Shareholder Passivity Reexamined†

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I. INTRODUCTION

The problem of who watches the watchers is as old as government, and not much more tractable for corporate than for government organizations. In theory, the shareholders of public companies elect directors, who watch corporate officers, who manage/watch the company on the shareholders' behalf. But since Berle and Means, we have understood that this theory is a fiction. The managers — the current officers and directors — pick the directors, and the shareholders rubberstamp the managers' choices.1 Perhaps thrice in a thousand cases, unhappy shareholders mount a proxy fight. About one fourth of the time, they win.2

Most modern corporate scholars, especially those with a law-and-economics bent, accept shareholder passivity as inevitable. They rely on market forces, especially takeovers, to limit managerial discretion. The critics' claim, stripped to its essentials, is that shareholders don't care much about voting except in extreme cases and never will. Collective action problems, which arise because each shareholder owns a small fraction of a company's stock, explain why shareholders can't be expected to care. I will call this view the "passivity story."

Takeovers have their place, but they are a costly and imperfect way to discipline wayward managers. Only a badly mismanaged target can justify the typical 50% takeover premium. Hostile takeovers also face strong legal obstacles, notably poison pills and state antitakeover laws, that didn't exist a few years ago. And for companies with competent managers who just need closer oversight, the takeover remedy, which usually involves kicking out the old managers, is disproportionate to the problem, and adds large disruption and transaction costs. So it's important to know whether shareholder voice can't work, as the critics claim, or whether it just hasn't been tried. 3

This article attempts, from within the law-and-economics tradition, to resurrect shareholder voice as a constraint on corporate managers. I argue that the critics' legal analysis is misdirected; their factual assumptions about shareholder size are obsolete; and their collective action explanation for passivity is superficial. Shareholder voting, historically only a minor nuisance to corporate managers, can become an important part of the multistrand web of imperfect constraints on managers, if legal rules permit. My emphasis is on the formal act of voting. Much actual oversight undoubtedly will be informal, but meaningful informal oversight will take place only if the formal power is available should it be needed.

This article focuses on shareholder voting short of a full-scale proxy fight, in which dissidents seek majority control of a company's board of directors. Proxy fights are in important ways more closely akin to hostile takeovers than to shareholder action that isn't directed at replacing particular corporate officers. Proxy fights also raise concerns about the abuse of power by dissident shareholders if they win, concerns that are weaker when control is not at stake. I will try to indicate where my analysis applies to proxy fights, but I will not ex-

3. I use "shareholder voice" broadly to mean any formal or informal effort to monitor corporate managers or to communicate a desire for change in a company's management or policies. See generally A. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).
plore the special issues that proxy fights raise.4

The passivity story assumes a benign legal environment. It sees shareholders as passive despite legal efforts, through the proxy rules, to facilitate shareholder voice. The failed legal efforts to help shareholders become evidence that shareholders don’t care about voting. In fact, institutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to own large percentage stakes or undertake joint efforts. Legal obstacles are especially great for shareholder efforts to nominate and elect directors, even to a minority of board seats. The proxy rules, in particular, help shareholders in some ways, but mostly hinder shareholder efforts to nominate and elect directors. Over the last 25 years, as institutional ownership has grown to levels that make shareholder activism feasible, legal obstacles have grown as well, often as byproducts of rules aimed at controlling takeovers. Cultural norms for proper and improper behavior by money managers reinforce these legal obstacles.

For the most part, no one legal barrier is insurmountable. The problem, instead, is the total burden imposed by many rules, including legal risk in the many areas where the law is uncertain. Institutional fiduciaries have strong incentives to avoid legal risk, because they face personal exposure if the risk comes to pass, while their beneficiaries get most of the upside. They care less about the conduct that legal rules, read narrowly, might permit, than about what those rules, read broadly, might prohibit.

The passivity story also assumes a company with thousands of anonymous shareholders, each owning a tiny fraction of the company’s voting stock. That assumption, never wholly true, is increasingly obsolete. Institutional investors have grown large enough so that a limited number of institutions own a sizeable percentage of the shares of most public companies. Moreover, the fastest growing institutions are public pension funds and mutual funds, which face fewer direct conflicts of interest in monitoring corporate managers than the corporate pension funds and bank trust departments who were formerly the principal institutional shareholders. Large institutions can combine forces, form trade groups to represent their collective interest, and one way or another act as monitors of corporate managers, if

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4. For a recent discussion of proxy fights, see Bebchuk & Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 CALIF. L. REV. 1071 (1990). I will use the term “proxy fight” or “control contest” to refer to a contest for corporate control; the term “proxy campaign” to refer to a contest not involving control; and the term “proxy contest” to refer to both proxy fights and proxy campaigns.
they see profit in doing so. Legal obstacles notwithstanding, some institutions are trying to do just that.

The passivity story treats the collective action problems that result from fractional share ownership as an overwhelming barrier to shareholder activism. I model the incentives of shareholder proponents, who must decide whether to make voting proposals. The model suggests that at current levels of institutional ownership, collective action problems, while important, are not insuperable for a broad range of issues. A central factor in the model is economies of scale. An institution that owns stakes in a number of companies enjoys economies of scale when it presses common issues at those companies. These economies can offset the incentives for passivity created by partial ownership of any one company. Thus, shareholder voice holds more promise for process and structural issues than for company-specific concerns. Examples of such issues include the process by which directors are nominated, dual-class recapitalizations, poison pills and other antitakeover measures, confidential voting, management compensation, and choice of state of incorporation.

The passivity story also predicts that nonproponents will be rationally apathetic — not even bothering to become informed, perhaps following a simple voting rule like “always vote with management.” I model the incentives of nonproponent shareholders to become informed, and conclude that while many small shareholders will remain uninformed, apathy makes exponentially less sense as shareholdings grow, as long as there is a critical mass of other large shareholders. Increased stake in the outcome, increased probability that their vote will affect the outcome, increased ease of coordinated voting among institutions, and scale economies combine to create substantial incentives for institutions to become informed voters.

An additional important dimension of shareholder voting is agenda control. For the most part, managers control what shareholders vote on, how proposals are packaged, when the shareholders vote, and when the shareholders find out what they’re voting on. Public choice theory teaches that she who sets the agenda can often control the substantive outcome. Legal rules could, but today do not, make it easier for shareholders to define their own agenda.

Conflicts of interest matter too. Institutional investors are the only viable watchers of corporate managers, but are themselves managed by money managers who have imperfect incentives at best, and significant conflicts of interest at worst. Different institutions have different incentives and conflicts. The public pension funds have the weakest promanager conflicts, but no institution is conflict free. These con-
flicts, rather than rational apathy, may explain why many institutions vote promanager on proposals that are likely to reduce share price. Legal rules aren’t very effective at constraining conflicts of interest, and some rules make the incentive problem worse.

Shareholder passivity, in sum, may be both legally and historically contingent. It may reflect less the inexorable logic of collective action, than a combination of legal obstacles to shareholder action, shareholder conflicts of interest, managers’ agenda control, and more dispersed and conflicted ownership in the past than today. The way to see if shareholder voting can matter is to change the legal rules that obstruct individual and collective shareholder action, adopt new rules that facilitate collective shareholder action, and develop an institutional and legal environment that more effectively controls money manager conflicts of interest. Piecemeal change, though, such as recent proposals to reform the proxy rules, has only limited promise. There are many obstacles to shareholder voice, and their burden is cumulative. Changing only the proxy rules won’t have dramatic results.

This article argues that shareholder monitoring is possible: It’s an idea that hasn’t been tried, rather than an idea that has failed. I defer to a second article currently in draft the question of whether more monitoring by institutional shareholders is desirable. Will direct shareholder oversight, or indirect oversight through shareholder-nominated directors, improve corporate performance, prove counterproductive, or, perhaps, not matter much one way or the other? What are the benefits and risks in giving money managers — themselves imperfectly monitored agents — more power over corporate managers? If more shareholder voice is desirable, how much more and for what issues? Which of the many relevant rules ought to be loosened, which tightened, and by how much, in light of the various purposes — often unrelated to shareholder voting — that those rules serve? For all of these questions, the answers may well be different for different institutions.6

This article proceeds as follows. Part II summarizes the views of the naysayers who invoke collective action problems to explain why shareholders will rarely do anything. Part III reviews the principal state and federal rules that affect, and mostly obstruct, shareholder


activism. Part IV discusses recent developments in institutional stock ownership and voting behavior that make the passivity story obsolete. These developments include rapid growth in ownership by less-conflicted public pension funds and mutual funds, increasing shareholder activism with public funds as the most visible actors, and the formation of trade groups that can facilitate collective shareholder action.

Part V presents a theoretical model of the incentives of shareholder proponents that sheds light on shareholder incentives to remain passive, and the importance of scale economies in reducing those incentives. Part VI models the incentives of nonproponent shareholders to become informed or remain rationally apathetic. Part VII addresses the importance of agenda control in determining substantive outcomes. Part VIII examines the incentives of the major types of institutional investors, and the conflicts of interest that they face. Part IX is a conclusion.

II. THE PASSIVITY STORY AND THE PROXY RULES

This Part briefly describes the passivity story and surveys recent writing recognizing the growing role of institutional shareholders in proxy contests.

A. The Passivity Story

In 1932, Berle and Means told the world that managers of big companies were powerful; their shareholders powerless. That picture was not, then or now, true of all firms. Some, especially smaller firms, have significant insider holdings. But it described most large public companies. Partly in response, Congress in 1934 adopted section 14 of the Securities Exchange Act (Exchange Act), which authorizes the Securities and Exchange Commission (SEC) to develop rules to govern the solicitation of proxies (Proxy Rules). Better disclosure, Congress hoped, would protect shareholders against manager overreaching.

Passivity story advocates believe that Congress and the SEC shouldn’t have bothered. Collective action problems make shareholder passivity inevitable, and we must rely on other constraints, especially takeovers, to keep managerial discretion within reasonable bounds. The modern, law-and-economics rendition of the passivity

10. Representative critiques include Baysinger & Butler, Revolution versus Evolution in Cor-
story developed in response to the rarity of successful proxy fights and the corporate social responsibility movement of the 1970s.\footnote{11} We see so few proxy fights, the story runs, because most companies run fine without them and even when performance lags, proxy fights are not economically viable. And the low support for social responsibility proposals shows that most shareholders aren’t interested in the proposals.\footnote{12} Passivity story advocates have special disdain for the SEC’s shareholder proposal rule. Allowing shareholders to include proposals in company proxy statements, they argue, imposes costs on the company, borne by all shareholders, to permit a few activists to advance their political agendas.

Moreover, collective action problems make manager proposals unlikely to fail and shareholder proposals unlikely to succeed, almost regardless of the merits of the proposals. The act of voting, and becoming informed enough to vote intelligently, requires an investment of time, which is a scarce resource. Yet a shareholder’s vote is unlikely to affect whether a proposal wins or loses. The cost and futility of becoming informed leads shareholders to choose rational apathy: They don’t take the time to consider particular proposals, and instead adopt a crude rule of thumb like “vote with management.”

Collective action theory also tells us, the critics argue, that shareholders won’t make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort. A shareholder proponent bears most of the

\begin{footnotesize}
\begin{enumerate}
\item[12]\ Prior to the 1970s, shareholder proposals were more likely to be related to corporate governance and financial matters, such as cumulative voting and dividend levels, but were no more likely than social responsibility proposals to succeed. See F. EMERSON & F. LATCHAM, SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS 103-04, 112 (1954); RYAN, Rule 14A-8, Institutional Shareholder Proposals, and Corporate Democracy, 23 GA. L. REV. 97, 116-18, 120 (1988).
\end{enumerate}
\end{footnotesize}
cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders free ride on her efforts. Free-rider problems work in tandem with the rational apathy of the free riders to discourage shareholder proposals from being made.\textsuperscript{13}

Scholars who see shareholder voting as unimportant rely instead on market forces, especially takeovers, to limit managers' discretion. Indeed, voting serves primarily to allow shareholders to sell their votes along with their shares in a takeover. Frank Easterbrook and Dan Fischel state the critics' position with customary clarity:

[C]ollective choice problems . . . suggest that voting would rarely have any function except in extremis . . .

These collective action problems may be overcome by aggregating the shares (and the attached votes) through acquisitions, such as mergers and tender offers. We expect voting to serve its principal role in permitting those who have aggregated equity claims to exercise control.\textsuperscript{14}

The shareholder impotence argument has been widely accepted by both academics and regulators. To take a recent example, scholars on all sides of the multifaceted debate over the one share, one vote rule shared the belief that shareholders were relatively powerless to oppose dual-class recapitalizations.\textsuperscript{15} The SEC relied on collective action problems to justify the rule.\textsuperscript{16} Scholars have also invoked collective action problems to explain why shareholders approve charter amendments against their own interest.\textsuperscript{17} In recent years, a number of writers, taking passivity as inevitable, have tried to explain why the

\begin{itemize}
\item \textsuperscript{13} I will generally use the terms "shareholder proposal" and "shareholder proponent" to refer to a shareholder effort either to present a proposal or actively oppose a manager proposal.
\item \textsuperscript{15} See, e.g., Fischel, \textit{Organized Exchanges and the Regulation of Dual Class Common Stock}, 54 U. CHI. L. REV. 119, 134 (1987) (one-share, one-vote rule needed because of collective action problems "any attempt by shareholders to monitor managers is likely to fail"); Gilson, \textit{Evaluating Dual Class Common Stock: The Relevance of Substitutes}, 73 VA. L. REV. 807, 832-40 (1987) (developing collective action explanation for why shareholders may approve a recapitalization against their self interest); Seligman (1986), \textit{supra} note 2, at 723-24 (one-share, one-vote rule needed because of management's "immense funding advantages" and the lack of "organized [shareholder] opposition" to dual-class proposals).
\end{itemize}
separation of ownership and control may be efficient after all. More generally, the assumed weakness of shareholder oversight underlies the central importance of takeovers in both public debate and academic commentary.

B. Views Recognizing the Growing Role of Institutions

A number of commentators have recognized the growing role of institutions in shareholder voting. Some have observed the impediments to shareholder voice created by various legal rules. Mark Roe describes the formal and informal barriers to banks, insurance companies and mutual funds owning large stakes in individual companies. Al Conard discusses some of the obstacles to shareholder action under the federal securities laws. John Pound stresses the costs of complying with the proxy rules. This work obviously overlaps with the discussion of legal rules in Part III of this article.

Other observers, skeptical about the value of takeovers, see shareholder activism as an alternative to takeovers, but don't explain how greater activism is to be achieved. For example, Jonathan Charkham, relying on Albert Hirschman's dichotomy between exit and voice, hopes that "[i]f takeovers were more difficult or impossible, would not investors be more inclined to use VOICE as an instrument for improving poor management?" Lou Lowenstein proposes a tax on short-term trading profits, in the hope that long-term shareholders will be


more active, and suggests that institutional shareholders be entitled to
nominate a minority of public company directors.23

Other commentators see little need for legal reform. Patrick Ryan,
for example, sees Rule 14a-8 as a "relatively neutral regulatory de­
vice" in no need of reform.24 Ron Gilson and Reinier Kraakman ar­
gue that institutional shareholders should nominate and elect a new
class of professional directors, but downplay legal barriers and express
puzzlement as to why shareholders don't now do as they suggest.25
Mel Eisenberg has suggested that shareholders already have the power
under state corporate law to, for example, include director nominees
in company proxy statements.26 Finally, Edward Rock notes that
growing institutional concentration reduces collective action
problems, but doesn't expect money managers to devote much effort to
monitoring, partly because of conflicts of interest.27

III. THE RULES GOVERNING SHAREHOLDER VOTING

This Part surveys the legal rules that govern shareholder voting,
and the advantages for managers and obstacles to shareholder action
that the rules create. My focus is on the rules that may affect a proxy
campaign not directed at taking control by nominating and electing a
majority of the board. For a control contest, the analysis is much sim­
er — the rules all apply and the target will almost certainly sue.

To summarize: Legal rules make it hard and sometimes impossi­
ble for a single shareholder to own a large stake in a single company,
especially if the shareholder is active on corporate governance issues.
Owning 5% is easy if you're passive; hard if you're active. Owning
10% is hard even if you're passive, but much harder if you're active.
Going beyond the threshold for triggering a company poison pill,
often only 10-15%, is impossible without the company's approval.
Particular institutions face additional legal limits on their ability to
own large stakes. Thus, legal rules largely foreclose institutional abil­

23. L. LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE
25. Gilson & Kraakman, Reinventing the Outside Director: An Agenda for Institutional In­
(1976). Eisenberg's rosy view of shareholder power under state law is, at least as much today as
when it was written, more a wish about what courts might do than a description of actual
practice.
27. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79
ity to own a large stake, which is the direct way to mitigate collective action problems.

Nor can shareholders who individually own smaller stakes readily act together on a voting matter. A group that together owns a 5%, 10%, or larger stake faces essentially the same legal obstacles as a single active shareholder who owns the same percentage stake. The need to coordinate compliance among a number of independent institutions magnifies the legal burden. Thus, legal rules also foreclose shareholder ability to form an effective voting coalition.

Probably the single most important shareholder task is nominating and electing directors. Electing good directors is especially important for diversified institutions, who can’t watch any one company closely and probably aren’t competent to do so anyway. Yet legal obstacles are especially great for shareholder efforts to nominate and elect directors, even for a minority of board seats. The Proxy Rules, for example, offer shareholders limited help on some matters, but provide mostly obstacles for director elections. And under the insider trading rules, electing a director has consequences comparable to owning a 10% stake.

Even when legal rules permit shareholder action, they raise costs. Those costs are important because a shareholder proponent bears most of the costs of her actions, receives a fraction of the benefits, and faces an opponent who has the enormous advantage of being able to spend other people’s money. The obstacles to forming groups magnify these cost barriers by discouraging cost-sharing among shareholders.

Moreover, legal uncertainty abounds. Legal risk adds to the expected cost that a shareholder must consider in deciding whether to act. Legal uncertainty also facilitates tactical lawsuits by company managers, who may not expect to win, but can increase shareholder costs by trying. Institutional fiduciaries are especially unlikely to take legal risks, because they face personal risk on the downside, while their beneficiaries get most of the upside. A pension fund manager or other fiduciary can’t take a calculated risk of subjecting herself to short-swing trading liability or triggering a vaguely worded poison pill. For many institutions, the adverse publicity from a possible lawsuit is an important deterrent by itself.

For a cautious fiduciary, legal risk involves not just the conduct that the rules clearly cover, but also the broader sphere of conduct that the rules, read expansively, might cover. That outer sphere is often very broad indeed. The SEC, in particular, is notorious for refusing to define the scope of its rules and instead issuing “menacing releases” which “hint[ ] that the laws and rules may proscribe much
more than they appear to."28 For some rules, the SEC staff will give limited guidance through no-action letters; for others, the staff won't even do this much.

Finally, perversity abounds. Shareholders who succeed at the ballot box face greater risk of being deemed control persons under the securities laws, triggering a poison pill, or losing voting power under a control share antitakeover law, by virtue of their success. Shareholders who nominate and elect directors must be careful whom they elect, and how often they talk to the directors, lest the shareholders be deemed control persons or face short-swing profit forfeiture under the deputization principle.

Cultural factors reinforce the legal obstacles to shareholder action. Money managers operate with a developed sense of proper and improper behavior that is as much culturally as legally defined. They compete on the basis of trading strategies, not on their skill as corporate monitors. They expect to take market risk, but legal risk is beyond the pale. If legal rules changed, cultural norms might follow, but only slowly.

Section A of this Part reviews the basic state rules that govern what matters the shareholders are entitled to vote on and many of the procedural rules for shareholder voting. Section B reviews the Proxy Rules, which govern the mechanics of soliciting shareholder votes, the information that shareholders must receive when their votes are solicited, and shareholder rights to include proposals in a company's proxy statement.

This Part also surveys the many other state and federal rules that restrict shareholder action. These include: disclosure requirements for 5% shareholders and shareholder groups under Exchange Act section 13(d) (section C); prohibitions on insider trading and short-swing trading under Exchange Act sections 10(b) and 16(b) (section D); rules imposing liability on persons who "control" a company (section E); state-authorized flip-in poison pills (section F); limits on how much stock particular institutions can own in a single company (section G); fiduciary duty rules (section H); state antitakeover laws (section I); antitrust laws (section J); and various rules that can lead to tainted promanager votes (section K). Section L considers cultural barriers to shareholder action and section M discusses the political economy of the rules governing shareholder voting. Part VII will dis-

cuss the managers' agenda control advantages, many of which are also a product of legal rules.

This Part is long and full of regulatory detail. The length, however, is part of the message. The obstacles faced by shareholders who would be active are many. No single rule is a show stopper, but their cumulative impact is large. The message that the rules convey to shareholders is: Be quiet, and no one will bother you. Be too active, and you’ll pay the price.

A. State Corporate Law

This section reviews the basic state rules governing shareholder voting and the procedural and cost-bearing advantages they provide for corporate managers. Additional state rules that create obstacles to shareholder action are discussed in section III.E (poison pills), section III.I (antitakeover laws), section III.K (tainted votes), and Part VII (managers' agenda control).

State corporation statutes establish the basic structure of corporate governance: shareholders elect directors and vote on a limited set of important matters; directors watch officers and approve major corporate decisions; officers run companies on a day-to-day basis. For the most part, I take that structure as given and examine the procedural rules that affect how shareholders carry out their voting role. The distinction between structural rules that establish voting roles, and procedural rules for how voting takes place, is necessarily fuzzy at the margin.

In not focusing on structural rules, I don’t mean to suggest that they are optimal. For example, we might want shareholders to be able to redefine what matters deserve a shareholder vote. Also, managers will fight shareholder power both at the polls and in state legislatures. If shareholder proposals begin to win with any frequency, managers will press state lawmakers to change the structural rules in the managers' favor, and the states may well respond. Antitakeover laws show this process at work: shareholders voted with their feet in favor of hostile takeovers; managers, aided by unions worried about jobs and local officials worried about local communities, ran to state lawmakers for protection; the lawmakers limited shareholder power so to vote. There is some evidence, discussed in section III.I, of a similar trend for voting rights.

