

# Shareholder Empowerment: The Right to Approve and the Right to Propose\*

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## Abstract

This paper develops a theory to explore the effect of shareholder empowerment on corporate decision making. We highlight important distinctions between the right to approve and the right to propose. Our main implications concern the right to propose: when shareholders can initiate their own proposals, managerial agency problems can be significantly controlled; however, the right to propose can also worsen corporate decisions by inducing managers to inefficiently accommodate extreme shareholder groups. Our analysis suggests that the right to approve managerial proposals (such as director nominations or new investment) constrains managers but not enough to bring about efficient actions. We identify implications of our analysis for a variety of current regulatory issues concerning director elections, proxy access, bylaw amendments, and shareholder voting.

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# 1 Introduction

The governance practices of American corporations have been reshaped over the last decade by a series of new regulations that have chipped away power from top executives, beginning with Sarbanes-Oxley and followed by court rulings and legislation in Delaware, new regulations from the New York Stock Exchange and the Securities and Exchange Commission, and most recently the Dodd-Frank Act.<sup>1</sup> This flurry of activity has brought to the forefront a fundamental issue in corporate governance: how to properly apportion decision making power between managers and shareholders. Managers have superior information, and thus are most likely to know which actions will maximize value, but they are vulnerable to agency problems and may take value-destroying actions if their interests are not aligned with shareholders.

The idea of giving shareholders more power over corporate decisions has wide appeal among corporate reformers and scholars who believe that shareholders need more tools to control managerial agency problems. Yet the benefits that many believe flow from shareholder empowerment are surprisingly difficult to find in practice. Three studies estimating abnormal returns surrounding regulatory changes that increased shareholder power find mixed, often negative, and generally insignificant evidence that investors value stronger shareholder rights (Akyol et al., 2009; Becker et

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<sup>1</sup>The Sarbanes-Oxley Act, passed by Congress in 2002, set new requirements for auditing and independence of directors. The Delaware Supreme Court's 2008 decision in *CA Inc. v. AFSCME* and the Delaware legislature's new Section 112 gave shareholders the right to propose and adopt proxy access procedures via bylaw. The New York Stock Exchange amended its Rule 452 so that beginning in 2010 brokers were no longer able to vote shares held in their customers' brokerage accounts (which were usually cast in support of management) unless specifically instructed to do so. In July 2010, Congress passed the Dodd-Frank Act that required nonbinding shareholder votes on executive compensation plans and gave the SEC clear authority to make rules on proxy access, and the SEC followed by adopting regulations in August 2010 changing Rule 14a-11 to allow large shareholders to nominate directors on the firm's proxy statement and Rule 14a-8 to allow shareholder amendments to bylaws concerning proxy access.

al., 2010; Larcker et al., 2011). If empowering shareholders is important for firm value, we might expect to see stronger voting rights in IPOs and private equity placements, but such firms do not appear to offer shareholders enhanced voting rights compared to existing public firms. Formal theoretical research on shareholder voting rights is also remarkably scarce. This state of affairs led one SEC Commissioner recently to complain that the case for proxy access is “unsupported by serious analytical rigor.”<sup>2</sup> Regulation seems to be well out in front of science at this point.

The purpose of our paper is to develop a theoretical framework that can be used to examine the consequences of various forms of shareholder empowerment on corporate decision making. An important feature of our analysis is highlighting the distinction between the power to approve actions and the power to propose actions. In most corporations shareholders already hold the right to approve many actions that are proposed by managers, such as the identity of directors, charter amendments, and whether to sell the firm, but they lack the power to make proposals of their own. Much of the recent activity among corporate governance reformers is intended to give shareholders the power to propose, such as the power to nominate directors or create bylaws that facilitate proxy access.<sup>3</sup> The existing theoretical literature tends to abstract away from the distinction by assuming that the power to propose and the power to approve are bundled together in a single “right to decide” (Aghion and Tirole, 1997; Harris and Raviv, forthcoming), but we show

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<sup>2</sup>Casey, Kathleen L., “Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations,” August 25, 2010: <http://www.sec.gov/news/speech/2010/spch082510klc.htm>. There is a healthy debate in the legal scholarship literature that touches on theoretical issues, but it does not attempt to model or otherwise formally examine the arguments. In its July 22, 2011 ruling striking down a proposed SEC proxy access rule, the D.C. Circuit Court of Appeals said the agency did not adequately analyze the costs or back up its claim that enhanced access would improve shareholder value (Holzer, 2011).

<sup>3</sup>Other popular topics include rescission of poison pills and switching from majority to plurality voting for corporate director elections.

that these rights influence corporate behavior in different ways and should be seen as conceptually different.

We study a model in which a manager proposes an action (for example, a level of investment in a new project or appointment of a director with a particular viewpoint on a new project) that impacts the firm's profit. If approval is required, shareholders vote to accept the manager's proposal or to reject it and receive the status quo payoff. If proposals are allowed, activist shareholders (possibly with private benefits from the project) can propose at a cost an alternative action, which may increase or decrease value.

We show that the right to approve is a fairly weak tool for controlling agency problems. The right to approve does limit the manager's ability to pursue private benefits at shareholder expense, but somewhat paradoxically the benefit to shareholders from this power may be minimal. This is because the manager can gain approval for even a highly distorting project so long as it delivers a payoff to shareholders equal to the payoff from not pursuing the project at all. The manager in effect can threaten shareholders with an undesirable status quo if they do not approve the manager's proposed action. As a result, in some situations the manager may capture all of the potential benefits from a corporate opportunity.

The right to propose, on the other, is potentially more effective; it can be used to drive corporate decisions to the profit maximizing level if the cost of proposing is not too large. However, and less obviously, proposal power also can lead the manager to choose actions that make shareholders worse off than if they did not have proposal power. This happens when managers try to preempt shareholder proposals by adjusting their initial decisions; if the cost of making a proposal is high enough, a shareholder activist will accept a compromise position in order to avoid the cost of proposing. Facing an active shareholder who seeks to maximize profit, the manager may compromise by choosing an action that is closer to profit maximization than what would otherwise be chosen.

But facing an active shareholder who seeks an inefficient action, the manager may compromise by choosing an action more inefficient than what would otherwise be chosen in order to forestall the risk of an even more extreme action being proposed and approved. We show that the right to propose is generally helpful when managerial agency problems are severe, and harmful when managers are focused on firm value.

Our emphasis on managerial accommodation to activist shareholders is consistent with evidence that shareholder proposals are often withdrawn following negotiations between management and the proposer. For example, Campbell et al. (1999) report that 17.7 percent of shareholder proposals were withdrawn by sponsors before a vote during the 1997 proxy season, and Smith's (1996) study of CalPERS notes that 72 percent of firms targeted during 1988-1993 adopted proposed changes or made changes resulting from a settlement with CalPERS. For U.K. firms, Buchanan et al. (2011) find that 116 of 133 withdrawn shareholder proposals were withdrawn following negotiation between the firm and proposers.

Some critics of shareholder rights argue that giving shareholders more authority will lead to worse decisions because shareholders are uninformed, or worse, irrational. It is easy to see how giving shareholders more power leads to no value improvement when shareholders are uninformed, and could lead to value destruction if they are irrational (they may approve proposals or candidates that harm the corporation). Our analysis shows, however, that giving shareholders more power can make them worse off even if they are fully rational and as informed as managers. Other critics argue that giving shareholders the power to propose will hurt corporate performance by distracting from the company's business. Our analysis shows that even if managers suffer no opportunity cost from responding to shareholder proposals, the threat posed by a proposal may induce them to choose an inefficient action. Somewhat paradoxically, even if shareholders overwhelmingly seek to maximize value, giving them more of a voice in corporate decisions can lead to less efficient decisions.

Our model identifies conditions under which proposal power is likely to cause managers to inefficiently accommodate activist shareholders. A key condition is uncertainty about shareholder preferences: if the manager knows that shareholders will not support the activist's agenda, the manager will not seek a middle ground, trusting the shareholders to reject the proposal; but with sufficient uncertainty about shareholder preferences, the manager may accommodate the activist rather than risk a vote. Our analysis thus supports current reform efforts to give managers more information about their individual shareholders.

