What's Wrong with Shareholder Empowerment?

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To begin, I want to thank the editorial board of The Journal of Corporation Law for inviting me to be the keynote speaker at this very prestigious event. It is truly a great honor to be here, and I hope my speech is worthy of your invitation. I would also like to thank Professor Stephen Bainbridge for not only being the major influence in my thinking about corporate law, but for taking the time to make comments on this presentation.

What I want to talk about this evening is the negative impact shareholder empowerment has on the efficiency of decision making at public companies. A public company is one where there is a specialization of function in both the holding of shares and managing the company. Managers manage, shareholders invest, and there is no required overlap between the two. Also, there are many shareholders, and their shares are traded on a public exchange. Of course, large corporations such as Apple, General Electric, Microsoft, Walmart, ExxonMobil, and General Motors immediately come to mind when you think of a public company, but the definition also covers the thousands of other corporations that are significantly smaller but still of significant size.

Shareholder empowerment is the shifting of decision making from the board of directors and executive management to shareholders. The major problem with shareholder empowerment is that it shifts the balance between authority and accountability—which needs to be heavily weighted toward authority for a public company to make the most efficient decisions—too far in the direction of accountability and counter to the approach taken by corporate law. For example:

- Corporate law makes the board of directors the ultimate decision-making

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1. A public company or publicly held firm is an economic organization in which: (i) management and shareholding are separable and separated functions; (ii) the shares are held by a number of persons; and (iii) the shares are freely transferable. Michael P. Dooley, Two Models of Corporate Governance, 47 BUS. LAW. 461, 463 n.9 (1992).

authority in a corporation. If the board of ExxonMobil, a company long known for being vertically integrated, decides on a strategy of selling off its company-owned service stations, which it has recently done, it is not obligated to consult its shareholders about the decision; Corporate law allows the board to delegate operational decision-making authority to executive officers. However, it is the board who decides how that authority is delegated and to whom; Corporate law provides the board of a public company the ability to make significant acquisitions without shareholder approval; Corporate law only allows the board of directors to initiate changes to the corporate charter. This is a very powerful tool to keep shareholders from disturbing the balance of power that is and should be tilted in favor of centralized authority; and Corporate law allows the public company to include exculpation clauses in its charter, relieving the directors of duty-of-care liability, and in doing so, supports the business judgment rule’s role in making sure that directors are not held liable for honest mistakes in judgment that turn out badly.

Consistent with what Berle and Means observed many years ago, corporate law grants “management a staggering degree of power.” Such an observation was meant to warn, not praise, corporate law’s approach to the balance of authority and accountability in a public company, and so began, in my opinion, the academic fixation on agency costs without giving adequate weight to the value of centralized authority. Nevertheless, despite the warning of Berle and Means, rules of corporate governance that favor a centralized authority, the board of directors and executive management, and minimize the involvement of shareholders are ideally suited to facilitate decision making at public companies. According to Kenneth Arrow, information scattered over a large organization must be both filtered and transmitted to a centralized authority in order for a large

3. DEL. CODE ANN. tit. 8, § 141(a) (West 2011).
5. DEL. CODE ANN. tit. 8, § 142(a) (West 2011).
6. Id. at § 251(f).
7. Id. at § 242(b)(1).
8. Id. at § 102(c)(7).
9. According to the Delaware Supreme Court:

Our law presumes that “in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.” Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.

In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

10. This large concentration of corporate authority was first identified by Professor Adolph Berle and Dr. Gardiner Means writing just after the 1927 and 1929 amendments to the DEL. GEN. CORP. L. See A.A. Berle, Jr. & Gardiner C. Means, Corporations and the Public Investor, 20 AM. ECON. REV. 54, 60 (1930) (discussing variation in stockholder and management power in corporation law).
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organization to make informed decisions and minimize error in decision making.\footnote{Kenneth J. Arrow, The Limits of Organization 68–70 (1974).}

In the context of a public company, pieces of information may be scattered over different states, countries, and even continents. To have the holders of these scattered bits of information make decisions that affect the company as a whole would lead to suboptimal decision making; and just to be clear, these holders of scattered bits of information include the overwhelming majority of shareholders. The need to make informed decisions provides corporate law a very good reason to minimize the role of shareholders in a public company’s decision-making process.

Of course, in a public company, it is typical to have decentralized decision making. For example, in a Wall Street firm it is quite possible that the most critical day-to-day business decisions will be made on the company’s trading desks and not in the boardroom or the executive suite. However, it is the board of directors, working through its executive officers, who are in the best position to determine how and to whom this decision-making authority will be delegated.\footnote{Robert Clark, Corporate Law 23 (1986) (discussing delegation of authority).} That is, the centralized authority, because of its informational advantages, is in the best position to determine the optimal command and control structure for the company. Finally, in terms of timeliness, it is imperative that the board and its executive officers have the authority to make the vast majority of decisions or delegate decision-making authority without shareholder approval. Such a shareholder approval process would simply freeze up the corporation and ultimately lead to its failure.