1. Substantive Rules

The matters on which shareholders vote under state law typically include electing directors, amending the corporate charter, reincorpo-
rating in another state, merger with another company, sale of substantially all assets, and liquidation. 29 The charter may, but for public companies rarely does, specify other matters that require a shareholder vote. State law also typically sets forth a few matters on which the shareholders can act unilaterally, such as removing directors from a nonclassified board and amending bylaws. 30 On the large class of matters where a shareholder vote isn’t required, the shareholders can pass a precatory resolution asking the directors to take certain actions, but the directors need not accede to the request. Most state statutes let companies specify in their charters which shares are entitled to vote. Nevertheless, most public companies have a single class of common stock, with each share entitled to one vote. In this article, I assume a one share, one vote structure.

The matters on which shareholders vote can be roughly divided into three areas. First, shareholders can indirectly control the company’s management by electing directors. Second, shareholders must approve major changes in the “contract” between managers and shareholders through their vote on charter amendments. Third, the shareholders must approve major changes in the company’s structure, such as a merger, sale of substantially all assets, or liquidation.

The shareholders’ actual control in each of these areas is much less than recitation of their rights would suggest. Apart from the rare proxy fight, directors run unopposed and invariably win. Moreover, most directors have closer ties to a company’s officers than to its shareholders: some are officers themselves; others have business ties to the company that make them reluctant to disagree with the CEO; even “independent” directors generally serve at the CEO’s pleasure. And while the Wall Street Rule (if you don’t like the management, sell your stock) may be gradually dying for shareholders, what can be called the “Wall Street Rule for Directors” (if you don’t like the management, resign) is alive and well. 31

Most charter amendments are routinely approved. In recent years, the principal nonroutine proposals have been antitakeover amendments designed to further insulate the directors from shareholder oversight. For a merger, the buyer can usually avoid a shareholder vote by having the target merge with a subsidiary of the buyer. On the

target's side, the shareholders almost always approve a merger or sale of assets unless there's a better offer outstanding from a third party.  

2. Procedural and Cost-Bearing Rules

In addition to specifying the matters that shareholders vote on and the vote required for passage, state law specifies procedural rules for conducting the vote. Companies must hold an annual meeting at which the shareholders elect directors and vote on any other proper business. Directors and, in some states, large shareholders can also call a special meeting at any time. State law also establishes minimum notice period (typically 10 days) and quorum (typically one third of the outstanding shares) requirements. Most shareholders don't attend the meeting and instead vote by proxy. Proxies are generally revocable at any time before the vote is taken.

Votes by proxy generally aren't confidential. Thus, a company's managers will know who has voted in their favor, subject to any inability to trace beneficial holders, and can resolicit shareholders who haven't voted promanager. Dissidents who use a separate proxy card and proxy statement can also identify supporters. But neither side will be sure until the meeting is held how any shareholder will vote, because shareholders can change their votes at any time. Nor will a contestant know whether failure to receive a proxy from a particular shareholder means that the shareholder has voted against the contestant, or has simply abstained.

Most state laws give shareholders the right to inspect and copy shareholder lists for a "proper purpose." Electing directors or voting on other matters germane to the company's business qualifies as such a purpose. However, companies often contest a dissident shareholder's right to inspect the list, in an effort to delay release of the list. This increases the dissident's costs, and reduces the list's value.

32. Section IV.B discusses recent trends away from routine approval of antitakeover amendments.

33. See, e.g., Del. Code Ann. tit. 8, §§ 211(b) (annual meetings), 211(d) (special meetings) (1983); Rev. Model Business Corp. Act § 7.02(a)(2) (1984) (ten percent shareholder can call a special meeting).


36. See, e.g., Trans World Corp. v. Odyssey Partners, 561 F. Supp. 1311 (S.D.N.Y. 1983); Note, Protecting the Shareholders' Right to Inspect the Share Register in Corporate Proxy Contests for the Election of Directors, 50 S. Cal. L. Rev. 1273 (1977); cases cited infra note 64. In states such as New York, which require the requesting shareholder to have a minimum percentage holding, see N.Y. Bus. Corp. Law § 624(b) (McKinney 1986), the Proxy Rules complicate the task of obtaining a shareholder list. A request that other shareholders endorse a list request is a
A key factor in the frequency with which proxy campaigns are begun, and how vigorously they are conducted, is expense reimbursement. The company's board of directors decides, within broad limits, which expenses will be reimbursed from the company treasury. The board invariably reimburses its own expenses, and never reimburses a losing dissident.\footnote{If the dissident wins a proxy fight at a company without a staggered board, the new board will pay the dissident's expenses.\footnote{If the dissident wins on another matter, the board may, but rarely will, pay some or all of the dissident's expenses.}}

\section*{B. The Proxy Rules}

The Proxy Rules govern disclosure when proxies are solicited; establish procedures for proxy solicitation; provide limited access to company annual proxy statements for shareholder proposals; and require companies to mail a dissident's proxy materials to their shareholders at the dissident's cost or else give the dissident a shareholder list.\footnote{The rules are usually seen as helping shareholders by correcting state failure to protect shareholder voting rights.\footnote{That picture, however, is only a partial one. The Proxy Rules ensure that shareholders receive information about voting proposals and provide some valuable procedural protections. But they also impose costs, delays, and legal risks on shareholder efforts to communicate with each other, if the communication is even loosely tied to the prospect of a shareholder vote. This section complements the usual picture of the Proxy Rules by reviewing the obstacles to shareholder action the Rules create, and proxy solicitation, which requires a full proxy statement that must be cleared by the SEC before use. Studebaker Corp. v. Gittlin, 360 F.2d 692 (2d Cir. 1966).}}

\footnote{37. In theory, managers can spend corporate funds to inform shareholders of the managers' views on a policy conflict, but not to preserve their own positions. In practice, a policy conflict can always be found. See M. Eisenberg (1976), supra note 26, at 105-10.}

\footnote{38. In some states, the board may need shareholder approval to reimburse shareholder expenses, see, e.g., Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955); Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950) (Delaware law), but the approval is easy to obtain.}

\footnote{39. See, e.g., Penn Central Agrees to Pay Former Dissidents $975,000, Wall. St. J., Apr. 23, 1982, at 24, col. 1 (partial reimbursement of dissidents' expenses for successful opposition to Penn Central's proposed acquisition of Colt Industries).}


the limited benefits they offer.\footnote{A few commentators, especially J. POUND (1990), \textit{supra} note 21, have noted the costs that the proxy system imposes on shareholders. Easterbrook \& Fischel (1983), \textit{supra} note 10, at 422-23, note that proxy compliance costs may discourage proxy fights, but their basic view is that shareholders are passive, so the Proxy Rules don't matter much one way or the other. Jarrell \& Bradley, \textit{The Economic Effects of Federal and State Regulations of Cash Tender Offers}, 23 J.L. \& Econ. 371, 371 n.1 (1980), speculate that expanded SEC regulation of proxy fights, beginning in 1956, made them less viable as a way to change corporate control.}  

1. \textit{Disclosure and Voting Procedures}  

The Proxy Rules require anyone who "solicits" "proxies" from shareholders to give each solicitee a written proxy statement containing various specific disclosures and to clear the proxy statement with the SEC before use. There is a narrow exception for solicitations by someone other than the company directed to 10 or fewer shareholders.\footnote{Rule 14a-2(b)(1), 17 C.F.R. § 240.14a-2(b)(1) (1990).}  

The broad reach of the Proxy Rules begins with expansive definitions of "proxy" and "solicitation." The SEC defines "proxy" grandly, if none too clearly, as "every proxy, consent or authorization within the meaning of section 14(a) of the [Exchange] Act."\footnote{Rule 14a-l(f), 17 C.F.R. § 240.14a-l(f) (1990). Exchange Act § 14(a) is no more precise. It tells the SEC to write rules governing how persons may "solicit any proxy or consent or authorization in respect of any [registered] security." 15 U.S.C. § 78n(a) (1988).} The courts have construed this definition expansively to include such things as an authorization to request a shareholder list and a request for funds by a shareholder committee which, if it gathers enough money, may then solicit proxies.\footnote{See Studebaker Corp. v. Gittlin, 360 F.2d 692 (2d Cir. 1966); Canadian Javelin Ltd. v. Brooks, 462 F. Supp. 190 (S.D.N.Y. 1978).}  

The SEC also defines "solicitation" in sweeping terms to include not only a request that someone execute, not execute, or revoke a proxy, but also "[t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."\footnote{Rule 14a-l(l)(iii), 17 C.F.R. § 240-14a-l(l)(iii) (1990) (emphasis added).} The courts have expansively construed the open-ended terms "other communication" and "reasonably calculated." A communication that doesn't solicit anything can still be a "solicitation"! The test is whether the communication is "part of a continuous plan ending in solicitation and which prepare[s] the way for its success."\footnote{SEC v. Okin, 132 F.2d 784, 786 (2d Cir. 1943).} The solicitation need not be targeted directly at shareholders nor written by the solicitor: advertisements urging state takeover of a public utility and...
story ideas given to the financial press can qualify. Nor are the Proxy Rules limited to communications by the contestants. A third party who proffers voting advice is “soliciting” votes. The cost and delay of preclearing such advice effectively bars third parties from providing voting advice to shareholders. Thus, shareholders can’t share information gathering costs by buying information from a central provider.

The Proxy Rules can also chill presolicitation efforts by a shareholder proponent to gauge whether a solicitation is worthwhile. There is a “fine line between gauging the market pulse and drumming up proxy support,” and the company’s managers can sue claiming the line was crossed before the proponent cleared her proxy materials. Similarly, there is risk in forming a shareholder group with a view to a later solicitation, lest the organizing efforts be deemed a solicitation.

The preclearance requirements include filing a preliminary proxy statement with the SEC at least 10 days before the proposed mailing date, to give the SEC staff time to review and, if necessary, object to, the proxy materials. Any subsequent written proxy materials must be filed with the SEC at least two days before use. Written instructions for personal or telephone solicitation must be filed five days in advance. The written text of speeches, press releases, and radio or TV scripts must be filed on the day first made or issued. In general, a full proxy statement must precede or accompany any other solicitation materials.

For a routine company proxy solicitation, these rules are a minor nuisance; indeed, the SEC neither reviews nor requires prefiling of several broad categories of routine proxy statements. But for a share-

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52. Rule 14a-6, 17 C.F.R. § 240.14a-6 (1990). The time limits can generally be shortened by the SEC for “good cause.”

53. Rule 14a-3(a), 17 C.F.R. § 240.14a-3(a) (1990). For election contests and solicitations in opposition to a prior solicitation, limited solicitation materials can precede the proxy statement, but must be filed with the SEC in preliminary form five business days before use. Rules 14a-11(e), 14a-12, 17 C.F.R. §§ 240.14a-11(e), 12 (1990).
holder proponent, preclearance can be a significant source of delay and expense, particularly for a director election campaign, which requires special disclosures. Preclearance also injects the SEC staff into the middle of a proxy campaign, as arbiter of the information that proponents must include and the truth of the assertions made by the parties. Practitioners commonly complain about extensive nitpicking by the SEC staff. Some also believe that the staff "approves proxy materials for incumbents that a dissident would be unable to clear."

Preclearance delay is especially important for a shareholder who wants to oppose a management proposal. She must decide to oppose the proposal, prepare and preclear proxy materials, mail the materials, and get votes back, all in the 30 days or so between the date of the company proxy statement and the shareholder meeting date. This is no mean feat in the best of circumstances, since 30 days is a practical minimum time for beneficial owners to receive proxy materials, often through multiple layers of record holders, and send voting instructions back through the same channels.

No solicitation, within or without the formal proxy statement, written or oral, may contain[] any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any [prior] statement . . . which has become false or misleading.

Securities lawyers are so accustomed to this antifraud language that its chilling effect on communication gets overlooked. But imagine a political campaign where each contestant, and each newspaper commenting on the campaign, had to state a long list of prescribed facts, including all "material" facts, avoid misleading anyone, correct any prior statements which were no longer accurate, and preclear everything with a government agency, in an environment where the central


56. Proxy fights aside, the only recent proxy solicitation in opposition to a manager proposal was at Honeywell in 1989. The opponents' proxy materials were cleared by the SEC a scant seven days before the meeting. See K. v AN NUYS, CONFLICTS OF INTEREST IN PROXY VOTING: EVIDENCE FROM THE 1989 HONEYWELL PROXY FIGHT 4 (University of Rochester Working Paper, 1990).

The concept of materiality has only the vaguest of definitions and incumbent officials can use public funds to sue their opponents claiming failure to do any of the above, with no requirement that they show any concrete harm. The antifraud proscription may have its place, at least for company proxy statements. But it seems serious overkill as applied to shareholder proponents, when company managers stand ready and eager to correct any misstatements that a shareholder might make, and overkill especially when applied not just to the core proxy statement, but to all written and oral communications. Whether on balance the rule is desirable or not, its chilling effect cannot be seriously doubted.

The cumulation of the broad scope of the Proxy Rules; the required disclosure items; often unwritten lore on the types of statements to which the SEC staff will object; the antifraud proscription; and complex rules, discussed below, on when and how a shareholder proposal can be included in the company's proxy statement, makes expert (and expensive) legal counsel a must for any shareholder contemplating any action remotely connected with voting.

It is a measure of the burden imposed by the Proxy Rules that only one independent source, Institutional Shareholder Services (ISS), publishes proxy voting advice on a large number of companies, and that ISS, having tried and failed to obtain SEC concurrence that its advice is exempt from the preclearance rules, has chosen not to preclear its materials. ISS and Analysis Group are taking the risk that the SEC or someone else will sue; they hope, with some reason for optimism, that a court will find preclearance to be an unconstitutional restriction on free speech or, mindful of the constitutional issue, will stretch the relevant exemption to cover their conduct. United Shareholders Association goes even further: it doesn't preclear the press releases and newsletters to members its sends out in support of its own proposals, made as part of its Target 50 Campaign.

58. ISS sought SEC staff concurrence that its voting advice was excluded from the Proxy Rules under the Rule 14a-2(b)(2) exemption for voting advice by financial advisors. See Letter from SEC Special Counsel Cecelia Blye to ISS General Counsel Nell Minow (Dec. 15, 1988) (ISS's voting advice is not exempt from preclearance); Letter from Nell Minow to Cecelia Blye (Apr. 4, 1989) (advising the SEC of ISS's intent not to preclear).


For the most part, we can only speculate about the burden that various legal rules place on shareholder action. But the conscious decisions by ISS, Analysis Group, and United Shareholders not to comply with the preclearance rules show that, at least for the Proxy Rules, the burden is substantial. That message is reinforced by recent proposals by the California Public Employees' Retirement System (CalPERS) and United Shareholders seeking rule changes that would reduce proxy compliance costs for shareholder proponents.  

2. Shareholder Proposals

The shareholder proposal rule, Rule 14a-8, gives shareholders some rights to use a company's proxy statement to offer proposals for other shareholders to vote on at the annual shareholder meeting. The various limits on shareholder access, however, prevent the rule from living up to its potential as a way to reduce and spread the costs of collective shareholder action.

A shareholder proponent can offer only one proposal per year, and must submit the proposal to the company about five months before the next annual meeting. A proposal must also meet substantive requirements, the most important of which are that it must: involve a proper subject for shareholder action; not relate to ordinary business operations or the election of directors; and not conflict with a manager proposal. The net effect of the exclusions is that politically motivated shareholders can offer a wide variety of social responsibility proposals that most shareholders don't care about, while access is sharply limited for issues that affect the corporation as a profitmaking institution. Rule 14a-8 bars access in three key areas — director nominations; statements in opposition to management proposals; and alternatives to management proposals. We bear the costs of the social responsibility proposals, without the corporate governance benefits that a less restrictive rule might bring.

The niggardliness of Rule 14a-8 doesn't stop with the substantive prohibitions. A qualifying proposal must be listed on the company's proxy card, and the proponent has 500 words in the proxy statement to present a supporting statement. She won't know until after the meeting how many votes the proposal has received. In contrast, the

62. Letter from CalPERS General Counsel Richard Koppes to Linda Quinn, Director, SEC Division of Corporation Finance (Nov. 3, 1989), reprinted in 1 PRACTISING LAW INST., 22D ANNUAL INSTITUTE ON SECURITIES REGULATION 298 (1990) [hereinafter CALPERS PROPOSAL]; Letter from United Shareholders Assn. Director Ralph Whitworth to SEC Chairman Richard Breeden (Mar. 20, 1990), reprinted in 1 PRACTISING LAW INST., supra, at 333.

company’s managers can make an opposing statement of any length, note their opposition in bold print on the proxy card, spend corporate funds to solicit votes against the proposal, and review the ballots as they come in and resolicit shareholders who vote for the proposal.

3. Access to Shareholder Lists

An important part of any shareholder campaign is identifying the shareholders. Here, unfortunately, the Proxy Rules offer little help. Rule 14a-7 embodies a “disclose or mail” principle: a company must mail a dissident’s proxy materials to its shareholders at the dissident’s expense, or give the dissident a list of record holders. Companies invariably mail the materials themselves to avoid disclosing shareholder names. Even if a company were to release a shareholder list, the list would include neither shareholdings nor the company’s list of the names and addresses of beneficial owners who haven’t objected to having their identity disclosed to the company (NOBO list).64

For shareholder lists, Rule 14a-7 can fairly be called a “nonaccess” rule. It doesn’t obstruct shareholder collective action, as such. And the SEC’s Form 13F disclosure rules for large institutions enable shareholder proponents to identify some of their fellow shareholders. But Rule 14a-7 represents a missed opportunity for the SEC to level the playing field by requiring company managers to share their knowledge of shareholder identities and shareholdings, without the delay and lawsuit expense needed to obtain a list under state law.

C. Disclosure Under Section 13(d)

Exchange Act section 13(d) and the related SEC rules (13(d) Rules) require any person or “group” which beneficially owns more than 5% of a public company’s stock to file a Schedule 13D containing disclosure about the person or group, its stock ownership, its plans with respect to the company, and various other matters. A proponent’s plans for a voting initiative must be disclosed in a Schedule 13D when formed, which will often be before the proxy campaign has begun. Beneficial ownership is defined broadly to include sole or shared power to sell or direct the sale of securities, or to vote or direct the

voting of securities.65

The 13(d) Rules impose a disclosure obligation with attendant cost and, more importantly, create legal risk. The company’s managers can and often will sue claiming misdisclosure of one sort or another, usually that the shareholder has concealed her true intent.66 Mere allegation of a concealed intent is usually enough to warrant court-ordered discovery.67 Under the 13(d) Rules, like the Proxy Rules, the managers need show no concrete harm from the alleged misdisclosure. The judicial remedy is often no more than corrective disclosure, but the SEC or other shareholders can also seek profit disgorgement, and the cost of the suit must be borne win or lose.68

It’s unfortunately all too clear that a shareholder consortium formed to influence company policy through the voting process is a 13(d) “group.” Congress required 13(d) reporting by “two or more persons [who] act as a . . . group for the purpose of acquiring, holding, or disposing of securities of an issuer.”69 This language needs stretching to reach a consortium formed solely to solicit votes, but the SEC has so stretched it. The Commission defines “group” to include “two or more persons [who] agree to act together for the purpose of acquiring, holding, voting, or disposing of equity securities.”70 The courts have allowed the stretch and have also construed the group concept broadly. A group can be formed informally, without written documentation, and its existence can be proved by circumstantial evidence.71 A subsidiary question is when a group is formed. Courts

65. See Exchange Act § 13(d), 15 U.S.C. § 78m(d) (1988); Rules 13d-1 to 13d-7, 17 C.F.R. §§ 240.13d-1 to 13d-7 (1990); Schedule 13D, 17 C.F.R. § 240.13d-101 (1990). The Schedule must be filed within 10 days after a shareholder crosses the 5% threshold. Material changes in the disclosed information, including a 1% increase or decrease in percentage ownership, must be reported promptly in an amended Schedule 13D.


67. See, e.g., Rose, Decision by Federal Judge Strikes Down Much of Chevron’s Suit Against Pennzoil, Wall St. J., Jan. 15, 1990, at B4, col. 5 (pretrial order allows Chevron to continue discovery in its 13(d) suit against Pennzoil "on the chance that [Chevron] may unearth evidence of [concealed intent]").


71. On the informal nature of a group, see, for example, Wellman v. Dickinson, 682 F.2d 355, 363 (2d Cir. 1982); SEC v. Savoy Indus., 587 F.2d 1149, 1163 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979). On the SEC’s power to interpret § 13(d) to cover voting, see, for example, Portsmouth Square, Inc. v. Shareholders Protective Comm., 770 F.2d 866, 871 (9th Cir. 1985); Jacobs v. Pabst Brewing Co., 549 F. Supp. 1050, 1065 (D. Del. 1982); Comment, Section 13(d) and Disclosure of Corporate Equity Ownership, 119 U. Pa. L. Rev. 853 (1971).
have struggled, with predictable lack of articulable standards, to dis-
tinguish informal formation of a group from preliminary discussions
over whether to form a group.\textsuperscript{72}

The 13(d) Rules thus create a double bind for shareholders who
own modest individual stakes. If they don’t organize, they’re unlikely
to succeed. Organizing also allows cost-sharing, which can reduce the
incentives for passivity created by fractional ownership. If sharehold-
ers do organize, they’ve formed a group, with attendant reporting re-
quirements and litigation risk. The larger and thus potentially more
effective the group is, the more burdensome the reporting require-
ments will be. The members of a loose group formed to cosponsor a
voting proposal may not know each other’s goals, nor when other
members are buying or selling shares. Each member can file its own
Schedule 13D, but each filing must identify all other group members
and disclose all information about other filers which “the filing person
knows or has reason to know.”\textsuperscript{73}

Shareholders who stop short of cosponsorship must still be wary of
the 13(d) Rules. If a proponent seeks indications of support from a
few other shareholders before beginning a proxy campaign, has she
unwittingly formed a group? The only sensible answer legal counsel
could give is “maybe,” which means “don’t risk it.”\textsuperscript{74} A proponent
can safely contact 10 other shareholders under the Proxy Rules, but
not under the 13(d) Rules.

