THE MYTHICAL BENEFITS OF SHAREHOLDER CONTROL

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INTRODUCTION

IN "The Myth of the Shareholder Franchise,"[1] Professor Lucian Bebchuk elegantly argues that the notion that shareholders in public corporations have the power to remove directors is a myth. Although a director facing a proxy contest might find this to be a bit of an overstatement, the core idea is sound. In a public company with widely dispersed share ownership, it is difficult and expensive for shareholders to overcome obstacles to collective action and wage a proxy battle to oust an incumbent board. Nor is success likely when directors can use corporate funds to solicit proxies to stay in place. The end result, as Adolf Berle and Gardiner Means famously observed in 1932, is that shareholders in American public corporations are "subservient" to directors "who can employ the proxy machinery to become a self-perpetuating body."[2]

In other words, not only is Bebchuk correct to suggest that shareholder control is largely a myth in public companies today, *it has been recognized to be largely a myth for at least three-quarters of a century*.[3] What should we conclude from this? Bebchuk con-

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[1] Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675 (2007).

[2] Adolph A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 277, 5 (1932).

[3] See id.; see also Robert Charles Clark, Corporate Law 95 (1986) (noting the cynic's view that "the whole institution of shareholder voting is a fraud"); Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 311 (1999) ("[S]hareholders in public corporations do not in any realistic sense elect boards. Rather, *boards elect themselves*.").

cludes the time has come to breathe life into the idea of the shareholder-controlled public firm. But as a matter of logic, this conclusion does not follow from the observation that shareholder power to vote out directors is largely mythical. There are many myths—vampires, zombies, giant alligators in the sewers of New York City—we would not want to make real.[4] Why make shareholder power to oust directors a reality?

In this Response to Bebchuk's essay, I will address this vital question. The lack of director "accountability" typically seen in public corporations has an obvious downside. While directors have some interest in ensuring the firm's survival, they do not have a strong financial interest in optimal corporate performance. As a result, board control contributes to the "agency cost" problem in firms. Nevertheless, as Part I will describe, board governance offers important upsides as well. An extensive literature on the theory of the corporation (a literature largely glossed over by Bebchuk in his essay)[5] suggests that shareholders enjoy net benefits from board

[4] Like shareholder power to remove boards, the presence of alligators in the sewers is not entirely a myth. In 1935, the *New York Times* reported that a group of teenagers in Harlem discovered an eight-foot alligator swimming in the sewer. The alligator was removed and killed. See Alligator Found in Uptown Sewer, N.Y. Times, Feb. 10, 1935, at 29.

[5] For example, Professor Bebchuk does not address in any depth the arguments raised in Professor Anabtawi's recent article on intershareholder opportunism, see Iman Anabtawi, Some Skepticism About Increasing Shareholder Power, 53 UCLA L. Rev. 561 (2006), except to touch on the issue indirectly when he dismisses the possibility that minority shareholders with "special interests" might use increased shareholder rights as leverage to pressure boards to take actions that disserve other equity investors. See Bebchuk, supra note 1, at 720–722.

Similarly, Bebchuk incorrectly implies that under the team production model of the board, board governance is primarily a vehicle for protecting stakeholders' interests, and then critiques the model on the ground that it leaves stakeholders with too little power and directors "accountable to no one." Id., at 731. This critique misses the point of the team production model: directors *should* be "unaccountable," because if either shareholders or stakeholders were given greater leverage over boards, they might use that leverage to pressure boards to opportunistically threaten the interests and specific investments of other members of the corporate "team." See infra text accompanying notes 16–20. Bebchuk's second critique of the team production model of board governance—that it does not explain how closely held firms with a controlling or majority shareholder can attract specific investments, see Bebchuk, supra note 1, at 731 n.117—overlooks several answers to this question offered in the team production literature. See, e.g., infra note 18 (noting the importance of interpersonal trust and controlling shareholders' human capital investments in discouraging opportunism in closely held firms); Blair & Stout, supra note 3, at 273 (noting possibility that closely

governance. This is because board governance, while increasing agency costs, also promotes efficient and informed decisionmaking, discourages intershareholder opportunism, and encourages valuable specific investment in corporate team production.

Because board control has both costs and benefits, the wisdom of Bebchuk's proposal to make it easier for shareholders to oust directors cannot be determined by theorizing. It must be based on evidence. Part II will look at the empirical evidence and conclude that the evidence does not support Bebchuk's proposal. To the contrary, studies of charter provisions in IPOs strongly support the claim that shareholders themselves often prefer firms with strong board control.

Why, then, do so many observers, including but not limited to Bebchuk, believe shareholders should be given greater influence over boards?[6] Why is the idea of shareholder control so appealing when there is so little evidence that it works? Part III will argue that calls for greater "shareholder democracy" appeal to laymen, the business media, and even many business experts not because they are based on evidence, but because they have a strong emotional allure. In particular, the emotional appeal of shareholder control can be traced to three sources: a common but misleading metaphor that describes shareholders as the "owners" of corporations, the opportunistic calls of activist shareholders seeking leverage over boards for self-interested reasons, and a strong but unfocused sense that something (anything!) should be done in the wake of recent corporate scandals.

