

Managerial Accommodation, Proxy Access, and the Cost of Shareholder Empowerment*

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Abstract

This paper develops a theory of corporate decision making to study the benefits and costs of shareholder empowerment. We show how permitting shareholders to propose directors or policies can cause value-maximizing managers to take value-reducing actions to accommodate activist investors with non-value-maximizing goals. The model identifies an important distinction between the right to approve and the right to propose. The right to approve is weak though always beneficial; the right to propose is impactful but can help as well as hurt shareholders. We identify implications for current policy discussions 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 decisions and legislation in Delaware, new rules from the New York Stock Exchange and the Securities and Exchange Commission, and most recently the Dodd-Frank Act.¹ 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 empirically. Three studies estimating abnormal returns surrounding regulatory changes that increased shareholder power find mixed, often negative (Akyol et al., 2012;

¹The 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 could no longer vote shares held in customers' brokerage accounts (which were usually cast in support of management) unless explicitly 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. 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 (struck down by the U.S. District Court of Appeals for D.C. in July 2011) and Rule 14a-8 to allow shareholder amendments to bylaws concerning proxy access (stayed pending resolution of challenge to Rule 14a-11).

Larcker et al., 2011) but sometimes positive (Becker et al., forthcoming), and generally insignificant evidence that investors value stronger shareholder rights. 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 regularly 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.”² 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 alternative forms of shareholder empowerment on corporate decision making. Because the existing literature has focused extensively on the benefits of shareholder empowerment, an important contribution of our paper is to highlight the *costs* of empowerment. Our analysis stresses the importance of distinguishing 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. The existing theoretical literature tends to abstract away from the distinction by assuming that the power to

²Casey, 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 U.S. Court of Appeals for D.C. said the agency did not adequately analyze the costs or back up its claim that enhanced access would improve shareholder value (Holzer, 2011).

propose and the power to approve are bundled together in a single “right to decide” (Aghion and Tirole, 1997; Harris and Raviv, 2010), but we show that approval and proposal 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 shareholders have no decision rights, the manager’s proposal goes into effect. If approval is required, shareholders vote whether to accept the manager’s proposal; if they reject it then the status quo action prevails. If proposals are allowed, an activist shareholder (possibly with private benefits from the project) may propose at a cost an alternative action, subject to approval of shareholders as a group.

We show that the right to approve is a 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 as 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.

The right to propose, on the other hand, 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 the manager tries to preempt a shareholder proposal by adjusting his or her initial decision; 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, a manager

suffering from an agency problem may compromise by choosing an action that is closer to profit maximization than would otherwise have been chosen, in which case the right to propose helps shareholders. But facing an active shareholder who seeks an inefficient action, the manager may compromise by choosing an inefficient action in order to forestall the risk of an even more extreme action being proposed and approved; in this case shareholders are worse off from having the right to propose. We show that the right to propose tends to be helpful when managerial agency problems are severe, but 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. (2012) find that 116 of 133 withdrawn shareholder proposals were withdrawn following negotiation between the firm and proposers. Fisher-Vanden and Thorburn (2011) find that firms experiencing a greater number of climate-related shareholder resolutions are more likely to accommodate activist preferences by participating in a voluntary environmental program, and that these firms experience a 1% drop in stock price on initial announcement and further losses later.

Proxy access, one of the more prominent policy issues recently, can be seen as lowering the cost of proposing, and thus making the right to propose more accessible. Our model identifies conditions under which proposal power is likely to cause managers to inefficiently accommodate activist shareholders. One condition is uncertainty about how shareholders will vote: 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, 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. The right to propose also can be harmful when the firm has an activist blockholder whose preferences are not aligned with profit maximization: managers have an incentive to accommodate these blockholders with inefficient actions or side payments. For example, if union pension funds seek to advance the interests of union employees rather than their fellow shareholders as some evidence suggests (Woidtke, 2002; Del Guercio and Woidtke, 2012), then proposal rights may be harmful in firms with large union blockholders.

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 role 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 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, 2010). Our paper is part of a strand of that literature emphasizing that decision rights are not absolute, but often fragmented and procedurally circumscribed (Marino and Matsusaka, 2005; Alonso and Matouschek, 2007, 2008). Finally, our paper can 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 Model

2.1 Actors and Preferences

The model has three actors, a manager, a blockholder, and a set of identical small shareholders. The actors together influence the choice of an action x that generates a profit or a loss for the firm as well as private benefits for the actors. If the firm does not make a decision, then $x = 0$, called the status quo point. The action can be thought of as investing an amount x in a new line of business, divesting a fraction x of assets from businesses in Sudan, selling the firm to another firm at a price x , and so on.³ An action 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 θ .⁴ The firm's value is maximized with $x = \theta$.

The manager receives a noncontractible private benefit from the action parameterized by $a \geq 0$ 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 both firm profit and private benefits could be seen as representing an incentive contract that does not bring about full alignment of interests, 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

³Our 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.

⁴Other 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 θx and cost is $.5x^2$; then profit would be $x(\theta - .5x)$.

to embed some sort of agency problem in the model because countering such problems is a central rationale for shareholder empowerment. If $a = 0$ then the manager cares only about profit and there is no agency problem. 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 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 $b \geq 0$ so that the blockholder’s payoff is

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

where $Z \equiv b(2\theta + b/s)$. The blockholder might receive a nonpecuniary benefit if the blockholder values the firm engaging in “socially desirable” activities; or the blockholder might receive a pecuniary benefit if the firm builds a plant in an area where the blockholder owns hotels and restaurants. One can think of situations in which b is positive or negative, but we focus our analysis on the case of a positive b in order to prevent the analysis from becoming too long. When $b = 0$ the blockholder seeks only to maximize profit. The blockholder’s “ideal” action is $\theta + b/s$.