In sum, the public company needs a head on its fictional shoulders. There are huge benefits for a public company in having corporate law provide corporate governance rules that strongly favor a centralized authority. This understanding has led Professor Bainbridge to famously state that the “preservation of managerial discretion should always be the null hypothesis.”\footnote{Stephen Bainbridge, The Business Judgment Rule as Abstention Doctrine, 59 Vand. L. Rev. 83, 109 (2004) (discussing the tradeoff between authority and accountability).} And in that statement, I agree.

However, in such an authority model of corporate law, there is still a need for accountability. It is important to try to minimize the “opportunistic behavior” of the board and its executive officers. But when I talk about opportunistic behavior, it is important to realize that I am not just talking about agency costs (that is, the extracting of private benefits from the corporation by management), but also the error caused by having decision-making authority located in the wrong part of a public company.\footnote{Bernard S. Sharfman, Why Proxy Access Is Harmful to Corporate Governance, 37 J. Corp. L. 387, 401 (2012) (citing Arrow, supra note 11, at 73–74).} To remedy this error, Kenneth Arrow suggested that from time-to-time it may be more efficient to shift decision making away from a centralized authority to another part of a large organization.\footnote{Arrow, supra note 11, at 74–75.} If so, this implies implementing a shift in decision-making authority from the board to a company’s shareholders when necessary.

This is why corporate law provides a number of tools of accountability that shareholders can utilize to control one or both types of opportunistic behavior. For example, corporate law mandates fiduciary duties and provides shareholders the ability to enforce those duties through litigation; it requires shareholder approval of major

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15. Arrow, supra note 11, at 74–75.
corporate actions for changes to the articles of incorporation and major mergers or acquisitions; it gives shareholders the power to unilaterally propose and adopt bylaws; and finally, it allows shareholders to wage proxy contests when necessary.\textsuperscript{16}

What I have been describing is a balancing act between authority and accountability where it is not possible to know exactly where the ideal balance exists at any particular public company at any particular time.\textsuperscript{17} Even so, a strong argument can still be made that implementing a shift in decision making from the board to shareholders will lead to sub-optimal results. I have already begun to make this argument by explaining the great value that centralized authority provides in a public company. I will now continue to make this argument by explaining the ramifications of having disparities between management and shareholders in terms of information, skill in decision making, and interests.\textsuperscript{18} In regard to the disparity of interests, that means both in terms of being involved in corporate governance and trying to achieve the corporate objective.

These disparities cannot be understated. For example, in comparison to management, think of two very important and different types of equity investors: liquidity traders and information traders. Liquidity traders do not collect and evaluate information; rather, these traders participate in the market depending on their funding needs.\textsuperscript{19} This is your passive, index-fund investor.\textsuperscript{20} In combination with limited liability, these traders utilize portfolio diversification to eliminate the unsystematic risk associated with their equity investment. These traders have no information about any of the companies they hold in their portfolio, no identified skills in decision making, and definitely no interest in the corporate governance of the hundreds or thousands of companies they invest in.\textsuperscript{21} This group of investors is the role model for those who believe shareholders are “rationally apathetic.”\textsuperscript{22} Therefore, the disparities between management and shareholders are at their maximum when we think of shareholders as being only liquidity traders.

However, there are other types of equity investors. For example, information traders can also hold shares in a public company. An information trader is one who trades in the financial markets based on recommendations and advice.\textsuperscript{23} Information traders include sophisticated, professional investors such as activist hedge fund managers, money managers, and other market professionals.\textsuperscript{24} An information trader is willing and able to devote resources to gathering and analyzing information as a basis for its investment

\begin{footnotes}
\item[16] Sharfman, supra note 14, at 406.
\item[18] Dooley, \textit{supra} note 1, at 466–67.
\item[20] \textit{Id.}
\item[21] \textit{Id.}
\item[22] Iman Anabtawi, \textit{Some Skepticism About Increasing Shareholder Power}, 53 \textit{UCLA L. Rev.} 561, 574 n.61 (2006). Shareholders are rationally apathetic because they will not undertake the costs of getting involved in corporate decision making unless the “proportionate share of the expected collective benefits from doing so exceeds its expected costs.” \textit{Id.} at 574.
\item[23] Sharfman, \textit{supra} note 14, at 403.
\item[24] \textit{Id.}
\end{footnotes}
decisions.

While, at least in theory, an information trader does not have access to inside information, the function of an information trader is to look for differences between value and price based on the information he possesses and then trade to capture the value of this informational advantage. However, an information trader is also likely to be rationally apathetic since whatever limited time, resources, and skill he has to devote to his work are most likely targeted toward valuation, not corporate governance. Of course, there are information traders who will be exceptions to this general rule. For example, activist hedge-fund managers who take large positions in public companies as a means to effect change. But even still, for the large majority of information traders, there are still large disparities in terms of information, at least in terms of inside information, skill in decision making, and interest in corporate governance between them and management. In sum, there are strong incentives for the overwhelming majority of shareholders to be rationally apathetic and delegate decision-making authority to the board and its executive management.

