[Florida Law Review](http://scholarship.law.ufl.edu/flr)

Volume 64 | Issue 6 Article 9

1-27-2013

Corporate Governance: The Sweedish Solution

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CORPORATE GOVERNANCE: THE SWEDISH SOLUTION

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Abstract

The optimal allocation of authority among executives, directors, and shareholders of public companies has been debated as long as there have been public companies, and the issue now seems further from resolution than ever. In recent years Sweden has changed its corporate governance system by delegating the nomination of corporate directors (and thus, in effect, ultimate control) to committees typically comprising representatives of each company's largest shareholders. This system gives shareholders a degree of power "that only the most daring corporate governance initiatives in the rest of the world could even imagine."[1] The change is a big success—it has pleased many corporate constituencies without upsetting any. Part I of this Article describes that change and some similar developments in other countries. Part II discusses whether the Swedish model can work in America and concludes that it can. Part III offers two promising ways to move toward shareholder primacy.

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1. Jesper Lau Hansen, *On the Independence of Directors in the Nordic Countries—Where the Shareholder Is King*, *in* 1 SHAREHOLDER CONFLICTS 69, 69 (P. Krüger Andersen et al. eds., 2006).

I. THE TRANSFORMATION OF CORPORATE GOVERNANCE IN SWEDEN (WITH NOTES ON SEVERAL OTHER COUNTRIES)

A. *Sweden*

Traditionally, most public Swedish corporations were dominated by a few large shareholders.[2] Their power stemmed largely from owning stock with higher voting than financial rights.[3] CEOs had much less influence than they do in the United States.[4] However, the influence of most prominent families has now waned.[5] Foreign ownership (mainly by British and American institutional investors) of publicly traded

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2. *See* Ulf Larsson-Olaison, *The Translation of Transplanted Rules: The Case of the Swedish Nomination Committee*, *in* INTERPRETATION OF LAW IN THE GLOBAL WORLD: FROM PARTICULARISM TO A UNIVERSAL APPROACH 325, 331 (J. Jemielniak & P. Miklaszewicz, eds., 2010) ("[M]any Swedish firms are controlled by so-called spheres . . . . These spheres are often tied to a family . . . ."); Daniel Johanson & Katarina Østergren, *The Movement Toward Independent Directors on Boards: A Comparative Analysis of Sweden and the UK*, 18 CORP. GOVERNANCE: AN INT'L REV. 527, 532 (2010) (stating that "[t]wo business groups have historically dominated Swedish industry"). A study published in 2003 showed that 26.3% of public companies in Sweden had a majority control block and 64.2% had a shareholder with at least 25%. Marco Becht, *Reciprocity in Takeovers* 19 figs.1 & 2 (ECGI Working Paper Series in Law No. 14/2003, 2003), *available at* http://ssrn.com/abstract=463003.

3. *See* Magnus Engvall & Christian Holmberg, Nomination Committees, Pension Funds and Board Turnover: Evidence from the Swedish Code of Corporate Governance 6 (May 30, 2007) (unpublished Master thesis, Stockholm School of Economics), *available at* http://www.essays.se/essay/cbb3bb0fe8 ("[T]he Swedish setting is characterized by many owners with large control (voting) rights in proportion to cash flow (dividend) rights."). Dual class common stock existed at 66% of Swedish companies. *See* Becht, *supra* note 2, at tbl.2. However, even in 2003 there was virtually no difference in market value between high-voting and low-voting shares. *See* Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 331, 340 (2003) (finding a difference of only 1%). This suggests that voting power cannot generate personal benefits for the owner.

4. *See* Engvall & Holmberg, *supra* note 3, at 8 (stating that "the CEO has a larger impact on board election" in the U.S. than in Sweden); Larsson-Olaison, *supra* note 2, at 332 (stating that "managerial influence on board work is not the main problem in Sweden").

5. *See* Paolo Santella et al., *A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in the EU and in the US*, 23 EUR. BUS. L. REV. 257, 261 (2012); TOMORROW'S CO., TOMORROW'S CORPORATE GOVERNANCE: BRIDGING THE UK ENGAGEMENT GAP THROUGH SWEDISH-STYLE NOMINATION COMMITTEES 13 ("Today . . . Swedish pension funds, mutual funds and industrial holding companies are commonly among the largest shareholders of companies. As well as the local institutional shareholders, foreign institutions own a significant proportion of the market.") [hereinafter TOMORROW'S CORPORATE GOVERNANCE].

Swedish stock has grown and is now 40% of the total.[6] Previously, conflicts between minority and large shareholders were not uncommon.[7] In 1993, the Swedish Shareholders' Association, an organization of small shareholders, began to agitate for a larger role in governance for other stockholders.[8] The initiative met resistance.[9]

In 2004, the Swedish Corporate Governance Code (CGC)—a body of law promulgated by a private group called the Swedish Corporate Governance Board—was revised. Unlike the Companies Act, the CGC is not mandatory, but most public companies hew to it.[10] The CGC provides that the Annual General Meeting of shareholders (AGM) appoints a nominating committee (NC), comprised of a majority of non-board members and devoid of any members from management,[11] to present the next AGM with a slate of nominees for the board.[12] This arrangement starkly contrasts with the practices of the United States and Britain, where the nominating committee is almost invariably a subcommittee of the board—inevitably resulting in a system where boards tend to be self-perpetuating.[13]

Generally members of the NC "represent the company's major owners," although "at least one member must be independent of the company's largest shareholders."[14] The NC has "responsibility for

6. *See* Per Lekvall, *The Swedish Corporate Governance Model*, *in* THE HANDBOOK OF INTERNATIONAL CORPORATE GOVERNANCE: A DEFINITIVE GUIDE 368, 375, *available at* http://www.bolagsstyrning.se/media/28166/the%20swedish%20corporate%20governance%20model%20-%20article%20in%20the%20iod%20handbook%202009.pdf; Rolf H. Carlsson, *Swedish Corporate Governance and Value Creation: Owners Still in the Driver's Seat*, 15 CORPORATE GOVERNANCE: AN INT'L REV. 1038, 1039 (2007) (stating that foreign ownership now varies from 35% to 40%).

7. *See* Johanson & Østergren, *supra* note 2, at 531.

8. *See* Larsson-Olaison, *supra* note 2, at 333; Thomas Poulsen et al., *Voting Power and Shareholder Activism: A Study of Swedish Shareholder Meetings*, 18 CORPORATE GOVERNANCE: AN INT'L REV. 329, 331 (2010).

9. *See* Larsson-Olaison, *supra* note 2, at 334–35.

10. *See* SWED. CORPORATE GOVERNANCE BD., THE SWEDISH CORPORATE GOVERNANCE CODE 5 (2010), *available at* http://www.corporategovernanceboard.se/media/45322/svenskkodbolagsstyrn_2010_eng_korrigerad20110321.pdf [hereinafter THE SWEDISH CORPORATE GOVERNANCE CODE].

11. *See* THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at Corp. Gov. Code §§ 2.3–2.4 (2010).

12. *See id.* at 14; Larsson-Olaison, *supra* note 2, at 336. The name of the committee is variously translated into English as "nominating committee," "nomination committee," or "election committee."

13. In the United States, shareholders cannot place nominees for the board in the corporate proxy statement. *See infra* note 172 and accompanying text. Accordingly, shareholders can challenge the board's own nominees only by waging proxy fights, which are extremely expensive and, hence, extremely rare. *See infra* note 97 and accompanying text.

14. *See* B. Espen Eckbo et al., *Efficiency of Share-Voting Systems: Report on Sweden* 31 (ECGI Working Paper Series in Law No. 173/2011, 2011), *available at*

finding the right people to serve on boards,"[15] and so many NCs retain professional search consultants to assist them in this task.[16] "The CEO and other members of the executive management cannot be members of the committee. The chairman and other members of the board can be members of the committee . . . ."[17] Most NCs have five members, and "[n]ormally the largest shareholders are entitled to appoint one member each."[18] "The Swedish Shareholder Association, which represents small investors, is granted a seat on behalf of these small shareholders in several firms . . . ."[19] "In most companies the shareholders forming the [nominating committee] will account for 15–25% of the votes to be cast . . . ."[20] In some cases, institutions will purchase stock in a company for the express purpose of seeking representation on its nominating committee.[21] "[M]embers of the nomination committee are to promote the interests of all shareholders."[22] As a consequence, "the traditional owners have to share their influence with other types of owners (i.e., local institutional investors)."[23]

The Annual General Meeting is not just an event, but an institution; it "stands at the peak of a governance hierarchy,"[24] "with the board being fully subordinate to the AGM."[25] "The shareholders' meeting is a limited company's highest decision-making body . . . . [T]he shareholders' meeting has a sovereign role over the board of directors

http://ssrn.com/abstract=1651582.

15. TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 3. The committee sometimes interviews potential directors and people who have worked with them. *Id*. at 21.

16. PER LEKVALL, SWED. CORPORATE GOVERNANCE BD., NOMINATION COMMITTEES IN SWEDISH LISTED COMPANIES 1–2 (2008), *available at* http://www.corporategovernanceboard.se/media/1531/nomination%20committees%20in%20swedish%20listed%20companies%20-%20artikel%20i%20icgn%20yearbook%202008.pdf.

17. Eckbo et al., *supra* note 14, at 31–32; *see also* Poulsen et al., *supra* note 8, at 331 ("[T]he chairman of the board is invited to participate for informational reasons.").

18. Eckbo et al., *supra* note 14, at 32; *see also* TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 20 ("The [nominating committee] usually comprises representatives of the four or five largest shareholders and the chairman of the board.").

19. Poulsen et al., *supra* note 8, at 332.

20. TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 20.

21. *See, e.g.*, Engvall & Holmberg, *supra* note 3, at 2 (citing the purchase by Cevian Capital of stock in Volvo).

22. THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at 14; Eckbo et al., *supra* note 14, at 31 (citing THE SWEDISH CORPORATE GOVERNANCE CODE).

23. Larsson-Olaison, *supra* note 2, at 346.

24. TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 4. The real power of the AGM in Sweden contrasts with its status in many other European countries where most companies are dominated by a few shareholders and AGMs "are often seen only as rituals . . . or 'annual headaches.'" Poulsen et al., *supra* note 8, at 330.

25. LEKVALL, *supra* note 16, at 1.

and the chief executive officer."[26] It has "exclusive decision-making powers on certain matters, e.g. changes to the articles of association, election of board members and auditor and adoption of the balance sheet and income statement."[27] "The board is obliged to follow any specific directives passed by the shareholders' meeting, providing these do not contravene" the law or the corporation's charter.[28]

In addition to its control of the company through the nomination committee, the AGM "can, if necessary, issue instructions to the board."[29] Although the nominating committee also recommends the company auditor and the remuneration of each member of the Board of Directors,[30] the ultimate decision on remuneration lies with the AGM.[31] The auditor reports to the AGM and, in addition to the usual audit functions, has a duty "to review the performance of the board and the CEO."[32] The auditor's report must state "if any board member or the CEO has acted in a way that may give cause for liability for damages."[33] The board has a remuneration committee to set the compensation for executives, but its members are chosen by the AGM and "are to be independent of the company and its executive management."[34] The NC also evaluates the performance of directors, often with the participation of outside professionals.[35] "Boards are subordinate to the AGM and the executive subordinate to the board—so it may be said that the Swedish system is 'owner-centric.'"[36]

Shareholder primacy is also ensured by specific rules. For instance, the Corporate Governance Code states: "Share- and share-price-related incentive programmes are to be designed with the aim of achieving increased alignment between the interests of the participating individual and the company's shareholders."[37] Moreover, equity compensation plans (such as stock options) for executives must be approved by a *ninety percent* vote of the shareholders![38]

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26. THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at 9.

