The Rights and Wrongs of Shareholder Rights

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I. SHAREHOLDER RIGHTS

The company is a legal structure designed to bring together the different parties of a firm—its employees, investors, customers, and suppliers—in the delivery of its corporate purpose. Corporations were established as institutions with autonomous lives—self-standing, legal entities independent of those who worked, financed, and managed them. They were devices to ensure long-term commitment to shared goals and risks, with reciprocal obligations on those engaged in them. A company had to declare its purpose before earning a licence to trade. For example, the East India Company, England's earliest public company, to issue shares to the public as permanent capital, was given the monopoly for English trade in Asia with reciprocal obligations to protect trade along its

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routes.[1] There was a mutual relationship between the company and society and a mutual benefit to both.[2]

This was carried through to the eighteenth and nineteenth centuries, with canal and railway companies operating under charter to deliver on a public purpose. It was with freedom of incorporation in the middle of the nineteenth century that the focus on public purpose gave way to private interest. Nevertheless, public benefit remained at the heart of many private companies, with the families who owned them, such as Cadbury and Rowntree's, having an interest in wider social purpose beyond pure financial gain. However, to meet the needs for growth in industrial firms in the twentieth century, equity was issued for internal investment and acquisition that diluted these families to the point that they lost control of their companies.[3] Public markets provided capital that promoted economic development and brought transparency to what were previously opaque private firms. However, this came at a price in the separation of ownership from the control of firms.

With the separation of ownership and control came a concern, expressed most forcefully by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property*, about the need for shareholders to reassert their authority over corporations to ensure that they were run in the interest of their owners, not the self-interest of their managers. The truth, largely forgotten, is that this argument was embedded in a larger vision that wanted economic and political power, in all its guises, to be exercised to benefit the community at large. This pluralist frame of reference subsequently fell out of view, with consequences that reverberate today.[4] So was born what has become a preoccupation ever since with the "agency problem" in the modern corporation of aligning the interests of managers with those of their shareholders to avoid unprofitable growth or undue complacency.

The common response has been the strengthening of shareholder rights. As Figure 1 (see below) shows, there has been a marked increase and convergence in investor protection in all major industrialised countries over the past twenty years, regardless of their legal traditions or stage of

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1. PHILIP J. STERN, THE COMPANY-STATE: CORPORATE SOVEREIGNTY & THE EARLY MODERN FOUNDATIONS OF THE BRITISH EMPIRE IN INDIA 61–64 (2011).

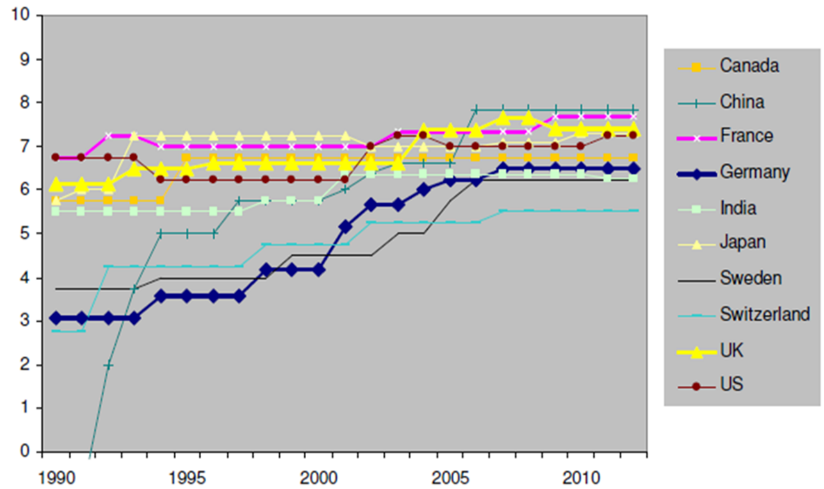
2. Colin Mayer, *Reinventing the Corporation*, 4 J. BRIT. ACAD. 53, 59 (2015).

3. Julian Franks, Colin Mayer & Stefano Rossi, *Spending Less Time with the Family: The Decline of Family Ownership in the UK* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 10628, 2004), http://www.nber.org/papers/w10628 [https://perma.cc/E7EA-6PWB].

4. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 474 (2014); *see also* Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179, 182 (2005).

development. In some countries, such as China, Germany, and Sweden, it has been very pronounced. In others, such as the U.K. and the U.S., shareholder protection was already well established at the beginning of the 1990s and has experienced only modest changes since.[5]

Figure 1: Shareholder Protection in Twin Countries between 1990 and 2013



The above graph, from the Law, Finance, and Development project at the University of Cambridge, presents an aggregate of ten variables, which act as proxies for shareholder protection laws, for the years 1990–2012. Each variable is scored between 0 and 10, with the possibility of intermediate scores (0 = minimum, 10 = maximum strength of protection), so the left-hand scale goes from 0 to 10. Variables include: powers of the general meeting for de facto changes; agenda setting power; anticipation of shareholder decision facilitated; prohibition of multiple voting rights (super voting rights); independent board members; feasibility of director's dismissal; private enforcement of director's duties (derivative suit); shareholder action against resolutions of the general meeting; mandatory bidding; and disclosure of major share ownership.

The justification for the strengthening of shareholder rights is twofold. In the context of dispersed ownership systems such as the U.K. and the U.S., it provides a countervailing power to that of corporate

5. MATHIAS SIEMS, COMPARATIVE LAW 235–36 (2014); Dionysia Katelouzou & Mathias Siems, *Disappearing Paradigms in Shareholder Protection: Leximetric Evidence for 30 Countries, 1990–2013*, 15 J. CORP. L. STUD. 127, 134 (2015).

executives and managers who control corporate assets. Conversely, in more concentrated ownership systems that are commonplace outside of the U.K. and U.S., it gives minority investors protection against the dominant shareholders who can exploit their power to the detriment of other shareholders.

If equity markets are to operate efficiently as allocators of resources and monitors of the use of capital, then minority shareholders as residual claimants need to have the means of protecting themselves against both management and dominant shareholders—a truth recognised in all countries.[6] Their rights, therefore, ensure that the policies and practices of companies are consistent with value creation, not value diversion, for the benefits of vested interests.[7]

There is no doubt that shareholder rights have been important in avoiding the conflicts identified by Berle and Means some eighty years ago. The question is whether they go far enough in protecting not only the interests of minority shareholders but also the interests of all the other parties who are critical to corporate success and are vulnerable to sectional interests.