There’s no hard evidence on how burdensome the 13(d) Rules are
to institutional shareholders. The Schedule 13D isn’t unduly complex,
so litigation risk is probably a greater concern than direct compliance
costs. To date, however, institutional shareholders generally haven’t
cosponsored resolutions if doing so would subject them to the 13(d)
Rules, thus forgoing the cost-sharing benefits that a consortium could
provide. The College Retirement Equities Fund (CREF), say, will
sponsor a poison pill resolution at Company \textit{A}, and the Wisconsin In-
vestment Board will sponsor an similar resolution at Company \textit{B}, but
CREF and Wisconsin typically won’t cosponsor each other’s resolu-
tions if their combined holdings exceed 5%.

Institutions who acquire a 5\% stake without “the purpose . . . [or]
effect of changing or influencing the control of the issuer” can file

\textsuperscript{72} See, e.g., Pantry Pride, Inc. v. Rooney, 598 F. Supp. 891, 899-900 (S.D.N.Y. 1984); Scott


\textsuperscript{74} See Connolly & Martin, Legal Restraints Governing Group Activity: Part II, INSIGHTS,
Apr. 1990, at 16, 19 (“whether activity . . . short of co-sponsoring . . . would constitute group
activity will depend upon the specific facts and circumstances”).
Schedule 13G instead of Schedule 13D.\textsuperscript{75} Schedule 13G calls for less information than Schedule 13D and does not need to be filed as promptly or amended as often. The Schedule 13G option offers scant comfort, however, even for qualifying institutions. The SEC has offered no guidance on what the elastic concept of "influencing control" means. Much of what shareholders might want to do, especially any effort to nominate and elect directors, could arguably bar use of Schedule 13G.\textsuperscript{76} There are no cases construing the Schedule 13G eligibility requirements because when in doubt, shareholders haven't tried to use the schedule. But that nonuse only confirms the dubious benefits it offers.

D. Insider Trading Reporting and Liability

There are two principal sources of insider trading restrictions. Exchange Act section 16 requires officers, directors, and 10\% beneficial owners of public companies to report purchases and sales to the SEC and to forfeit any "short-swing" profits. And case law under Exchange Act section 10(b) prohibits anyone from trading while in possession of material nonpublic information that the person has a duty not to disclose or trade on.

Consider first the 10\% shareholder. The shareholder must report her purchases and sales every month. Any profits from selling shares purchased within 6 months, or repurchasing shares sold within 6 months, must be forfeited to the company. Onerous matching rules can result in forfeiture from a series of trades that, taken together, produce no profit.\textsuperscript{77} These rules create a strong incentive not to cross the 10\% threshold. The forfeiture rules greatly reduce a shareholder's liquidity, and the reporting burden is substantial, especially for a large institution which is frequently buying and selling.

Special factors increase the incentive for particular institutions to stay under 10\%. Open-end mutual funds must redeem shares on a daily basis, and thus need liquidity for much of their portfolios. Pension fund managers may worry that holding a large illiquid position


\textsuperscript{76} See Connolly & Martin (1990), supra note 74, at 20 (offering the cautious advice that an effort to solicit proxies will "generally prevent" use of Schedule 13G, regardless of the purpose of the solicitation); Letter from Arthur Loring, General Counsel, Fidelity Investments, to Linda Quinn, Director, SEC Div. of Corp. Fin. (July 18, 1990) (proposing that the SEC exclude 13G-eligible institutions who engage in non-control-related voting activities from 13(d) definition of "group").

\textsuperscript{77} See Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).
could be deemed a breach of fiduciary duty. And pension plan sponsors may want to be free to move funds from one asset type to another.

Uncertainty about who "beneficially owns" shares within the meaning of section 16(b) increases the section's chilling effect. Must a mutual fund group combine the shares held by individual funds to determine if the 10% threshold has been crossed? If a fund group's total ownership exceeds 10%, will informationless trading by an index fund within the group trigger forfeiture? Must a pension plan sponsor that uses several money managers combine the shares held by those managers? The SEC has unhelpfully advised investors that beneficial ownership depends on the facts and circumstances of each case, and warned that "the right to vote or control the voting" of shares is a factor tending to show beneficial ownership.78

A shareholder or group that seeks to nominate and elect directors faces obstacles comparable to a 10% shareholder. The SEC, stretching the case law as is its usual wont, takes the view that an institution that has "expressly or impliedly 'deputized' an individual to serve as its representative on a company's board of directors" is deemed to be a director for both reporting and profit-forfeiture purposes.79 The Commission hasn't defined how or when deputization takes place, instead leaving that "fact-intensive analysis" to case-by-case determination.80 If a shareholder group nominates and elects a director, each group member risks being deemed to have deputized the director. The mere

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78. Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 18,114, 4 Fed. Sec. L. Rep. (CCH) ¶ 26,062, at 19063-7 (Sept. 23, 1981). The SEC has proposed a complex definition of beneficial ownership under § 16 that is better for shareholders in some ways and worse in other ways than the current uncertainty. See Exchange Act Release No. 27,148, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,439 (Aug. 18, 1989); Proposed Rule 16a-1, Fed. Sec. L. Rep. (CCH) ¶ 26,013 (to be codified at 17 C.F.R. § 240.16a-1). The proposed rules would use the broad 13(d) definition to determine who must file § 16 reports. Thus, most mutual fund groups and pension plan sponsors would have to aggregate their holdings. The rule excludes, however, shares held in fiduciary accounts by an institution that can file Schedule 13G. Thus, an institution can avoid § 16 reporting by remaining passive, thus qualifying to use Schedule 13G. For purposes of profit forfeiture and reporting of individual transactions, as opposed to reporting at all, the proposed rules limit beneficial ownership to persons who have a "direct or indirect pecuniary interest" in securities. Money manager fees are deemed not a pecuniary interest if they are based on "overall performance over a period of one year or more" and stock in the subject company represents 10% or less of the manager's portfolio. Thus, a money manager could avoid short-swing liability, and reduce but not eliminate its reporting burden, by diversifying and structuring its fees properly.


fact that an institution or group nominates a director could suffice to establish deputization; we simply don’t know, for lack of decided cases.

The deputization principle makes it risky for an institution to nominate anyone as a director, and highly risky to nominate a director with a prior connection to the institution. If deputization is found, profit forfeiture is automatic: a firm can’t avoid liability by insulating the director from the people who make investment decisions. The principle is also perverse: we presumably want shareholders to talk to the directors that they nominate, but if they do, the contacts become evidence of deputization.

A shareholder who nominates and elects directors also faces insider trading risk under section 10(b). The directors will sometimes be privy to material nonpublic information, knowledge of which can be imputed to the shareholder. The shareholder can’t trade the stock until the nonpublic information is disclosed, and thus loses much of its liquidity. A shareholder who violates the trading ban is liable for private damage actions and for civil penalties of up to three times its profits. Under section 10(b), unlike section 16, an institution can try to build a Chinese wall between the director and the people making buy-sell decisions. But there is no safe harbor that will ensure that the wall can withstand a lawsuit. Nor does the wall shield an institution from the adverse publicity of being sued.

An institution may also be liable for insider trading by its employees. A broker-dealer or investment adviser is liable as a controlling person for improper trades by an employee unless it has established and enforced “written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information.” The SEC, unhelpful as usual, has offered no guidance on what such policies and procedures must include.

An anecdote may illustrate the burden of the insider trading rules for institutional shareholders. Fidelity Investments has generally been a leader on corporate governance issues. But Fidelity representatives don’t sit on corporate boards because this would “cause[ ] a lot of legal problems.” When Peter Lynch, a Fidelity director and the manager of the Fidelity Magellan mutual fund, became a director of W.R.

83. Cowan, A Savvy Outsider Ventures Inside, N.Y. Times, Aug. 3, 1989, at D8, col. 3 (reporting views of Fidelity managing director Robert Pozen); see also Clark, Taking a Big Bite, INST. INVESTOR, Aug. 1990, at 67, 70 (CalPERS structured its 20% stake in Santa Fe Realty as
Grace, Fidelity required *all of its funds*, not just Magellan, to sell their Grace stock. To avoid any risk of short-swing liability, Fidelity also keeps the aggregate stock positions of its many funds below 10%.

**E. Liability of Controlling Persons**

Shareholders face additional legal obstacles should they exercise "control," often vaguely defined, over corporations. The securities laws are a principal but not the only source of these barriers. First, a shareholder or group which controls a public company can sell its shares only through a registered offering or the "dribble out" provisions of Securities Act Rule 144. Registration involves delay, expense, strict liability for material misstatements, and no assurance that registration is even possible, since the company's assistance is needed and may not be forthcoming.

Second, the controlling shareholder is liable for the company's securities law violations. The Securities Act provides an exemption from liability if the shareholder "had no knowledge of or reasonable ground to believe in the existence of the facts [which create liability]," and the Exchange Act provides an exemption if the shareholder "acted in good faith and did not directly or indirectly induce the ... violation," but these exemptions offer scant comfort. Both are highly context specific, and the shareholder's knowledge or good faith will always be judged in hindsight, after a violation has taken place.

The SEC expansively defines control as the "power to direct ... the management and policies of a person, whether through the ownership of voting securities ... or otherwise." This definition goes well beyond actual control. It's especially perverse for shareholder efforts to nominate and elect directors. Success in that endeavor can show power to direct the company's management and policies, and thus lead to control person liability. Frequent contact between the director and the

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86. In most circuits, this liability is nonexclusive, and a controlling person may also be liable for its agents' acts under the common law of agency. See, *e.g.*, *In re Atlantic Fin. Mgmt.*, 784 F.2d 29, 30-31 (1st Cir. 1986) (collecting cases).
shareholders who nominated her enhances that risk, because it is evidence that the shareholders are exercising, or at least could exercise, that power.

The SEC having defined control broadly, its staff interprets it more broadly still. The standard practitioner's advice is that a 10% holding "should create caution" and might even "create a rebuttable presumption of control, especially if such holdings are combined with executive office, membership on the board, or wide dispersion of the remainder of the stock." Thus, control person liability adds an additional strong impediment to a shareholder or group owning more than 10% of a company's stock; doubly so if the 10% shareholders seek to nominate and elect directors.

Shareholders who are also creditors (banks, insurers, pension funds, investment banks) face additional risks if they even arguably control a debtor company. Their claims can be subordinated in bankruptcy, or the debtor can sue claiming improper influence over the business. Practitioners advise that a claim of control can be founded on "holding a significant equity stake in the debtor." To determine how large a stake represents control, a bankruptcy judge could well adopt the 10% or so threshold used in the securities laws. Even a small risk of subordination will affect a creditor's negotiating strength.

Active shareholders face additional risks under the Superfund law, which imposes cleanup liability on every "owner or operator" of a hazardous waste facility. The term owner or operator isn't defined, except to exclude a person who "without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility." This implies that sharehold-

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90. Sommer, Who's "in Control"?—S.E.C., 21 BUS. LAW. 559, 568 (1966); see also Enstam & Kamen, Control and the Institutional Investor, 23 BUS. LAW. 289, 315 (1968) (10% is "rule of thumb" for the potential existence of working control). The SEC recently noted the "widely held belief that the ownership of 20% . . . voting power in a widely held company in most instances constitutes control." Exchange Act Release No. 27,035, 54 Fed. Reg. 30,490, 30,492 n.23 (July 14, 1989).

91. Investment banks have special reason to avoid even arguable control over a public company. If the investment bank underwrites the securities of such a company, it loses its due diligence defense and becomes strictly liable for material misstatements. See Securities Act § 11(b), 15 U.S.C. § 77k(a) (1988).


ers and lenders are liable for Superfund cleanup if they "participate in management," whatever that means.\textsuperscript{95} Finally, various statutes require regulatory permission before anyone can acquire control of an air, rail, or water carrier or a broadcast TV, cable TV, or radio company, or a 10\% interest in an electric or gas utility or an insurer.\textsuperscript{96}

F. Poison Pills

Flip-in poison pills with low percentage thresholds are a recent and important addition to the obstacles to shareholder voice. Pills are adopted by individual companies, but I treat them as a legal restriction because state lawmakers have granted corporate managers the unilateral power to adopt pills. It matters little whether state lawmakers restrict shareholder action directly or, knowing that corporate managers will accept the invitation, empower corporate managers to adopt restrictions without shareholder approval.\textsuperscript{97} Almost half of the major public companies have adopted pills,\textsuperscript{98} and the rest can put one in place on short notice if the need arises.

A typical flip-in pill works as follows.\textsuperscript{99} If any person or group acquires beneficial ownership of more than a threshold percentage of a company's stock, every other shareholder can buy a large amount of a common stock equivalent from the company for a low price. This destroys most of the value of the large shareholder's investment.

\textsuperscript{95} On shareholder liability, see, for example, New York v. Shore Realty Corp., 759 F.2d 1032, 1042-45 (2d Cir. 1985); United States v. Northeastern Pharmaceutical & Chem. Co., 810 F.2d 726 (8th Cir. 1986), cert. denied, 484 U.S. 848 (1987); Note, Interpreting the Meaning of Lender Management Participation under Section 101(20)(A) of CERCLA, 98 YALE L.J. 925 (1989). On lender liability, see, for example, United States v. Fleet Factors Corp., 901 F.2d 1550 (11th Cir. 1990).

\textsuperscript{96} Enstam & Kamen (1968), supra note 90, collect some of the relevant statutes. For a typical insurance law, see N.Y. INS. LAW §§ 1501(a)(2), 1506(a)(2) (McKinney 1985) (control presumed at 10\% ownership; acquisition of control requires superintendent's prior approval).


\textsuperscript{98} See INVESTOR RESPONSIBILITY RESEARCH CTR., INC., CORPORATE TAKEOVER DEFENSES 1989, at 1447 (1989).

\textsuperscript{99} The discussion in text is based on a form of poison pill recommended by Skadden, Arps, Slate, Meagher & Flom for consideration by clients. Differences among pills drafted by different law firms are usually minor, because the pills are public documents and innovations are quickly copied.
panies commonly use a 20% threshold percentage, and some go as low as 10%, with a strong trend over time to lower thresholds.\textsuperscript{100} Companies can also quickly lower the threshold if a large shareholder emerges. Moreover, some pills let the company’s board of directors \textit{retroactively} reduce the threshold, commonly to 10%, by declaring a shareholder to be an “adverse person.”\textsuperscript{101} Institutional fiduciaries can’t take even a small risk of triggering a poison pill. The downside risk is simply too great. Thus, the pill is a near-absolute barrier to forming a shareholder group larger than the threshold percentage for \textit{any} voting purpose.

Pills define beneficial ownership and “group” status at least as broadly as the 13(d) Rules. Beneficial ownership includes the right to vote shares, except pursuant to a revocable proxy given in response to a public solicitation that complies with SEC rules. The company’s board of directors, hardly a disinterested body, decides questions about a shareholder’s level of beneficial ownership or the existence of a group. Delaware case law permits use of a pill against a group formed solely to conduct a proxy contest, so long as the target’s board “could ... have reasonably concluded” that the pill wouldn’t “materially impair” the dissidents’ chances.\textsuperscript{102}

Poison pills put even shareholder proponents who stay below the threshold percentage at risk. Proponents must be doubly careful to comply with the Proxy Rules and the 13(d) Rules, lest the proxies they receive count toward the pill’s threshold percentage. The judicial remedy for violating the Proxy Rules or the 13(d) Rules is often only corrective disclosure. The pill dramatically escalates the cost of a violation, or a decision to test the outer limits of the SEC’s broad definitions of solicitation, proxy, or group.

G. \textit{Ownership Limits}

In a variety of ways, banks, insurance companies, mutual funds, and investment banks — most of the major categories of institutional investors — are limited in how much of a company’s stock they can own. Mark Roe has catalogued most of these restrictions, so a brief

\textsuperscript{100} Of 333 poison pills adopted or amended in 1989, 25 had a 10% threshold, 53 had a 15% threshold, 200 had a 20% threshold, and 55 had a 25% or higher threshold (all percentages rounded to nearest 5%). \textsc{Corp. Control Alert}, Dec. 1989, at 10-26; \textit{cf.} N.Y. Bus. Corp. Law § 505(a)(2) (McKinney Supp. 1990) (minimum 20% threshold).


Banks face tight restrictions on stock ownership. Outside of their trust departments, they can't own stock at all, and bank holding companies can own only 5% of the voting stock of an operating company. As a result, banks own puny amounts of stock. Citicorp, with total assets of over $200 billion, holds about $1 billion in equities, including preferred stock and nonvoting common stock. Other banks own even less. Savings and loans are forbidden to own any common stock.

Bank trust departments aren't directly barred from holding large stakes. No more than 10% of a bank's trust funds can be invested in the stock of a single company, but the trust would surely be this diversified anyway. The prohibition on direct bank control, however, limits what the bank can do with a large stake, and thus reduces incentives to acquire such a stake. The common use of a Chinese wall between a bank's loan and trust departments protects the trust department against conflict of interest and insider trading risk, but further reduces the bank's influence and thus its incentives to take a major position.

For insurance companies, common stock typically does not count toward required regulatory capital or surplus at all. Insurers can purchase stock out of excess capital and surplus but face limits on the percentage of these funds that they can invest in stocks, and tighter limits on how much they can invest in the stock of a single company.

Mutual funds face tough conflict of interest rules if they exceed 5% ownership of a company or put a representative on a company's board of directors. Moreover, to call itself diversified and retain critical tax advantages, a mutual fund cannot, for 75% of its assets, put over 5% of total assets into the stock of a single company, nor own more than a 10% stake in a company. Open-end funds must also stand ready to redeem shares on short notice, which limits their ability to take concentrated, illiquid positions.

Investment banks can own stock, even a control block. But their broker-dealer subsidiaries, which hold most of their capital, face SEC

103. Roe (forthcoming 1991), supra note 19. I will give citations only for restrictions not documented by Roe.


106. See, e.g., N.Y. INS. LAW § 1402 (McKinney 1985); CAL. INS. CODE § 1170 (West 1972).

107. Investment Company Act § 22(e), 15 U.S.C. § 80a-22(e) (1988), requires redemption within 7 days, but most mutual funds promise in their prospectus to redeem securities on a daily basis.
net capital rules that require a 30% "haircut" from market value for all common stocks, a 45% haircut on positions in a single company that exceed 10% of net capital, and a 100% haircut on a block that has no ready market.\textsuperscript{108} Broker-dealers are usually highly leveraged off a limited net capital base, so these haircuts sharply limit their equity investments.

Pension funds, alone of the major financial institutions, have no direct limit on how much stock they can own, nor on the percentage stake they can have in a particular institution. They are limited in other ways, however, as discussed in the next section.

\section*{H. Fiduciary Liability}

The liability of corporate pension plan fiduciaries under the Employee Retirement Income Security Act (ERISA),\textsuperscript{109} and of public pension plan fiduciaries under the common law of trusts, affect shareholder action in a number of intersecting ways. The prevailing watchword, though, is caution. Broad diversification and passivity are safe; concentrated ownership and activism are dangerous.\textsuperscript{110}

Under ERISA, pension plan managers must act for the exclusive benefit of plan participants, or face civil and criminal liability. They are enjoined to exercise "the care, skill, prudence, and diligence . . . [of] a prudent man acting in a like capacity," and to "diversify[ ] . . . so as to minimize the risk of large losses, unless . . . it is clearly prudent not to do so."\textsuperscript{111} Diversifying widely, owning small percentage stakes in hundreds or even thousands of companies, is safe, since it is what others "in a like capacity" are doing. In contrast, owning large stakes in a smaller number of companies, which could increase the gains from monitoring, is risky because it isn't what others are doing, and doesn't "minimize" the risk of "large losses."

Finance texts teach that 95\% of the value of diversification is gained by owning only 20 properly chosen stocks; 99\% by owning 100 stocks.\textsuperscript{112} A large loss on one investment will likely be offset by a large

\begin{footnotes}
\item[110] See generally B. KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT (1989); Krikorian, Fiduciary Standards for Institutional Investors: Overview and Current Issues, in FIDUCIARY RESPONSIBILITIES (forthcoming 1991), supra note 55; B. LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986). Except where specifically noted, I treat both corporate and public pension plans as subject to the same rules, because ERISA borrows heavily from the common law of trusts and because public plan managers, though not formally subject to ERISA, will be reluctant to depart from ERISA's codification of fiduciary duties.
\item[112] See, e.g., R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 156 (3d ed.)
\end{footnotes}
gain on another. But that may not matter to a court or agency which, with selective hindsight, sees only the large loss. Indeed, the common law of trusts traditionally applied the prudence standard to each individual investment, not to the portfolio as a whole, and is only now beginning to recognize portfolio investing. Under ERISA, Labor Department rules require fiduciaries to consider portfolio diversification in making investment decisions. But the Department gives diversification its "customary meaning" as a means for "reducing the risk of large [individual] losses," not its modern meaning as a way to reduce portfolio risk. In practice, courts haven't always offset losses against gains.

As for passivity, the Labor Department insists that ERISA fiduciaries treat voting rights as a plan asset. This requires that the pension plan vote its shares, instead of abstaining, and do so for the exclusive benefit of plan beneficiaries. But the Department has not encouraged shareholders to make their own proposals, as opposed to merely voting on proposals made by others. Assistant Secretary of Labor David Walker recently warned:

> [P]roactive efforts by pension plans should be pursued with caution. They must also be in the interest of plan participants and beneficiaries, cost beneficial, and otherwise consistent with ERISA. . . . Any attempts on behalf of shareholders to micromanage would likely be counter-productive and normally would not be cost-beneficial in any event.

The Labor Department has been silent on the basic question of whether an ERISA fiduciary can ever spend plan money to promote a


113. Compare RESTATEMENT (SECOND) OF TRUSTS § 213 (1959) (gain from one breach of trust should not be offset against loss from another "distinct" breach) with RESTATEMENT (THIRD) OF TRUSTS § 227(a) (Proposed Final Draft Apr. 6, 1990) (prudent investor standard should be applied to trust portfolio, not to individual investments seen in isolation); see also Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. REV. 52, 66-67 (1987) (traditional trust law requires that "each investment . . . measured in isolation" be safe).

114. 44 Fed. Reg. 37,221, 37,223 (1979); see also id. at 37,224 n.7 (index funds must use a "screen or filter process" to exclude companies that have suffered "significant, adverse financial developments," even if the companies are still in the index). The portfolio diversification rules are in 29 C.F.R. § 2550.404a-1(b) (1990).