At a formal level, our paper can be seen as an application of the theory of agenda control developed in the political economy literature beginning with Romer and Rosenthal (1979). We build on that literature by incorporating institutional features specific to corporate governance, such as the distinction between blockholders and other shareholders. The importance of uncertainty about shareholder preferences in generating distortionary accommodation follows Matsusaka and McCarty (2001), again developed in a political economy context. More broadly, our paper can be seen as a contribution to the growing literature on assignment of decision rights in organizations associated with Aghion and Tirole (1997) (such as Alonso et al. (2008), Rantakari (2008), and Van Den Steen (2010)), specialized to corporate governance issues (Harris and Raviv, forthcoming). Our paper is part of a strand of that literature that emphasizes the idea that decision rights are not absolute, but may be fragmented and procedurally circumscribed (Marino and Matsusaka, 2005; Alonso and Matouschek, 2007, 2008). Finally, our paper can also be seen as formalizing and analyzing arguments and conjectures that have been offered in the law literature, for example Gordon (1991) and Bebchuk (2005).

## 2 Examples of Approval and Proposal Rights

The authority held by shareholders over different parts of the corporate governance process are typically lumped together into a single bundle of “powers” or “rights,” obscuring the difference between approval and proposal rights. Table 1 lists the configurations of rights in American corporations associated with various corporate decisions and separates them into approval and proposal rights.

In the United States, shareholder rights are conditional, and vary with the state of incorporation and the company’s basic governance documents, such as the charter. Typically, shareholders must approve major corporate decisions, such as selling the company, and must approve charter changes. They do not have the right to propose (except in a precatory manner) major operational changes or charter changes. Shareholders do have the right to propose changes in the bylaws, in large part through SEC rule 14a-8, which may allow them to influence firm policy and some minor business decisions.

Shareholders must approve nominees to the board of directors, but have a limited ability to propose nominees. Also, the form of approval varies by state of incorporation and charter and bylaw provisions. Under the plurality rule, the nominee with the most votes is elected even if the person receives only a single vote; in this case the shareholders do not have the option to reject management’s nominee unless they propose an alternative. Under the majority rule, a nominee must receive the affirmative vote of a majority of the total votes cast, meaning that shareholders can reject a nominee without having to propose an alternative.

It is useful to keep in mind that the configuration of rights seen in the United States is not inevitable. Practices vary in other countries. For example, in the United Kingdom shareholders have significantly more proposal rights, such as the right to propose changes to the corporate charter and major business decisions (see Buchanan et al. (2011) for a thorough discussion).

<b>Table 1. Typical Shareholder Rights in American Corporations</b>	
Right to approve but not propose	Charter changes; major business decisions (e.g. sale of firm)
Right to propose but not approve	Minor business decisions (implemented through bylaw changes); director elections under plurality rule
Right to approve and propose	Bylaw changes; director elections under ma- jority rule

### 3 Model

The model has three actors, a manager, a blockholder, and a set of identical small shareholders. The actors together have the opportunity to take an action  $x$  that could generate a profit or a loss. If they do not make a decision, then  $x = 0$ , called the status quo point. The action can be an investment of an amount  $x$  in a new line of business, a decision to divest a fraction  $x$  of assets from businesses in Sudan, the price  $x$  to offer another firm that is seeking to acquire the firm in question, and so on.<sup>4</sup> A decision generates profit for the firm of  $\pi(x) = -(x - \theta)^2$ , where  $\theta > 0$ . The critical feature of this payoff function is that it has a maximum and profit is declining with the distance from  $\theta$ .<sup>5</sup> The firm's value is maximized with  $x = \theta$ .

The manager receives a noncontractible private benefit from the action parameterized by  $a > 0$

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<sup>4</sup>Our assumption that the action space is one-dimensional fits most literally with single-issue elections. However, the key implications of our analysis carry through with a multidimensional issue space.

<sup>5</sup>Other functions would work as well, for example,  $-|x - \theta|$ . Symmetry is convenient but not essential. The profit function could be microfounded, for example, by supposing that revenue is  $\theta x$  and cost is  $.5x^2$ ; then profit would be  $x(\theta - .5x)$ .



so that the manager’s payoff is  $u(x) = \pi(x) + 2ax$ . We can express the payoff more conveniently as

$$u(x) = -(x - \theta - a)^2 + Y, \tag{1}$$

where  $Y \equiv a(a + 2\theta)$  is a choice-irrelevant constant. This quadratic formulation is standard in the decision rights literature. The assumption that the manager’s payoff depends on profit as well as private benefits could be seen as capturing some sort of incentive contract, but formally we assume the manager’s wage is fixed and independent of the decision process, and the manager’s participation constraint is not binding. It is important to embed some sort of agency problem in the model because countering such problems is the central rationale for shareholder empowerment. In our analysis we focus on two cases: “no agency problem” ( $a = 0$ ) and “severe agency problem” ( $a > \theta$ ). The manager’s “ideal” action is  $\theta + a$ .

The blockholder owns a fraction  $s > 0$  of the firm’s shares. We assume the blockholder’s stake is too small to be pivotal in any shareholder election. This is intended to capture the typical case envisioned by recent reform proposals that tend to focus on small blocks. In situations where the block is large enough to swing election outcomes, the blockholder has effective control of the firm, and the strategic issues we analyze do not emerge.

The blockholder receives a private benefit from the action parameterized by  $b$  so that the blockholder’s payoff is

$$v(x) = s\pi(x) + 2bx = -s(x - \theta - b/s)^2 + Z, \tag{2}$$

where  $Z = b(2\theta + b/s)$ . The parameter  $b$  can be positive or negative; it could be a nonpecuniary benefit, for example, if a blockholder seeks to have the firm engage in “socially desirable” activities, or it could be a pecuniary benefit, for example, if the firm builds a plant in an area where the blockholder owns hotels and restaurants. The blockholder’s “ideal” action is  $\theta + b/s$ .

If the firm allows shareholder proposals, the blockholder can make a proposal at a cost of  $k > 0$ . The cost  $k$  represents expenses associated with retaining lawyers, filing fees, and information

acquisition costs, among other things. In practice, these costs are nontrivial, estimated by Buchanan et al. (2011) as \$525,070 for proxy contests in American corporations. We assume that only a blockholder can make a proposal, but the case of an atomistic shareholder is subsumed by the case  $s = 0$ .

Figure 1 depicts the sequence of actions. The game begins with the manager proposing an action  $x$ . This can be interpreted either as the manager proposing action  $x$  directly or as the manager proposing a director who favors action  $x$ .<sup>6</sup> After the manager's proposal, if shareholders have the right to propose, they can offer an alternative action or, under the director interpretation, they can offer an alternative director candidate. If shareholders have the right to approve, then they vote on whether to accept the manager's proposal, and if a competing proposal is on the table, whether to accept the alternative. We rule out side payments between the parties for most of the analysis, turning to that issue only after working through the basic model.<sup>7</sup>

We do not assume that the manager has superior information about the payoffs associated with the decision. It is well understood that one reason to delegate decisions to managers is to take advantage of their superior information; one of our purposes is to show that delegation to managers might be beneficial to shareholders even when managers do not have an information advantage and do suffer from agency problems, or put differently, we want to show how shareholder empowerment can be harmful even when managers are not better informed than shareholders.<sup>8</sup>

At a later stage of the analysis we introduce uncertainty about shareholder voting patterns.

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<sup>6</sup>Given our aims in this paper, we do not include model elements that distinguish director from bylaw elections. A richer model of director elections would assume that nominees take positions on an issue designated by  $x$ ; one can think of  $x$  as a nominee's platform, and shareholders vote based on a director's stated platform.

<sup>7</sup>Without the possibility of side payments, all outcomes we study will be Pareto efficient in the sense that there is no alternative outcome that would make all of the parties better off.

<sup>8</sup>For evidence that firm performance depends on manager and board information, see Duchin et al. (2010).

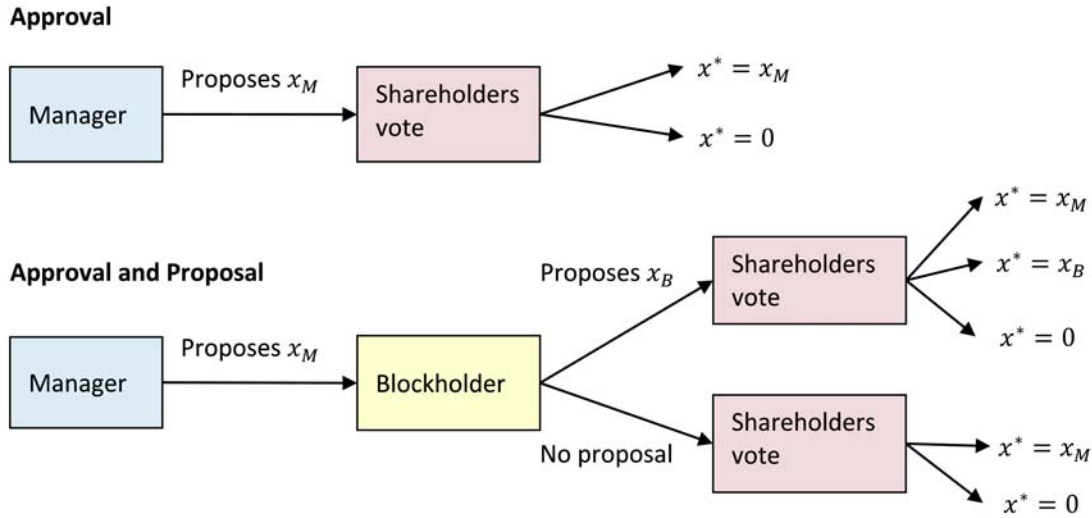


Figure 1: Sequence of Actions

Specifically, we assume that the shareholders as a group may end up voting for a proposal that reduces firm value. This could happen because shareholders are ignorant, or because they have a private benefit from the project that was not recognized until they voted.