II. THE RIGHT BALANCE

Shareholder rights are not ends in themselves. In seeking to right the wrong identified by Berle and Means, we have lost sight of its original purpose. Owners are shareholders, but shareholders are not always

6. *See* Ross Levine, *Finance and Growth: Theory and Evidence* (Nat'l Bureau of Econ. Research, Working Paper No. 10766, 2004), http://www.nber.org/papers/w10766.pdf [https://perma.cc/3JVT-HRBT]; *see also* Asli Demirgüç-Kunt & Vojislav Maksimovic, *Funding Growth in Bank-based and Market-based Financial Systems: Evidence from Firm-level Data*, 65 J. FIN. ECON. 337, 341 (2002); James R. Brown, Gustav Martinsson & Bruce C. Petersen, *Law, Stock Markets, and Innovation*, 68 J. FIN. 1517, 1531 (2013) (for work that focuses on the financing of innovation).

7. Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 125–26 (2003). The authors find that that well-governed firms beat poorly governed firms by 8.5% per annum according to an index of shareholder rights. *See* John E. Core, Wayne R. Guay & Tjomme O. Rusticus, *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. FIN. 655, 655 (2006). Given the influence of this paper, particularly in pioneering the use of corporate governance indices in empirical work, it has given rise to substantial discussion. *See id.*; Shane A. Johnson, Theodore Moorman & Sorin Sorescu, *A Reexamination of Corporate Governance and Equity Prices*, 22 REV. FIN. STUD. 4753, 4773–74 (2009) (suggesting that market models used by the paper have been misspecified); *see also* Xavier Giroud & Holger M. Mueller, *Corporate Governance, Product Market Competition, and Equity Prices*, 66 J. FIN. 563, 598 n.20 (2011) (for studies that address these concerns and find that basic results still hold); Ronald W. Masulis, Cong Wang & Fei Xie, *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1854 (2007) (identifying how takeover defences destroy shareholder value); Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1362–68 (2013) (for a legal perspective on how corporate governance indices are used and misused in empirical work).

owners. Owners are engaged shareholders. They are involved in the oversight and sometimes the management of firms. They appoint the executives and the board of companies and monitor their performance. They may define the purpose of the company and assist the executive in the delivery of it. If the executive fails, then they seek its replacement. In particular, unlike disengaged shareholders, they accept responsibilities as well as rights—responsibilities to ensure that the company delivers on its purpose and to bear at least some of the consequences for its failure to do so.

Shareholders are investors. They provide capital, they earn returns from their investments, they receive reports on the performance of their investments, and they sometimes cast votes at shareholder meetings. The distinction between owners and shareholders is critical to understanding the ability of companies to be able to define, uphold, and deliver on their purpose. Disengaged shareholders have an interest in the financial performance of the firm, but no more. The purpose of the corporation, from their perspective, is to generate as large a financial return as possible, with little consideration as to how it is done.

From the perspective of the disengaged shareholder, corporate purpose appears, at best, a little more than branding gloss and, at worst, an active impediment. An obligation to a purpose risks shackling the firm from pursuing the most profitable opportunity. This scepticism is rooted in the belief that the costs of disengaged ownership are outweighed by the benefits of disengaging from ownership obligations. But corporate purpose is about creating an asset that extends beyond the brick and mortar, or even the human capital, of the business; it is about creating and underpinning the intangible assets that increasingly dominate the value of tangible assets.

This is where the distinction between owners and shareholders is critical. Shareholders can derive the benefits of intangible assets, but in so doing they threaten their preservation. Reputations need to be nurtured and protected from those shareholders who place a high value on the short-term benefits of exploiting them. That is the role of engaged owners—they have interests in promoting, protecting, and preserving the corporation to enhance its reputational capital. That is why the apparent attraction of being liberated from the shackles of purpose can be illusory, and why the presence of owners who define and preserve purpose can benefit, not undermine, disengaged shareholders. The open question is how to promote ownership while simultaneously recognising that even committed owners sometimes need to sell; that the ability to sell is fundamental to share ownership; and that sometimes the threat and reality of selling, or exiting, has an important disciplinary impact on management.

At present, the conventional wisdom is to emphasise the shareholder as investor, too little on the shareholder as owner.

Shareholder rights are one, and only one, means of promoting the efficient running of the corporation as a legal structure designed to bring together the different parties to the firm in the delivery of its corporate purpose. The corporation should protect the interests of its minority investors, but it also needs to protect the interests of the other parties—creditors, employees, customers, suppliers, and communities—involved in its corporate purpose. Where the shareholder rights movement has erred is in unbalancing the corporation by emphasising the interests of short-term shareholders over other parties.

This is sometimes discussed in the context of what is described as the "stakeholder" view of the firm in which the rights of parties such as employees, suppliers, and communities are emphasised in relation to those of shareholders.[8] While this approach is correct in pointing to the significance of other parties, it errs in the opposite direction of seeking to confer control on employees through mutual ownership, customers in cooperatives, or society in the form of corporatism and public ownership. There is room for all of these, and there is merit in permitting and promoting a plurality of corporate forms. But, this is again to miss the point by looking only at the firm in terms of its constituent parts.

The starting point for redefining the corporation should be the definition of corporate purpose and the promotion of it through the participation of all relevant parties. This is achieved not simply by conferring control on one particular group—be it minority shareholders, employees, or customers—but by respecting their collective interest in the delivery of corporate purpose. The achievement of corporate purpose involves the judicious balancing of the interests of different parties and ensuring that their incentives are aligned with those of the company as a whole.

Key to this is the ability of companies to commit to their different interest groups. Commenting on Colin Mayer's book,[9] *Financial Times* economics columnist, Martin Wolf, further develops the argument:

> Moreover, it is often in the interests of all parties to bind themselves not to behave in such a way. But, with an active market in corporate control, such commitments cannot be made. Those who make the promises may disappear before they can deliver. . . . Long-term commitments could in theory be managed instead by trying to specify

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8. R. Edward Freeman, *The Politics of Stakeholder Theory: Some Future Directions*, 4 BUS. ETHICS Q. 409, 417 (1994).