115. See Leigh v. Engle, 858 F.2d 361, 367-68 (7th Cir. 1988).


shareholder proposal. The danger that a court might find the campaign cost to be money imprudently spent may explain why no ERISA fiduciary, to my knowledge, has ever offered a proposal. Public pension funds have made proposals, but they aren't governed by ERISA. Nor do we know whether a fund can spend money to defend a lawsuit by the company, sue the company if need be in furtherance of a proposal, or, worse yet, pay an adverse judgment out of plan assets. Yet litigation is always a risk for an active shareholder.

A further obstacle to owning a large stake in a single company or actively monitoring company managers is the received trust law wisdom that active management of an operating business violates the prudent investor rule. It isn't clear that oversight of someone else's management violates this rule, or even that the rule is still good law. But counsel can't advise pension trustees how much involvement is safe.

If an ERISA fiduciary loses a fiduciary duty lawsuit, she must pay the loss personally, including legal fees; the plan can neither reimburse nor insure against these costs. The fiduciary can insure separately, but this is small comfort to individuals who may lack the wherewithal to do so. Criminal liability for willful violation of any provision of ERISA provides an additional reason for caution, though the risk of actual prosecution is low.

Bank trust officers are bound by the common law of trusts, and thus have incentives for caution similar to pension plan managers. Moreover, if a bank lends funds to a company in which it owns stock as a trustee, a trust beneficiary can claim that the bank's voting actions were tainted by a conflict of interest, and benefited the bank's loan position rather than its stock position. To avoid this risk, as well as claims that the bank, as lender, was privy to inside information that informed its stock trading decisions, banks commonly build a Chinese wall between the lending and trust departments. The wall, however, interferes with effective monitoring and doesn't offer complete protec-

118. See Restatement (Second) of Trusts § 227 Comment f (1959) ("the following are not proper trust investments: . . . employment of trust property in the carrying on of trade or business").

119. The Restatement (Third) of Trusts § 227 (Proposed Final Draft Apr. 6, 1990) does not include the ban on active management found in the Restatement (Second).

120. See 29 U.S.C. § 1110 (1988); Leigh v. Engle, 858 F.2d 361, 369 (7th Cir. 1988). In a suit by the Labor Department for breach of fiduciary duty under ERISA, there is also a (probably uninsurable) penalty of 20% of the amount recovered, whether through settlement or judicial decree. 29 U.S.C. § 1132(f) (as amended by Pub. L. No. 101-239, § 2101, 101 Stat. 2123 (1990)).

tion. Passivity is safer: It’s easier to find a conflict in what the bank does than in what it doesn’t do.

I. State Antitakeover Laws

Most states have antitakeover laws that restrict shareholder voting power to some degree. A few have recently adopted statutes that sharply restrict shareholder power. This may reflect an emerging trend in the 1990s, as the states, with hostile takeovers fading and institutional voting power growing as a threat to local companies and their managers, turn their attention to proxy contests. This section surveys the principal types of statutes.

From a shareholder voting perspective, freeze laws are the least troublesome of the major types of antitakeover laws. These statutes prohibit mergers and other business combinations with an “interested shareholder” for three to five years after the shareholder acquires stock above a threshold level, usually 10-15% of the outstanding shares. They provide a further reason for shareholders not to buy large blocks, but don’t otherwise greatly affect shareholder voting.122 Disclosure laws, adopted by 21 states, require a shareholder or group that owns more than a threshold percentage (typically 5%) to file a disclosure form with the state in addition to the Schedule 13D federal filing. These laws add modestly to the disclosure and litigation risk burden created by the 13(d) Rules.123

Control share laws, adopted in at least 27 states, have a greater chilling effect on shareholder action. They typically deprive a person or group that acquires a 20% stake from voting any shares over the 20% threshold unless the other shareholders vote to restore voting rights at a special shareholder meeting.124 The 20% holder must pay the company’s expenses for holding the special meeting. Some statutes also prohibit acquisition of shares over the 20% threshold without the prior consent of the other shareholders;125 some limit which shareholders can vote to restore voting rights in an effort to make a


123. See, e.g., N.Y. BUS. CORP. LAW §§ 1600-1613 (McKinney 1986). Lieberman & Bartell (1990), supra note 97, at 150 n.4, compile the statutes.


125. See, e.g., OHIO REV. CODE ANN. § 1701.831(A) (Baldwin 1986).
favorable vote harder to obtain. 126

Control share laws typically adopt the broad 13(d) definition of "group," which covers voting groups. 127 Thus, a shareholder consortium can't cross the 20% threshold. Some states exclude voting power obtained through a proxy solicitation governed by the Proxy Rules, but others don't. Without this exclusion, a shareholder proponent could arguably lose voting rights if she gains more than 20% support, which — Catch 22 — will happen for any successful proposal. 128

A few states have recently adopted more extreme antishareholder laws. Massachusetts, for example, recently required public companies to have staggered boards. 129 Employees also receive “tin parachute” severance benefits if terminated within one year after a proxy fight. 130

A new Pennsylvania “disgorgement” law requires any shareholder or group who acquires a 20% stake in a Pennsylvania company, or discloses that it “may seek to acquire control . . . through any means,” to disgorge any profits from selling shares for 18 months thereafter, if the shares were bought up to 24 months before the attempt. “Control” is defined using the broad SEC definition discussed in section III.E. Thus, a shareholder effort to nominate and elect directors may foreclose liquidity for 18 months, even if the effort fails! 131 Pennsylvania also has a “cash-out” law that requires any person or group which acquires 20% voting power in a public company to offer to buy all other shares at a court-determined fair price. The law has no exception for voting power obtained by soliciting proxies. In theory, anyone who receives 20% support in an election contest must offer to buy out all other shareholders. 132


127. See, e.g., NASAA-ABA MODEL CONTROL SHARE ACT, supra note 124, § 3(a). Some statutes, such as IND. CODE ANN. § 23-1-42-1 (West 1989), leave “group” undefined, but a reviewing court is likely to adopt the SEC definition.

128. Compare NASAA-ABA MODEL CONTROL SHARE ACT, supra note 124, § 3(e)(3)(K) (excluding voting rights obtained through a proxy solicitation) with IND. CODE ANN. § 23-1-42-2 (West 1989) (no comparable exclusion); see NASAA-ABA MODEL CONTROL SHARE ACT, supra note 124, commentary to § 3(e)(3)(K) (“Without such an exclusion, ordinary proxy solicitations would regularly result in a control share acquisition by the soliciting person in acquiring the power to direct the exercise of voting power of 20% or more.”).

129. MASS. GEN. LAWS ANN. ch. 156B, § 50A (West Supp. 1990). After January 1, 1992, the shareholders can opt out, but only by an impossible-to-obtain vote of two thirds of the outstanding shares.

130. MASS. GEN. LAWS ANN. ch. 149, § 184 (West Supp. 1990).

131. 1990 Pa. Laws 36 (to be codified at 15 PA. CONS. STAT. ANN. §§ 2573-2574); see also 1990 Ohio Legis. Serv. 5-222, 5-239 (Baldwin) (to amend OHIO REV. CODE ANN. § 1707.043) (18-month disgorgement period; limited exception for bona fide attempt to acquire control).

Many states combine multiple antitakeover laws. For example, Pennsylvania has freeze, disclosure, control share, and tin parachute laws in addition to the disgorgement and cash-out laws discussed above; Ohio has freeze, disclosure, control share, and disgorgement laws. Some laws nominally apply to companies incorporated elsewhere that meet specified nexus requirements. These laws are probably unconstitutional, but the need to challenge them adds to a shareholder’s litigation burden.

In sum, state antitakeover laws further burden the process of shareholder collective action. They affect all types of shareholder action, and make it especially hard for shareholders to nominate and elect directors, even to a minority of board seats. Moreover, if shareholders gain power at the polls, the states — acting out of some combination of concern for employees and communities and accession to managers’ lobbying and campaign contributions — may act to preserve the managers’ autonomy. The states can change structural rules (e.g., require a staggered board; reduce the vote needed to adopt a manager proposal); create roadblocks for active shareholders; or cut back shareholder rights, such as power to call a special meeting or act by written consent.

J. Antitrust Concerns

The Hart-Scott-Rodino Antitrust Improvements Act and accompanying Federal Trade Commission (FTC) rules requires large shareholders to file a disclosure form with the FTC and the Department of Justice, pay a $20,000 filing fee, and receive FTC approval before buy-

Corp. v. Centaur Partners, 710 F. Supp. 111 (E.D. Pa. 1989) holds that the Pennsylvania cash-out law is triggered by execution of shareholder consents to call a special shareholder meeting.


135. See, e.g., 15 PA. CONS. STAT. ANN. § 1914(a) (Purdon Supp. 1990) (adopted 1988) (charter amendments can be approved by a majority of the votes cast; most states require a majority of the outstanding shares); Garrity, Some Distinctive Features of the New Pennsylvania Business Corporation Law, 45 BUS. LAW. 77 n.146 (1989) (observing that Honeywell’s unsuccessful antitakeover amendments would have passed under the Pennsylvania rule).

ing more than 15% or $15 million, whichever is less, of a public company's stock. There are exemptions for (i) purchases of up to 10% of a company's stock made "solely for the purpose of investment"; (ii) purchases by institutional investors solely for the purpose of investment and in the ordinary course of business, up to the greater of 15% or $25 million; and (iii) all purchases by public pension funds.

The key term "solely for the purpose of investment" is defined so narrowly that anything a shareholder does, beyond passively voting shares, could require a filing. The purchaser must have "no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." The FTC has listed, as activities that "could be . . . viewed" as inconsistent with investment purpose: "(1) Nominating a candidate for the board of directors of the issuer; (2) proposing corporate action requiring shareholder approval; [and] (3) soliciting proxies . . . ." A senior FTC official recently warned that the FTC construes the exemption "very narrowly" to apply only to "passive investors," and is "closely scrutiniz[ing]" institutional efforts to become active shareholders. The concept of an active investor, it seems, isn't in the FTC's vocabulary.

For the moment, Hart-Scott-Rodino is only a minor barrier to large shareholder purchases or formation of shareholder groups. Institutions that make shareholder proposals don't file the Hart-Scott-Rodino forms, and the FTC hasn't yet prosecuted them. There is no private right of action for failure to file, nor a vague concept of group ownership to impede joint shareholder efforts. But the FTC could require active shareholders to file at any time, especially if the shareholders begin to nominate director candidates. Compliance, if required, would still be a one-time event, and could become routine since institutional purchases only weakly implicate the antitrust concerns underlying the filing requirement. But the $20,000 per company


138. See 15 U.S.C. § 18a(c)(9) (1988) (investment intent exemption); 16 C.F.R. § 802.64 (1990) (institutional investor exemption); 16 C.F.R. § 801.1(a)(2) (exempting state agencies, which include public pension funds). The FTC proposed in 1989 to exempt all purchases of up to 10% of an issuer's voting stock without regard to intent, 54 Fed. Reg. 7960 (Feb. 24, 1989), but doesn't plan to adopt the proposal.


141. Prepared Remarks of John Sipple, Chief, FTC Premerger Notification Office, before the Antitrust Law Section of the New York State Bar Association 15, 16, 19 (Jan. 16, 1990). The FTC has set up a special project to examine the investment intent exception, including whether it should apply to active institutional shareholders. Telephone conversations with John Sipple (Aug. 24, 1990) and Kenneth Libby (an FTC attorney working on the project) (Dec. 20, 1990).
filing fee is a significant deterrent for a large institution which might have to file for all portfolio companies.

If institutional shareholders nominate and elect their own directors on a broad scale, the Clayton Act section 8 ban on any "person" being a director of two competing companies creates an additional antitrust hurdle.142 It's easy for the same individual not to serve on the boards of competing companies. But the interlock ban may also prevent an institution from deputizing two individuals to represent it on the boards of competing companies.143 How deputization would be determined is unclear; the FTC wants to use the vague standards applied under Exchange Act section 16.144

K. Tainted Votes

In many proxy contests, corporate managers will receive votes from shares they don't personally own, for reasons unrelated to the merits of the proposal. The managers can often increase in midcontest the number of votes in their pocket, should the need arise. This section catalogs the ways in which managers can obtain such tainted votes. First, managers can put pressure on institutional investors to vote promanager for reasons unrelated to the merits of the proposal. The conflicts of interest that make such pressure effective are explored in Part VIII.

Second, under New York Stock Exchange (NYSE) rules, stockbrokers who hold shares in street name for their clients can vote those shares on routine matters unless the client gives them voting instructions at least 10 days before the meeting. They can't vote client shares if they know of a contest, nor on a merger or other matter "which may affect substantially the rights of privileges of such stock."145 Operating under this vague standard, the NYSE lists in a weekly bulletin the matters on which member firms may vote client shares. Brokers invariably vote client shares promanager.


145. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL ¶ 402.06(D) (looseleaf 1990); see also 2 Am. Stock Ex. Guide (CCH) ¶¶ 9528-9529; National Association of Securities Dealers, Rules of Fair Practice art. III, § 1, Interpretation .05, NASD Manual (CCH) ¶ 2151.05.
Usually, this rule simply pads the affirmative vote on routine matters. Unfortunately, the NYSE staff takes an expansive view of what matters are routine. Increasing authorized common stock is considered routine, as is eliminating director liability for violating the duty of care. A manager proposal to eliminate cumulative voting is routine; a shareholder proposal to reinstate it is not. The NYSE staff can also be incredibly ignorant; it has more than once authorized a promanager vote despite a well-publicized proxy fight. Even when the NYSE instructs brokers not to vote client shares on a particular matter, enforcement is nonexistent, and anecdotal evidence suggests that brokers sometimes vote when they shouldn't. Moreover, abstaining on a shareholder proposal, as the NYSE requires, has the same effect as a promanager vote if the proposal requires a percentage of the outstanding shares for passage or if the company treats abstentions as "no" votes, as many do.

Third, commercial banks, which also hold stock as nominees, can vote client shares on any matter, subject only to the bank's fiduciary duty to its clients. Banks, like broker-dealers, routinely vote promanager.

Fourth, company proxy cards invariably provide that shareholders who simply sign the card have voted for the managers' choice on all issues presented. Some shareholders simply sign and return the card, never having read the proxy statement. The rational apathy that leads to such voting is hard to control, but legal rules turn apathy into a promanager vote.

Fifth, the managers tabulate the ballots, or at least appoint the tabulators. Even if the tabulators are basically honest, the complex system of proxy voting, where shareholders vote through layers of record holders and votes can be repeatedly cast and revoked, produces many ballots that can be either counted or thrown out as irregular, and some where the number of votes cast is unclear. The tabulators must exercise discretion, and experience teaches that they exercise that discretion in the managers' favor more often than not.


148. See, e.g., Gavin, Changes in Corporate Control and Governance Communicated Through Proxy Power, in FIDUCIARY RESPONSIBILITIES (forthcoming 1991), supra note 55 ("The primary objective in the timing of [proxy contest] mailings is to have the first and last proxy card in the mail. This deals with those shareholders who only sign the first card as well as those who sign every card, no matter who the sender.").

Sixth, managers can put blocks of stock in friendly hands, even in midcontest. Polaroid, for example, recently defeated a hostile bid by issuing a 14% block to an employee stock ownership plan (ESOP) and selling a large block of voting preferred stock to Corporate Partners, a white squire fund, on terms highly favorable to Corporate Partners.150

Finally, managers can vote some shares that they don’t own. Corporate pension plans usually own at least some stock in the sponsoring company. Company managers usually can ensure that these shares are voted promanager; some vote the shares themselves. Contrast this with the usual rule that treasury shares and shares held by subsidiaries can’t vote.151 Similarly, ESOP trustees, who are often company managers, can vote unvested ESOP shares. Unvested ESOP shares were an important factor in the 1990 Lockheed proxy fight.152 Moreover, some companies have standstill agreements with large shareholders under which the shareholder agrees to vote promanager on all or at least some matters.153

L. Cultural Factors

Informal, cultural barriers compound the formal legal obstacles to shareholder action. Money managers don’t keep on their desks an extensive description of the many relevant legal rules. A few have sophisticated legal counsel; many do not. They operate instead on a developed sense of proper and improper behavior. For most, trying to out-trade the next money manager is the norm; trying to improve performance by being a good corporate monitor is not. Taking market

The tabulators chose a procedure for interpreting multiple ballots by record holders that they had been told orally was incorrect by a representative of Independent Election Corp. of America, which handles voting for many record holders. The chosen procedure swung the vote in the managers' favor. The court upheld the tabulators' choice as reasonable.

150. See Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989). A mid-contest issuance is likely to be upheld, the cases suggest, if the transaction is at arms-length and the voting power is reasonably related to the price paid for the stock. Compare, e.g., Shamrock Holdings, 559 A.2d at 278; British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc., 664 F. Supp. 1519 (S.D.N.Y. 1987) (upholding sale of stock to investment bank); and Geko Corp. v. Coniston Partners, 811 F.2d 414 (8th Cir. 1987) (same) with, e.g., Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (enjoining dividend of supervoting stock which loses most of its votes upon transfer) and Packer v. Yampol, C.A. No. 8432 (Del. Ch. 1986) (enjoining company's sale of supervoting stock to its CEO).


153. Cummins Engine, for example, recently sold a 27% stake to three other companies under a six-year standstill agreement that binds the other companies to vote for Cummins' director nominees. See Cowan, Cummins Will Sell 27% Stake, N.Y. Times, July 16, 1990, at D1, col. 6.
risk is the norm; taking legal risk is not. For index fund managers, keeping costs to a minimum is expected; spending money on corporate governance issues is not. For pension fund sponsors, being highly diversified is customary; taking concentrated positions is not. If the legal rules were changed, cultural norms might change too, but only slowly.

Some money managers also believe that legal obstacles are stronger than they really are.154 Pension fund managers believe that owning more than 10% of a company’s stock is highly risky, though they may neither need nor, given their size, even be able to use the liquidity that is foreclosed by short-swing profit forfeiture. Many believe that it is illegal to control an operating company; in this, they are simply wrong. Some believe that they ought to be massively diversified, though there are no decided cases to tell them so and the financial benefits are minimal. Mutual fund managers worry that they will lose access to the soft information obtained through analyst meetings and visits to company facilities if they become active, though it isn’t clear how often this will happen, nor that the information does the managers much good. Possible causes of shareholder reluctance to own large stakes or otherwise do what they can within the existing rules include fear of a political backlash should institutions gain too much power,155 concern that large positions can lead to large, embarrassing losses,156 and simple fear of the unknown. No one has done it, whatever “it” is, therefore it must be risky or illegal. It’s hard for a fiduciary to take the first, risky step.

Money manager training reinforces the passivity norm. A generation of MBAs have grown up with modern portfolio theory, in which securities are fungible, characterized by risk and return and no more. Finance texts teach, for example, that a properly constructed package of put and call options is equivalent to the underlying common stock. And so it is, except for voting rights — an exception that the texts don’t deem worthy of mention.157

The culture of passivity may be especially strong because it is convenient. A passive manager can ignore, for the most part, the conflicts

154. The statements in text are based on a number of informal discussions with money managers between 1988 and 1990.
156. One public fund manager, when I asked why his fund didn’t take large positions, noted that another fund — Wisconsin Investment Board — recently suffered considerable embarrassment by being the largest shareholder in Prime Motor Inns when it went bankrupt. Telephone conversation (Nov. 5, 1990).
of interest discussed in Part VIII. She can convince herself that she is both doing well and doing good for others; that her high pay is deserved because she is making money for her beneficiaries. A manager who becomes active in corporate governance, in contrast, must confront more directly the tension between supporting management, which may be in her self interest, and doing what's right for her beneficiaries.

M. The Political Economy of the Shareholder Voting Rules

This section provides a rough outline of the political economy of the legal rules affecting shareholder voting; why the rules may have developed as they did. The discussion complements Mark Roe's analysis of legislative efforts to limit the power of large financial institutions.158

To some extent, the promanager, antishareholder tilt of the rules affecting shareholder voting is deliberate: Congress, the SEC, and the states fully intended the rules to insulate corporate managers from too much shareholder oversight, by financial institutions or anyone else. The first federal foray into proxy voting, the adoption of Exchange Act section 14 in 1934, is usually seen—with some justification—as an effort to protect shareholders. But one can find an intent to protect incumbents as well. One purpose of the Proxy Rules, a Senate Report explains, was to protect investors from proxy solicitations "by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials."159 The 1956 expansion of the Proxy Rules, especially the disclosures required of dissidents, came after a surge in proxy fights in the early 1950s, which led managers to pressure Congress and the SEC to act against the evil corporate "raiders."160 A promanager tilt can also be found in the broad reach of section 13(d). Congress authorized the SEC to exempt shareholders whose actions had neither the purpose nor the effect of changing or influencing control of the issuer. This was intended, the bill's sponsor said, to protect the "legitimate buyer" who was buying stock "strictly for investment purposes and with absolutely no interest in affecting management policy."161

159. S. REP. NO. 1455, 73d Cong., 2d Sess. 77 (1934).
161. 111 CONG. REC. 28,259 (1965) (remarks of Senator Williams) (emphasis added). The Business Roundtable and the American Society of Corporate Secretaries have predictably opposed the recent proxy reform proposals by CalPERs and United Shareholders, and instead have asked the SEC to tighten the Proxy Rules even further. See Letter from Richard Troy, Chairman, Am. Socy. of Corp. Secretaries' Ad Hoc Comm. on the Proxy System, to Linda Quinn,
At the state level, lobbying and campaign contributions by corporate managers produce much of the impetus for antitakeover laws. The laws passed in 1990 in Pennsylvania (to protect Armstrong World Industries) and Massachusetts (to protect Norton Industries) suggest that legislatures are willing to protect incumbent managers from attack through the proxy process as well as through a takeover bid.

