

REPLY
LETTING SHAREHOLDERS SET THE RULES

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In companies with dispersed ownership, boards are bound to have significant power. But the power that boards of U.S. companies have is not an inherent corollary of the separation of ownership and control. This power is partly a product of legal rules that insulate boards from shareholder intervention. In my view, which I have put forward in earlier work, corporate governance of U.S. public companies could be improved by eliminating or reducing some of the legally imposed limits on shareholder power.¹

The reform that I support has two key elements. First, it would reduce some of the substantial impediments facing shareholders when they seek to replace incumbent directors. Under existing arrangements, shareholder power to replace directors is largely a myth; outside the takeover contest, electoral challenges to incumbent directors are rare.² To make boards accountable, I support changes that would turn this myth into a reality.³

The second element is one that I put forward in an article published last year in this journal, *The Case for Increasing Shareholder Power*.⁴ *Increasing Power* advocates providing shareholders with power to initiate rules-of-the-game decisions — decisions to change the

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¹ For summaries of my view, see LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE 202-16* (2004); and Lucian A. Bebchuk, *Making Directors Accountable*, HARV. MAG., Nov.-Dec. 2003, at 29.

² See Lucian A. Bebchuk, *The Myth of the Shareholder Franchise* (Oct. 2005) (unpublished manuscript, on file with the Harvard Law School Library), available at <http://ssrn.com/abstract=829804>. This study documents that, from 1996 to 2004, incumbents confronted challengers seeking to manage the company better as a standalone entity in only about 110 cases, roughly 12 a year. Of these 110 cases, only 20 cases, about 2 a year on average, involved companies with a market capitalization that exceeded \$200 million. Furthermore, during this nine-year period, in targets with a market capitalization exceeding \$200 million, challengers won in only two cases. *Id.* at 1-2.

³ *Id.* at 2; Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003).

⁴ Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

governance arrangements in the company's rule book by changing the corporate charter or the company's state of incorporation. In contrast to the corporate law of the United Kingdom and other common law countries, U.S. corporate law has long denied shareholders the power to change the company's basic rules of the game.

Increasing Power puts forward a detailed proposal for a new default regime under which shareholders would be able to make rules-of-the-game decisions. Under this regime, shareholders satisfying some minimum ownership and holding requirements would be able to place on the corporate ballot proposals for changing the charter or state of incorporation. To ensure that such changes are not produced by transient circumstances or majorities, they would take effect only if approved by shareholders in two consecutive annual meetings. To provide incentives to initiate beneficial proposals, shareholders initiating proposals that receive a sufficiently large number of votes — but not those that fail to attract meaningful support — would receive a reimbursement of their expenses. The proposed regime would be expected to affect governance arrangements mainly indirectly by inducing boards themselves to initiate changes that shareholders view as value-maximizing.⁵

In this issue of the journal, Professor Stephen Bainbridge and Vice Chancellor Leo Strine take issue with my arguments for increasing shareholder power.⁶ Professor Bainbridge offers the perspective of one who does not wish to see any change in the status quo. He accepts my account of shareholder weakness but believes it should be “welcome[d].”⁷ In his view, any increase in shareholder power would be undesirable.

Vice Chancellor Strine puts forward a critique from the perspective of an “open-minded corporate law ‘traditionalist.’”⁸ Unlike Bainbridge, Strine is sympathetic to the concern that, under existing arrangements, boards are insufficiently accountable and excessively insu-

⁵ *Increasing Power* focuses on showing the merits of the proposed arrangement as a default. Because the question of whether opting out should be permitted depends on general considerations not specific to the subject governed by this arrangement, *Increasing Power* leaves outside the scope of its analysis whether opting out should be allowed and suggests that readers should form their own views based on their general approach to contractual freedom. See Bebchuk, *supra* note 4, at 875.

⁶ See Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); 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 (2006).

⁷ Bainbridge, *supra* note 6, at 1735.

⁸ Strine, *supra* note 6, at 1759. Strine acknowledges his constraints as a sitting judge who decides corporate law cases, and he does not indicate, nor rule out, that the view he describes is his own. For convenience of exposition, I will refer to the view Strine attributes to “open-minded corporate law traditionalists” as Strine's.

lated.⁹ In his view, however, changes, if any, should be limited to enhancing shareholder power to replace directors. Companies must remain purely representative democracies in which shareholders can overrule a board that refuses to make rules-of-the-game changes the shareholders favor only by electing a new team of directors that would initiate such changes.

I respond below to Bainbridge and Strine as well as further develop my arguments for shareholder power to make rules-of-the-game decisions. Part I discusses the significant costs arising from granting boards control over rules-of-the-game decisions during the often long life of public companies. Part II responds to the claim that shareholder power to make rules-of-the-game decisions is inconsistent with reaping the benefits of centralized management.

Part III shows that reform of the corporate election process, which I very much support, would not by itself eliminate the problems resulting from denying shareholders the power to make rules-of-the-game decisions. Part IV argues that, despite problems with shareholder incentives and decisionmaking, leaving boards with unaccountable control over the governance rules could well be inferior to empowering shareholders. Finally, Part V responds to the claim that the proposed arrangement can be dismissed on the grounds that, if it were beneficial, it would already be offered by corporate charters or state law rules.

Before proceeding, it is worth stressing that my support of shareholder power to make rules-of-the-game decisions is not based on a belief that such a regime would work perfectly; I recognize its problems and costs. Winston Churchill famously observed that “democracy is the worst form of Government except all those other forms that have been tried from time to time.”¹⁰ In companies with dispersed ownership, allowing shareholders to intervene in rules-of-the-game decisions may be the worst mechanism for making such decisions — except for the alternative of having these decisions controlled by boards, whose actions the rules of the game in part aim to regulate.

⁹ Strine’s traditionalist is “disquieted by the corporate status quo” and “frustrated at the apparent inability of corporate boards to address . . . problems.” Strine, *supra* note 6, at 1766–67.

¹⁰ Winston S. Churchill, Speech at the House of Commons (Nov. 11, 1947), *in* 7 WINSTON S. CHURCHILL: HIS COMPLETE SPEECHES, 1897–1963, at 7566 (Robert Rhodes James ed., 1974).

I. THE COSTS OF BOARD CONTROL OVER THE RULES OF THE GAME

A. *Private Ordering in Midstream*

U.S. corporate law leaves a lot of room for private ordering. U.S. firms are free to choose among states of incorporation. And the laws of all such states set many arrangements as default provisions from which companies are free to opt out.

Allowing private ordering has three important potential benefits. First, even if the same arrangement were good for all public companies, public officials might err in identifying it. Therefore, it might be desirable to allow private parties, who might be better informed, to opt out of the publicly selected arrangement in favor of one they view as superior. Second, even if the arrangement selected by public officials were initially the right one, things might change over time, and private ordering can then provide adjustment to new circumstances. Third, one size might not fit all: companies differ in their circumstances, attributes, and needs. Private ordering allows a company to tailor its governing arrangement.

Financial economists and legal scholars pay much attention to the governance choices that firms make when they first go public. But public firms often lead long lives in dynamic environments. In his Response, Strine accepts that “traditionalists” must recognize “that developments in the business world might give rise to a need to strengthen or modify” investors’ protections from insider opportunism.¹¹ Thus, in addition to choices of governance arrangements made at the IPO stage, also important are such choices made (explicitly or implicitly) afterward — during the life of a public company — in response to new problems, circumstances, evidence, and tools.

Increasing Power provides empirical evidence highlighting the importance of the explicit and implicit rules-of-the-game decisions that public firms make in midstream. It documents that companies often live long lives after they go public.¹² Table 1 below provides some additional statistics presenting the age distribution in 2005 of the ninety-seven Fortune 100 firms that are publicly traded. As the table indicates, about four-fifths of these companies went public before 1990, that is, before state antitakeover law became fully developed. Indeed, more than two-fifths of these companies went public before the end of World War II, and more than a quarter of these companies went public even before the adoption of the 1933 and 1934 Securities Acts.

¹¹ Strine, *supra* note 6, at 1762.

¹² See Bebchuk, *supra* note 4, at 866.

