if the threshold of success is met.

Contingent compensation would also present a problem for challengers who have to rely on outside funds to finance a control contest. Since compensation of expenses would not be assured, lenders would be more reluctant to extend credit to such challengers. However, there is no reason to believe that such problems would disproportionally affect good challengers. If anything, good challengers would be more able to obtain financing in a success-contingent scheme, since they would, on average, have a better chance of getting reimbursed.

180. *See infra* text accompanying notes 185-86.

181. *See supra* text accompanying notes 48-66.

182. *Cf.* Friedman, *supra* note 58, at 953-55 (noting that "vigorous persuasion" by professional solicitors may impair free choice of stockholders); Machtinger, *supra* note 36, at 214-15 (examining when shareholders or corporation should bear proxy fight informational costs).

183. Some commentators have argued that expenses for last-minute telephone calls and fees to proxy solicitors confuse rather than inform shareholders. They believe shareholders are adequately informed by mailed proxy statements. *See, e.g.,* Friedman, *supra* note 58, at 953-55; Latcham & Emerson, *supra* note 58, at 11; Machtinger, *supra* note 36, at 214-15. The use of proxy solicitors has, however, become a standard feature in proxy contests, and proxy solicitors also perform other functions that these commentators regard as informative (for example the preparation and mailing of the proxy statements). *See, e.g.,* E. ARANOW & H. EINHORN, *supra* note 149, at 557-58; G. MOODY & C. BAGLEY, *supra* note 15, at A-13. Also, since many shareholders will not read mailed communications (proxy statements are up to several hundred pages long), personal proxy solicitations and telephone calls may have an important informative function. *Cf.* Schulman, *supra* note 15, at 178 (acknowledging that even personal visits to shareholders may increase shareholder information but nevertheless opposing reimbursement for such expenses). Thus, we are not convinced that telephone calls or personal solicitations provide less valuable information than other proxy contest communications.

Such a differentiation, however, depends on the ability to distinguish inherently informative from inherently disinformative expense items. In practice, drawing such a distinction is at best difficult and imprecise, and involves substantial administrative costs. Therefore, we advocate no change in the current practice of allowing all kinds of expenses, except those that are clearly improper, to be reimbursed.

We do, however, favor limiting reimbursement to a reasonable level of expenses. This reasonableness requirement should be more strictly construed than is the current practice. An upper limit would impose some restraint even on contestants who are virtually assured of meeting the threshold of success, and thus would cut down on wasteful escalations of contest expenditures.

4. *The Optimal Threshold for Success*

So far, we have concluded that challenger reimbursement should be success-contingent and that challengers who attain the requisite level of "success" should be reimbursed for their reasonable expenditures on all items that are not clearly improper. We now turn to the question of the optimal threshold of success. By threshold of success we mean the percentage of votes challengers are required to receive in order to be awarded reimbursement.

Note that the present practice is also a form of success-contingent compensation: challengers receive compensation if they gain control of the board and can award compensation to themselves. It is, however, quite unlikely that the present practice is optimal, since gaining board control depends on whether all directors are elected in the shareholder meeting. Many corporate charters provide for staggered boards,[184] that is, for election of only some of the board members at each annual meeting. But if less than half of the board is up for reelection, no amount of shareholder support may give the challengers control of the board in *one* proxy contest. Thus, in companies with staggered boards, challengers face an implicitly higher threshold of success than in companies where all directors are elected at each annual meeting. This disparity between allocation rules for companies with staggered boards and those for companies without is not justified.

Having concluded that the allocation practices should not vary depending on the existence of a staggered board, we still face the question of the optimal success threshold. Presently, in contests in which the majority of the board is to be elected, the implicit success threshold is in gaining a majority of the votes cast.

184. TAKEOVER DEFENSES, *supra* note 25; TAKEOVER DEFENSES UPDATE, *supra* note 25 (in survey, 223 of 421 companies had such provisions).

We are not able to determine with precision the optimal threshold of success and in particular whether, for challengers, winning more votes than the incumbents is too low, too high, or optimal as a threshold. But note that establishing a threshold for compensation that deviates greatly from the threshold for winning the contest creates incentives to spend on a contest not to affect its outcome, but merely to obtain reimbursement. Assume, for example, the success threshold is gaining 30% of the votes cast. Challengers who reassess whether to continue as the contest progresses may decide to increase spending in order to increase the likelihood of meeting the success threshold (and thus to get reimbursement for past expenditures), even if the additional spending does not significantly increase their chances of winning. From the social perspective, such additional expenditures are wasted even if these challengers were good contestants. The greater the divergence between the success threshold and the victory threshold, the greater the incentives to engage in this wasteful spending. Since we have neither strong analytical arguments nor strong empirical evidence to show that winning a contest is not the optimal success threshold for compensation,[185] we tentatively advocate not changing the present rule other than by granting victorious challengers an affirmative right to reimbursement.[186]

C. *Assessing the Rules on Reimbursement of Incumbents*

According to current practice, incumbents are generally compensated for all their expenditures in control contests.[187] The only two restrictions are that the contest must involve a question of policy and that the expenses must be reasonable. However, as explained above, reimbursement is rarely if ever denied for either reason.[188] In this Section, we consider the consequences of this practice.

