The Economic Structure of Corporate Law

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e Munhoz Advogados

Harvard University Press
Cambridge, Massachusetts
London, England

mizing strategy under managerial liability is for firms to self-insure by increasing their capitalization or purchase insurance, whichever is cheaper. In either case, the incentive to engage in overly risky activities goes down.

The problem with managerial liability is that risk shifting may not work perfectly. It is unlikely, for example, that managers who are liable for mass torts, with mammoth but uncertain expected liabilities, could shift all of this risk. Because of the huge amounts involved and the difficulty of monitoring, insurers are unwilling to assume the highest possible expected liability. To the extent that risk is not completely shifted, a legal rule of managerial liability creates risk for a group with a comparative disadvantage in bearing that risk. This inefficiency leads to both an increase in the competitive wage for managers and a shift away from risky activities. And there is no guarantee that the social costs of this shift away from risky activities will not exceed the social costs of the excessively risky activities in the absence of managerial liability.

A final method of reducing the incentive to engage in overly risky activities created by limited liability is the regulation of inputs. The regulation of nuclear power plants, for example, could be justified as a response to the perverse incentives created by limited liability. Again, however, there are costs associated with direct regulation of risk taking. Regulators have no better incentives than market participants to balance the social costs and benefits of engaging in certain activities. Indeed the economic theory of regulation suggests that many regulatory schemes arise in order to create, rather than eliminate, "defects" in markets. Thus the regulation of nuclear power plants may have the purpose and effect of shielding other types of energy producers from competition rather than eliminating perverse incentives created by limited liability. Whether the social costs of regulation exceed the social costs of excessively risky activities is an empirical question. The desirability of regulation cannot be established simply by identifying the potential incentive to engage in overly risky activities created by limited liability.

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Voting

If limited liability is the most distinctive feature of corporate law, voting is second. Shareholders elect a board, which chooses managers; shareholders can recall the directors and fundamentally alter the way the corporation runs. Creditors have no similar powers. Votes may not look much like contracts, but the *structure* of voting—who votes, using what institutions—is contractual, and efficient too.

Why Do Shareholders Vote?

"Why do shareholders vote?" is three questions in one. First, why do any investors have voting rights? Second, why do shareholders alone have voting rights? Third, why do shareholders exercise their voting rights? Our concern in this chapter is with publicly held corporations. We discuss voting in closely held corporations in Chapter 9.

Rules and Practices

Most states allow firms to establish almost any voting practices they please. For example, Delaware permits firms to give shares any number of votes (including none) and to give votes to bondholders in addition to (or instead of) shareholders.[1] The votes may cumulate or not, at the option of the firm. (Cumulative voting permits shareholders to cast multiple votes for a single candidate, so that a candidate may be elected by less than a majority of the shares.)[2] Investors may vote in person or by proxy. They may

[1] 8 Del. Code §§151(a), 221.

[2] 8 Del. Code §§102(b)(3), 214.

choose managers directly or through the mediation of a board of directors.[3] They may permit directors (or managers) to serve full terms or may oust them for any or no reason in midterm.[4] The necessary quorum may be set at less than half of the votes, and the firm may require supermajority approval on selected questions.[5] Any of these rules may be set or altered at any time by those with power to vote. The situation is much the same in other states.[6] Although different states create different presumptive rules (for example, votes may be cumulative unless provided otherwise), this does not detract from the status of the enactments as enabling statutes.

There are nonetheless recognizable patterns in corporate choice under these states. Almost all shares have one vote, and only shares possess votes. Preferred stock or bonds may acquire votes when the firm is in financial difficulty. Cumulative voting is rare in publicly held corporations, as is nonvoting stock or stock with seriously limited voting rights.[7] Shareholders rarely select managers; they instead select boards of directors, which in turn choose managers. There are no special elections between the scheduled yearly ones; directors are not recalled from office. Shareholders vote by proxy, not in person, and elect the slate of candidates proposed by the incumbents. The quorum is half of the available votes, and issues are decided by a majority of the votes cast. Exceptions to these practices are infrequent.

A number of statutory rules limit the ability of firms to create the voting structures they prefer. For example, although investors may transfer their votes by selling the instruments to which votes are attached, they may not sell the vote independent of the instrument.[8] Statutes control evasion of the no-sale rule by limiting the ability of shareholders to grant irrevocable proxies. A proxy—that is, the voter's grant of authority to someone else to cast his votes—is revocable by the grant of a new proxy to someone else; even a proxy purporting to be irrevocable is binding only if coupled with an "interest" in the stock, such as a pledge to secure a loan.[9] The voting trust—a form of irrevocable proxy in which several shareholders convey their shares and the attached votes to a trustee who must vote them as a bloc in accordance with instructions—was unlawful at common law. When it was authorized by statute, the authorization was accompanied by rules setting time limits and requiring periodic renewals of the trustee's powers.[10] The statutory voting trust is employed only in close corporations.

Statutes in every state require votes to be taken on certain "fundamental" transactions, such as mergers and sales of substantially all the assets of the firm.[11] Statutes also require the board of directors to submit other proposals to voters when, for example, a sufficient number of voters or directors request such a submission.[12] There are a few more restrictions, of substantially less importance.

[3] 8 Del. Code §§102(b)(1), 109(b), 141(a) & (f), 228(a).

[4] 8 Del. Code §141(k). The only exception concerns directors elected by a minority of shares with cumulative voting. These directors may be fired only for good reasons or by a majority large enough to have prevented their election initially.

[5] 8 Del. Code §216.

[6] See American Bar Association, *Model Business Corporation Act* ch. 7 (rev. 1984), which a majority of states follow.

[7] A few firms have multiple classes of common stock with different voting rights. For an analysis of this voting structure, see Daniel R. Fischel, "Organized Exchanges and the Regulation of Dual Class Common Stock," 54 *U. Chi. L. Rev.* 119 (1987). See also Gregg A. Jarrell and Annette B. Poulson, "Dual-Class Recapitalizations as Antitakeover Mechanisms: The Recent Evidence," 20 *J. Fin. Econ.* 129 (1988); Richard S. Ruback, "Coercive Dual-Class Exchange Offers," ibid. at 153; Kenneth Lehn, Jeffry Netter, and Annette Poulson, "Consolidating Corporate Control: The Choice between Dual-Class Recapitalizations and Leveraged Buyouts," 26 *J. Fin. Econ.* (1991). The volume of legal literature on stock with different voting rights outstrips the significance of the phenomenon. See Ronald J. Gilson, "Evaluating Dual Class Common Stock: The Relevance of Substitutes," 73 *Va. L. Rev.* 807 (1987); Jeffrey N. Gordon, "Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice," 76 *Cal. L. Rev.* 1 (1988); Joel Seligman, "Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy," 54 *Geo. Wash. L. Rev.* 687 (1986); George W. Dent, Jr., "Dual Class Capitalization: A Reply to Professor Seligman," ibid. at 725.

