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COMMENT: THE CASE FOR REAL SHAREHOLDER DEMOCRACY

George Dent[†]

We have now had two excellent presentations of opposing views.¹ In order to continue to build on this success, I will try to give a provocative idea here. Craig White did an able job of taking on Lucian Bebchuk from one side of the continuum. What I will do—and, Professor Bebchuk, if you think this is unfair, well, that’s just tough—I am going to take you on from the other side.

I agree with Professor Bebchuk that our corporate governance system now is flawed, that many boards of directors are heavily influenced or dominated by the CEO so that the company is not managed with the goal of maximizing shareholder wealth. I also agree with him that more shareholder input into the election of directors would improve things, but that the reforms recently enacted or proposed do not go far enough in this direction.

We have heard statements from a couple of speakers today to the effect that most boards are doing a good job. Most boards have improved, and are trying to do the right thing; I am not going to question that. But that seems to me like saying, “Most people don’t engage in armed robbery, so why do we need laws against armed robbery?” In a minority of companies, boards are still not doing a good job. In several recent cases catastrophes struck corporations, and boards were not there to prevent this from happening. It is unrealistic to think that conditions have changed so that the same thing could not possibly happen again today. I am confident that there are some boards where the same thing could happen. But I am not sure Rule 14a-11² would

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¹ See Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557 (2005); Craig Owen White, *Corporate Governance: Directors v. Shareholders?*, 55 CASE W. RES. L. REV. 569 (2005).

² Security Holder Director Nominations, 68 Fed. Reg. 60784-01 (proposed Oct. 23,

even help prevent such incidents. Professor Bebchuk admits that any benefits from the rule would be small.

We have heard references to some of the rule's detriments this morning: disruption and diversion of company personnel to deal with more frequent election contests, deterrence of the best candidates from serving as directors because life is going to be unpleasant on boards, and balkanization of boards into hostile factions. I think those supposed detriments have been exaggerated by the critics. But if the rule has even small detriments, they still outweigh its benefits because those benefits will be paltry. Professor Bebchuk has said in defense of Rule 14a-11 that even if it does not bring much improvement, its lack of success could justify consideration of more expansive reforms of corporate elections; people will come back and say we need to go farther down that road.

I am not sure that would happen. First of all, pro-management forces will be saying—and we have already had a hint of this in some comments this morning—that we should take more time to see if these reforms work. Of course, “more time” turns out to be basically forever. Second, the failure of Rule 14a-11 could weaken the enthusiasm of investors for more shareholder involvement in elections. In other words, if 14a-11 produces no benefits, the reaction may not be that we need to go farther in the same direction. Rather, investors may lose hope for efforts to strengthen shareholder democracy.

Furthermore, as I mentioned before, the enthusiasm for reform ebbs and flows. At most times there is little impetus for reform. We have now a window of opportunity. If we let that window shut without doing anything substantial, it may be a long time before it opens again.

I am not suggesting, though, that we abandon efforts for more shareholder input. Quite the contrary, I offer what will be to Professor Bebchuk, I hope, a friendly challenge, and to Mr. White what will be more of a provocation, and that is to consider an alternative that is bolder and yet quite simple.

I propose that the nomination of the corporation's official slate of directors be removed from the incumbent board, which is often passive and dominated by the CEO, and be given instead to a committee consisting of the ten to twenty largest shareholders. These shareholders should seek directors who strive to maximize shareholder wealth.

Choosing different directors is not, however, the primary objective. As Professor Bebchuk and others have suggested, independence

in the sense of a lack of conflicts of interest is no guarantee of effective board performance. The more important goal is to change the incentives of directors. As a behavioral psychologist would say: The question is not so much *who* sits on the board, but what is their schedule of reinforcement? There was mention earlier today of a conference directed by Jay Lorsch at Harvard. He has said that too many directors feel that they serve at the pleasure of the CEO.³ Directors who were selected *by* the shareholders would strive to *serve* the shareholders, even if they were the same people who are serving on the board now.

Right now there is a lot of pressure on directors to go along with the CEO. If you do not feel like doing that, what do you do? You do not fight. You either do not take the position to begin with, or you say, "This is not fun, I don't want to serve on this board any more." If the same people were really chosen by the shareholders, their incentive would be to serve the interests of shareholders. It is not really again a question of whether they are independent, or unaffiliated. It is a question of where the incentives are.

But would directors so chosen serve special interests of the larger shareholders? This is a criticism we always get of shareholder primacy, but it is highly improbable. Professor Bebchuk touched on this in connection with 14a-11, and I think the same thing is true of my proposal. Any special interest would have to be shared by a majority of the largest shareholders. It is hard to imagine such a situation arising. Besides, the committee I envision would only nominate directors. If the nominees seem committed to special interests, if by some unimaginable scenario all the official nominees were beholden to the company's labor union, other shareholders would have an incentive to run and elect an opposing slate.

Would directors chosen by shareholders overemphasize short-term performance? It is a common criticism that investors are only concerned about short-term performance. It is hard for me to imagine that the largest shareholders would communicate to directors that they want the board to focus on next quarter's earnings.

