

## BEBCHUK'S "CASE FOR INCREASING SHAREHOLDER POWER": AN OPPOSITION

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Responding to Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

Lucian Bebchuk's characteristically provocative article, *The Case for Increasing Shareholder Power*,<sup>1</sup> has stimulated lively and fruitful debate in the pages of the *Review* and beyond. We are honored to comment on Professor Bebchuk's Article in this Forum.

The central argument of the Article is that the traditional, director-centered corporate form should be replaced in favor of a novel governance system of Bebchuk's own invention — a regime that nominally retains directorial primacy, but in fact eviscerates directorial discretion by vesting directly in shareholders the authority to change the company's charter and authorize mergers and other transformative corporate events.<sup>2</sup> As Vice Chancellor Strine's "corporate law traditionalist" recognizes, the Bebchuk approach would undermine "the core element of the Delaware way: the empowerment of centralized management to make and pursue risky business decisions through diverse means."<sup>3</sup>

This is a proposal for radical and risky change, offered notwithstanding — with no recognition of — the enormous historical success of the Delaware approach. The adage "if it ain't broke don't fix it" does not begin to capture the risk of Bebchuk's agenda. One would rather have to say something like "if it has performed superlatively over the course of generations, and the visible preferences of the market confirm its wisdom, and its continued proper functioning is central to the nation's economy, don't gratuitously disassemble it."

In our view, the "case for increasing shareholder power" is exceedingly weak, and in this space we summarize several of our core objections. *First*, Bebchuk's proposal involves the abrupt overthrow of core Delaware corporate law principles and therefore risks extraordinarily costly disruption without any assurance of corresponding benefit. *Second*, Bebchuk's proposal — which rests on the (virtually explicit) hypothesis that corporate

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<sup>1</sup> Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

<sup>2</sup> See *id.* at 835.

<sup>3</sup> Leo Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1763 (2006).

boards cannot be trusted to respect their fiduciary duty — finds no resonance in the observed experience of boardroom practitioners. And *third*, Bebchuk's proposal exalts shareholder power in a manner that is not only inconsistent with statute and decades of Delaware case law, but also is particularly suspect in light of the palpable practical problems of any shareholder-centric approach.

## I.

The "business and affairs" of every Delaware corporation "shall be managed by or under the direction of a board of directors."<sup>4</sup> This simple statement of board primacy, which appears as Section 141(a) of the Delaware General Corporation Law, announces a general principle that echoes in specific applications throughout the Delaware statute and case law. Accordingly, the Delaware model "invests corporate managers with a great deal of authority to pursue business strategies through diverse means, subject to a few important constraints."<sup>5</sup> Significant corporate action (including the "rules of the road" and "game ending" decisions at issue in Bebchuk's proposed reforms) may be undertaken under existing law only with the informed and deliberate assent of the board of directors — a legally accountable fiduciary obliged by law to advance the interests of the corporation and its shareholders. In the context of charter amendments and certain extraordinary corporate events, shareholders are asked to react to board recommendations, but have very limited power to initiate corporate action.

This basic framework has been in place for nearly a century and by any measure it has performed admirably. As the economists Bengt Holmstrom and Steven Kaplan have observed, notwithstanding "the alleged flaws in its [corporate] governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. . . . If anything, [the broad evidence] suggests a [corporate governance] system that is well above average."<sup>6</sup> Moreover, as Bainbridge persuasively argues in his separate reply to Bebchuk, informed IPO investors have historically chosen and continue to choose the default, director-centric governance terms provided under Delaware law.<sup>7</sup> Indeed, "in the real world, companies almost never 'go public' with enhanced shareholder

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<sup>4</sup> DEL. CODE ANN. tit. 8, § 141(a) (2006).

<sup>5</sup> Strine, *supra* note 3, at 1762.

<sup>6</sup> Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 Harv. L. Rev. 1735, 1739–40 (2006) (quoting Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 1 (European Corporate Governance Inst., Finance Working Paper No. 23/2003, 2003).

<sup>7</sup> *Id.* at 1743–44.

power."<sup>8</sup> The revealed preferences of informed investors thus powerfully confirm the wisdom of the Delaware approach.