## 4 Shareholder Empowerment When There Is No Uncertainty

Initially, assume there is no uncertainty about shareholder preferences. The benchmark case is when the decision is fully delegated to the manager and shareholders have no say. In this case, the manager chooses  $x^* = \theta + a$ .<sup>9</sup> When the manager has the same payoff as shareholders, the manager chooses the profit-maximizing action:  $x^* = \theta$ . Requiring shareholder approval or allowing

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<sup>9</sup>Our model does not include fiduciary duty as a constraint on the manager. Fiduciary duty could be modeled as a boundary around  $\theta$  beyond which the manager cannot allow the action to be chosen without suffering a personal cost (such as a lawsuit). Such a constraint would mute the manager's strategic behavior, but would not reverse the main implications as long as the manager retained some discretion.

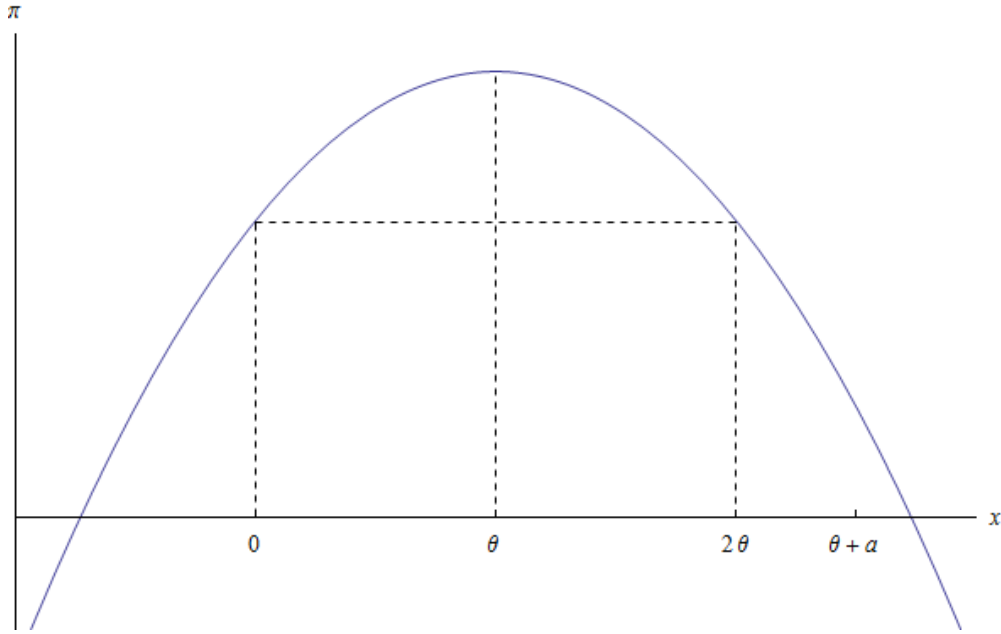


Figure 2: Right to Approve

shareholder proposals has no effect in this case. The remainder of this section focuses on the case of a severe agency problem:  $a > \theta$ .

#### 4.1 Right to Approve

Here we consider the case, for example, of a management proposal to sell the firm, change the state of incorporation, or appoint a certain person as a director. The manager proposes an action and shareholders only have two options: approve or reject it. If they reject the recommendation, then the status quo decision ( $x = 0$ ) prevails. Because shareholders can achieve a payoff of  $u(0)$  by rejecting the proposal, they will not accept a proposal that yields a lower payoff than  $u(0)$ . Therefore, the maximum proposal that shareholders would approve satisfies  $\pi(0) = \pi(x)$ , or  $x = 2\theta$ . See Figure 2.

Because we are focusing on the case of a severe agency problem, the manager's payoff is increasing in  $x$  up to  $a$ , and the manager prefers as high a level of the action as shareholders will approve. Therefore, the manager proposes  $x^* = 2\theta$  and shareholders approve. Observations: First, even

though shareholders have the right to approve, it provides a limited benefit: they end up earning the same return as they would have under the status quo policy even though a profitable project is available. Second, the right to approve prevents an even worse outcome that would prevail without the right, namely the manager's ideal action,  $\theta + a$ . So the right to approve does prevent the manager from selecting a policy that actively destroys value. In other words, the right of approval prevents actions that destroy value but does not bring about value-increasing actions.

## 4.2 Right to Approve and Propose

Here we consider the case in which shareholders have the right to propose actions that would require shareholder approval if proposed by management. A change in bylaws, such as a requirement that a director receive a majority (rather than a plurality) of votes to join the board, is an example for American corporations. This case also represents director elections under a majority rule: the manager's candidate must be approved by shareholders in order to join the board, even if unopposed, and shareholders are permitted to propose an alternative candidate (in a proxy fight) at a cost.

As before, because shareholder approval is required, the manager cannot propose an action greater than  $x = 2\theta$  or it will be rejected in favor of the status quo. The manager must also take into account the possibility of a proposal from the blockholder. The blockholder will make a proposal if shareholders will support the blockholder's proposal instead of the manager's proposal (there is no uncertainty here about how shareholders will vote), and if the payoff from the blockholder's proposal exceeds the payoff from the manager's proposal by enough to justify the cost of making a proposal.

The following observation is useful for characterizing the equilibria:

**Observation.** *In every equilibrium, the blockholder does not make a proposal.*

To prove this, suppose there was an equilibrium in which the blockholder did make a proposal  $x_B$ . For this to be an equilibrium, it must be the case that shareholders approve the proposal – otherwise the blockholder could be better off not proposing and avoiding the cost  $k$ . If the manager’s preferences are different from the blockholder’s preferences, there must exist an alternative action  $x_M$  sufficiently close to  $x_B$  that the blockholder would prefer to accept (and avoid the proposal cost, that is, such that  $v(x_B) - k < v(x_M)$ ) and that the manager prefers (that is, such that  $u(x_M) > u(x_B)$ ). Thus,  $x_B$  cannot be part of an equilibrium. Observation 1 implies that the equilibrium action will maximize the manager’s utility subject to deterring the blockholder from making a proposal.

Case 1.  $b = 0$  (Value-focused blockholder)

Working backwards, we see that shareholders will approve a proposal  $x = \theta$  over any alternative. Because  $x = \theta$  is the blockholder’s ideal action, if the blockholder makes a proposal, it will be  $x = \theta$  and the shareholders will approve it regardless of the manager’s proposal. Turning to the manager’s choice, because the blockholder’s cost of proposing is  $k$ , the blockholder is indifferent between making a proposal and accepting the manager’s proposal  $x_0$  if

$$v(\theta) - k = v(x_0). \tag{3}$$

This yields  $x_0 = \theta + \sqrt{k/s}$ . Any proposal  $x \in [\theta - \sqrt{k/s}, \theta + \sqrt{k/s}]$  is sufficiently close to the blockholder’s ideal action to deter a proposal. The manager would like  $x$  to be as large as possible up to  $2\theta$ , so the manager chooses  $x = 2\theta$  if that will deter, and otherwise  $x = x_0$ . Shareholders approve the proposal so the equilibrium outcome is  $x^* = \min \{x_0, 2\theta\}$ .