[8] Some states ban sales of votes by statute (N.Y. Bus. Corp Law 609[e]), and other states do so by judicial decision (Macht v. Merchants Mortgage & Credit Co., 22 Del. Ch. 74, 194 A. 19 [1937]). See Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982) (discussing the situations in which vote selling is prohibited).

[9] For example, 8 Del. Code §212.

[10] For example, 8 Del. Code §218 (ten years' duration).

[11] For example, 8 Del. Code §251(c) (requiring vote of a majority of all stock, not just of a quorum, to approve a merger).

[12] For instance, 8 Del. Code §109(a) (although the board of directors may be given the power to amend the bylaws, this "shall not divest the shareholders or members of the power" to adopt, alter, or repeal bylaws; §211(b), (d) (meetings and

Voting as an Aspect of Contracting

The combination of explicit contracts, the structural rules of corporate law, and the fiduciary principle (see Chapter 4) still leave much to discretion. The items left unspecified—who is to do which tasks and work with whom, what products to make, how to sell them, and so on—often will be more important than the items capable of specification. Something must fill in the details.

Voting serves that function. The right to vote is the right to make all decisions not otherwise provided by contract—whether the contract is express or supplied by legal rule. The right to make the decisions includes the right to delegate them. Thus voters may elect directors and give them discretionary powers over things voters otherwise could control.

Because voting is expensive, the participants in the venture will arrange to conserve on its use. It could be employed from time to time to select managers and set the ground rules for their performance and not used again unless the managers' performance was seriously inadequate. Indeed, the collective choice problems that attend voting in corporations with large numbers of contracting parties suggest that voting rarely serves any function except *in extremis*. When many are entitled to vote, none expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive to study the firm's affairs and vote intelligently.[13] If, for example, a given election could result in each voter gaining or losing $1,000, and if each is sure that the election will come out the same way whether or not he participates, then the voter's optimal investment in information is zero. And even if a voter thinks his vote will be dispositive, so that an investment up to $1,000 is warranted, that may be insufficient. If there are 1,000 voters, the effect on them as a group will be $1 million. A thousand dollars' worth of information may be quite insufficient to make a $1 million decision; worse still, 1,000 people investing $1,000 each may mean that all of them are acting on inadequate information, even though a single investment in $10,000 worth of knowledge might be adequate. Those who have more shares, such as investment companies, pension trusts, and some insiders, do not face the collective action problem to the same extent. Nonetheless no shareholder, no matter how large his stake, has the right incentives unless that stake is 100 percent.

Collective action problems may be overcome by aggregating the shares (and the attached votes) through acquisitions, such as mergers and tender offers. Voting serves its principal role in permitting those who have gathered up equity claims to exercise control. Short of aggregating, however, some sort of collective information-generating agency is necessary. In a firm, the managers serve this function, and consequently it is unlikely that voters would think themselves able to decide with greater insight than the managers do. No wonder voters delegate extensively to managers and almost always endorse their decisions. But this acquiescence should not obscure the fact that managers exercise authority at the sufferance of investors.

special meetings to be held as provided in bylaws); §228 (voters may act without meeting by obtaining signatures of a majority). See also SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947) (construing Delaware law as requiring directors to submit shareholders' proposals to a vote at a meeting).

[13] See Anthony Downs, *An Economic Theory of Democracy* (1957); Mancur Olson, *The Logic of Collective Action* (1965).

Voting as Part of Risk Bearing

Voting exists in corporations because someone must have the residual power to act (or delegate) when contracts are not complete. Votes could be held by shareholders, bondholders, managers, or other employees in any combination. Given the collective choice problem, one might expect voting rights to be held by a small group with good access to information—the managers. Yet voting rights are universally held by shareholders, to the exclusion of creditors, managers, and other employees. When a firm's founders take the firm public, they almost always find it advantageous to sell claims that include votes, and thus ultimately the right to remove the insiders. Why do the insiders sell such claims? Why do investors pay extra for them? (They must pay something, or the insiders would not expose themselves to the risk of removal.)

The reason is that shareholders are the residual claimants to the firm's income. Creditors have fixed claims, and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line.

As the residual claimants, shareholders have the appropriate incentives (collective choice problems notwithstanding) to make discretionary decisions. The firm should invest in new products, plants, and so forth, until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion. And although the collective choice problem prevents dispersed shareholders from making the decisions day by day, managers' knowledge that they are being monitored by those who have the right incentives, and the further knowledge that the claims could be aggregated and votes exercised at any time, leads managers to act in shareholders' interest in order to advance their own careers and to avoid being ousted.

This is not, or course, a complete explanation. The interests of shareholders may conflict with the interests of creditors. Shareholders have an incentive to adopt various strategies with the effect of transferring wealth to themselves, such as choosing risky investment projects and withdrawing assets from the firm. Creditors seek to control this conduct in two ways. One is exquisitely detailed contracts.[14] Creditors become residual claimants when equity holders' conduct exposes to them to unanticipated risk. Thus we expect to, and do, observe creditors who possess rights to approve especially risky transactions, such as substantial construction projects, mergers, and the like. Approval rights of this sort are built into bond indentures and major bank loans, and the lending instruments also contain conditions that define certain risk-creating conditions as defaults and thus confer other approval powers on lenders. The other device is implicit in the nature of debt: what is borrowed must be repaid. The need to pay cash forces the firm into financial markets for fresh money, to an even greater extent than

dividends compel managers to return to equity markets. As we observed in Chapter 2, firms that continually must raise money are subject to continual monitoring. If they choose projects that create excessive risk or have low expected returns, they must pay more for capital. As long as they are being paid, and consent to participate at negotiated interest, creditors obtain both compensation and control without votes.