Bebchuk waves off these broad lessons from experience, and, armed with little more than a theory and a smattering of concededly inconclusive data, urges a fundamental reapportionment of the balance of decisionmaking power between shareholders and directors. Make no mistake: Bebchuk is after a revolution. As Bainbridge puts it, Bebchuk wishes "to replace the existing, mostly permissive rules disempowering shareholders with a new set of mostly mandatory rules empowering them."<sup>9</sup> And Vice Chancellor Strine's "traditionalist" observes that Bebchuk aims at nothing less than the replacement of the traditional corporate republic with a form of direct shareholder democracy.<sup>10</sup>

It is impossible to predict all the results of Bebchuk's approach (and the law of unintended consequences is a powerful independent reason to resist sweeping un compelled change of the sort Bebchuk proposes).<sup>11</sup> At a minimum, however, we must be prepared for wasteful and expensive contested ballots on any number of purported "rules of the road" or "specific business" changes, and — as the specter of such elections hangs over management — a concomitant erosion of board collegiality and directors' ability to manage for long-term value. In addition, the pool of qualified directors would be certain to diminish, perhaps precipitously, as experienced businessmen and businesswomen would have far less incentive to serve in what would be a much reduced capacity. Why be a pin in a bowling alley, subject to being knocked down by the fancy of whatever unaccountable shareholder "body" steps up to the line for a shot? At the same time, there is reason to fear a decline in the quality of corporate decisionmaking on fundamental issues, as shareholder plebiscite by diverse shareholders, sometimes ill-informed, sometimes fractured by divergent interests, replaces the situation-specific business judgment of a fully-informed board. That is an awful lot to ask in the name of a slogan.

Thorny new practical and legal problems would also ensue. For example, would shareholders setting corporate policy owe fiduciary duties to

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<sup>8</sup> Lynn Stout & Iman Anabtawi, *Sometimes Democracy Isn't Desirable*, WALL ST. J., Aug. 10, 2004, at B2; see also Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435, 1453 (2005) ("[C]ompanies 'going public' follow [Delaware] default rules as a matter of course, even though the enabling nature of U.S. corporate law allows them substantial room to modify their charters to weaken director power or to increase shareholder clout.").

<sup>9</sup> Bainbridge, *supra* note 6, at 1735.

<sup>10</sup> See Strine, *supra* note 3, at 1782–83.

<sup>11</sup> Recent scholarship confirms the risk that "shareholder empowerment" may yield deleterious unintended consequences. For example, Lynn Stout observes that so-called "shareholder democracy" appears to be encouraging private buy-outs of public companies, concluding that "[t]here is reason to suspect that the modern trend toward greater 'shareholder power' has gone too far and is beginning to harm the very shareholders it was designed to protect." Lynn Stout, *Investors Who Are Too Bolshy For Their Own Good*, FIN. TIMES, Apr. 23, 2007 at 9.

one another? What legal recourse (if any) would be available when a majority shareholder (or group) changes "the rules of the road" to the detriment of the minority? Would shareholders (like directors under the current regime) owe fiduciary duties to non-shareholder corporate constituencies in non-*Reylon* circumstances? If so, how and by whom might they be enforced? And if not, what other redress, if any, would be available for these dispossessed constituencies? And what result when the shareholders vote for divergent "rules of the road" — which are to be binding and which ignored, and who decides? What if these rules are constantly changed?

The Bebchuk proposal likewise raises complex issues relating to the allocation of risk and reward between shareholders and corporations. As a general rule, those entrusted with corporate management — officers and directors — bear legal risk for the actions of their corporations. Shareholders do not: the law deems investments in corporate enterprises sufficiently socially desirable that it allows shareholders to reap the benefits of corporate performance through share ownership without risk of liability for harm that the corporation may cause to others. In exchange for the privilege of investing without exposure to personal liability, shareholders must cede control and responsibility over corporate conduct to others, namely directors and officers. But would this trade-off continue to make sense under the Bebchuk regime of shareholder empowerment?

Making matters worse, practitioners and businesspeople would be unable to look to the well-developed corpus of Delaware common law for guidance in navigating such issues. Contemporary Delaware corporations jurisprudence is built on the bedrock understanding that "a corporation is not a New England town meeting,"<sup>12</sup> and that directors are "not a passive instrumentality" for effectuation of shareholder will.<sup>13</sup> But in Bebchuk's brave new world, these foundational propositions are, by hypothesis, no longer true — which means that the utility of Delaware's doctrinal inheritance would be substantially compromised.