Observations: The right to propose limits the ability of the manager to overinvest. However, the effectiveness of the power to propose depends on  $k$  and  $s$ . As expected, effectiveness increases as the cost of making a proposal declines, which is one argument for easing proxy access. Effectiveness also increases as the blockholder’s ownership increases because the blockholder receives only a fraction

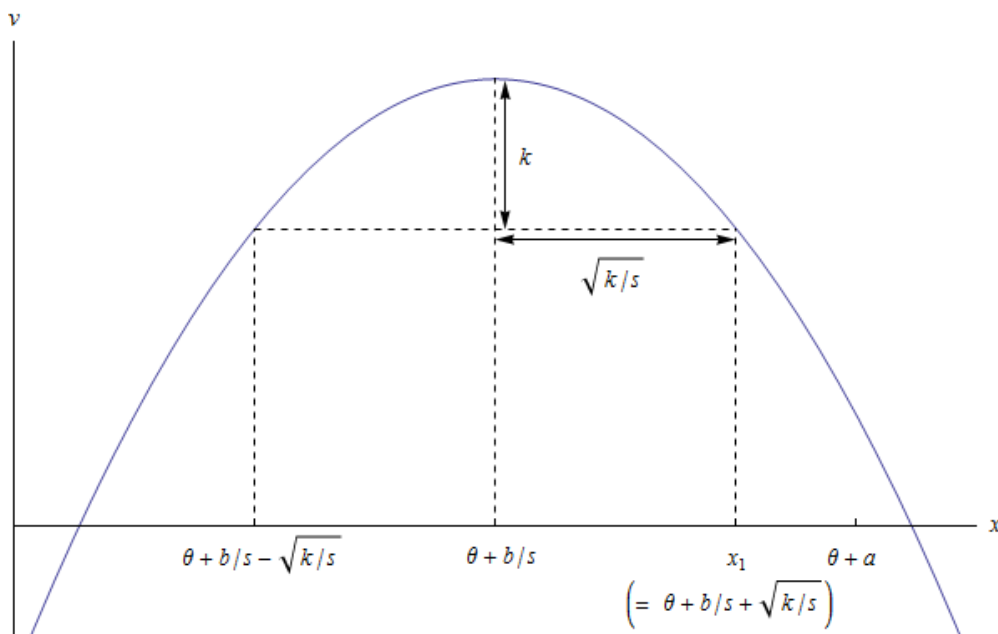


Figure 3: Right to Propose with Moderate blockholder,  $0 < b/s < \theta$

of the benefit but bears the entire cost of making a proposal. Note also that deterrence is complete – the blockholder never makes a proposal in equilibrium – we show later that this feature disappears when the model is extended to include uncertainty about shareholder preferences.

Case 2.  $b > 0$  (Benefit-seeking blockholder, aligned with manager)

In this case the blockholder receives a private benefit from the action, and the direction of the benefit is aligned with the manager’s private benefit. If the private benefit is extremely large ( $b/s > \theta$ ) then shareholders will reject both the manager’s and the blockholder’s ideal action. The highest action that the shareholders will accept is  $2\theta$ , and that will be the manager’s choice.

If the blockholder’s private benefit is not too large ( $0 < b/s < \theta$ ), shareholders would approve the blockholder’s ideal choice,  $x = \theta + b/s$ , compared to the status quo, if proposed. The manager prefers a higher  $x$  than this; since the blockholder and shareholders would approve  $x = \theta + b/s$ , the manager will never propose  $x < \theta + b/s$ . Figure 3 illustrates the situation. The manager can deter

the blockholder from proposing  $x = \theta + b/s$  by choosing an action  $x_1$  that satisfies<sup>10</sup>

$$v(\theta + b/s) - k = v(x_1), \tag{4}$$

which gives  $x_1 = \theta + b/s + \sqrt{k/s}$ . Because  $x_1$  deters a proposal of the blockholder's ideal action, it deters all other possible proposals from the blockholder (any other proposal gives the blockholder a lower payoff and is no more likely to be approved). The manager prefers  $x_1$  to the blockholder's proposal, so chooses  $x = x_1$  if shareholders will approve it and  $x = 2\theta$  otherwise, in either case deterring the blockholder from making a proposal. Therefore, the equilibrium outcome is the manager proposing and shareholders approving  $x^* = \min\{x_1, 2\theta\}$ .

Observations: A blockholder with more extreme preferences than the manager has no effect, while a less extreme blockholder exerts a moderating influence on the manager. The implications are otherwise similar to those in the case with a value-focused blockholder.

Case 3.  $b < 0$  (Benefit-seeking blockholder, opposed to manager)

In this case, the blockholder receives negative private benefits from the action, meaning that the blockholder's interests pull in the opposite direction from the manager's interests. For example, if  $x$  is the price to offer a potential acquirer, the blockholder may be a hedge fund that is biased toward selling the firm (due to agency problems arising from delegated portfolio management) and in favor of a price below the profit-maximizing level, while the manager may be biased toward the firm remaining independent and in favor of a price that is above the profit-maximizing level.

The blockholder's ideal action is less than  $\theta$ , and as usual the manager's ideal action is greater than  $\theta$ . Working backward, if shareholders face a choice between a "low" proposal from the blockholder and a "high" proposal from the manager, they will choose whichever proposal is closer to  $\theta$ . This means that in order to defeat a managerial proposal  $x$ , the blockholder must propose an action greater than  $2\theta - x$ . The manager's proposal must deter the blockholder from making a

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<sup>10</sup>Equilibrium requires that the blockholder makes no proposal if indifferent between proposing and not proposing.



proposal, which is accomplished by giving the blockholder a payoff equal to what the blockholder would receive from proposing the minimum winning alternative. The deterring managerial proposal  $x_2$  then satisfies

$$v(x_2) = v(2\theta - x_2) - k. \tag{5}$$

The solution is  $x_2 = \theta - k/4b$ . Observation 1 implies that the equilibrium outcome maximizes the manager's payoff subject to deterring a blockholder proposal (5). The manager wants the action to be as large as possible, so chooses the minimum of  $x_2$  and  $2\theta$ :  $x^* = \min\{x_2, 2\theta\}$ .

Observations: As in the previous cases, the power to propose moderates the manager's over-investment, as long as the cost of proposing is not too large. Less obviously, shareholders are better off when the blockholder has more extreme private benefits (high  $|b|$ ). This is because the blockholder's private benefits run in the opposite direction from the manager's private benefits, so the more extreme is the blockholder, the more the manager must moderate his or her proposal. The somewhat counterintuitive implication is that shareholders may be better off with a benefit-seeking blockholder than a value-focused blockholder if the blockholder's interests are opposed to the manager's interests.

### 4.3 Right to Propose but not Approve

This could be the case, for example, of a shareholder proposal to disinvest from Sudan. The managers can disinvest from Sudan on their own, without needing shareholder approval. However, shareholders may have the option to force disinvestment by amending the bylaws. Shareholder approval is required for the bylaw proposal but not for the manager's decision. This could also represent elections for corporate directors under plurality voting: the manager's candidate wins if unopposed, but must be preferred by shareholders to the alternative if a blockholder candidate is proposed.

Because shareholder approval is not required, the manager can proceed with his or her ideal action and implement  $x = \theta + a$  unless there is a proposal from the blockholder (in contrast, the manager is limited to  $x \leq 2\theta$  when approval is required). In all other respects, behavior in this case is the same as when shareholder approval is required. Specifically, when  $b \geq 0$  the manager chooses to deter if necessary so that  $x^* = \min\{x_1, \theta + a\}$  where  $x_1$  is defined by (4). When  $b < 0$ , the manager chooses to deter if necessary so that  $x^* = \min\{x_2, \theta + a\}$ , where  $x_2$  is defined by (5).

#### 4.4 Conclusions

With no uncertainty, several broad conclusions emerge. Increasing the power of shareholders – either by requiring approval or allowing them to make proposals – curtails managerial agency problems and can increase firm value. The power to approve prevents value-destroying actions by managers but is unable to bring about value-increasing actions; the power to propose, on the other hand, can push the manager toward value maximization. The power to propose is most beneficial to shareholders when there is a blockholder who receives large private benefits that run in the opposite direction from the manager’s private benefits. The power to propose does not change behavior via actual proposals, but by altering the manager’s behavior. Although the complete absence of actual proposals is not robust to introducing preference uncertainty into the model, the observation that proposal power influences behavior to a large extent through a threat effect is robust, and implies that empirical research focusing on actual shareholder proposals is likely to miss much of the impact of the proposal rights (as found by Smith (1996) in his study of CalPERS).

## 5 Shareholder Empowerment with Uncertainty about Preferences

An important feature of real corporate elections is uncertainty about how shareholders will vote. This could be because shareholders have private benefits associated with the decision that are not

visible to outsiders, or because some of them vote irrationally. Here we incorporate uncertainty into the model, and show that uncertainty has a striking and important effect on the consequences of different shareholder rights. Most important, even if shareholders vote for value maximization on average, the possibility that they might sometimes vote otherwise can induce managers to make decisions that hurt shareholders when an interested blockholder is empowered.