The right to vote (that is, the right to exercise discretion) follows the residual claim. When the firm is in distress, the shareholders' residual claim goes under water, and they lose the appropriate incentives to maximize on the margin. Other groups, such as preferred stockholders or creditors, then receive the benefits of new decisions and projects until their claims are satisfied. There is little reason for shareholders, or managers answerable to them, to invest the money and energy necessary to make improvements when someone else reaps the gain. Thus shareholders lose the controlling votes when their shares are under water, whether by contract or through the operation of bankruptcy laws; managers become answerable to other investors. They may choose to leave the managers in office through "workout" agreements, but this does not obscure the fact that the discretionary power has passed. Because managers try to enhance their own reputations, we would expect them to be as faithful in the pursuit of creditors' interests as they once were in pursuit of shareholders' interests.

The fact that voting rights flow to whichever group holds the residual claim at the moment strongly supports our analysis of the function of voting rights. It also suggests why, ordinarily, only one group holds voting rights at a time. The inclusion of multiple groups (say employees in addition to shareholders) would be a source of agency costs. People who did not receive the marginal gains would be influencing corporate discretion, and the influence would not maximize the wealth of the participants as a group. Thus the joint participation of different classes of participants in voting is rarely seen unless compelled—as, for example, "codetermination" (the participation of employees) in Germany and "good faith bargaining" with unions in the United States. There is another reason why only one class of participants in the venture commonly holds dispositive voting rights at one time. The voters, and the directors they elect, must determine both the objectives of the firm and the general methods of achieving them. It is well known, however, that

[14] See Clifford W. Smith, Jr., and Jerold B. Warner, "On Financial Contracting: An Analysis of Bond Covenants," 7 *J. Fin. Econ.* 117 (1979), for a discussion of some of the costs of writing detailed contracts. See also Laurentius Marais, Katherine Schipper, and Abbie Smith, "Wealth Effects of Going Private for Senior Securities," 23 *J. Fin. Econ.* 155 (1989).

when voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choices.[15] If a firm makes inconsistent choices, it is likely to self-destruct. Consistency is possiblé, however, when voters commonly hold the same ranking of choices (or when the rankings are at least single-peaked).

The preferences of one class of participants are likely to be similar if not identical. This is true of shareholders especially, for people buy and sell in the market so that the shareholders of a given firm at a given time are a reasonably homogeneous group with respect to their desires for the firm. So firms with single classes of voters are likely to be firms with single objectives, and single-objective firms are likely to prosper relative to others. This suggests not only why only one class holds the controlling votes at a time but also why the law makes no effort to require firms to adhere to any objective other than profit maximization (as constrained by particular legal rules).

One final point on the relation between voting and residual claims. Shareholders do not always have equal power. Sometimes stable coalitions (a group of insider shareholders and some institutional allies) may hold effective control for long periods. This is beneficial, for reasons we have explained, because it alleviates the collective action problem. It is not troublesome if the gains from corporate action are divided proportionally among all shareholders. Even when gains are not proportionally divided, the aggregation of "voting power" is not significant if coalitions can change. As long as each share has an equal chance of participating in a winning coalition, the gains from monitoring will be apportioned so as to preserve appropriate incentives at the margin.

Does Voting Matter?

Whether voting serves the functions we have assigned it is necessarily an empirical question. There are no conclusive answers, but several considerations are suggestive. One is simply the survival of voting. If it is not worth the costs of running elections, firms that eliminated voting would have prospered relative to others. That has not happened, and one may infer that voting is beneficial.

Second, voting facilitates takeovers. A tender offer for stock enables the buyer to assume control of the target by exercising the votes attached to the acquired shares. Such acquisitions are associated with substantial price premiums, and tactics that make takeovers more difficult are associated with price reductions.[16] (We return to this topic in Chapter 7.) Third, voting contests produce price increases—presumably reflecting real increases in the value of the firm—whether or not they lead to changes in control.[17] The price increase takes place when the market learns of the contest, and it persists even if the insurgents are defeated. This sequence is explicable only if voting and the prospect of future monitoring produces pressure on managers to act in the interest of investors.

Fourth, because the collective choice problem is the principal limit on the ability of the residual claimants to influence decisions by voting, one would expect that if votes are valuable then a reduction in the costs of collective action—as, for example, by the assembly of a large bloc of shares—would be associated with an increase in the price of all shares. The available data suggest that bloc assembly is associated with price increases for shares outside the bloc. Tender offers assemble the largest blocs and produce the largest increases, but smaller blocs produce price increases too. Fifth, in the rare cases in which firms have outstanding issues of stock with identical rights to share in the profits but significantly different voting rights, the stock with the stronger voting rights trades at a premium of 2–4 percent relative to the other series of stock. Similarly, in proxy contests, the price of all stock falls on the record date, after which stock generally is sold without the buyer acquiring a right to vote in the impending election.[18] This premium for voting rights probably represents the anticipated (and fully di-

[15] Kenneth J. Arrow, *Social Choice and Collective Values* (2d ed. 1963); Duncan Black, *The Theory of Committees and Elections* (1958).

[16] See Jarrell and Poulson, supra note 7; Ruback, supra note 7. See also Sanford J. Grossman and Oliver D. Hart, "One Share–One Vote and the Market for Corporate Control," 20 *J. Fin. Econ.* 175 (1988).

[17] Peter Dodd and Jerold B. Warner, "On Corporate Governance: A Study of Proxy Contests," 11 *J. Fin. Econ.* 401 (1983); Harry DeAngelo and Linda DeAngelo, "Proxy Contests and the Governance of Publicly Held Corporations," 23 *J. Fin. Econ.* 29 (1989) (tracing the gains to subsequent control transactions of the kind discussed in Chapters 5 and 7). See also John Pound, "Proxy Contests and the Efficiency of Shareholder Oversight," 20 *J. Fin. Econ.* 237 (1989).

[18] Ronald C. Lease, John J. McConnell, and Wayne H. Mikkelson, "The Market Value of Control in Publicly-Traded Corporations," 11 *J. Fin. Econ.* 439 (1983); Dodd and Warner, supra note 17. See also Haim Levy, "Economic Evaluation of Voting Power of Common Stock," 38 *J. Finance* 79 (1983) (voting premium averaging 45 percent in Israel).

luted) value attributable to the opportunity of those votes to improve the performance of the corporation. It is not possible to attribute the premium to the privilege of those with votes to "divert" profits to themselves, because such diversions accrue (if at all) to insiders, while public investors who could not expect to get such diversions are willing to pay the premium.