Now, we are not quite ready to declare that blood will run red in the streets of Wilmington if Bebchuk has his way. But it is critical to appreciate just how radical a break with all history Bebchuk proposes. This would be an abrupt and fundamental reordering of power within the corporate form. In view of the enormous long-term success of the Delaware approach and the apparent satisfaction of the marketplace, and given the absence of any persuasive empirical basis for Bebchuk's proposal, we believe that such a break is plainly unwarranted.

Moreover, it is borderline facetious for Bebchuk to invoke "the lessons of history" to justify his agenda.<sup>14</sup> The relevant historical point — appar-

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<sup>12</sup> *TW Servs., Inc. v. SWT Acquisition Corp.*, Nos. CIV.A. 10427, 10298, 1989 WL 20290, at \*8 n.14 (Del. Ch. Mar. 2, 1989).

<sup>13</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

<sup>14</sup> Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1812 (2006).

ently lost on Bebchuk — is that evolutionary development is a far more reliable path to improved corporate governance than upheaval. Indeed, part of the genius of the Delaware way has been the courts' ability to develop incremental legal changes to meet evolving corporate circumstances within the existing doctrinal framework. An important example: during the then-unprecedented wave of takeover activity in the 1980s, the Delaware courts rejected calls from the academy to disqualify directors from the takeover arena and instead announced — in *Unocal*, *Moran*, and other decisions — a nuanced approach, crafted to protect shareholder interest and consistent with precedent and long history, that has facilitated the world's most robust and sustained market for corporate control. The historical record powerfully suggests that Delaware got it right. With Holmes, we say that the logic of the law is — and should be — experience.

## II.

Bebchuk's proposal is not only fundamentally ahistorical, but it also rests on an inaccurate account of boardroom behavior. To read *The Case for Increasing Shareholder Power* is to enter an alternative universe in which directors do not seek to advance shareholder interest but are to the contrary engaged in a constant struggle to extract private benefits at shareholders' expense. We are thus treated to arguments built on the hypothesis that "for self-serving reasons, management does not wish to initiate [] value-increasing change[s]," and asked to entertain fanciful models of the "bargaining" that takes place between directors on the one hand and shareholders on the other, in which directors' "monopoly" over corporate policy allows them to avoid value-enhancing policies and line their own pockets instead.<sup>15</sup>

The trouble with this line of argument is that it bears no relationship to reality. Advisors who actually work with public company directors know that directors are keenly aware of their fiduciary duties to shareholders and others, extensively advised as to how to satisfy those duties, and vigilant to identify and cure potential conflicts. No one who has actually been in the board room of a major U.S. corporation in recent times could plausibly argue that directors are not focused on shareholder interests. To be sure, some directors, and some boards, are more effective than others, and there will always be an occasional outlier or miscreant. But the assumption that undergirds much of Bebchuk's analysis — that directors are generally engaged in a constant struggle to maximize their private benefits at shareholders' expense — cannot be even remotely squared with the experience of those of us who actually work with directors as they strive to meet their fiduciary obligations.

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<sup>15</sup> Bebchuk, *supra* note 1, at 857, 863–64.

Bebchuk's extreme distrust of directors reflects a specific (albeit exaggerated) application of the "agency cost" concern that has animated corporate law scholars since Berle and Means. In Bebhuk's recent work, however, agency costs have become a fixation, which (without plausible basis or evidence) he alleges cause directors to "divert resources through excessive pay, self dealing, or other means; reject beneficial acquisition offers to maintain [their] independence and private benefits of control; over-invest and engage in empire building; and so forth."<sup>16</sup> For Bebhuk, the risks of agency are so vast that the considerable (and historically validated) virtues of a director-centric regime must be overthrown nearly in their entirety.