To model uncertainty, we suppose that shareholders prefer to maximize profit on average, but with some (possibly small) probability they receive private benefits from the action. Formally, the preferences of shareholders as a group are  $\pi(x) + 2cx$ , where

$$c = \begin{cases} -\gamma & \text{with prob} = p \\ 0 & \text{with prob} = 1 - 2p \\ \gamma & \text{with prob} = p \end{cases} \quad (6)$$

and  $p < 1/2$  is the probability that shareholders receive private benefits. Note that  $E[c] = 0$ . We sometimes refer to  $p$  as the “riskiness” or “unpredictability” of shareholder voting. To simplify the analysis, we assume that  $\gamma > \max\{a, |b/s|\}$  so that shareholders will support the proposal with the highest action if  $c = \gamma$ , and will support the proposal with the lowest action if  $c = -\gamma$ . Note that we assume shareholders are identical so that we can treat them as a group. In the absence of any sort of shareholder rights, the manager chooses  $x = \theta + a$  as before.

## 5.1 Right to Approve

If shareholders reject the manager’s recommendation, then the status quo prevails ( $x = 0$ ). The manager chooses his proposal taking into account both the probability of gaining approval and the desirability of the action conditional on being approved. A manager without an agency problem ( $a = 0$ ) chooses  $x = \theta$ , which the shareholders approve unless  $c = -\gamma$ . The only difference between complete delegation and approval is that with approval the status quo action prevails with

probability  $p$ .

A manager with an agency problem ( $a > \theta$ ) prefers an action in excess of the profit-maximizing level. Reasoning backwards, if  $c = 0$  then shareholders approve any proposal  $x \in [0, 2\theta]$  (and reject outside this range). If  $x \in (0, 2(\theta + \gamma)]$  then the proposal will be approved by shareholders if  $c = \gamma$  and rejected by shareholders if  $c = -\gamma$ . The probability of approval is constant and equal to  $1 - p$  for any proposal in  $(0, 2\theta]$  and the probability of approval is constant and equal to  $p$  for any proposal in  $(2\theta, 2(\theta + \gamma)]$  or  $[-2(\gamma - \theta), 0)$ . In light of this, the manager would never choose  $x < 0$ , and will choose  $x = 2\theta$  if the proposal is in  $(0, 2\theta]$ . The manager's choice then boils down to  $x = 2\theta$  versus  $x = \theta + a$ . The condition for  $x = 2\theta$  to be optimal is

$$(1 - p)u(2\theta) + pu(0) \geq pu(\theta + a) + (1 - p)u(0). \quad (7)$$

Inequality (7) reduces to  $p \leq 4a\theta / (a^2 + \theta^2 + 6a\theta)$ . It is straightforward to show that the inequality is satisfied for some parameter configurations and not others so both proposals are possible.

Inequality (7) is satisfied for sufficiently small  $p$ , and violated for sufficiently large  $p$ : if shareholder voting becomes sufficiently predictable (low enough  $p$ ), requiring approval causes the manager to moderate the action to  $x = 2\theta$ . Inequality (7) is also violated for sufficiently large  $a$ : as the manager's private benefits increase, requiring approval is less likely to bring about moderation. Shareholders are weakly better off with the right to approve because approval sometimes restrains the manager's tendency to overinvest. Introducing uncertainty does not change the qualitative effect of approval rights, but makes the manager willing to run the risk of rejection under some circumstances. With uncertainty in the model, some management proposals will be rejected in equilibrium, which was not the case in the certainty model.

## 5.2 Right to Propose but not Approve

This case demonstrates the cost of giving shareholders the power to propose, one of our central results. Unlike previous cases where proposal power is always beneficial, here we show that under certain conditions the manager might accommodate the blockholder in order to deter a proposal, leading to a less efficient action than if shareholders did not have the right to propose.

Equilibrium behavior depends on the configuration of preferences. Rather than work through every case, we focus on a particular parameter configuration that displays the key intuition, the case of a moderate manager and an extreme blockholder ( $0 < a < b/s$ ). In this case both the blockholder and the manager would like an inefficiently high action, and the blockholder is the most extreme. Recall that with no uncertainty, the manager ignores this type of extreme blockholder because shareholders would reject a proposal from such a blockholder. With uncertainty, however, there is the possibility of an extreme proposal being approved, which may cause the manager to accommodate the blockholder.

Working backward, suppose shareholders have a choice between a proposal from the manager and a proposal from the blockholder. The blockholder would never propose an action less than the manager's proposal, and the manager would never propose an action less than  $\theta$ . If  $c = -\gamma$ , shareholders reject both proposals; if  $c = \gamma$ , shareholders approve the blockholder's proposal; and if  $c = 0$ , shareholders approve the manager's proposal as long as it does not exceed  $2\theta$ , and otherwise reject both proposals. Since the blockholder's probability of winning is the same for any proposal greater than the manager's proposal, the blockholder's only proposal would be the blockholder's ideal action,  $x = \theta + b/s$ . The manager can deter the blockholder from such a proposal by choosing an action  $\bar{x}_0$  that satisfies

$$v(\bar{x}_0) = pv(\theta + b/s) + (1 - p)v(\bar{x}_0) - k. \tag{8}$$

The deterring action gives the blockholder a certain payoff equal to the payoff the blockholder would receive from a lottery over  $\theta + b/s$  and  $\bar{x}_0$  with a cost  $k$ . The solution is  $\bar{x}_0 = \theta + b/s - \sqrt{k/ps}$ . If  $\theta + a \geq \bar{x}_0$ , then the manager deters “automatically” simply by proposing his ideal action. Therefore, if the manager chooses to deter he selects  $\max\{\bar{x}_0, \theta + a\}$ .

If the manager cannot deter automatically ( $\theta + a < \bar{x}_0$ ), then the manager chooses between an “accommodating” proposal that deters the blockholder and a lottery over the manager’s ideal action and the blockholder’s ideal action. Deterrence is optimal for the manager if

$$u(\bar{x}_0) \geq (1 - p)u(\theta + a) + pu(\theta + b/s). \quad (9)$$

Condition (9) reduces to  $1 - \sqrt{k/ps} (b/s - a)^2 \leq \sqrt{p}$ , where the left hand side is positive because  $b/s - a > \sqrt{k/ps}$  when deterrence is not automatic. It is straightforward to show that inequality (9) is satisfied for some parameter values and not others.

When inequality (9) is satisfied, an interesting result appears: shareholders can be worse off in expectation when they have the power to make proposals. This is not because an extreme proposal might happen to be approved – indeed, when an extreme proposal is approved it is beneficial for shareholders – but rather because the manager accommodates the blockholder in order to deter the possibility of a proposal. For example, when shareholders have the right to propose, a manager with a tendency to overinvest chooses to invest even more (increasing the action from  $\theta + a$  to  $\bar{x}_0$ ) in the face of a blockholder seeking more investment. To see that such deterrence hurts shareholders in expectation, compare the shareholders’ payoff with the deterring action  $\bar{x}_0$  to the payoff associated with the manager’s choice when proposals are not allowed,  $\theta + a$ . Because  $\theta + a < \bar{x}_0$ , shareholders are better off with deterrence when their ideal action is  $\theta + \gamma$  (which happens with probability  $p$ ) and worse off when their ideal action is  $\theta$  or  $\theta - \gamma$  (which happens with probability  $1 - p$ ). Because  $\bar{x}_0 > \theta$ , the gains when  $c = \gamma$  are less than the losses when  $c = -\gamma$ . This net loss, together with the observation that shareholders are worse off with deterrence when  $c = 0$  leads to the conclusion

that shareholders are worse off in expectation when the blockholder is accommodated.

It seems worth noting that this damaging consequence of proposal power can occur even if the manager is entirely focused on profit maximization ( $a = 0$ ).<sup>11</sup> Without the threat of a blockholder proposal, the manager would choose the action that maximizes expected profit ( $x = \theta$ ), but with the threat of a proposal, the manager may choose to inefficiently increase the action in order to placate the blockholder and avoid the risk of an extreme proposal being approved.