Finally, there is some evidence about the performance of firms in which there are no residual claimants or in which the residual claimants do not vote. Firms without shareholders do poorly compared with other firms, and firms whose structure prevents the formation of a control bloc of shares also do relatively poorly.[19] Thus the evidence strongly suggests that votes are important despite the collective action problem, and that the voting process enables firms to operate more efficiently.

State Rules Concerning Elections

The Presumption of One Share, One Vote

The most basic statutory rule of voting is the same in every state. It is this: all common shares vote, all votes have the same weight, and no other participant in the venture votes, unless there is some express agreement to the contrary.

Such agreements are rare.[20] Although there are hundreds of different voting arrangements, such as classified boards to which different shares vote for different posts, and preferred stock with contingent voting rights, almost all publicly traded shares in substantial firms have one vote each, and that vote may be cast for positions on an unclassified board. There have been persistent arguments that this is not "democratic" because some people (those with more shares) have more votes than others.

The presumptively equal voting right attached to shares is, however, a logical consequence of the function of voting we have discussed above. Votes follow the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management. Those with disproportionate voting power will not receive shares of the residual gains or losses from new endeavors and arrangements commensurate with their control; as a result, they will not make optimal decisions. Nonvoting bonds and nonvoting employees are not troublesome, however, because neither group has a residual claim.

This also explains why cumulative voting is rare in publicly traded firms and why most state statutes contain a presumption against cumulative voting. Cumulative voting gives disproportionate weight to certain "minority" shares, and the lack of proportion once more creates an agency cost of management. It makes realignments of control blocs difficult by distributing a form of holdup power widely; although every share has the same holdup potential, the aggregate holdup value exceeds the value of the firm and thus makes negotiation very difficult.

Cumulative voting (or any other method of requiring supermajority consent to corporate actions) has the additional property of impeding changes of control and thus supporting the position of managers *vis-à-vis* residual claimants. Cumulative voting thus produces the same costs as any other stratagem by which managers seek to insulate themselves from the displeasure of shareholders. Because cumulative voting permits representation of "minority" interests in the firm's governance, moreover, it increases the chance that there will be multipeaked preferences among the members of the board. Cumulative voting and other minority representation schemes thus expose the firm to an uncompensated risk of making inconsistent or illogical decisions.

These considerations also underlie the statutory limits on the establishment and duration of voting trusts and the fact that in practice such trusts are used only in closely held firms. Voting trusts are designed to inhibit transfers of control. In closely held firms they stop family feuds and promote monitoring; in public firms they would increase agency costs by separating the right of

[19] See, for example, Maureen O'Hara, "Property Rights and the Financial Firm," 24 *J. L & Econ.* 317 (1981) (mutual banks, in which voting power depends on depositions rather than transferable shares, do poorly relative to banks with transferable shares); Eric Rasmusen, "Mutual Banks and Stock Banks," 31 *J. L. & Econ.* 395 (1988); David G. Davies, "The Efficiency of Public versus Private Firms: The Case of Australia's Two Airlines," 14 *J. L. & Econ.* 149 (1971) (firms with identifiable residual claimants prospers relative to firms without them). Note that we limit this comparison to firms operating for profit.

[20] See Lease, McConnell, and Mikkelson, supra note 18 (finding only thirty issues of nonvoting or unequally weighted voting common stock traded on any exchange or over the counter at any time between 1940 and 1978). On why they exist at all, see Fischel, supra note 7.

control from the residual claim. "Control share" statutes, which prevent holders of large blocs from voting unless other investors allow them to, similarly divorce control from the residual claim, and we predict that they reduce the value of the firm. (Chapters 7 and 8 discuss antitakeover laws in detail and present data about control share statutes and related developments.) No matter the source, the separation of control from the residual interest introduces a substantial, and in public firms unnecessary, agency cost.

The Prohibition of Vote Buying

It is not possible to separate the voting right from the equity interest. Someone who wants to buy a vote must buy the stock too. The restriction on irrevocable proxies, which are possible only when coupled with a pledge of the stock, also ensures that votes go with the equity interest.

These rules are, at first glance, curious limits on the ability of investors to make their own arrangements. Yet they are understandable on much the same basis as the equal-weighting rule. Attaching the vote firmly to the residual equity interest ensures that an unnecessary agency cost will not occur. Separation of shares from votes introduces a disproportion between expenditure and reward.

For example, if the owner of 20 percent of the residual claims acquires all of the votes, his incentive to take steps to improve the firm (or just to make discretionary decisions) is only one-fifth of the value of those decisions. The holder of the votes will invest too little. And he will also have an incentive to consume excessive leisure and perquisites and to engage in other behavior that does not maximize profits because much of the cost would be borne by the other residual claimants.[21] The risk of such shirking would reduce the value of investments in general, and the risk can be eliminated by tying votes to shares.

[21] We therefore disagree with Dean Clark's argument that vote buying should be permitted, if the purchaser has a substantial equity interest and hopes to profit solely by appreciation in the value of that interest. Robert Charles Clark, "Vote Buying and Corporate Law," 29 *Case West. L. Rev.* 776 (1979). Clark does not discuss the agency cost problems associated with such vote buying, and he does not try to explain why vote buying is universally condemned.

One possible response is that the agency costs created would be eliminated if the owner of 20 percent of the residual claims could obtain returns disproportionate to his equity interest. As long as there is a market in votes that parallels the market in shares, competition among vote buyers could be sufficient to compensate equity investors for the value of the dilution of their interests.

This is intriguing but, we think, unsatisfactory. Transactions in votes would present difficult problems of valuation and create other costs without conferring any apparent benefit compared with transactions in votes tied to shares.[22] Moreover, the collective choice problem would exert a strong influence over the market price of votes. Because no voter expects to influence the outcome of the election, he would sell the vote (which to him is unimportant) for less than the expected dilution of his equity interest. He would reason that if he did not sell, others would; he would then lose on the equity side but get nothing for the vote. Thus any positive price would persuade him to sell.