The most that can be said of Bebhuk's account of the agency cost issue is that it is feverishly overstated. To the extent the director-centric model of corporate governance risks any so-called agency costs — and the evidence on this point is frankly inconclusive — the risk is effectively managed in existing practice. In the first place, directors become directors because they are successful businessmen and businesswomen with sufficient history of professional achievement and reputations for integrity to be elected by the shareholder body. Moreover, once elected, directors "operate within a pervasive web of accountability mechanisms"<sup>17</sup>: among others, the powerful constraints of personal and professional reputation and the discipline of the capital and product markets curb self-interested directorial behavior of the sort Bebhuk identifies.<sup>18</sup> In addition, the law of fiduciary duty — and its enhanced application in situations (such as conflict transactions) that increase the risk of self-interested behavior — provides a further important protection.<sup>19</sup> There is no substantial reason to believe that these structural constraints are inadequate to control any so-called agency costs.

Indeed, as Lynn Stout has recently observed, the entire "agency cost" critique "is being questioned by a new generation of corporate scholars," who increasingly suspect that the agency cost model "reflects both a mistaken view of corporate law, and a mistaken view of corporate economics."<sup>20</sup> This emerging scholarly view recognizes what those with empirical experience inside the board room have known all along: control by directors solves intractable problems that direct shareholder governance cannot. For example, directors are better informed about the long-term prospects

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<sup>16</sup> *Id.* at 850.

<sup>17</sup> STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.5, at 37 (2002).

<sup>18</sup> *See id.*

<sup>19</sup> Other market-based mechanisms sometimes thought to reduce agency costs include incentive pay arrangements and the market for corporate control.

<sup>20</sup> Lynn A. Stout, *Shareholders Unplugged*, LEGAL AFF., Mar.–Apr. 2006, at 21, 21, available at [http://www.legalaffairs.org/issues/March-April-2006/argument\\_Stout\\_marapr06.msp](http://www.legalaffairs.org/issues/March-April-2006/argument_Stout_marapr06.msp); see also Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719 (2006) (likening the agency model to a superseded Kuhnian paradigm that fails to account for observed "phenomena in corporate law").

and value of a corporation; unlike directors, a dispersed and diverse shareholder body will seldom have the time, skill or incentives to understand what is happening in the firm.<sup>21</sup> Moreover, only the board of directors can successfully mediate among both competing shareholder interests (as discussed in further detail below), and among non-shareholder constituencies (such as employees, customers, suppliers, and creditors), to ensure the level of commitment to or investment in the firm necessary to facilitate its long-term success.<sup>22</sup>

At best, then, the agency issue is one consideration among many (and a waning one, at that) in constructing a sound corporate governance regime. And the potential negative effects of agency costs have been effectively managed in practice through existing legal and non-legal devices. In his blinding focus on agency costs, Bebchuk loses sight of this broader perspective and overlooks both the enormous achievements of the director-centric approach and the risks of abrupt change; he would manage the costs by killing the enormously effective agent. To observers with open eyes, the lesson of experience is clear: boards are uniquely capable of structuring corporate policy and mediating among diverse corporate constituencies, and directors, with very few exceptions, can be relied upon to

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<sup>21</sup> Academic critics of Delaware law used to answer this point with the claim that because markets for widely traded securities are efficient, the present prices of shares already and accurately reflected their long-term value. Indeed, much of the academic case for "director passivity" in the 1980s was built on the so-called "efficient market theory," which, at least in academic circles, was accepted as a reliable foundation for corporate lawmaking. But a growing body of recent scholarship concludes that "the [efficient market] theory was wrong—woefully so." Louis Lowenstein, *Searching for Rational Investors in a Perfect Storm: A Behavioral Perspective*, 7 J. BEHAV. FIN. 66, 66 (2006); see *id.* at 71–73 ("throwing cold water on EMT"); Stout, *supra* note 8, at 1440 n.16 (gathering evidence against the efficient market thesis); Stout & Anabtawi, *supra* note 8 ("[E]ven finance economists increasingly acknowledge what businesspeople have always known: stock prices don't always accurately measure value. (Remember the Internet bubble?) As a result boards can often do a far better job of picking the business strategy best for the firm in the long run than unorganized, uninvolved and price-obsessed stockholders can."). Even Eugene Fama ("intellectual father of the theory known as the 'efficient market hypothesis'") and Michael Jensen (another early and influential proponent of the efficient market theory) now recognize that markets often behave irrationally, not efficiently. See Jon E. Hilsenrath, *As Two Economists Debate Markets, The Tide Shifts*, WALL ST. J., Oct. 18, 2004, at A1.