The result has been a widespread, and unfortunate, acceptance of yet another myth—the myth that shareholder control in public

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held firms work well when one party's specific investments are especially important); Margaret M. Blair & Lynn A. Stout, Team Production in Business Organizations: An Introduction, 24 J. Corp. L. 743, 749 (1999) ("[T]eam production problems can be found in both public and close corporations. However, public and close corporations adopt very different strategies for dealing with those problems.").

[6] For example, prominent academics have argued that shareholders and not directors should decide when to sell the firm, see, for example, Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981), and against charter provisions that make it harder for public shareholders to remove directors, see, for example, Ronald J. Gilson, The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concept, 34 Stan. L. Rev. 775 (1982). The SEC has waded into the fray on several occasions as well. See infra text accompanying note 47.

companies actually benefits shareholders. This Response will conclude by reminding readers of the dangers of policymaking based on myth rather than evidence, using the cautionary case of stock options.

I. THEORETICAL ADVANTAGES OF BOARD POWER

In this Response, I do not attempt to contest the claim that shareholders in public corporations have little power to remove directors. That much is obvious to the informed observer. Although Bebchuk has performed a valuable service by demonstrating that shareholders in public corporations today are nearly as weak and disenfranchised as in Berle and Means's era, the interesting question is *why* do shareholders in public companies have so little power?

A. Board Governance Allows Efficient and Informed Decisionmaking

Board governance benefits shareholders by performing not one but three important economic functions. Perhaps the most obvious is promoting more efficient and informed business decisionmaking. It is difficult and expensive to arrange for thousands of dispersed shareholders to express their often-differing views on the best way to run the firm. Nor should we expect shareholder governance to produce particularly good results given the rational apathy of most shareholders toward corporate decisionmaking. Accordingly, most experts agree that board governance offers important advantages in terms of efficient and informed decisionmaking. Among legal scholars, my colleague Professor Stephen Bainbridge has taken the lead in emphasizing this explanation for board power in several recent articles.[7]

[7] See, e.g., Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 Harv. L. Rev. 1735 (2006); Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547 (2003). The basic idea can be traced back at least to Berle and Means, supra note 2, at 284–85 ("So long, then, as a property requires a contribution by its owner in order to yield service it will tend to be immobile. . . . [T]o translate property into liquid form the first requisite is that it demand as little as possible of its owner . . . .").

Still, as Bebchuk has pointed out elsewhere,[8] if more efficient and informed decisionmaking were all director governance provided, it would be hard to explain why corporate law limits shareholder voting quite so severely. The default rules of corporate law allow shareholders to vote only to elect directors and to veto "fundamental" corporate changes (e.g., mergers) the directors must propose.[9] Yet one can imagine many important decisions—for example, whether the CEO should be fired or shareholders should be paid a special dividend—about which shareholders could easily become informed and efficiently register their views. And if board governance provides only efficient and informed decisionmaking, why not at least make it easier (as Bebchuk proposes) for shareholders to replace the board? Why does corporate law not only strictly limit the matters on which shareholders may vote but also make it difficult for them to exercise their votes effectively to boot?

A second problem with emphasizing efficient and informed decisionmaking as the primary reason for board governance is that it may be a better explanation for *executive* governance. After all, if we want decisions to be made by a small number of highly informed individuals who are deeply involved in the firm's day-to-day operations, what better way to accomplish this than by hiring (as virtually all large companies do) a skilled executive team? Why then prohibit shareholders from voting directly to choose or remove the executives?[10] Why add the extra decisionmaking layer of a board—especially one whose members are often not involved in the company and that meets only a few times each year?

Better decisionmaking does a good job of explaining why companies hire executive teams. It does not go nearly as far, however, toward explaining why companies also have powerful boards. Nor does it explain directors' extreme lack of "accountability" to

[8] See, e.g., Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833, 835, 880–84, 891–92 (2005).

[9] See Blair & Stout, supra note 3, at 310 (discussing shareholder voting).

[10] Bainbridge has argued that board control is better than CEO control because group decisionmaking can restrain individual shirking and self-dealing. See Stephen M. Bainbridge, Why a Board? Group Decisionmaking in Corporate Governance, 55 Vand. L. Rev. 1, 35–36 (2002). This seems plausible, but group decisionmaking can also be accomplished at the executive level by hiring a team.

shareholders.[11] In addition to promoting better decisionmaking, board power likely offers shareholders other important advantages.

B. Board Governance Deters Intershareholder Opportunism

Board power does indeed serve shareholder interests in a second way—by protecting shareholders from *each other*. The risk that a large shareholder might try to influence corporate decisions in a self-serving way that harms other shareholders is well recognized in closely held firms, where corporate law and practice have evolved numerous strategies to constrain intershareholder opportunism.[12] What is less well understood is that by making it easier for large shareholders in public firms to threaten directors, a more effective shareholder franchise might increase the risk of intershareholder "rent-seeking" in *public* companies.