9. COLIN MAYER, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT (2013).

> every eventuality. About a second's thought makes it clear that this is impossible. It would not just be inconceivably complex and costly. It would come up against the deeper problem of uncertainty. We have little idea of what might happen in the next few months, let alone the next few decades. If people are to make long-term commitments, trust is the only alternative. But a company whose goal is whatever seems profitable today can be trusted only to renege on implicit contracts. It is sure to act opportunistically. If its managers did not want to do so, they would be replaced. This is because, as Prof Mayer argues: "The corporation is a rent extraction vehicle for the shortest-term shareholders." Aligning managerial rewards to shareholder returns reinforces the opportunism.[10]

This concept of commitment shifts the view of the corporation from a top down instrument of its shareholders to an entity in its own right designed to fulfill its corporate purpose through integrating the interests of its constituent parts as a whole. Shareholders are one, and only one, part of that entity, and shareholder returns are one, and only one, measure of its success. Integration requires a corporate culture that is conducive to a unified pursuit of purpose.

III. CORPORATE CULTURE

The importance of corporate culture in unifying the pursuit of purpose has been documented in extensive case studies of companies such as First Chicago, Hewlett-Packard, ICI, Nissan, and Xerox.[11] Jillian Popadak explores how a company's strategic decision making is affected by interventions from shareholders by exploring what happens when there are close votes on resolutions at shareholder meetings.[12] She contrasts companies where propositions just go through with those where they fail. Even though the firms are in other respects identical, Popadak documents significant differences in the subsequent evolution of their culture and performance after the votes.

Popadak reports that in companies where the propositions go through, there are:

> [S]tatistically significant increases in results-orientation and statistically significant decreases in customer-orientation, integrity, and collaboration. This suggests that following an increase in shareholder governance, managers implement processes which lead

10. Martin Wolf, *Opportunist Shareholders Must Embrace Commitment*, FIN. TIMES (Aug. 26, 2014), https://www.ft.com/content/6aa87b9a-2d05-11e4-911b-00144feabdc0.

11. JOHN P. KOTTER & JAMES L. HESKETT, CORPORATE CULTURE AND PERFORMANCE 58–67, 107–40 (2011).

12. *See generally* Jillian A. Popadak, A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value (Mar. 10, 2014) (unpublished manuscript).

> employees to believe that performance and achievement are the appropriate response to unforeseen contingencies even if this involves sacrificing honesty, ethics, and teamwork.[13]

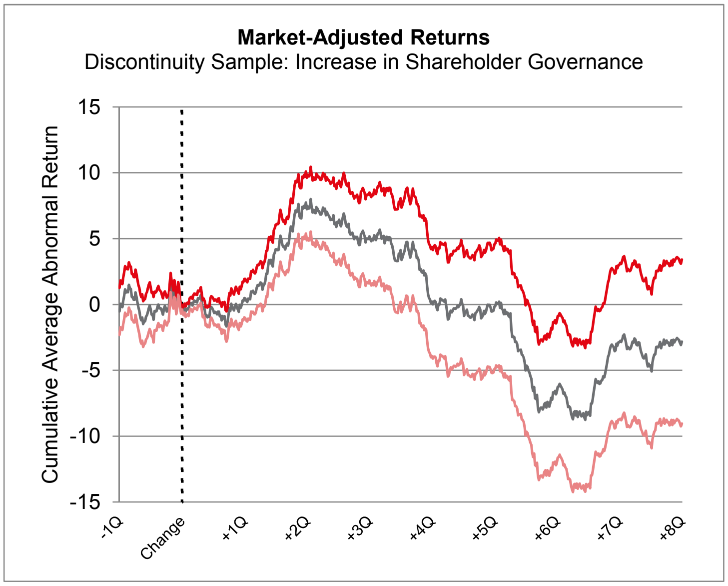
Popadak finds that, in the short term, the results orientation brings financial gains, but these are quickly reversed (see Figure 2 below):[14]

> Specifically, in the year of the change in corporate culture, increases in sales, profitability, and payout occur. Yet, in the long term, which is defined as up to five years after the increase in governance, decreases in both intangible assets and customer satisfaction along with increases in goodwill impairment occur. By the end of the third year, the tangible gains in sales and profitability erode and the intangible losses dominate. [15]

Short-term financial gains are therefore pursued even if they undermine the firm's long-term best interest.

13. *Id.* at 3.
14. *Id.* at 4–8.
15. *Id.* at 4.

Figure 2: Market-adjusted Returns Following an Increase in Shareholder Governance and Change in Corporate Culture



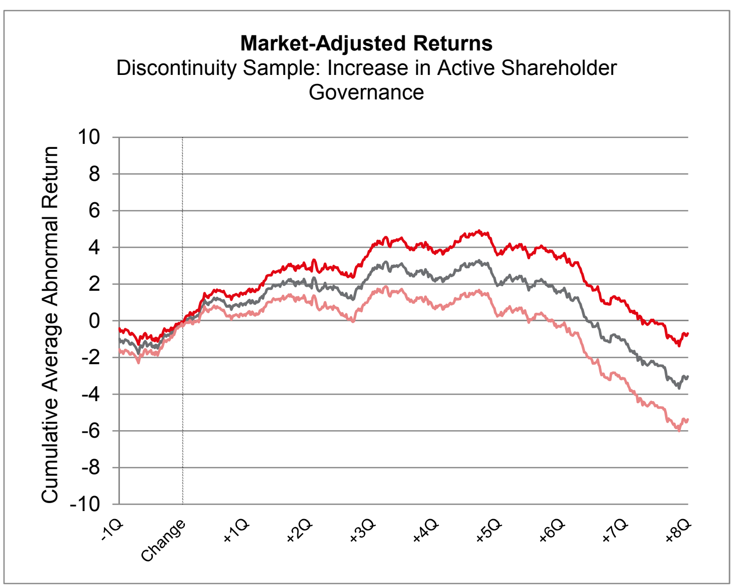


Figure 2 shows abnormal equity returns—the difference between actual and expected returns—following an increase in governance around shareholder priorities. The first chart employs a "regression discontinuity approach" for a sample of S&P firms in which governance-related proposals were brought to a vote between 2005 and 2011 and fell within 10% of the passing threshold; the second chart employs an instrumental variable approach for a larger sample of firms over the same period. The central line represents the relative cumulative average abnormal returns; the upper and lower lines represent the upper and lower 95% confidence intervals from a test of the difference between the increase in shareholder governance and non-increase in shareholder governance firms.[16]