Turning to comparative static properties, condition (9) implies that value-destroying accommodation is more likely when  $k$  increases. This is because the deterring action declines when the cost of proposing rises, making it more palatable to the manager. Similarly, deterrence is more likely when  $s$  increases because it requires a lower action to deter the blockholder.<sup>12</sup>

The other comparative static results are more complicated. To gain some perspective on what parameter configurations lead to harmful deterrence by the manager, Figure 4 plots the manager's behavior by extremity of the blockholder ( $b/s - a$ ) and unpredictability of shareholder voting ( $p$ ), holding constant  $k$  and  $s$ . The southwest region satisfies  $\sqrt{k/ps} > b/s - a$  and is where deterrence is automatic with the manager's ideal action. The northeast region is partitioned by condition (9). Shareholders are worse off when they have the power to propose in the strategic deterrence region. The comparative statics for  $p$  are nonmonotonic: for a sufficiently low  $p$ , deterrence is automatic; as

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<sup>11</sup>Note that a manager with  $a = 0$  is not the same as a manager that seeks to maximize the welfare of shareholders if uncertainty in shareholder preferences occurs for rational reasons. If uncertainty represents irrational behavior or mistakes, then  $a = 0$  would represent a manager who seeks to maximize shareholder welfare, in this case by protecting shareholders from the risk that they might approve a harmful proposal from the blockholder. If variation in preferences is rational, a manager who wanted to maximize shareholder welfare would encourage a blockholder proposal to give shareholders a good option if they turn out to have extreme preferences.

<sup>12</sup>Recall that we are considering blocks that are not large enough to swing the election. An increase in  $s$  that allowed the blockholder to determine the election outcome presumably would have a significant effect, but through different channels than analyzed here.

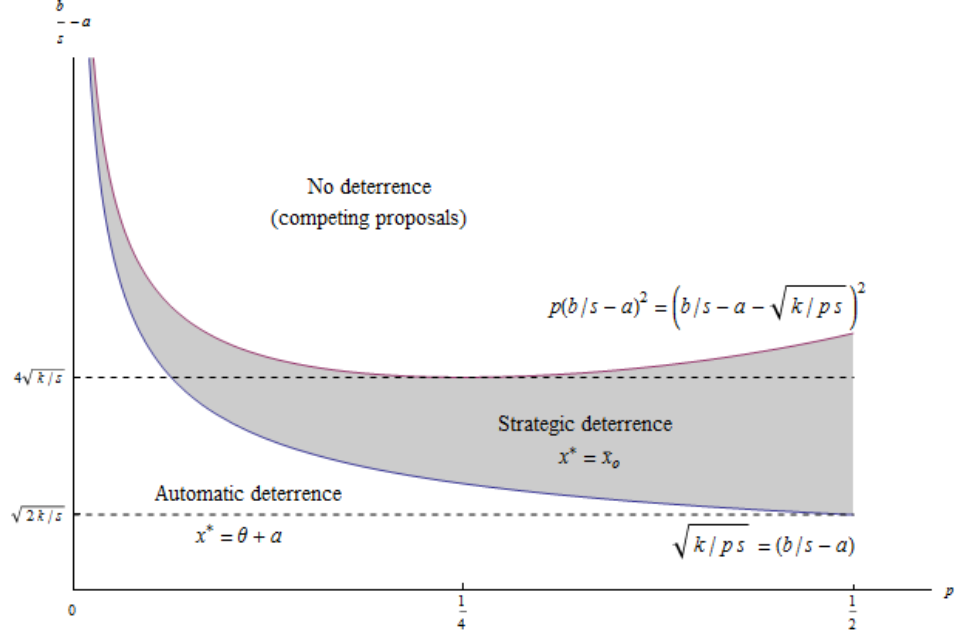


Figure 4: Deterrence Regions when Shareholders Can Propose

$p$  increases at some point the manager finds it optimal to accommodate the blockholder (assuming the blockholder is sufficiently extreme); with an even higher  $p$ , the manager may find it optimal to allow the blockholder proposal to appear because deterrence is too costly; and then for highest values of  $p$ , the manager again may choose to deter. The comparative statics for blockholder extremism (or equivalently, in terms of managerial moderation) are monotonic: with a less extreme blockholder, deterrence is automatic; as the blockholder becomes more extreme, at some point the manager chooses to strategically deter; and for a very extreme blockholder the manager allows the proposal because accommodation is too costly.

Note that shareholder proposals occur in equilibrium when the model includes uncertainty about shareholder preferences. The fact that shareholder proposals do occur in practice lends some support for the materiality of the uncertainty model compared to the perfect certainty model. Several empirical studies beginning with Karpoff et al. (1996) have attempted to identify the characteristics of firms that receive shareholder proposals. In our model, a shareholder proposal



occurs in the “no deterrence” region where the blockholder has extreme preferences and uncertainty is in the intermediate range. This yields the prediction that a firm will be targeted for a proposal when it has a blockholder that seeks a larger change from the status quo than the managers seek, and when uncertainty about the view of the other shareholders is neither very high nor very low.

### 5.3 Right to Approve and Propose

This case represents director elections under a majority voting rule. It also represents situations in which shareholders are permitted to propose charter amendments. Requiring shareholders to approve the manager’s proposal alters the main behavioral conditions because the status quo action remains a live option for the shareholders. So, for example, a manager who seeks to accommodate an extreme blockholder ( $b > 2\theta$ ) cannot deter by offering a proposal  $x > 2\theta$  without running the risk that shareholders will reject the accommodating proposal in favor of the status quo. While this changes the various deterrence cutoffs, it does not change the qualitative features of the equilibria. Rather than work through the various cases in detail, we summarize the main results in the following proposition, and develop the details in the appendix.

**Proposition.** *In the case of a moderate manager,  $a = 0$ , and a blockholder with  $b > 0$ , unless deterrence is automatic, the manager deters with  $x = \theta + b/s - \sqrt{k/ps}$  if and only if  $1 - \sqrt{ks/pb^2} \leq \sqrt{p/(1-p)}$ . In the case of a moderate blockholder and an extreme manager,  $b/s < \theta < a$ , unless deterrence is automatic, the manager deters with  $x = \theta + b/s + \sqrt{k/s(1-2p)}$  if and only if  $1 - \sqrt{k/s(1-2p)(a-b/s)^2} \leq \sqrt{(1-2p)/(1-p)}$ .*

The general picture is that this bundle of shareholder rights may or may not advance the welfare of shareholders. When the manager is focused on maximizing profit rather than pursuit of private benefits and there is an extreme blockholder, giving shareholders the right to propose can cause the manager to accommodate the blockholder by taking an extreme action, reducing the firm’s value.

When managers are focused on private benefits, however, and there is a value-focused blockholder, the right to propose helps shareholders by inducing the manager to moderate his decisions and by offering shareholders more moderate options.

#### 5.4 Greenmail and Other Side Payments

Our analysis to this point precludes side payments between the actors. Here we discuss what happens if the manager can make a “payment” of some sort to the blockholder. The payment can take the form of cash, such as when a dissident shareholder is bought out at premium (greenmail) or when a union is granted an above-market compensation contract.

We now assume the manager can transfer cash  $t$  to the blockholder. Because the transfer payment links the two payoff functions, it is useful to add parameters indicating the intensity of manager and blockholder preferences concerning the action compared to their value of cash. The manager’s new payoff function is

$$u^t(x) = \alpha u(x) - t, \tag{10}$$

and the blockholder’s new payoff function is

$$v^t(x) = \beta v(x) + t, \tag{11}$$

where  $\alpha$  and  $\beta$  are the manager and blockholder intensity parameters, respectively.

The sequence of the game is modified so that the manager and blockholder can agree to a transfer payment and an action choice  $N = \{t, x\}$  before either party takes any other action. If they agree, the settlement is assumed to be binding on both parties. It is not necessary for our purposes to specify how the gains from trade are divided if an agreement is reached as we are primarily interested in the conditions under which a side payment is mutually beneficial.