My colleague Professor Iman Anabtawi explores this advantage of director control in some detail in a recent article.[13] As Anabtawi describes, shareholders in public firms have conflicts of interest that can give rise to opportunistic behavior. An especially troubling situation involves the investor who takes a position in a stock and uses his voting power to push for business strategies that increase the value of *another* security the investor also holds. Hedge fund Perry Capital, for example, recently acquired a block of Mylan Laboratories common stock while simultaneously entering a derivatives contract with a brokerage firm that allowed Perry to keep the Mylan votes while hedging away its economic interest in the stock. Perry then used its position as a large Mylan shareholder to pressure Mylan's board to acquire another company, King Pharmaceuticals, at a hefty premium over market price. Why would Perry want Mylan to overpay for King? Probably because Perry

[11] Corporations often magnify this lack of accountability through staggered board provisions, dual-class structures, and the like. See infra text accompanying notes 37–39.

[12] Casebook discussions of close corporations generally focus on intershareholder opportunism and how it can be constrained through cumulative voting rules, fiduciary duties, and the like. See, e.g., Lewis D. Solomon et al., Corporations Law and Policy 417–514 (4th ed. 1998).

[13] See Anabtawi, supra note 5.

also held a large block of King stock—and had not hedged away its economic interest in King.[14]

The case of Perry Capital illustrates the danger inherent in changing the rules of corporate law in a way that gives opportunistic shareholders in public companies greater leverage over boards. By the same token, corporate law rules that insulate boards from shareholder pressures can discourage predatory shareholder behavior. Board power serves the interests of investors who worry about director "shirking" but fear shareholder "sharking" even more.[15]

C. Board Governance Promotes Specific Investment in Team Production

As we have just seen, shareholders can be exploited not only by corporate officers and directors (the usual suspects in "agency cost" discussions) but also by their fellow shareholders. They face this risk because stock is, counterintuitively, an illiquid investment. Although a single shareholder may be able to sell a small number of shares easily, when exploited shareholders try to sell en masse, the result is a predictable loss of value.

The connection between illiquidity and vulnerability explains why shareholders can be exploited. It also provides the foundation for a third theory of director power on which I, Margaret Blair, and others have written: the team production theory.[16] Team production analysis recognizes that shareholders are not the only group to make illiquid, "firm specific" investments in corporations. Executives, customers, creditors, suppliers, employees, and other corpo-

[14] Posting of Justin Hibbard to Deal Flow, http://www.businessweek.com/the_thread/dealflow/archives/2006/01/the_not-so-divi.html (Jan. 11, 2006, 13:20 PM EST).

[15] See Eric W. Orts, Shirking and Sharking: A Legal Theory of the Firm, 16 Yale L. & Pol'y Rev. 265, 280 (1998) (describing "sharking" as opportunistic behavior by principals in principal-agent relationships).

[16] See, e.g., Stephanie Ben-Ishai, A Team Production Theory of Canadian Corporate Law, 44 Alta. L. Rev. 299 (2006); Blair & Stout, supra note 3; Margaret M. Blair & Lynn A. Stout, Director Accountability and the Mediating Role of the Corporate Board, 79 Wash. U. L.Q. 403 (2001); Allen Kaufman et al., A Team Production Model of Corporate Governance Revisited, 19 Acad. Mgmt. Executive 9 (2005); Lynn M. LoPucki, A Team Production Theory of Bankruptcy Reorganization, 57 Vand. L. Rev. 741 (2004); Symposium, Team Production in Business Organizations, 24 J. Corp. L. 743 (1999).

rate "stakeholders" also put time, money, and expertise into relationships with companies. These investments have value only if the company survives and thrives and the relationship is preserved. A typical start-up, for example, needs an entrepreneur with an idea, equity investors to fund initial operations, and executives to provide skill and long hours implementing the idea. Each contribution is essential, and each risks being lost if the firm goes under or the investor is forced out of the corporate "team" before the project succeeds.

Economists have long recognized that formal contracts cannot fully protect specific investments in team production.[17] As a result, all "specific investors"—whether they are stockholders, executives, customers, or rank-and-file employees—are vulnerable to the risk that someone given control over the corporation might use that control to threaten the value of their investment or exclude them from the corporate team. If shareholders controlled public corporations, at least some might be tempted to use shareholder control in an opportunistic fashion to "hold up" other team members. This is because shareholders can profit from threatening other stakeholders' interests. For example, they can raise earnings by demanding that long-term employees accept reduced health benefits or risk being fired, or by requiring customers to purchase additional software in order to get continued customer support. When specific investments are large enough, the immediate financial returns from making such opportunistic threats can easily outweigh any longer-term reputational costs. Anticipating this, many important corporate stakeholders would be justifiably reluctant to make specific investments in public companies run by widely dispersed but powerful shareholders, some of whom might be tempted to pump up share price by making opportunistic threats.[18]

[17] See Blair & Stout, supra note 3, at 265–71; see also Margaret M. Blair & Lynn A. Stout, Specific Investment and Corporate Law, 7 Eur. Bus. Org. L. Rev. 473 (2006).

[18] Investors in close corporations may have less trouble encouraging specific investment for a number of reasons. For example, because there are fewer individuals involved, and these individuals often interact with each other, reputation and interpersonal trust can play a larger role in protecting against opportunism. Similarly, many shareholders in close corporations are also employees who make substantial specific human capital investments, reducing their ability to realistically threaten to disrupt the firm.