One example of where this happened was to Sears Holdings in 2005 when hedge fund billionaire Eddie Lampert acquired a large position in the company. In the first year after the acquisition, Sears' share price outperformed the market by 18%. Two years later, the shares had sunk 45%, and sales retreated to pre-Lampert levels.[17] In Britain, an analogous example is British Home Stores' decline and fall under Sir Philip Green's direction.[18] Similarly, ICI's precipitate demise had parallel roots. In 1987, it declared that its purpose was:

> [T]o be the world's leading chemical company, servicing customers internationally through the innovative and responsible application of chemistry and related science. . . . Through achievement of our aim we will enhance the wealth and well-being of our shareholders, our employees, our customers and the communities which we serve and in which we operate.[19]

By 1994, its purpose had been redefined as "our objective is to maximise value for our shareholders by focusing on businesses where we have market leadership, a technological edge and a world competitive cost base."[20] The company made an overt change in its stated priorities in response to a large shareholder, Hanson Trust, building a significant holding to address the unevenness of performance reflecting its antecedents as a merged entity. In ICI's case, the intervention was to lead to the breakup of the company, with one part merging to form the pharmaceutical company AstraZeneca and the other being taken over by AKZO.

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16. This permits causal inferences by finding an instrument (i.e., variation in portfolio diversification), which is correlated with the explanatory variable of interest (i.e., shareholder primacy), but is uncorrelated with the outcome of interest (i.e., corporate culture or other omitted variables). The assumption is that investors with less diversified portfolios apply more active governance and only affect corporate culture through this channel.

17. *Supra* note 12, at 3.

18. Jonathan Ford, *BHS: A Dealmaker's Debacle*, FIN. TIMES (Apr. 29, 2016), https://www.ft.com/content/08ce87aa-0ded-11e6-ad80-67655613c2d6.

19. JOHN KAY, OTHER PEOPLE'S MONEY: THE REAL BUSINESS OF FINANCE 47 (2015).

20. *Id.* at 19.

This is not to suggest in any way that the effects of stronger shareholder rights or governance are necessarily detrimental. For example, Vincente Cuñat, Mireia Gine, and Maria Guadalupe find that votes narrowly cast in shareholder meetings in favour of propositions that remove anti-takeover provisions yield significant positive returns to shareholders.[21] These gains are associated with falls in company acquisitions and capital expenditures, which the authors interpret as suggesting that increasing managerial discipline discourages value-diminishing investments. However, Cuñat, Gine, and Guadalupe's results are also consistent with managerial autonomy being conducive to greater corporate investment. No doubt there are firms with such a poor focus on results—engaging in value destroying investments with few intangible assets—that increased shareholder governance has enduring payoffs for them. However, there are others for which excessive shareholder pressure has adverse effects on their corporate culture and long-term value creation.

IV. IMPLEMENTING ENTREPRENEURS' VISION

Another function served by the firm is to enable the implementation of what Goshen and Hamdani describe as "idiosyncratic visions."[22] These are ideas based on visions of the founders and entrepreneurs that are difficult to communicate to outside investors. Well-informed, long-term owners can be highly beneficial.[23] However, placing control in the hands of uninformed investors may threaten the adoption of visionary innovations that are valuable to the company in the long-term. Instead, investors might in some circumstances be better off binding themselves to the mast of the entrepreneur and standing by their initial judgements.

Goshen and Hamdani illustrate this in the case of Henry Ford:

> Ford did not invent the automobile, nor did he own any valuable intellectual property in the technology. He was competing with hundreds of other entrepreneurs attempting to create a "horseless carriage." Ford, however, had a unique vision regarding car production. The Detroit Automobile Company, the first firm that he founded, was controlled by investors. While investors demanded that

21. Vicente Cuñat, Mireia Gine & Maria Guadalupe, *The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value*, 67 J. FIN. 1943, 1969–70 (2012) (this study uses a regression discontinuity design).

22. Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Value*, 125 YALE L.J. 560, 565–66 (2016).

23. Where management's idiosyncratic value is sufficiently large, it may simply launch a management buyout, with management owning control and cash-flow rights and investors providing debt. *See* Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217–54 (1989). (This is an example of how a large informed shareholder can be beneficial.).

> cars be immediately produced and sold, Ford insisted on perfecting the design prior to production, leading to delays and frustration on both sides. The tension eventually led investors to shut down the firm. Ford's second attempt, the Henry Ford Company, was also controlled by investors. Again, after designing a car, Ford resisted the investors' pressure to move directly into production. Ultimately, Ford's obstinacy prompted investors to replace him with Henry Leland, who changed the company's name to the Cadillac Automobile Company and successfully produced the car that Ford had designed. In Ford's third attempt—the Ford Motor Company—he insisted on retaining control. This time, with no outside-investor interference, Ford transformed his innovative ideas for car design and production [his idiosyncratic value] into one of the greatest corporate success stories of all time. . . .
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> . . . Finally, with yet another move along the spectrum of ownership structures, Ford's grandson, Henry II, took the corporation public in 1956 with a dual-class share structure, ensuring that control stayed with the Ford family to this day.[24]

V. THE CAPABILITY TO COMMIT

In both the case of a unified purpose and common culture and the promotion of idiosyncratic ideas, companies need to be able to commit to what, in the short-term, may appear to be value diminishing but are, in the long-run, value enhancing policies. A variety of mechanisms exist that allow companies to do this. While the U.K. and the U.S. are frequently categorised together as Anglo-American systems—in order to contrast them with those of Continental Europe and Asia—the differences between the two countries are as great as their similarities. The U.S. has numerous commitment mechanisms: dual-class share structures, staggered boards, and "poison pill" defences against contested takeovers, which do not exist in the U.K.

Whether these commitment devices achieve what they purport to do is ultimately an empirical question. Much of the evidence is highly sceptical. As an example, one popular approach in the U.S. is the use of antitakeover statutes. To identify causal effects, empirical studies exploit a natural experiment—the passage of state-level business combination (BC) statutes that increase a firm's protection from unsought takeover bids by providing for the implementation of antitakeover devices.[25] Because

24. Goshen & Hamdani, *supra* note 22, at 566–67, 567 n.22.

25. These statutes impose a moratorium (3–5 years) on large asset sales and mergers between a large shareholder and the firm after the shareholder's stake passes a predetermined threshold. For robustness, these studies also examine other aspects of this legislation, including fair price and control

firm specific considerations tend to drive the choice of governance arrangements, this addresses the concern that other factors or characteristics may influence or be correlated with the business outcome under examination.[26] By contrast, because legislative changes are outside the control of individual firms and are passed in the state of incorporation rather than the state of location, which could be influenced by local economic conditions, they provide a precise identification of the effects of takeover protections in relation to firms that are not covered by them.