A conscious promanager tilt only partly explains the development of obstructive rules, however. Through much of the period from 1934 to the present, SEC staffers genuinely believed that the Proxy Rules helped shareholders by ensuring complete and accurate information as a basis for voting. The costs of disclosure rarely were part of the equation. Some examples: former SEC staffers Frank Emerson and Franklin Latcham described the Proxy Rules as the “cornerstone of shareholder democracy”; 162 SEC Chairman Sinclair Armstrong pushed through the 1956 amendments that increased the burden of the Proxy Rules for dissidents, while believing that the rules “provided an enormous base for the thing called ‘corporate democracy.’ ” 163 The same belief in the proshareholder nature of the Proxy Rules was universally held when I worked for the Commission in 1987 and 1988. The SEC’s preference for extensive disclosure is also partly explainable in political terms. Congress is more likely to take the SEC to task for the scandal that more disclosure might have prevented than for the subtle costs of excessive disclosure. 164

A third element of the political economy of shareholder voting rules, closely related to agency belief in the value of its own rules, is the bureaucratic tendency to construe jurisdiction broadly, without defining the outer boundaries of that jurisdiction, lest the definition leave an unintended loophole. The SEC has pushed, for example, for broad definitions of key terms in the Proxy Rules, the 13(d) Rules, and elsewhere. In some cases, the investor protection rationale for regulation is thin, and the SEC seems oblivious to the costs of the expansive sweep of its rules. 165 The FTC has likewise never explained why it

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165. In the proxy area, see, for example, Studebaker Corp. v. Gittlin, 360 F.2d 692, 695 n.2 (2d Cir. 1966) (SEC supports Studebaker’s attempt to treat dissident’s effort to obtain 5% support required under state law to obtain a shareholder list as a proxy solicitation); Halstead v.
construes the investment purpose exemption from the Hart-Scott-Rodino rules so narrowly, and there seems little antitrust reason for doing so.

Sometimes, obstructive rules appear almost by accident, with the SEC showing no appreciation for their consequences. For example, the Commission added the critical word “voting” to the activities that cause shareholders to be considered a “group” under the 13(d) Rules with the casual explanation that: “Minor word changes have also been made from the predecessor [rule] . . . . The Commission considered ‘voting’ to be subsumed within the term ‘holding’ but has decided to make this express to avoid any misunderstanding.”166 Similarly, it’s doubtful that the Commission has ever considered the impact on shareholder voting of its ultrabroad interpretation of control.

Without more extensive research, which is beyond the scope of this article, we can’t say how much of the promanager tilt of the rules affecting shareholder voting is an intended result of manager lobbying efforts; how much results from misguided beliefs by regulators in the beneficial effects of the rules they administer; how much from agency efforts to expand jurisdiction; and how much is an accidental by-product of rules adopted for other purposes at a time when shareholder voice was unimportant and thus not weighed in the regulatory balance. Most likely all four causes play a role.

IV. COLLECTIVE ACTION PROBLEMS: EVIDENCE

To recap where this article has been and where it is going, Part III developed my legal claim: Shareholder passivity may be partly a function of legal rules. Institutional shareholders who want to become active face costs, legal limits, and legal risks wherever they turn. Legal barriers are especially great for the central shareholder task of nominating and electing directors. For the most part, no single rule is a show stopper; no single cost is prohibitive. But the accumulation of numerous obstacles and risks imposes a substantial burden on shareholder action. Even a small risk may be enough to dissuade a pension plan manager or other fiduciary, who sees the downside risk of activ-

ism while her beneficiaries get the upside. Against this background, the failure of institutions to purchase large stakes in individual companies, form voting groups, or mount director election campaigns may reflect legal barriers as much as the collective action problems posited by the passivity story.

This Part develops my factual claim: Shareholder passivity may also be historically contingent, a function of more dispersed and more conflicted ownership in the past than we have today. Section IV.A reviews the data on institutional share ownership, and its implications for shareholder voting. Section IV.B reviews recent shareholder activism on corporate governance issues. Parts V and VI develop my theoretical claim that collective action problems are not an insuperable barrier to shareholder action. Parts VII and VIII discuss, respectively, two additional explanations for shareholder passivity: agenda control by corporate managers and institutional investor conflicts of interest.

A. The Growth of Institutional Ownership

The passivity story assumes a stylized model of the large public corporation as having thousands of shareholders, each owning a tiny fraction of its shares. Those stylized facts, never wholly true, are today simply false. Carolyn Brancato, using an incomplete definition of "institution," estimates that institutions owned 42.7% of all corporate equities in 1986, compared to 38.5% in 1981. Large companies typically have even higher institutional ownership, often over 60% and in some cases over 75%. Demographic trends ensure that these percentages will continue to rise for the foreseeable future.

More importantly, individual institutions have grown to substantial size, and own significant percentages of individual companies. At yearend 1989, the 50 largest institutions owned $925 billion in stocks, or 27% of the entire U.S. stock market. The 13 largest institutions

167. See, e.g., Manne (1972), supra note 10, at 491 ("AT&T and others have too many shareholders to conduct shareholders' meetings like a New England town meeting"); Easterbrook & Fischel (1983), supra note 10, at 402 (using an example with 1000 voters, each with a 0.1% stake in the election outcome); Clark, Vote Buying and Corporate Law, 29 CASE W. RES. L. REV. 776, 779-84 (1979) (using an example with 10,000 shareholders to illustrate rational apathy and free rider problems).


held over half of this amount — an average of over 1% of the U.S. market each.\textsuperscript{170} It's common for a single institution to hold 2-3% of the stock of a single company. A few institutions will cross the 5% threshold for filing a Schedule 13D or 13G, though usually not the 10% threshold at which insider trading rules kick in. Institutional investors also aren't anonymous. SEC Form 13F filings provide a good picture of institutional holdings.\textsuperscript{171} The biggest institutions are well known; some have widely recognized acronyms, such as CalPERS, CalSTRS, NYCERS, and CREF.\textsuperscript{172}

No important financial barriers prevent a single institution from owning 5%, 10%, perhaps more of a single company. An institution that owns 1% or more of the equity interest in corporate America, as the largest institutions do, would remain amply diversified if it owned 5% stakes in 20% of the publicly traded companies, instead of 2% stakes in half the companies. Large stakes reduce liquidity, but that shouldn't matter much for an institution that is already too big to sell quickly an appreciable fraction of its portfolio. The smaller stakes that most institutions hold today may reflect less the need for diversification or liquidity than the legal obstacles to such ownership stakes discussed in Part III. If the legal obstacles were reduced, ownership stakes might increase.

Legal obstacles notwithstanding, institutions are talking about, and occasionally moving toward, owning substantial stakes individually, or forming groups to hold such stakes. Berkshire Hathaway has purchased stock representing roughly a 10-15% stake in several major companies, including Capital Cities/ABC, Champion International, Gillette, Salomon Brothers, US Air, and Wells Fargo, and a Berkshire officer has become a director of some of these companies as part of the transaction.\textsuperscript{173} CalPERS recently spent $400 million for a 20% stake in Santa Fe Realty.\textsuperscript{174} The Council of Institutional Investors is encouraging its members to pool their funds to buy stakes of 15% or so in selected companies, and possibly seek board representation as


\textsuperscript{172} CalPERS is the California Public Employees' Retirement System; CalSTRS is the California State Teachers Retirement System; NYCERS is the New York City Employee Retirement System; CREF is the College Retirement Equities Fund.


\textsuperscript{174} See Clark (1990), supra note 83, at 70.
These are small steps in a $3 trillion stock market, but they suggest an emerging trend. There were sharp changes in the 1980s in the relative sizes of different institutions. The table on the next page shows stock ownership growth from 1980 to 1988 for six major types of institutions. Public pension funds and mutual funds grew rapidly, from 7.0% of NYSE capitalization in 1980 to 16.7% in 1988. In contrast, corporate pension funds, nonpension bank trusts, and insurance companies shrank slightly, from 38.2% of NYSE capitalization in 1980 to 37.7% in 1988. These trends have accelerated in the last few years, with private pension funds, insurers and nonpension bank trusts declining from 38.5% of NYSE capitalization in 1986 to 37.7% in 1988, while public pension funds and mutual funds grew from 14.2% to 16.7%.

The differences in growth rates are important. As discussed in Part VIII, public pension funds (a group in which, for convenience, I include CREF) and mutual funds have weaker direct conflicts of interest in monitoring corporate managers than do corporate pension funds, banks, and insurers, who rely on corporations for new business, or foundations and endowments, who want to receive corporate gifts. This suggests that public pension funds and mutual funds will be more likely to advance their own proposals and to oppose management proposals. Indeed, public funds have been the leading actors in the recent increase in institutional activism described below.

175. Telephone conversation with Sarah Teslik, Executive Director, Council of Institutional Investors (Nov. 13, 1990).
### CHANGES IN INSTITUTIONAL EQUITY OWNERSHIP

**Panel A: NYSE Data for 1980-1988**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Stock Owned in 1980</th>
<th>Stock Owned in 1988</th>
<th>Asset Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$billions</td>
<td>As % of NYSE Cap.</td>
<td>$billions</td>
</tr>
<tr>
<td>Public Pension Funds</td>
<td>44</td>
<td>3.6%</td>
<td>224</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>42</td>
<td>3.4</td>
<td>188</td>
</tr>
<tr>
<td>Private Pension Funds</td>
<td>224</td>
<td>18.0</td>
<td>511</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>79</td>
<td>6.3</td>
<td>164</td>
</tr>
<tr>
<td>Bank Trusts</td>
<td>173</td>
<td>13.9</td>
<td>252</td>
</tr>
<tr>
<td>NYSE Capitalization</td>
<td>1243</td>
<td>100.0%</td>
<td>2458</td>
</tr>
</tbody>
</table>

**Panel B: Brancato Data for 1981-1986**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Stock Owned in 1981</th>
<th>Stock Owned in 1986</th>
<th>Asset Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$billions</td>
<td>As % of Mkt. Cap.</td>
<td>$billions</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>39</td>
<td>2.5%</td>
<td>201</td>
</tr>
<tr>
<td>Public Pension Funds</td>
<td>47</td>
<td>3.1</td>
<td>150</td>
</tr>
<tr>
<td>Private Pension Funds</td>
<td>239</td>
<td>15.5</td>
<td>493</td>
</tr>
<tr>
<td>Foundations/Endowments</td>
<td>28</td>
<td>1.8</td>
<td>58</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>87</td>
<td>5.7</td>
<td>141</td>
</tr>
<tr>
<td>Bank Trusts</td>
<td>155</td>
<td>10.1</td>
<td>293</td>
</tr>
<tr>
<td>Market Capitalization</td>
<td>1542</td>
<td>100.0%</td>
<td>3109</td>
</tr>
</tbody>
</table>

Ownership concentration is especially high among public funds. In 1989, the 4 largest pension funds, and 14 of the 20 largest, ranked by total assets, were public funds. The largest mutual fund groups — Fidelity, Vanguard, T. Rowe Price — rival the largest pension funds in size. This concentration facilitates joint action and reduces the incentives for passivity created by fractional ownership.

### B. The Rise in Shareholder Activism

Institutional ownership is beginning to translate into significant voting power. Social responsibility proposals continue to struggle to meet the 3-10% thresholds for inclusion on next year’s ballot. But as ownership by public pension funds and mutual funds grew in the 1980s, so did shareholder activism on corporate governance, with the public funds as the leading players. Perhaps too, the takeover boom of the 1980s, which highlighted manager willingness to deprive share-

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holders of takeover premiums, increased shareholder sensitivity to the importance of governance issues.

Charter amendments illustrate the change in shareholder voting patterns. In the early 1980s, antitakeover amendments passed routinely by the hundreds, usually with large margins. Today, most antitakeover amendments still pass, but they often just squeak by with 50-60% approval, and occasionally fail. Moreover, managers routinely seek a proxy solicitor’s judgment about the chance of success before proposing an amendment. Many charter amendments never see the light of day because the proxy solicitor concludes that passage is doubtful. As takeover lawyer Martin Lipton recently advised clients: “If a company does not have a staggered board and has significant institutional ownership, the odds are against being able to get one.” Such judgments are reflected in the sharply reduced rate with which antitakeover amendments are proposed. Dual-class recapitalizations, a hot topic just a couple of years ago, are a nonissue today because they’re unlikely to pass unless insiders already control the vote.

Beginning with proposals by CalPERS, CREF, and the Wisconsin Investment Board in 1987, major public pension funds have gone beyond voting against management proposals, and are offering their own corporate governance proposals. For shareholder proposals on greenmail, putting a poison pill to a shareholder vote, confidential voting, and other shareholder rights issues, affirmative votes of 30% or more are now common. Shareholders are winning occasional outright


181. See, e.g., Pension Funds Join Private Holders to Snatch Last-Minute Victory from Honeywell Board, CORP. CONTROL ALERT, June 1989, at 1, 4 (in 1989 proxy season, ten companies proposed staggered boards and seven sought to limit shareholder action by written consent; both figures are much lower than in prior years). The dropoff probably doesn’t reflect saturation, because many companies lack these provisions. See INVESTOR RESPONSIBILITY RESEARCH CTR., INC. (1989), supra note 98, at 1454, 1473. Part of the decline in proposals may reflect reduced need, given manager success at obtaining protection from the state legislature. But staggered boards and dual-class capital structures remain important. Also, it’s not clear which is cause and which is effect: managers may seek legislative protection because they don’t expect shareholders to approve antitakeover amendments.

182. Dual-class recapitalizations are possible in 1991 because a court invalidated the SEC’s one-share, one-vote rule. The Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

183. In the 1990 proxy season, for example, poison pill proposals received 43% support and confidential voting received 34% support, on average. IRRC 1990 Report, supra note 179, at 93.
victories,\textsuperscript{184} as well as some negotiated settlements with managers who want to avoid a close contest and the possible embarrassment of defeat.\textsuperscript{185} In the recent Avon, Lockheed, and USX proxy fights, poison pill and confidential voting proposals won even though the dissidents otherwise failed or reached a compromise with management.\textsuperscript{186} Occasionally, institutions successfully voice their negative opinions on proposed mergers.\textsuperscript{187}

The victories to date are small. Confidential voting can reduce conflicted voting on other matters, but isn't a substantive change. Some companies have ignored shareholder resolutions seeking a shareholder vote on a poison pill or made small changes that make the pill "chewable" — it won't apply, for example, to a fully financed, all-cash offer held open for at least 3 months — without seeking a shareholder vote on the chewable pill.\textsuperscript{188} Moreover, proxy fights are still rare, and incumbents still win most of the time. But in the recent Texaco, Lockheed, and National Intergroup fights, the incumbents, to gain institutional support, agreed to nominate one or more representatives of the large institutions to their boards. A cynic might say that chewable pills and a few institutional representatives on boards are token changes. On the other hand, until recently, managers didn't feel the need to throw even a few tokens to their institutional shareholders.

Large institutions are increasingly abandoning the "exit" alternative to voice — the "Wall Street Rule" that investors should sell their stock if they don't like the managers. They're too big to sell large

\textsuperscript{184} Victories on shareholder proposals to ask the directors to redeem poison pills or put them up for a shareholder vote include Armo, Avon Products, Champion International, Consolidated Freightways, K Mart, and Ryder Systems. See Franklin, \textit{Economic Health Test: Bill Seeks Further Accountability by Public Pension Funds}, N.Y.L.J., May 18, 1989, at 5 col. 3; \textit{INST. SHAREHOLDER SERVS.}, Issue Alert, June 1990, at 3.

\textsuperscript{185} Negotiated agreements include: Exxon's agreement to add a scientist to its board, see Wald, \textit{Exxon Head Seeks Environmentalist to Serve on Board: Pension Fund Pressure}, N.Y. Times, May 12, 1989, at A1, col. 4; National Intergroup's agreement to let its poison pill expire in three years, see Franklin (1989), \textit{supra} note 184; the weakening of poison pills by many Canadian companies to "appease institutional investors," see \textit{Power of the Press Transforms Canada's Pills from Poison to Placebo}, CORP. CONTROL ALERT, Apr. 1990, at 1; and the adoption of confidential voting by at least 48 companies, see IRRC 1990 Report, \textit{supra} note 179, at 97-100.

\textsuperscript{186} See \textit{INST. SHAREHOLDER SERVS.}, Issue Alert, June 1990, at 3.


\textsuperscript{188} For example, Lockheed and USX adopted chewable pills and Champion International plans, I understand, not to respond to the shareholder resolution seeking a vote on its pill. See Investor Responsibility Research Ctr., Inc., \textit{Corporate Governance Highlights}, Nov. 2, 1990; see also Wachtell, Lipton, Rosen & Katz, Memorandum to Clients: Proxy Resolutions (Nov. 8, 1990) ("We . . . advise clients that . . . even if a majority of shareholders vote in favor of the resolutions, the pill need not be redeemed, the golden parachutes need not be rescinded and the takeover law opt-out need not be exercised."); Stevenson, \textit{Director Responses to Precatory Stockholder Resolutions}, in 1 \textit{PRACTISING LAW INST.} (1990), \textit{supra} note 62, at 277.
portions of their portfolio, and know it. As James Martin of CREF recently put it, "We're the quintessential long-term investors." Further evidence that institutional shareholders are interested in collective voice comes from their financial support of trade groups. Such groups can help institutions cooperate to achieve collective goals. The Corporate Governance Service of the Investor Responsibility Research Center provides data on corporate takeover defenses and how institutions vote. The Council of Institutional Investors, founded in 1985, is an umbrella organization for public and union pension plans that are interested in expanded shareholder voice. Institutional Shareholder Services, also founded in 1985, offers voting advice on proxy issues involving individual companies, lobbies for expanded shareholder rights, and was a prime mover in the 1989 defeat of antitakeover charter amendments proposed by Honeywell and the passage of corporate governance proposals in the 1990 Lockheed proxy fight. The Institutional Voting Research Service of Analysis Group, begun in 1988, also provides voting advice. The founding dates of these groups testify to the recency of shareholder interest in corporate governance.

Indirect shareholder cooperation through trade groups is especially important because legal rules make direct cooperation difficult. Institutions become a 13(d) group if they cosponsor a proposal, but they safely can belong to a trade group which endorses the proposal. Also, money managers who face political or client pressure to be passive can fund a trade group that is less constrained. Thus, Robert Monks, the founder of Institutional Shareholder Services, describes himself as a "lightning rod" for clients who find it "difficult . . . to take a high visibility position." News stories also attest to newfound interest in shareholder voting. They carry titles like "Institutions' Proxy Power Grows"; "The Big Owners Roar"; "Big Holders Resolve to Flex Their Muscles"; and

189. Pauly, Wall Street's New Musclemen, NEWSWEEK, June 5, 1989, at 46, 46; see also, e.g., Wallace, Institutions' Proxy Power Grows, N.Y. Times, July 5, 1988, at D1, col. 3 (quoting CalPERS General Counsel Richard Koppes as saying "[w]e don't have the luxury of withdrawing and going somewhere else").


191. I have, on occasion since 1988, acted as a consultant to ISS and to its founder, Robert Monks.

192. Wayne, A Fervent Advocate of the Proxy Battle, N.Y. Times, May 8, 1990, at D1, col. 3. Mr. Monks recently left ISS to form a new venture, Institutional Shareholder Partners, which will take a more active role than ISS in seeking changes at particular companies. Wayne, A Shareholder Advocate Plans More Active Role, N.Y. Times, Sept. 27, 1990, at D4, col. 5.
"Wall Street’s New Musclemen." Their common message: institutional shareholders are waking up. They’re winning a few votes, coming close in others, seeking representatives on boards of directors, supporting proposals for confidential voting and against poison pills and greenmail.

Institutional shareholders are starting to become a significant lobbying force at both the state and federal levels. The institutions failed to defeat the recent Pennsylvania and Massachusetts antitakeover laws, but they succeeded in weakening the laws and obtaining opt-out rights not offered in the original bills. The institutions then lobbied Pennsylvania companies to opt out, and many companies did so. And institutional support was important in the SEC’s adoption of its short-lived one share, one vote rule. We also know that bondholders, who don’t face legal obstacles to substantial ownership or to collective action, commonly organize in response to bankruptcies or to workout-related exchange offers. Some “vulture funds” purchase a large percentage of a company’s debt in order to influence the workout process. Shareholders might also organize, at least for some issues, if legal rules allowed.

In sum, the model of public companies as owned by thousands of anonymous shareholders simply isn’t true. There are a limited number of large shareholders, and they know each other. Moreover, shareholders care about governance issues. They don’t passively support management proposals, nor automatically oppose proposals by other shareholders. They form organized groups to facilitate lobbying, information gathering, and information sharing. Sometimes, despite legal obstacles, they win. We don’t know how much more sharehold-


ers would do under a more facilitating legal regime. But shareholders have shown that they care about voting, which means that legal reforms may well affect shareholder behavior. 198

V. THE INCENTIVES OF SHAREHOLDER PROONENTS

Part III developed my legal claim: Shareholders who want to be active in corporate governance are hampered by legal rules at every turn. Part IV developed my factual claim: Within the confines of these rules, institutional shareholders are becoming increasingly active in a variety of ways. Taken together, Parts III and IV suggest that shareholder passivity is not inevitable but is instead legally and historically contingent.

This Part and Part VI develop my theoretical claim: The collective action problems facing active shareholders are important but not overwhelming. Under a more facilitating, less obstructive legal regime, institutional shareholders could find it in their self-interest to take an active interest in corporate governance. They are most likely to become active for process and structural issues that exhibit economies of scale; less likely to become active for company-specific issues. Moreover, institutions that don’t offer proposals themselves may find it in their interest to be informed voters and not automatically vote promanager, as long as there is a critical mass of other informed voters.

This Part develops a simple model of shareholder incentives to sponsor a voting proposal. A similar analysis would apply to shareholder response to a management proposal. Readers who are not mathematically inclined can skip the equations without losing the flow of the argument. 199 The model focuses on the formal act of voting. The stilted dialogue of a proxy campaign is hardly a sensible way for shareholders to talk to or oversee managers. Proxy campaigns can, however, establish a base of shareholder power from which informal communication will flow.

Section V.A considers the shareholder proponent’s decision

198. For more pessimistic views of the emerging shareholder activism, see, for example, Longstreth, Takeovers, Corporate Governance, and Stock Ownership: Some Disquieting Trends, J. PORTFOLIO MGMT., Spring 1990, at 54, 58 (“If CREF and CalPERS had not existed, corporate managers might wish to have ‘invented’ them, because they give a vestige of reality to the notion that shareholders continue to have a voice over corporate affairs.”); Koether (forthcoming 1991), supra note 55 (remarking on “the continued passivity of most institutions” in proxy fights).