Of course, directors can make opportunistic threats, too. The difference is that, unlike shareholders, directors *do not benefit financially* from making threats, at least not in their positions as directors. To the extent directors have an interest in the corporate entity, their interest is to keep the entity healthy so they can keep their board positions. (Although it is often asserted without support that corporate directors can use their powers in a self-serving fashion to enrich themselves, this claim ignores the very real constraints imposed by the duty of loyalty.[19]) Board governance, as a result, attracts specific investors by offering what renowned corporate lawyer Marty Lipton has described as the promise of "business continuity."[20] Stakeholders contemplating making specific investments in relationships with corporations put more faith in firms run by boards than in firms run by powerful and possibly opportunistic shareholders. The result is that board power serves shareholders' collective ex ante interest in attracting valuable specific investments even as it frustrates individual shareholders' ex post attempts to increase "shareholder value" at the expense of other stakeholders.

D. Summing Up: The Enduring Appeal of Board Governance

Since the public corporation first emerged in the nineteenth century, it has proven to have enduring appeal for large, uncertain, long-term business projects, including railroads, canals, automobile and aerospace manufacturing, pharmaceuticals, software, and brand name consumer products. An important part of this appeal lies in the advantages of board control.[21] Incorporation allows thou-

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[19] Unlike the duty of care, which is notoriously tempered by the business judgment rule, the duty of loyalty has teeth. A director who uses his position to promote an "interested" corporate transaction that personally enriches the director must be prepared to defend the transaction in court as "fair" in terms of both price and process, and the burden of establishing fairness rests on the director. See Blair & Stout, supra note 3, at 284, 298–99 (discussing duty of loyalty). Directors can only enrich themselves at the corporation's expense by holding other positions in the firm—for example, as executives or large stockholders—and, even then, the duty of loyalty to some extent applies. See Clark, supra note 3, at 192–94, 215–20, 472–73 (discussing loyalty constraints on executive compensation and controlling shareholders).

[20] Martin Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101, 110 (1979).

[21] The appeal of incorporation is often attributed to its ability to offer investors limited liability. This notion is undermined by a recent empirical study finding that the

sands or even hundreds of thousands of diverse corporate participants—shareholders, employees, executives, suppliers, customers, and sometimes even the local community—to make illiquid commitments to large, uncertain, long-lived projects, safe in the knowledge that control over the project rests in the hands of a small and informed group of individuals who have a modest personal interest in ensuring the company's success and (perhaps more importantly) no strong financial interest in trying to expropriate wealth from other participants.

Of course, board power has disadvantages as well. To the extent directors are "unaccountable" to either shareholders or other stakeholders, they may not always do the best possible job of running the firm. Directors have an enforceable fiduciary duty of loyalty that discourages outright theft. For a variety of reasons, however, the duty of care (famously hamstrung by the business judgment rule) is far less effective at preventing director shirking.[22] As a result, board governance inevitably creates a risk that directors will manage corporations in a fashion that is adequate but not optimal.

Accordingly, board power has benefits but also some costs. This makes it impossible to assume, based on armchair theorizing alone, that shareholders would benefit from stronger voting rights. Before changing longstanding rules of corporate law to give shareholders greater leverage over boards, as Bebchuk suggests, lawmakers should demand compelling evidence that the benefits of changing the rules outweigh the costs.

II. EMPIRICAL EVIDENCE FAVORING BOARD POWER

The evidence necessary to support Bebchuk's proposal is missing. As Bebchuk observes, "increased shareholder power to re-

corporate form was a popular way of doing business in California long before that state offered limited liability to investors and that the addition of limited liability did little to change stock prices. See Mark I. Weinstein, Share Price Changes and the Arrival of Limited Liability in California, 32 J. Legal Stud. 1, 1–3 (2003) (finding that late adoption of limited liability for California corporations had no apparent effect on market valuation of their shares).

[22] See generally Lynn A. Stout, In Praise of Procedure: An Economic and Behavioral Defense of *Smith v. Van Gorkom* and the Business Judgment Rule, 96 Nw. U. L. Rev. 675 (2002).

place directors would be desirable if and only if such a change would improve corporate performance and value."[23] Yet even the limited subset of evidence that Bebchuk chooses to cite in support of his proposal is remarkably weak and uncertain.[24]

A. The Weak Evidence Favoring Shareholder Governance

In particular, Bebchuk cites five empirical studies of proxy contests in support of his proposal.[25] Closer inspection reveals that at least two of the five cut *against* Bebchuk's thesis, finding *negative* abnormal returns from proxy contests when dissenting shareholders succeed in gaining board seats.[26] Another two undermine his proposal more indirectly, finding that proxy contests increase shareholder "value" primarily when they trigger a firm's liquidation or sale.[27] An extensive literature, which Bebchuk does not discuss, addresses why putting a firm up for sale often raises share price for reasons unrelated to improved performance, including bidder overpayment,[28] inefficient market

[23] Bebchuk, supra note 1, at 678.

[24] In an earlier draft, Bebchuk acknowledged this, noting that the evidence that making it easier for shareholders to remove directors would in fact improve corporate performance is "at most suggestive and indirect."

[25] Bebchuk, supra note 1, at 712 n.68.