In the preceding Section, we considered the reimbursement scheme for challengers. We concluded that challengers should not receive full reimbursement, and that their compensation should be success-contingent, with the success threshold based on the percentage of votes received. We also concluded that reimbursement should be subject to a strictly enforced reasonableness requirement.

185. In cases where less than a majority or more than a majority of the votes cast suffices to win a contest, for example in approvals of mergers, we tentatively advocate that the threshold for winning rise or fall as well.

186. If it were determined that challengers should receive more compensation than they would get under this success threshold, we could either give some compensation to those who do not meet the threshold, or we could lower the threshold. Both of these options entail certain disadvantages. Giving some compensation to losers would make the overall compensation scheme less success-contingent; lowering the threshold would, as described, encourage wasteful expenditures.

187. *See supra* note 146 and accompanying text.

188. *See supra* notes 130-46 and accompanying text.

The same general arguments apply to reimbursement for incumbents. Like challengers, incumbents should not receive full compensation because full compensation has two significant undesirable effects. First, as incumbents will often face virtually no costs in defending, they have few incentives to withdraw from a contest. As a result, many undesirable incumbents will choose to defend even when desirable challengers institute contests. Second, full compensation will impose too few restraints on spending. As a result, incumbents will incur excessive expenditures.

Moreover, compensation of incumbents should be contingent on achieving a threshold level of success. Success-contingent compensation favors incumbents who expect to receive outside support or who are themselves large shareholders. Since incumbents in either of these groups tend to be good contestants, success-contingent compensation leads to more efficient entry and spending decisions than does providing a lower level of compensation to all contestants.

Note that this analysis suggests that the current compensation practice for incumbents is significantly more flawed than the one for challengers. Incumbents presently receive full compensation automatically, while challenger compensation is already intermediate and success-contingent (though gaining board control is not an efficient success threshold). Thus, we recommend major revisions in the present compensation practice for incumbents in order to make their compensation scheme more efficient.

For the remainder of this Section, we will discuss whether compensation rules should be neutral or more generous for incumbents than challengers. If incumbents systematically are more desirable than challengers, favoring incumbents may be desirable because it will increase both their entry into contests and their spending (and thus their chance of winning).

On the other hand, note that under the present proxy rules, other factors would favor incumbents even if incumbents were to receive compensation neutrally with challengers. First, incumbents have certain institutional advantages, such as greater access to corporate information and greater control over the timing of shareholder meetings and record dates. Second, if shareholders believe that incumbents, on average, are more desirable than challengers,[189] the mere fact that a contestant is an incumbent may make it more likely for shareholders to vote for that contestant. Arguably, even if one concludes that incumbents are on average more desirable than challengers, these advantages may sufficiently favor

189. *See infra* text accompanying notes 190-98.

incumbents and additional advantages—in the form of more generous compensation—may not be necessary.

We now present two reasons why incumbents may, on average, be better than challengers (and consequently why certain advantages to incumbents may be warranted). We first argue that prior monitoring more effectively screens against bad incumbents than against bad challengers. We then explain why the possibility of extortive threats would attract more bad challengers than bad incumbents.

First, incumbents are subject to greater internal and external monitoring than challengers. Some former bad incumbents will have been fired by their colleagues on the board of directors;[190] some will have had their companies taken over;[191] and some will have been ousted in prior control contests. Most importantly, unlike incumbents, many challengers will have never been appointed as managers of a company. Challengers, however, are not subject to the same kind of prior monitoring. While the possibility of monitoring does not mean that incumbents should never be ousted by proxy challenges,[192] the existence of prior monitoring provides a strong argument for the proposition that incumbents are, on average, better suited to manage the company than the challengers that would emerge under neutral rules. Therefore, it may be efficient[193] to grant incumbents more generous reimbursement than challengers.[194]

Second, incumbents may, on average, be more desirable than challengers because undesirable challengers may initiate contests for the purpose of extortion. By extortion we mean a threat by a challenger to go

190. *See* Weisbach, *Outside Directors and CEO Turnover,* 20 J. FIN. ECON. 431 (1988).