27. *Id.* at 10.

28. *Id.*

29. TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 4.

30. THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at 14.

31. In particular, "[t]he shareholders' meeting is to decide on all share and share-price related incentive schemes for the executive management." *Id.* at 23.

32. Lekvall, *supra* note 6, at 372.

33. *Id.*

34. TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 22.

35. *See* Carlsson, *supra* note 6, at 1049; *see also* TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 21 ("In some cases committee members will interview each director to help them make their own evaluations . . . . In undertaking their evaluation, boards are most likely to use an external consultant once every two or three years.").

36. TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 14.

37. THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at 23.

38. Aktiebolagslagen [The Swedish Companies Act], ch.16, § 8 (2005:551).

Despite the initial opposition to greater power for outside investors, the new system quickly achieved wide acceptance—even when a nominating committee recommended the termination of five directors of one company.[39] The transformation was so well-received "it is almost as if nobody ever opposed the nomination committee concept."[40] In some cases, this happened even before the revision of the Corporate Governance Code. For example, Volvo—one of the few Swedish companies "not connected to an ownership sphere and thereby traditionally regarded as being under managerial control"[41]—instituted an election committee "composed of representatives of large institutional investors with no directors included" in 1998.[42] The change precipitated no strife.

The new system has been implemented with very little turmoil. "Typically, the nominees to the board listed in the [AGM] agenda are the ones proposed by the nomination committee," and no shareholder proposes opponents.[43] Investors are not at each other's throats. Managers who consider the choices of the NC to lack proper vision or knowledge could offer an opposing slate at the AGM and solicit proxies on its behalf, but they rarely do so.[44] Disputes seem to be fairly rare and minor.[45] In general, "[NCs] function as a vehicle for . . . negotiated compromises between small shareholders and controlling shareholders."[46] "While large shareholders generally have a dominating position in the nomination committee, the rationale for electing the committee at the annual general meeting is precisely to give small shareholders a say (large shareholders could easily meet in private if

39. *See* TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 18 (stating that shareholders of TeliaSonera "overwhelmingly supported" the move).

40. Larsson-Olaison, *supra* note 2, at 337.

41. *Id.*; Carlsson, *supra* note 6, at 1049 ("The new practice is strongly supported by most institutional investors such as pension and mutual funds providing opportunities for them to have an impact on board composition.").

42. Larsson-Olaison, *supra* note 2, at 337–38.

43. *See* Eckbo et al., *supra* note 14, at 34.

44. *See* TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 19 ("Counter-proposals were a feature of shareholder meetings twenty years ago or so, but now are rare.").

45. *See, e.g.*, Engvall & Holmberg, *supra* note 3, at 2 (stating that the purchase by Cevian Capital of a large stake in Volvo in order to take a seat on its nomination committee "met strong resistance from, among others, Swedish pension funds"). Engvall and Holmberg also claim that "conflicting interests that can occur between controlling owners that can extract private benefits and non-controlling owners." *Id.* at 34. However, their only evidence of friction is that representation of pension funds on Swedish nominating committees has resulted in higher board turnover in smaller public companies. *See id.* The traditional controlling owners may not welcome these changes, but they seem to be accepting them as they occur. *See supra* notes 39–42 and accompanying text; *infra* note 55 and accompanying text.

46. Poulsen et al., *supra* note 8, at 329.

they desired).”[47]

What of “short-termism,” the bugaboo of critics of shareholder primacy in the United States?

> [T]his is rarely seen as an issue in practice. Instead, the annual cycle is viewed positively as a regular opportunity for shareholders to confirm they are happy with the direction the company is going. Two factors contribute to this outcome. First, the members of the nomination committee usually are taking a longer-term view and are not striving for quick gains . . . . Secondly, the hierarchy in the Swedish system makes it clear that a [nominating committee] is not taking over the job of a board. Strategic decisions are delegated to the board and the shareholders have no say in those decisions . . . .[48]

In fact, “active shareholder engagement in the nomination process has increased confidence in the board function . . . .”[49] The system “puts extra pressure on the board of directors to . . . create more value for the shareholders.”[50]

It also does not seem to be a major problem that shareholders with representatives on the NC become, to some extent, insiders. At first glance, such a structure of governance would seem to pose two inherent problems. First, these shareholders might on occasion have inside information about the company and therefore be forbidden to trade in its stock. However, the NC does not meet very often and it does not get much material nonpublic information, so “the risk of being an insider does not materialise very often.”[51] Moreover, an investor concerned about such a problem could decline to appoint a representative or could have its representative resign. Alternatively, the representative can simply not transmit inside information to the investor.

The second inherent problem posed by insider status is the potential for investors to exploit their NC representation through preferential self-dealing with the company. However, there is no evidence that this has

47. *Id.* at 331–32.

48. TOMORROW’S CORPORATE GOVERNANCE, *supra* note 5, at 26. However, “[a] shareholder with a short-term strategy can influence the discussions at the [nominating committee], and may succeed in getting a sympathetic director appointed to the board, but only when they have convinced the [committee] and ultimately, the AGM.” *Id.* at 32. Rolf Carlsson has expressed concerns about use of the NC by “short term activist[s]” to achieve their goals. Carlsson, *supra* note 6, at 1049–50. However, I have not found even an allegation of an incident where a company was damaged by such behavior. Moreover, despite this reservation, Carlsson favors retention of the NC system. *See infra* notes 56–57 and accompanying text.

49. TOMORROW’S CORPORATE GOVERNANCE, *supra* note 5, at 4.

50. *Id.* at 25 (quoting an interviewee).

51. *Id.* at 33.

been an actual problem—or even perceived as a serious potential problem—in Sweden. That is not surprising.[52] First, most large shareholders (like pension funds) do not have any activities that would lend themselves to self-dealing with an industrial company. The private benefits of having a representative on the NC are so meager that some eligible shareholders decline the opportunity.[53] Second, other members of the NC and all members of the board and executive management could be expected to know of, and object to, such self-dealing. Lastly, other shareholders could also be expected to know of an investor's potential for self-dealing. Although it is customary to give the largest shareholders representation on the NC, it is not mandatory. If the other shareholders fear self-dealing by a particular shareholder, they can simply deny that shareholder representation on the NC.

In some respects, the Swedes actually regulate conflicts of interest more rigorously than Americans do. For instance, if the board or its remuneration committee "uses the services of an external consultant, it is to ensure that there is no conflict of interest regarding other assignments this consultant may have for the company or its executive management."[54] By contrast, such conflicts of interest of compensation consultants are common in the U.S.[55]

In sum:

> [T]he quality of board nomination processes in Swedish companies has improved significantly over the last few

52. In considering this problem, it is significant that the movement to change Swedish corporate governance was initiated by an association of small shareholders. *See supra* note 8 and accompanying text.

53. *See* Carlsson, *supra* note 6, at 1049 ("Some foreign institutional investors have chosen not to take a seat on the nomination committee . . . .").

54. THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at 23. The similar Danish system has statutes curbing self-dealing. *See* Danish Companies Act § 80; Hansen, *supra* note 1, at 71 (stating of this provision that "the shareholders holding a majority of votes at the general [shareholder] meeting may not abuse their powers to the detriment of minority shareholder or of the company in general").

55. *See, e.g.*, Gretchen Morgenson, *Corporate America's Pay Pal*, N.Y. TIMES, Oct. 15, 2006, § 3, at 1 (chronicling how one consulting firm repeatedly boosted executive compensation for over 1,800 clients); Gretchen Morgenson, *Advice on Boss's Pay May Not be so Independent*, N.Y. TIMES, Apr. 10, 2006, at A1 (discussing the "long and lucrative relationship" between one executive compensation consulting firm and its client); James D. Cox, *Fair Pay for Chief Executive Officers*, *in* LAW AND CLASS IN AMERICA: TRENDS SINCE THE COLD WAR 99, 106 (P.D. Carrington & T. Jones eds., 2006) ("The role of the compensation consultant is fraught with conflicting interests . . . ."). As a result, use of consultants tends to inflate compensation. *See* Kevin J. Murphy & Tatiana Sandino, *Executive Pay and "Independent" Compensation Consultants*, 49 J. ACCT. & ECON. 247, 248 & n.2 (2010); Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 63–64 (2007) ("[M]anagers use the compensation consultants as 'camouflage' to extract premium rents from the compensation committee.").

> years. The 'old boys' network' criticism of just a few years ago has all but vanished . . . . There is little or no support in the Swedish business community and securities market for a change towards the concept of a subcommittee of the board nominating board members. The present model is generally considered to work well and be better adapted to the Swedish governance system.[56]

Comparing the two systems, one Swedish commentator provided the following critique:

> [I]n some countries companies are controlled by their executive management. Such cases are the US corporations . . . . [T]he Board . . . to a large extent is dominated by the Chairman/CEO. Shareholders experience all kinds of impediments to get any real influence on board nominations and elections.[57]

A Danish scholar says that the American corporate governance system "would seem to look upon shareholders much as landowners looked on peasants in pre-revolutionary Russia."[58]

The Swedish Corporate Governance Board explicitly recognizes its investor-centered governance system as a weapon in the struggle to attract investment capital:

> Good corporate governance is a question of ensuring that companies are run as efficiently as possible *on behalf of their shareholders*. The confidence of existing and potential shareholders that such is the case is crucial to their interest in investing in companies, thus securing corporate Sweden's supply of risk capital.[59]

The Swedish economy "is currently a star performer, with economic growth faster than that of any other wealthy nation . . . ."[60] Of course, Sweden's robust growth cannot be ascribed solely to its corporate governance system, but it is suggestive.

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56. LEKVALL, *supra* note 16, at 2; *see also* Carlsson, *supra* note 6, at 1050 ("There are scattered voices in favour of Sweden following the Anglo-Saxon practice of including the nomination committee as part of the board. Fortunately, a solid majority is against such abuse of sound corporate governance principles.").

57. Carlsson, *supra* note 6, at 1051.

58. Hansen, *supra* note 1, at 75.

59. THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at 3 (emphasis added).

60. Paul Krugman, *What Ails Europe?*, N.Y. TIMES, Feb. 26, 2012, at A19.

B. *Corporate Governance in Other Foreign Countries*

Although the primary focus of this Article is on Sweden, it should be noted that Sweden is not unique in its treatment of shareholders of public companies. The Nordic countries generally favor shareholder primacy.[61] In Europe it is well-established that "it is the general meeting [of shareholders] that decides on fundamental matters, such as the alteration of the articles."[62] As in Sweden,[63] European shareholders are not at each other's throats, but rather all voting matters tend to "receive[] overwhelming support of the shareholders."[64] In 2007, the European Shareholders Directive was issued, with the aim "to allow shareholders effectively to make use of their rights throughout the [European] Community."[65] The directive has lowered legal obstacles to proxy voting in the European Union[66] and has only furthered European shareholder primacy.