2.2 Shareholder Rights and Sequence of Actions

Shareholder rights can take several forms. In the extreme case of no shareholder rights, the manager chooses x unilaterally. In the intermediate case of approval rights, shareholders vote whether to approve the manager’s proposal x or reject it in favor of the status quo. In the case of proposal rights, an individual shareholder is permitted to make a proposal to provide shareholders with an alternative choice of x .

If shareholders have the right to propose, the blockholder can make a proposal at a cost $k > 0$. The cost represents expenses associated with retaining lawyers, filing fees, and information acquisition, among other things. In practice, these costs are nontrivial, estimated by Buchanan et al. (2012) 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 as the manager proposing action x directly or the manager proposing a director who favors action x .⁵ 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 whether to accept the manager's proposal. If a competing proposal is on the table, shareholder vote whether to accept the manager's or the blockholder's proposal. We rule out side payments between the parties for most of the analysis, turning to that issue only after working through the basic model.⁶

2.3 Shareholder Voting

An important feature of corporate elections is a degree of unpredictability from the perspective of management about how shareholders will vote. There are several reasons why shareholder elections are not fully predictable, and our main conclusions emerge under alternative microfoundations. For concreteness, we conduct most of the analysis using one specific rationale, and discuss in an

⁵Given our aims in this paper, we do not include model elements that distinguish director elections from votes on bylaw changes. 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.

⁶Without 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.

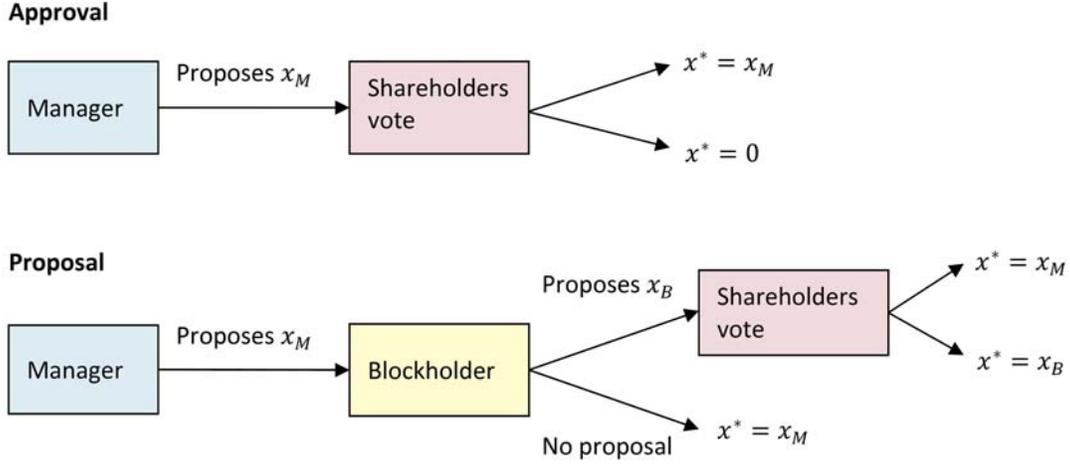


Figure 1: Sequence of Actions

extension how the model would behave under alternative approaches. In particular, we suppose that shareholders are uninformed individually and rely on proxy advisory firms to decide how to vote. Formally, when faced with two proposals, one from the blockholder (x_B) and one from the manager (x_M), shareholders are unable on their own to determine which proposal would lead to higher profit. They receive a recommendation $r \in \{x_B, x_M\}$ from an advisory service about which proposal is likely to be most profitable, such that

$$\Pr(r = x_B | \pi(x_B) > \pi(x_M)) = \Pr(r = x_M | \pi(x_M) \geq \pi(x_B)) = p > .5 \quad (3)$$

This specification reflects the possibility of error by the advisory firm. The parameter p represents the predictability or certainty of a shareholder election. The assumption that managers have better information than shareholders about corporate actions is common in the literature and has some empirical support (Duchin et al., 2010).

3 Preliminaries: Strategic Behavior with Fully Predictable Voting

We begin the analysis by considering the special situation in which there is no uncertainty about how shareholders will vote. This case illuminates some of the core strategic tradeoffs before we turn to the full model, and it may also have practical relevance for situations in which management can accurately forecast voting behavior.

The benchmark case is when shareholders have no decision rights and the decision is fully delegated to the manager. In this case, the manager chooses $x^* = \theta + a$.⁷ When the manager has the same payoff as shareholders, the manager chooses the profit-maximizing action: $x^* = \theta$.

3.1 Right to Approve

This represents the case 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 that shareholders can accept or reject. If shareholders reject the proposal, then the status quo decision ($x = 0$) prevails. Because shareholders can achieve a payoff of $u(0)$ by rejecting the proposal, they will turn down a proposal that yields a payoff below $u(0)$. Therefore, the maximum proposal that shareholders would approve satisfies $\pi(0) = \pi(x)$, or $x = 2\theta$. The manager then proposes as large an action as possible subject to not exceeding 2θ , that is, $x^* = \min\{\theta + a, 2\theta\}$. Figure 2 illustrates one case.