191. *See* Morck, Schleifer & Vishny, *Management Ownership and Market Valuation,* 20 J. FIN. ECON. 293, 294 (1988).

192. *See generally* Dodd & Warner, *supra* note 15 (successful proxy contests increase company value).

193. One could, however, argue that more generous reimbursement is unnecessary because, as we explained, incumbents enjoy other advantages over challengers and, if they are better than challengers, they have a greater probability of success. Whether these factors suffice to outweigh the effects of greater monitoring will depend on the degree to which such monitoring is effective in disciplining incumbents; the frequency with which shareholders will vote for better contestants; the frequency with which they will vote for incumbents; the significance of incumbents' other advantages; and the relative merit of benefiting incumbents by lowering their costs or by increasing their probability of winning.

194. For a related reason, it might be desirable to make compensation of incumbents less contingent on success. Good incumbents are more likely than good challengers to be small shareholders. Incumbents who are small shareholders are subject to a higher level of prior monitoring than incumbents who are large shareholders (since large shareholders are less likely to be fired by independent directors and their companies are less subject to takeovers). The same is not true for challengers who, whether small or large shareholders, are not subject to prior monitoring. Thus, the relationship between large shareholders and a good contestant as outlined in Part III, *see supra* text accompanying notes 163-64, is likely to be stronger in the case of challengers than in the case of incumbents. Since the desirability of success contingency depends, in part, on the strength of this relationship, the optimal rule for incumbent compensation should be less contingent than the rule for challengers.

forward with a contest, and to impose on incumbents the risk of not being fully reimbursed for their expenditures, in order to extract an extortion payment for withdrawing from the contest. The possibility of obtaining extortion payments may attract bad challengers to initiate control contests.[195]

To be sure, challengers may also be subject to extortion from bad incumbents (who may threaten to defend a contest and thereby impose on good challengers the risk of not being fully reimbursed). However, incumbents are generally more vulnerable to extortion than challengers and extortion will consequently induce more bad challenges than bad defenses by incumbents. One reason is that incumbents may be more willing than challengers to accede to threats because incumbents can shift to the company the cost of the extortion payment. For instance, the company could pay challengers "greenmail" if they withdraw from the contest.[196] This, in turn, makes extortion more rewarding to challengers than to incumbents. A second reason is that *one* challenger who engages in such extortion can threaten incumbents in a large number of companies, while an incumbent engaged in such conduct can threaten only one company and its relatively few potential challengers. Thus, even if any one incumbent is as likely to extort as any one challenger,[197] more incumbents will be subjected to extortive challenges.[198]

195. Apart from the fact that extortion may attract bad challengers, it is undesirable because it could lead incumbents to make inefficient settlements or withdraw from contests because incumbents, if they are not fully reimbursed, may wish to avoid the risk of having to spend their personal wealth.

196. Conceptually, incumbents could receive greenmail payments as well. However, while incumbents have the company agree to pay greenmail concurrently with the challengers' agreement to withdraw, challengers can only promise that, when they take control, they will cause the company to agree to pay greenmail. Such a promise by challengers may be hard to enforce.

197. In fact, given the same reimbursement rules, challengers would be more likely than incumbents to extort. For a threat to succeed, it is of crucial importance that it be credible. But very often, if the threat of leading a proxy contest fails, the costs of executing the threat would be higher than the expected benefits from continuing the contest. In such circumstances, the threat may not be credible. Challengers will, on average, have an advantage in making such credible threats. Even in cases where the threat is not credible when one considers merely the benefits and costs resulting from continuing the contest at hand, the threat can be made credible by investing *reputation* in it. That is, for contestants with a reputation for extortive behavior, the expected benefits from continuing with a contest would not only consist of the expected benefits of this one contest (which may be low), but also of making *future* extortive threats more credible. A reputation as a successful extortionist is obviously advantageous to challengers, who have the ability to develop it by controlling the number and kind of proxy contests they lead.