TABLE 1: AGE DISTRIBUTION OF PUBLIC FORTUNE 100 FIRMS¹³

Time of Going Public	Cumulative Percentage of Firms
Pre-1930	28%
Pre-1945	35%
Pre-1960	42%
Pre-1975	63%
Pre-1990	79%
All	100%

Needless to say, one cannot expect the drafters of IPO charters during, say, the 1950s to have anticipated and provided adequate arrangements for the wide range of issues confronting public firms in 2005. For example, hostile takeover bids became important only during the 1960s, and their modern regulation developed in the 1980s and 1990s. Executive pay practices were significantly different in the 1950s. The use of independent directors has greatly increased during the intervening fifty years. This period has also witnessed the development of option and derivative markets, as well as the development of the plaintiffs' bar. One could go on and on.

Given the importance of governance decisions that public firms make in their lifetimes, the board's control over governance arrangements can give rise to substantial costs. During that lifetime corporate circumstances and needs will likely change markedly, as will the available governance tools and technologies and the state of knowledge about them. Under the existing rules, however, not all value-enhancing changes in governance arrangements can be expected to occur. In fact, value-enhancing changes that disfavor the board might well not occur.

As a result, firms' choices of governance arrangements are distorted. When developments in the business world give rise to a need to strengthen or modify protections for investors, charters might well not be amended to provide such protections. When developments in the business world or in state law make it desirable to reincorporate in a state that would impose greater constraint on the board, such a reincorporation could well not occur. The control that boards have over reincorporation decisions has also provided states seeking to attract in-

¹³ To prepare this table, the earliest date in which stock price information about a given company appears in the CRSP dataset was used as a proxy for the time the company went public. I am grateful to Charlie Wang for his help in producing this table.

corporations with incentives to offer rules that favor management and to avoid rules that disfavor it.¹⁴

Notably, in contrast to Bainbridge's claim,¹⁵ shareholder power to make rules-of-the-game decisions can produce beneficial consequences and improve governance arrangements even if shareholders commonly use their power not to adopt arrangements tailored to the needs of specific companies, but rather to push for the adoption of similar arrangements in a wide range of companies. The investor community might recognize from time to time the general desirability of imposing a certain governance constraint on boards generally. In the absence of shareholder power to initiate rules-of-the-game decisions, adoption of such a constraint is unlikely without regulatory intervention. With shareholder power over rules of the game, such intervention could be unnecessary.

B. Do Markets Force Boards To Adopt Value-Increasing Changes?

While Strine accepts the existence of a significant midstream problem, Bainbridge does not. In Bainbridge's view, professional managers of established firms have an incentive to continue to supply efficient governance terms.¹⁶ In his opinion, "it is not Panglossian to conclude that managers' interests generally are aligned with those of shareholders."¹⁷

There is a strong basis, however, for concluding that, with respect to the choice of governance arrangements in midstream, management's interests are *not* generally aligned with those of shareholders. To begin, management's midstream choices are not the same as those of founders taking the company public. In earlier work published in this journal, I have explained in detail why management's midstream choices with respect to charter amendments and reincorporation decisions might well not overlap with the choices that would be optimal from the shareholders' perspective.¹⁸

To see the difference between founders' choices at the IPO stage and boards' midstream choices, consider a founder taking a firm public and deciding whether to adopt an arrangement that would increase the value of shares by V and decrease private benefits by B . It is possible to argue that the founder will fully internalize the benefit of V if

¹⁴ See *infra* section V.C; see also Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

¹⁵ Bainbridge, *supra* note 6, at 1738 (claiming that my proposal relies on the ability of shareholders to select arrangements tailored to companies' special needs).

¹⁶ *Id.* at 1739.

¹⁷ *Id.* at 1740.

¹⁸ See Bebchuk, *supra* note 14, at 1458–84; Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1835–47 (1989).

the arrangement is included in the charter, because benefits to outside shareholders purchasing shares at the IPO will be reflected in an increased share price. In contrast, consider an established firm in which board members hold a total of 5% of the shares. Suppose that new circumstances or technologies would make a particular change efficient. Suppose also that, like in the IPO example, the change would increase the value of shares by V and reduce private benefits by B . In this case, because management would capture only 5% of this value, it might elect not to implement the change even if doing so would be efficient overall (that is, if V exceeds B).

It is also important to recognize that market forces do not force management to adopt all value-increasing governance changes.¹⁹ While markets impose *some* constraints on management, these constraints are by no means stringent. Consider, for example, the market for corporate control. Bainbridge believes that the threat of being ousted tightly aligns the interests of management and shareholders. Because management can block hostile bids, however, hostile bidders must be prepared to pay a substantial premium to gain control.²⁰ The disciplinary force of the market for corporate control is further weakened by the prevalence of golden parachute provisions and payments acquirers make to target company managers. The market for corporate control thus leaves management with considerable slack.

Nor will the market for new capital compel management to adopt value-increasing arrangements. Failure to adopt such arrangements would not generally prevent management from raising additional capital. It would mean only that the company would have to sell shares at a slightly lower price. The costs of raising capital at somewhat worse terms would be borne mainly by shareholders, with management bearing only a fraction.²¹

The midstream problem should be of concern to all those holding the widespread view that agency problems are important in publicly

¹⁹ For a full analysis of the limits of the various market forces management faces, see BEBCHUK & FRIED, *supra* note 1, at 53–58; Bebchuk, *supra* note 14, at 1461–67; and Bebchuk, *supra* note 18, at 1840–46.

²⁰ See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Anti-takeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 926 (2002) (reporting that the final bids in a hostile context offer a premium of 37% on average compared with the target's pre-bid price).

²¹ It might be worth noting that management's holding of shares and options, partly due to the effects of compensation schemes, also does not generally induce the adoption of value-increasing arrangements. Consider a value-increasing arrangement that would reduce management's private benefits. Management would bear only some (and often a small) fraction of the costs to shareholders of not adopting a value-increasing arrangement but would bear fully the reduction in private benefits that the arrangement would bring about. Obtaining larger private benefits without internalizing the full cost to shareholders, management might prefer not to adopt the value-increasing arrangement.

traded companies. We often think about corporate governance as a mechanism for reducing the agency problem. Under the existing scheme for rule changes, however, the choices of governance arrangements made by public firms are themselves subject to an agency problem. The very need for governance arrangements highlights why leaving them to the control of boards is problematic.

C. *The Performance of the U.S. Stock Market*

Bainbridge suggests that the problems I focus on cannot be substantial given the U.S. economy's past performance. He argues that my concerns reflect a view of U.S. corporate governance as "largely dysfunctional."²² This view is inconsistent with the performance of the U.S. stock market during the past two decades, Bainbridge claims, because such performance must reflect a superior corporate governance system.²³ This type of argument, often invoked by opponents of reform, has rhetorical appeal, and Strine also seems to be influenced by it.²⁴ It is therefore worth explaining why successful stock market performance does not preclude the potential benefits from significant reform of the corporate governance system.

I do not view the U.S. corporate governance system, nor that of many other countries with developed stock markets, as largely dysfunctional. But between the dysfunctional and the optimal lies a rather large gap, and a developed stock market that grows over time is consistent with a governance system that lies in that gap and could be significantly improved. Bainbridge, like Professors Holmstrom and Kaplan on whose views he relies, does not view the 2002 corporate governance reforms as undesirable. But the strong stock market performance on which his inference of healthy corporate governance relies had taken place largely before the adoption of these reforms; indeed, the U.S. stock market has underperformed relative to its peers since the reforms. Similarly, the pre-2002 performance of the U.S. stock market should not serve as a basis for concluding that additional reforms are unnecessary.

Superior stock market performance does not necessarily result from better corporate governance. The relative performance of two economies and their stock markets depends on many factors besides corporate governance, such as monetary policy, fiscal policy, population growth, labor market policy and institutions, shocks arising from asset-

²² See Bainbridge, *supra* note 6, at 1739–40.

²³ See *id.* He quotes and relies on Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, J. APPLIED CORP. FIN., Spring 2003, at 8, 8.

²⁴ See Strine, *supra* note 6, at 1770 & n.32 (noting that the "current balance has produced impressive overall results" and citing Bainbridge's quotation of Holmstrom and Kaplan).

pricing bubbles, and the organization and regulation of the banking sector. That the Russian stock market outperformed the U.S. market in the past decade does not indicate that Russia has a superior corporate governance system. And though the U.S. stock market greatly underperformed those of Germany and Japan during the 1970s and greatly outperformed them during the 1990s, I doubt that anyone would infer from this massive reversal in stock market returns a parallel change in relative corporate governance rankings.