199. The model focuses solely on shareholder actions and treats the manager response as fixed and known in advance. A fuller, game-theoretic model would also consider manager incentives to oppose shareholder proposals, and the interaction between shareholder and manager actions. I plan to develop such a model in future work.
whether to make a proposal. Section V.B analyzes the proponent’s separate decision on how much to spend to solicit support. Section V.C shows how economies of scale can increase proponents’ incentives both to make proposals and to wage vigorous campaigns. Part VI models the incentives of nonproponent shareholders, who must vote on proposals made by others, and have to decide whether to become informed about the issues or remain uninformed.

A. The Decision Whether To Make a Proposal

I begin the collective action analysis with a simple model of the decision faced by a shareholder proponent who is considering whether to make a proposal that the managers are expected to oppose. The proponent owns a fractional interest in a corporation, and seeks to maximize her own wealth. She must decide whether to make the proposal in the first place, and if the proposal is made, how much to spend promoting it. I assume that all shareholders share pro rata the benefits from success. This assumption seems reasonable for a noncontrol contest, but will not hold for a proxy fight where the proponent can realize private benefits from control.\(^{200}\)

Let:

- \(B\) = the expected benefit to all shareholders as a group if the proposal is adopted.
- \(C_i\) = the proponent’s cost to make the proposal.
- \(C_o\) = the nonproponent shareholders’ cost to consider and vote on the proposal.
- \(C_c\) = the cost to the corporation of shareholder and manager action on the proposal.
- \(P\) = the probability that the proposal succeeds, which \(P\) depends on the proponent’s spending level \(C_i\).
- \(F_i\) = the proponent’s fractional share ownership. I assume for convenience that the firm has one share outstanding.
- \(F_o\) = the share ownership of all other shareholders: \(F_o + F_i = 1\).

The proponent’s expected private benefit from making a proposal equals the probability of success \(P\), times the corporate benefit from success \(B\), times her fractional ownership stake \(F_i\). Her private cost is her own cost \(C_i\) plus her share of corporate cost \(F_i \cdot C_c\). The proponent will make the proposal if there is a cost level \(C_i\) where expected benefit exceeds expected cost.

\(^{200}\) The model developed below generalizes Olson’s model of collective action to obtain a pure public good. M. OLSON (1971), supra note 5, at 22-23. It would reduce to Olson’s model, apart from notational differences, in the special case where \(C_i = C_o = 0\) and there are no economies of scale. E. ROCK (forthcoming 1991), supra note 27, applies Olson’s model to shareholder voting.
Make Proposal If: \((P \times B \times F_i) - (F_i \times C_e) - C_i > 0\)  \(1\)

It would be socially optimal, however, for the proponent to make a proposal whenever the expected total benefit to all shareholders \((P \times B)\) exceeds the total cost of the proposal \(C_i + C_c + C_o\).

Proposal Socially Beneficial If: \((P \times B) - C_c - C_i - C_o > 0\)  \(2\)

Some socially beneficial proposals will not be made because the proponent’s private gain is negative. To see when this will happen, note that the nonproponent shareholders’ gain from a proposal equals the probability of success \(P\) times their share of the benefit \(F_o \times B\), less their share of corporate cost \(F_o \times C_c\), less their own cost \(C_o\):

\[
\text{Nonproponents' Gain} = F_o \times [P \times B - C_c - C_o/F_o]
\]

By comparison, from equation (1), the proponent’s gain is:

\[
\text{Proponent's Gain} = F_i \times [(P \times B) - C_c - C_o/F_i]
\]

The proponent’s per share cost \(C_o/F_i\) to make the proposal will be much greater than the per share cost \(C_o/F_o\) for other shareholders to consider it. Thus, the proponent’s gain per share, given by the bracketed term in equation (4), will be smaller, and sometimes much smaller, than the nonproponents’ gain per share, given by the bracketed term in equation (3).

Shareholders’ collective action problems are usually framed in terms of the proponent’s ability to capture only a fraction of the benefits from success, and other shareholders’ ability to free ride on the proponent’s efforts. This is too simple. Other shareholders can free ride on the proponent’s efforts, as shown by the absence of a term involving \(C_i\) from Nonproponents’ Gain. But the proponent can also free ride, in a sense, on the cost to the other shareholders of considering a proposal, as shown by the absence of a term involving \(C_o\) from Proponent’s Gain. The social loss from proponents’ failure to make socially desirable proposals depends on the relative size of the free riding terms \(C_o/F_i\) and \(C_o/F_o\).

Regulation can affect both proponent’s cost \(C_i\) and share ownership \(F_i\). Consider proponent’s cost first. Legal rules that increase that cost will discourage proposals. Conversely, cost-decreasing rules, such as rules that shift costs from the proponent to the corporation, will encourage proposals. The shareholder proposal rule is such a cost-shifting rule, though a feeble one. Expense reimbursement for successful proposals would also reduce the proponent’s expected cost. For many issues, the expected benefit \(B\) will increase proportionately with firm size, while the proponent’s cost will increase less than proportionately. Thus, if ownership percentage \(F_i\) is constant, a proposal will look more attractive for a large firm than for a small one.
Consider next proponent’s share ownership $F_i$. An increase in $F_i$ reduces the proponent’s per share cost and thus encourages proposals. Conversely, legal rules that prevent large individual stakes and joint shareholder action discourage proposals. Legal rules that limit individual stakes also reduce the concentration of nonproponent holdings. This indirectly increases campaign cost $C_i$ and reduces the chance of campaign success because more nonproponents need to be convinced and smaller holders are more likely to be apathetic. And, of course, the larger the proponent’s own stake, the fewer nonproponents need convincing.

Several additional factors are not captured in the model. First, shareholders might be passive not because of legal obstacles, collective action problems, or conflicts of interest, but because the benefit from activism is small. Detailed exploration of the benefits of shareholder activism is beyond the scope of this article. Suffice it to say that (i) shareholders vote on a variety of issues that affect stock prices by a percentage point or two, and even a few percentage points are significant in a $3$ trillion stock market; (ii) recent empirical studies suggest that the presence of a large but not controlling shareholder may improve corporate performance; and (iii) although cultural differences make international comparisons difficult, German and Japanese banks, which are less hobbled by statute, hold substantial stakes in industrial companies and seem to play a positive role. Thus, there is certainly the potential for shareholder action to produce major benefits.

Second, the model assumes that shareholders seek to maximize the value of their shares. That assumption is only a crude approximation of the real world, for several reasons. A central theme of this article is that money managers face important conflicts of interest — private incentives that lead them not to maximize the value of managed assets. Moreover, many large institutions are heavily indexed. Index fund managers may see their role as matching the index at minimum cost, without regard to whether the index does well or poorly. If Wells Fargo (a major index fund manager) acts that way, the pension funds that hire Wells Fargo can still try themselves to improve portfolio performance (as some do), or another manager may compete with Wells

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Fargo by offering indexing plus monitoring, but only time will tell to what extent that will happen. Cultural factors also limit the extent to which money managers look to governance as a way to improve portfolio performance. These caveats, however, don’t affect the model’s value in assessing whether collective action problems dictate passivity. Instead, they strengthen my case that we also need to consider other factors, including cultural norms and conflicts of interest.

Third, the model doesn’t take into account the relative advantages of becoming a proponent versus supporting someone else’s proposal. Even if a proponent can gain from making a proposal, she may be better off waiting for someone else to make the proposal instead. There are several potential solutions to this problem, none perfect. There may be obvious leaders, due to size, lack of a direct conflict of interest, or both. They will know that if they don’t act, no one else is likely to. Also, for recurring issues, the major institutions can divide up the universe of companies, with tit-for-tat enforcement. Trade groups can facilitate such coordination. Something like this happens now. The active institutions coordinate their efforts so that one company isn’t targeted for action by several institutions. Moreover, if legal rules allowed, the largest shareholders could combine forces and present joint proposals.

**B. The Decision on How Much To Spend**

The divergence between private and social benefits from making a proposal is, though in oversimplified form, part of the standard collective action critique of shareholder voting. But there is a second, less well understood problem. The divergence between private and social benefits affects not only whether a proposal will be made, but how well it will be funded. The proponent will spend an amount $C_i'$ that maximizes her private gain. Private gain is maximized when the marginal gain from spending an additional dollar is zero. From equation (1), this will occur when:

$$d[P^*F_i'B - C_c*F_i - C_i]/dC_i = 0 \Rightarrow dP/dC_i = 1/(F_i*B)$$

In contrast, total net benefit is maximized when the marginal social gain from spending an additional dollar is zero. From equation (2), this will occur when:

$$d[P*B - C_c - C_i - C_o]/dC_i = 0 \Rightarrow dP/dC_i = 1/B$$

The disparity between privately and socially optimal spending can be quite large. The proponent will stop spending at a level $C_i'$ where the marginal social gain from spending an extra dollar spent is $1/F_i - l$. If the proponent owns 2% of a company’s shares, a reasonable
number for a large company with no dominant shareholder, she will stop spending at a point where the marginal social gain is $(1/0.02 - 1) = $49. Underspending arises because the proponent keeps only a pro rata share of the gains from success, but bears the entire marginal cost of more vigorous solicitation. Her best strategy involves accepting a reduced chance of success in return for lower solicitation costs. Thus, even if a proposal is made, it may fail because the proponentrationally spends too little to offer a strong chance of success.

Reducing the proponent’s cost won’t solve the underspending problem. Whatever the proponent’s cost, she will only spend until the marginal social benefit from spending an extra dollar is $1/F_i - 1$. Cost-reducing and cost-shifting rules will lead proponents to make more proposals, but many of these proposals will still fail because they won’t be strongly pushed.

The simplest way to bring the proponent’s incentive to spend closer to optimum is through higher share ownership. Thus, the need for incentives to wage a vigorous campaign increases the importance of legal barriers to joint shareholder action and to individual holdings of large blocks. Legal rules that required companies to reimburse some of the proponent’s costs would also help. For example, reimbursement of expenses for successful proposals would make expected marginal cost from spending an extra dollar less than a dollar, which would increase the proponent’s privately optimal spending level.

C. Economies of Scale

An important aspect of shareholder collective action is economies of scale. Institutional shareholders own shares in many companies, and some monitoring issues cut across a number of companies. A proponent who offers the same proposal at a number of companies will face a lower proposal preparation cost per company. Also, other institutions are likely to own stock in many of the same companies as the proponent. This reduces the proponent’s per-company solicitation cost. Scale economies can lead an institution to offer more proposals, and promote them more vigorously, than an individual who owns the same percentage stake in a single company.

Scale economies imply that shareholder voice holds greater promise for process and structural issues than for company-specific issues. Examples of such issues include confidential voting; choice of state of incorporation; whether shareholders should vote to approve various actions (poison pills, golden parachutes, large new stock issuances); capital structure (should a company have blank check preferred or a class of nonvoting common); cumulative voting; antitakeover charter
amendments of various sorts; the value of growth through diversification; and the structure of management compensation.

In contrast, shareholder passivity is more likely for company-specific issues, such as whether to recapitalize; whether to fund a new project by borrowing or by selling stock; whether to make a particular acquisition or divestiture; whether to vote for the incumbent directors or for a dissident slate.

Director nominations might seem a paradigm company specific issue, but in fact involve important common issues. Institutional shareholders could decide that some of the board members of a public company should be nominated by major shareholders, develop a list of acceptable directors, and then nominate and try to elect several directors from that list at each of a number of companies. ISS and CalPERS are developing a director database for exactly that purpose.\textsuperscript{203} The process issue is who should select the candidates — shareholders or managers — with the specific identity of the directors a secondary concern. Board design also raises structural issues, including staggered or nonstaggered board; board size; the desirability of an independent chairperson; whether a former CEO should remain on the board; and whether insiders other than the CEO should be directors.

Even issues that are largely company specific, such as the merger of two companies or the level of CEO compensation, have some common elements. Shareholders might, for example, begin with a presumption against diversification, or a preference for compensation that is sensitive to company performance. More generally, corporate governance issues can be seen as lying along a continuum from common issues like confidential voting to company-specific issues like whom to vote for in a proxy fight, with most issues falling somewhere in between. Where a given issue falls along the continuum depends partly on the gains from more individualized analysis. Shareholders can, for example, nominate directors at a large number of portfolio companies, or they can do so only for poor performers. They will subclassify companies as long as the perceived benefit from doing so outweighs the lost scale economies.

Closely related to economies of scale is the deterrent value of a successful or near-successful campaign targeted at one or a few companies. A director election campaign targeted at underperforming company $A$ may lead other poor performers to change their ways, lest

\textsuperscript{203} See White, \textit{Business Roundtable, CalPERS Declare a Truce Over Director Questionnaire}, Wall St. J., Nov. 19, 1990, at B6B, col. 5; see also Gilson & Kraakman (forthcoming 1991), \textit{supra} note 25 (making a similar proposal).
they face a similar campaign. A proponent may wage a more vigorous campaign at company $A$ than would be cost-justified looking at $A$ in isolation, because of the campaign's deterrent value. Also, a proponent who makes proposals at companies $A$ through $Y$ may not offer one at company $Z$ because the marginal gain is negative given that $Z$ will already be partially deterred by the proposals made at $A$ through $Y$. Thus, deterrence effects imply that proposals will be targeted at fewer companies, and supported more vigorously, than the model below suggests.

Institutional practice confirms that scale economies and deterrence are important. The institutions have focused their efforts on process and structural issues, disclaiming intent or ability to micromanage individual companies. They commonly offer the same proposal at a number of companies during a proxy season. They support trade groups which advocate process and structural reform. And proponents target a limited number of companies for action in any given year, often companies with poor financial performance or demonstrated indifference to shareholder concerns.$^{204}$

We can model a proponent's incentives in a world with economies of scale by generalizing the one-company collective action model presented above. Assume that an institutional proponent can make the same proposal at $n$ identical companies. Let:

- $B =$ the expected per company benefit to the shareholders if the proposal is adopted.
- $C_i =$ the proponent's cost to make the proposal at one company.
- $e =$ the fractional decrease in proponent's per company cost is reduced due to economies of scale.
- $C_o =$ the nonproponent shareholders' cost to consider and vote on the proposal, if made at only one company.
- $o =$ the fractional decrease nonproponents' per company cost due to economies of scale.
- $C_c =$ the per company cost of shareholder and manager action on the proposal.
- $P =$ the per company probability that the proposal succeeds.

The one company model can be seen as a special case of this model in which there are no economies of scale.

Consider first the proponent's incentive to make a multicompany proposal. Her one-company solicitation cost per share was $C/F_i$. Her per share cost for making $n$ similar proposals is reduced by scale econ-

$^{204}$ See, e.g., Investor Responsibility Research Ctr., Inc., Corporate Governance Highlights, Nov. 2, 1990 (CalPERS is "focusing on 'poor performers'" in choosing companies for its 1991 corporate governance proposals).
omies to $C_c(1 - e)/F_r$. Thus, her gain from making the proposals, by comparison with equation (4), is:

$$n\text{-Company Gain} = n \times F_i \times [P*B - C_c - C_c(1 - e)/F_r]$$

(5)

The proponent will make more proposals because the benefit from doing so will be positive in some cases where one-company benefit would have been negative.

The nonproponents' per share cost to consider the proposal was $C_o/F_o$ in the one-company case. This too is reduced by scale economies to $C_o(1 - o)/F_o$. Since both proponents and nonproponents' gains increase, more proposals become socially beneficial once economies of scale are taken into account. The disparity between proponent's and nonproponents' net benefit per share, and thus the number of socially beneficial proposals that are not made, is reduced but not eliminated by scale economies. It now depends on the relative magnitude of the $n$-company free-riding terms $C_c(1 - e)/F_r$ and $C_o(1 - o)/F_o$.

The introduction of scale economies into the model suggests an additional way that legal rules affect shareholder incentives. Costs that don't exhibit scale economies will be especially effective in discouraging shareholder action. Some costs, like deciding what proposal to make or drafting a proxy statement, have strong economies of scale. Others, like the risk of a company lawsuit or insider trading liability, do not. Thus, safe harbors that reduce legal risk do much to facilitate shareholder action. The cost of complying with the safe harbor is likely to exhibit scale economies, while the risk of violating the underlying rule may not.

Scale economies also increase a proponent's incentive to spend once a proposal is made, and bring the proponent's spending level closer to the socially optimal level of spending by the shareholders of that company seen in isolation. The proponent will again choose a spending level at which her private marginal return from more spending is zero. From equation (5), that will occur when:

$$d[P*B - C_c - C_c(1-e)/F_r]/dC_c = 0 \rightarrow dP/dC_c = (1-e)/(B*F_i)$$

At that spending level, the marginal per-company social benefit from spending is $(1-e)(1/F_r - 1)$.

205. The potential economies are reduced because different SEC staffers review the proxy materials for the same proposal made by the same proponent at different companies. The staffers predictably raise different and sometimes inconsistent objections, and may also object to wording that had been cleared by someone else the year before. See CalPERS Proposal, supra note 62, at 8, 22, in 1 PRACTISING LAW INST. (1990), supra note 62, at 305, 319.

206. The derivation assumes that $e$ is independent of $C_c$. If $e$ depends on $C_c$, the equation in the text will still hold if we use the local scale economy factor $e$ that applies at the optimal spending level.
If scale economies are large (\(e\) close to 1), most of the social gain from additional spending that was lost in the one-company case will be captured. In the extreme case where \((1 - e)\) is less than \(F_i\), the proponent will spend more than would seem socially optimal if we look at one company at a time.²⁰⁷ A reasonable scale economy factor for, say, a poison pill or confidential voting proposal might be \(e = 0.75\) or \(0.80\). With changes in legal rules, this could plausibly climb to \(0.90\) or so.

The combination of group action and an issue with strong economies of scale can lead to strong incentives for shareholder action. Assume, for example, that five 2% shareholders combine forces to make proposals at a number of companies, on an issue where common costs are 75% of total solicitation costs. The proponents' per share solicitation cost will be only one twentieth of the cost incurred by a 2% shareholder making a proposal only once. And where the 2% shareholder will stop spending when the marginal social gain from spending an extra dollar is \$49\), the 10% group will spend until the marginal gain per company is \((1 - e)/(1/F_i - 1) = \$2.25\).

In sum, collective action problems reduce both the frequency with which proponents make proposals, and the vigor with which the proponents lobby for the proposals they make. But at current levels of ownership concentration, collective action problems are not the enormous barrier to shareholder action that the passivity story makes them out to be, especially for issues with substantial scale economies. We need to look elsewhere — especially to legal obstacles and conflicts of interest — to understand why shareholders so rarely make proposals, and why the proposals they make so rarely succeed. I turn next to the second major collective action problem posited by the passivity story: the supposed apathy of nonproponent shareholders.

### VI. THE INCENTIVES OF NONPROPRIETOR SHAREHOLDERS

If the managers or a shareholder proponent make a proposal, how will the nonproponent shareholders react? One possibility is that they won't react at all. Becoming informed takes time, which is a scarce resource, and a shareholder who holds a tiny stake knows that her vote probably won't be decisive anyway. Thus, shareholders will stay uninformed. Perhaps they won't vote at all; perhaps they'll adopt a crude rule of thumb like "always vote with management"; what they won't do is vote intelligently. If such rational apathy were universal and the natural default rule was "vote with management," the propo-

²⁰⁷. The proponent will not in fact overspend. Instead, the socially optimal level of spending will also increase, to a level that maximizes the social gain from additional spending:

\[
d[P^*B - C_s - C_s(1 - e) - C_s(1 - o)]/dC_s = 0 \Rightarrow dP/dC_s = (1 - e)/B.
\]
nent’s position would be hopeless, the managers’ control of the vote absolute. Apathy is consistent with evidence that various antitakeover actions — dual-class recapitalizations; some types of antitakeover amendments; poison pills — have a significant negative impact on stock price, but shareholders nonetheless approve them (or, for poison pills, vote against proposals seeking a shareholder vote on the pill).208

Apathy is not automatic, however. Shareholders have a choice: remain apathetic or become informed. This Part presents a simple model of the factors that affect that choice. To state the results first: shareholders can’t entirely free ride on the efforts of others. If there is a critical mass of other informed shareholders, so that a shareholder’s vote might matter, her ride is not free, merely cheap.209 Indeed, apathy becomes exponentially less attractive as shareholdings grow. A shareholder who owns 100 shares has an incentive to become informed 10,000 times greater than a shareholder who owns a single share.

Institutions can also realize strong economies of scale when they evaluate similar proposals at a number of portfolio companies. NYCERS might see 50 poison pill resolutions a year, with only minor variations. It has a far greater incentive to make an informed voting decision than a shareholder who owns the same stake in a single company. The combined effect of large holdings and economies of scale can be staggering: If NYCERS owns a million shares and sees a proposal 50 times, it has five billion times more incentive to become informed than a 100-share holder!

One possible conclusion: Rational apathy may be less important than commonly believed in explaining how large institutions vote. We may need to look elsewhere — to agenda control and especially to conflicts of interest — to understand why many institutions vote against apparent self-interest on, say, antitakeover amendments and dual class recapitalizations.

A. The Decision To Become Informed

I assume that a proponent makes a voting proposal, that nonproponent shareholders seek to maximize their private wealth, and that


each nonproponent must choose between two possible information states: informed and (relatively) uninformed. This obviously oversimplifies the continuum of possible levels of information. In particular, a totally uninformed shareholder wouldn’t be able to make the crude estimates that the model assumes an uninformed shareholder can make. Total ignorance does not seem a good description of large institutions, though it may describe some individual shareholders who discard their proxy statements unread. Let:

- \( b' \) = the shareholder’s uninformed estimate of the expected change in per share firm value if a proposal is adopted.
- \( b = \) the shareholder’s informed estimate of the expected change in per share firm value if a proposal is adopted.
- \( p_\pm = \) the probability that \( b \) and \( b' \) will have different signs, as estimated by an uninformed shareholder.
- \( b_\pm = \) the expected difference \(|b - b'|\) between the uninformed and informed value estimates, given that they have different signs.
- \( c_0 = \) the shareholder’s cost to become informed. I assume that the cost of making the crude estimates \( b', p_\pm \), and \( p_0 \) is negligible, as is the cost of voting.
- \( p_0 = \) the likelihood that the shareholder’s vote will affect whether the proposal succeeds, as estimated by an uninformed shareholder.
- \( f_0 = \) the shareholder’s fractional ownership of the company’s shares. I assume, as above, that the firm has one share outstanding.