With few exceptions, these studies have cast doubt on the effectiveness of takeover protections. Bertrand and Mullainathan, who pioneered this approach, find that firms incorporated in states that pass BC statutes pay higher wages but are less likely to close down old plants or create new ones. Their explanation is that executives, insulated from market discipline, prefer to enjoy the "quiet life," avoiding difficult decisions and buying peace from the workforce, with costs for plant-level productivity and profitability. Specifically, the introduction of antitakeover legislation results in a roughly 0.8% drop in return on capital.[27]

A second example is staggered boards. The battle over staggered boards, in which the composition of boards can only be changed gradually over an extended period of time, has assumed particular significance. Staggered boards have been high on the agenda of shareholder rights activists and corporate governance rating agencies.[28] As a result, the proportion of S&P 500 companies with staggered boards has fallen from 60% in 2000 to only 12% in 2013, leading Leo Strine, the Chief Justice of

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share acquisition statutes, though business combination statutes are viewed as providing the strongest protection.

26. For general evidence that firm specific considerations drive the choice of governance arrangements, see generally Renée B. Adams, Benjamin E. Hermalin & Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LITERATURE 58 (2010).

27. Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1070 (2003). Another study reporting similar results is Xavier Giroud & Holger M. Mueller, *Does Corporate Governance Matter in Competitive Industries?*, 95 J. FIN. ECON. 312 (2010). They find operating performance as measured by ROA drop, especially in noncompetitive industries. *Id.* at 316–17; *see also* Julian Atanassov, *Do Hostile Takeovers Stifle Innovation? Evidence from Antitakeover Legislation and Corporate Patenting*, 68 J. FIN. 1097 (2013). It finds that innovation activity, as measured by patents and patent citations, decrease by 11% and 16% respectively, though this effect is virtually eliminated by the presence of a blockholder, notably oversight from public pension funds. *Id.* at 1110. For an overview of this literature, see Jonathan M. Karpoff & Michael D. Wittry, Institutional and Legal Context in Natural Experiments: The Case of State Antitakeover Laws 54 app. tbl. A1 (May 10, 2016) (unpublished manuscript).

28. In the last decade, shareholder proposals to de-stagger have outnumbered any other shareholder proposal submitted at U.S. companies.

the Delaware Supreme Court, to remark that staggered boards have become an endangered species.[29]

Findings from cross-sectional studies have largely validated this collective drive, presenting staggered boards as harmful to firm value. One study finds staggered boards reduce Tobin's Q—a measure of firm value—by 3%–4%, with effects stronger for staggered boards established in the corporate charter than those established by the company's bylaws, which cannot be amended by shareholders.[30]

However, the above-mentioned studies have been challenged. Karpoff and Wittry (2015) and Catan and Kahan (2016) show that focusing solely on BC statutes at the expense of wider institutional, political economy and historical conditions can lead to bias and even reverse interpretations.[31] They find that for a range of firm outcomes examined in prior studies, the effect of BC statutes becomes insignificant once controls are added.[32] Likewise, in regard to staggered boards, Cremers, Litov, and Sepe[33] find that, cross-sectionally, firms with staggered boards have lower firm value in line with previous research. However, when they use time-series analysis, they find that staggered boards are positively related to firm value. On average, adoption of a staggered board is associated with an increase in firm value of 6.9%.[34]

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29. Strine, *supra* note 4, at 497.

30. Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 428 (2005); *see also* Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501, 506–07 (2007).

31. Emiliano M. Catan & Marcel Kahan, *The Law and Finance of Antitakeover Statutes*, 68 STAN. L. REV. 629, 661–65 (2016); Karpoff & Wittry, *supra* note 27, at 8. For the use of regulatory and legal changes as a natural experiment, see Timothy Besley & Anne Case, *Unnatural Experiments? Estimating the Incidence of Endogenous Policies*, 110 ECON J. 672, 689–92 (2000); Timothy Werner & John J. Coleman, *Citizens United, Independent Expenditures, and Agency Costs: Reexamining the Political Economy of State Antitakeover Statutes*, 31 J.L. ECON. & ORG. 127, 136–44 (2015).

32. In replications, poison pills are found to be economically and statistically significant, which chimes with the importance attached to them by legal scholars. *See, e.g.*, Karpoff & Wittry, *supra* note 27, at 9–11.

33. *See* K. J. Martijn Cremers, Lubomir P. Litov & Simone M. Sepe, Staggered Boards and Long-Term Firm Value, Revisited (May 22, 2016) (unpublished manuscript); K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67 (2016) [hereinafter Cremers & Sepe, *Shareholder Value*]. Time series analysis can control for firm characteristics that do not change over time; as such, it is better equipped to isolate what change in firm value within the same firm occurred before or after the adoption of a staggered board, and thus rule out reverse causality which is found to drive cross-sectional results.

34. In establishing this association, the authors rule out a number of alternative explanations: they find no evidence that the valuation effects of adopting a staggered board are driven by expectations of future takeover activity that often produce substantial premia for the target's shareholders. Nor do they find that the adoption is accompanied by other changes in firm governance that toughen safeguards against managerial entrenchment—and so amply compensate shareholders for the costs of staggered boards. Cremers & Sepe, *Shareholder Value*, *supra* note 33, at 102–03.

This is an advance on the identification methods of previous staggered board studies, though it still falls short of direct causality. A study by Cohen and Wang provides stronger inferences in this regard.[35] It investigates two Delaware court decisions in the Airgas case, which had diverging impacts on companies with staggered boards, depending on the random timing of a company's annual meeting. Measuring announcement returns after these two rulings, the authors find evidence consistent with the view that staggered boards reduce stock price, albeit not at conventional levels of significance.[36]

All this suggests caution should be applied when evaluating evidence on antitakeover statutes and staggered boards. Most significantly of all, they suggest that treating firms as homogenous entities may miss interesting patterns at a granular level. For instance, Johnson, Karpoff, and Yi report that initial public offering companies (IPOs) employ more takeover defences, such as staggered boards, when they have important business partnerships—large customers, dependent suppliers, or strategic alliance partners—to protect.[37] In the absence of such defences, those partnerships could be threatened by possible takeovers of the IPO firms. Consistent with this, they find a positive association between these defences and subsequent valuation and operating performance.[38] Others

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35. Alma Cohen & Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment*, 110 J. FIN. ECON. 627 (2013). For a study that sheds light on causality via RD and IV techniques but finds that adopting antitakeover provisions increases shareholder value by approximately 3%, see Erin E. Smith, Do Shareholders Want Less Governance? Evidence from the Adoption of Antitakeover Provisions 4 (Mar. 19, 2015) (unpublished manuscript).