Students of a country's corporate governance system should not become complacent after a period in which the stock market outperforms the markets of peer economies, nor should they become alarmed and eager for drastic change after a period of stock market underperformance. Rather, they should focus steadily on direct assessment of potential problems and proposals for addressing them.

II. DOES CENTRALIZED MANAGEMENT REQUIRE BOARD CONTROL OVER THE RULES OF THE GAME?

Bainbridge and Strine both stress the indisputable need for a board to have the authority to make binding and unreviewable business decisions.²⁵ Shareholders in public companies generally lack the information and incentives to make adequate business decisions and choose business strategies. Therefore, it is widely accepted that ceding authority to the board is in shareholders' interest and is part of a public company's optimal structure. In Bainbridge's view, moreover, maintaining board authority under the centralized management model is inherently inconsistent with giving shareholders power over rules-of-the-game decisions. Thus, he deems my proposal "likely to disrupt the very mechanism that makes the widely-held public corporation practicable: namely, the centralization of . . . authority."²⁶ Strine, too, reminds readers that "the empowerment of centralized management" is a core element of our corporate law.²⁷ He argues that the law should facilitate management's ability "to make good-faith business decisions with the speed and efficiency modern commerce demands" and "free up managers to manage."²⁸

As this Part explains, however, the debate over the proposed reform cannot be resolved using arguments based on the general idea of centralized management. Effective centralized management does not require boards to retain absolute power. Indeed, in comparison to other types of decisions, those concerning rules of the game are particularly

²⁵ See Bainbridge, *supra* note 6, at 1744–46; Strine, *supra* note 6, at 1762–63.

²⁶ Bainbridge, *supra* note 6, at 1749.

²⁷ Strine, *supra* note 6, at 1763.

²⁸ *Id.* at 1763–64.

well-suited to possible overruling by shareholders. Moreover, the proposed shareholder power over rules of the game is similar to certain limits on board authority that are already widely accepted.

For a person or group to have meaningful and effective authority over a set of decisions does not require such authority in all circumstances and over all other decisions. To illustrate, consider the United States Constitution, which vests in the President a great deal of authority and empowers her to make a wide range of decisions with speed and efficiency. But the President also is subject to “rules of the game” set by congressional legislation and to changes in these rules that Congress may adopt. It is possible to debate, of course, whether the Constitution imposes excessive, insufficient, or optimal procedural limitations on Congress’s power to amend the rules of the game to which the executive branch is subject. But few would argue that the mere existence of such congressional power is inconsistent with presidential authority.

Indeed, in companies with centralized management, subjecting the board to shareholder power to make rules-of-the-game decisions is a sensible and natural constraint. When Bainbridge and Strine discuss the value of board authority, they stress authority over business decisions. It is with respect to such decisions that boards are likely to have informational advantages over shareholders because company-specific information, including some that might not be publicly available, is important for such decisions. And it is in making such decisions that speed is often needed.

Rules-of-the-game decisions, however, typically do not require inside, company-specific information. Rather, they require making judgments regarding issues that arise in a wide range of companies. Consider, for example, decisions whether to remove a charter-based staggered board and whether to reincorporate a company in Delaware. Individuals may reasonably disagree on the correct decision with regard to either choice, but their disagreements are unlikely to turn on inside information that boards have and shareholders lack. In fact, shareholders are less likely to have an informational disadvantage (relative to the board) when making rules-of-the-game decisions than when deciding — as they are currently required to do under state law — whether to approve a management proposal for a merger.

Even Bainbridge acknowledges, at the end of his discussion of centralized management, that the value of managerial authority does not preclude all limits on it. He states that because “the shareholder wealth maximization norm does not easily lend itself to judicial enforcement . . . , it is enforced indirectly through a . . . varied set of extrajudicial accountability mechanisms,” such as shareholder power to

vote out the directors.²⁹ If some accountability mechanisms are in principle consistent with centralized management and board authority, Bainbridge should not dismiss as inconsistent with centralized management a proposal to hold management accountable to shareholders by empowering the latter to make rules-of-the-game decisions.

In fact, the proposed shareholder power to make rules-of-the-game decisions is similar in nature to other constraints on management that are already in place and widely accepted. To begin, Bainbridge views shareholder power to oust directors as a legitimate “accountability device” that is supposed to be “used sparingly” as a safety valve when the board manages the company poorly.³⁰ Shareholder power to make rules-of-the-game decisions similarly should be viewed as a safety valve, to be used when the board fails to initiate value-increasing changes in the charter or state of incorporation. Indeed, one might view shareholder power to make rules-of-the-game decisions as a weaker limitation on board authority than the power to oust the directors. While the latter power enables shareholders to overturn the board’s business decisions, the former does not.

Moreover, regardless of whether shareholders are given the power to make changes in the rules of the game, management’s authority is limited by rules of the game already in place. A board’s authority is subject to the arrangements specified by the corporate charter and the rules of the company’s state of incorporation. The board cannot change these arrangements, which often were adopted before the current directors began serving, without shareholder approval. Bainbridge and Strine do not question this limitation on board authority as inconsistent with centralized management. If subjecting a board’s authority to rules of the game already in place does not fundamentally conflict with centralized management, the proposed shareholder power will not conflict either. Allowing shareholders to make rule adjustments over time would merely ensure that the rules in place are updated, if necessary, to reflect changes in circumstances and information.³¹

Additionally, under existing state law shareholders have the authority to amend company bylaws.³² This power does not enable shareholders to make all changes in the rules of the game: the bylaws are subordinate to the charter, opting out of some state law provisions is

²⁹ Bainbridge, *supra* note 6, at 1750.

³⁰ *Id.*

³¹ Strine mentions speed as a virtue of centralized management. *See* Strine, *supra* note 6, at 1763. It is therefore worth noting that shareholder power to make rule changes would not slow down any board-initiated change. Rather, the proposed shareholder power would only make possible additional shareholder-initiated changes.

³² *See, e.g.*, 2 MODEL BUS. CORP. ACT ANN. § 8.01 (Supp. 2000–2002); 1 RODMAN WARD, JR. ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 109.6 (4th ed. 2005).

permitted only through the charter, and bylaw amendments cannot produce a reincorporation.³³ But the existence of shareholder power to amend the bylaws suggests that shareholder power to make rules-of-the-game decisions is not fundamentally inconsistent with centralized management.

Finally, the United States limits shareholder power to make rule changes far more severely than do the United Kingdom and other common law countries. Given that U.K. companies also have dispersed ownership and centralized management, this feature of U.K. law highlights again that shareholder power to make rules-of-the-game decisions can be consistent with centralized management.³⁴

Increasing Power, I should note, does suggest that shareholders should be able to use their power to make rules-of-the-game decisions to grant themselves future authority to make some major, specific business decisions, such as selling or dissolving the company.³⁵ That is, I favor including arrangements that allow shareholder intervention in major business decisions in the menu of permissible rules of the game from which companies may choose. But this element of my view is separable from giving shareholders the basic power to make rules-of-the-game decisions. One who does not wish to accept it should simply limit the array of governance arrangements from which shareholders may choose but should not deny shareholders the basic power to make rules-of-the-game decisions — the power on which both *Increasing Power* and this exchange focus.

III. WOULD ELECTION REFORM BE SUFFICIENT?

Under the comprehensive corporate reform I support, shareholder power over rules-of-the-game decisions should accompany a new default arrangement making it easier for shareholders to replace incumbent directors. Under this arrangement, a company's shareholders would have, at least in every other year, both access to the corporate ballot and the power to replace all directors. Furthermore, the campaign expenses of candidates who receive a significant number of votes

³³ See Bebchuk, *supra* note 4, at 845–46 & nn.18–20, 26–28.

³⁴ Bainbridge dismisses the U.K. law, citing a book that suggests that there is “British prejudice against industrial capitalism” and that U.K. firms are “plagued” by “lack of ‘managerial expertise.’” Bainbridge, *supra* note 6, at 1744 n.51 (quoting JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, *THE COMPANY* 82–83 (2003)). He does not offer reasons for dismissing similar rules in other common law countries, nor does he indicate whether he views Britain as a country in which public firms lack centralized management or as one in which companies do have centralized management together with greater shareholder power than exists in the United States.