Britain also treats shareholders well:

> Shareholders in the United Kingdom are, in fact, far more powerful, and far more central to the aims of the corporation than are shareholders in the United States. U.K. shareholders possess considerably greater corporate governance authority and capacity to discipline errant officers and directors. In addition, U.K. shareholders benefit from fiduciary duties and a conception of corporate purpose that focuses far more clearly on their interests than

61. *See* Hansen, *supra* note 1, at 69 ("[T]he shareholder does enjoy an unrivalled position of power within Nordic limited companies, a position that only the most daring corporate governance initiatives in the rest of the world could even imagine.").

62. A. DORRESTEIJN, EUROPEAN CORPORATE LAW 193 (2009). In some countries the AGM also decides on dividends. *See* Christoph Van der Elst, *Shareholder Rights and Shareholder Activism: The Role of the General Meeting of Shareholders* 9 (ECGI Working Paper Series in Law No. 188/2012, 2012), *available at* http://ssrn.com/abstract=2017691. The AGM also generally fixes the remuneration of the directors. *See id.* at 13–15; *see also id.* at 18 ("[I]n some countries the general meeting is provided with specific rights regarding transactions between corporate incumbents and the company."). Even Japanese law, which traditionally gave shareholders very little power, is now "friendlier to hostile [takeover] bids than Delaware law." Henry Hansmann & Reinier Kraakman, *Reflections on the End of History for Corporate Law* 2 (Yale Law & Economics Research Paper No. 449, 2011), *available at* http://ssrn.com/abstract=2095419.

63. *See supra* notes 43–47 and accompanying text.

64. Van der Elst, *supra* note 62, at 28.

65. Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the Exercise of Certain Rights of Shareholders in Listed Companies 17, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:184:0017:0024:EN:PDF. Legislation pending in Switzerland would also enhance the shareholder role in corporate governance. *See* Benedict F. Christ, *How Activist Shareholders May Profit from Proposed Changes to Swiss Corporate Law*, 5 CORP. M&A NEWSLETTER 50 (Sept. 2012).

66. *See* Santella et al., *supra* note 5, at 301.

> is the case in any U.S. state—including Delaware . . . . The practical consequence is that U.K. shareholders loom much larger in the boardroom than U.S. shareholders do.[67]

As a result, relations between shareholders and managers are less contentious in Britain than here.[68]

In fact, American shareholders' rights are much weaker than those in many other developed countries.[69] Australia and Canada allow shareholders to place nominations for the board of directors on the corporate proxy statement,[70] a privilege not extended to American shareholders.[71] In other countries, shareholders have the power to amend the certificate of incorporation without board approval and to call special shareholder meetings.[72] Shareholders of Delaware corporations lack these powers.[73] In Denmark, shareholders must approve substantial corporate gifts.[74] This is significant because American CEOs often use corporate gifts to suborn supposedly independent directors.[75]

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67. Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. 579, 581–82 (2010). The British government has now proposed a binding shareholder vote on executive compensation. *See* Cleary Gottlieb Steen & Hamilton LLP, Alert Memo: Binding Shareholder Say-on-Pay Vote on Route to Reality in the UK: US Companies Take Note (July 9, 2012), *available at* http://www.cgsh.com/files/News/3b4b3be5-0f26-49ce-9c95-0bfd5207e8df/Presentation/NewsAttachment/2339ed13-5b2d-4e59-9830-0ce4ed80a645/CGSH%20Alert%20-%20Gov%20UK%20Binding%20Say%20on%20Pay.pdf.

68. *See* Santella et al., *supra* note 5, at 1 ("We also find through descriptive statistics that institutional investors in the US seem to have a more adversarial voting pattern vis-à-vis company managements than in the UK; this might be due to the fewer voting rights given to shareholders by the US regulatory framework.").

69. *See* Santella et al., *supra* note 5, at 275, 301.

70. *See* Robert McDermott & Sean Farrell, *Overview of Recent Corporate Governance Reforms*, GLOBAL CORPORATE GOVERNANCE GUIDE 2004, http://www.globalcorporategovernance.com/n_namericas/134_140.htm (last visited Sept. 6, 2012).

71. *See infra* note 170 and accompanying text.

72. *See* Jennifer Hill, *Evolving 'Rules of the Game' in Corporate Governance Reform*, 1 INT'L J. CORP. GOV. 28 (2008); Hansen, *supra* note 1, at 71 (stating that shareholders owning over 10% of the stock of Danish public companies can compel the board to convene a special shareholder meeting within two weeks).

73. *See* DEL. CODE ANN. tit. 8, § 211(d) (2009) ("Special meetings of the stockholders may be called by the board of directors . . . ."); DEL. CODE ANN. tit. 8, § 242(b)(1) (2010) (stating that an amendment of the certificate of incorporation requires first a resolution of the board and then majority shareholder approval).

74. *See* Danish Companies Act § 195; Hansen, *supra* note 1, at 73 (discussing this provision).

75. *See* George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213, 1241–43 (2008) [hereinafter Dent, *Academics in Wonderland*].

The supposedly sovereign power of American shareholders through voting is nothing more than an illusion.[76] Shareholder rights in the United States are so weak that Rupert Murdoch's News Corp. changed its incorporation from Australia to Delaware: "gaining access to Delaware's pro-managerial governance regime was an important aspect of the reincorporation decision."[77] "The net result of News Corp.'s move from Australia to Delaware was an appreciable reduction in shareholder rights and an enhancement of managerial powers, including the power to implement 'poison pills'—a power unavailable in Australia."[78]

II. THE RELEVANCE OF THE SWEDISH EXPERIENCE TO THE UNITED STATES

All of the evidence suggests that shareholder primacy works well for Sweden. This Part considers possible arguments as to why it would not work well in the United States, and in turn rebuts each of those arguments.

A. *Shareholder Conflicts*

One possible objection is that American "investors are dispersed, diverse and wholly unused to playing nomination roles even if companies were eager to test drive the [Swedish] practice."[79] This criticism seems unfounded. First, the physical dispersion of investors is unimportant in the age of electronic communication. The significance of their physical dispersion has been further reduced by the rise of proxy advisory services, which serve as de facto coordinators of proxy voting by institutional investors.[80] In turn, "institutional investors decrease information asymmetry" between management and shareholders.[81]

Moreover, Swedish investors are at least as physically dispersed as American shareholders. Forty percent of public company shares are held by foreign investors, many of which are American.[82] Finally, stock ownership in U.S. companies has been shown to be more concentrated

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76. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 701 (2007).

77. Jennifer G. Hill, *Subverting Shareholder Rights: Lessons from News Corp.'s Migration to Delaware*, 63 VAND. L. REV. 1, 50 (2010).

78. *Id.* at 49.

79. Stephen Davis & Jon Lukomnik, *Seeking Governance Inspiration—From Sweden?* 7 COMPLIANCE WEEK 1, 2 (2010), *available at* http://vlex.com/vid/seeking-governance-inspiration-sweden-229656983.

80. *See* Dent, *supra* note 75, at 1266–68.

81. Roni Michaely & Christopher Vincent, *Do Institutional Investors Influence Capital Structure Decisions?* 40 (Johnson School Research Paper Series No. 54-2011, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1941902.

82. *See supra* note 6.

than previously thought and may not be much more fragmented than in other industrialized countries.[83]

A related objection to shareholder power is that the interests of different shareholders vary; some allegedly do not want to maximize share value. These investors can wreak havoc by engaging in "empty voting"—in other words, by acquiring and exercising voting power in excess of their economic share ownership.[84] If shareholders had control, it is charged, public companies would be torn asunder by warring factions of investors.[85] Accordingly, investors actually *like* to be impotent: "shareholders will prefer to irrevocably delegate decisionmaking authority to some smaller group, as, in the long run, this will maximize shareholder wealth."[86]

This preference is supposedly evidenced by the frequency of antitakeover devices (ATDs) in the charters of companies going public through an initial public offering (IPO). If these devices impaired stock value by an amount greater than their value to the insiders, it is argued, efficiency dictates that they would not be there, so they must be efficient.[87]

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83. *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1377 (2009).

84. *See* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 626, 661–81 tbl.1 (2008) (listing more than eighty events of decoupling around the world); Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343, 344 (2007).

85. *See, e.g.*, Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1287 (2008); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577–93 (2006) (alleging various conflicts of interest among shareholders); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1751, 1754–57 (2006) (positing danger of special interest shareholders); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 661 (2006).

86. Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 624 (2006); *see also* Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 803 (2007) (implying that investors do not value strong shareholder rights); Lynn Stout, *Investors Who Are Too Bolshy for Their Own Good*, FIN. TIMES, Apr. 23, 2007, at 9 [hereinafter Stout, *Bolshy Investors*] ("[T]he modern trend toward greater 'shareholder power' has gone too far and is beginning to harm the very shareholder it was designed to protect.").

87. *See* Bainbridge, *Director Primacy*, *supra* note 85, at 1737; Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 358 (1991) (positing that "entrepreneurs selling stock to the public would bear the cost" of suboptimal corporate governance provisions); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 502 (2003) ("[W]e continue to believe that the IPO charter terms provide substantial evidence of appropriate governance structures."); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 853–56 (2002) ("[S]hareholders *act as if* they value corporate governance rules that insulate boards from hostile takeovers.").

Both these arguments have been questioned. Empty voting has not yet been a problem; those sounding the alarm have not shown a single instance where it altered the outcome of a shareholder vote. And empty voting is unlikely to become a problem. For outside investors, it depends on stock lending, which "is, to an important degree, self-policing."[88] One situation in which disparate voting and economic interests may cause serious problems is dual class stock (where a corporation has multiple classes of voting stock with disparate voting rights).[89] In these situations, however, the holders of superior voting rights are always insiders, not institutional investors.[90]

Except for a few types of shareholders—such as labor unions, politically motivated investors, and investors who do business with the company—who typically hold just a small fraction of a company's stock, and whose identity and motives are well known to other shareholders, nearly all shareholders favor the goal of maximizing share price.[91] This fact is demonstrated by the lack of actual shareholder conflicts at shareholder meetings: "shareholders do not have the kinds of disputes one would expect if they were a diverse group of Americans engaged in a struggle to make corporations in their images."[92] On the other hand, investors have not mounted all-out corporate wars to end

88. Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 25 (2006); *see also* Reena Aggarwal et al., The Role of Institutional Investors In Voting: Evidence from the Securities Lending Market, *available at*, http://ssrn.com/abstract=2023480 (study finding that institutional investors often restrict or call back their loaned shares prior to the record date in order to exercise their voting rights, especially for portfolio companies with weaker corporate governance, weaker performance, higher institutional ownership, and when antitakeover or compensation proposals are on the ballot); Alon Brav & Richmond D. Mathews, *Empty Voting and the Efficiency of Corporate Governance*, 99 J. FIN. ECON. 289 (2011) (using an economic model to show that empty voting can be beneficial but may warrant additional disclosure requirements); Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 67 (2011); George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 111–15 (2010) [hereinafter Dent, *Essential Unity*]; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1076 (2007) (questioning whether empty voting is a significant problem).