198. Providing reimbursement to incumbents and challengers may, however, have opposite ex ante effects on managerial behavior. Lowering reimbursement to incumbents while increasing it to challengers would result in an increased threat of being ousted. Schulman, *supra* note 15, at 16-17, 31. Other things being equal, this would increase managerial incentives to enhance shareholder support. Depending on whether managers chose to improve their actual performance or to manipulate shareholder perceptions of managerial performance, one might conclude that challengers should receive more reimbursement or less reimbursement, respectively, than incumbents. But note that the effects of increasing reimbursement to challengers differ from those of decreasing

Prior monitoring and extortion are reasons why incumbents may be better contestants than challengers. As a result, it may be warranted to provide incumbents with more generous compensation than challengers. Note, however, that as the compensation level to incumbents (but not to challengers) is increased, relatively worse incumbents will enter proxy contests and spend more on them. Thus, even if incumbents are better than the challengers who emerge under neutral rules, non-neutral compensation rules will screen more effectively against bad challengers than against bad incumbents. Therefore, at some point, increasing the degree to which incumbents are favored will no longer be efficient. In particular, it is not desirable to provide incumbents with full compensation, since, as we pointed out, that provides hardly any incentives to withdraw or limit expenses, and thus has significant undesirable effects on entry and spending in proxy contests.

Our analysis, then, supports allocation rules for incumbents that provide less than full compensation and are success contingent. It may, however, be justified to provide incumbents with more generous compensation than is provided to challengers. The present system does not meet these criteria because it provides full compensation independent of success, and subject only to an ineffective reasonableness standard. Instead, we propose that full reimbursement (subject to a more strictly enforced reasonableness requirement) be made contingent upon the incumbents' surpassing a threshold of support from the shareholders. This threshold may be lower than the threshold for challengers. In addition, one could give some, but not full, reimbursement to incumbents who fall short of this threshold.[199]

V
ISSUE CONTESTS

So far, this analysis has focused on proxy contests for the election of directors. Even though proxy contests can be waged over any issue on which shareholders vote, historically almost no other contests have been fought. However, starting in the 1980s, an increasing number of proxy contests concerned issues other than director elections.[200] For example,

reimbursement to incumbents. Increasing reimbursement to challengers would primarily increase the risk of ouster; decreasing reimbursement to incumbents would primarily increase the risk of having to use personal funds in contests in order to preserve the private benefits of control.

199. *But see* Easterbrook & Fischel, *supra* note 15, at 413 (if incumbents may not use corporate funds, they will not spend enough on proxy contests because they would incur expenses disproportionate to their shareholdings). Easterbrook and Fischel apparently believe that directors never make expenditures for private benefits.

200. R. SCHRAGER, *supra* note 4, at 8-15 (up to the 1980s, almost all proxy contests concerned the election of directors).

issue contests have involved charter amendments,[201] merger agreements,[202] acquisitions of other companies,[203] liquidation plans,[204] stock repurchases,[205] reincorporations into other states,[206] recapitalization plans,[207] shareholder resolutions,[208] and executive compensation schemes.[209]

In this Part, we analyze cost allocation rules in issue contests. After briefly restating the current rules, we will consider whether the rules in issue contests should differ from the rules in control contests. In light of our conclusions we will evaluate and recommend significant changes to the current rules. Throughout this Part, we will focus on the allocation of challengers' expenses.[210]

The current rules are implicitly less favorable to challengers in issue contests than in control contests. Challengers receive the compensation awarded to them by the board of directors. In control contests, victorious challengers gain control over, or at least some representation on, the board of directors. Thus, they can either grant reimbursement to themselves or they at least obtain some bargaining power. But in issue contests, challengers never gain any representation on the board, and so are dependent on the mercy of a generally hostile board to receive reimbursement. Unsurprisingly, even victorious challengers are seldom compensated.[211]

There are, however, two reasons why challengers should receive more, rather than less, compensation in issue contests than in control contests. First, while takeovers are a meaningful alternative to control

201. *See, e.g., id.* at 57-59 (describing 1985 contest over Alexander & Baldwin, Inc.). *See generally* Brickley, Lease & Smith, *supra* note 55 (discussing anti-takeover amendments); Pound, *supra* note 15 (discussing issue contests involving charter amendments).

202. *See, e.g.,* Penn Central Corp., Proxy Statement (Penn Central Special Meeting of Shareholders, Oct. 29, 1981) [hereinafter Penn Central Proxy Statement].

203. *See, e.g.,* Florida National Banks Proxy Statement, *supra* note 51, at 207.

204. *See, e.g.,* R. SCHRAGER, *supra* note 4, at 71-73 (describing 1984 contest over City Investing Co. involving a management-proposed liquidation plan).

205. *See, e.g., id.* at 63-66 (describing 1984 contest over Beverly Hills Savings & Loan Association involving, among other issues, an agreement to repurchase shares).

206. *See, e.g., id.* at 67-68 (describing 1984 contest over Carter Hawley Hale Stores, Inc., involving a reincorporation into Delaware, among other issues).

207. *See, e.g., id.* at 132-36 (describing 1985 contest over Phillips Petroleum Co.).