We will characterize behavior when there is preference uncertainty and proposals are permitted (as in Section 5.2 above). The transfer payment is not subject to shareholder approval. Consider

first a parameter configuration under which deterrence is not automatic (i.e.,  $b/s - a > \sqrt{k/\beta ps}$ ) and the manager would not choose to deter the blockholder with an accommodating proposal (i.e., (9) does not hold). If a negotiated settlement is not reached, the manager and blockholder will propose their ideal actions and the shareholders will choose between them. Therefore, the manager will accept a settlement  $N = \{t, x\}$  that satisfies

$$\alpha u(x) - t \geq (1 - p)\alpha u(\theta + a) + p\alpha u(\theta + b/s), \quad (12)$$

and the blockholder will accept a settlement that satisfies

$$\beta v(x) + t \geq (1 - p)\beta v(\theta + a) + p\beta v(\theta + b/s) - k. \quad (13)$$

Now consider specifically a settlement that includes the manager's ideal action:  $N = \{t, x = \theta + a\}$ . Equation (12) implies  $t \leq -p\alpha u(\theta + b/s)$ , and equation (13) implies  $t \geq -p\beta v(\theta + a) - k$ . Combining these two conditions implies that there is a mutually agreeable settlement if

$$\alpha u(\theta + b/s) - \beta v(\theta + a) \leq k/p. \quad (14)$$

This condition can hold for some values of  $\alpha$  and  $\beta$ , meaning that the manager may find it optimal to pay off the blockholder in situations where the manager would not find it optimal to accommodate by adjusting the action. One of the more interesting implications of (14) is that side payments are more likely to occur when  $\alpha$  is large and  $\beta$  is small. Intuitively, the manager is more likely to buy off the blockholder when the manager cares a lot about the action and when the blockholder does not care a lot about the action. A good example might be decisions concerning managerial compensation levels, which are likely to be very important to the manager but not so important to a blockholder. Such a situation is ripe for the blockholder to threaten an action that reduces managerial compensation in order to extract a side payment of some sort from the manager. Buchanan et al. (2011) find that unions are the main sponsors of proposals to limit

managerial compensation, with 43 percent of compensation-related proposals coming from unions in their sample. Our analysis suggests that managers may respond to such proposals by making side payments to the union, such as concessions on worker compensation and benefits, employment levels, and working conditions. Our analysis suggests how “mischief” proposals can be a problem as well – even if the blockholder does not particularly care about the action, the blockholder may be able to extract a payment from the manager if the manager cares about the action.

Condition (14) also implies that a side payment is increasingly likely as uncertainty decreases. As  $p$  decreases, the likelihood of the extreme proposal winning decreases, which causes an increase in the manager’s payoff from the lottery and a proportional decrease in the blockholder’s payoff from the lottery with the proposal cost unchanged; the manager’s decreased willingness to settle then outweighs the blockholder’s increased willingness to settle. Also, settlements are more likely as  $k$  increases because the blockholder is less inclined to make a proposal.

The formal analysis above identifies conditions under which the manager and blockholder would agree to a side payment together with implementation of the manager’s ideal action. There are also agreements that involve a compromise on the action as well as a side payment. The analysis above focuses on the case where the manager will not accommodate the blockholder absent a negotiated settlement. It is straightforward to show that negotiated settlements involving side payments are possible in that situation as well. In all of these cases, the central tradeoff holds: negotiated outcomes are more likely when the manager has an intense preference over the action while the blockholder does not have an intense preference over the outcome.

## 6 Policy Implications

### 6.1 Approval Rights

The right to approve is the most common type of shareholder decision right. Traditionally, shareholders have the right to approve directors nominated by management, and more recently, shareholders have gained the right to cast approval votes (usually advisory) on compensation-related matters such as expensing of employee stock options and executive compensation plans (“say on pay”). Our analysis suggests that approval rights will curtail grossly value-destroying management behavior, but have little power to bring about value-maximization if the managers are not inclined in that direction; this is because managers can exploit the fact that if their proposal is rejected, the reversion point may be quite undesirable for shareholders. We do not identify any theoretical path by which shareholders can be made worse off by having approval rights, so the overall conclusion is that approval rights are weakly beneficial. That is, our analysis suggests that approval rights are beneficial for shareholders, but should be seen as offering only a limited solution to managerial agency problems.

Our analysis also suggests that precatory approval votes are unlikely to reveal much information about shareholder preferences. Votes cast only reveal shareholder preferences for the proposal compared to the fallback option that occurs if the proposal is rejected; shareholders may vote by a large majority in favor of a proposal they dislike if the fallback option is even worse. More generally, our analysis points out that in order to make inferences about preferences from an approval vote, it is necessary to understand what the fallback option is, which is often unclear in practice, especially for advisory votes. In the case of “say on pay,” the alternative compensation arrangement is unstated and not obvious, so if shareholders approve a compensation proposal it is unclear if they like the plan or simply prefer it to an hypothesized alternative they find even more distasteful.

Put differently, shareholder votes are only informative if we know the status quo point that each shareholder believes will prevail if the proposal is rejected, and such beliefs are difficult to observe. Because of the challenges of interpreting voting results, it is unclear theoretically what lessons managers should draw and how they should respond to particular election results.<sup>13</sup>

## 6.2 Proposal Rights and Proxy Access

In the United States, a fair amount of reform activity has focused on strengthening proposal rights by making it easier for shareholders to access the proxy statement, either to nominate directors or make proposals. Delaware Code and the Model Business Corporation Act grant shareholders the right to propose and approve bylaw changes, but give the board alone the right to propose charter amendments, and only the board can propose a change in the state of incorporation. In the United Kingdom, in contrast, shareholders have the right to propose changes in the corporation's fundamental governance documents, called the memorandum and articles of association. Shareholders in the United States seem to have more limited proposal rights than shareholders in other countries.<sup>14</sup>

Our analysis suggests that giving shareholders proposal rights is not necessarily in the shareholders' interest. As long as shareholder preferences are clear, proposal rights increase corporate value by restricting management's ability to pursue value-dissipating courses of action. However, when shareholder preferences are unpredictable, managers may respond to the threat of a proposal from a blockholder by adjusting corporate actions to please the blockholder, and shareholders can

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<sup>13</sup>Levit and Malenko (2011) identify another reason that shareholder votes may not be informative about shareholder preferences: shareholders might ignore their own information and vote strategically, conditioning on the chance of casting a pivotal vote. Our analysis can be seen as providing a reason to doubt the information content of shareholder votes even when shareholders do not vote strategically.

<sup>14</sup>See Bebchuk (2005; Section II) and Buchanan et al. (2011) for a description and comparison of shareholder rights in the United States and United Kingdom.

be worse off than if they did not have the right to propose.

We find that proposal rights are most likely to be damaging when managers are value-focused and blockholders are not. One implication is that the right to propose should be restricted to shareholders whose interests are likely to be focused on value. This could be promoted by requiring a shareholder to hold a minimum fraction of the firm's equity in order to propose, consistent with proposals to require ownership of 1 to 3 percent of a company. For the same reason, lowering the cost of proxy access is not necessarily good for shareholders. In 2007 the SEC promulgated eProxy rules that reduce the cost to insurgents of proposing alternative directors. Our analysis suggests that is good for shareholders if insurgents are value-focused but may be harmful if they are focused on other agendas.

The case for requiring minimum holding periods is also complicated. One effect of holding period requirements is to select the type of blockholder that can make proposals. A requirement to hold shares for, say, three years before making a proposal is likely to empower individuals and groups that are inherently inclined to hold stock for long periods of time. The most obvious such group is pensions and labor unions (and indeed, these organizations have tended to favor holding period requirements). If pensions and labor unions are focused solely on value maximization, then empowering them can help shareholders. If, as seems likely, these groups care about more than profits (such as employment, wages, and benefits), then empowering them can cause managers to accommodate them in value-destroying ways. More analysis is required, but as a first cut, requiring a holding period seems likely to distort corporate policy away from value maximization.

### **6.3 Uncertainty, Ownership Disclosure, and Information Intermediaries**

One of our strongest messages is that shareholder rights are most likely to be harmful when management is uncertain about shareholder preferences. It is the unpredictability of shareholder pref-

erences that can lead managers to accommodate an extreme blockholder, even if they believe the blockholder is unlikely to attract majority support for its proposal. It follows that when shareholders have proposal rights, management should be given information on the identity of shareholders and be able to communicate with them. One implication is that regulatory changes that provide managers with better information about the identity of their shareholders may be helpful in curtailing distortion. Thus, our analysis supports proposals to end the so-called NOBO/OBO system that classifies shareholders into “objecting beneficial owners” whose identity is shielded from management and “non-objecting beneficial owners” whose identity is not shielded. Reforms that allow public companies access to contact information for all of their beneficial owners and to contact their owners will reduce uncertainty about shareholder preferences, and reduce harmful accommodation. Similarly, our analysis suggests there is value in creating a data aggregator to obtain owner contact information, allowing companies to select proxy services on a competitive basis, and generally opening up communication between companies and shareholders. The United States is something of an outlier in terms of ownership disclosure: in the United Kingdom, public companies have the right to learn the identity of investors with voting rights through a written process; in Australia public companies keep a register of names and addresses of all shareholders; and in Canada public companies are permitted to communicate directly with their beneficial owners.<sup>15</sup>

It is widely believed that shareholder votes are heavily influenced by recommendations from a handful of third-party proxy advisory firms, most notably ISS. Our analysis suggests that such firms can play an important and productive role in corporate governance. Because individual shareholders have little incentive individually to collect information, the existence of a central information provider can lead to more informed decisions, and hence less uncertainty in elections.

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<sup>15</sup>See Corporate Secretary Guide (2010) and Holch (2010) for discussion of reform proposals relating to the NOBO/OBO distinction and communication between companies and their owners.