³⁵ For a detailed discussion of reasons for including such arrangements in the menu, see Bebchuk, *supra* note 4, at 892–907.

(for example, one-third of the votes cast) would be reimbursed, and voting would be confidential.³⁶

Strine is open to the possibility of reform that would facilitate electoral challenges.³⁷ Strine's opinions and writings have had a substantial and beneficial impact on Delaware doctrine, and I hope his views on corporate elections will influence the Delaware legislature.³⁸ However, while Strine and I share similar views with respect to election reform, Strine disagrees that such reform should be accompanied by shareholder power over rules-of-the-game decisions.³⁹

I view election reform as critical to improving corporate governance. If political constraints compelled a choice between giving shareholders viable power to replace directors and giving them power to make rules-of-the-game decisions, I might choose the former. But *Increasing Power* and this exchange focus largely on determining the optimal set of default arrangements for our corporate governance system. In this discussion, electoral reform and power over rules-of-the-game decisions are not mutually exclusive. It is possible to adopt both, and I believe there are good reasons to do so.⁴⁰

In theory, invigorated elections could induce a board to adopt a rule change favored by shareholders out of concern that shareholders

³⁶ Bebchuk, *supra* note 2, at 2.

³⁷ See Strine, *supra* note 6, at 1778–82. Strine has also expressed cautious support for election reform in earlier writings. See William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1072–74 (2002); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 999–1001 (2003).

³⁸ Given that the threat of federal intervention in this area has somewhat subsided, however, one cannot be optimistic about the prospects of such legislative changes anytime soon.

³⁹ See Strine, *supra* note 6, at 1775–76.

⁴⁰ Strine seems to believe that it would be more difficult to adopt reforms that provide shareholders with power to make rules-of-the-game decisions than reforms that enhance their power to replace directors. See *id.* at 1768–69. I do not share this view. In terms of the policy debate, both reforms need to address a similar set of concerns and objections. Indeed, the various concerns and objections that Bainbridge and Strine raise in response to my proposal are similar to ones that have been raised by those opposing enhanced shareholder power to replace directors. See, e.g., Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003); Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal* (UCLA Sch. of Law, Law & Econ. Research Paper No. 03-22, 2003), available at http://papers.ssrn.com/abstract_id=470121.

While I do not view rules-of-the-game reform as less politically feasible than election reform, I am not optimistic about the chances of either in the near future. In my view, the main impediment to both reforms is the political power of vested interests. Management groups can be expected to oppose strongly either reform, and they are a powerful interest group that can use the resources under their control to influence lawmaking in the corporate area. See Lucian Bebchuk, *Politics and Investor Protection* (Apr. 2005) (unpublished manuscript, on file with the Harvard Law School Library); Lucian Bebchuk & Zvika Neeman, *A Political Economy Model of Investor Protection* 11 (July 2005) (unpublished manuscript), available at <http://www.law.nyu.edu/clep/Bebchuk1.pdf>.

would otherwise replace the directors with a new team committed to initiating the desired change. But voting for such a new team is an imperfect mechanism for accomplishing rule changes. Voting for the new team bundles together a given rule change with replacement of the incumbent team of directors — and this second change might be one that shareholders wish not to make. Shareholders might therefore vote against the new team even if they favor the rule change.⁴¹ *Increasing Power* refers to this issue as the “bundling” problem and suggests allowing shareholders to initiate rule changes not bundled with director replacement.⁴²

Strine’s own discussion of election reform highlights the desirability of giving shareholders the power to make rules-of-the-game decisions. Strine supports an election reform statute that would enable shareholders to opt into a new election regime, giving them enhanced power to replace directors, using the same procedure I proposed for making rules-of-the-game decisions in general: by a majority vote at two successive meetings.⁴³ But if shareholders are permitted to change in this way the rules governing corporate elections, then why not also permit them to use this procedure to change other rules of the game?

Furthermore, any reformed election system is bound to include several features — for example, the minimum holding requirement for placing a candidate on the ballot, or the threshold for getting reimbursement of campaign expenses — whose default setting will be rather ad hoc. Under the election reform proposal I support, firms would be allowed to opt out and tailor the election regime.⁴⁴ If such tailoring is allowed, boards surely should not be given veto power over it because board control would hinder modifications that would make it easier for contests to occur. This problem could well lead Strine to support shareholder power to do such tailoring using the procedure requiring a majority vote at two successive elections.

And if shareholders are allowed to tailor the rules of the game governing corporate elections, there is little reason not to allow them to do so for other rules of the game. Without an accompanying power to make rules-of-the-game decisions, enhanced shareholder power to remove directors would not fully address existing problems of board insulation. We should adopt both.

⁴¹ As evidence of this problem, *Increasing Power* documents that boards commonly decline to follow majority-passed precatory resolutions to dismantle staggered boards. See Bebchuk, *supra* note 4, at 852–56.

⁴² See *id.* at 851–61.

⁴³ See Strine, *supra* note 6, at 1778.

⁴⁴ See Bebchuk, *supra* note 2, at 27–28.

IV. CAN SHAREHOLDERS BE TRUSTED?

Most shares in the economy are held by institutional investors, such as mutual funds and state pension funds. Decisions on how these institutions will vote are made not by the investors who ultimately provide their capital but rather by agents whose interests might diverge from those of the investors. Bainbridge and Strine suggest that, even assuming there are problems with board control over the company's rules-of-the-game decisions, shareholders should not be given power to make such decisions because institutional investors cannot be expected to make good use of that power.⁴⁵

In this Part, I examine concerns arising from the incentives of institutions to be passive and thus to underutilize any new power given to them (section A), from the "special interests" of some institutional investors (section B), and from the mistakes that institutional investors might make in judging what would serve shareholders (section C). I explain why these concerns, individually or in combination, do not provide good reasons for leaving boards in control of the rules of the game.

A. *Institutional Investor Passivity*

Both Bainbridge and Strine comment on the passivity of most money managers and their unwillingness to get meaningfully involved in corporate governance matters. Bainbridge argues that, because of collective action problems, most financial institutions will not have an incentive to make use of power to initiate rule changes.⁴⁶ Strine too is concerned about the limited efforts that institutional investors devote to corporate governance matters.⁴⁷

My proposal has taken into account the economic forces that discourage institutional investors from being active. That an activist investor might have to share the benefits of an improved stock price with fellow shareholders creates a free-rider, collective action problem that discourages activism.⁴⁸ Furthermore, most mutual funds cannot be expected to initiate proposals — such active involvement is not part of their "business model" — and can at most be expected to vote for others' proposals. They are, in the words of Robert Pozen, "reluctant activists."⁴⁹

⁴⁵ See Bainbridge, *supra* note 6, at 1751–55; Strine, *supra* note 6, at 1764–66.

⁴⁶ See Bainbridge, *supra* note 6, at 1750–54.

⁴⁷ See Strine, *supra* note 6, at 1765.

⁴⁸ See Bebchuk, *supra* note 4, at 874, 876–78.

⁴⁹ Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.–Feb. 1994, at 140, 140.

Nonetheless, some large shareholders and some activist institutional investors can be expected to initiate proposals from time to time. And when these proposals enjoy wide shareholder support, even passive money managers might well vote for them and enable their passage.

Note that the cost of initiating proposals would be limited. Moreover, my proposal includes a reimbursement rule that would partly address the free-rider problem and further reduce cost barriers. Shareholders who initiate proposals that gain a substantial number of votes would be reimbursed by the company. This element mitigates the incentive problem identified by Bainbridge and Strine.

Finally, and most importantly, even if institutional investors may be expected to use sparingly the power to make rules-of-the-game decisions, at least initially, that expectation does not provide a basis for depriving them of such power. The collective action problem at most suggests that granting this power would lead to the adoption of value-increasing changes favored by shareholders in fewer cases than would be desirable. And having fewer such changes than desirable would be better than having none at all.

B. Money Managers with "Special Interests"

Bainbridge argues that the investors that would make the greatest use of additional power are funds with a labor or social activist agenda. Such funds, he is concerned, would bring about arrangements that would advance their agendas at the expense of long-term value, or alternatively would extract concessions from boards by threatening to initiate a vote to pass such an arrangement. As *Increasing Power* stresses, however, proposals that seek to advance special interests at the expense of long-term shareholder value would have no significant chance of passing.⁵⁰ Because most money managers focus on maximizing shareholder value, such proposals would have little chance of obtaining majority support in two consecutive annual meetings.