While shareholders are always (weakly) better off with the right to approve, observe that the right to approve is of limited benefit to shareholders. The right to approve has no effect on the action chosen when the managerial agency problem is “moderate” ($a < \theta$); and even when the

⁷Our model does not include fiduciary duty as a constraint on the manager. Fiduciary duty could be modeled as a boundary around θ 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.

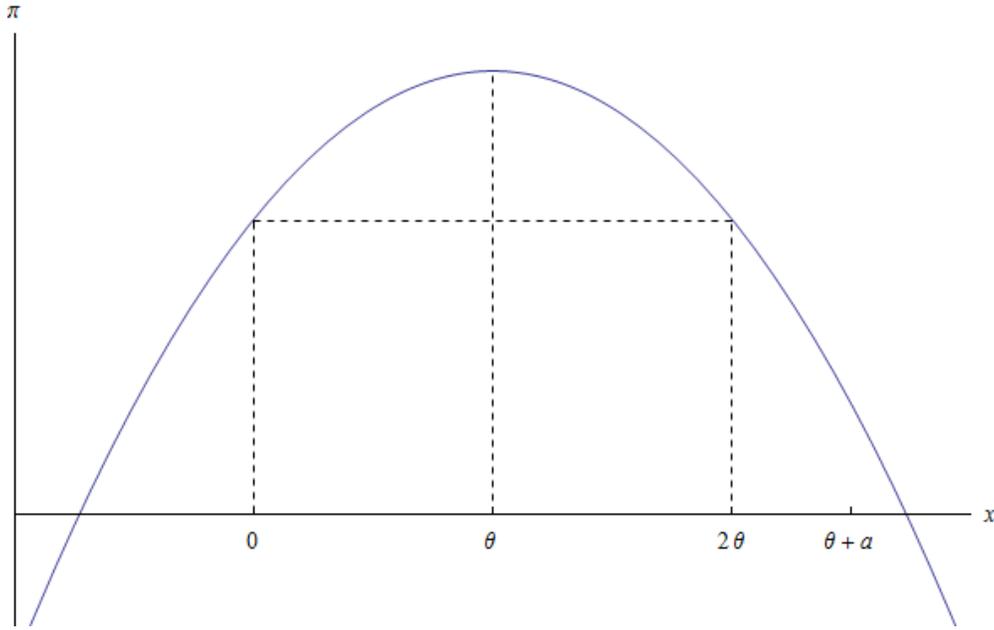


Figure 2: Right to Approve

managerial agency problem is “severe” ($a > \theta$), shareholders end up with the same return they would have received under the status quo.

3.2 Right to Propose

In this case, the blockholder is permitted to propose an action, and shareholders vote to approve the blockholder proposal or the manager’s proposal. This represents the case in which shareholders are permitted to nominate directors for the board under plurality voting, or propose actions such as disinvestment from Sudan or disclosure of corporate political campaign contributions.⁸ The following observation is useful for characterizing the equilibria:

⁸A subtle point here is that we assume the manager’s proposal goes into effect if the blockholder’s proposal is rejected. An alternative process would subject the manager’s proposal to an approval vote if the blockholder’s proposal is rejected. Such a case describes director elections under a majority rule. The analytics of that case, which might be called “proposal + approval” rights, are similar to the case we consider.

Observation. *In any 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 by not proposing and avoiding the cost k . If the manager’s preferences differ from the blockholder’s preferences, there always exists an alternative action x_M sufficiently close to x_B that the blockholder would prefer to accept and avoid the proposal cost (i.e., such that $v(x_B) - k < v(x_M)$) and that the manager prefers (i.e., such that $u(x_M) > u(x_B)$). Thus, x_B cannot be part of an equilibrium. The observation implies that the equilibrium action will maximize the manager’s utility subject to deterring the blockholder from making a proposal.

The blockholder’s ideal action is $x = \theta + b/s$, so the manager can deter a blockholder proposal by taking action x_0 that satisfies

$$v(x_0) \geq v(\theta + b/s) - k. \tag{4}$$

At equality, equation (4) has two solutions: $x_0^- = \theta + b/s - \sqrt{k/s}$ and $x_0^+ = \theta + b/s + \sqrt{k/s}$, implying that any manager action in $[x_0^-, x_0^+]$ is sufficiently close to the blockholder’s ideal action to deter a proposal.⁹ In addition, the manager can deter a blockholder proposal by taking an action less than $\theta + b/s$. In that range, the blockholder has to propose a lower action to obtain the support of shareholders, but such a proposal would make the blockholder worse off besides burdening the blockholder with the cost of making a proposal.

Because the blockholder must not find it optimal to propose in equilibrium, the manager’s equilibrium choice maximizes the manager’s utility subject to a deterrence constraint, $x^* < x_0^+$. Therefore, the manager chooses $x^* = \min\{\theta + a, x_0^+\}$. Figure 3 illustrates the case with $x_0^+ < \theta + a$ where the right to propose constrains the manager to x_0^+ .

⁹Equilibrium requires the blockholder not to make a proposal if indifferent between proposing and not proposing.