[26] Lisa F. Borstadt & Thomas J. Zwirlein, The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance, 21 Fin. Mgmt. 22, 23 (1992) ("A dissident victory does not necessarily improve the long-term share price performance of the firm. A negative, but insignificant, drift in the abnormal returns is observed for this group of firms in the post-proxy period."); David Ikenberry & Josef Lakonishok, Corporate Governance through the Proxy Contest: Evidence and Implications, 66 J. Bus. 405, 407 (1993) ("The performance of targeted firms following a contest is surprising . . . . [I]n proxy contests where dissidents obtain one or more seats, abnormal returns following resolution of the contest are significantly negative. Two years following the contest, the cumulative abnormal return has declined by more than 20%.").

[27] Harry DeAngelo & Linda DeAngelo, Proxy Contests and the Governance of Publicly Held Corporations, 23 J. Fin. Econ. 29, 30 (1989) (finding shareholder "wealth" gains from proxy contests "largely attributable to gains by sample companies in which dissident activity leads to sale or liquidation of the firm"); J. Harold Mulherin & Annette B. Poulsen, Proxy Contests and Corporate Change: Implications for Shareholder Wealth, 47 J. Fin. Econ. 279, 280 (1998) (finding that "shareholder wealth gains associated with proxy contests are driven primarily by firms that are acquired in the period proximate to the contests").

[28] See, e.g., Bernard S. Black, Bidder Overpayment in Takeovers, 41 Stan. L. Rev. 597 (1989).

discounting,[29] downward-sloping demand,[30] and shareholder wealth extraction from other stakeholders.[31]

This weak and mixed evidence on the benefits of proxy contests mirrors a broader pattern in empirical studies of corporate law.[32] Although dozens of papers have tried to find relationships between particular governance practices and corporate performance, most fail to find any strong connection,[33] and the few studies that do (including at least one study relied upon by Bebchuk) often are not supported by other researchers.[34]

[29] See, e.g., Richard E. Kihlstrom & Michael L. Wachter, Corporate Policy and the Coherence of Delaware Takeover Law, 152 U. Pa. L. Rev. 523 (2003); Reinier Kraakman, Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive, 88 Colum. L. Rev. 891 (1988).

[30] See, e.g., Lynn A. Stout, Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law, 99 Yale L.J. 1235 (1990).

[31] See, e.g., Blair & Stout, supra note 3; Andrei Shleifer & Lawrence H. Summers, Breach of Trust in Hostile Takeovers, *in* Corporate Takeovers: Causes and Consequences 33 (Alan J. Auerbach ed., 1988).

[32] In support of his proposal, Bebchuk also cites some studies suggesting that antitakeover defenses that insulate directors from takeover bids reduce shareholder wealth. See Bebchuk, supra note 1, at 713–14. For theoretical reasons, the results of these studies are inconclusive on the ex ante effects on shareholder wealth. See Lynn A. Stout, Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem, 55 Stan. L. Rev. 845, 856–61 (2002). As important, proxy fights and takeovers are very different, and evidence supporting the benefits of one does not amount to evidence of benefits from the other.

[33] See Jill E. Fisch, Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy 6 (Fordham Law Legal Studies, Research Paper No. 105, 2005), available at http://ssrn.com/abstract=878391 ("Empirical studies of corporate governance reforms . . . have produced conflicting results."). Of course, this is exactly what we should expect to see if corporate governance is endogenous and businesses efficiently select the governance structures that suit their individualized needs—including, in many cases, a need for weak shareholder rights. See infra text accompanying note 35.

[34] Bebchuk cites as "substantial evidence" of the benefits of stronger shareholder rights a recent study by Paul Gompers et al., Corporate Governance and Equity Prices, 118 Q.J. Econ. 107 (2003). See Bebchuk, supra note 1, at 712, 713 n.70. Still more recent studies, however, question the significance of Gompers et al.'s results. See John E. Core et al., Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations, 61 J. Fin. 655, 655 (2006) (investigating Gompers et al.'s findings and concluding "our results do not support the hypothesis that weak governance causes poor stock returns"); N. K. Chidambaran et al., Does Better Corporate Governance "Cause" Better Firm Performance? 5 (Mar. 2006) (unpublished manuscript, on file with the Virginia Law Review Association), available at http://ssrn.com/abstract=891556 (finding no performance differences between firms with "good" governance changes and firms with "bad" governance changes); see also Fisch, supra note 33, at 6–7 (discussing other studies with strong results that could not be replicated).

What explains this pattern? Why is it so hard to prove that particular governance measures improve corporate performance? Part of the problem may lie in academics' tendency to equate "corporate performance" with short-term share price performance, a dubious metric at best.[35] Gauging corporate performance by measuring share price changes over weeks or months is a bit like picking your accountant by measuring his or her height. It is easy to do but unlikely to ensure a good outcome.