Indeed, the evidence on shareholders' voting on precatory resolutions provides strong support for this prediction. Although a wide range of precatory resolutions are put forward, the ones that obtain majority support are those — such as proposals to expense options, repeal staggered boards, rescind poison pills, or eliminate supermajority provisions — that are widely viewed by financial institutions as serving shareholder interests.⁵¹ In contrast, proposals that seek to advance

⁵⁰ Bebchuk, *supra* note 4, at 883–84.

⁵¹ See GEORGESON S'HOLDER, ANNUAL CORPORATE GOVERNANCE REVIEW 16 (2005), available at http://www.georgesonshareholder.com/pdf/2005_corpgov_review.pdf. In 2005, the percentage of votes cast "for" averaged 60% for proposals to expense options at the time of grant,

social or labor agendas fall far short of passing. For example, in the 2005 proxy season, while proposals to expense options at the time of grant obtained on average 60% of votes cast, support for proposals to link pay to social criteria averaged 7% of votes cast, and support for proposals to restrict executive compensation averaged 9% of votes cast.⁵²

Thus, the ability to initiate special interest proposals would not give special interest shareholders “blackmail power” with which to extract concessions from the board. Bainbridge argues that these shareholders would still have some such power because the board, facing uncertainty as to whether the proposals will fail, would be willing to make concessions to get rid of the uncertainty.⁵³ Based on the extremely low levels of support that special interest precatory resolutions have received over the years, however, there should be little uncertainty of this sort.

Furthermore, the requirement that shareholder-initiated rule changes obtain approval in two annual meetings would address this concern. In the unlikely event that a special interest proposal were to obtain majority approval in one annual meeting, the board would have ample opportunity before the second annual meeting to campaign against the proposal (or make concessions if need be). Thus, a small initial uncertainty about a proposal’s support would not lead the board to make concessions. Boards would be influenced only by proposals that they view — either to begin with or after passing one vote — as having widespread support among shareholders.⁵⁴

Bainbridge also argues that special interest shareholders would be able to use bundling to achieve passage of their proposals.⁵⁵ Suppose that a shareholder with special interests initiates a vote on a package combining value-reducing special interest measure *A* with value-increasing measure *B* that the board did not initiate. If the combined measure is value-increasing, Bainbridge argues, the packaging will enable the special interest shareholder to pass the special interest meas-

61% for proposals to repeal classified boards, 57% for proposals to rescind poison pills, and 60% for proposals to eliminate supermajority provisions. *Id.*

⁵² *Id.*

⁵³ See Bainbridge, *supra* note 6, at 1756.

⁵⁴ Bainbridge also argues that, because I suggest in my work on executive compensation that directors’ small personal holdings of shares cannot deter them from approving some value-decreasing CEO pay packages, I must also accept that directors might be willing to accept value-decreasing proposals initiated by special interest groups. See *id.* at 1755. But my point in the executive compensation work is that directors’ willingness to favor executives is not countervailed by the reduction in the value of their holdings that a value-reducing package would produce. It hardly follows from this point that directors will be willing to make value-decreasing moves when the moves do not serve the interests of the CEO (or the directors themselves) but rather are desired by outside shareholders with special interests.

⁵⁵ See *id.* at 1756–57.

ure *A*.⁵⁶ However, if confronted with such a package, the board will likely respond by initiating a vote on only *B*; shareholders would then approve the proposal to pass *B* alone.⁵⁷ Thus, packaging will not enable passage of the special interest proposal: shareholder power to initiate rules-of-the-game decisions could pressure boards into adopting value-increasing changes but not value-decreasing ones.⁵⁸

Overall, increasing shareholder power should not be expected to lead to a net increase in the power of special interests to advance their own agenda at the expense of shareholders at large. Indeed, if anything, reforms that increase boards' accountability would generally make them more, not less, attentive to the preferences of the majority of shareholders. Accordingly, such reforms would make boards less, not more, likely to take steps that sacrifice shareholder value.⁵⁹

C. Institutional Investors' Mistakes

Strine expresses reservations about the quality of the judgments that institutional investors have been making — and thus about the quality of the decisions they might be expected to make using the power my proposal would confer on them.⁶⁰ In his view, institutions often display myopia, perhaps due to the high turnover of their portfolios.⁶¹ He observes that institutional investors have supported or at least failed to resist executive compensation plans that produce incentives to focus on short-term results.⁶² He also has reservations about the tendency of some money managers to rely on advisors such as Insti-

⁵⁶ See *id.*

⁵⁷ Of course, a proposal to pass a package of *A* and *B* can also be defeated by a proposal initiated by another shareholder to adopt only *B*, but the board is most likely to engineer this defeat, especially given the advantage that the board will still retain under my proposal. While shareholder-initiated rule changes would have to obtain majority approval in two consecutive annual meetings, a board-initiated change would have to obtain majority approval only once in order to be adopted. Thus, if a special interest shareholder proposes *A* and *B* for vote in an annual meeting, the board will be able to bring only *B* to a vote in that annual meeting, resulting in the approval of *B* and the rejection of *A* and *B* as a package. Or the board can wait, and if the package of *A* and *B* obtains majority approval in that meeting, reflecting wide support for *B*, the board will still be able to propose *B* alone in the next annual meeting.

⁵⁸ Although the package of *A* and *B* will not pass for the reasons just explained, note that, if the board would not otherwise initiate *B*, which is the premise of Bainbridge's point, adopting the package of *A* and *B* would still make shareholders better off compared with having no changes adopted as would occur without shareholder initiation power.

⁵⁹ Indeed, there is some empirical evidence indicating that boards that are less insulated from takeovers are more likely to try to keep labor costs down. See Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535, 545 (1999) (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs).

⁶⁰ Strine, *supra* note 6, at 1766, 1771.

⁶¹ *Id.* at 1764 & n.24.

⁶² *Id.* at 1766–67.

tutional Shareholder Services.⁶³ This skepticism about the quality of institutional investors' judgments makes Strine reluctant to allow them to "tinker with [firm] governance structures."⁶⁴

1. *Assessing the Flaws in Institutions' Judgments.* — I do recognize that there are problems on the investors' side of the market and plan to focus on them in future work. But the existence of these problems does not imply that the judgments of institutional investors on rules-of-the-game decisions would be commonly unreliable. First of all, while Strine is reluctant to allow institutions to make rules-of-the-game decisions, he still finds their judgments considered enough for him to support an increase in shareholder power to replace directors.⁶⁵ But if shareholders can be trusted to make good decisions overall with respect to director replacement, it is not clear why they cannot be trusted to make such decisions with respect to the rules of the game.

Indeed, rules-of-the-game decisions are in important respects less demanding than director replacement decisions. First, unlike the former, the latter usually require company-specific information and assessment. Strine's concern about the unwillingness of institutions to devote resources and attention to governance issues seems especially relevant for such decisions. In contrast, rules-of-the-game decisions depend to a large extent on general, system-wide judgments such as whether expensing options, separating CEO and chair positions, and removing staggered boards are desirable. Making an informed and good judgment on such questions is less demanding of the institutional investor than deciding among the competing teams in fifty contested elections for directors each year.

Second, the fact that some shareholders follow high-turnover strategies and thus might have short-term horizons does not provide a good basis for opposing my proposal. It is far from clear that the rules of the game favored by short-term and by long-term shareholders would commonly differ. If a governance provision does not serve long-term shareholder value, its adoption will likely reduce short-term prices (which reflect expectations about long-term value) — and thus will be unlikely to serve the interests even of short-term shareholders.

Third, assuming the concern about the influence of short-term shareholders is valid and significant, it is mitigated by the requirement that a shareholder-initiated proposal be approved in two consecutive annual meetings. This requirement ensures that a rule change could not result from the preference for a short-term stock rise held by a transient majority reacting to temporary circumstances. While the

⁶³ *Id.* at 1765.

⁶⁴ *Id.* at 1767.

⁶⁵ *See id.* at 1777.

myopia concern might warrant safeguards constraining how quickly or often shareholders may adopt rule changes, it cannot justify preventing shareholders from ever doing so.