<sup>22</sup> See Hilsenrath, *supra* note 21; see also Robert K. Rasmussen & Douglas G. Baird, *The Prime Directive* 3–4 (Vanderbilt Univ. Law Sch., Law & Economics Working Paper No. 06-19, 2006) (criticizing scholarly focus on agency costs as excessive and for detracting from the board's "prime directive" of choosing the best managers); Stout, *supra* note 8, at 1436. In a similar vein, the late Sumantra Ghoshal persuasively argued that the "agency model" remains paramount in corporate governance research, notwithstanding the evident reality "that companies survive and prosper when they simultaneously pay attention to the interests of customers, employees, shareholders, and perhaps even the communities in which they operate," largely due to the scholarly preference for "testable propositions" and "reductionist prescriptions" over "the wisdom of common sense." See Martin Lipton, *Twenty-Five Years After Takeover Bids in the Target's Boardroom: Old Battles, New Attacks, and the Continuing War*, 60 BUS. LAW. 1369, 1379 (2005) (quoting Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. OF MGMT. LEARNING & EDUC. 75, 81 (2005)).

fulfill their fiduciary obligations with the skill and fidelity that the law demands and shareholders deserve.<sup>23</sup>

### III.

It is an irony that Bebchuk has chosen to make his "case for increasing shareholder power" at a time when the conceptual underpinnings of the shareholder primacy theory are under increasing and well-deserved scrutiny. The shareholder-centric thesis rests on the premise that shareholders are animated by the common objective of maximizing share value — put simply, the reason Bebchuk wishes to empower shareholders is that he believes they will use their power to achieve the common goal of higher share value. By the same token, however, if a shareholder has private interests distinct from shareholders generally, that shareholder should be expected to use its vote to advance its distinct agenda, possibly to the detriment of fellow shareholders or the corporation generally.<sup>24</sup>

Recent scholarship and recent developments in the marketplace confirm the existence of powerful private shareholder interests and the attendant risk in disempowering directors. The economic fault lines within the contemporary shareholder body are sufficiently deep that, absent the mediating intervention of directors, self-interested (and value destroying) shareholder conduct seems virtually inevitable. For example, as Iman Anabtawi has recently documented, shareholders with short-term investment horizons (such as hedge funds) will support corporate policies that tend to inflate current share prices at the expense of long-term value, such as foregoing research and development (R&D) investment or accepting an immediate though less than fully priced premium bid. Long-term investors, however, will tend to support a different agenda of (for example) steady R&D investment and resistance of takeover offers that do not reflect long-term corporate value.<sup>25</sup> The short investment perspective of hedge funds, for

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<sup>23</sup> One unfortunate result of the academy's obsession with agency cost analysis is that the rising generation of law students seems to have been indoctrinated with an ideologically charged and, frankly, false view of what actually happens in corporate boardrooms. We have recently had occasion to teach and guest lecture in major law schools and, more than once, have been startled by students' blithe assumption that directors are not only indifferent to their fiduciary obligations, but also that they candidly deliberate about how, for example, to maximize their personal gain in the context of corporate decisions. The cynical premise of much agency cost theory—that directors are somehow *opposed* to shareholder interest—is flatly inaccurate but has nevertheless been transmitted to students as if it were fact.

<sup>24</sup> Unlike directors, shareholders (other than controlling shareholders) do not owe fiduciary duties to other shareholders, are not otherwise obligated to advance the best interests of the firm, and are not subject to any of the other legal, social or reputational constraints that govern board conduct. Thus, it is reasonable to expect shareholders to promote their private interests in the same circumstances where experience shows directors will act for the good of shareholders and the corporation.

<sup>25</sup> See Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579–83 (2006). Here again, given the collapse of the efficient market hypothesis, *see supra* note 21, there is no basis to assume that present share prices reflect long-term value, and the better assumption is that boards of directors are best positioned to evaluate a company's true worth.

example, coupled with their demonstrated activism and concentrated holdings, suggests that short-termers may unduly influence the corporate electoral arena. Empowering shareholders under these circumstances thus risks a tyranny of the majority — or perhaps, worse yet, a tyranny of the minority — that would be destructive of long-term corporate value.<sup>26</sup>