Competition among those bidding for votes might drive the price up but not, ordinarily, all the way up to the value of the expected equity dilution. Each person bidding for votes would be concerned that he would end up with less than a majority, and unless he obtained a majority he would have nothing at all. Thus he would offer less than the prospective value of the equity dilution. This concern obviously does not apply to one who buys shares the day before the election, votes them, and sells the day after the election—and so "buys" votes in common parlance. Such a person bears the gains or losses attributable to the election, and his conduct is not unlawful in any state as vote buying.

One cannot exclude the possibility that competition among buyers of votes would fully compensate the sellers. In that event, however, the bidders would see no difference between buying votes and buying shares, which, after the votes had been cast, could be held or resold to their former owners. If state or federal law restricts the transfer of shares, then the sale of votes in a competitive

[22] In vote-selling games there is no core solution when gains are not equally apportioned, and there may be no core solution even when they are equally apportioned. See Lester G. Telser, "Voting and Paying for Public Goods: An Application of the Theory of the Core," 227 *J. Econ. Theory* 376 (1982), for a related discussion.

market is an attractive second-best solution.[23] Chapters 7 and 8 discuss laws (and corporate practices) restricting trading in shares during contests for corporate control. The only other situation in which buying the votes without the shares is advantageous is when the buyer is planning to dilute the interests of the other equity owners. As we discuss in Chapter 5, investors would agree to prohibit such dilutions in order to ensure that all control changes increase value. Thus the legal rules tying votes to shares increase the efficiency of corporate organization, with the potential exception of control contests in which the shares themselves cannot be sold.

The Absence of Tenure of Office

Although members of boards of directors typically are elected for specific terms, they do not have tenure of office. Voters may call elections on short notice and oust the directors for any reason or none. Delaware, the dominant corporate jurisdiction, has the least secure tenure of all.[24]

These rules denying tenure to the board put the voters firmly in control—should they choose to exercise it—at any time and ensure that the residual claimants have the final say. Managers may be given a quick boot if agency costs become unacceptable. It is true that in public corporations directors are rarely evicted in midterm, but the possibility of ouster may be sufficient to ensure that directors act as faithful agents of the residual claimants. The ability to change directors at once would be most important in contested takeovers, in which a bidder that had acquired a majority of the stock wanted to install its own team.

It is interesting to compare the political system's treatment of tenure. Most elected officeholders have tenure for defined periods.

[23] See Thomas J. André, Jr., "A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control," 63 *S. Cal. L. Rev.* 533 (1990).

[24] See note 5, supra, and, for example, Campbell v. Loew's, Inc., 36 Del. Ch. 563, 134 A.2d 852 (1957). Compare Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437 (Del. 1971) (board may not change the date of meeting so as to disadvantage the opposition). Provisions in bylaws purporting to furnish tenure of office through supermajority vote requirements for ouster sometimes are sustained, but they are of questionable effectiveness in many states. See Texas Partners v. Conrock Co., 685 F.2d 1116 (9th Cir. 1982) (Delaware law).

Even states that allow recall of officeholders in theory do not recall them in practice. Why do political officeholders have more secure (if more limited) tenure? One possible explanation is that managers do not need tenure to motivate them to act in investors' interests. Because the consequences of their acts are reflected in stock prices and in their own future salaries, they strive to maximize firms' discounted future returns even if they have insecure tenure. There is no similar monitoring and reward system for political officeholders, who therefore tend to discount the future more steeply than their constituents. Tenure of office may be a partial antidote to this discounting problem.

The Common Law Rules for the Conduct of Elections

Unlike federal law, which we discuss in the next section, state law usually imposes no restrictions on the conduct of elections apart from requiring the incumbents to furnish lists of shareholders to prospective challengers at the challengers' expense.[25] Managers may campaign against shareholders' proposals, and for their own reelection, at corporate expense; the firm may reimburse insurgents' expenses if they win, and incumbents may reimburse insurgents even if they lose (although this is rare).[26] It is sometimes said that incumbents may use the firm's resources to defend their positions only if the dispute concerns corporate "policy" rather than "personal" matters. But it would be a poor director indeed who could not find some element of policy in the dispute. People do not wage proxy campaigns to eject directors just because they wear gaudy clothes; they object to how the incumbents run the firm. Thus the distinction between policy and personal issues stated in the cases turns out to be no limit at all.

All of these rules (or, rather, the lack of rules in all of these instances) are consistent with the analysis we have proposed. Because proxy fights may be waged by parties who lack significant

[25] Delaware has an elaborate set of rules concerning the circumstances under which shareholders' lists must be furnished. See 8 Del. Code §220.

[26] For example, Hall v. Trans-Lux Daylight Screen Picture Corp., 20 Del. Ch. 78, 171 A. 226 (1934); Rosenfield v. Fairchild Engine & Airplane Corp. 309 N.Y. 168, 128 N.E.2d 291 (1955).

ownership of shares, a successful contest could put in office insurgents inferior to the incumbents in managerial skill (but superior in ability to siphon wealth). These insurgents gain more in perquisites and side payments than they lose in diminution of the value of their stock. All residual claimants benefit if such insurgents are defeated. Incumbents' use of corporate funds to campaign for reelection or for the election of their nominees spreads the costs of the election across all of the residual claimants. Like the other principles we have discussed, this reduces the agency costs that would arise if particular directors incurred expenses disproportionate to their shareholdings. The gains and losses of the directors' decisions accrue to all residual claimants; if the costs are not similarly spread, the directors will not equate costs and benefits to the firm at the margin. The same consideration explains why insurgents may reimburse themselves if they prevail and why incumbents may reimburse unsuccessful insurgents.

It may seem odd, however, that challengers are not reimbursed by the firm as a matter of course. There are substantial free-riding problems in mounting a campaign. The collective choice problem that inhibits voters from learning about the firm in order to cast intelligent ballots applies in spades to waging a fight. The full costs are borne by the challengers in every case, yet they obtain reimbursement only if they prevail, and they obtain the gains (if any) from changes in management only in proportion to their equity interests. The divergence between cost and benefit makes proxy contests rare and drives challengers to the more costly alternative of the tender offer. Because the firm appears to gain whether or not the insurgents prevail, it could be argued that the firm should pick up the expenses of those who seek election to at least the same extent as it picks up the incumbents' expenses.