89. *See* Ronald W. Masulis et al., *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1715 (2009) ("[A]s insider voting rights rise relative to cash flow rights, dual-class firms tend to make less profitable capital investments, consistent with the firms making investment decisions in pursuit of private benefits rather than shareholder wealth maximization.").

90. *See* DALE A. OESTERLE, MERGERS AND ACQUISITIONS IN A NUTSHELL 263 (2d ed. 2006) (stating that higher-voting stock is "sold exclusively to insiders"); *id.* at 266 (stating that in "time-phased" voting plans, "[i]nsiders hold and outsiders trade," with the result that insiders wind up holding more of the higher-voting stock).

91. *See* Dent, *Essential Unity*, *supra* note 88, at 105–22.

92. Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1043 (1996). *See also* Dent, *Essential Unity*, *supra* note 88, at 119–22.

CEO domination and seize power for themselves.[93] Even if they do not crave CEO domination, perhaps they are indifferent about it.

Some believe that investors' failure to wage war stems not from their satisfaction with CEO dominance but from unfavorable default rules,[94] the high cost of corporate warfare, and the shareholders' collective action problem.[95] Among other things, management can pay for its proxy campaign from the corporate treasury (that is, with the shareholders' own money), while shareholders must finance their fight through voluntary contributions. Although all stockholders share pro rata in any benefits realized by a proxy fight, no shareholder can be compelled to help finance the effort. This ability of shareholders to "free ride" makes a broad-based proxy fight impossible in practice. As a result, proxy fights are extremely rare.[96]

Market behavior confirms this skepticism that investors are content with CEO dominance. Companies with strong shareholder rights out-perform others.[97] In the recent financial meltdown, boards of directors in general "played an abysmal role."[98] However, firms with boards with "true independence"—that is, with a majority of directors with no compromising connections with the CEO—performed better than others during the crisis.[99] The experience suggests that boards should be *more* accountable to shareholders, not less.

The persistence of poison pills and other ATDs in IPOs is indeed a problem for advocates of shareholder primacy, but not a huge one. The

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93. "CEO domination" is a more accurate characterization of most public companies today than "director primacy." *See infra* note 153 and accompanying text.

94. For example, in Delaware, amendment of the corporate charter requires first a resolution of the board, then a shareholder vote. *See* DEL. CODE ANN. tit. 8, § 242(b)(1). Thus, it is impossible for investors to amend the charter in the face of an entrenched board, no matter how large the majority in favor of change.

95. *See* Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 338–49 (2010) (describing some of the impediments to shareholder action).

96. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 559 (2005).

97. *See* Vidhi Chhaochharia & Luc Laeven, *Corporate Governance Norms and Practices* 33 (IMF, CEPR & ECGI Working Paper, 2008), *available at* http://ssrn.com/abstract=1103608 (finding that firm-level pro-shareholder governance features are associated with higher market valuation of the firm); Dent, *Essential Unity*, *supra* note 88, at 120–21; *cf.* Reena Aggarwal et al., *The Impact of Corporate Governance Mandates on Poorly Governed Firms* 29 (Georgetown University McDonough School of Business Working Paper, 2012), *available at* http://ssrn.com/abstract=2023879 (finding that companies required to adopt greater board independence by the Sarbanes–Oxley Act of 2002 experienced a relative increase in firm value and in the likelihood of CEO turnover and relatively better earnings quality).

98. Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 352 (2012).

99. *See* Bill Francis et al., *Do Corporate Boards Affect Firm Performance? New Evidence From the Financial Crisis* 35 (Bank of Finland Research Discussion Paper No. 11, 2012), *available at* http://www.ssrn.com/abstract=2041194.

cost of ATDs is borne by all the pre-IPO shareholders but benefits only those who have control.[100] There are often tax benefits to executives from underpricing an IPO,[101] so the executives may prefer to have ATDs that benefit them, even at the cost of a lower price for the stock in the IPO.

Further, most IPOs sell much less than half a company's stock to the public, so most new public firms do not have enough publicly traded stock to make a hostile takeover even a mathematical possibility. The detriment of the poison pill to stock value, then, must be discounted for the probability that the company will not be a takeover target for many years and likely will never be a target.

If ATDs are properly priced and the control group accepts their cost, then investors should have no cause to complain about them, but it's not at all clear that this is the case. Underwriters and others who participate in pricing IPOs can only guess at the effect of myriad factors on the stock's market value, of which ATDs are just minor ones.[102] Many purchasers in IPOs are individuals who are not very sophisticated; the selling team may calculate (rightly or wrongly) that these customers do not properly value strong corporate governance.[103] In sum, there are too

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100. *See* Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 716 (2003) (noting that those who "will continue to run the firm after the IPO . . . will fully capture the benefits of [ATDs] and will bear only part of the cost of the reduced IPO share price"). There may also be personal benefits to the managers (as opposed to the outside investors) of venture capital firms that are usually major shareholders of IPO firms. *See* Dent, *Academics in Wonderland*, *supra* note 75, at 1257.

101. In about one-third of IPOs from 1996 to 2000, executives received stock options at an exercise price equal to the IPO offering price. *See* Michelle Lowry & Kevin J. Murphy, *Executive Stock Options and IPO Underpricing*, 85 J. FIN. ECON. 39, 40 (2007). In one study, over half of these executives realized a net profit from underpricing of the IPO. *Id.* at 43–45 & tbl.1. Further, by retaining control, insiders can extract perquisites (like luxurious offices and expense accounts) that are not taxed at all. *Cf.* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 85 (2001) (positing that ATDs may be used in IPOs to protect incumbents' large private benefits). In effect, the U.S. Treasury bears some of the inefficiency costs of ATDs. IPOs may also be deliberately underpriced for various reasons. *See, e.g.*, Kathleen Weiss Hanley & Gerard Hoberg, *Litigation Risk, Strategic Disclosure and the Underpricing of Initial Public Offerings*, 103 J. FIN. ECON. 235, 252 (2012) (concluding that IPOs are often underpriced as a hedge against lawsuits).

102. *See* Daines & Klausner, *supra* note 101, at 113 ("Perhaps governance terms are expensive for investors to price at the time of the IPO. This would allow management to get protection at low (or no) cost."). The cost of ATDs varies from firm to firm, and it would be costly for analysts and investors to calculate that cost in each individual case. *See* Michael D. Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 776–77 (2003).

103. IPOs are heavily marketed to unsophisticated "sentiment" or "noise" investors. *See* François Derrien, *IPO Pricing in 'Hot' Market Conditions: Who Leaves Money on the Table?*, 60 J. FIN. 487, 497 (2005); Alexander P. Ljungqvist et al., *Hot Markets, Investor Sentiment, and IPO Pricing* 31, 34–36 & fig.1 (AFA San Diego Meetings, 2003), *available at*

many uncertainties in the IPO process to consider the persistence of ATDs conclusive proof of their efficiency.

Moreover, the use of most ATDs is discretionary with the board of directors, and the board is supposed to act in the interests of the shareholders in handling takeover bids.[104] Clearly ATDs can be used to benefit shareholders, as when a board uses a poison pill to hold a bidder at bay while the board seeks a higher bid. Problems arise only when a board employs ATDs to benefit the managers, not the shareholders. If American boards were responsive to shareholders, as they are in Sweden, ATDs would not be a problem.

The experience of Sweden provides strong evidence that all the concerns about shareholder primacy are unfounded. Shareholder control has not led to warfare among different investors.[105] The current Swedish situation has evolved slowly, so it is impossible to perform an event study of how the change affected Swedish stock prices. Moreover, the former situation in Sweden was typically domination by one or two shareholders, so it is unclear whether adoption of the new system affected stock prices there as much as it would if that system were instituted here. However, it is significant that none of the players in Sweden are complaining about shareholder primacy because of inter-shareholder conflicts—or for any other reason. Neither are British investors complaining about their greater power generally or, specifically, about the absence of antitakeover devices in Britain.

It is true that American investors are "wholly unused to playing nomination roles" because they have been rigorously excluded from a major role in corporate governance, but the transfer of such power did not cause problems in Sweden.[106] Moreover, some American investors are already preparing for such a role. "CalPERS is leading a quiet project designed to create a pool of pre-selected investor-oriented directors. Funds could tap them when using access rights."[107]

B. *Investor "Short-Termism"*

Another objection to shareholder primacy in America is that many American investors are alleged to be short-sighted.[108] Like the claim of

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http://ssrn.com/abstract=282293. It is not surprising, then, that "IPOs have provided public market investors with low returns throughout the last three decades." Xiaohui Gao et al., *Where Have All the IPOs Gone?* 1 (Working Paper, 2011), *available at* http://ssrn.com/abstract=1954788.

104. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

105. *See supra* notes 44–48 and accompanying text.

106. *See supra* notes 40–48 and accompanying text.

107. Davis & Lukomnik, *supra* note 79, at 2.

108. *See, e.g.*, MICHAEL T. JACOBS, SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA (1991).

fundamental shareholder conflicts, this charge has always seemed dubious on its face. Rational investors should favor long-term projects that will maximize long-term shareholder wealth.

Corporate finance theory confirms this intuition. The Efficient Capital Markets Hypothesis (ECMH) holds that capital markets efficiently price securities at the present value of all expected future returns.[109] The short-termism theory posits that wise long-termist managers are pressured by short-termist shareholders (like hedge funds) into adopting policies that will damage the company in the long run (like cutting research and development). If this were so, the very news of hedge fund activism would alert shareholders to the looming blunder. Even if investors did not realize this on their own, the company's far-sighted managers would protest, and the awakened shareholders would rally behind them. In fact, this does not happen, and other investors do not flee companies targeted by hedge fund activists; rather, they hang on or jump in.[110]

Further, according to the ECMH, if a company makes unwise changes of any kind, the market should recognize the wrong turn and send the company's stock price down. Yet, all the evidence of hedge fund activism is to the contrary: "Hedge fund intervention does not as a systemic matter impact negatively on" research and development.[111] "[T]argets of intense hedge fund activism . . . show strong improvements in operating performance,"[112] "including both productivity and profitability gains at the plants of the targeted companies."[113] "[H]edge fund activists facilitate improvements in terms

109. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 347–70 (7th ed. 2003) (describing and documenting the hypothesis).

110. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1773 (2008) [hereinafter Brav et al., *Hedge Fund Activism*]; Kahan & Rock, *supra* note 88, at 1091–92 (stating that traditional institutional investors are happy to "tag[ ] along" with activist hedge funds). The acceptance of hedge fund activism by other investors also indicates that they expect all shareholders to benefit from it, not just the hedge fund. *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure* 13–14 (Harvard Law & Economics Discussion Paper No. 702, 2011), *available at* http://ssrn.com/abstract=1884226; Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism*, 32 J. CORP. L. 681, 701–02 (2007). Correlatively, hedge funds profit from an increase in the portfolio company's stock price, in which all stockholders share, and not from private benefits. *See* Cheffins & Armour, *supra* note 88, at 67.