208. *See, e.g., id.* at 143-45 (describing 1985 contest over Rorer Group in which shareholders proposed repeal of poison pill).

209. *See, e.g., id.* at 89-93 (describing 1985 contest over Fortune Financial Group, Inc., in which shareholders attacked a bonus plan, among other issues).

210. In these contests, incumbents are compensated for all their expenses. As in election contests, we recommend that compensation of incumbents be made contingent on some threshold of success, since success-contingent compensation will tend to encourage better incumbents to advocate better proposals. *See supra* Section III(A).

211. *See, e.g.,* Grodetsky v. McCrory Corp., 49 Misc. 2d 322, 324, 267 N.Y.S.2d 356, 359 (Sup. Ct. 1966).

contests, they are significantly less effective as an alternative to issue contests. It is therefore more important to preserve issue contests as a viable option for issue challengers. Second, challengers in issue contests will generally both advocate better proposals and be more dependent on reimbursement.

Two factors make takeovers a less adequate alternative to issue contests than to control contests. For one, successful takeovers, like control contests, generally result in a shift in control from incumbents to challengers. But in issue contests, challengers may generally be content with the incumbents' management. Rather than seek control for themselves, they may oppose only a particular management proposal. For example, shareholders may oppose adoption of an anti-takeover charter amendment without wanting to displace the incumbents. In these cases, a takeover would not be an effective way to attain the limited objectives of the issue contest.

Moreover, the nature of the issue contest may make a takeover harder to stage. Take, for instance, contests over anti-takeover charter amendments or proposed mergers. Shareholders frequently learn about the proposed amendment or transaction only a short time before the scheduled vote,[212] making it difficult to attempt a takeover beforehand. Further, after an anti-takeover amendment is adopted or a merger consummated, a takeover will be more difficult to stage and the objectionable transaction difficult to reverse. Thus, it is more important to maintain issue contests as viable alternatives.

The second reason for treating challengers more generously in issue contests is rooted in the fact that (with some exceptions to be discussed below) challengers in issue contests gain neither control nor the private benefits that come with control.

The fact that challengers derive no private benefits of control has two implications. First, challengers will tend to initiate issue contests only if they believe that doing so increases the value of their stock.[213] Therefore, issue contests will tend to involve desirable challenges. Moreover, the expected gains to challengers will tend to be lower in issue contests than in control contests since one source of gains—private benefits—is generally absent.[214] Therefore, challengers will have less incentive to initiate issue contests. Since the proposals advocated by

212. *See, e.g.*, DEL. CODE ANN. tit. 8, § 222(b) (1983) (notice of meeting may be given as little as 10 days in advance); Penn Central Proxy Statement, *supra* note 202, at 12 (proxy materials calling for special meeting on October 29, 1981, dated September 25, 1981).

213. *Cf.* Yoran, *supra* note 52, at 470 (proxy contests about corporate transactions only involve questions of policy; control contests involve questions of policy and control).

214. Due to the absence of private benefits, expected gains to challengers in issue contests are lower than in control contests. The absence of private benefits does not mean that expected gains to society are lower. From society's perspective, there are private benefits: those of the incumbents.

challengers tend to increase company value, and since challengers require greater inducement to enter because of their lower expected gains, it is desirable for challengers to receive more generous reimbursement in issue contests.

As we have seen, reimbursement for challengers currently is less generous in issue contests than in control contests. We therefore propose that, at a minimum, challengers receive reimbursement at the same de facto standards in issue contests as in control contests.[215] Preferably, reimbursement to challengers should be contingent on a lower threshold of success in issue contests than in control contests, or partial reimbursement should be provided if the threshold of success is not met.

There is, however, one type of issue contest in which challengers may well derive private control benefits: takeover issue contests. A takeover issue contest is often waged by a raider as part of a hostile takeover, for example to block an anti-takeover charter amendment or a defensive merger with a white knight. Success in such an issue contest increases the chance of success in the takeover bid and thus creates the potential for private benefits from control.[216] Since in takeover contests the raider aims at obtaining control, challengers should be reimbursed according to the same standards as in control contests.

VI
SHOULD PROXY RULES BE MANDATORY?

In our discussion so far we have analyzed and tried to identify the efficient design of proxy rules in general and cost allocation rules in particular. These proxy rules should at least be instituted as "default" rules, that is, they should apply to all corporations that do not provide for a different set of rules in their charter. In this Part, we discuss the extent to which companies would elect to opt out of socially desirable proxy rules and, consequently, to what extent standard proxy rules should be mandatory.[217] We conclude that companies, if free to opt out of proxy

Issue contests merely differ from control contests in that the challengers do not seek to obtain private benefits.