36. Cohen & Wang, *supra* note 35, at 633–40. The quasi-experimental design employed by this study has many appealing features, though it leaves a number of unanswered questions. First, as with all event studies that focus on short-term market reactions, it says little about long-term effects of staggered boards on firm fundamentals. Second, as others have pointed out, findings appear quite sensitive to sample selection, the removal of outliers, and the choice of different industry fixed effects. *See* Yakov Amihud & Stoyan Stoyanov, Do Staggered Boards Harm Shareholders? 14 (Apr. 7, 2016) (unpublished manuscript); *see also* Cremers & Sepe, *Shareholder Value*, *supra* note 33, at 96 n.144. Third, insofar as existing Delaware law permits the use of powerful antitakeover protections such as poison pills, it is not possible to determine whether having annual elections for directors would generate greater shareholder value than having staggered boards but with restrictions on takeover defences such as poison pills. Thus, it provides limited real-world guidance to firms contemplating the adoption of a staggered board outside a takeover context where even sceptics acknowledge the intellectual case is strongest. *See* Guhan Subramanian, *Board Silly*, N.Y. TIMES (Feb. 14, 2007), http://www.nytimes.com/2007/02/14/opinion/14subramanian.html?_r=0. Finally, it speaks only to the average effect of staggered boards; it is possible that staggered boards will have different effects for different firms.

37. William J. Johnson, Jonathan M. Karpoff & Sangho Yi, *The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms*, 117 J. FIN. ECON. 307, 313 (2015).

38. This association continues to hold when the authors use the identity and characteristics of the IPO company's law firm as an instrument for takeover defences, supporting the inference that takeover defences are a cause of, not just correlated with, higher value and performance. *Id.* at 320–25.

find that these protections matter more to companies that rely on R&D and intangibles,[39] operate in opaque information environments,[40] and have higher advisory needs[41]—settings which are consistent with the importance of commitment. Acquisitions financed with debt or takeovers that result in a significant increase in market power may be especially disruptive.[42]

There is also evidence that value effects depend on industry structure. Kadyrzhanova and Rhodes-Kropf draw a distinction between defences that impose a delay on potential acquirers and ones that do not.[43] They find that delay provisions, such as staggered boards, increase bargaining power by locking in shareholders, with effects strongest in concentrated industries where targets are relatively scarce.[44] Similarly, defences may complement other organisational practices and features such as management quality.[45] Baranchuk, Kieschnick, and Moussawi, for instance, find that long-term incentives, combined with protection from early failure, takeover, or both is supportive of innovation activity.[46]

Finally, commitment devices need not take the form of traditional takeover protections. Flammer and Kacperczyk report the impact of state-level constituency statutes on innovation.[47] Under these statutes, a corporation's directors are permitted to incorporate a wide range of stakeholder interests in their business decisions.[48] The authors find that

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39. Cremers, Litov & Sepe, *supra* note 33, at 5; Cremers & Sepe, *Shareholder Value*, *supra* note 33, at 128.

40. Augustine Duru, Dechun Wang & Yijiang Zhao, *Staggered Boards, Corporate Opacity and Firm Value*, 37 J. BANKING & FIN. 341, 358–59 (2013).

41. Seoungpil Ahn & Keshab Shrestha, *The Differential Effects of Classified Boards on Firm Value*, 37 J. BANKING & FIN. 3993, 4011 (2013).

42. Ling Cen, Sudipto Dasgupta & Rik Sen, *Discipline or Disruption? Stakeholder Relationships and the Effect of Takeover Threat*, 62 MGMT. SCI. 2820, 2823 (2015).

43. Dalida Kadyrzhanova & Matthew Rhodes-Kropf, *Concentrating on Governance*, 66 J. FIN. 1649, 1650 (2011).

44. *Id.* at 1651.

45. Thomas J. Chemmanur, Imants Paeglis & Karen Simonyan, *Management Quality and Anti-Takeover Provisions*, 54 J.L. & ECON. 651, 653 (2011).

46. Nina Baranchuk, Robert Kieschnick & Rabih Moussawi, *Motivating Innovation in Newly Public Firms*, 111 J. FIN. ECON. 578, 579 (2014). These complementary methods are consistent with this theory. *See* DAVID R. SKEIE, VESTING AND CONTROL IN VENTURE CAPITAL CONTRACTS, STAFF REPORT NO. 297, FED. RES. BANK OF N.Y. 23 (2007); Gustavo Manso, *Motivating Innovation*, 66 J. FIN. 1823, 1824 (2011). Manso finds that the optimal incentive scheme for innovation combines substantial tolerance, and even support for early failure, with rewards for long-term success as well as timely feedback on performance. *See id.* However, this should not be viewed as providing a general justification for tolerating managerial failure.

47. *See* Caroline Flammer & Aleksandra Kacperczyk, *The Impact of Stakeholder Orientation on Innovation: Evidence from a Natural Experiment*, 62 MGMT. SCI. 1982 (2015). Note some of the problems described in relation to antitakeover statutes apply here, e.g., the role of corporate lobbying and political economy considerations.

48. *Id.* at 10.

after enactment, the number of patents increases significantly over time so that, after forty-eight months, the number of patents and citations increase by more than 4%, suggesting that stakeholder orientation has an enduring effect on innovation.[49]

It is important to view these claims as suggestive rather than definitive and causal.[50] The flipside of acknowledging the importance of heterogeneous effects is that arrangements will not be appropriate in every circumstance. There are many companies in which stakeholder interests are adequately protected through contract or where the investments that parties make in the firm are modest and require little protection. There are companies that do not invest heavily in intangibles and are not pursuing idiosyncratic visionary ideas of entrepreneurs and founders. Managers with a small opportunity set and few available resources may have limited scope to pursue idiosyncratic value.[51] Others may suffer from tunnel vision and overconfidence; the corporate landscape is littered with the husks of businesses and ideas that failed because entrepreneurs dug their heels in rather than relinquish control and accept outside input.[52] In these instances, the costs of commitment devices may greatly outweigh their benefits. As with any complex human and commercial activity, there is a ledger of pluses and minuses and evidence that the net effect depends on the nature of and the context in which activities are being undertaken.