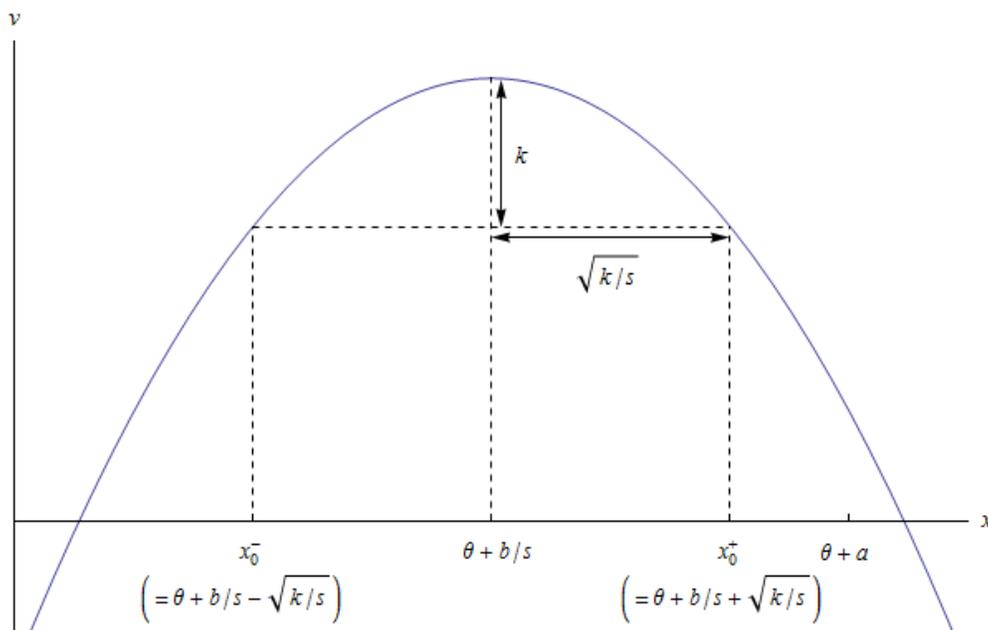


Figure 3: Right to Propose

The right to propose can be more effective than the right to approve (when $x_0^+ < 2\theta$). As with the right to approve, the right to propose always moves the action closer to profit maximization (or has no effect) than if shareholders had no decision rights. A blockholder with more extreme preferences than the manager is ignored (when $a < b/s$), while a less extreme blockholder exerts a moderating influence on the manager (when $b/s + \sqrt{k/s} < a$).¹⁰ 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; and effectiveness increases as the blockholder's ownership increases because high ownership makes the blockholder more willing to bear the cost of making a proposal to increase profit. Note that deterrence is complete – the blockholder

¹⁰As an aside, in the case where $b < 0$, the blockholder has an even more moderating influence, and for certain parameters can lead the manager to adopt the profit-maximizing action. This implies, somewhat counterintuitively, 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.

never makes a proposal in equilibrium. This counterfactual feature disappears in the full model with uncertainty about shareholder voting.

3.3 Conclusions

The preceding results are collected in the following proposition:

Proposition 1. *Suppose shareholder voting is fully predictable. If shareholders have no decision rights, then $x^* = \theta + a$. If shareholders have the right to approve then $x^* = \min\{\theta + a, 2\theta\}$, and the manager's proposal is always approved. If shareholders have the right to propose then $x^* = \min\{\theta + a, x_0^+\}$; and no shareholder proposal occurs.*

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 has no effect on corporate actions except when managerial agency problems are severe, but even then, it only gives shareholders the payoff they would receive under the status quo action. The power to propose, on the other hand, pushes 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 voting uncertainty into the model, the observation that proposal power influences behavior through a threat is robust, and implies that empirical research focusing on actual shareholder proposals is likely to miss much of the impact of proposal rights (as found by Smith (1996) in his study of CalPERS).

4 Main Results

This section analyzes the full model in which shareholder voting is to some degree unpredictable. We show that unpredictability has a striking and important effect on the consequences of shareholder rights. In particular, shareholders can be worse off when they have the right to propose.

As discussed above, we model unpredictability by assuming that shareholders receive a noisy signal r from a proxy advisory service about which option before them is likely to yield the highest profit. If shareholders know the ideal points of the manager and blockholder, they can infer from that information alone which party’s proposal is most conducive to generating profit, and voting behavior is fully predictable. To avoid this trivial situation, we assume that shareholders cannot observe the manager’s and blockholder’s preferences, and absent information from the proxy advisory firm, they assume that the two preference configurations $0 \leq a < b/s$ and $0 \leq b/s < a$ are equally likely. With this assumption, shareholder posteriors are

$$\Pr(\pi(x_B) > \pi(x_M)|r = x_B) = \Pr(\pi(x_M) \geq \pi(x_B)|r = x_M) = p. \quad (5)$$

Therefore, shareholders support the proposal that produces the highest profit with probability p . We sometimes refer to $1 - p$ as the “unpredictability” or “uncertainty” of shareholder voting. Later in the analysis, we discuss other potential sources of uncertainty about shareholder voting.

4.1 Right to Approve

With unpredictability about shareholder voting, the right to approve becomes even less effective. To illustrate this, we similarly assume that shareholders cannot observe the manager’s preferences, and absent information from the proxy advisory firm, they assume that $a < \theta$ and $a > \theta$ are equally likely. Comparing the manager’s proposal x_M with the status quo, the proxy advisory firm makes the right recommendation to shareholders with probability p .