Even if the largest shareholders did that, the directors would have an incentive to ignore them so as not to offend shareholders who are concerned about shareholder wealth. Lots of directors serve on many boards. How do you get a reputation for being a good director so that you will be invited to serve and remain on other boards? Today, you at least have to get along with the CEO because the selection process

³ JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES 17 (1989).

is heavily influenced by the CEO. The CEO typically has a veto over, or actually dominates, the selection of directors.

Now imagine a world in which the selection of directors was dominated by shareholders. Even if you came under pressure from some of your own shareholders in a particular company to focus on the short-term, you would have to think, "Wait a second. If I do that and the company's fortunes briefly flare and then fizzle, is that going to enhance my reputation as a director?"

If instead you enhance share value, lots of investors will be impressed and want you to sit on the boards of their companies. So it is unlikely that directors chosen by shareholders would focus on the short-term at the expense of prudent, patient capital.

Would directors chosen to serve shareholders mistreat other constituencies? That too is unlikely.

First, what are the interests of the other constituencies? True, for an employee of an unprofitable plant it is better that the company keeps running that plant, even if it means the company may go bankrupt in a few years, rather than shut it down today.

But, in general, employees, customers, suppliers, and the communities in which companies operate tend to benefit themselves from the efficient operation of the corporation. Generally, the companies that are the most profitable grow the most rapidly, and the companies that grow the most rapidly are likely to increase employment, wages, and benefits. So in the long run, employees' interests are very little different from, if not identical to, the shareholders' goal of maximizing shareholder wealth.

The criticisms of shareholder primacy seem to me to be weak. One possible response is to ask if one can guarantee that this or that parade of horrors will not occur under my proposal. Of course, the answer to that is no; one never can. Human institutions are always imperfect. Recall Churchill's comment about democracy: It is the worst form of government except for all the others that have ever been tried.

Just as democracy is imperfect, shareholder primacy will be imperfect because directors, investors, and executives are human beings. The proper question is not, "Is it perfect?" The proper question is, "Compared to what?" We should compare shareholder primacy with the current system in which most boards are heavily influenced, if not dominated, by the CEO.

I noted the objection that shareholder primacy leads to domination by special interests. Well, managers have their own special interests, and there is plenty of evidence that they use their influence now to

advance those interests. Professor Bebchuk has done studies about excessive compensation. We have seen in the last ten or twelve years that executive compensation exploded without any justification in managers' performance that I am aware of.

Another current problem is empire building, as when CEOs devote corporate resources to unprofitable acquisitions or to other unpromising projects. As for concern for other constituencies, CEOs have no reason to treat them better than shareholders would, and there is no evidence that they do so now.

As for short-term focus, we have already seen plenty of that with pump and dump schemes by executives who exaggerate earnings and then sell their stock at artificially inflated prices. It would be a lot harder for the ten to twenty larger shareholders to pull a stunt like that. So even if you are less sanguine than I am about the idea of shareholder control, it is hard to argue that it would be worse than CEO domination is now.

You all know the story of the economist who is walking with a student. The student says, "Professor, that looks like a \$20 bill on the street. Shall I pick it up?" The economist says, "Don't be silly. If it really were a \$20 bill, somebody would have already picked it up."

Well, if this idea I am putting forth is so great, why didn't somebody else already think of it? Why hasn't some state tried to challenge Delaware by adopting this law? Why don't investor groups push it? As for the states, occasional efforts by other states to take franchise business away from Delaware have invariably failed.

First of all, Delaware has a big advantage to start with just in having a fully fleshed out, well known statute. For any state to compete it would have to offer a law that was not just marginally but dramatically better than Delaware's. And if some state did that, Delaware would just move its law in the same direction and regain its initial advantage from superior judicial competence and familiarity. So, whatever benefits there might be in what I am suggesting, it is highly unlikely that North Dakota could attract a huge number of franchise fees by adopting it.

As for investors, they have the same collective action problem with respect to legislation that they have now in voting. Suppose TIAA-CREF or some other institutional investor waged a big campaign to improve corporate governance. TIAA-CREF is a big outfit, but it still owns just a tiny fraction of all American stock. So its share of any benefit from better corporate governance would also be small, and proportionately no greater than any other investor's gain. There

really is not much incentive for any particular investor to knock itself out to change the system.

That does not mean, though, that shareholders are taking abuses lying down. Bob Monks claims that excessive executive compensation alone exacts a tax of ten percent on investors, and that, to escape this mistreatment, investors are fleeing to private equity.⁴ Why?

Well, venture capitalist and leveraged buyout firms do participate actively in choosing directors, and this participation does not seem to result in mistreatment of other constituencies, subjection of the portfolio company to special interests or excessive focus on short-term performance, or any of the other horrors conjured up by critics of shareholder primacy.

In general, these firms are well managed and do not waste resources on unprofitable undertakings. I realize that shareholder control is not politically viable right away, but I am an academic—I think ideas have consequences—and people who care about corporate performance as a key element of the success of the American economy can get behind good ideas. I hope that eventually this proposal will be adopted.

⁴ Lucian Arye Bebchuk, *Symposium on Corporate Elections*, Harvard Law and Economics Discussion Paper No. 448, *17, at <http://ssrn.com/abstract=471640> (November 2003) (Comment of Robert Monks).