VI. British Particularities

Identifying the circumstances in which these devices benefit corporate purpose constitutes a more fruitful line of inquiry than simply asking whether or not they are generically beneficial. In the U.K., policy and precedent have foreclosed this approach. Section 172 of the Company Act 2006 recognises the interests of parties other than just shareholders. However, these are derivative responsibilities on directors subordinate to those of the owners of the company; they are not primary obligations in their own right. Their effectiveness is further circumscribed by the courts' lack of business expertise and reluctance to second-guess the decisions or policies of directors, save in cases of very bad behaviour or where directors

49. *Id.* at 17.

50. Caution may be in order because many studies rely on cross-sectional evidence which is subject to endogeneity issues.

51. Noam Wasserman, Bharat Anand & Nitin Nohria, *When Does Leadership Matter: A Contingent Opportunities View of CEO Leadership* 11–12, *excerpted in* HANDBOOK OF LEADERSHIP THEORY AND PRACTICE (Nitin Nohria & Rakesh Khuruna eds., 2010).

52. NOAM WASSERMAN, THE FOUNDER'S DILEMMAS: ANTICIPATING AND AVOIDING THE PITFALLS THAT CAN SINK A STARTUP 205–16, 297–304 (2012).

have left clear proof of their thought processes.[53] This outlook, enshrined in the business judgement rule, reflects the legal traditions of the common law system, which approaches issues from a perspective in which the contract predominates.[54]

The upshot is that U.K. directors are not liberated from the pursuit of shareholder interests to nearly the same extent as in the U.S. In the U.S., variants of dual-class shares are commonplace, and some of the most prominent companies have issued dual-class shares (see Figures 3 and 4 below). Recent examples include Facebook, Google, LinkedIn, and Under Armour, all of which came to the stock market with dual-class shares that conferred substantially more voting rights on their founders than on investors who subscribed to public issues.

Figure 3: Antitakeover Provisions and Prevalence of Dual-Class Shares in Several Industries in the U.S.[55]

Industry	**Anti-Takeover Provisions**	**Dual-Class Shares**
Apparel	18%	10%
Communication, Printing, and Publishing	17%	38%
Industrial Services	24%	10%
Metal, Plastics, Paper, and Packaging	34%	15%
Average All IPOs	22%	5%

53. PAUL DAVIES & SARAH WORTHINGTON, GOWER & DAVIES: PRINCIPLES OF MODERN COMPANY LAW 443–48 (2012).

54. P.M. Vasudev, *Corporate Stakeholders in Canada: An Overview and a Proposal*, 45 OTTAWA L. REV. 135, 157 (2013).

55. Laura Casares Fields, Control Considerations of Newly Public Firms: The Implementation of Antitakeover Provisions and Dual Class Shares Before the IPO 34 (Feb. 10, 1999) (unpublished manuscript).

Figure 4: Examples of Dual-Class Shares in the U.S.

Google: Class A common stock one vote per share Class B 10 votes per share Larry Page, Sergey Brin and Eric Schmidt 37.6% of votes; executive and directors 61.4%. **LinkedIn:** Class A common stock one vote per share Class B 10 votes per share Class B shareholders give to all pre-IPO investors Reid Hoffman 21.7% increasing over time.

Evidence on the impact of dual-class shares is relatively limited, though the most authoritative study to date, by Gompers, Ishii, and Metrick (2010), found that companies with dual-class shares are more likely to have agency problems than those with a single share class. Firm value is negatively associated with the wedge between insiders' cash flow rights and voting rights, which is large enough in many cases to provide insiders with a majority of the votes despite their claims to only a minority of the economic value.[56] However, this work is far from the final say; Gompers, Ishii, and Metrick's own results are quite sensitive to sample selection and estimation methods used to address endogeneity concerns.[57]

More importantly, the effectiveness of dual-class shares, like other commitment devices, hinges on the details. There is growing attention to the ways in which dual-class shares and other commitment devices are designed to deliver their purported benefits without giving rise to abuse or unintended consequences. These include the use of sunset clauses and conditionalities; vote caps; minimum equity thresholds held by insiders; open eligibility criteria; basic voting rights for common shares; and a myriad of other features related to a company's governance.[58] This type of

56. Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Companies in the United States*, 23 REV. FIN. STUD. 1051, 1052 (2010).

57. In instrumental variable regressions, point estimates are similar, but significance levels are much lower. Results are strongest for a particular subset of dual class firms—ones with voting control, but less than 50% of the cash-flow rights, representing around 35%–40% of the dual class universe. *Id.* at 1084–85.

58. For statements of good practice, see DUAL CLASS SHARE POLICY, CANADIAN COALITION FOR GOOD GOVERNANCE (Sept. 2013), http://www.ccgg.ca/site/ccgg/assets/pdf/dual_class_share_policy.pdf [https://perma.cc/8RB3-WAY3]. *See also* CONSULTATION CONCLUSION TO CONCEPT PAPER ON WEIGHTED VOTING RIGHTS, H.K. EXCHS. & CLEARING LTD. (June 2015), https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082cc.pdf

fine variation rarely shows up in the data and leaves open the possibility that intermediate or hybrid structures may be more beneficial for corporate performance.

An important recent development, in this respect, is the principle of proxy access. Shareholders in a number of U.S. companies, such as Apple, are being granted the right to put forward nominations to their board of directors in their annual proxy statements if they, or a group of (for example up to twenty) shareholders, have held more than a certain fraction of shares (e.g., 3%) for a particular period of time (e.g., three years).[59] It thereby confers greater rights on blocks of shares held for long periods rather than on just company founders and other insiders. This practice is similar to principles such as the *Loi Florange* in France, by which shareholders who have held their shares for more than two years automatically have the right to double voting rights unless the company specifically opts not to apply this.[60] Italy has a similar law.[61]

U.K. rules do not allow what are termed "premium-listed companies" to issue any form of dual-class shares that confer differential voting rights on different classes of shareholders. British regulatory authorities, along with institutional investors, believe that dual-class shares, however designed, discriminate against minority shareholders who have fewer voting rights per share.[62] They are, therefore, regarded as a violation of minority investor protection and equality of treatment of shareholders.[63] A second contrasting example is the powerful limit on the use of the staggered board. It is a mandatory rule of U.K. company law that shareholders can remove directors at any time by an ordinary resolution. A meeting to vote on such a resolution can be requisitioned by only 5% of the company's voting shares.[64]

[https://perma.cc/7T9Y-8ZSN]. The exchange gave up on dual-class shares after the Hong Kong Securities and Futures Commission (SFC) rejected it.