111. William W. Bratton, *Hedge Funds and Governance Targets: Long-Term Results* 15 (Institute for Law & Economics Research Paper No. 10-17, 2010), *available at* http://ssrn.com/abstract=1677517.

112. Nicole M. Boyson & Robert Mooradian, *Intense Hedge Fund Activists* 1 (Northeastern University Working Draft, 2010), *available at* http://ssrn.com/abstract=1571728. In a broad attack on short-termism by many players in the corporate and financial worlds, including many investors, Professor Lynne Dallas recognizes that activist hedge funds are not the villains. Dallas, *supra* note 98, at 306–09.

113. Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Risk, and*

of both production efficiency and capital re-allocation."[114] Stock prices of companies targeted by hedge funds tend not only to rise but also to retain their gains.[115] The latter phenomenon is hardly surprising since any tendency for the share prices of targeted companies first to rise and later to fall would violate the ECMH.[116]

Allegations of short-termism are further belied by the published positions of Institutional Shareholder Services, the leading proxy advisory firm. Its declared approach to evaluating pay-for-performance features evaluations over three- and five-year periods.[117] As one commentator has said of the charge of short-termism, "there is not a lot of empirical data to back it up."[118] Another has stated, "no one has *demonstrated* that the long/short phenomenon exists."[119]

Product Market Competition 26 (NBER Working Paper No. w17517, 2011), *available at* http://ssrn.com/abstract=1944424.

114. *Id.*

115. *See* Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 370 & fig.1 (2009) (empirical study finding that companies subjected to hedge fund activism earn positive abnormal returns); Brav et al., *Hedge Fund Activism*, *supra* note 110, at 1729 ("The abnormal return around the announcement of [hedge fund] activism is approximately 7%, with no reversal during the subsequent year."); Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUNDS. & TRENDS IN FIN. 185, 208–30 (2009); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 187 (2009) (empirical study finding "a significantly positive market reaction for the target firm around the initial Schedule 13D filing date [by activist hedge funds, and] significantly positive returns over the subsequent year").

116. If such a pattern could be perceived, astute investors would sell the company's stock and sell it short before it dropped. But if shrewd shareholders did that, the stock price would never rise to begin with. And if the stock price never rose to begin with, hedge funds could not profit by this ploy. It is telling that no advocate of the short-termist hypothesis has advocated investing on the basis of its corollary market postulates.

117. *See* GARY HEWITT & CAROL BOWIE, INST'L S'HOLDER SERVS., EVALUATING PAY FOR PERFORMANCE ALIGNMENT: ISS' QUANTITATIVE AND QUALITATIVE APPROACH 3 (Feb. 17, 2012), *available at* http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf. The statement says further: "Business cycles and compensations plans' performance cycles span multiple years. An assessment of alignment between shareholders and executives should accordingly see pay across timeframes that approach the length of performance and business cycles." *Id.* at 6.

118. Joe Nocera, *A Defense of Short-Termism*, N.Y. TIMES, July 29, 2006, at C1. "Baruch Lev, the well-known accounting professor at New York University . . . scoffs at the notion that short-termism is even a problem." *Id.*

119. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 13 (1991); *see also* Luigi Zingales, *The Future of Securities Regulation*, 47 J. ACCT. RES. 391, 415 (2009) ("While popular, I do not know of any empirical support for this view."). *See also* Ben W. Heineman, Jr. & Stephen Davis, Are Institutional Investors Part of the Problem or Part of the Solution? 24 (Yale Sch. of Mgmt., Millstein Ctr. for Corp Governance and Performance), *available at* http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/80235_CED_WEB.pdf ("defining the actual problem [of short-termism] with specificity is both empirically and conceptually difficult"). Of course, many investors tend to hold stocks only for a short period of time. However, that does not mean that they advocate policies that would

Legitimate questions have been raised about how well stock market prices reflect fundamental (or intrinsic) value.[120] However, most of these questions concern broader market behavior, such as the persistence of the housing market bubble, not the mispricing of individual stocks within an industry. Moreover, for the short-termist hypothesis to be valid, markets cannot just be occasionally, slightly, and randomly inaccurate; they must be frequently and substantially inaccurate in the same, predictable way. Thus the short-term scam artists must fool the stock market repeatedly, despite warnings of managers, who are routinely vindicated but continue to be ignored by investors. If this actually happened, it would raise questions not only about shareholder primacy but about the very idea of markets and a market economy.

Leveraged buyouts (LBOs) are sometimes claimed to demonstrate the existence of short-termism. LBOs occur, it is argued, because shareholders of a public company coerce its managers to pursue a short-term strategy; an LBO puts the company into private hands, freeing it from these malevolent pressures.[121] Certainly managers of firms undergoing LBOs often give this explanation for the transaction.

One problem with this explanation is that many investors in the private equity funds that perform LBOs are the same investors that are supposedly the short-termist demons tormenting public companies. Why they would be short-termists in one context and patient capitalists in another is not explained. More important, LBOs invite a very different explanation: public companies incur agency costs. That is, managers follow the typical human tendency to benefit themselves rather than others—namely, the shareholders for whom they are fiduciaries—whereas, shareholders are unable to curb the managers' self-serving behaviors.[122] Thus, a powerful CEO has become more or less synonymous with the concept of waste.[123] An LBO replaces

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impair long-term value.

120. *See* Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435, 1439–40 (2005) (alleging that the relationship between the two is "extremely loose") [hereinafter *Takeovers in the Ivory Tower*]; Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 636 (2003).

121. *See* Dale A. Oesterle, *Are Leveraged Buyouts a Form of Governance Arbitrage?*, 3 BROOK. J. CORP. & COM. L. 53, 67 (2008); Stout, *Bolshy Investors*, *supra* note 86 (stating that private companies can "avoid dealing with public shareholders' loud and often conflicting demands").

122. *See* Michael C. Jensen, *Eclipse of the Public Corporation* 6 (Harvard Business Review, 1989), *available at* http://ssrn.com/abstract=146149 (last updated 1997).

123. *See* Clara Xiaoling Chen et al., *The Agency Problem, Corporate Governance, and the Asymmetrical Behavior of Selling, General, and Administrative Costs*, 29 CONTEMP. ACCT. RES. 252 (2012).

numerous, scattered public shareholders with a sophisticated LBO firm that can monitor the managers and design compensation packages that induce them to abandon the wasteful practices that were indulged when the company was public and instead to render their optimal performance.

This curbing-agency-costs explanation seems more plausible than the eliminating-short-termist-public-shareholders rationale.[124] After LBOs, firms often cut unnecessary expenses, sell off unsuitable assets, and lay off unprofitable employees—steps consistent with the former explanation—rather than expanding research and development and inaugurating new projects, which would be predicted by the latter rationale.[125] After LBOs, firms' executive compensation is also "redesign[ed] . . . away from earnings-based and non-financial" bonus criteria to stock options conditioned on performance.[126] Of course, firm managers prefer to ascribe the LBO to impetuous investors, rather than to their own behavior, but these claims are not credible.

Although the interest of shareholders is to maximize the value of the equity, the managers do not always share that interest. Sometimes managers may profit from short-term measures. They may doctor a company's financials and other public disclosures in order to mislead the market and inflate the company's stock price and then unload their stock at the inflated price before they reveal the truth, causing the stock price to fall back to its proper level.[127] Outside investors do not control

124. *See* Dent, *Essential Unity*, *supra* note 88, at 128–30.

125. *See* John Haltiwanger et al., *Private Equity and Employment* 4, 33 (NBER Working Paper No. w17399, 2011), *available at* http://ssrn.com/abstract=1931170 (empirical study finding that employment declines on average six percent over five years after an LBO, and reductions are greater in public-to-private buyouts).

126. Henrik Cronqvist & Rüdiger Fahlenbrach, Abstract, *CEO Contract Design: How Do Strong Principals Do It?* (Swiss Finance Institute Research Paper No. 11-14, 2011), *available at* http://ssrn.com/abstract=1786132; Robert J. Jackson, *Private Equity and Executive Compensation*, 60 UCLA L. REV. (forthcoming 2012) (finding that "the total amount of CEO pay is similar in [public and private-equity owned] firms, but that private equity owners tie CEO pay much more closely to performance").

127. *See* ROBERT H. TILLMAN & MICHAEL L. INDERGAARD, PUMP AND DUMP: THE RANCID RULES OF THE NEW ECONOMY 4–5 (2005); David C. Cicero, *The Manipulation of Executive Stock Option Exercise Strategies: Information Timing and Backdating*, 64 J. FIN. 2627, 2627–28 (2009) (examining stock price patterns that suggest executives use private information to increase the profitability of stock option exercises); Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667, 667 (2007) ("[T]he likelihood of a misstated financial statement increases greatly when the CEO has very sizable holdings of in-the-money stock options."); Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 456 (2008) ("[M]anagers . . . often inflate the short-term stock price before selling to boost their trading profits."). A recent study finds that investment myopia is associated with an aging CEO, but that this tendency is countered by large shareholdings of institutional investors. Jaideep Chowdhury, *Managerial Myopia: A New Look* 37 (James Madison University Research Paper, 2011), *available at*

the company's disclosures and therefore cannot engage in such schemes. Accordingly, it should not be surprising that managers were more responsible than investors for the imprudent choices that led to the recent financial crisis.[128] One recent study of firms' sensitivity to growth opportunities finds "significant distortions as a result of managerial myopia."[129] However, "[c]onsistent with an agency explanation, this investment distortion disappears when we conduct similar tests using only firms with strong corporate governance."[130] In other words, shareholder power is not the cause of, but rather a counter to, short-termism. On the other hand, managers may engage in empire building—that is, they may undertake projects that do not promise at least a market rate of return because those projects will expand the company and justify greater compensation and perquisites.

Of course, managers may honestly disagree with the proposals of activist shareholders. Given the difficulty of predictions in business, it is certain that the activists are not always right and the managers always wrong. However, the market evidence indicates that the investors are usually right. Shareholder primacy should lead to less short-termism, not more, as well as less empire building.

Moreover, we have the benefit of the Swedish experience. There is some evidence that Swedish shareholders tend to hold their stock for longer periods than American investors do. However, there is no requirement that shareholder representatives on Swedish nominating committees have held their stock for any minimum period of time before gaining representation on the nominating committee or that they commit to retain their stock for any minimum period.[131] There is no evidence that shareholder primacy has caused Swedish companies to abandon long-term projects, or to go private in order to escape the tyranny of short-termist investors.[132] Nor is there any such evidence in Britain or other nations that give shareholders more power than the

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http://ssrn.com/abstract=1991429. In other words, it is the institutional investors that take a long-term view, while at least older CEOs are the short-termists.

128. *See* Dallas, *supra* note 98, at 352; *see also supra* note 100 and accompanying text.

129. Jaideep Chowdhury & Jason D. Fink, *Managerial Myopia: Tests and Implications* 2 (James Madison University Research Paper, 2012), *available at* http://ssrn.com/abstract=2055353.