"Special interest" or "social" shareholders present a parallel risk. Public pension funds and labor union pension funds control vast amounts of invested capital and have powerful incentives to pursue private agendas through corporate policy. State pension funds, for example, are subject to considerable pressure to advocate corporate policies that facilitate in-state economic development, without regard to whether such development is in the corporate interest.<sup>27</sup> Similarly, union pension funds use the corporate franchise to advance a distinct labor agenda, again "without consideration, perspective or even interest in the long-term interest of the corporation and its shareholders as a whole."<sup>28</sup>

Finally, modern derivative and hedging techniques have created the more complex problem of "hedged investors" who may hold corporate voting rights without any corresponding economic interests. To take a simple example, a shareholder whose short positions exceed its long position will be better off if share value declines. Such hedged investors will have no incentive to vote their shares so as to promote corporate value; to the contrary, they should be expected to vote their shares so as to advance entirely private interests that may be directly *opposed* to share value, such as supporting an underpriced transaction with another company that the hedged investor also owns. Empowering shareholders under these circumstances, of course, risks destroying corporate value and compromising the interests of non-hedged shareholders, and is socially inefficient as well.

The well-publicized effort of Perry Corp. to influence the sale of Mylan Laboratories, Inc. illustrates the point dramatically. Perry Corp., a hedge fund, owned seven million shares of King Pharmaceuticals, which Mylan agreed to purchase at a sixty-one percent premium in late 2004. Mylan's shares fell on news of the deal, however, reflecting the market's apparent

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<sup>26</sup> See Anabtawi, *supra* note 25, at 579–83; see also Robert G. Kirby, *Should a Director Think Like a Shareholder? (It Depends on Who the Shareholder Is!)*, in *DIRECTORSHIP, SIGNIFICANT ISSUE FACING DIRECTORS* 6-1, 6-2 (1996) ("Hedge funds and arbitrageurs are shareholders, just like Warren Buffett. . . . However, they are primarily financial engineers interested in the largest possible profit in the shortest period of time. In most cases, they have no interest at all in the long-term economic success of the enterprise. If the directors of publicly held, corporate America thought like these shareholders, I believe something approaching chaos would rapidly ensue.").

<sup>27</sup> See, e.g., Anabtawi, *supra* note 25, at 588–89; Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 *COLUM. L. REV.* 795, 796, 801–14 (1993).

<sup>28</sup> Lipton, *supra* note 22, at 1377; see also Anabtawi, *supra* note 25, at 589–90 (describing attempts by a union fund to demand concessions in collective bargaining negotiations); Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 *COMP. LAB. L. & POL'Y J.* 97, 114 (2000) (describing union fund's use of shareholder power to gain recognition of union organizing activity).

belief that the price was too rich. In order to ensure the merger's approval, Perry then purchased a 9.9% stake in Mylan, but fully hedged the stake, eliminating any market risk. Perry had thus become Mylan's largest shareholder, with more influence over the merger vote than any entity or individual, but it had no economic interest in the company at all — and, what's more, the worse the transaction was for Mylan, the more lucrative the result would be for Perry.<sup>29</sup>

The Mylan situation starkly demonstrates the distorted voting incentives sometimes created by modern hedging techniques, and it is not an isolated case. To the contrary, such "vote buying by hedge funds is probably common";<sup>30</sup> an important recent study catalogues numerous other similar situations (which it calls "the new vote buying") and suggests that the scale of the potential problem is likely much greater.<sup>31</sup> In addition, complex hedging transactions of this sort are only the most advanced examples of shareholder vote manipulation — sophisticated holders "have long tried to game the system of owning shares to influence votes," by, for example, "buy[ing] shares for only a brief period before a record date or deadline that gives them the right to vote and then [] immediately sell[ing] the shares."<sup>32</sup> Professional investors are able to — and, according to recent research, clearly do — "borrow" millions of shares of stock for short periods at nominal amounts at or around voting record dates in order to influence corporate elections (without, of course, having any corresponding interest in corporate performance).<sup>33</sup>

The takeaway point here is that "hedged" shareholders should be expected to cast their votes without regard to the well-being of the company.<sup>34</sup> We cannot know how widespread the phenomenon may be — the

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<sup>29</sup> See Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 816, 825–29 (2006).