The shareholder will vote “yes” if the expected benefit from the proposal \( b \) or \( b' \) is positive, and “no” if the expected change is negative. The expected gain from becoming informed, evaluated while uninformed, equals the probability \( p_\pm \) that more information will change the shareholder’s vote, times the probability \( p_0 \) that the shareholder’s vote will affect the outcome, times the expected gain \( f_0 \times b_\pm \) from a change in outcome. The shareholder will become informed if this gain exceeds the cost \( c_0 \) of becoming informed.

Become Informed If: \[ p_\pm \times p_0 \times b_\pm \times f_0 > c_0 \quad (6) \]

The likelihood \( p_0 \) that a shareholder’s vote will affect the outcome will depend on the nature and importance of the proposal, the existence of other large shareholders, how those shareholders are expected to vote, and the shareholder’s ownership stake \( f_0 \). For a small percentage stake \( f_0 \), which is the norm for even a large institution, we can use a linear approximation: \( p_0 = A' \times f_0 \).

Here \( A' \) incorporates the other factors on which \( p_0 \) depends. The intuition behind this approximation is simple: the vote of a shareholder who owns ten shares is ten times as likely to affect the outcome
as the vote of a shareholder who owns one share.\textsuperscript{210} We can now modify equation (9) to read:

\begin{equation}
\text{Become Informed If: } A \ast b_{\pm} \ast f_{\pm} > c_o \quad (7)
\end{equation}

where $A = A' \ast p_{\pm}$ is a modified background term.

The shareholder's decision to become informed thus depends on four factors: the background term $A$; the expected benefit from becoming informed $b_{\pm}$; the shareholder's ownership level $f_o$; and the cost $c_o$ to become informed. Consider first the shareholder's ownership $f_o$. The potential gain and the probability that the shareholder's vote will change the outcome both increase with ownership level, so the incentive to become informed increases as $f_o \text{ squared}$. A large shareholder may still remain uninformed if the background term $A$ is very small or the issue unimportant. But other things being equal, rational apathy makes exponentially less sense for a large shareholder than for a small shareholder. If legal rules that keep ownership percentages low and discourage joint action are important for proponents, they are doubly so for nonproponents.

The background term $A$ reflects a probabilistic assessment of the decisions that other shareholders are expected to make. If management has a favorable vote essentially locked up, because it holds a dominant stake or because all other shareholders are small and expected to vote promanager, then $A$ will be small, and even a large shareholder may decide to remain uninformed. Institutional ownership can, however, reach a critical mass where becoming informed makes sense. As total institutional ownership grows, it makes more sense for each institution to become informed, because it knows that other institutions will face the same choice, and will probably also decide to become informed. Similarly, as ownership becomes more concentrated, each shareholder's incentive to make an informed choice becomes stronger.\textsuperscript{211}

Large shareholders can also talk to each other; assess with a few phone calls whether a vote is likely to be close and therefore worth

\textsuperscript{210} Cf. Chamberlain & Rothschild, \textit{A Note on the Probability of Casting a Decisive Vote}, 25 J. ECON. THEORY 152 (1981) (in election with $n$ voters, each of whom will vote yes with probability $p$, where $p$ has a probability distribution $f(p)$ that is nonzero near $p=1/2$, the likelihood that any given vote will affect the outcome is of order $1/n$).

\textsuperscript{211} In theory, the background term $A$ could decline again if institutional ownership was extremely high. Conflicts of interest aside, all shareholders have the same interest in increasing company value, and thus are likely to vote the same way if informed. Knowing this, institution $I$ may decide to remain uninformed, and rely on institutions 2-50 to vote the right way. This scenario seems unlikely, however. Institutions don't all vote alike, whether due to conflicts of interest or for other reasons, which makes it important for each institution to vote. Moreover, institutions can share information. Institution $I$ can cheaply call up informed institution 2, and follow its lead on how to vote.
careful attention; discuss how they plan to vote or what it will take to change their vote. Such informal coordination, which is feasible for large nonproponent shareholders, both increases the chance that a shareholder's vote will matter and makes it easier to assess that chance. Nonproponent shareholders must stop sort of explicit agreements on how they will vote, lest they become a 13(d) group, and they face some legal risk just for talking to each other, but limited coordination is better than none.

The data presented in Part IV suggest that if a critical mass must be reached before informed voting makes sense, we have reached or are close to reaching that mass for many large companies. Some shareholder proposals win; some manager proposals lose; other manager proposals are never made because a loss seems likely. Moreover, proxy campaign participants act as if the votes of large holders matter. The small holders get the mass-mailed proxy statement; the big holders also get letters, telephone calls, and personal meetings. Some shareholder proponents take institutional ownership levels into account in deciding whether to offer a proposal — the higher the better.212 Major shareholders also act as if their votes count. Legal risk notwithstanding, they talk to each other about how to vote; sometimes they cut deals with one side or the other in return for a favorable vote. Indeed, conflicts of interest arise in large part because the big holders’ votes matter. Otherwise, corporate officers wouldn’t need to twist money managers’ arms for favorable votes.

The per share benefit \( b_\pm \) is straightforward. The more important the proposal, the more likely the shareholder is to become informed. Since the firm, by assumption, has only one share outstanding, \( b_\pm \) increases with firm size. Thus, the larger the firm, the greater the incentive to become informed, holding percentage ownership constant. Since other nonproponent shareholders will have similar incentives, the background term \( \lambda \) will also be higher for an important proposal, or a proposal at a large company.

Finally, the lower the cost \( c_\sigma \), the greater the nonproponent's incentive to become informed. Here, the Proxy Rules both help and hurt. They help because the proxy statement conveys some information about the proposal; to vote, a shareholder need only sign and mail the accompanying proxy card. Purchase of information and advice from third-party providers would also reduce \( c_\sigma \), but the Proxy Rules largely bar this source of information. Preclearance, by increasing the

proponents' cost to provide information, may also decrease at the margin the amount of information provided.

Even beyond the proxy statement, much of the spending by shareholder proponents and managers involves an effort to inform nonproponent shareholders. Some of that information will affect the perceived importance $b_\pm$ of a voting issue; some will facilitate the nonproponent's information gathering, thus reducing the cost $c_\sigma$.

Though the nonproponent's ride on the efforts of others is not free, it is still cheap; each shareholder's incentive to become informed is less than socially optimal. The shareholder will become informed when the private benefit from doing so $b_\pm * f_\sigma$, times the likelihood $A * f_\sigma$ that becoming informed matters, exceeds private cost $c_\sigma$. Shareholders as a group will benefit if an individual shareholder becomes informed when the total benefit to all shareholders (which I will denote $B_\pm$), times the likelihood that becoming informed matters, exceeds the shareholder's cost:

$$B_\pm * A * f_\sigma > c_\sigma$$

In the simple case where the shareholder's benefit estimate $b_\pm$ equals the average estimate $B_\pm$ made by all shareholders, social gain exceeds private gain by a factor of $1/f_\sigma$. Thus some shareholders will stay uninformed when it would be socially optimal for them to become informed. Legal rules that allow large shareholdings, or facilitate shareholder coalitions, will increase $f_\sigma$ and thus make it more likely that nonproponents will become informed when that's the socially desirable result.

B. Economies of Scale

Scale economies increase nonproponent incentives to become informed. To model this, let:

$$c_o = \text{the shareholder's cost to become informed about a proposal, if made at only one company.}$$

$$o = \text{the fractional reduction in the nonproponents' per company cost due to scale economies.}$$

The per-company cost to become informed is then reduced to $c_o(1 - o)$. The shareholder will become informed if, from equation (7):

$$[A * b_\pm * f_\sigma^2]/(1 - o) > c_o$$

For nonproponents the scale economy factor $o$ can be very close to one. Some of the proponent's costs to present a proposal are common,

213. $B_\pm$ is both an estimated total benefit to all shareholders and an ownership-weighted average benefit because the firm has one share outstanding.
but others are not. In contrast, for many process and structural proposals, virtually all of the nonproponent's costs will be common. Thus, where a proponent may achieve scale economies of \( e = 0.75 \) or so; a nonproponent who sees many similar proposals a year can achieve scale economies of \( o = 0.95 \) or higher. Also, though not directly reflected in the model, nonproponents who own stock in the same companies and see the same issues over and over again will find it easier to talk informally to each other, which can increase the background term \( \lambda \).

A numerical example can illustrate the combined effect of large size and strong economies of scale. Suppose that a staggered board reduces company value by 1% on average, that 80% of all public companies would adopt staggered boards if they could get shareholder approval, and that staggered board proposals will pass if institutions remain uninformed. The expected loss to an institution with a $25 billion stock portfolio if these companies all adopt staggered boards is $25 billion \( \times .8 \) (fraction of portfolio companies that adopt staggered boards) \( \times 0.01 \) (fractional loss in value) = $200 million. With a cost to become informed of a few thousand dollars, can apathy be rational? Even one chance in ten thousand that one's vote will matter provides ample reason to become informed. In today's environment, the chance that the vote of an institution of that size will matter is far higher than that.

Several additional points are not reflected in the model. First, pension funds, under Department of Labor rules, must vote and establish procedures to ensure that the vote is informed. Such antiapathy rules can force dispersed shareholders to make a collectively desirable investment in informed voting. They may also mitigate conflicts of interest, because informed shareholders may find it harder to paper over their conflicts.

Second, to make good trading decisions, money managers need information about corporate governance proposals that affect share prices, just as they need information about financial performance. Thus, managers who trade actively should become informed if the voting benefits plus the trading benefits exceed the cost of becoming informed. Trading benefits depend not on the relatively low chance that the trader's vote will matter, but instead on the probability that the proposal will succeed. That probability is high for manager proposals, and, as institutional holdings grow, may become significant for some shareholder proposals as well. Indeed, the price impact of corpo-

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214. Private trading benefits can, in theory, lead to institutions spending more than is socially
rate governance issues is in tension with the claim that institutions are uninformed. Someone must be informed, or else prices wouldn’t change. In the usual explanation for efficient markets, institutions form most of the cadre of well-informed investors who set prices at the margin. 215 If they aren’t informed, who is?

Third, uninformed shareholders won’t always vote promanager. Small shareholders might use such a default rule because the managers’ recommendations are often (though not always) wealth-increasing. 216 But a large shareholder, even one who remains poorly informed, can adopt a more sophisticated default strategy, in which the uninformed estimate $b'$ is positive for some types of proposals and negative for others. Finally, some smaller shareholders will become informed, rationally or otherwise. Perhaps they enjoy voting; perhaps they read the proxy statement to learn about the business they’ve invested in; perhaps they think their vote counts. Whatever the reason, some small shareholders seem to make informed judgments. 217

The analysis above suggests that large institutions already have significant incentives to become informed voters in many situations. If so, we need an explanation other than rational apathy for why many institutions vote promanager even against self-interest as measured by stock price. Parts VII and VIII explore two possible explanations: agenda control by corporate managers and money manager conflicts of interest.

VII. AGENDA CONTROL BY CORPORATE MANAGERS

Legal and collective action obstacles to shareholder action are only part of the managers’ advantage in a voting contest. Managers also have important agenda control advantages, especially for their own proposals. Some of these advantages are created by legal rules, others are not, but legal rules could produce a more level playing field. This Part describes the managers’ agenda control advantages, and the ex-optimal to become informed. See generally S. Grossman, The Informational Role of Prices (1989).


216. See Bebchuk (1989), supra note 17, at 1839.

217. See K. Van Nuys, Managerial Incentives and Shareholder Approval: Evidence From the 1988 Proxy Season (University of Rochester Working Paper, 1990). Van Nuys estimates that in the 1988 proxy season, 53% of noninstitutional, noninsider shareholders voted for blank check preferred stock proposals, 59% voted for proposals to limit shareholder power to act by written consent or call a special meeting, and 61% voted for proposals to require supermajority approval of a merger. The rest voted no, abstained, or didn’t vote. Many small shareholders simply didn’t vote, but the differences between types of proposals suggest that some small shareholders made informed judgments.
tent to which those advantages derive from legal rules. Section A dis-
cusses the managers' control over proposal packaging and timing for
their own proposals. Section B discusses the managers' partial control
over proposal timing for shareholder proposals. Part VIII will discuss
the managers' further advantages from being able to pressure some
institutional investors to remain passive or vote in ways that decrease
share value.

A. Agenda Control for Managers' Proposals

Corporate managers have important advantages in seeking share-
holder approval for the managers' proposals. Managers control what
the shareholders get to vote on, when they get to vote, what order
proposals are offered in, and when the shareholders learn what's on
the agenda. The managers can, among other things, tie a "good"
(sharedholder wealth increasing) proposal to a "bad" (shareholder
wealth decreasing) one, offer a proposal that increases but doesn't
maximize shareholder wealth, or threaten to take bad actions (or forgo
good actions) if shareholders don't approve a change. Managers can
also spend corporate funds, essentially without limit, to lobby for a
favorable result. Such agenda control matters. In the political arena,
scholars are starting to unravel the ways in which agenda affects sub-
stantive outcome. A fair summary of recent research is that agenda
matters more, and in more different situations, than we used to think it
did.218

First, the managers control what the shareholders vote on. Some
examples may illustrate why this matters. First, the rare proxy fight
aside, shareholders vote for or against a slate of directors selected by
the managers. Shareholders can't propose their own nominees, or
even choose among more candidates than there are positions to be fil-
led. The managers' candidates win routinely, with an overwhelming
percentage of the vote. But that no more shows the voters' true prefer-
ences than the equally overwhelming support enjoyed by political can-
didates in one-party "elections." Even in a proxy fight, the managers
can change the number of directors and the qualifications for directors
in midcontest.

A second example is blank check preferred stock. Blank check
preferred is a useful financing tool, but also has antitakeover value. In
particular, it's an essential component of most poison pills. Managers

218. See, e.g., Levine & Plott, Agenda Influence and its Implications, 63 VA. L. REV. 561
(1977); Hammond & Thomas, The Impossibility of a Neutral Hierarchy, 5 J.L. ECON. & ORG.
155 (1989). For discussion of managers' agenda control for charter amendments, see, for exam-
ask for and normally receive complete blank check authority, even though the shareholders might prefer to limit the uses to which the blank check stock can be put. Similarly, companies routinely seek authority to issue many more shares of common stock than are currently outstanding, without limiting the purposes for which the shares can be used.

A third example illustrates some of the complexities of agenda control. In 1987, Holiday Corporation asked its shareholders to vote on a single proposal encompassing: (i) a massive special dividend; (ii) grants to Holiday managers of restricted stock representing 10% of the company's equity; (iii) an amended stock option plan that quintupled the number of shares issuable upon the exercise of outstanding options; and (iv) a "capped voting" charter amendment that, for five years, limited any shareholder or group to 10% of the total voting power. To no one's surprise, the shareholders approved the proposal. Some shareholders thought the managers were being greedy, but they weren't given the chance to vote for, say, a dividend with less generous stock grants. Within three years, the managers' restricted stock was worth over $200 million and the stock options were worth multimillions more.

A company's managers control not only what the shareholders vote on, but when. Managers routinely engage proxy solicitors to estimate the chance that a proposal will pass. If a favorable vote seems doubtful this year, the managers can wait for a more propitious moment. Managers can also count the votes as they come in and withdraw or modify in midvote a proposal that seems likely to fail, or adjourn the shareholder meeting to allow more time to gather support.

The managers also control the order in which matters appear on the shareholders' agenda. If proposals 1 and 2, taken together, might produce strong opposition, they can be offered and adopted one at a time. If proposal 2 would be voted down if offered first, but approved if proposal 1 has been previously adopted, then ordering will affect outcome. Proxy solicitors can advise managers what probably will and won't pass. Blank check preferred stock again provides an example. A blank check preferred proposal may succeed if the managers place it in an otherwise plain vanilla proxy statement and stress its


value as a financing tool, but may fail if placed on the same ballot with three other antitakeover amendments. Next year, the managers can propose the other antitakeover amendments.

The managers also control when the shareholders learn what’s on the agenda. The shareholders usually have no notice of matters to be voted on until they receive the proxy statement, about a month before the meeting. This makes it extremely hard for shareholders to develop a counterproposal or an opposing solicitation, get it cleared by the SEC, and then lobby against management’s proposal. The 30-day period is already the practical minimum for reaching individual shareholders through layers of nominee holders and getting votes back. Thus an opponent must rely almost exclusively on institutional support. The harder it is for shareholders to offer alternatives to manager proposals, the greater the managers’ control over the outcome. A political analogy is to floor amendments in the House or Senate: rules that restrict floor amendments increase committee control over the final bill.221

Moreover, managers have superior information about the votes as they come in. A shareholder who solicits votes against a management proposal without using a separate proxy card won’t see the ballots, and thus won’t know the outcome until after the meeting. If success seems doubtful, the managers have various options, including increased campaign efforts, targeted lobbying of shareholders who have voted against them, strategic withdrawal of a proposal, and compromise on favorable terms with a shareholder proponent who is less well-informed about the likely outcome, and thus disposed to compromise.

Shareholder tendency to accept a compromise is compounded by reimbursement rules that permit but don’t require the company to reimburse the shareholder’s expenses. As part of a compromise, the company can agree to pay the proponent’s expenses; even if it doesn’t, settlement reduces the overall cost of the contest. In contrast, success at the polls carries no likelihood of reimbursement.

B. Managers’ Timing Control for Shareholder Proposals

For shareholder proposals, managers lose their proposal packaging edge, but retain a significant procedural edge. For shareholder proposals included in the company proxy statement, like the managers’ own proposals, the managers have superior information about the votes as they are cast, with concomitant ability to increase campaign

221. J. ROBINSON, THE HOUSE RULES COMMITTEE 44-46 (1963), discusses the importance of House Rules Committee control over when and in what order bills are voted on, and of House rules limiting floor amendments.
efforts, resolicit shareholders who cast antimanager votes, or reach a favorable compromise with a less-informed shareholder proponent. And, of course, the managers retain their funding advantage.

Shareholder proponents must send proposals that will be included in the company proxy statement to the company a full five months before the annual meeting, ample time for the managers to prepare their opposition. Increasingly, advance notice bylaws give the managers ample time to defend against shareholder proposals not included in the company proxy statement as well. In contrast, the managers needn't show their hand until they mail the company proxy statement.

The managers can also manipulate the date of the shareholder meeting. State law gives the managers substantial though not unlimited power to postpone or adjourn a meeting to allow more time for lobbying, or move up the meeting date to give the proponent less time to solicit support. Such tactics are routinely used in proxy fights, and may become common for other matters if shareholders begin to win more often. Delays in the meeting has the fringe benefit of running up the proponent's tab, since the delay allows more time for solicitation, countersolicitation, and legal battles.

Agenda control and collective action issues interact. The more costly it is for shareholders to offer alternatives, the stronger the managers' agenda control. Collective action factors, in turn, reduce shareholder willingness to bear the cost of offering alternatives. There is a common, though only partial solution to both problems — make it easier for shareholders to oppose manager proposals and make their own proposals, especially alternatives to management proposals.

Managers also have a critical substantive edge for many shareholder proposals. Apart from director elections, bylaw amendments, and a few other matters, shareholder proposals don't bind the managers. If the managers adopt a poison pill and the shareholders ask that it be redeemed, the managers can simply refuse, and the shareholders have little recourse short of a proxy fight.

VIII. INSTITUTIONAL INVESTOR CONFLICTS OF INTEREST

Discussions of shareholder voting often treat the "shareholder" as a simple entity that maximizes return on investment. The real story is
far more complex. Institutional investors, like the companies whose shares they own, are managed by managers who need watching and appropriate incentives. Moreover, the single phrase "institutional investor" obscures important differences between institutions.

This Part examines institutional money manager incentives and conflicts of interest, and the evidence on how these conflicts alter patterns of voting and activism. Conflicts can strongly skew the decision to become visibly active on corporate governance issues. They can also skew, though less strongly, how institutions vote on someone else's proposal. It's no accident that public funds are in the forefront of the nascent institutional shareholder movement, mutual funds are somewhere in the middle, and bank trust departments and insurers remain mostly promanager.223

A. Corporate Pension Funds

Corporate pension funds are the largest category of institutional investor; they own almost one sixth of all stocks. Most companies rely on outside money managers to invest their pension fund assets; a minority manage pension assets in-house. Most companies delegate voting authority along with investment authority, but some delegate only investment authority.224 Thus, there are three patterns to be evaluated: investment and voting by an outside money manager; investment and voting in-house; and investment by an outside manager with in-house voting.225

Consider first the most common pattern: outside money managers who both purchase and vote pension plan shares. These managers have a duty to their beneficiaries to cast votes that enhance share value.226 The first prerequisite for a money manager, though, is money to manage. Existing corporate clients must be kept happy, new


225. Partial delegation of voting power is also possible: the corporate sponsor can delegate voting power only for routine issues; retain the right to override the money manager's decision; require in-house review of antimanager votes; or delegate voting power to some money managers but not others. Companies typically use partial delegation schemes to ensure promanager votes, much as other companies, with like intent, delegate investment power but not voting power.

226. For a well-funded defined-benefit plan, the residual gains from better performance go primarily to the corporate sponsor (and indirectly to its shareholders) rather than to plan beneficiaries. See Fischel & Langbein, ERISA's Fundamental Contradiction: The Exclusive Benefit
clients attracted. When the plan's interests counsel a promanager vote, no conflict arises. The interesting case is when the plan's interests counsel an antimanager vote.

At one level, the need to attract business is consistent with fiduciary duty. Better performance means more money to manage. But there are powerful countervailing incentives. Pension managers face pressure from corporate officers to vote promanager. Sometimes, the pressure is explicit: the CEO of the sponsoring company orders or urges a money manager to vote promanager, either in general or on a particular issue. Or a CEO of one company writes to other CEOs, urging them to ask their fund managers to vote promanager. Such pressure is especially effective when the fund manager must vote for or against a client company's own proposal.