59. *See, e.g.*, Tim Bradshaw & Stephen Foley, *Apple Opens Board Nominations to Large Investors*, FIN. TIMES (Dec. 23, 2015), https://www.ft.com/content/f52529a8-a905-11e5-955c-1e1d6de94879.

60. *See Analysis: Differentiated Voting Rights in Europe*, INSTITUTIONAL SHAREHOLDERS SERVS., INC., https://www.issgovernance.com/analysis-differentiated-voting-rights-in-europe/ [https://perma.cc/G8LK-2U38].

61. *Id.*

62. There are two designations of listing on the London Stock Exchange premium (formerly known as primary) and standard (formerly termed secondary). Premium-listed companies are not permitted to issue dual class shares.

63. G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 58–89, 82–83 (1996).

64. *See, e.g.*, *Removal of a Director from Office*, CO. LAW CLUB, http://www.companylawclub.co.uk/removal-of-a-director-from-office [https://perma.cc/P7EQ-7RA6]; Companies Act, 2006, c. 46 § 303(2) (Eng.).

The contrast extends to the rules regarding the use of takeover defences by target firms of hostile acquisitions. U.S. law allows companies to create blocking positions in the event of a hostile takeover by issuing new shares to existing shareholders but excluding those held by the acquirer.[65] This poison pill defence dilutes the shares held by the acquirer making it prohibitively expensive for the acquirer to proceed with a bid. The target management is thus empowered to use its business judgement in determining whether an acquisition is in the best interests of shareholders as owners, or fails to reward them adequately for their shares should the takeover go ahead. The case against poison pills is that they can allow managements to entrench themselves, protect their own interests, or both. In this territory, there are very few, if any, initiatives that do not have some downsides to offset the potential upsides.

The U.K. Takeover Code, which defines the rules by which takeovers are conducted, has been strengthened in the wake of Kraft's takeover of Cadbury.[66] Put-up-or-shut-up requirements, greater recognition of employee interests, improved transparency of bidders's plans, and increased clarity over post-offer commitments have put the interests of long-term investors and stakeholders on a more solid footing. However, these changes are still seen as a halfway house and are unlikely to alter the incentives or behaviour of a bidder who is intent on parking its tanks on the target company's lawn.[67]

Moreover, takeover regulation has long leaned against the American view, stipulating that a target of an acquisition cannot adopt poison pills once a takeover bid has been initiated. Management is not granted similar discretion, the reason being that poison pills are regarded as a way of frustrating value-enhancing bids against the interests of minority shareholders. This particular concern is not without justification, though it is emblematic of the general way in which U.K. regulations restrict the ability of founders to retain control of companies after they are listed on stock markets and limit management's freedom to defend themselves against hostile acquisitions. It has thereby contributed significantly to the dispersed nature of ownership of its listed companies and to the unusually high level of exposure of companies to hostile takeovers. Between 1991 and 2005, hostile takeovers in Britain enjoyed a 61% success rate—far

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65. *See generally* Harvard Law School Forum on Corporate Governance and Financial Regulation, http://corpgov.law.harvard.edu (tag: poison pills). *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354–55 (Del. 1985)

66. *See* Ben Morris, *The Cadbury Deal: How It Changed Takeovers*, BBC (May 2, 2014), http://www.bbc.co.uk/news/business-27258143 [https://perma.cc/N3TU-PM89].

67. Thanks to Mark Seligman for his commentary on the nature and impact of post-Cadbury Takeover Code.

higher than elsewhere.[68] Nor have successive U.K. governments chosen to offset the bias, declaring that only in exceptional cases are they prepared to contest 'market' judgements.[69]

The biases in Britain cumulatively lean against corporate purpose. Limitations on dual-class shares, staggered boards, and anti-takeover devices are viewed as important forms of minority investor protection, with founders and managers not afforded the discretion the U.S. confers on them to adopt what they regard as appropriate ownership structures. Notwithstanding its imperfections, what marks out the U.S., and is a significant source of its corporate success, is its diversity and promotion of a variety of forms of ownership and control. The U.K. promotes a much more uniform and shareholder-oriented system that has restricted the way in which firms can structure their operations. There may be considerable advantages to promoting and celebrating corporate diversity and facilitating it through enabling permissive regulation and legislation. However, it is not advantageous to prescribe what a particular school of thought dictates as being the right way of structuring firms. To the extent purpose matters, this bias needs redressing.

CONCLUSION

Companies were originally established to embody purpose, and for good reason. Markets cannot substitute for organisations with purpose. They are complementary, not substitutes. For companies to be able to deliver on purpose, they need to be able to commit to it and establish the internal cultures that are consistent with it. Shareholder primacy has made clear where the power of organisations ultimately lies. It is not with CEOs, chairmen, or board directors. These are agents; they are not the principals. Whatever the good intention of the management, however compelling the purpose statements of companies, if the shareholders are not committed to them, they are of little significance.

In some cases, this is justified by the need to align management with shareholder interests. In others, management needs to be able to stand back and take a more balanced view of what is in the corporate interest as a whole. They need to be able to commit to the community of interests in the firm, including those promoting idiosyncratic ideas that are the source

68. Jonathan Ford, *A New Approach to British Deal Making is Required*, FIN. TIMES (June 11, 2014), http://www.ft.com/cms/s/0/3a8a12a6-f14c-11e3-9fb0-00144feabdc0.html.

69. Recently the U.K. Government has raised questions about the merits of in particular foreign takeovers. For a comprehensive description of the U.K. Government position on takeovers, see generally Antony Seely, *Mergers and Takeovers: The Public Interest* (Briefing Paper No. 5374), HOUSE OF COMMONS LIBR. (2016).

of corporate innovation and value creation in the long-run. This may involve constraining the power of shareholders.

This is not to suggest that shareholder rights should be diminished in all circumstances, but that companies should have greater latitude in determining what is suited to their particular activities. Diversity should be welcomed and encouraged through regulation that is enabling and permissive rather than prescriptive and restrictive. The U.K. has not been wrong to strengthen shareholder rights, but it has erred in seeking its uniform adoption.