<sup>30</sup> David Skeel, *Behind the Hedge*, LEGAL AFF., Nov.–Dec. 2005, at 28, 32, available at [http://www.legalaffairs.org/issues/November-December-2005/feature\\_skeel\\_novdec05.msp](http://www.legalaffairs.org/issues/November-December-2005/feature_skeel_novdec05.msp).

<sup>31</sup> Hu & Black, *supra* note 29, at 844–47, 848–49 tbl.2 (cataloguing twenty-one examples and observing that "the list is surely partial").

<sup>32</sup> Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. TIMES, Dec. 2, 2004, at C4.

<sup>33</sup> See Susan E. K. Christoffersen et al., *Vote Trading and Information Aggregation 2–4* (European Corporate Governance Inst., Finance Working Paper No. 141/2007, 2007), available at [http://ssrn.com/abstract\\_id=686026](http://ssrn.com/abstract_id=686026). The study further found that a majority of this "vote-borrowing" was undertaken by would-be voters who opposed management. *Id.* at 30; see also Kara Scannell, *Hedge Funds Vote (Often)*, WALL ST. J., Mar. 22, 2007 at C1 (noting market and regulatory concern that "corporate elections are undermined by improper voting," especially by hedge funds who may "sway corporate contests by voting shares that they have borrowed but don't own, or hedged to minimize how much they have at stake"); Kara Scannell, *How Borrowed Shares Swing Company Votes*, WALL ST. J., Jan. 26, 2007, at A1 (noting that the "borrowed vote" and "empty voting" practices commonly associated with hedge funds increasingly allow such activist investors to manipulate the corporate franchise for private gain, usually with an immediate-term perspective and often at the expense of the corporation and its shareholders as a whole).

<sup>34</sup> The point is amplified by the confounding fact that money managers—the folks who actually "own" shares—now reportedly boast that they have set up proxy voting units separate and apart from

"new vote buying" occurs through complex, subterranean and generally undisclosed transactions — but it is very likely on the rise. This is thus exactly the *wrong* time to be considering increasing shareholder power.<sup>35</sup> Now, more than ever, divergent groups of shareholders can be expected to pursue conflicting agendas in the corporate arena, and — now more than ever — a board of directors answerable to all shareholders and the corporate community generally is needed to mediate. Where there is such smoke, it is probably unwise to be tossing gasoline around.

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The recent exchange among Bebchuk, Strine, and Bainbridge in the pages of the *Harvard Law Review* attests to the value of Bebchuk's contribution: he has again turned an illuminating spotlight on the most significant issues in corporate law. The view here, however, is that, having raised these core issues, Bebchuk fails to resolve them with due appreciation for precedent, history, and practice. The Delaware way may not be perfect, but it is very good, and it has served the nation and the economy well for a long time. As Vice-Chancellor Strine's "traditionalist" acknowledges, there is room to consider reform in the appropriate case, but there is simply no cause for revolution. The "case for increasing shareholder power" should be dismissed.

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those that make the investment decisions. Vice Chancellor Strine has aptly called this phenomenon the "separation of ownership from ownership." See Leo E. Strine, Vice Chancellor, Court of Chancery of the State of Delaware, SEC Open Meeting: The Federal Role in Upholding Shareholders' State Law Rights (May 7, 2007) webcast available at <http://www.connectlive.com/events/secopenmeetings/>. This practice further uncouples shareholder voting from underlying economic interest, and compounds the fact that most such money-management professionals have personally-incentivized time horizons that may be quite at odds with the investment goals of their clients (who will often be saving for retirement and have no interest in chasing the quick bump over long-term value accretion). If ownership is now widely divorced from ownership as Vice Chancellor Strine describes, it seems an odd response to lead a revolution under the slogan of empowering shareholders in ways never before seen.

<sup>35</sup> A recent paper made the point this way:

[C]hanges in the markets and in finance theory evince that the assumptions central to the paradigmatic position on corporate voting are no longer valid. It is simply not true to say that the "preferences of [shareholders] are likely to be similar if not identical." Shareholders are neither necessarily nor commonly in the residual claimant position that the literature has heretofore assumed. *Parties instead routinely utilize financial derivatives and structured finance techniques to reallocate various interests in the firm, including both residual claims and voting rights.*

Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 778 (second alteration in original) (emphasis added) (footnote omitted) (quoting Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983)).