Fourth, the record of institutional investors in their voting decisions on precatory resolutions is better than Strine seems to believe. Strine is influenced by a perception that “[l]ittle in the history of the precatory proposal process persuades the traditionalist that institutional investors are able to identify value-maximizing . . . ideas for governance.”⁶⁶ However, an examination of the types of precatory resolutions that have been receiving majority support from shareholders indicates that none of them reflects the poor judgment that concerns Strine.

As already noted, precatory resolutions that have commonly obtained majority support are those calling for expensing options at the time of grant, requiring shareholder approval for future golden parachutes, repealing classified boards, rescinding poison pills, or eliminating supermajority provisions.⁶⁷ Whatever position one holds on the option-expensing debate, support for expensing is clearly not an unreasonable view or one that reflects poor judgment. As to classified boards, poison pills, golden parachutes, and supermajority provisions, Alma Cohen, Allen Ferrell, and I find in our recent study that, of the universe of governance provisions followed by the Investor Responsibility Research Center, these arrangements are among the most negatively correlated with firm value.⁶⁸ Correlation does not imply causation, and the evidence does not unambiguously establish that these provisions are value-reducing. Clearly, however, the choices that shareholders have made are hardly ones that call into question institutional investors’ judgments.

2. *What Is the Alternative?* — Having questioned the validity of concerns based on possible mistaken judgments by institutional investors, I now turn to the final and most important reason for doubting whether these concerns justify opposing shareholder power to make rules-of-the-game decisions. Granting the validity of these concerns does not imply that shareholders should be denied such power. It is certainly true that institutions are unlikely always to make perfect choices. But the choice is not between imperfect decisionmaking by shareholders and a mechanism generating perfect decisions. The choice is between giving shareholders power to influence the rules of the game and maintaining boards’ indefinite control over these rules.

⁶⁶ *Id.* at 1771.

⁶⁷ See GEORGESON S’HOLDER, *supra* note 51, at 16.

⁶⁸ Lucian Bebchuk et al., *What Matters in Corporate Governance* 16–22 (John M. Olin Ctr. for Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 491, 2004), available at http://papers.ssrn.com/abstract_id=593423.

Given this choice, the prospect of institutions making occasional mistakes hardly indicates that the alternative of board control is superior. While Strine might be correct that institutions have made some mistaken judgments to support (or at least not oppose) boards' decisions adopting flawed pay arrangements, it would be hard to argue that boards' decisions in this area were better.⁶⁹ And while institutions might have been mistaken as to which packages would best serve shareholders, boards might have been at least partly influenced by objectives other than enhancing shareholder value.⁷⁰

What makes board control of the rules of the game so unattractive is that these rules are supposed to regulate and constrain the company's directors and officers. Giving those being regulated the power to control all adjustments to the regulations is bound to distort the governance arrangements of public companies in management's favor.

Consider again the question of staggered boards. Most of the staggered boards that companies now have were put in place prior to the development of the rules that made staggered boards such a powerful takeover defense.⁷¹ Should a board control forever whether it will retain a classified structure? Even accepting that the desirability of staggered boards is a matter on which reasonable people may disagree, giving the decision to directors — the party protected by the staggered board — appears problematic. Even accepting the shortcomings of institutional investors, letting shareholders influence such decisions could well be better.

Thus, although shareholder power to make rules-of-the-game decisions would have its own costs, letting boards control the rules, or having the government make all necessary adjustments to the rules over time, are likely to be worse options. Anyone concerned about the quality of the arrangements governing public companies would do well to consider not only the potential problems with investors' involvement but also whether leaving governance arrangements under the full control of boards is an acceptable alternative. In my view, it is not.

⁶⁹ Elsewhere in his Response Strine seems to share the view that board decisions with respect to executive compensation practices have been far from exemplary. *See* Strine, *supra* note 6, at 1766–67 & n.28.

⁷⁰ *See* BEBCHUK & FRIED, *supra* note 1, at 23–44.

⁷¹ *See* Bebchuk, Coates & Subramanian, *supra* note 20, at 939–44.

V. ARE ALL BENEFICIAL ARRANGEMENTS ALREADY IN THE MARKETPLACE?

A. *Pangloss Redux*

Bainbridge devotes a significant part of his Response to describing the standard contractarian argument that the marketplace can be expected to produce on its own *all* optimal governance terms. Bainbridge begins by posing the following question: “If shareholder empowerment is as value-enhancing as Bebchuk claims, why do we not already see it in the marketplace?”⁷² On his view, the very fact that the proposed arrangement is not already offered in the marketplace indicates that the arrangement is not value-enhancing. “We . . . may appropriately infer from the existing regime,” Bainbridge argues, “that investors in fact have a revealed preference for director primacy.”⁷³

Below I discuss the problems with Bainbridge’s use of this argument to oppose my proposal. But I should note at the outset that this standard contractarian argument is not uniquely applicable to the proposal made by *Increasing Power*. It is available “off-the-shelf” and can be rolled out against any proposed legal rule (whether default or mandatory) that changes current arrangements. Indeed, contractarians have used this argument to criticize all investor-protection rules proposed or adopted over the years. For example, Professors Carlton and Fischel used it to criticize the constraints on insider trading that federal law introduced several decades ago.⁷⁴ According to these authors, the fact that corporate charters had not prohibited insider trading prior to the federal prohibitions indicates that permitting insider trading is likely efficient and that the current prohibitions are likely value-decreasing.

Increasing Power refers to this standard contractarian argument, which presumes that the marketplace already offers all optimal governance arrangements, as Panglossian.⁷⁵ If the Panglossian argument were valid, it would have far-reaching consequences. It would imply that much of the protection U.S. investors now enjoy — which results from arrangements introduced by federal rules and exchange requirements and not previously offered by corporate charters and state law — is value-reducing and should be dismantled.

⁷² Bainbridge, *supra* note 6, at 1736.

⁷³ *Id.* at 1744.

⁷⁴ Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 894–95 (1983).

⁷⁵ Bebchuk, *supra* note 4, at 888–90; *see also* Lucian Arye Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. LAW. 1047, 1049–59 (2002) (arguing that competition among states results in excessive protection for incumbent managers).

The standard contractarian argument Bainbridge uses consists of two claims — the IPO claim and the state competition claim. According to the IPO claim, those who take companies public have incentives to include optimal governance provisions in the IPO charter.⁷⁶ According to the state competition claim, states seeking to attract incorporations have incentives to provide value-maximizing rules because those taking a company public have an incentive to incorporate in a state offering such rules.⁷⁷ On the contractarians' view, the IPO mechanism and the state competition mechanism reinforce each other, together operating to produce a strong presumption that arrangements not produced by the marketplace are not value-enhancing. Below I discuss in turn each of the two mechanisms on which Bainbridge relies.

B. IPO Charters

Bainbridge, following the standard contractarian argument, argues that firms can be expected to include optimal terms in their charters at the IPO stage, when “the incentive so to do is particularly strong.”⁷⁸ Thus, he argues, the fact that the arrangement proposed by *Increasing Power* is not found in IPO charters is a strong blow against it.

In my view, firms going public cannot be expected to make optimal choices from the menu of permissible provisions for several reasons that I describe in detail in earlier work.⁷⁹ For one thing, the contractarian assumption that all governance arrangements are accurately priced at the IPO stage is just that: an assumption. There is now a large body of empirical evidence calling into question the extent to which capital markets accurately incorporate all available public information.⁸⁰ And there is little empirical work that tests whether, in particular, legal arrangements are accurately priced by the market.

⁷⁶ See, e.g., Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543–46 (1984); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418–22 (1989).

⁷⁷ See, e.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 253–62, 273–76 (1977).

⁷⁸ Bainbridge, *supra* note 6, at 1739.

⁷⁹ See Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1395–1408 (1989); Lucian Arye Bebchuk, *Why Firms Adopt Anti-takeover Arrangements*, 152 U. PA. L. REV. 713, 719–48 (2003); Lucian Arye Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* 1–28 (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper Series No. 398, 2002), available at <http://ssrn.com/abstract=327842>.

⁸⁰ For reviews of the evidence on the subject, see ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000); and Nicholas C. Barberis & Richard H. Thaler, *A Survey of Behavioral Finance*, in *HANDBOOK OF THE ECONOMICS OF FINANCE* 1053 (2003).