215. *See* Yoran, *supra* note 52, at 470 (criticizing different standards for contests involving election of directors and other contests).

216. Such control would, however, be attained only by ultimate success in the takeover.

217. The extent to which corporate rules should be mandatory has lately become the subject of debate among corporate scholars. For an overview of the debate, see Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law,* 89 COLUM. L. REV. 1395 (1989). Recent contributions to the debate include Bebchuk, *supra* note 31; Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal,* 74 CORNELL L. REV. 407 (1989); Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract,* 85 COLUM. L. REV. 1403 (1985); Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law,* 89 COLUM. L. REV. 1703 (1989); Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,* 89 COLUM. L. REV. 1618 (1989); Coffee, *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special*

rules, would adopt rules more favorable to incumbents, and less favorable to challengers, than the efficient rules. Therefore, companies should be free to adopt rules that, compared to the standard proxy rules, favor challengers and disfavor incumbents. But companies should be constrained in adopting proxy rules that favor incumbents over challengers.

Assume that a company has complete freedom in designing the corporate rules by which it is governed. Further assume that two other conditions are met. First, all parties to the corporate contract[218] have perfect information about all the effects of such rules. Second, such rules do not generate any externalities, that is, they do not affect any party to the corporate contract. Under these conditions, companies would tend to adopt the rules that maximize social wealth. Under perfect information, companies would wish to adopt the rules that maximize the value captured by the parties to the corporate contract. Since no other party is affected by the rules, these rules will also maximize social wealth. However, if corporate rules generate externalities, or parties do not possess perfect information, the privately adopted rules may deviate from the efficient ones.

We therefore explore, in the context of proxy rules, the way in which privately adopted rules may deviate from efficient ones. We first examine the effects of externalities assuming that companies possess perfect information and adopt proxy rules that maximize the value captured by the parties to the corporate contract.[219] Then, we consider how, even absent externalities, a lack of perfect information can cause companies to adopt inefficient proxy rules.

A. Externalities

Rational and perfectly informed parties to the corporate contract would wish to adopt a set of rules that maximizes the value to be captured by them. However, the terms to which they will agree will fail to

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Case of Remedies, 53 BROOKLYN L. REV. 919 (1988); Easterbrook & Fischel, *The Corporate Contract,* 89 COLUM. L. REV. 1416 (1989) (normative principles for determining which rules should be mandatory); Eisenberg, *The Structure of Corporation Law,* 89 COLUM. L. REV. 1461 (1989); Gordon, *The Mandatory Structure of Corporate Law,* 89 COLUM. L. REV. 1549, 1554 (1989) (advocating a "mixed system of optional and mandatory legal rules").

218. By corporate contract, we mean the *nexus of contracts* that makes up the corporation, that is, the web of contractual and quasi-contractual arrangements which govern the relationship between the corporation and its constituents. For our purposes, these arrangements primarily consist of federal and state regulation of the proxy process as well as pertinent corporate charter and by-law provisions. The parties to the corporate contract are all the parties whose interests are represented, directly or indirectly, when the corporate contract is formed.

219. In discussing externalities, we limit ourselves to externalities that are of particular significance to proxy rules. For a discussion of some externalities that affect corporation law in more general ways, see Gordon, *supra* note 217.

take account of the effects on groups that are not parties to the corporate contract. As a result, the privately adopted rules, although value-maximizing for the parties to the corporate contract, will tend to be inefficient.

This general reasoning on the link between externalities and inefficient rules is undisputed. Even commentators who strongly favor private market arrangements have recognized that the existence of significant externalities can justify mandatory corporate rules.[220] Since proxy rules, too, generate substantial externalities, mandatory terms in proxy rules may be justified.

As discussed, proxy rules principally affect three groups: shareholders, incumbents, and challengers; but only shareholders and incumbents are parties to the corporate contract.[221] Therefore, the privately adopted corporate contract would not take account of the impact of proxy rules on private control benefits of challengers. In other words, the rules that maximize the private wealth of the parties to the corporate contract do not necessarily maximize social wealth. Thus, the value of the corporation to the parties to the corporate contract differs from the value to society, which includes, in addition to company value and control benefits to incumbents, any private control benefits to challengers.

Since control benefits to challengers are not taken into account, the proxy rules contracted for by incumbents and shareholders would tend to be inefficient. In particular, these rules will be less favorable to challengers, and more favorable to incumbents, than the efficient rules.[222] That is, the presence of externalities would cause companies, if permitted, to opt out of the standard proxy rules even if the standard rules maximize social wealth.