There is nonetheless a substantial problem with allowing challenges at the firm's expense. The firm's offer to pay for the contest may become an attractive nuisance. There are always publicity seekers willing to stand for office on someone else's money. An offer to pay for the contest is worthwhile only if, in its absence, significant numbers of otherwise beneficial contests will be stifled, and even then only if there is a good way to distinguish plausible challengers from frivolous ones.

We may put the difficulty of weeding out frivolous candidates to one side. Almost all proxy contests are waged by owners of substantial blocks or by former officeholders, and it is precisely such people who do not need the lure of automatic compensation by the firm in order to make the contest worthwhile.

Issue Voting

Shareholders' voting is not limited to the election of directors. State law typically requires that certain actions such as fundamental corporate changes (mergers, liquidations, sales of assets) and charter amendments be approved by a specified percentage of outstanding shares.[27] Moreover, a variety of other actions are commonly submitted for shareholders' votes even though not required by statute. We consider these aspects of issue voting below.

Fundamental Corporate Changes

The corporate law of every state provides that the business of the corporation shall be managed by, or under the direction of, the board of directors. Shareholders typically do not vote on matters of ordinary business judgment. All statutes provide, however, that in situations of "extraordinary" action—fundamental corporate changes—the issue must be submitted to shareholders. This rule, too, helps reduce agency costs.

Shareholders, as residual claimants, have the most to lose (or to gain) as a result of fundamental corporate changes. Moreover, the possibility of large gain or loss in these transactions because of their size is sufficient to overcome the collective action problems, particularly for institutional investors, that would make voting on ordinary business decisions meaningless. The vote on the merger can be viewed as a midterm election of directors, a vote of confidence on a major decision. The statute requires the midterm election as a partial response to the collective action problems that make it difficult for shareholders to organize to oust directors between elections. The right to vote is simply an additional monitoring device possessed by the residual claimants when the stakes

[27] 8 Del. Code §242 (shareholders' approval required for amendments to the certificate of incorporation); §251 (shareholders' approval required for mergers); §271 (shareholders' approval required for sales of assets); §275 (shareholders' approval required for dissolutions).

are high enough. Although shareholders approve almost all mergers, this may be attributable to advance consent by institutional investors, consent that would not be necessary if there were no right to vote.

Charter Amendments

The other area in which shareholders' approval is commonly required is charter amendments. Of particular interest in this regard are amendments designed to deter potential bidders from making a tender offer. Because these amendments reduce the probability that the firms' shareholders will be the beneficiaries of a tender offer at a significant premium over market price, they reduce shareholders' wealth on average. (Chapter 7 summarizes the data; see also note 7 in this chapter.) If shareholders' voting serves as a monitoring device on self-interested behavior by management, shareholders should vote against these amendments. The evidence is consistent with this hypothesis. Many institutional investors depart from their customary adherence to the Wall Street Rule (vote with management or sell your shares) and vote against "shark-repellent" amendments.[28] The more shares held by institutions, the less likely an antitakeover amendment's adoption—and the less damaging the amendments that are adopted.

Shareholders' Voting When It Is Not Required

Our analysis thus far has focused on voting that is required by law. But managers routinely submit a wide range of issues to shareholders including stock option plans, the selection of an independent auditor, and mergers where vote is not required. What explains this pattern?

Managers submit issues for approval because legal rules encourage them to do so. Shareholders' approval of a transaction decreases the probability of a successful attack in court. Transactions between a director or officer and a corporation will not be void or voidable, despite the conflict of interest, if the transaction is approved by a vote of the shareholders.[29] Similarly, a merger will more likely survive a judicial challenge if it is approved by a majority of the shares not held by the acquirer.

The effect of these rules is unclear. Legal rules encouraging managers to submit issues to a vote where the need for monitoring is high—such as in situations involving self-interested transactions—may increase shareholders' welfare. But the collective action problem yields ratification as a matter of course. The risk that wealth-reducing transactions will be permitted because of shareholders' ratification is minimized, however, by the common law rule that shareholders cannot ratify fraud[30] and the tendency of courts to scrutinize whether self-interested transactions are beneficial to firms. Again, the survivorship principle suggests that there is a net benefit of legal rules encouraging shareholders' approval of certain transactions (although the rules here are less well entrenched and consistent than in the case of fundamental corporate changes).

Federal Regulation of the Proxy Machinery

Firms have incentives to locate in states that enable them to adopt voting procedures that promote the wealth of investors (see Chapter 8). Firms use their leeway under state law to design rules that assign votes to the optimal holders and help them overcome the collective action problem (principally by facilitating cheap transfers of shares), while at the same time ensuring that the voters share common objectives (overcoming the difficulty of aggregating preferences in democracies). They develop practices concerning the types of issues resolved by voting (that is, by direct rather than representative decisions) and the amount of disclosure before voting. Enduring practices are the best evidence of what constitutes the optimal allocation of resources on voting procedures.

Many others writing in the Berle and Means tradition[31] have not

[28] See Office of the Chief Economist, Securities and Exchange Commission, "Shark Repellants and Stock Prices: The Effects of Antitakeover Amendments Since 1980" (1985); James A. Brickley, Ronald C. Lease, and Clifford W. Smith, Jr., "Ownership Structure and Voting on Antitakeover Amendments," 20 *J. Fin. Econ.* 267 (1988); Paul H. Malatesta and Ralph A. Walkling, "Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure," 20 *J. Fin. Econ.* 347 (1988).

[29] 8 Del. Code §144(a)(2).

[30] For example, Kerbs v. California Eastern Airways, 33 Del. Ch. 474, 184 A.2d 602 (1962); Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912).

[31] See Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (1933). See generally Symposium, Corporations and Private Property, 26 *J. L. & Econ.* 235–496 (1983), assessing the significance of this book.

viewed the corporate world this way. The modern corporation, according to Berle and Means, is characterized by omnipotent managers who, through control over the proxy machinery, keep themselves in office. Section 14 of the Securities Exchange Act of 1934 was believed to rectify this perceived imbalance by guaranteeing shareholders a right to more say in the management of their property.[32]

The proxy rules have four principal components: (1) general disclosure provisions designed to keep shareholders informed even if there is no contested election; (2) provisions requiring disclosure by rival groups in the event of a proxy fight to ensure that shareholders will be adequately informed and able to vote intelligently;. (3) a general antifraud provision prohibiting the use of false or misleading statements in cases where proxies are solicited; and (4) a provision allowing shareholders, subject to certain exceptions, to communicate with other shareholders by placing a proposal in the proxy materials.