130. *Id.* at Abstract.

131. In one reported incident, an investor purchased a company's stock just to get representation on the nomination committee. *See* Engvall & Holmberg, *supra* note 3, at 2. However, this ploy "met strong resistance" from other shareholders. *Id.* It is not clear what an investor could hope to accomplish that would injure other shareholders, and I do not know of any incidents where any damage has been caused to the companies in question. Some have suggested that full voting rights be limited to shareholders who have owned their stock for a substantial period of time. *See* Dallas, *supra* note 98, at 351–53. The Swedish experience suggests that this is unnecessary, at least for purposes of representation of a shareholder nominating committee.

132. *See supra* notes 49–51 and accompanying text.

United States does.

No one has suggested why American investors would be less rational than investors in these nations. Indeed, American institutions have major investments in Sweden,[133] and they have not clashed with other shareholders there. Are we to believe that these investors are short-termists in America but not in Sweden?

But even if the short-termism of some investors is cause for concern, it seems that the Swedish system would combat rather than exacerbate the problem. A large shareholder gets only to appoint one member of the nominating committee, which nominates a slate of directors at the next annual meeting. Thus, the shareholder must wait at least a year before having any influence on the composition of the board. A longer wait—probably much longer—would be necessary before the board could alter corporate operations. Indeed, because the Swedish system makes the board responsive to the shareholders and not to the CEO, it ultimately makes it harder for a short-termist activist to complain that an incumbent board is flouting shareholder interests. In sum, the evidence from Sweden and elsewhere is that shareholder control does not cause any problems of short-termism.

C. *Shareholder Ignorance*

Other commentators have argued against shareholder primacy because investors lack the knowledge requisite to run corporations.[134] They concede that in theory there is a difference between managing and choosing the (best) people to manage, but they insist that in reality the latter necessarily entails the former.[135]

Like the other critiques of shareholder power, this one seems unconvincing. A patient can seek and choose the best brain surgeon without interfering with his operation. In any number of fields individuals and organizations choose agents, monitor their performance, and replace agents who are perceived to be inadequate. The process of

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133. *See supra* note 7 and accompanying text.

134. *See* Stephen M. Bainbridge, A *Comment on the SEC Shareholder Access Proposal* 13 (UCLA School of Law, Law & Econ. Research Paper No. 03-22, 2003), *available at* http://ssrn.com/abstract=470121 ("Shareholders have neither the information nor the incentives necessary to make sound decisions on either operational or policy questions."); Stout, *Takeovers in the Ivory Tower*, *supra* note 120, at 1443 (alleging that investors are "often driven by emotion and cognitive bias"); Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2012) ("[S]hareholders are at an informational disadvantage in nominating directors relative to directors.").

135. *See* Stephen M. Bainbridge, *Director Primacy* 13 (UCLA School of Law, Law-Econ. Research Paper No. 10-06, 2010), *available at* http://ssrn.com/abstract=1615838 ("[G]iving investors this power of review differs little from giving them the power to make management decisions in the first place."); *see also* Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 FLA. L. REV. 1, 3–4 (2009).

monitoring may well intrude on the agent's performance, and a principal may choose not to exercise a right to interfere with the agent's performance, but monitoring need not and typically does not substantially impair the benefits of the agent's expertise.

Expertise and informational advantage are not the sole or even the most important, concerns; one must also consider the parties' incentives. Agents and fiduciaries have an incentive to favor their own interests over those of the beneficiaries. That is why we subject agents—no matter how expert they are—to the authority of the principal and fiduciaries to fiduciary duties. That is why we do not let CEOs set their own compensation or make corporate boards formally self-perpetuating.

Some evidence in America contradicts the shareholder-ignorance thesis. The quality of equity compensation proposals improved after the Securities and Exchange Commission (SEC) began requiring shareholder approval of all equity-based executive compensation plans, policies, and practices for large public companies in 2003,[136] and this shareholder "say on pay" has worked well.[137] Similarly, adoption of a majority (rather than plurality) voting requirement for election to a board of directors is also associated with enhanced equity values.[138] Among other things, shareholders have worked to eliminate staggered boards—widely accepted as harmful to the success of a company[139]—and the presence of a large block-holder on a board of directors has resulted in higher (not lower) capital expenditures.[140] Evidently, shareholders know what they are doing.

136. *See* Lilian Ng et al., *Does Shareholder Approval Requirement of Equity Compensation Plans Matter?*, 17 J. CORP. FIN. 1510, 1527 (2011).

137. *See* GREG RUEL, GMI RATINGS, GMI'S SAY ON PAY REVIEW: POTENTIAL SAY ON PAY FAILURES FOR 2012 (Nov. 2011), *available at* http://www3.gmiratings.com/wp-content/themes/gmi/images/pdf/1772gmi_sayonpayreview_112011.pdf; Steven Balsam & Jennifer Yin, *The Impact of Say-on-Pay on Executive Compensation* 22–23 (Research Draft, 2012), *available at* http://ssrn.com/abstract=2026121 (empirical study finding, among other things, that "affected firms shifted their compensation mix to more performance-based compensation" and that "shareholder voting on say-on-pay is not random, but systematically related to compensation practices"). It is embarrassing that there is even a debate about "say on pay" given that Sweden requires a *ninety percent* vote for approval of executive equity compensation. *See supra* note 39 and accompanying text.

138. Yonca Ertimur, et al., *Does the Director Election System Matter? Evidence from Majority Voting* 27–28 (2012), *available at* http://ssrn.com/abstract=1880974.

139. *See*, *News Alert*, THE HARV. L. SCH. S'HOLDER RIGHTS PROJECT (Mar. 19, 2012), http://srp.law.harvard.edu/newsletters/03-19-2012_SRP-News-Alert.html (announcing efforts by several institutional investors).

140. *See* Anup Agrawal & Tareque Nasser, *Corporate Financial and Investment Policies in the Presence of a Blockholder on the Board* 24 (5th Annual Conference on Empirical Legal Studies Paper, 2011), *available at* http://ssrn.com/abstract=1783891.

Moreover, with respect to corporate governance the Swedish experience refutes Professor Stephen Bainbridge's position that shareholders lack the information and incentives to participate usefully in corporate governance.[141] Nomination committees are not supposed to interfere with actual management, and they do not.[142] There is no reason why shareholder primacy would operate any differently here.

D. *Self-Dealing by Powerful Shareholders*

Another possible concern about shareholder primacy is the possibility of self-dealing by newly empowered shareholders. However, most large investors (like mutual and pension funds) do not engage in activities that would lend themselves to self-dealing, not to mention the several hurdles that would have to be overcome to achieve these unfair profits. First, self-dealing is a breach of fiduciary duty (unless the controlling shareholder sustains the burden of proving that the transaction was entirely fair to the company).[143] Second, under no scenario for effecting shareholder primacy would a single minority shareholder dominate the committee that nominates directors, much less the board itself.[144] Any attempt at self-dealing should be apparent to other members of the nomination committee and to the directors, who would have to approve the transaction. It is hard to imagine that a single minority shareholder could bully this large cast of sophisticated characters into accepting a transaction that would injure the company.

Moreover, the Swedish experience belies this worry, too. It is telling that small shareholders first proposed the Swedish system and that the self-dealing potential of representation on the nomination committee is so remote that some eligible shareholders have waived representation.[145] Self-dealing by shareholders that are represented on the NC has not posed any problems.[146]

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141. *See* Bainbridge, *supra* note 134.

142. There is a clear understanding that a nominating committee "is not taking over the job of a board. Strategic decisions are delegated to the board and the shareholders have no say in those decisions . . . ." TOMORROW'S CORPORATE GOVERNANCE, *supra* note 5, at 26.

143. In reviewing self-dealing transactions, courts use phrases like "entire fairness," *see, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1112 (Del. 1994); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985), "intrinsic fairness," *see, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971), and "closest scrutiny," *see, e.g.*, Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc., 430 N.W.2d 447, 452 (Iowa 1988).

144. Under my own proposal each of the largest shareholders would have one of ten to twenty seats on the nomination committee. *See* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907–11 (1989).

145. *See supra* note 53 and accompanying text.

146. *See supra* notes 52–55 and accompanying text.

Of course, it is not impossible that empowered shareholders might occasionally exploit their positions for individual profit. However, no human institution is immune from abuse. The proper question is not whether shareholder primacy would be perfect, but whether it would be better than the alternatives. American public companies already suffer often from self-serving conduct by executives.[147] Directors are supposed to prevent such conduct, but managers often subvert the directors' independence.[148] If shareholders controlled, they would have strong incentives to curb such activity. Perhaps shareholder primacy would not completely eliminate self-dealing, but almost certainly it would reduce it considerably.

E. *Employees and the Social Welfare System*

Swedish law also treats workers differently than American law does in both corporate governance and in employment law. About 65% of private sector workers in Sweden are unionized.[149] Further, "Swedish law requires that at least three board members represent the employees."[150] However, that is a separate issue from the division of power between, on one side, executives and the board and, on the other, the shareholders.

Professor Christopher Bruner argues that the treatment of employees in corporate governance must be viewed not in isolation but in light of "the deep connection between corporate governance and numerous other forms of regulation that condition relationships within the corporate enterprise."[151] In particular, in America, employers are expected to provide employees with "the very things that government

147. *See* Dent, *supra* note 75, at 1244–49.

148. *See id.* at 1240–44.

149. *See* Ander Kjellberg, *The Decline in Swedish Union Density Since 2007*, 1 NORDIC J. OF WORKING LIFE STUDS. 67, 70 tbl.2 (2011).

150. Johanson & Østergren, *supra* note 2, at 530. The significance of this requirement should not be exaggerated. Employee representatives

> participate in the board work on equal terms with members appointed by the general meeting with the same duties, rights and responsibilities. As such, they must represent the interest of the company and not (at least not legally) the interests of the employees. This system seems to work although (or perhaps because) employee representatives are commonly known to be rather quiet in the board meetings.

Evis Sinani et al., *Corporate Governance in Scandinavia: Comparing Networks and Formal Institutions*, 5 EUR. MGMT. REV. 27, 33 (2008). For a general description of this system of "co-determination," see Carlsson, *supra* note 6, at 1039–41. In any case, co-determination now "is clearly on its way out, and European law and practice as a whole are moving quickly toward the standard shareholder-oriented model." Hansmann & Kraakman, *supra* note 62, at 11.

151. Bruner, *supra* note 67, at 650.

programs do in other countries, namely, protecting workers against the risk of lost income, and providing health and retirement benefits."[152]

Even assuming this characterization to be true, it is still unclear how it is relevant to the debate between shareholder primacy and America's current regime, which is to a large extent CEO primacy.[153] To maximize shareholder wealth, employees should be paid only what the market demands for that purpose. If employees are treated better under the American system of CEO domination, then CEOs must be paying employees *more* than that amount.