Note that this argument parallels the one made in the context of hostile takeovers.[223] In designing the rules on hostile takeovers,

220. *See, e.g.*, Easterbrook & Fischel, *supra* note 217, at 1442 (optimal contracts will be formed only when parties internalize their costs and when all contract options are available).

221. To be sure, the shareholders and incumbents at the time of the proxy contest are not necessarily the same shareholders and incumbents who designed the corporate contract. Nonetheless, the former may have a contractual relationship with the latter; for example, the shareholders at the time of a contest may have bought their shares from those initial shareholders, and the incumbents at the time of the contest may have been hired by the initial incumbents. Since the initial shareholders and incumbents have an interest in selling their shares at the highest price, they will, under perfect information, take full account of the interests of subsequent shareholders. Similarly, to the extent that subsequent incumbents *pay* the initial incumbents or shareholders for their control benefits (for example, through consulting agreements with the initial incumbents or a lower salary), their interests will be taken into account by the parties to the corporate contract.

222. This does not mean that shareholders and incumbents will always agree on proxy rules to assure victory for incumbents. Shareholders have an interest in allowing for the possibility of successful proxy contests because such contests may increase company value. Furthermore, the threat of such a contest may provide desirable ex ante incentives for managers to maximize company value.

223. *See supra* text accompanying notes 20-28; *see also* Grossman & Hart, *supra* note 22.

shareholders will wish to maximize the value accruing to themselves, without taking account of the value accruing to the raider. Therefore, the takeover rules that maximize value for shareholders will be more pro-target than socially efficient takeover rules would be. Such arguments have led commentators such as Easterbrook and Fischel, who are usually strong believers in the efficiency of private arrangements, to advocate legal limits on the ability of companies to resist takeovers.[224]

B. Imperfect Information

Even putting aside externalities, imperfect information may lead parties to the corporate contract to adopt inefficient proxy rules. Such inefficient rules may be adopted at two occasions. First, the provisions in the initial charter of a corporation that goes public may be inefficient. Second, such provisions may be contained in midstream charter amendments, that is, in amendments to the charter of a publicly traded company.

That imperfect information may systematically lead to rules which inefficiently favor incumbents is of particular concern in the case of midstream charter amendments.[225] Even strong proponents of freedom to opt out have acknowledged that midstream amendments present special problems.[226] As in the case of proxy contests, shareholders will lack adequate incentives to obtain information on whether such an amendment is desirable for two reasons. First, the wealth of small shareholders will not be affected greatly by whether the amendment is adopted.[227] Second, these shareholders will consider it unlikely that their few votes will determine whether the proposed amendment passes.[228] As a result, shareholders may vote in favor of undesirable amendments. Furthermore, incumbents have an incentive to propose mainstream charter amendments in their own favor even if such amendments are inefficient. To be sure, such amendments would reduce the value of the company to shareholders,[229] and thus lower the value of the stock of the company held by the incumbents. But incumbents will generally own only a small fraction of the shares of the company. Their loss from the decline in stock value caused by an inefficient amendment may easily be outweighed by their

224. Easterbrook & Fischel, *supra* note 217, at 1436-42 (private optimal corporate contract may be inefficiently biased against raiders); *see* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) (advocating legal prohibition of auctions); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (advocating legal prohibition of defensive tactics in general).

225. *See* Bebchuk, *supra* note 31, at 1836-39.

226. Easterbrook & Fischel, *supra* note 217, at 1442-44.

227. *See supra* note 31 and accompanying text.

228. *See id.*

229. By definition, absent externalities, an amendment would only be inefficient if it reduced company value by more than it increased private control benefits.

gains from increased private control benefits. Thus, the possibility of a decline in the stock value will not adequately restrain incumbents from proposing inefficient amendments.

Some commentators believe that even initial charter provisions may contain terms that systematically tend to favor incumbents at the expense of shareholders.[230] These commentators hold the view that the buyers of stock initially offered to the public rationally elect not to assess fully many aspects of the company's charter. Consequently, the impact of some charter provisions on the value of the company would not be fully reflected in the price for stock the company can obtain in the initial offering. In that case, the initial charter terms that maximize the sum of stock price and control benefits would not be value-maximizing. In particular, the pre-offering owner of the company may expect to remain an incumbent of the company and therefore try to maximize her control benefits and the value from the sale of stock to the public. Since the impact of charter provisions would not be fully reflected in the public offering price, that owner would have an incentive to include charter provisions on proxy contests that inefficiently favor incumbents.[231]

C. *The Desirable Approach to Opt-Outs*

As the foregoing analysis has shown, companies have incentives to opt out of the standard proxy rules even if the standard rules are efficient. More importantly, our analysis has demonstrated that this divergence between privately adopted and socially optimal arrangements has a systematic direction: both externalities and imperfect information in the design of proxy rules would cause companies to adopt rules which, compared with efficient rules, favor incumbents and disfavor challengers. As challengers are absent at the formation of the corporate contract, their potential control benefits will not be given sufficient weight. Similarly, imperfect information will tend to cause proxy rules adopted by companies to be more favorable to incumbents than the efficient proxy rules.