The proxy rules displace private arrangements with respect to both the issues on which shareholders are entitled to vote and the information they are entitled to have. Regulation is not entitled to the same presumption of efficiency as long-standing voluntary arrangements.

The Behavioral Assumptions of the Proxy Rules

The proxy rules depend on two principal assumptions: that shareholders demand more information about corporate matters than managers provide voluntarily and desire to be more involved in setting corporate policy than state law allows. A corollary assumption is that shareholders are easily misled and will vote contrary to

[32] 15 U.S.C. §78n. The implementing rules appear in 17 C.F.R. §240.14a. The design of §14 was expressed in the House Report: "Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13–14 (1934).

their interests (their "true" wishes) unless the type and accuracy of information provided to them is carefully specified.

These assumptions are not supported by evidence. Indeed, both casual empiricism and economic theory contradict the behavioral assumptions that underlie the federal proxy rules. Shareholders' involvement in the voting process has not increased with the adoption of the proxy rules. Managers still are rarely displaced by voters; managers' recommendations on fundamental corporate changes, amendments of bylaws, or other matters are routinely followed; shareholders' proposals do well if they receive 5 percent of the vote. In those rare situations where a proxy fight for control develops, the insurgent's chance for success is determined by the number of shares he owns rather than by the force of his arguments.

Proponents of the need for greater shareholders' involvement through the proxy machinery do not so much dispute the fact of shareholders' apathy as argue that this indifference is attributable to lack of a meaningful opportunity to participate. Thus if more information were disclosed, if shareholders were given a more "meaningful" opportunity to participate, the argument runs, they would assume their proper role as decision makers and owners of the corporation.

The more plausible explanation for the disparity between the rhetoric of shareholders' democracy and the conduct of shareholders themselves is that the behavioral assumptions underlying the proxy system do not hold. As we have emphasized, there is no reason why those who supply capital to the firm should have interest or expertise in managing the firm's affairs. Given the combination of a collective action problem and easy exit through the stock market, the rational strategy for most dissatisfied shareholders is to sell rather than incur costs in attempting to bring about change through votes.[33] There are, however, good reasons why investors would choose to limit both the scope of voting and the information supplied: rational ignorance implies delegation implies less voting; and the costs of information imply limits on disclosure to investors who won't act on information even if they possess it.

It is interesting to compare the regulation of proxy voting with

[33] The greater the availability of the sale or exit option, the less desirable is the voting or voice option. See Albert O. Hirschman, *Exit, Voice, and Loyalty* (1970). It is difficult to imagine a more effective exit option than the market in shares.

the regulation of union elections in labor law. The National Labor Relations Board has long regulated parties' statements in union elections, acting on the belief that employees are attentive to election campaigns and that the exercise of their free choice is easily affected by campaign propaganda. Research strongly suggests, however, that employees do not pay careful attention to election campaigns and are not easily misled by rhetoric.[34] If words do not mislead employees—if, indeed, they do not even pay attention to campaigns that strongly affect their future—how much less is the concern for sophisticated investors in stocks, investors for whom, because of the exit option, voting is much less important than for the employees?

This is not at odds with our analysis about the role of voting in monitoring managers. There is an optimal amount of monitoring, which firms facilitate in their own interest. As we pointed out, voting is used only for large events (mergers and the like), when the gains exceed the substantial costs of information and aggregation of blocs. The existence of these gains is no warrant for inferring, as the Securities and Exchange Commission (SEC) has done, that if some voting is good, more disclosure and more voting must be better still. Because it is so easy to sell one's shares, and because managers must set attractive terms for new securities (including terms for voting) if they are to maximize their returns, there is no good reason to think that the voting rules designed by the firms themselves will be inferior to those the SEC prescribes.[35]

Implications of the Assumptions Underlying the Proxy System

Many specific legal rules and doctrines are based on the behavioral assumption of the interested and attentive shareholder. In this section we discuss some of these rules and doctrines and also analyze them under more reasonable assumptions of shareholders' behavior.

Under the accepted definition, a misrepresentation or withheld piece of information is material if there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[36] The difficulty with this definition is that it provides no guidance on what the "reasonable shareholder" considers important when voting. One possibility would be not to regulate the content of speech and rely instead on the marketplace of ideas and the incentives of parties to disclose the optimal amount of information. Corporate elections then would approach political elections, where the value of the vote is greater given the lesser availability of the exit option, yet speech is unregulated.

The behavioral assumptions underlying federal proxy regulation are most clearly evident in the shareholders' proposal rule. Rule 14a-8 of the federal proxy rules provides that a publicly held corporation must include any shareholder proposal that does not fit within one of the exceptions to the rule. What could be more democratic than allowing each interested and attentive shareholder to submit proposals to be carefully considered by other interested and attentive shareholders?

The reality is that the shareholders' proposal rule is an antidemocratic device. Because most shareholders are passive, the vast majority show no interest in others' proposals, which are routinely defeated by huge margins. Yet the majority must subsidize the activities of the minority who are allowed to make proposals without incurring the costs.

Supporters of the rule are unfazed by costs or lack of success of shareholders' proposals. They argue that the rule is beneficial because it has a "healthy indirect impact" on corporate behavior.[37] What this presumably means is that the proposal, because of the publicity generated or otherwise, causes the firm to abandon a profit-maximizing strategy in favor of one that some find more "moral" or "socially responsible." But this argument stands the

[34] Julius G. Getman, Stephen B. Goldberg, and Jeanne B. Herman, *Union Representation Elections: Law and Reality* (1976). Compare the articles questioning the methodology in 28 *Stan. L. Rev.* 1161–1207 (1976) with the authors' defense, Stephen B. Goldberg, Julius G. Getman, and Jeanne M. Brett, "Union Representation Elections: Law and Reality: The Authors Respond to the Critics," 79 *Mich. L. Rev.* 564 (1981).

[35] See also John Pound, "Proxy Voting and the SEC: The Case for Deregulation," 26 *J. Fin. Econ.* (1991), concluding along our lines that the proxy rules disserve investors' interests.