There may be a more fundamental reason, however, why the business world has stubbornly refused to give hungry academics the evidence they crave about how they can improve corporate performance through governance "reform." In brief, business firms enjoy a wide range of choice over the governance rules they adopt and work under. Sensibly enough, they choose the rules that work best for their particular business (and, in the process, for their investors). This means that we should not expect to see a strong connection between any particular governance structure and corporate performance because different structures work well for different firms. In other words, corporate law is *endogenous*.[36]

B. The Strong Evidence Favoring Board Governance

To understand this idea, let us start with an often overlooked fact of business life: investors are not forced to purchase shares in public corporations at gunpoint. They can invest instead in proprietorships, partnerships, limited partnerships, and closely held companies. Furthermore, when investors do buy shares in public companies, they can choose *which* firm's shares to buy.

This last point is important because American corporations can choose which state's laws they will incorporate under. Even more significant, they can choose to modify those laws through custom-

[35] See Lynn A. Stout, Share Price as a Poor Criterion for Good Corporate Law, 3 Berkeley Bus. L.J. 43, 48 (2005); see also Fisch, supra note 33, at 1.

[36] See George S. Dallas & Hal S. Scott, Mandating Corporate Behavior: *Can One Set of Rules Fit All?* (2006), available at http://www.law.harvard.edu/programs/pifs/pdfs/S&P6.05Monograph.pdf; Sridhar R. Arcot & Valentina G. Bruno, One Size Does Not Fit All, After All: Evidence from Corporate Governance 8 (May 16, 2006) (unpublished article, on file with the Virginia Law Review Association), available at http://ssrn.com/abstract=887947; Chidambaran et al., supra note 34, at 1 (noting that "studies . . . suggest that . . . these governance mechanisms are *endogenously* determined").

ized charter provisions, including charter provisions that *strengthen or weaken shareholders' voting rights*.[37] Bebchuk's proposal does nothing for shareholders that corporate law does not already allow them to do for themselves. If investors truly believed greater shareholder control meant better corporate performance, they could "vote with their wallets" by preferring shares in firms that give shareholders more control.

If investors often did this, it would be evidence that shareholder control serves shareholder interests, at least in those firms. Yet studies indicate that equity investors generally *do not* prefer companies that give them stronger rights. This can be seen most clearly in the context of initial public offerings or "IPOs." Companies "going public" have every incentive to adopt governance structures that appeal to outside investors (generally sophisticated mutual and pension funds). If greater shareholder control meant better shareholder returns, IPO companies could raise more money by offering shareholders more control. Yet studies find that when IPO firms use customized charter provisions to modify shareholder voting rights, they generally use them to move in the direction *opposite* to that recommended by Bebchuk, *weakening* shareholder rights.

During the 1990s, for example, between thirty-four percent and eighty-two percent of IPO charters included staggered board provisions that made it harder for shareholders to remove directors.[38] An even more dramatic example of this trend can be seen in the recent Google IPO. Google went public with a dual-class charter that left outside investors largely powerless. Far from shunning Google's IPO, investors oversubscribed it.[39] In the language of eco-

[37] See Del. Code Ann. tit. 8, § 102(b)(1) (2001) (noting that a corporate charter may include "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation" including "any provision creating, defining, limiting, and regulating the powers of the corporation, the directors, and the stockholders").

[38] See Laura Casares Field & Jonathan M. Karpoff, Takeover Defenses of IPO Firms, 57 J. Fin. 1857, 1861 (2002); John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 Cal. L. Rev. 1301, 1357 (2001); Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs, 17 J.L. Econ. & Org. 83, 110 (2001).

[39] See Lynn A. Stout & Iman Anabtawi, Sometimes Democracy Isn't Desirable, Wall St. J., Aug. 10, 2004, at B2.

nomics, investors "revealed" a preference for a firm in which they themselves had almost no power.

Are investors stupid? Why do they not avoid IPOs with weak shareholder rights? Is it possible that shareholders, like Ulysses, sometimes see advantage in "tying their own hands" and ceding control over the corporation to directors largely insulated from their own influence?[40]

Reformers calling for greater "shareholder democracy" rarely ask such questions.[41] Yet investors' long-standing willingness to buy shares in companies controlled by "unaccountable" boards (a willingness that dates back at least to the days of Berle and Means) provides compelling empirical evidence that investors themselves often prefer weak shareholder rights. This raises an important question: why do so many observers still support the kind of top-down, one-size-fits-all governance "reform" recommended by Bebchuk when there is so little evidence that shareholders—or anyone else—would benefit?

III. THE EMOTIONAL APPEAL OF "SHAREHOLDER DEMOCRACY"

This Response closes by suggesting that the myth of the shareholder franchise rests on a larger, deeper myth: the myth that public corporations are run well when they are run according to shareholders' wishes. This larger myth of the benefits of shareholder control has captured hearts and minds not because it is based on evidence but because it has tremendous emotional appeal. This emotional appeal can be traced to three sources.

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[40] See Lynn A. Stout, The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance, 152 U. Pa. L. Rev. 667, 670 (2003).

[41] Bebchuk is to be complimented for addressing this puzzling issue in an elegant article in which he suggests several reasons why, in theory, investors might not penalize IPO firms for antitakeover provisions. See Lucian A. Bebchuk, Why Firms Adopt Antitakeover Arrangements, 152 U. Pa. L. Rev. 713, 728–48 (2003). The empirical case that antitakeover defenses are in fact contrary to investors' interests, however, has yet to be made. See Stout, supra note 32, at 856–61.