Most money managers have felt such explicit pressure on occasion. In a 1987 survey, half of all corporate pension officers thought it "appropriate" to advise pension money managers how to vote proxies on other companies' proposals; 75% thought this appropriate for their own company's proposals. Half of those who thought such action appropriate had taken it. The money managers overwhelmingly took the advice; only 7% did not vote the corporate party line.227

Overt pressure has become less common since the Labor Department began to scrutinize pension plan voting practices in 1988.228 But the pressures haven't gone away; they've just become less explicit or gone underground.229 A phone call asking how the manager intends to vote will convey the message nicely. Even money managers who haven't been overtly pressed to change their votes feel implicit pressure to vote promanager. Current clients will know, and some prospective clients will ask, about voting policies, and money managers know the answer those clients want to hear.

Despite these pressures, some money managers will cast antimanager votes, whether from concern for legal liability or desire to improve performance. Voting, after all, is usually a low visibility matter. It's an order of magnitude harder, though, to take the highly visible step of presenting one's own proposal, and spending plan assets to support that proposal. That might scare off corporate pension officers

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229. And maybe not that far underground. See, e.g., Gavin (forthcoming 1991), supra note 148 (proxy solicitor John Gavin explains that: "a call from the client . . . can sometimes swing a [money manager's] negative vote to a positive").
who wouldn't ask about the manager's voting policies, or who prefer to hire money managers who vote the plan's economic interests as long as those votes can be taken quietly. The fiduciary role provides a second, strong inducement for money managers to do no more than vote plan shares on whatever proposals happen to be made. The gains from activism go mostly to the pension plan's beneficiaries, while the fiduciary risks personal liability for the losses.

Consider next the company that keeps both investment and voting power in-house. In-house money managers have only one client, and will obviously do that client's bidding. That probably means voting promanager, but not always, because of the countervailing incentives to increase returns and avoid ERISA liability. In-house managers are highly unlikely, though, to make waves by offering their own proposals. If company $A$ owned a large stake in underperforming company $B$, $A$'s managers might decide to seek change on a quiet, informal basis. But the large stakes that would justify such action don't often exist.

The third alternative — delegating investment power and retaining voting power — is potentially the most conflict-ridden. The corporate pension officer can happily vote promanager, free of the countervailing incentive to increase returns, which remains the money manager's task. As Labor Department scrutiny has made it harder for companies to control how money managers vote, more corporate managers are choosing this course. Often, the conscious purpose is to ensure promanager votes.230

In sum, some corporate pension fund managers, some of the time, will vote the plan's interests even when that requires an antimanager vote. But we can't expect corporate pension managers to become visibly active in the best of circumstances, and some corporate officers are trying to limit antimanager votes by bringing voting power in-house.

B. Public Pension Funds

Public pension funds have been the principal players in the recent movement toward greater institutional activism. They have two important characteristics not shared by most corporate pension funds: size and independence. Fourteen of the twenty largest pension funds,

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230. See Pension Fund Sponsors Urged to Retain Control of Proxy Voting, 22 Sec. Reg. & L. Rep. (BNA) 979 (1990); Business Roundtable: Bring the Vote Inside, INSTITUTIONAL SHAREHOLDER SERVS., INC., Issue Alert, Dec. 1989, at 3. Clifford Whitehill of General Mills has suggested to me the more hopeful possibility that corporate managers, once they bring voting in-house, will realize that not all manager proposals deserve support. He believes that this has happened at General Mills.
for example, are public funds. Public fund managers don’t solicit business from corporate managers, so they aren’t directly concerned with whether corporate managers like how they vote. Their incentives for maximum effort on their beneficiaries’ behalf are still limited, since the beneficiaries get the upside, but at least those incentives aren’t perverted by direct conflicts. Public funds are also governed by the common law of trusts rather than ERISA, which gives them somewhat more legal maneuvering room. Moreover, public fund managers may be less deeply imbued with the prevailing passivity norm than their private-sector counterparts.

Public funds do have conflicting incentives. Public fund managers need to be good political operators as well as good money managers. Some even have to run for election. They may become active shareholders partly to generate good publicity for themselves. Politicians, who ultimately control public funds, may want to support popular causes, control how the fund votes on antitakeover measures, or use the fund’s voting power for political ends (trading, say, a promanager vote for a promise of local investment). Corporate managers will support political moves to restrict fund power. A public fund will hesitate before voting against antitakeover measures proposed by a local company, even if it opposes such measures generally.

The ultimate political outcome is uncertain, but thus far, these conflicts have been manageable. Politicians aren’t shy about calling fund managers to express their views, but they don’t receive knee-jerk obeisance. Some public funds support social responsibility proposals, but many others don’t. Many states try to get their pension funds


232. Multiemployer pension plans are also substantially independent of corporate managers. But these plans aren’t very large. Multiemployer plans currently own about $42 billion in stocks, or about 1.2% of U.S. equities. See Employee Benefit Research Inst., Quarterly Pension Investment Report, June 1990, at 9.


234. The makeup of a fund’s board of trustees can also affect its willingness to be an active shareholder. Some CREF trustees are corporate officers, who argue for less activism (per anecdotal evidence). Similarly, half of the CalPERS trustees represent employers, and some oppose its activist posture. See White, Calpers’ Chief Wields Big Stick for Institutional Shareholders, Wall St. J., Apr. 3, 1990, at C1, col. 4.

235. See, e.g., White, Pension Funds Stake Out New Territory, Wall St. J., Nov. 17, 1989, at C1, col. 4 (public fund manager reports getting “pressure constantly from politicians, like any other state, but that usually is beaten off by people with better sense”).
to invest in local enterprises, even if investment returns suffer a bit. 236
But the funds oppose such efforts, 237 and have limited local investing
to a small fraction of their portfolios. State employees will support
fund independence because, as pension beneficiaries, they want the
funds to earn the best possible return on investment. 238

C. Banks

Banks and bank holding companies own little stock for their own
account. But they hold large amounts of stock as fiduciaries through
their trust business and as money managers for corporate pension
plans. In either capacity, banks have been relentlessly passive. Even
more than independent managers of corporate pension money, they
routinely vote promanager. 239

Several factors combine to explain bank passivity. Banks that
manage corporate pension funds face the same conflicts as other man­
gerers of such funds. Bank trust officers, in both their pension and
trust business, also have a fiduciary's usual incentives for passivity. A
further source of bank conflicts is their commercial lending business.
Sometimes, banks manage pension money for their commercial bank­
ing clients. Often, a bank will hold stock in the companies to which it
lends. Even without such overlaps, the bank won't want to develop a
reputation for casting antimanager votes, lest it lose current or pro­
spective banking clients. Many banks have Chinese walls between
their loan and trust departments, but this doesn't stop trust officers
from knowing what votes the lending officers prefer. Trust officers
also receive some overt pressure for a promanager vote, wall or no
wall. 240

For the bank's noncorporate trust accounts, many clients are look­
ing for stability and are willing to accept less than stellar performance,
so the countervailing desire to maximize returns may be weaker than
for independent money managers. Indeed, active monitoring may in­
terfere with the bank's desired reputation as safe and stolid.

236. See, e.g., Hinds, Public Pension Funds Tempt States in Need, N.Y. Times, Dec. 2, 1989,
at 1, col. 1; The Rise of Local Investing, INST. INVESTOR, Mar. 1990, at 79.
C1, col. 3.
238. See, e.g., Berss, One Hand Dirties the Other, FORBES, June 25, 1990, at 63 (Wisconsin
Federation of Teachers supports Wisconsin Investment Board's active role on corporate
governance).
239. For an example of the conventional wisdom that banks vote promanager, see Could
Girard Have Won the Proxy Fight?, CORP. CONTROL ALERT, Sept. 1990, at 11 (proxy solicitor
Morrow & Co. describes banks and insurers as "the two groups most likely to support
management").
240. See, e.g., J. HEARD & H. SHERMAN (1987), supra note 190, at 50.
The conflicts, while real, would not be insurmountable were the profit lure strong enough. In the 1980s, for example, money center banks made loans to hostile takeover bidders despite client objections and occasional client lawsuits. For plain vanilla commercial loans, relationships matter because everyone's price is about the same, but such loans aren't a very profitable business. For voting, though, where the benefits go mostly to the beneficiaries, the profit lure has thus far been too weak to override the conflict. Habit and culture may also matter. Bankers who grew up when commercial lending was the heart of the bank's business may believe that antimanager votes cost them valuable business, even if the business is no longer that valuable. And the benefits from active monitoring of corporate managers may appear nebulous to conservative trust officers.

D. Insurance Companies

Insurance companies own significant amounts of stock for their own accounts, and have corresponding incentives to increase share value. But they also face important conflicts if they become too active on corporate governance. First, they may lose insurance business. Life and health insurers sell group and executive policies to companies; property and casualty insurers insure companies against various risks. Also, insurers, like banks, are major lenders to corporations and manage large amounts of corporate pension money. Like banks, they may lose loan opportunities and pension business if they develop an antimanager reputation. Some insurers, such as Prudential and Equitable, own investment banks, and face the investment banks' own conflicts.

On balance, insurers' conflicts seem similar in strength to bank conflicts. Some types of insurance — property and casualty in particular — are more complex products than bank loans. The pricing and terms of the insurance are likely to dominate client concerns about voting practices. And insurance company loans usually don't involve the same close working relationship between lender and borrower that bank loans do. On the other hand, insurers are less able to rely on fiduciary duty as a defense to corporate pressure, since much of their portfolio is held for their own account.

E. Mutual Funds

Mutual funds compete, in substantial part, on the basis of investment return. They consist mostly of pooled individual money, and thus should face less direct conflicts of interest than institutions that depend on corporate business. Some are controlled by investment
banks, which have strong incentives to keep clients happy, but many are independent. Some independent mutual funds will vote antimanager, but none have taken the next step and offered their own proposals.

Possible explanations for why even independent mutual funds have been mostly passive to date, none perfect, include: (i) mutual funds often invest 401(k) and defined contribution pension plan funds for corporations, and thus face some of the same pressures as other corporate pension fund managers; (ii) mutual fund managers care about receiving soft information through analyst meetings and phone calls to company financial officers, and an activist posture may reduce that access; (iii) their marketing-based incentive to outperform the fund down the street may not be congruent with the long term, improve the company instead of sell the stock, orientation of an activist institution; and (iv) both shareholder activism and the large holdings of mutual fund groups may simply be too new for monitoring to have come to the forefront yet.

The conflict of interest explanation is illustrated by episodes such as the decision by Armstrong World Industries, a principal supporter of the recent Pennsylvania antitakeover law, to switch its $180 million employee savings plan to Fidelity Investments from Vanguard Group, after Fidelity withdrew its opposition to the new law. Fidelity is a leader among mutual funds in opposing antitakeover laws, and changed its position in return for a significant weakening of the law’s provisions. I have no reason to doubt Fidelity’s public statement that its decision on the antitakeover law wasn’t affected by its pending bid for Armstrong’s business. But were Armstrong’s motives so pure? Will other mutual funds remain silent, the better to compete with more outspoken funds?

The access to soft information explanation is hard to evaluate. Companies often cut off access for stock analysts who issue negative reports. But it’s easier to cut off a “sell-side” analyst whose advice isn’t selling anything than a “buy-side” manager who may still buy. Companies may cut off access for a fund that sponsors a proposal, but seem less likely to do so based on antimanager votes without more.

The historical explanation, that mutual funds aren’t yet very active because, until recently, they were much smaller and activism seemed


futile, receives some support from the recent moves by Fidelity Investments and Mutual Shares to remove investment limitations from their funds. Fidelity funds are now able, for example, to own more than 10% of a single company or seek changes in the board of directors. How much Fidelity and Mutual Shares will do with this new freedom remains to be seen, however. The self-imposed restrictions are gone, but the legal barriers remain. And other large fund groups haven’t taken similar steps.

On balance, mutual funds, with their strong incentives to maximize return on assets, are likely to be relatively willing followers on corporate governance matters, especially if assured anonymity through confidential voting rules. Corporate officers can still inquire into a fund’s voting record, but some may not ask, for fear of fiduciary liability. Mutual funds, however, will be reluctant to lead.

**F. Investment Banks**

Investment banks and their broker-dealer subsidiaries don’t own much stock directly, but do hold many shares in street name for clients. In theory, brokers could offer voting advice to small shareholders, or even vote client shares. This would be a way of pooling the resources of small shareholders and overcoming their usual apathy.

In practice, however, brokers almost invariably vote promanager. No broker offers its clients independent voting advice on a regular basis, despite a special Proxy Rules provision that permits them to do so without being deemed to be soliciting proxies. This is understandable: they face strong conflicts in opposing corporate managers, from whom they get underwriting and merger advisory business. Their stock analysts also have a strong need for access to corporate officials, access that can be cut off for an obstreperous broker.

Regulatory concern has focused not on brokers’ possible role as informed voters, but instead on their actual role as automatic yes votes. The New York Stock Exchange, under SEC oversight, allows member firms to vote client shares, but only on routine matters and only if the client is sent a proxy card and given the opportunity to vote herself. I have suggested above that the limits on broker power to


244. These rules are discussed in Part III.K supra. All major broker-dealers are NYSE members. The SEC has the power to regulate when broker-dealers can vote client shares under Exchange Act § 14(b), 15 U.S.C. § 78n(b) (1988), but hasn’t done so, presumably because it is satisfied with the NYSE rules.
vote client shares may not go far enough, but the rules point in the right direction.

Investment banks, like commercial banks, can go against their corporate clients' preferences if the stakes are high enough, as they are for hostile takeovers. But even there, too much visibility is bad for business. Most investment banks will advise and lend money to hostile bidders, but taking an equity stake is going too far, as Shearson Lehman discovered when it invested in Beazer PLC's bid for Koppers. And the gains from voting street-name shares against corporate managers are small given the apathy of many individual shareholders.

Investment banks' conflicts affect not only how they vote client shares, but also how they manage captive mutual funds. Here, though, the conflict is more attenuated. The mutual fund has a separate board of directors and owes a fiduciary duty to its investors. This makes it harder, though not impossible, for a company to pressure an investment bank to force a captive fund to vote promanager. Captive mutual funds, even more than other mutual funds, are unlikely to take the lead on corporate governance issues, but they may be able to be moderately independent voters.

G. Foundations and Endowments

Foundations and endowments are the last major category of institutional investors. They own about 2% of all corporate equities. To date, they've occasionally been active on social responsibility issues, but have been entirely passive on corporate governance. This is easily understood: gifts from corporations and their often wealthy top managers are an important source of funds for these institutions. The risk of discouraging corporate donors may outweigh the possible increase in portfolio returns from being active.

It is too much to expect foundations and endowments to take a visible, leading role on corporate governance issues. But they are at least free of direct oversight from conflicted watchers. Thus, given the anonymity of confidential voting, foundation and endowment managers seem likely to vote in the institution's economic self-interest. This makes them likely followers on corporate governance issues, if someone else takes the lead.

H. The Need for More Data

We know who the shareholder proponents are: primarily public funds. We know how some institutions vote. We can speculate about

245. See Eichenwald, Takeover with a Twist, N.Y. Times, Apr. 24, 1988, § 3, at 1, col. 2.
the strength of the conflicts faced by different institutions. But we lack direct evidence on how different types of institutions vote. We don’t know, for example, whether corporate pension funds are more or less likely than banks or insurers to vote antimanager in general, or on particular issues. Nor do we know whether corporate pension funds that are managed in-house vote differently than externally managed funds.

There have been only a few attempts to determine how different institutions vote. James Brickley, Ronald Lease, and Clifford Smith report that ownership by banks, insurers, and nonbank trusts (treated as a single “pressure sensitive” group) correlates with promanager votes on antitakeover amendments, while ownership by public pension funds, mutual funds and endowments (treated as a single “pressure resistant” group) correlates with “no” votes. All institutions become more likely to vote against a proposal as the expected shareholder wealth loss from passage increases. 246 Karen Van Nuys reports that public pension funds were significantly more likely than bank trusts and insurers to vote against Honeywell’s 1989 proposals to adopt a staggered board and limit shareholder power to act by written consent. 247

Other work doesn’t subclassify institutions. Karen Van Nuys estimates that during 1988, institutions voted for various manager proposals between 56% and 74% of the time, depending on the issue; the rest voted no or abstained. Proposals to adopt blank check preferred stock, require supermajority approval of a merger, or limit shareholder rights to act by written consent or call a special meeting received lesser support; proposals to eliminate director liability under the duty of care, increase authorized common stock, adopt a stock option plan, or eliminate cumulative voting received a more positive response. 248  

Georgeson & Co. reports that institutional ownership correlates with support for shareholder poison pill and confidential


247. K. VAN NUYS (1990), supra note 56, at 2. The Investor Responsibility Research Center conducts an annual survey of how public pension funds, private pension funds, investment managers and foundations and endowments “generally” vote on various corporate governance issues. See, e.g., L. KRASNOW (1989), supra note 179, at 9-10, 31. The survey suffers, however, from severe self-selection bias in the survey respondents (for example, only four private pension funds responded in 1989), and the “generally” qualifier can conceal a fair amount of case-by-case variation in voting.

voting proposals. In contrast, John Pound reports that institutional ownership correlates with manager success in proxy fights, but he relies on data from the early 1980s, before the recent trend toward institutional activism. Moreover, institutions may vote promanager in proxy fights, which involve intense management pressure and don’t exhibit economies of scale, yet vote against the managers on some structure and process issues.

I. The Effects of Institutional Conflicts

All major institutions have significant conflicts of interest; all but public pension funds have incentives to keep corporate managers happy. For each, conflicts of interest will tilt the voting calculus to some extent away from maximizing share value. But institutions are not alike. How an institution votes will depend on the importance of the issue, the strength of the conflict and of the countervailing incentives to maximize share value, how readily corporate managers can find out how the institution voted, and the likelihood that its vote will make a difference, which in turn depends on how other shareholders are expected to vote.

For a conflicted institution, crossing the street in a crowd is safer than crossing alone. Thus, for a particular type of proposal, there can be a tipping point in institutional support. Once enough institutions vote antimanager, others are likely to do so as well because fiduciary duty, combined with the example of what others are doing, offers an effective defense to pressure. The likelihood that managers will respond to the threat of defeat by stepping up their pressure increases the level of antimanager sentiment needed to reach that tipping point. Nevertheless, we may be near such a tipping point today for some antitakeover proposals, which once won routinely but are now rarely offered and when offered sometimes lose.

Conflicts of interest affect both how institutions vote and which institutions will take a lead role on corporate governance issues. The first conflict is less severe than the second. Some conflicted institutions will vote promanager against their beneficiaries’ interests but others will vote antimanager, and some institutions who vote promanager on a less important matter will switch their vote when a management win means a large loss. With regard to taking the lead, only public pension funds, and perhaps mutual funds, are potential


shareholder proponents. They are also likely to be the major supporters of trade groups that promote shareholder activism. Other institutions will vote yea or nay, and a few may join trade groups, but they can't be expected to do more.

As discussed in Part IV, institutional ownership of most major companies continues to grow. But institutional ownership has been substantial for decades, and the institutions have been quiet until very recently. The conflicts analysis suggests that activism may have grown as much because of changes in who the institutions are as because of continued growth in total institutional holdings. Public pension funds and mutual funds have grown three to four times as fast as the market as a whole, and that apparently matters.

Conflicts of interest analysis can also help to explain why focused lobbying of institutions for a shareholder proposal or against a manager proposal makes a difference. Why, for example, did a formal opposing proxy solicitation lead to defeat of Honeywell's staggered board proposal, when Honeywell had expected passage? Partly, the solicitation may have focused attention on Honeywell's weak business performance. But the solicitation may have also made it safer and more important for conflicted institutions to vote no. Safer because others were doing so; more important because of the greater chance that their vote would matter.

J. The Role of Legal Rules

Legal rules can never perfectly control conflicts of interest, but they can reduce the impact of conflicts on voting decisions. The Labor Department's insistence that voting rights are a pension plan asset is a modest step in that direction. The Department, however, has done little to enforce its rules and has only insisted that shares be voted and encouraged development of formal voting guidelines. Merely requiring that a pension plan vote its shares, without challenging apparently conflicted voting decisions, won't help much.

The Labor Department's efforts could even backfire. Suppose that a money manager would like to vote against staggered boards as a general rule, but vote yes when pressured to do so. If required to adopt a formal voting policy, she might decide to vote for staggered boards. It may be easier to concoct a reason why staggered board proposals are acceptable than to explain mixed yes and no votes. And always voting no may put her at risk of developing an antimanager reputation.

Legal rules that allow managers not only to see the ballots, but to resolicit shareholders who vote against them, facilitate corporate pres-
sure for favorable votes. In contrast, rules such as confidential voting that shield the institutions' votes from corporate scrutiny could increase the institutions' willingness to cast antimanager votes. Rules that keep institutions' stakes in individual companies low indirectly enhance the effectiveness of corporate pressure by decreasing the strength of the countervailing incentives to increase portfolio value. To be sure, companies will lobby large shareholders more strongly, but this seems only a partial counterweight to the enhanced incentives that would flow from owning a large stake.

CONCLUSION

This article is long but its message is simple: Shareholder passivity is not inevitable even in large public companies. Instead, legal barriers, manager agenda control, and conflicts of interest may be important reasons why shareholders do as little as they do. Shareholders who would purchase large stakes, join forces with others to present voting proposals, or nominate and elect their own directors, face a complex web of legal barriers and risks. Many also face strong conflicts of interest, which are only weakly controlled by legal rules.

History matters too. Until recently, institutional ownership was heavily weighted toward strongly conflicted institutions. Institutional holdings, while large, may not have been large enough to produce meaningful voting power, once conflicts are taken into account. The recent surge in institutional activism suggests that institutional holdings, especially holdings by less-conflicted institutions, may finally have reached a critical mass where such activism begins to make sense. In contrast, collective action problems, while important, seem manageable for the large institutions who are today the dominant shareholders. Especially for issues with strong economies of scale, apathy may not be rational after all.

We can't answer the counterfactual question of how much shareholders would do under a less obstructive, more facilitating legal regime. Nor have I addressed in this article the extent to which more shareholder monitoring of corporate managers is desirable. Some monitoring is needed, because corporate managers need to be watched by someone, but how much, and by which institutions, is a complex matter that I will pursue in a separate article. It is enough here to raise the possibility: Shareholder monitoring might work, might become an important part of the larger web of legal and market constraints on corporate managers, if legal rules permit. Shareholder voice is an idea that hasn't been tried, not one that has failed. It deserves our renewed attention.