Furthermore, and most important for this exchange, even assuming that firms can be expected to include the most value-maximizing arrangements available in their IPO charters, no inference against my proposed regime can be based on the absence of these terms from corporate charters. As I stress in *Increasing Power*, state corporate law mandates board control over charter amendments and reincorporations, features from which firms are not free to opt out.⁸¹ While state corporate law follows an enabling approach with respect to most corporate law issues, it does not do so with respect to board control over rules-of-the-game decisions. Although Bainbridge devotes substantial attention to firms' incentives to offer optimal provisions at the IPO stage and to inferences from the absence of my proposed arrangement in IPO charters, his analysis does not take into account that firms have not been permitted to include this arrangement in their charters. Bainbridge does note the mandatory nature of state law on this subject,⁸² but he does not take this aspect of state law into account when he subsequently questions my proposal on grounds of its absence from charters.⁸³

As a good contractarian,⁸⁴ Bainbridge should be troubled by the fact that state law has thus far mandated board control over the rules of the game. This aspect of existing corporate arrangements is clearly undesirable from a contractarian perspective, and Bainbridge should be prepared to criticize mandatory arrangements that happen to protect boards. At the minimum, Bainbridge should not use the absence of my regime from charters — an absence that state law has compelled — as evidence that such a regime would reduce shareholder value.

C. State Competition

The competition among states for incorporations is the second mechanism on which Bainbridge relies to ensure the presence of all value-increasing arrangements in the marketplace.⁸⁵ Subscribing to the “race to the top” view,⁸⁶ Bainbridge believes that the “process of competitive federalism tends to produce those laws preferred by investors.”⁸⁷ On this view, because states seeking incorporations wish to attract founders taking firms public — and because firm founders seek

⁸¹ See Bebchuk, *supra* note 4, at 888–90.

⁸² See Bainbridge, *supra* note 6, at 1735 & n.5.

⁸³ See, e.g., *id.* at 1736–37.

⁸⁴ See *id.* at 1735 n.5 (describing himself as a “contractarian”).

⁸⁵ See *id.* at 1741–42.

⁸⁶ For early works putting forward this view, see generally FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 212–27 (1991); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); and Winter, *supra* note 77.

⁸⁷ Bainbridge, *supra* note 6, at 1742.

states offering rules desired by investors — states have incentives to establish rules that maximize shareholder value.

1. *Assuming that State Competition Works Well Overall Does Not Establish a Presumption Against My Proposal.* — Even accepting Bainbridge's favorable view of state competition and the rules it produces, it is far from clear why Bainbridge would dismiss my proposal at the outset, or apply a strong presumption against it, on the ground that it is not already part of state law. For one thing, state law has adopted many changes in rules over time, and current state law is thus a product of such changes.⁸⁸ Accordingly, one who views current state law favorably, as Bainbridge does, should keep an open mind to suggested changes to current state law.

Furthermore, Bainbridge does explicitly accept that state law might be inefficient on significant issues involving board control. He concedes that state antitakeover law provides boards with excessive insulation from takeovers,⁸⁹ and he has reservations about the failure of state law to facilitate proxy contests.⁹⁰ These views imply that current state law might fail to serve shareholders, and could be improved, with respect to important issues of corporate law.

Indeed, Bainbridge accepts not only that state law might sometimes fail to produce value-maximizing rules but also that such failure is especially likely for issues affecting board control. He concedes that one could expect managers to push for and obtain from states rules that put “[managers’] interests ahead of those of shareholders” in those cases in which managers’ control is most threatened.⁹¹ But my proposal deals directly with the degree to which management controls the company’s rule book. Thus, Bainbridge should be more receptive to the possibility that managers have been able to obtain from states not only rules that insulate them excessively from control contests, but also rules that provide them with excessive control over rules-of-the-game decisions.

2. *The Failings of State Competition.* — The preliminary discussion above indicates that, even accepting Bainbridge’s view that state competition commonly works well, there are good reasons not to establish a presumption against my proposal merely because it has not already been adopted by state law. It is important to stress, however, that there are also good reasons not to accept such a favorable view of state competition. Because I discuss in detail the failings of state com-

⁸⁸ See, e.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 233–42 (1985) (discussing some corporate law changes that Delaware and other states have adopted over the years).

⁸⁹ See Bainbridge, *supra* note 6, at 1742.

⁹⁰ See *id.* at 1740.

⁹¹ *Id.*

petition in a series of articles,⁹² I only briefly outline several reasons for not accepting such a view of state competition.

(a) *Reincorporations*. — First, while Bainbridge and other race-to-the-top scholars focus on states' incentives to attract incorporations from firms that go public, states are also concerned about reincorporations.⁹³ The control that boards have long had over reincorporation decisions has provided states with incentives to supply rules that boards favor, even if those rules are not the ones most favored by investors. By providing shareholders with the power to make reincorporation decisions, my proposal would reduce states' future incentives to cater to managers' interests over those of investors. Any attempt to make inferences from existing state law should recognize that it is a product of a process distorted by management's control over reincorporations.

(b) *Tensions Within the Race-to-the-Top Account*. — Second, there is a tension between the substantive content of current state law and the reason contractarians offer for why state competition can be expected to produce optimal rules.⁹⁴ States have incentives to adopt value-maximizing rules, contractarians argue, because firms that are free to choose among competing state law systems can be expected to choose the value-maximizing arrangements. While this argument is based on the optimality of firm choices among alternative governance arrangements, important elements of state law are mandatory. In particular, Delaware's judge-made fiduciary duty law, which supporters of state competition hail, is largely mandatory.

Now if firms can generally be relied on to make optimal choices among governance provisions, then the mandatory features of state law cannot be optimal; prohibitions on firms' contractual freedom are desirable only if firms cannot be relied on to make optimal choices

⁹² See Bebchuk, *supra* note 14; see also Oren Bar-Gill et al., *The Market for Corporate Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 134 (2006); Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where To Incorporate*, 46 J.L. & ECON. 383 (2003) [hereinafter Bebchuk & Cohen, *Firms' Decisions*]; Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race To Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999) [hereinafter Bebchuk & Ferrell, *Federalism and Corporate Law*]; Lucian A. Bebchuk & Assaf Hamdani, *The Path of Federal Corporate Law*, 106 COLUM. L. REV. (forthcoming 2006) [hereinafter Bebchuk & Hamdani, *The Path of Federal Corporate Law*]; Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002) [hereinafter Bebchuk & Hamdani, *Vigorous Race*].

⁹³ The problems resulting from board control over reincorporation decisions were first analyzed in Bebchuk, *supra* note 14. For a formal model of these problems, see Bar-Gill et al., *supra* note 92. See also Bebchuk & Ferrell, *supra* note 92, at 1172–77 (focusing on how state antitakeover law has diverged from shareholder interests due to problems resulting from board control over reincorporations).

⁹⁴ See Bebchuk, *supra* note 14, at 1496–99.

when designing their IPO charters. But if firms cannot be relied on to make optimal choices among alternative charter provisions, then they cannot be relied on to make optimal choices among alternative states of incorporation. And if firms do not make incorporation choices that are optimal for shareholders, then state competition cannot be expected to yield a value-maximizing regime.

(c) *Lack of Competition.* — Third, while Bainbridge's discussion assumes that states vigorously compete for reincorporations, the competition is more akin to a leisurely walk.⁹⁵ There is empirical evidence that a very large majority of companies are incorporated either in Delaware or in their states of headquarters.⁹⁶ In the market for out-of-state incorporations, Delaware is a virtual monopolist,⁹⁷ with other states merely offering incorporation services to local companies without charging them any significant franchise tax.⁹⁸

Because states other than Delaware do not focus on obtaining revenues from the incorporation business, their choice of rules is likely to be influenced significantly by the local bar (which seeks to keep local companies incorporated in-state) and the managers of public companies headquartered in-state.⁹⁹ And because Delaware seeks to attract companies headquartered in other states, decisions by other states to favor management push Delaware to do the same.¹⁰⁰

(d) *Delaware's "Relatively Moderate" Antitakeover Law.* — Fourth, Bainbridge draws race-to-the-top inferences, as other subscribers to this view do, from the fact that Delaware's takeover law provides management with weaker protection from takeovers than the law of some other states.¹⁰¹ However, as Alma Cohen, Allen Ferrell, and I explain in a recent review of the evidence on state competition, this inference is invalid for several reasons Bainbridge fails to address.¹⁰²

To begin, Delaware's antitakeover protections are more moderate than those of some states but stronger than those of others. Furthermore, the outcome of state competition cannot be assessed by comparing Delaware law with that of other states. Assuming that Delaware's antitakeover laws are relatively moderate, it still is possible, indeed likely, that state competition supplies all states with incentives to pro-

⁹⁵ This argument is fully developed in Bebchuk & Hamdani, *Vigorous Race*, *supra* note 92.