A. The Misleading Metaphor of Shareholder "Ownership"

The first source is the popular but misleading metaphor that describes shareholders as "owners" of corporations.[42] As a legal matter, the claim that shareholders "own" the corporation is obviously incorrect. Corporations are independent legal entities that own themselves; shareholders own only a security, called "stock," with very limited legal rights. Nevertheless, the ownership metaphor exerts a powerful, if often subconscious, influence on the way many people think about corporate governance. After all, if shareholders "own" corporations, shouldn't they also control them?

Sophisticated observers generally avoid the trap of "ownership" talk. Instead, they fall prey to two other mistaken ideas. The first is the casual assumption, prevalent in the economic literature on "agency costs," that shareholders are the "principals" in public corporations and that directors are shareholders' "agents." As corporate law experts have pointed out, however, the agency metaphor misstates the real legal status of shareholders and directors. At law, a principal has a right to control her agent. Directors are not agents but fiduciaries largely insulated from shareholders' control, and they owe duties not just to shareholders but also to the firm as a whole.[43]

The other mistaken idea that often influences experts is the claim that shareholders are the "sole residual claimants" in corporations.[44] Again, as a factual matter, this is patently incorrect. In a public company, the board of directors controls both dividend payouts and corporate expenses (meaning the board controls whether the corporation's books show any "earnings"). This means that shareholders are unlikely to receive, and certainly are not legally entitled to receive, every penny received by the corporation that is not obligated to be paid out on some formal contract. Rather, while shareholders may share in the wealth when the corporation

[42] See Lynn A. Stout, Bad and Not-So-Bad Arguments for Shareholder Primacy, 75 S. Cal. L. Rev. 1189, 1190–92 (2002). This metaphor may have roots in the nineteenth century, when most corporations were closely held firms with only a single shareholder or a very small number of shareholders. In such firms, shareholders exercise far more control, and it may make more sense to think of them as "owners."

[43] See Blair & Stout, supra note 3, at 290 (citing Restatement (Second) of Agency § 385 (1958)).

[44] See Stout, supra note 42, at 1192–95.

does well and suffer when the firm does poorly, so may employees, creditors, and other stakeholders. Director discretion means that many different groups are potential residual claimants and residual risk bearers in public firms.

Thus none of the three phrases commonly used to describe shareholders' relationship to the public corporation—whether as "owners," "principals," or "sole residual claimants"—is factually correct. Nevertheless, all three give the idea of greater shareholder control an emotional appeal that ignores the realities of business law and practice.

B. Ex Post Shareholder Calls for "Shareholder Democracy"

A second reason why many people may find the idea that shareholder control necessarily benefits shareholders to be appealing may be that particular shareholders at particular firms sometimes *say* they want more control. Activist hedge funds, in particular, often anoint themselves to be the champions of "shareholder value" and argue that they that ought to be allowed to control the board's actions.

As discussed earlier, however, a major advantage of board control is that, by requiring shareholders and stakeholders alike to give up much of their power over the corporation ex ante, board governance protects shareholders' and other stakeholders' illiquid specific investments in corporations from attempts by large shareholders to extract wealth by threatening those investments ex post. For this reason, ex post shareholder demands for greater control should be viewed with a jaundiced eye for what they often are: opportunistic attempts to increase "shareholder value" by changing the corporate rules in the middle of the game.[45]

If we really want to gauge shareholders' true preferences, the best way to do this is not to listen to what some shareholders say but instead to look at what shareholders collectively do at the investment stage, when they must "put their money where their mouths are." As we have already seen, at the investment stage,

[45] See supra text accompanying notes 15–19. For the same reason, Bebchuk's proposal to give shareholders stronger voting rights does not become less objectionable because corporations can "opt out" since Bebchuk would only allow opting out with ex post shareholder approval.

shareholders seem perfectly happy to buy shares in companies controlled by boards (or, at least, unwilling to pay the price of keeping control themselves). This observation highlights the danger of giving too much credence to shareholders' after-the-fact calls for greater control. Like Ulysses, shareholders chose to bind themselves to boards ex ante for good reasons.

C. The "Enron Effect"

Finally, let us turn to the third and perhaps most powerful source of the emotional appeal of shareholder governance. This is the sense of imminent crisis that has been sparked by recent large-scale corporate frauds, including the failures at Enron, WorldCom, Tyco, Adelphia, and HealthSouth. Faced with what seem like obvious cases of executive malfeasance and director negligence (as well as the lesser outrage of apparently runaway executive pay at firms like Disney and General Electric), many observers have concluded that *something must be done*. When this sense of crisis is combined with misleading descriptions of shareholders as "owners," "principals," or "sole residual claimants" (not to mention activist shareholders' ex post calls for greater leverage), it is easy to jump to the conclusion that the "something" that "must be done" is to give shareholders in public firms a louder voice and a stronger hand.