On its face this possibility seems barely plausible. CEOs who can divert substantial funds from investors may toss a few pennies to their employees—and by so doing, CEOs could profit by gaining the admiration of those with whom they work daily. However, one would expect CEOs to keep most of the surplus for themselves as well as for the directors and other high executives whose support is necessary or convenient to the CEO. Thus, Professor Lucian Bebchuk dismisses the "employee benefit" justification for CEO domination as a mere cover for management entrenchment and "management slack."[154] The empirical literature seems to confirm this skepticism. There is little or no difference between the compensation of employees of public companies, where shareholder primacy is rare, and employees of privately-owned companies, in which, almost by definition, shareholders exercise ultimate control.[155]

In arguing against shareholder primacy, Professor Christopher Bruner invokes the experience of Walmart, which "endeavored to boost returns for shareholders at the expense of other constituencies by 'shifting health care costs' to employees and to taxpayers funding limited state health care programs," but ultimately abandoned this attempt because of broad public opposition.[156] The choice of this

152. *Id.* at 638 (citing David Charny, *The Employee Welfare State in Transition*, 74 TEX. L. REV. 1601, 1606 (1996)).

153. *See* Dent, *Academics in Wonderland supra* note 75, at 1240–44; Z. Jill Barclift, *Corporate Governance and CEO Dominance*, 50 WASHBURN L.J. 611, 611 (2011). Others use the term "board capture" for domination of boards by CEOs. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 61–79 (2004).

154. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 837, 908–13 (2005).

155. *See* Frank R. Lichtenberg & Donald Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior*, 27 J. FIN. ECON. 165, 166–67, 184–93 (1990) (finding higher productivity after an LBO and that this was not a result of reduced research and development, wages, capital investment, or layoffs of blue collar workers); Paige Parker Ouimet & Rebecca Zarutskie, *Acquiring Labor* 40–41 (2011), *available at* http://ssrn.com/abstract=1571891 (finding that many acquisitions are motivated by a desire to acquire the target's employees and that in these cases wages rise substantially after an acquisition).

156. Bruner, *supra* note 67, at 642.

precedent is ironic because Walmart, although publicly traded, is still effectively controlled by the corporation's founding family. In other words, the incident proves the opposite of what Professor Bruner intended—it illustrates the irrelevance of corporate governance structure to the vulnerability of well-known retail companies to public opinion.

To support his thesis, Professor Bruner offers another example—opposition to leveraged hostile tender offers because of their supposed detrimental effect on employees.[157] He is right that this concern was often expressed as a justification for allowing incumbent, CEO-controlled boards of directors to thwart tender offers that shareholders favored, but it is unclear whether the concern was a valid basis for public opposition, rather than a convenient ruse fabricated by executives seeking to entrench themselves through legislation to be adopted by compliant lawmakers. If the effects of takeovers on employees had been a serious public concern, there would have been no reason to distinguish between hostile and friendly takeovers, and thus the power to thwart takeovers should have been conferred on the employees themselves rather than their bosses. Of course, such legislation was never even suggested, much less adopted.

If the concern had been about *leveraged* acquisitions—which might raise *some* valid concerns for workers[158]—legislatures could have singled out mergers financed with debt. They did not. Moreover, if Professor Bruner's distinction between CEO domination and shareholder primacy were central, antitakeover legislation should have distinguished between acquisitions by public companies, which generally feature the former, and acquisitions by private companies, which are generally shareholder-controlled. Again, no such law was even proposed. Antitakeover laws seem to serve primarily to benefit incumbent managers. Although labor representatives may have gone along with these laws, they made no great effort to mold them to benefit employees and seem to have considered these laws a minor issue.

Although Professor Bruner posits that shareholder primacy is more threatening to American workers than to others because American government provides relatively few social welfare benefits, it is still interesting that Swedish workers have registered no objections to the shift to shareholder primacy, especially given that the Corporate Governance Code states that the purpose of corporate governance there is to run companies "as efficiently as possible on behalf of their shareholders."[159] If shareholder primacy and the growing prominence of British and American investors threatened employees, certainly the

157. *Id.* at 639.

158. LBOs may be followed by employee layoffs. *See* Haltiwanger et al., *supra* note 125, at 30.

159. THE SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 10, at 3.

powerful Swedish unions would have protested. Once again, they have not, and their acquiescence testifies eloquently that workers have nothing to fear from shareholder control.

F. *Corporate Governance and Other Constituencies*

A related argument against shareholder power is that not only employees but other constituencies, like customers and communities in which a firm does business, may make various kinds of investments in the firm, investments that might be devalued by a change of the firm's strategy. In that case, "shareholders might reassure stakeholder investors and encourage their specific investment by ceding control to a board that cannot personally profit (as shareholders can) from business strategies that enhance shareholder wealth by destroying the value of other stakeholders' specific investments."[160] Similarly, a board that is not accountable to shareholders (or anyone else) may be more socially responsible; it may "sacrifice profits in the public interest."[161]

Professor Lynn Stout argues that directors are more sensitive than "anonymous shareholders" to "shaming or other 'social sanctions' that follow corporate misbehavior."[162] This argument, once again, is unconvincing at best. America has had many corporate scandals in which managers and directors of public companies enriched themselves; they do not seem to have been deterred by the prospect of "shaming."

Further, if Professor Stout were right, we would expect to see more corporate misbehavior and more abuse of outside constituencies by companies that have gone from public to private in LBOs because boards then lose their independence and become subject to the private equity firm as dominant shareholder. I am not aware of any evidence of such a phenomenon. Moreover, outside constituencies and public interest groups have not objected to LBOs, which suggests that they do not share Professor Stout's view.

Finally, the Swedish experience offers no evidence to support her argument. There have been no charges of antisocial behavior by shareholder-dominated companies and no movement to eliminate the new system in order to improve corporate social responsibility.

G. *If Shareholder Primacy is Beneficial, Why Haven't Shareholders Adopted It?*

If the foregoing arguments for shareholder primacy are valid, then why has it not been instituted? Professor Stephen Bainbridge argues that

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160. *See* Lynn A. Stout, *New Thinking on "Shareholder Primacy"* 17 (UCLA School of Law, Law-Econ. Research Paper No. 11-04, 2011), *available at* http://ssrn.com/abstract=1763944.

161. *Id.* at 20.

162. *Id.*

shareholders *favor* their own powerlessness.[163] This argument is also weak. Shareholders have not chosen powerlessness but have had it imposed upon them because the rules disfavor them. In particular, in a proxy fight shareholders face a collective action problem because they are numerous and must bear their own solicitation costs.[164] By contrast, management is centralized and can pay its costs out of the corporate treasury—that is, their battle against shareholders is financed with the shareholders' own money.

Nonetheless, contrary to Professor Bainbridge's claim, shareholders have struggled for a stronger voice in corporate governance, and they have achieved considerable success.[165] Changing conditions have helped, including the rise of activist hedge funds and of proxy advisory services that have reduced the cost of intelligent proxy voting for institutional investors.[166] Traditionally, American institutional investors were passive and followed the "Wall Street Rule"—vote with management or sell.[167] That attitude has been changing for several years, and institutional investors are increasingly assertive.[168] However, it is unclear whether anything shareholders can do would install the Swedish system in the United States. The next section will discuss two ways this might be accomplished.

III. TWO WAYS FORWARD

Instituting shareholder control of American public companies would give the nation a significant economic boost. But how is it to be achieved? Delaware is the domicile now chosen by most American public companies, largely because it favors managers over shareholders.[169] Delaware will not voluntarily surrender the substantial franchise fees it receives by abandoning that bias. Another state could challenge Delaware by adopting a corporate code that instituted

163. *See supra* note 86 and accompanying text. The argument is bolstered by investors' acceptance of antitakeover devices in companies going public. *See supra* note 87 and accompanying text.

164. *See supra* notes 94–96 and accompanying text.

165. *See* Dent, *Academics in Wonderland*, *supra* note 75, at 1264–69.

166. *See id.*

167. *See* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE x (4th ed. 2008); *see also supra* note 79 and accompanying text.

168. *See* Dent, *Academics in Wonderland*, *supra* note 75, at 1264–69.

169. *See* George W. Dent, Jr., *For Optional Federal Incorporation*, 35 J. CORP. L. 499, 505–07 (2010); *see also supra* notes 68–69 and accompanying text. A recent study finds that "Delaware firms pay their CEOs significantly more generously than do non-Delaware firms" and that "Delaware firms exhibit significantly lower pay-performance sensitivity . . . implying that the higher pay more likely reflects rent expropriation rather than shareholder wealth maximization." Pornsit Jiraporn et al., *Does Delaware Incorporation Affect Executive Compensation? An Empirical Analysis* 2 (Texas A&M International University Research Paper, 2012), *available at* http://ssrn.com/abstract=2007983.

shareholder control. However, shareholders could move a public company from Delaware to that state only if they controlled it; but if they already controlled it, they would not need to change its state of incorporation. Thus Delaware is largely immune to interstate competition. Nonetheless, there are two possible paths to shareholder primacy: SEC rulemaking and shareholder-adopted bylaws.

A. *SEC Rulemaking*

The Dodd–Frank Act gave the Securities and Exchange Commission (SEC) authority to require inclusion of shareholder nominations for the board of directors in an issuer's proxy statement.[170] The SEC could use this power to require issuers to include nominations of, say, a committee of representatives of the issuer's ten largest shareholders.[171] Corporate boards could continue to offer shareholders their own slate of nominees. Shareholders would then choose between the two.

The Commission exercised this statutory authority when it adopted Rule 14a-11, which was struck down by the District of Columbia Circuit Court of Appeals because the SEC had not performed an adequate cost–benefit analysis of the rule.[172] Some critics argued that increasing shareholder power would do more harm than good to corporate governance.[173] However, these critiques were based on debatable assumptions about corporate governance—assumptions that seem to be belied by the Swedish experience.

The rule also attracted a more subtle objection: even if the rule might improve corporate governance, its benefits were outweighed by the costs of compliance for issuers. The critics were answered by supporters of the rule, and both focused on empirical event studies concerning the stock market's reaction to various incidents in the course of the rule's life.[174]

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170. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376 (2010) (amending The Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a)).

171. The SEC would have to provide rules for the formation and operation of these committees.

172. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1153–54 (D.C. Cir. 2011).

173. *See* Bainbridge, *supra* note 134, at 17; Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 499–500 (2012); Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 394 & n.163 (2010).

174. *See* David F. Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 446 (2011) (finding a small negative reaction to the adoption of SEC Rule 14a-11). However, the market might have been disappointed "in the laxness of the regulation." *Id.* at 432 n.5; *see also* Fabrizio Ferri, *'Low-Cost' Shareholder Activism: A Review of the Evidence* 17–18 (Columbia Business School Research Paper, 2010), *available at* http://ssrn.com/abstract=1718495 (noting that "the Council of Institutional Investors, while supporting proxy access, strongly opposed the version proposed by the SEC in July 2007

Although Rule 14a-11 would have afforded shareholders a new opportunity to place nominations for the board on a corporate proxy statement, the rule was so restrictive and its procedures so cumbersome that investors would probably have made very little use of it.[175] At the same time, Rule 14a-11 would have imposed nontrivial costs on issuers, costs that would have been relatively more burdensome to smaller public companies.[176] As a Danish scholar put it, "The real panacea, that of dominant shareholders, is not available, forcing legislators [here, regulators] to discipline management by the crude and intrusive instrument of law-making."[177] Thus, it is not surprising that the market might have had a slightly negative reaction to adoption of the rule.