In light of these considerations, we recommend that companies have complete freedom to adopt rules which favor challengers and disfavor incumbents more than the standard proxy rules do. If a company

230. *See* L. BEBCHUK, FREEDOM OF CONTRACT AND THE CORPORATION: AN ESSAY ON THE MANDATORY ROLE OF CORPORATE LAW (Harvard Program in Law and Economics Discussion Paper No. 46, 1988); Brudney, *supra* note 217, at 1411-27; Clark, *supra* note 217, at 1718-19; Coffee, *supra* note 217, at 1676-77; Eisenberg, *supra* note 217, at 1516-18.

231. Note that if the owner/incumbent held all the stock of the company prior to the public offering and the offering price were fully to take account of the impact of charter provisions on company value, the owner/incumbent would have an incentive to include efficient charter terms. Of course, even in that case, as the owner/incumbent may lack perfect information, she may still include inefficient rules. However, there would be no reason to believe that such rules will systematically favor incumbents over challengers.

wanted to change the standard proxy rules in a way more favorable to challengers and less favorable to incumbents than the standard rules, it is highly likely that such a change is desirable.

On the other hand, we recommend restrictions on the ability of companies to institute rules favoring incumbents over challengers. As discussed, companies are subject to substantial incentives to adopt rules that inefficiently favor incumbents over challengers.[232]

CONCLUSION

This Article has put forward a framework for analyzing legal policy towards proxy contests. We have applied this framework to evaluate the rules governing reimbursement by the corporation of the costs incurred by incumbents and challengers. The general framework that we have developed, however, can be used to analyze any other aspect of the law governing proxy contests.

Much of our analysis has focused on proxy contests for control, which are the only alternative to hostile takeovers to gain control against the will of the incumbent directors. As we have shown, control contests avoid certain disadvantages associated with hostile takeovers: the transaction costs of shifting ownership, the free rider problem, and the pressure to tender problem. But control contests involve other problems: shareholders commonly lack adequate incentives to become fully informed and cast an educated vote, and challengers often lack adequate incentives to initiate contests and devote resources to them. These problems are in part a function of the legal policy towards proxy contests. In particular, these problems are affected by cost allocation rules, which govern the extent to which contestants' expenses are reimbursed by the company.

To provide an analytical framework, we have identified and analyzed the three major effects of proxy contest rules in general, and cost allocation rules in particular. First, proxy rules have an impact on contestants' entry decisions and thus on the number of contests. Second, proxy rules affect the amount contestants spend and thus their chances of success. Third, proxy contest rules affect ex ante managerial behavior. All these effects must be taken into account in designing proxy contest rules.

Applying our general framework to the cost allocation rules, we have reached the following conclusions. First, contrary to present practice, incumbents should not receive full compensation. Full compensa-

232. Factors to consider in restricting rules favoring incumbents over challengers include the degree to which the privately adopted proxy rules would deviate from the efficient rules, and the ability of regulators to identify efficient proxy rules.

tion causes incumbents not to withdraw even when faced with desirable challengers, and leads to excessive expenditures.

Second, the current practice of making challengers' reimbursement contingent upon success is desirable. The rule, however, should be modified by making reimbursement contingent on the percentage of votes received (rather than on gaining control of the board), thus making it independent of whether all the directors are up for reelection. Furthermore, contrary to present law, incumbents' compensation should be made success-contingent as well.

Finally, turning to issue contests, we concluded that challengers should receive more generous reimbursement in such contests than in control contests because hostile takeovers are a less available alternative to such contests, and because challengers generally derive no private control benefits from such contests. Thus, existing law is greatly flawed, because it provides challengers in issue contests with no reimbursement whatsoever.

We have also shown that some restrictions on the ability of companies to opt out of proxy rules are warranted. Due to externalities and informational imperfections, companies are likely to adopt proxy arrangements that are more favorable to incumbents and less favorable to challengers than the socially optimal arrangements. Therefore, while we recommend that companies have complete freedom to adopt proxy rules favoring challengers over incumbents, we advocate restrictions on the ability to adopt rules which, compared to the standard rules, favor incumbents over challengers.