⁹⁶ See Bebchuk & Cohen, *supra* note 92, at 388–94; Bebchuk & Hamdani, *Vigorous Race*, *supra* note 92, at 564–68.

⁹⁷ See Bebchuk & Hamdani, *Vigorous Race*, *supra* note 92, at 576–80.

⁹⁸ See *id.* at 573.

⁹⁹ See *id.* at 606–07.

¹⁰⁰ See *id.* at 607.

¹⁰¹ See EASTERBROOK & FISCHER, *supra* note 86, at 222–23; ROMANO, *supra* note 86, at 59–60; Bainbridge, *supra* note 6, at 1743.

¹⁰² See Bebchuk et al., *supra* note 92, at 1803–04.

vide excessive protection from takeovers. This theoretical possibility is supported by the empirical evidence that states adopting more anti-takeover provisions are significantly more successful in attracting incorporation from in-state companies.¹⁰³

(e) *The Empirical Evidence.* — Fifth, contrary to the claims of Bainbridge and other supporters of the race-to-the-top view,¹⁰⁴ the existing body of empirical evidence does not support this view. Cohen, Ferrell, and I document in detail the grounds for this conclusion in our review of the evidence.¹⁰⁵ For example, the evidence on whether Delaware incorporation is correlated with higher Tobin's *Q* (a standard measure of firm value used by financial economists) is rather mixed.¹⁰⁶ In any event, such a correlation would not imply that Delaware law increases value; such a correlation could simply reflect a selection effect — that is, a tendency of higher-value firms to incorporate in Delaware.¹⁰⁷

Similarly, the evidence is mixed as to whether reincorporation in Delaware correlates with a positive abnormal return.¹⁰⁸ And even if such a correlation did exist, it would not imply that Delaware law increases value. Such correlation could be due simply to confounding events — that is, it could reflect a tendency of firms to bring reincorporation proposals when they have good news for shareholders or expect to have good developments in the future.¹⁰⁹

¹⁰³ See *id.* at 1815–18; Bebchuk & Cohen, *supra* note 92, at 411–17; Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1801 (2002).

¹⁰⁴ See Bainbridge, *supra* note 6, at 1742–43; see also EASTERBROOK & FISCHER, *supra* note 86, at 214–15; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2384 (1998) (“The empirical research on state competition undermines the race-for-the-bottom argument . . .”).

¹⁰⁵ See Bebchuk et al., *supra* note 92.

¹⁰⁶ Bainbridge relies on Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001). See Bainbridge, *supra* note 6, at 1743. Although Daines found a correlation between Delaware incorporation and increased Tobin's *Q*, subsequent studies using a larger set of controls do not confirm this finding. See Bebchuk & Cohen, *supra* note 92, at 403 (finding no evidence of such a correlation in 1999); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 41 (2004) (finding no evidence of such a correlation during the 1990s except for firms with a very small market value).

¹⁰⁷ There are good reasons (including empirical evidence) for believing that the selection of state of incorporation is not random and that the selection problem is significant enough to make it impossible to draw inferences about the superiority of Delaware state law from a correlation between Delaware incorporation and higher Tobin's *Q*. For a detailed discussion of the selection problem, see Bebchuk et al., *supra* note 92, at 1788–90.

¹⁰⁸ Bainbridge relies on the event study conducted by Romano, *supra* note 88. See Bainbridge, *supra* note 6, at 1743. But subsequent event studies paint a far more mixed picture. See Bebchuk et al., *supra* note 92, at 1790–97 (reviewing the full set of event studies on reincorporation).

¹⁰⁹ There are good reasons for believing that management decisions to bring a reincorporation proposal, and to bring it at a particular time, are not random. Any stock return accompanying a reincorporation could thus be due to management decisions to schedule reincorporation votes in

Moreover, even if this type of empirical work could and did establish that Delaware's law was superior to that of other states, such a finding would not imply that state competition works well overall. Because state laws are quite similar to each other, and because Delaware firms derive benefits from network externalities and access to a specialized judiciary, a somewhat higher value for Delaware firms would be fully consistent with an equilibrium in which Delaware and other states all offer considerably suboptimal protections to investors.¹¹⁰

(f) *The Lessons of History*. — Sixth, as Assaf Hamdani and I document in a study of the path of federal intervention over the past seven decades, federal intervention has systematically replaced state law arrangements with regimes more protective of investors.¹¹¹ Without the federal interventions of the past seven decades, the U.S. level of investor protection would likely be much lower than it is at present. Readers should not buy into the race-to-the-top view unless they are prepared to accept that existing U.S. law provides investors with an excessive level of protection.

Thus, although my proposal deserves consideration even by those who believe state competition works well, there are substantial reasons to question that belief. Overall, there is a strong basis for concluding that state law has been and continues to be distorted in management's favor. For this reason, I am far from optimistic that, at least in the absence of fear of federal intervention, state law will move significantly toward enhancing shareholders' power. For the purposes of this exchange, however, the important point is that such a shift would be desirable.

Finally, it should be noted that, while there are valid and serious concerns about the performance of state competition thus far, this performance would be significantly improved were shareholders given the power to initiate and adopt reincorporation decisions through the proposed procedure.¹¹² Eliminating board control over reincorporations

relatively good times, or to inferences about management's private information concerning the company's future that investors might draw from the decision to bring a reincorporation proposal or from its timing. For a detailed discussion of the confounding events problem, see Bebchuk et al., *supra* note 92, at 1792–97.

¹¹⁰ For a demonstration of this point in a formal model of state competition, see Bar-Gill et al., *supra* note 92.

¹¹¹ See Bebchuk & Hamdani, *The Path of Federal Corporate Law*, *supra* note 92.

¹¹² Whereas *Increasing Power* puts forward the case for shareholder power to make rules-of-the-game decisions in general — including but not limited to decisions to reincorporate — earlier works I coauthored focused on allowing shareholders to opt into another state's corporate law or a federal regime. See Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001); Bebchuk & Hamdani, *Vigorous Race*, *supra* note 92, at 610–14; see also Lucian Bebchuk & Allen Ferrell, *Federal Intervention To Enhance Shareholder Choice*, 87 VA. L. REV. 993 (2001); Bebchuk & Ferrell, *supra* note 75 (responding to

would reduce states' incentives to favor management. This beneficial effect on states' incentives, and thus on the evolution of state law, is an important advantage of the proposed regime.

VI. CONCLUSION

Public companies often live long lives in ever-changing circumstances. Anyone concerned about private ordering in corporate law should thus be concerned about the process that produces public firms' ongoing governance choices. Under longstanding mandatory rules of state corporate law, the board controls decisions to change the corporate charter or the state of incorporation. As I show here, as well as in *Increasing Power*, boards' control over changes in the rules of the game regulating their own power is highly problematic. Moving to a regime with shareholder power to make such decisions would improve governance arrangements across a wide range of corporate issues.

I also examine, both here and in *Increasing Power*, possible objections to such shareholder power and show that they either are invalid or could be addressed by appropriate rule design. Giving shareholders such power would be consistent with centralized management in public companies, would not be made unnecessary by reforms in corporate elections, and should not be dismissed because of the shortcomings of institutional investors as agents.

Finally, the proposed regime should hardly be dismissed because it is not already in the marketplace. The fact that board control has long been a mandatory feature of state law should induce even pure contractarians to reconsider the allocation of power over rules-of-the-game decisions. There is a strong case for a serious reexamination of this basic corporate law question.

criticisms of the Bebchuk-Ferrell proposal to allow shareholders to opt into a federal takeover regime). For a formal demonstration of how giving shareholders power to make reincorporation decisions would improve state law, see Bar-Gill et al., *supra* note 92.