This response—we might call it the "Enron Effect"—fails to appreciate both the causes of corporate fraud and the lessons of business history. Enron did not collapse because its shareholders did not have enough power. In fact, an outside observer might have easily concluded that the firm was a model of "good corporate governance," with a large majority of (supposedly) independent directors, an independent audit committee, no staggered board provision, and stock option compensation to tie both director and executive pay to "performance."[46] More generally, Enron's collapse—

[46] See Erica Beecher-Monas, Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud, 55 Admin. L. Rev. 357, 359 (2003) (stating that Enron had an audit committee of six outside directors); Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. Chi. L. Rev. 1233, 1241 (2002) (stating that Enron's board "was a splendid board on paper" with mostly outside directors); Nathan Knutt, Executive Compensation Regulation: Corporate

and the recent scandals at other firms—occurred at a time in history when *shareholders enjoyed more influence over boards than ever before*.

In the days of Berle and Means, shareholders in public companies were far more powerless and more handicapped by collective action problems than they are today. Most were private individuals with very small stakes, no ready means of communicating with each other, and no access to corporate funds or the corporate ballot. Today, shareholders have much greater ability to act in concert and to influence boards as a result of a variety of developments that include the increasing clout of institutional investors like pension funds and mutual funds; the rise of "activist" investment funds; the creation of shareholder advisory services like Institutional Shareholder Services ("ISS"); the development of new information technologies that make intershareholder communication quicker, cheaper, and easier; and the SEC's adoption of rules designed to give shareholders greater voice.[47]

These developments make the suggestion that we can avoid future Enrons by giving shareholders in public firms more control seem a bizarre non sequitur. Greater shareholder power in the 1970s and 1980s did not prevent corporate scandals in the 1990s. If the medicine did not work the first time, why should taking more work now?

America, Heal Thyself, 47 Ariz. L. Rev. 493, 507 (2005) (stating that "Enron's philosophy was to pay for performance"); Leo E. Strine, Jr., Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America, 119 Harv. L. Rev. 1759, 1773 (2006) (noting that Enron and other companies embroiled in scandals did not have staggered boards).

[47] For example, in the mid-1980s, the SEC pressured the exchanges to restrict certain uses of dual-class stock. See Douglas C. Ashton, Revisiting Dual-Class Stock, 68 St. John's L. Rev. 863, 898–901 (1994). In 1992, it amended the proxy rules to encourage greater shareholder communication and coordination, see Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, Investment Company Act Release No. 19,031, 57 Fed. Reg. 48,276 (Oct. 22, 1992) reprinted in [1992 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 85,051 (Oct. 28, 1992), and it is presently considering a proposal to approve "electronic" proxy voting that would make it much cheaper and easier for dissenting shareholders to mount a proxy battle, see Internet Availability of Proxy Materials, Exchange Act Release No. 52,926, Investment Company Act Release No. 27,182, 70 Fed. Reg. 74,598 (proposed Dec. 15, 2005), *reprinted in* [2005–2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,510 (Dec. 21, 2005).

CONCLUSION

In fact, the medicine may hurt. Lack of shareholder power did not contribute to Enron's fall. One thing that did contribute, however—and that contributed to problems at many other firms as well—was Enron's willing embrace of the favorite governance "reform" fad of the 1990s, stock options.[48] Just as shareholder power is hailed as the obvious solution to Corporate America's problems today, stock options were hailed as the ideal way to ensure "good corporate governance" a decade ago. Congress found this notion sufficiently compelling that in 1993, it amended the Internal Revenue Code to prohibit corporations from deducting as a business expense any executive compensation in excess of $1 million unless the compensation was somehow tied to "performance."[49] The result was an explosion in the use of stock options that has since been linked to similar explosions in executive pay, earnings "restatements," and large-scale frauds.

The case of stock options offers a cautionary tale on the unintended consequences of top-down corporate governance "reforms" that are not based on compelling evidence. By adopting a solution without fully understanding the problem, Congress likely did far more harm than good. Bebchuk's proposal presents the same danger. For generations, American investors have voluntarily ceded control over their investments in public companies to boards of directors largely insulated from shareholder influence. Economic theory teaches that investors do this because board control serves their self-interest in at least three ways: by promoting efficient and informed decisionmaking, by discouraging intershareholder opportunism, and by encouraging specific investment in corporations by executives, employees, customers, creditors, and other corporate stakeholders. Business history and practice support this view.

[48] See Margaret M. Blair, Shareholder Value, Corporate Governance, and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom, *in* Corporate Governance and Capital Flows in a Global Economy 53, 60–62 (Peter K. Cornelius & Bruce Kogut eds., 2003) (describing negative effects of options at Enron and elsewhere).

[49] See I.R.C. § 162(m) (1993). Interestingly, the added requirement that executive option grants be submitted for shareholder approval also clearly did little to prevent their abuse, another object lesson in the foolishness of placing our faith in "shareholder democracy" as a vehicle for improving corporate governance.

Given this background, we should demand strong empirical evidence indeed before concluding that giving shareholders greater control over corporate directors would be a good idea.

That evidence is missing. Rather than being driven by data, calls for greater shareholder control over public corporations seem driven by sentiment and the unspoken assumption that shareholder democracy, like Mom and apple pie, must be a good thing. In other words, the proposal laid out by Bebchuk in "The Myth of the Shareholder Franchise" itself rests on a myth: the myth that greater shareholder control in public firms benefits shareholders. Unless and until we can make this fable a reality, a strong shareholder franchise should also remain a fiction.