Nonetheless, that reaction does not show that enhanced shareholder involvement in corporate governance is invariably unwise; it merely shows that the costs of the SEC's clumsy rule may have outweighed its benefits. The Swedish experience indicates that having directors nominated by representatives of the largest shareholders is beneficial, so an SEC rule providing for inclusion of a slate of the nominees of a committee of a company's largest shareholders should be well-received by the market. Nonetheless, to satisfy potential critics the SEC should allow corporations to opt out of the rule by a majority shareholder

because [it was] too restrictive"). One empirical study reached "findings . . . consistent with the view that financial markets placed a positive value on shareholder access, as implemented in the SEC's August 2010 Rule." Bo Becker et al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge* 4 (NBER Working Paper No. w17797, 2012), *available at* http://ssrn.com/abstract=1998597; *see also* JoAnna Tochman Campbell et al., *Shareholder Influence Over Director Nomination Via Proxy Access: Implications for Agency Conflict and Stakeholder Value*, 13 STRATEGIC MGMT. J. 166 (2012) (finding a positive overall market reaction to announcement of the rule); Torsten Jochem, *Does Proxy Access Increase Shareholder Wealth? Evidence from a Natural Experiment* 1 (University of Pittsburgh Research Paper, 2012), *available at* http://ssrn.com/abstract=2022706 (finding that the court decision striking down Rule 14a-11 "resulted in a decline of valuations for plausibly entrenched firms, smaller firms . . . and firms in which more investors qualified . . . [for] greater proxy access"); Jonathan B. Cohn et al., Abstract, *On the Optimality of Shareholder Control: Evidence from the Dodd-Frank Financial Reform Act* (University of Texas Research Paper, 2011), *available at* http://ssrn.com/abstract=1742506 (finding that "increased hurdles to proxy access are associated with losses in shareholder value for firms owned by institutional investors who are likely to use proxy access").

175. *See, e.g.*, Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347 (2011).

176. *See* Thomas Stratmann & J.W. Verret, *Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?*, 64 STAN. L. REV. 1431, 1431–32 (2012). One possible cost of the rule is that it could have been used by union pension funds bent on promoting their own interests at the expense of the other shareholders. *See* Bainbridge, *supra* note 85, at 1751 (discussing the potential for unions to exploit shareholder activism at the expense of other stockholders).

177. Hansen, *supra* note 1, at 76.

vote.[178] I doubt that investors would do so. To be consistent, the rule should also allow shareholders of companies that opt out to be able to opt back into the rule by a majority vote. The incumbent board would remain free to nominate a competing slate, in which case shareholders would choose between them.[179]

Such a rule would encounter furious opposition from corporate executives. Even the minor bow to shareholder power in the ill-fated Rule 14a-11 provoked their wrath. A rule that would make them accountable to the owners of their firms would encounter even greater resistance. Given the executives' political power and financial influence in Washington, they might well succeed. However, there is another path that they may not be able to block.

B. *Shareholder-Adopted Bylaws*

Shareholders may already be able to seize control of public companies through their power to amend the bylaws to create a committee of the ten largest shareholders to nominate directors and provide that the committee's slate of nominees be included on the company's proxy statement.[180] This possibility faces three obstacles. The first is that it might not be supported by holders of a majority of the outstanding shares. Gaining that support is more difficult because abstentions and shares not voted in effect count as negative votes. Further, in a proxy fight, conditions favor management. Shareholders face a collective action problem because they are scattered and must pay their own proxy expenses even though each shareholder will receive only a small fraction of any gains resulting from a successful campaign.[181] Management, however, is centralized and pays its costs out of the corporate treasury. Second, a majority vote might not suffice. A large minority of public companies require a supermajority vote to amend their bylaws.[182]

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178. Some commentators criticized Rule 14a-11 for lacking such an opt-out provision. *See* Grundfest, *supra* note 173, at 384. Because of the obstacles to shareholder action, it would be better to have a provision for shareholder-committee nominations from which shareholders could opt out rather than requiring shareholder action to opt into the provision. *See* Bebchuk & Hirst, *supra* note 95, at 338–42. To be even more cautious, the SEC could begin by applying the rule to only a select set of companies. *See, e.g.*, James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1842–44 (2012) (describing a process of "staging regulation" by which the SEC has sometimes applied rules to fewer than all public companies).

179. *See infra* notes 182–190 and accompanying text discussing some of the subsidiary issues this situation would raise.

180. Shareholders have this power in all states. *See, e.g.*, DEL. CODE ANN. tit. 8, § 109(a) (2010).

181. *See supra* note 95 and accompanying text; *see also* Dent, *supra* note 75, at 1253.

182. *See* Bebchuk & Hirst, *supra* note 95, at 341. An effort to adopt such a bylaw under

A third obstacle is that the shareholders' power to amend the bylaws coexists with the rule that a corporation is to be "managed by or under the direction of a board of directors."[183] Attempting to reconcile these two provisions, the Delaware Supreme Court held in *CA, Inc. v. AFSCME Employees Pension Plan*[184] that a shareholder-adopted bylaw may be valid, but that it will not bind the board if it would require the board to breach its fiduciary duties.[185]

Would the contemplated bylaw be valid and binding? Shareholders could argue that this situation differs from that in *CA, Inc.* because the bylaw there required the board to take some action—in that case, to reimburse proxy insurgents who have achieved a certain level of support.[186] For the board to do that might cause it to breach its fiduciary duties if the reimbursement would violate Delaware law.

By contrast, a bylaw establishing a shareholder nomination committee (SNC) could not require the board to take any illegal action. Corporate employees would only have to perform some minimal, ministerial tasks, such as giving notice of the identity of the ten largest shareholders. Further, this bylaw would involve shareholder voting, which Delaware courts have called the "ideological underpinning upon which the legitimacy of directorial power rests."[187]

However, fiduciary duties require the board not only to refrain from illegal acts but also to act affirmatively in the best interests of the corporation. A traditional part of this activity is recommending to the shareholders the people whom the board judges best qualified to be directors. Under current conditions, a board's failure to do this could give rise to chaos over the election of directors at the annual shareholder meeting and leave the company vulnerable to miscreants who could seize control and mismanage the company.[188] Such a failure would seem to violate the board's duty to manage.

The existence of an SNC arguably would not relieve the board of its duty to nominate candidates for the board. An SNC could nominate candidates the board considered incompetent or dishonest, or simply not

SEC Rule 14a-8 would also be complicated by the restrictions of that rule. *See id.*

183. DEL. CODE ANN. tit. 8, § 141(a) (2010). The board enjoys this power "except as may be otherwise provided . . . in [the] certificate of incorporation." *Id*. However, to amend the certificate requires first a resolution of the board and then a shareholder vote. *Id*. § 242(b)(1). Thus, the shareholders cannot amend the charter unless they already control the board, and if they already control the board they do not need to amend the charter.

184. 953 A.2d 227 (Del. 2008).

185. *See id.* at 239–40.

186. *Id.* at 230.

187. *See, e.g.*, Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

188. Directors are generally elected by a plurality of the shareholder votes. *See* FRANKLIN A. GEVURTZ, CORPORATION LAW 186–87 & n.28 (2d ed. 2010). Thus, in the absence of an official slate, a faction might prevail with just a few votes.

the best possible candidates. In that case, the board would have not just the right but also a fiduciary duty to offer the shareholders an alternate slate. Thus, it seems that a shareholder-adopted bylaw cannot relieve the board of its duty nominate candidates for the board. Even more so, it cannot deprive the board of its discretion to do so. If the board believed that the shareholder committee's nominees were well-qualified, it could of course support that slate. If it felt otherwise, the board could nominate another slate and leave it to the shareholders to choose between them.

Shareholders are already free to nominate candidates for the board, so establishment of an SNC does not impose shareholders into a realm reserved exclusively to the board. The contemplated bylaw would only require the board to identify the largest shareholders. The only conceivable objection would be that the very existence of such a committee constitutes such a threat to the welfare of the corporation that the board could not properly authorize even this minor, ministerial task. Especially given the significance attached to the shareholder franchise, it seems that such an objection could not possibly prevail.

A bylaw could further provide that the SNC slate shall be included on the corporation's proxy statement. That provision would require the cooperation of the board and the corporate officers who compile the proxy statement, but the cost and threat (if any) to the company of doing so seem so small that the board could not claim that it would be a breach of its fiduciary duty to cooperate. Moreover, even if the board tried to exclude the SNC slate from the proxy statement on the grounds that, in its business judgment, it was better for the corporation to do so, existing SEC rules probably require the board to include the slate. SEC Rule 14a-9 prohibits any proxy solicitation "which omits to state any material fact necessary in order to make the statements therein not false or misleading."[189] "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important . . . ."[190] Perhaps the nomination of one or two directors by a 3% shareholder (as in proposed Rule 14a-11) would not be considered important by most reasonable shareholders, but the nomination of a full slate by a committee of the company's largest shareholders clearly would be considered important and, therefore, could not be omitted.

Of course, the board could exhort shareholders to reject the SNC's slate and the shareholders might do so, especially if the board-nominated slate had access to the corporate treasury for its proxy expenses and could dramatically outspend the SNC slate.[191] However, it

189. SEC Rule, 17 C.F.R. § 240.14a-9(a) (2011).

190. TSC Indus., Inc. v. Northway, 426 U.S. 438, 449 (1976).

191. A different question would arise if the bylaw were to provide for payment by the corporation of the proxy solicitation expenses of the SNC's nominees. That would require board

seems likely that investors would react positively to board candidates who would be responsive to shareholders.

CONCLUSION

Corporate executives, lawyers, and scholars have long debated the proper role of shareholders in corporate governance of public companies. However, until recently all discussion about the consequences of shareholder control has been mere speculation because it had never been tried. But now shareholder dominance has been established in Sweden, and it has been a resounding success. There seems to be no reason why it could not be equally successful in the United States. The SEC (by rule) and shareholders (by bylaw) could provide for the creation of committees of representatives of the largest shareholders. These committees would present to the shareholders a slate of nominees for the board of directors, as is done in Sweden. Shareholders then could either reject this slate and stick with a self-perpetuating board or choose the shareholder-nominated slate, thereby creating a board directly accountable to shareholders.

It seems likely that shareholders of at least some public companies would choose the candidates of the shareholder nomination committee. The Swedish experience suggests that such efforts would be very successful, in which case they would probably be imitated by nearly all public companies. This would result in increased efficiency and profitability of American companies, to the benefit of the entire American economy.

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action similar to that which the Delaware Supreme Court has said could not be compelled by bylaw. *See supra* note 163 and accompanying text. The bylaw could, however, provide for reimbursement unless the board concluded that approving reimbursement would breach its fiduciary duties. If the members of the shareholder committee independently solicited proxies for the SNC slate, they would have to file with the SEC under the proxy rules. *See* SEC Rule 14a-6, 17 C.F.R. § 240.14a-6 (2011). They might also have to file under the Williams Act. *See* Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2012).