If the manager's ideal point would create more profit than the status quo ($a < \theta$), then the manager proposes $x = a + \theta$ and shareholders approve with probability p . The manager chooses this action because no other other action has a higher probability of approval or provides a higher payoff.

If the manager's ideal point would create less profit than the status quo ($a > \theta$), then the manager weighs two options. The manager can propose his or her ideal action, which would be approved with probability $1 - p$. Alternatively, the manager could propose 2θ , which would be approved with probability p . The manager would never propose less than 2θ because such a proposal would be approved with probability p , but would generate a lower payoff for the manager than 2θ . The manager's choice then boils down to $x = \theta + a$ versus $x = 2\theta$. The condition for $x = \theta + a$ to be optimal is

$$pu(0) + (1 - p)u(\theta + a) \geq pu(2\theta) + (1 - p)u(0). \quad (6)$$

Inequality (6) reduces to $p \leq (\theta^2 + a^2 + 2a\theta)/(\theta^2 + a^2 + 6a\theta) \equiv p^*$. The inequality holds for sufficiently small p and does not hold for sufficiently large p . Equilibrium behavior is the same as in the case with fully predictable shareholder voting unless p is sufficiently small (when $.5 < p \leq p^*$), in which case the approval requirement no longer causes the manager to moderate his or her action. Observe that with unpredictable voting, some management proposals are turned down in equilibrium.

4.2 Right to Propose

This case demonstrates the cost of giving shareholders the power to propose, one of our central results. Unlike the case with no uncertainty where proposal power is always beneficial, here we show that under some 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.

It is convenient to divide the analysis into two parameter configurations.

4.2.1 Moderate Manager, Extreme Blockholder: $0 \leq a < b/s$

Consider first the case where the blockholder is more extreme than the manager. Working backward, suppose that shareholders have a choice between a proposal from the manager and a proposal from the blockholder. Note that the blockholder would never propose an action less than the manager proposes. Since the blockholder's probability of winning is a constant $1 - p$ for any proposal greater than the manager's, the blockholder's optimal proposal is $x = \theta + b/s$. The manager can deter the blockholder from such a proposal by choosing an action x_1 that satisfies

$$v(x_1) = pv(x_1) + (1 - p)v(\theta + b/s) - k. \quad (7)$$

The deterring action gives the blockholder a certain payoff equal to the expected payoff from launching a costly challenge and winning with probability $1 - p$. The solution is $x_1 = \theta + b/s - \sqrt{k/(1 - p)s}$. If $\theta + a \geq x_1$, then the manager deters automatically by proposing his ideal action.

If the manager's ideal action does not deter automatically, then the manager chooses between the deterring action x_1 and a lottery over the manager's ideal action and the blockholder's ideal action. Deterrence is optimal for the manager if

$$u(x_1) \geq pu(\theta + a) + (1 - p)u(\theta + b/s), \quad (8)$$

which reduces to

$$1 - \sqrt{\frac{k}{(1 - p)s(b/s - a)^2}} \leq \sqrt{1 - p}. \quad (9)$$

When inequality (9) is satisfied, one of our main results appears: shareholders are worse off when they have the power to make proposals. This is because the manager accommodates the blockholder by choosing a larger action than the manager would otherwise choose (increasing the action from $\theta + a$ to x_1) in order to deter a proposal. The harmful outcome does not arise through

shareholders mistakenly approving a bad proposal, but rather through the manager implementing a bad proposal in order to avoid the possibility of an even worse proposal from the blockholder. Note that this damaging consequence of the right to propose can occur even when the manager is focused entirely on value maximization ($a = 0$) so it should not be seen as a consequence of agency problems.

When inequality (9) is not satisfied, both the manager and the extreme blockholder propose their respective ideal actions, and shareholders choose between them after receiving r . Shareholders are worse off with proposal rights in this situation as well because they may approve the blockholder's profit-reducing proposal.

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.

4.2.2 Moderate Blockholder, Extreme Manager: $0 \leq b/s < a$

Now consider the case where the blockholder is more closely aligned than the manager with shareholder interests. Again working backward, suppose that shareholders have a choice between a proposal from the manager and a proposal from the blockholder. The blockholder would never propose an action greater than what the manager proposes. Since the blockholder's probability of winning is a constant p for any proposal less than the manager's proposal, the blockholder's optimal choice is $x = \theta + b/s$. The manager can deter the blockholder from such a proposal by choosing an action x_2 that satisfies

$$v(x_2) = (1 - p)v(x_2) + pv(\theta + b/s) - k, \tag{10}$$

or $x_2 = \theta + b/s + \sqrt{k/ps}$. If $\theta + a \leq x_2$, then the manager deters automatically by proposing his ideal action.

If the manager's ideal action does not deter automatically, then the manager chooses between the deterring action x_2 and a lottery over the manager's ideal action and the blockholder's ideal action. Deterrence is optimal for the manager if

$$u(x_2) \geq (1 - p)u(\theta + a) + pu(\theta + b/s), \quad (11)$$

which reduces to

$$1 - \sqrt{\frac{k}{ps(a - b/s)^2}} \leq \sqrt{p}. \quad (12)$$

Inequality (12) is satisfied for some parameter values and not others. When inequality (12) is satisfied, shareholders are better off when they have the power to propose: a manager with a severe agency problem will be pushed to moderate his or her action choice in order to accommodate the blockholder (reducing the action from $\theta + a$ to x_2) and deter a proposal. The right to propose can thus increase firm value when there is a value-focused blockholder and the manager suffers from a severe agency problem.