[36] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[37] Donald Schwartz and Elliot L. Weiss, "An Assessment of the Shareholder Proposal Rule Proposal," 65 *Geo. L. J.* 635 (1977); David Vogel, *Lobbying the Corporation* (1978).

rationale for shareholders' voting—and federal proxy regulation—on its head. If the purpose of the federal proxy rules is to enable shareholders to influence corporate policy, it is difficult to find merit in a device that forces the majority of shareholders to subsidize conduct of a minority that is contrary to their presumptive goal of profit maximization.

Among contemporary proposals, fewer ask firms to abandon profitable but hazardous activities and more ask firms to abandon devices that protect the managers, such as poison pills. For reasons developed in Chapter 7, we are sympathetic to the merits of such proposals. Still, whatever costs takeover defenses create have not altered the cost-benefit ratio for the shareholders' proposal mechanism. If ready access to the ballot (for issues of investors' choosing) were beneficial on balance, it would be adopted by the firms themselves or by state law.

Proposed Reforms of the Proxy System

Because proponents of federal regulation ignore the economic realities of shareholders' voting and instead assume that shareholders demand more involvement in the corporate decision-making process, they also assume that the shareholders enduring indifference to voting is attributable to defects in the regulatory process. A variety of reforms have been proposed, including increased disclosure, greater access to the proxy machinery, and increased regulation of institutional investors. Each would reduce shareholders' welfare.

Increased Disclosure

One explanation for the low level of shareholders' involvement is that investors lack the information necessary to vote intelligently. Thus it has been argued that the firm should be required to disclose more information about its activities and the background and qualifications of its management. As we have emphasized, there is no evidence that shareholders have any interest in this information. Since disclosure is costly, and these costs must be borne by the firms' existing investors, increased mandatory disclosure of this type makes shareholders worse off. Shareholders' welfare may be reduced in another, and perhaps more fundamental, respect. Mandatory disclosure of the kind commonly proposed may have the effect, and perhaps the intended effect, of deterring profit-maximizing behavior. Requiring firms to disclose their policy with respect to compliance with the environmental laws, violations of regulatory statutes, or questionable foreign or domestic payments all may affect the willingness of the firm to undertake the conduct at issue. Due to a fear of litigation, adverse publicity, or regulatory intervention, managers may simply decide that the costs of disclosure may exceed the expected benefits from the activity.

Greater Access to the Proxy Machinery

Another common explanation for shareholders' apparent lack of interest in corporate decision making is that they lack the ability to participate meaningfully in the electoral process. Under the current system, the incumbent board nominates directors who are then routinely elected by shareholders. This system of self-perpetuating management is anathema to those who believe that shareholders should have the right to control the nomination and election process. To remedy this perceived defect, a number of reforms have been proposed, ranging from granting shareholders the right to have their nominees for directors included in the proxy materials to requiring that all corporations have nominating committees composed entirely of independent directors who would select nominees after consideration of proposals by shareholders.

The only defect in the current system that proponents of greater shareholders' access to the proxy machinery have identified, however, is that it is inconsistent with the behavioral assumption of the interested and informed shareholder. If this assumption is incorrect, there is no basis for concluding that shareholders should have control over the nomination process. On the contrary, a fundamental premise of the economics of shareholders' voting is that shareholders, because of the collective action problem, lack the expertise and incentive in most cases to identify and evaluate different potential candidates for the purpose of deciding how to vote.

Moreover, adoption of these proposed reforms may impose substantial costs. Apart from increased administrative costs generated by complicating the proxy machinery and creating a new bureaucratic layer, agency costs would increase. Unless they have no effect whatsoever (other than increasing administrative costs), the proposed reforms increase the ability of small investors, or even those with no financial stake in the firm, to place their nominees on the board at the expense of large investors. This violation of the principle of one share, one vote would increase agency costs for the reasons that we have discussed. The result is lower share prices to the detriment of all shareholders.

Increased Involvement by Institutional Investors

The largest shareholders of many corporations are financial institutions that invest and manage funds for the benefit of smaller investors. These institutions typically possess sole or shared authority for the voting of shares. In this capacity, institutional investors have been criticized for investing insufficient resources in deciding how to vote. The staff of the SEC, for example, has "urged" institutions to "discontinue the practice of categorizing an uncontested election of directors as a routine matter warranting an automatic vote for the entire slate of nominees, bearing in mind that more exacting judgments with respect to the elections of directors may improve corporate accountability and long-term profitability."[38] To achieve this objective, proposals have been made to require institutions to establish voting criteria and disclose their voting policies to beneficiaries or to pass the vote through to beneficiaries who could then vote themselves.[39]

The impression one gets from this rather dismal literature is that institutional investors are disserving their beneficiaries by not taking their voting responsibilities more seriously. But this is implausible. Professional money managers operate in a competitive industry where the liquidity of assets makes it easy to assess managers' performance and shift from one investment to another. Money managers who do not make sound decisions regarding the costs of establishing more elaborate voting procedures in relation to the benefit of such procedures would not be able to attract investment dollars. Institutional investors thus have every incentive to expend the optimal amount on voting procedures. Indeed, the practice of institutional investors' voting against antitakeover amendments suggests that such investors vote against managements when it is in their interest to do so. Their perceived unwillingness to make "more exacting judgments" is no doubt rational behavior in light of the economics of shareholders' voting discussed above. The problem lies in the behavioral assumptions of the regulators and reformers, not in the voting practices of institutional investors.

Pass-through voting raises additional problems. The cost of locating and transmitting information to widely scattered beneficiaries would be substantial, and there is no reason to believe that the beneficiaries value the right to vote enough to justify these costs because individual shareholders have less incentive to monitor management than does one large institutional investor. Thus the effect of pass-through voting is to aggravate the collective decision problem by breaking up voting blocs. Like greater shareholders' access to the proxy machinery, pass-through voting will lead to higher agency costs and lower share prices, to the detriment of investors. Economic analysis vindicates the current state of the law.

[38] SEC Staff Report on Corporate Accountability, Committee Print, Senate Committee on Banking, 96th Cong., 2d Sess. 422 (1980).

[39] Myron P. Curzan and Mark L. Pelesh, "Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues,"93 *Harv. L. Rev.* 670, 694 (1980).