Moreover, to the extent that shareholders heed the recommendations of advisory firms, managers may find it easier to determine the likely outcome of votes on various proposals, again reducing uncertainty. However, if the recommendation of ISS is itself unpredictable, the presence of a single large decision maker who swings a large block of votes could introduce more uncertainty into elections (correlated voting might lead to unpredictability that would be canceled out by the law of large numbers if each shareholder voted independently). Another concern is that if the advisory firms can be manipulated and misled by extreme blockholders, the probability of a winning proposal from an extreme blockholder will go up, which could lead to more accommodation.

Our model also identifies unanticipated consequences that might flow from the New York Stock Exchange's amended Rule 452 that limited discretionary voting by brokers in director elections. Prior to amendment, brokers were permitted by default to vote the shares they held on behalf of customers who did not provide specific instructions; after amendment, brokers could not vote these shares without explicit instruction to do so by their customers. It is widely believed that brokers tended to vote in support of management nominees. Removing these "automatic" votes for management nominees reduces the predictability of shareholder elections, and also likely increases the success probability of a shareholder nominee who is opposed by management. Both effects would increase  $p$  in our model, and therefore are predicted to engender more accommodation of shareholder activists by management, which in this case would take the form of director nominees that are acceptable to the blockholder.

#### **6.4 Incentive Contracts and Alternative Governance Mechanisms**

Support for shareholder rights is based on a belief that managers may pursue actions that dissipate shareholder value, and in those situations, shareholders need to have the ability to counteract managers. Another tool for solving managerial agency problems, favored by many reformers, is

compensation contracts that tie managers' pay to firm value. A practical issue is how these two approaches to controlling agency problems interact.

Our analysis suggests that incentive contracts and shareholder rights are to some extent substitutes. The parameter  $a$  can be thought of as an (inverse) index of the strength of incentive contracts, with  $a = 0$  representing a contract that fully aligns manager and shareholder interests. We show that proposal rights generally increase value in situations where managers do not try to maximize value, but can be harmful in situations where managers are focused on profits. Incentive contracts and proposal rights can cause problems together, and might be viewed as "either-or" solutions.

Our analysis suggests (although we do not formally show) that managerial attitudes toward risk play a role in determining the consequences of proposal rights. As managers become more risk averse, they are more inclined to accommodate extreme groups to avoid the risk of an extreme proposal being approved. This suggests that proposal rights can be harmful in the presence of compensation contracts that force managers to bear significant risk. Similarly, some managers may be risk averse for noncontractual reasons, for example, if their human capital is largely tied to the firm's survival, and shareholder rights may be counterproductive in those situations.

Finally, our analysis indicates that shareholder proposal rights can be helpful or harmful depending on the context. When managers are inclined to pursue value maximization, activists are extreme, and there is significant uncertainty about how shareholders will vote, proposal rights can be harmful. When managers are inclined to pursue private benefits at the expense of corporate value and activists are focused on profits, proposal rights can be helpful. The conditional effectiveness of proposal rights suggests that shareholder empowerment should not be approached with a one-size-fits-all mentality: mechanisms that increase value in one firm may destroy value in another.

## 7 Conclusion

After a decade of policy innovation, shareholders have acquired many more rights to participate in corporate decisions, and activists are pressing for even more shareholder empowerment. Yet the regulation of shareholder rights is now well in advance of the science. The empirical literature in economics and finance is to a large degree descriptive and has produced few conclusive findings, and the underlying theoretical literature is small. Our purpose in this paper is to develop a theory that can help understand how various shareholder rights will affect corporate decision making. One novelty of our analysis compared to the existing theoretical literature is its emphasis on the difference between the right to approve and the right to propose. We show that approval rights are likely to be of limited effectiveness, and that proposal rights can make shareholders worse off. Thus, our analysis produces the somewhat paradoxical conclusion that even if shareholders generally seek to maximize value, and they are generally rational, giving them increased authority to determine corporate decisions can make value-destroying decisions more likely.

As an attempt to provide an initial framework for studying approval and proposal rights, our analysis is necessarily incomplete. Among the possibilities we have omitted is the possibility of multiple blockholders. Intuitively, the analysis would be fairly similar in the presence of multiple blockholders that shared similar preferences, but the case of competing blockholders (with ideal actions on opposite sides of the manager's ideal action) is less obvious. We also do not consider coalitions of blockholders. Shareholders may agree to act in concert, creating blocks that allow more proposals and possibly can swing elections, leading to some new strategic issues. Perhaps most important, we do not explore or endogenize the information gathering and transmission process. Our analysis suggests that the impact of shareholder rights depends to a large extent on the information voters have and on what managers know about voter preferences. Information acquisition suffers from well known free-rider problems, which has led to the emergence of central information proces-

sors such as ISS that have become important actors in the corporate governance arena. A more complete theory of shareholder rights will require a deeper understanding of how information is acquired and disseminated in the face of severe free-rider problems.

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## A Appendix

### Proof of Proposition

Part (i). Suppose  $a = 0$  and  $b > 0$ . The manager can deter the blockholder from making a proposal by choosing  $\hat{x} < 2\theta$  that satisfies

$$pv(0) + (1 - p)v(\hat{x}) = pv(0) + (1 - 2p)v(\hat{x}) + pv(\theta + b/s) - k. \quad (15)$$

Equation (15) differs from the case where approval is not required because the extreme anti-investment shareholder will reject any proposal with positive investment in favor of  $x = 0$ . However, because this rejection occurs independent of whether the blockholder is deterred or not, the deterring investment level remains  $\hat{x} = \theta + b/s - \sqrt{k/ps}$  with one caveat: if  $2\theta < \hat{x}$ , then the manager cannot deter because moderate shareholders will not approve a proposal to invest between  $2\theta$  and  $\theta + b/s$ .

If the manager does not deter, the manager and blockholder propose their ideal investment levels,  $x = \theta$  and  $x = \theta + b/s$ , respectively. Regardless of whether the manager deters, the status quo prevails with probability  $p$ . Then the manager chooses to deter if

$$pu(0) + (1 - p)u(\hat{x}) \geq pu(0) + (1 - 2p)u(\theta) + pu(\theta + b/s). \quad (16)$$

This condition can be expressed as

$$1 - \sqrt{ks/pb^2} \leq \sqrt{p/(1 - p)}. \quad (17)$$

Equation (17) can be satisfied for some parameter configurations so deterrence can be an optimal strategy. Here again we see that a value-oriented manager may nevertheless find it optimal to propose an inefficient investment level (or nominate a director who favors an inefficient policy) in order to avoid the risk of an even more extreme proposal from the blockholder. The right to propose then reduces shareholder wealth in expectation.



Part (ii). Now consider the case of an extreme manager and moderate blockholder,  $b/s < \theta < a$ . Moderate shareholders will approve a proposal by the blockholder. If the manager proposes  $x > 2\theta$ , then the blockholder is deterred if

$$pv(\theta + a) + (1 - p)v(0) \geq pv(0) + (1 - 2p)v(\theta + b/s) + pv(\theta + a) - k, \quad (18)$$

which reduces to  $\theta + b/s \leq \sqrt{k/s(1 - 2p)}$ . Therefore, if condition (18) holds, the manager automatically deters with  $x = \theta + a$ .

[Since  $2\theta$  would also deter the blockholder, the manager chooses to deter with  $\theta + a$  if

$$(1 - p)u(0) + pu(\theta + a) \geq pu(0) + (1 - p)u(2\theta) \quad (19)$$

which reduces to  $(1 - 2p)/(1 - p) \leq (\theta - a)^2/(\theta + a)^2$ .]

If the manager proposes  $x \in (b/s, 2\theta]$ , then moderate shareholders support the blockholder's proposal if it exists, and otherwise the manager's proposal. The blockholder is deterred if

$$(1 - p)v(\hat{x}) + pv(0) \geq pv(0) + (1 - 2p)v(\theta + b/s) + pv(\hat{x}) - k. \quad (20)$$

The deterring investment level is  $\hat{x} = \theta + b/s + \sqrt{k/s(1 - 2p)}$ . The manager is willing to deter if

$$pu(0) + (1 - p)u(\hat{x}) \geq pu(0) + (1 - 2p)u(\theta + b/s) + pu(\theta + a). \quad (21)$$

It is straightforward, if tedious, to show that condition (21) can be satisfied for some parameter values, and alternatively can be expressed as

$$1 - \sqrt{\frac{k}{s(1 - 2p)(a - b/s)^2}} \leq \sqrt{\frac{1 - 2p}{1 - p}}. \quad (22)$$