When inequality (12) is not satisfied, both the manager and the blockholder propose their respective ideal actions. Shareholders are better off with proposal rights in this case, even though they may mistakenly approve the manager's proposal sometimes.

4.2.3 Comparative Statics and Firm Value

The preceding analysis results in the following proposition concerning the right to propose:

Proposition 2. *Suppose shareholder voting is not fully predictable. If $0 \leq a < b/s$ then (i) if $b/s - a \leq \sqrt{k/(1-p)s}$ then $x^* = \theta + a$ and the blockholder does not propose; (ii) if $b/s - a > \sqrt{k/(1-p)s}$ and (9) is satisfied then $x^* = x_1$ and the blockholder does not propose; and (iii) if (9) is not satisfied then the manager proposes $x = \theta + a$, the blockholder proposes $x = \theta + b/s$, and the manager's proposal wins with probability p . If $0 \leq b/s < a$ then (i) if $a - b/s \leq \sqrt{k/ps}$ then*

$x^* = \theta + a$ and the blockholder does not propose; (ii) if $a - b/s > \sqrt{k/ps}$ and (12) is satisfied then $x^* = x_2$ and the blockholder does not propose; and (iii) if (12) is not satisfied then the manager proposes $x = \theta + a$, the blockholder proposes $x = \theta + b/s$, and the manager's proposal wins with probability $1 - p$.

Proposition 2 leads to several comparative static implications. When k is sufficiently small, the manager chooses not to deter and a blockholder proposal is made. As k rises, at some point the manager finds it optimal to accommodate the blockholder by choosing an action closer to the blockholder's ideal action. When k is sufficiently large, the blockholder's cost of proposing is so high that the manager's ideal action automatically deters. To the extent that proxy access reduces the cost of making a proposal, the model implies that proxy access results in greater accommodation of blockholders, which helps shareholders when the manager's preferences are out of alignment with shareholders, but can hurt shareholders when there is a blockholder that favors non-value-maximizing actions.

A change in s has effects that push in different directions.¹¹ An increase in s increases the blockholder's relative preference for profit versus private benefits, making it easier to deter a proposal by choosing an action that increases profit. Deterrence then becomes easier for a profit-oriented manager and more difficult for a manager with severe agency problems. Inefficient accommodation can be more or less likely.

To gain further perspective on what parameter configurations lead to harmful deterrence by the manager, Figure 4 plots the manager's behavior for the case $0 \leq a < b/s$ by extremity of the blockholder relative to the manager ($b/s - a$) and unpredictability of shareholder voting ($1 - p$),

¹¹Recall 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.

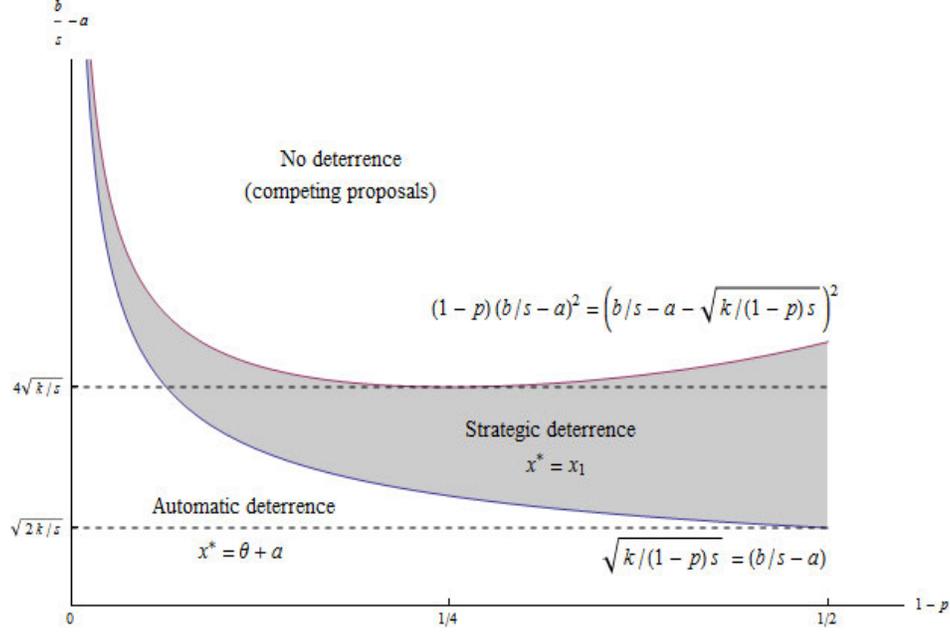


Figure 4: Deterrence Regions

holding constant k and s . The southwest region satisfies $b/s - a \leq \sqrt{k/(1-p)s}$ 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 unpredictability are nonmonotonic: for a sufficiently small $1 - p$, deterrence is automatic; as $1 - p$ increases at some point the manager finds it optimal to accommodate the blockholder (assuming the blockholder is sufficiently extreme); with a larger $1 - p$, the manager may find it optimal to allow the blockholder proposal to appear because deterrence is too costly; and then for highest values of $1 - p$, the manager again may choose to deter. The comparative statics for blockholder extremism relative to the manager 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.