What I have just described is a corporate governance universe where centralized authority is highly valued and shareholders have strong reasons to be rationally apathetic. If so, where does that leave the private ordering of corporate governance arrangements? Private ordering, of course, is the much-admired process of waiving by contract the default rules of corporate law. Even though I think this might be considered heretical by some, especially among those who consider themselves contractarians, I believe it means that the private ordering of corporate governance arrangements, where decision making is shifted from the board and its executive officers to shareholders, should be a rare occurrence, and moreover, should be presumed harmful to corporate governance unless proven otherwise. I say this because if corporate law has it right by giving so much authority to the board and its executive officers, then there should be little room for private ordering to enhance efficiency. In the terminology provided by Bernard Black, I would consider the default rules that provide for centralized authority to be “market mimicking.”

Finally, what are we to make of the shareholder empowerment movement? This movement, supported by both shareholder activists and the federal government, is a one-size-fits-all approach to the corporate governance of public companies that shifts decision making in only one direction, toward shareholders. I believe if shareholder activists and their primary enabler, the federal government, took a disciplined, firm-by-firm approach to analyzing the corporate governance arrangements they are advocating, they may see that in the vast majority of situations the shifting of decision making from the board to shareholders does not enhance decision making, but instead will lead to increased error and a shifting of agency costs from management to shareholders that overcomes whatever benefit is received from a reduction in management agency costs. Therefore, the more successful shareholder activists are, the more damage they will cause to our economy.

Moreover, even though I hope I am wrong, I currently have a somewhat pessimistic outlook on the ability of those who strongly support the value of centralized authority,

25. Id.
such as me, to minimize the harm caused by shareholder activists. I base this on several reasons, the least of which is that shareholder activists may simply be undervaluing the benefits of centralized authority and need to be reeducated. More importantly, to the extent their activities are motivated by rent seeking, the potential motivation of labor union pension funds; or their own political ambitions, the potential motivation of those elected officials who get the opportunity to manage public pension funds; or simply to maximize their income, the potential motivation of corporate governance professionals who take on the role of zealous advocates of shareholders rights; their objective for the company will not match the commonly accepted corporate objective of shareholder wealth maximization, or alternatively, the board objective of mediating the interests of those who have made firm specific investments. In addition, unlike the board and even controlling shareholders, the activities of shareholder activists are not constrained by fiduciary duties, meaning they do not have to consider the interests of the corporation and their fellow shareholders. Without fiduciary duties, how can their interests ever be aligned with that of the corporation?

Finally, I do not see an end to shareholder activism even if activists succeed in getting binding proxy access, majority voting, declassification of boards, binding say-on-pay, etc. implemented at all the largest public companies. After all, an end to their activism means an end to the benefits they can derive from such activities. Therefore, for shareholder activists, there is no ultimate goal to achieve. If so, then what we are dealing with can be referred to as “creeping shareholder activism,” a constant movement toward shareholder empowerment without regard for what is lost in the process in terms of efficient decision making.

In conclusion, the ability of corporate law to facilitate the efficient decision making of public companies requires the law to provide great deference to the value of centralized authority and to reflect the idea that shareholders will be rationally apathetic. No matter how many more Enrons, WorldComs, Bear Stearns, and Lehman Brothers we must endure, calls to shift decision making from the board of directors to shareholders will only result in harming the genius that is currently embodied in our corporate law.

Now, that ends the “academic” part of my presentation. For the rest of my time up here on the podium, I would like to address the editorial staff of The Journal of Corporation Law. Basically, I want to give you a little career advice. At this point, you are either relieved that you have lined up that great first job or are still frantically searching for it. In any event, I have no doubt that you will all eventually secure that first position that you are satisfied with, at least in the short-term. But going forward, what I would like you to do is to take a few moments every couple of years and ask yourself if what you are doing is really significant. That is, place yourself at the end of your career, not where you are at that moment, and ask yourself if what you are currently doing would satisfy that “future you” looking back in time.

Unfortunately, this process of self-reflection can easily be ignored for long periods of time. After all, you will not only be starting a very time consuming career, the practice of law, but you will also be starting families, buying your first home, dealing with aging parents, etc. Life can be very time consuming, conveniently allowing excuses for not

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taking the time to reflect on your career.

In my case, I finally started that process when I was 35 and that “future me” was not happy with what he saw looking back. It led me to law school at the age of 39. Of course, like many of you who were much younger when you entered law school, I had no idea how law school was going to make my career significant, but I had hope that it would. Fortunately, it turned out well, even though I did not figure out how I could do something significant until several years into my legal career. For me, I found that significance in writing law journal articles and more recently, in teaching law to both law and business students. Of course, that is my own thing, and you will most likely find significance in other endeavors. Nevertheless, I have this passion for writing law journal articles, and it gives me great pleasure to know that my articles are being read by students and professors alike. Moreover, I do not think I could have found any greater confirmation of my works’ significance than the invitation to speak to you this evening. What a great thrill it is to be here.

So, looking back from this podium as the keynote speaker at The Journal of Corporation Law spring banquet, I can say to you that both the “current me” and the “future me” are very satisfied with how my career has evolved, and I hope you will one day have a similar experience.

Thank you very much.