The net effect of the right to propose on shareholder wealth can be positive or negative. Whether the right to propose helps or harms depends to a large degree on the configuration of the manager's and blockholder's preferences. Proposition 2 suggests that for a firm in which the manager seeks to maximize profit while the blockholder is driven by private benefits, the right to propose will be harmful. In contrast, for a firm in which the blockholder seeks to maximize profit while the manager is focused on private benefits, the right to propose will be helpful. The general picture is that the right to propose can advance or impede shareholder interests, and from a policy perspective, shareholder rights should be made available in a way that discourages use by extreme blockholders and encourages use by profit-motivated blockholders.

4.2.4 Implications for the Occurrence of Shareholder Proposals

Several empirical studies beginning with Karpoff et al. (1996) have attempted to identify factors that cause firms to receive shareholder proposals. The literature has been exploratory in nature, and not framed in terms of a model of the proposal process. Our model yields a theory of proposal occurrence: a shareholder proposal occurs in the region where neither strategic nor automatic deterrence happens. The next proposition is a corollary of Proposition 2 but stated separately for clarity.

Proposition 3. *Suppose shareholder voting is not fully predictable and shareholder proposals are permitted. If $0 \leq a < b/s$ then a shareholder proposal occurs if (9) is not satisfied. If $0 \leq b/s < a$ then a shareholder proposal occurs if (12) is not satisfied.*

Proposition 3 identifies factors that predict the appearance of shareholder proposals, but perhaps as important, it also suggests factors that are unlikely to matter. Loose intuition might suggest that a firm with a severe agency problem is more likely to attract a proposal. However, our analysis points out that while such a firm is more likely to attract the ire of shareholders, the manager of

such a firm is more likely to take an accommodating action to deter a proposal. In our model, the occurrence of a proposal is not so much a symptom of an agency problem but the result of the failure of accommodation.

Turning specifically to the cutoff conditions (9) and (12), the model predicts that a proposal is more likely to occur when the manager and blockholder preferences are well out of alignment (when $(a - b/s)^2$ is large). When preferences diverge by a large amount, accommodation is too costly for the manager, and the manager chooses to allow a proposal to occur. To reiterate the point made above, this can happen when the manager suffers a severe agency problem but also when the manager is entirely focused on profit maximization.

The effect of uncertainty is nonmonotonic, although there is a sense in which a proposal is more likely when uncertainty increases. As shown in Figure 4, for sufficiently low uncertainty, a proposal will not occur because deterrence will be complete. As uncertainty grows, a proposal becomes more likely if the divergence between manager and blockholder preferences is large enough, although for very high uncertainty, the effect can reverse.

An increase in s makes (9) more likely and (12) less likely to hold. An increase in the blockholder's stake then decreases the likelihood of a proposal when the manager is more focused on profit than the blockholder, and increases the likelihood of a proposal when the manager is less focused on profit than the blockholder.

The empirical literature has also estimated the event return to the announcement of shareholder proposals, with no pronounced pattern emerging (Karpoff, 2001). Our analysis could be consistent with positive or negative returns associated with announcement of a proposal, depending on what model parameter is being revealed by the announcement. For example, if the announcement reveals a managerial agency problem that is much bigger than previously believed, the proposal would be bad news; if the announcement revealed the existence of a value-motivated blockholder that was not

previously known, the proposal would be good news. Our analysis suggests that in order to shed light on the proposal process, future event studies will benefit from grounding in a clear theory of the proposal process and being explicit about what information is conveyed by the announcement.

4.2.5 Remark on Source of Unpredictability

Our result that shareholders can be worse off by having the right to propose relies on unpredictability in the mind of the manager about how shareholders will vote. It is the fear that voters might approve an extreme proposal that leads the manager to accommodate the blockholder to the detriment of shareholder value. At first glance it might seem that the root problem is uninformed or irrational shareholders who sometimes vote against their own interest. However, that is not the problem, as we briefly illustrate with an alternative model.

Consider an alternative formulation of the model in which shareholders always choose the proposal that provides the highest payoff to them, but in which their preferences are stochastic, and focus on the case $0 \leq a < b/s$. Suppose that with probability $1 - p$ shareholders enjoy a large private benefit from the blockholder's proposal that makes voting for that proposal optimal. For instance, suppose the blockholder is urging the firm to divest (at a loss) all assets held in businesses operating in a country that abuses human rights. The manager expects that shareholders favor holding the assets in order to protect profit, but there is some possibility in the manager's mind that the median shareholder voter may wish to divest. Formally, this model is identical to the one analyzed above: if there are competing proposals, the manager's proposal would be approved with probability p and the blockholder's proposal would be approved with probability $1 - p$.

In this alternative model, in contrast to our proxy advisor model, if the blockholder proposal is approved, that action is in the interest of shareholders. However, if the manager chooses to accommodate the blockholder, say, by partly divesting assets in the questionable country, shareholders

can be worse off in expectation if they are sufficiently unlikely to actually favor divestment. In short, at the most basic level the damaging consequence of the right to propose does not arise from uninformed or irrational shareholders but from unpredictability in the mind of the manager about how shareholders may vote.¹²

4.3 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 a 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

$$u^t(x) = \alpha u(x) - t, \tag{13}$$

and the blockholder’s new payoff function is

$$v^t(x) = \beta v(x) + t, \tag{14}$$

where α and β 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.

¹²Voting rules are another source of uncertainty in shareholder elections, as discussed by Kahan and Rock (2008).

We will characterize behavior when proposals are permitted and the blockholder is extreme ($0 \leq a < b/s$). The transfer payment is not subject to shareholder approval. Consider first a parameter configuration under which deterrence is not automatic (i.e., $b/s - a > \sqrt{k/\beta(1-p)s}$) 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 shareholders will choose between them. Therefore, the manager will accept a settlement $N = \{t, x\}$ that satisfies

$$\alpha u(x) - t \geq p\alpha u(\theta + a) + (1-p)\alpha u(\theta + b/s), \quad (15)$$

and the blockholder will accept a settlement that satisfies

$$\beta v(x) + t \geq p\beta v(\theta + a) + (1-p)\beta v(\theta + b/s) - k. \quad (16)$$

Now consider a settlement that includes the manager's ideal action: $N = \{t, x = \theta + a\}$. Equation (15) implies $t \leq -(1-p)\alpha u(\theta + b/s)$, and equation (16) implies $t \geq -(1-p)\beta v(\theta + a) - k$. Combining these two conditions implies that there is a mutually agreeable settlement if

$$\alpha u(\theta + b/s) - \beta v(\theta + a) \leq \frac{k}{1-p}. \quad (17)$$

This condition can hold for some values of α and β , 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.

An interesting implications of (17) is that side payments are more likely to occur when α is large and β is small. Intuitively, the manager is more likely to buy off the blockholder when the manager cares a lot about the action while the blockholder does not care much about the action. An 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. (2012) 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 (17) also implies that a side payment is less likely when uncertainty increases. As $1 - p$ increases, the likelihood of the extreme proposal winning increases, which causes a fall in the manager’s payoff from the lottery and a proportional increase in the blockholder’s payoff from the lottery; the manager’s increased willingness to settle then outweighs the blockholder’s decreased willingness to settle. Also, settlements are more likely as k increases because the blockholder is less inclined to make a proposal.

The preceding analysis 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 also 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 the accommodation region 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 action.

5 Policy Implications

5.1 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 the threat of particularly extreme value-destroying behavior by management, but otherwise will have little effect on managerial actions or firm value. 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 a 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.¹³

5.2 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 reserve for the board 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.¹⁴

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

¹³Levit 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.

¹⁴See Bebchuk (2005; Section II) and Buchanan et al. (2012) 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 a minimum holding period 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 groups are 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. Similar observations have been made in the law literature, for example Sharfman (2012). More analysis is required, but as a first cut, requiring a holding period seems likely to distort corporate policy away from value maximization.

5.3 All Decision Rights Are Not Equal

One message of our paper is that shareholder decision rights should not be thought of as a switch that is either on or off, but rather as a choice between alternative decision processes that have very different effects. While some of the theoretical literature has proceeded at a fairly abstract level in which either the manager or the shareholders are given the power simply to make a decision, in reality shareholder rights always take the form of a decision *process* that involves some blending of approval and proposal rights. Our analysis highlights that the form of the decision process matters quite a bit in determining what effect it will have, and in particular, that approval and proposal rights are not at all the same.

Also, in practice decision rights tend to be conditional, with different rights available for different types of decisions. To illustrate, Table 1 lists the configurations of rights in American corporations associated with various corporate decisions and separates them into approval and proposal rights.

Table 1. Typical Shareholder Rights in American Corporations	
Right to approve	Charter changes; major business decisions (e.g. sale of firm)
Right to propose	Minor business decisions (implemented through bylaw changes); director elections under plurality rule
Right to approve and propose	Bylaw changes; director elections under majority rule

Shareholder rights 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 their ability to make nominations is limited by not having access to the proxy statement. 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; meaning that 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 all votes cast, meaning that shareholders can reject a nominee without having to propose an alternative.

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 more extensive proposal rights, such as the right to propose changes to the corporate charter and major business decisions (Buchanan et al., 2012).

5.4 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 preferences 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. Regulatory changes that provide managers with better information about the identity of their shareholders may be helpful in curtailing distortion. Thus, our analysis offers some support for 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.¹⁵

It is widely believed that shareholder votes are heavily influenced by recommendations from a handful of third-party proxy advisory firms, most notably ISS (Iliev and Lowry, 2012). 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. 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

¹⁵See 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.

Exchange’s amended Rule 452 that limits discretionary voting by brokers in director elections. Prior to amendment, brokers were permitted by default to vote shares they held on behalf of customers who did not provide specific instructions; after amendment, brokers could not vote these shares without explicit instruction from their customers. Because brokers tended to vote in support of management nominees, removing these “automatic” votes for management nominees reduces the predictability of shareholder elections, and likely improves the prospects for a nominee who is opposed by management. Both effects would increase $1 - p$ 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.

5.5 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 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.

6 Conclusion

After a decade of policy innovation, shareholders have acquired 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 is its emphasis on distinct rights to approve and propose, rather than consideration of a general "right to decide" that has been examined in previous work. We show that approval rights are of limited effectiveness when managers can threaten shareholders with an unpalatable fallback choice. We show that proposal

rights are more potent than approval rights, but that the power to propose can make shareholders worse off in some circumstances. The main insight behind this result is that the power to propose creates a pressure for managers to accommodate extreme blockholders, either by compromising on the policy in question or by delivering side benefits to the activist. When managers suffer from agency problems, the pressure to accommodate a value-maximizing activist shareholder tends to increase firm value, but when the managers do not suffer from agency problems, they may respond to pressure from a non-value-maximizing activist by taking value-destroying actions.

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 presence 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 processors 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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